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Investment Commentary—October 2010

We begin with a chart[1].

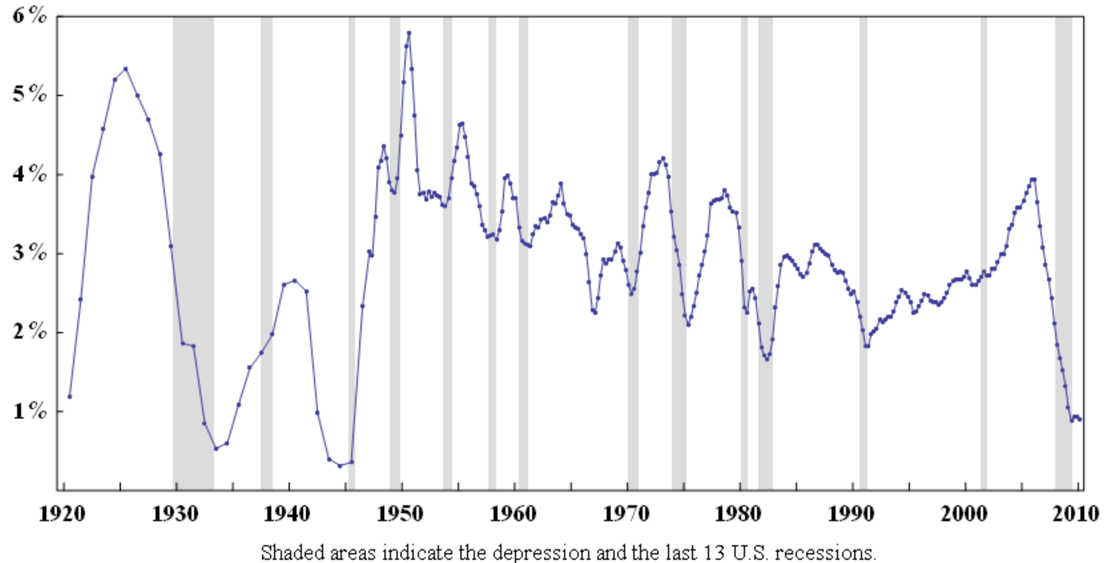

Figure 1: Expenditure on new single-family and multi-family housing units as a percentage of GDP.

Economists Steven Gjerstad and Vernon L. Smith studied the impact of housing construction on recessions and recoveries in the U.S. Figure 1, which tracks housing construction expenditures (sometimes we abbreviate as simply housing expenditures) over ninety years as a percentage of GDP, explains a great deal of U.S. economic history. It also illustrates the fundamental cause of the Great Recession and why it is proving so difficult to climb out of. In a nutshell:

- The level of housing construction expenditures swings dramatically, frequently moving by two percentage points of GDP or more over the course of one or two years.
- Most post-war recessions (note: recessions are shaded in Figure 1) were preceded by a sharp decline in housing expenditures. By the authors' count, housing is implicated in eleven out of fourteen post-war recessions. Also, most recoveries involve a sharp rebound in housing.
- Housing expenditures from around 1995 to 2006 were completely out of whack with the historical pattern. This led not only to the global financial crisis of 2008 (the details having been discussed at length in previous commentaries) but to a persistent housing glut (single-family and multi-family combined), which is suppressing the demand fro new housing units.
- Most importantly, the authors argue compellingly that a robust recovery typically requires a sharp rebound in housing expenditures. It's a bit of an

[1] From Gjerstad, Steven and Vernon L. Smith (2010), "Household Expenditure Cycles and Economic Cycles, 1920-2010," working paper available on Chapman University's Economic Science Institute website, http://www.chapman.edu/ESI/workingpapers.asp.

oversimplification (but not much) to say that until population growth gradually works off the housing glut, we're stuck with a slow recovery[2].

If you focus hard enough on the current excess supply of housing and the critical role that home-building plays in an economic recovery, all the discussion on Wall Street and in Washington about "QE2" seems like so much noise. QE refers to "quantitative easing"—when the Fed pushes interest rates lower through massive bond purchases. Quantitative easing was a key tool the Fed used to fight the financial crisis in late 2008 into 2009. Ben Bernanke has hinted strongly of late that a second round (QE2) is on the way. Speculation over QE2 was largely responsible for the impressive September rally in the stock market. (Speculation over QE2 has also been responsible for driving the dollar down, to the consternation of finance ministers around the world whose exports are disadvantaged by a comparatively strong currency; talk abounds of competitive devaluations, a.k.a. a currency war.) While it rarely pays to bet against the Fed, we do wonder how much impact QE2 will have. Where precisely are those hoards of creditworthy businesses or individuals with grand plans just waiting for rates to get low enough? Still, given the choice of an overly vigilant Fed and an insufficiently vigilant Fed, we'd choose the former.

