

## Can Wall Street withstand weak housing?

NEW YORK -- Sept. 21, 2006 -- If your nest egg is made of 2-by-4s and you're watching the real estate slowdown with a mixture of fear and nausea, then this article is for you.

The question: If real estate tanks, will stocks follow? Or will the market ignore housing? Or maybe -- just maybe -- will a decline in housing trigger a rise in stocks? It's something you really ought to think about if you're trying to figure out where to put your money.

Conventional wisdom, and some historical evidence, suggests that a decline in housing is associated with a fall in stocks. Evidence of a slump continues to mount: On Sept. 18, the National Association of Home Builders said its monthly sentiment index fell to a 15-year low. That's bad for homeowners, because it means that there's no port in the storm. But the case isn't completely closed: There's some tantalizing counter-evidence that stocks might do just fine in a housing downturn, or even benefit from it.

### **Time lag**

Let's start with the main, bearish case. Making the rounds of investment advisers is a chart prepared by Merrill Lynch (MER) showing the Standard & Poor's 500 stock index overlaid on an index of homebuilding activity from the National Association of Home Builders. The chart shows that the S&P 500 goes up one year after the homebuilding index goes up, and goes down one year after the homebuilding index goes down. [The correlation is 0.8, which means it's pretty strong.]

The scary part: The homebuilding index has plunged over the past year. If you believe that history repeats itself, the S&P 500 is about ready for a nosedive.

Another chart -- this one from InvesTech Research -- correlates changes in private residential construction with recessions. Going back to 1968, it shows that with just one exception, every time there has been a downturn in residential construction, a recession has occurred at the same time or shortly after. [The exception: 1995.] That indicator, too, is flashing red, because residential construction has shrunk over the past year. "Being a student of history, I would think I would want to play it very cautiously from a stock standpoint," says Standard & Poor's Chief Investment Strategist Sam Stovall.

### **Wealth effect**

It makes some sense that a housing slump would be bad for stocks. First, there's the direct effect on jobs in construction, real estate brokering, mortgage lending, and so on. Goldman Sachs (GS) estimates that housing and related industries account for nearly 10 million jobs [payroll and nonpayroll combined].

Second, consumer spending has been buoyed by the housing boom. People spent more freely because they felt wealthier and because they turned their homes into piggy banks through home equity loans, cash-out refinancing, and other means.

Take away jobs and consumer spending, and it's no wonder that many experts expect a housing slump to hurt stocks.

By this view, stocks aren't a good choice right now. What, then? Barry Hyman, equity market strategist for EKN Financial Services, says that the same rising rates that have squeezed housing have given investors a nice alternative: money market accounts, which are yielding better than 4 percent, and bank certificates of deposit, some of which yield 5 percent or more.

### **"Down but not out"**

Super-bears on housing have different advice. John Talbott, author of the none-too-subtly titled *Sell Now! The End of the Housing Bubble*, recommends avoiding not only the stock market, but banks, too, since lots of banks could be hurt by lax mortgage lending standards.

But not everyone is convinced that housing will crush stocks. Why? Some figure that the housing slump won't be severe or prolonged. Robert DiClemente of Citigroup argues that the adjustment to a slower rate of sales is well under way. He says that the issuance of building permits is actually 10 percent below the rate of new-home sales. This process "will clear the overhang of houses within the next six to nine months," DiClemente predicts in a recent research note. The headline on his report: "Down But Not Out."

Others say it's too soon to declare the stock market dead because of housing. "Summing it up, I'm in the camp that says I don't know and the jury is still out," says Jeffrey Saut, equity strategist for Raymond James Financial (RJF).

### **Back to the future**

Then there are the outright optimists. Bob Carey, chief investment officer for First Trust Advisors in Lisle, Ill., says that the stock market is 20 percent to 25 percent undervalued at current levels and should reach full valuation by sometime next year, which means: Get ready for a heck of a bull market. Carey says the demand for housing is driven by incomes and jobs, and since corporate profits are extremely strong, the outlook for income and job growth is good. Says Carey: "It's hard to imagine Corporate America doing well and somehow people not doing well on the employment side."

Carey has seen Merrill Lynch's chart showing a tight correlation between homebuilding and the S&P, but he says the pattern dates back only a decade or so. Before then, there was very little correlation, and he says the economy might return to that older pattern.

It's also possible that the housing slowdown could prod the Federal Reserve into cutting interest rates, which could boost stocks. Maybe, too, speculative investors will go back to dabbling in stocks instead of real estate, the way they did before the dot-com bubble burst and the real estate boom began.

### **Today's market**

But the most intriguing evidence that the stock market might not go down because of a housing slump is simply this: So far, it hasn't gone down. It's gone up. The stock market is famous for looking ahead, and it seems that investors collectively may have decided not to blow a gasket over housing. This past June, the S&P 500 got down to around 1,220. Now, with the news about housing getting steadily worse, it's up to 1,321, and on the verge of setting a five-year high.

Even more intriguing is that stocks of homebuilders -- a group that's been out of favor for quite a while -- show signs of bottoming out. Since their lows in early September, Pulte Homes (PHM) is up 14 percent, D.R. Horton (DHI) is up 16 percent, Lennar (LEN) is up 8 percent, and KB Home (KBH) is up 14 percent. If the stocks at the very epicenter of the housing slump can show signs of life, why is everyone so worried about the market as a whole? Good question.

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