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Housing Leads Us into a Recession, and Housing Leads us Out

During the most recent quarter, central banks around the world took several very momentous actions. The most important moves were effectively the adoption of open ended easing from the European and US central banks. But all told, according to ISI Group, there have been 270 easing actions over the past 18 months. This is almost as much monetary stimulus as in 2009. Needless to say, monetary policy makers are definitely nervous with weakening global growth (especially in Europe and China) and are trying to ensure that the liquidity event of 2008 doesn't repeat. These monetary policies have given tremendous support to risk markets, and stocks have rebounded quite nicely from the mid-year lows. It's now up to our fiscal policy makers - in US, Europe, and China to keep the momentum going. It's probably going to be a bumpy ride since most major policy decisions take place during crisis. Tough decisions will have to be made by all, but we are hopeful that we are moving forward rather than standing still or even moving backwards.

We believe the most important aspect of the recent monetary actions is that it reduces the tail risk of a liquidity event coming from Europe. Therefore, in this letter we can spend more time discussing one of our focus themes, US housing. We believe that housing in the United States is at the beginning phase of a multi-year recovery. We find this turnaround amazing given that only a year ago people were talking about the potential for several homebuilders to go bankrupt.

The setup for housing going into 2012 sounded like economics 101. Housing starts had been significantly below long-term averages since 2008 (Chart 1), the inventory of new homes had dropped below the critical 5-months of supply (Chart 2), and home affordability had been rising substantially (Chart 3). The only piece of the puzzle left was consumer confidence, a question of psychology. When will the consumer begin to feel comfortable buying a home? It seems as though 2012 may mark the start of a positive change in psychology.

While new home inventory remained very low, our biggest concern regarding the turn in the housing market was the large amount of shadow inventory on the market. In other words, the inventory of homes in the secondary market either from the foreclosure process or from those who were waiting to sell once the market firmed. During 2012 shadow inventory, while still four times average, has been declining for three years and is now 30% below peak.

In the end, while one can debate the inventory levels, the most important measure of the health of the housing market is price. We were recently at a conference hosted by Zelman & Associates. Ivy Zelman has been credited with calling the top of the housing market in 2006, and she called the bottom of the market in January 2012. Ms. Zelman expects home prices to be up 7% this year, in the strongest pace since 2005. As the public becomes aware of recent price gains, this could well be the tipping point of psychology that we have been waiting for. Moreover, the price increase is broad-based covering 90% of households. Even with the near-term price gains, home prices are still near 10-year lows. In addition, with 30-year fixed mortgage rates at a recent record low of 3.36%, the monthly principal and interest on a 30-year fixed rate mortgage is currently around 14% of income compared with an average of 22% over the past 30 years.