Speaking of regulators, we'd be remiss if we didn't follow up on last quarter's discussion of the European banking stress tests. We expressed hope three months ago that the stress test would put to bed any questions about the strength of Europe's banking system. In the event those hopes were dashed. The joy of the headline—Only Seven Banks Fail the Test!—faded quickly as details emerged. Without getting into specifics, suffice it to say that each country's banking regulator applied its own set of assumptions to its own banks. The assumptions varied wildly and some verged on Pollyannish. Europe had the opportunity to take a second banking crisis off the table and blew it. Meantime, the countries whose sovereign debt problems forced the Europeans to engage in a banking stress test—particularly Greece, Ireland and Spain—are struggling under austerity. The probability that one of these countries defaults in the next several years continues to grow. Stay tuned.

Returning to the U.S. housing glut, if the economy is stuck in neutral until excess housing supply is worked down, how long will that take? It's impossible to know with any precision, but we can take a stab at an order of magnitude. Let's start with vacancy data; an oversupply of housing units manifests itself in vacancies. Census Bureau data covering both single-family and multi-family housing indicates that as of June 30, 2010 the number of vacant housing units in the U.S. was approximately 2.5 million higher than it would be at normal vacancy rates. How fast can that 2.5 million be reduced? New units are being built at an annual rate of around 600 thousand. Household formation was running at about 1.2 million new households per year before the housing bust. It has been much lower in recent years due to slower immigration and

[2] It's important to distinguish the issue of the housing glut (more single-family houses/apartments/condos/co-ops in existence than families or individuals that need them) form the foreclosure crisis. Even if all foreclosures were magically resolved tomorrow by turning owners into renters, we'd still have too many housing units.

"doubling up," but should gradually get back to 1.2 million or perhaps even higher[3]. When you put all the numbers together, including an estimate of the number of units that succumb to a wrecking ball each year, something like 800 thousand units a year can probably be absorbed. At that rate, it will take something on the order of three years to work off the housing glut. That assumes home-building remains suppressed at around 600,000 for those three years. More likely, sometime sooner—perhaps in about two years—enough of the glut will be worked off to trigger an increase in home-building. In that case, it might take beyond 2013 to work off the remaining glut, but at least the missing engine in the recovery (home-building) would be back in place. In the meantime, the U.S. economy will probably be stuck in neutral—QE2 or no QE2.

If the economy is stuck in neutral for one, two, maybe three years, what impact will that have on the stock market? Short answer: perhaps less than you think. To wee why, consider the source of stock returns. At the most basic level returns on stocks come from either price appreciation or dividends. Price appreciation itself can be broken into two pieces: growth (or decline) in earnings and growth (or decline) in the price/earnings ratio. Of these two factors, only one—earnings—can grow indefinitely; p/e ratios go up and down but over the long term, growth in the p/e ratio is zero. So, in the long term returns on stocks come from profit growth and dividends. Back in the day stock market returns after inflation averaged 6½%, of which about 5% came from dividends and about 1½% came from after-inflation earnings growth. These relationships got messed up in the 1980s when mergers and acquisitions and share repurchases became much more common. The effect was to move some of stock returns out of dividend yield (cash funneled into M&A and repurchases is not available for dividends) and into per share profit growth. But underneath, the same relationships have held; about 1½% of market returns come from *organic* profit growth—the rest comes from dividends, plus the share of profit growth driven by financial engineering (M&A and repurchases) if you will. To repeat, of the long term market average return of about 6½%, only 1½% can be attributed to organic profit growth. So, as you think about a stalled economy over a protracted period of time, recognize that we are talking about the source of less than 25% of market returns—probably far less, since stalled means something like 1.5% to 2.0% growth in the U.S. and a very big chunk of corporate profits aren't even generated in the U.S. None of which is to say that the market may not plunge at some point in reaction to economic malaise. But the logical connection between slow growth and poor stock returns is not as tight as you may think. Especially for the well-established companies with relatively steady earnings, strong balance sheets and robust cashflows that continue to dominate our client portfolios.

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Boston, MA

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[3] The Joint Center for Housing Studies of Harvard University recently estimated that household formation between 2010 and 2020 will average between 1.25 million and 1.7 million.