Chart 1: Housing Starts Have Been Significantly Below Average Since 2008

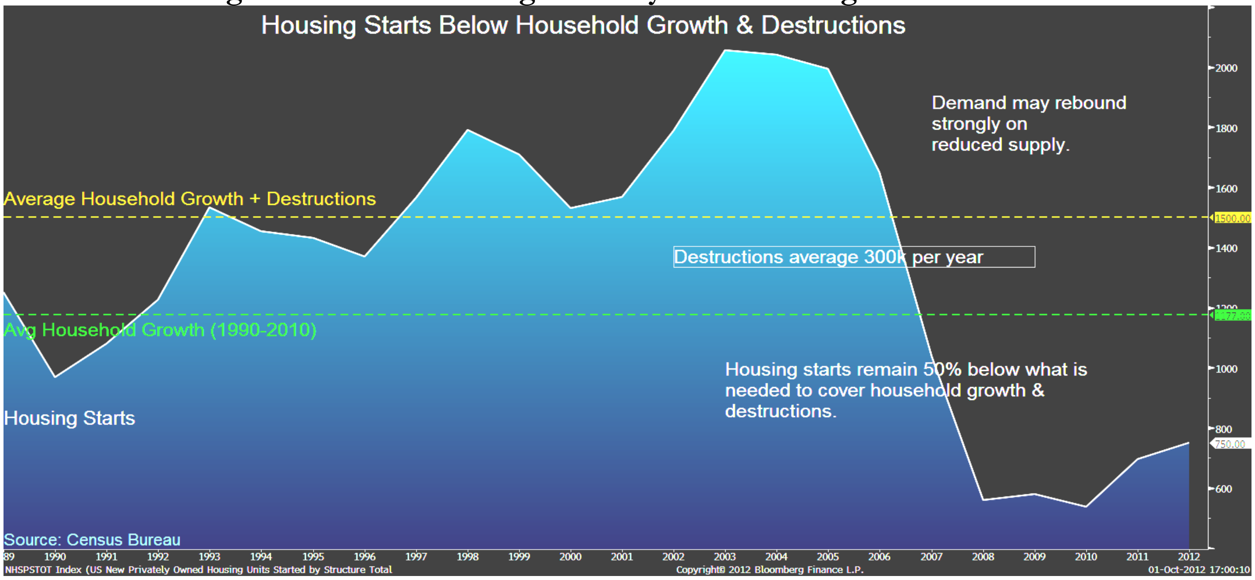


Chart 2: New Home Inventory Has Fallen Below 5 Months Supply

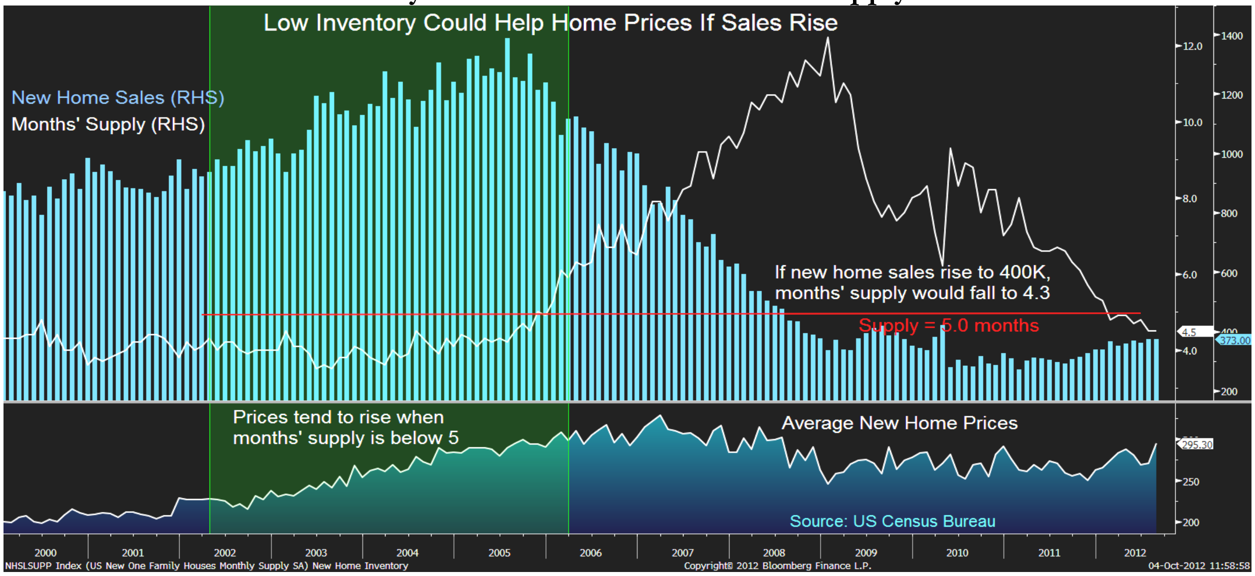
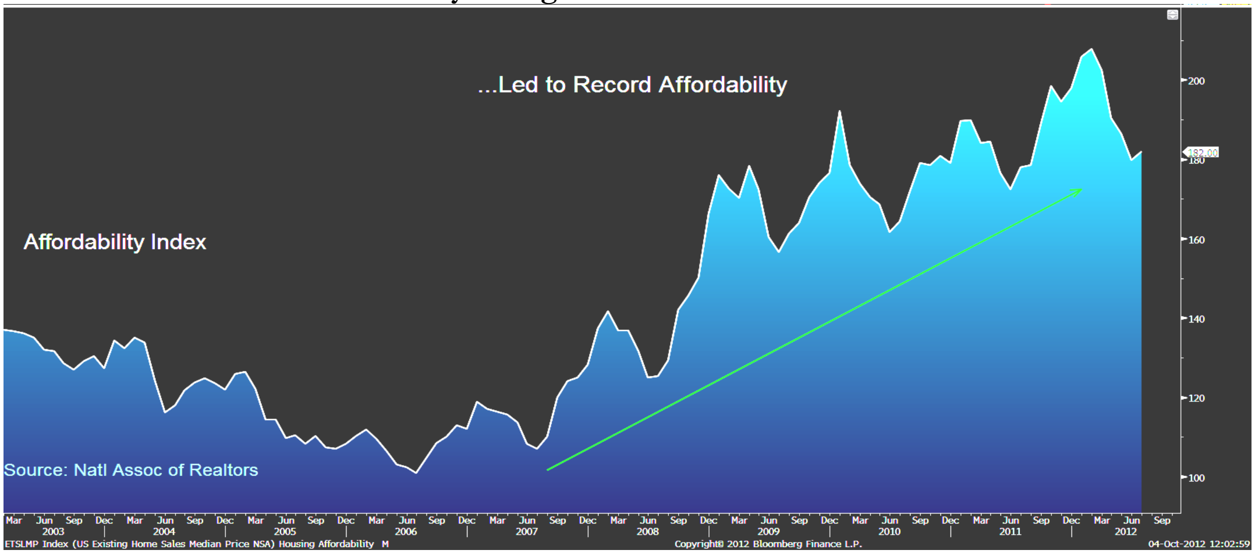


Chart3: Homeowner Affordability is High



Once a housing cycle begins, either up or down, historically it has lasted for 3-5 years. Thus, if history is any guide, and if this turn is real, as we believe it is, we have several more years of upside to go.

In our opinion, any improvement in housing will have a nice benefit to GDP as a whole. There is an old maxim that says housing leads us into a recession and housing leads us out. Going forward, a return to normal housing start levels could add 50-100bps to GDP. Analysis by Wolfe Trahan suggests a chain reaction as follows: 6 months after homebuilder sentiment begins to rise, GDP growth begins to show signs of strength, 6 months later consumers begin to feel more comfortable and spending picks up, and 3 months after that employment begins to strengthen. This would be a welcome offset to the necessary tightening that still must be done in order for the US to get its fiscal house in order.

Our equity positions are now effectively at benchmark. Our focus continues to be on a balance of GARP and Defensive companies and a preference for US growth over global growth. We still have a constructive view on equities for the long-term, but recognize there are near-term risks, especially as Europe is in recession, China looks like it might have a hard landing, and the US is getting closer to an unresolved fiscal cliff.

Bonds continue to provide safety with little (or negative) real return. To compensate, our focus continues to focus on corporate bonds over government bonds, keeping the ladder of maturity relatively short (under 5 years), and buying higher yielding stocks. It is a wonderful time to buy a house, as the Fed continues to focus on keeping mortgage rates low to support a housing recovery.

While we have spoken generically about asset allocation in this report, we believe that it is a very individual decision. We do our best work for you when we are up-to-date on changes that may be occurring in your lives. If your situation changes at any time, please reach out to us and let us know.

We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,

John A. Zaro III, CFA	Laura K. Drynan, CFA
Managing Partner	Partner

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