

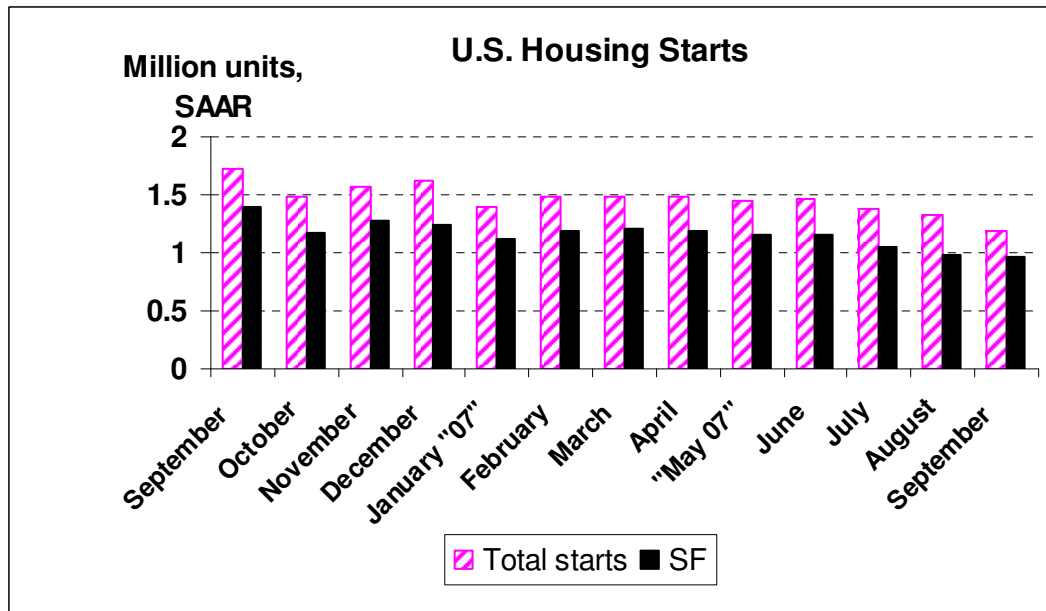
October 18, 2007

TO: Distribution

From: Al Schuler

Subject: U.S. Housing Starts – September 2007

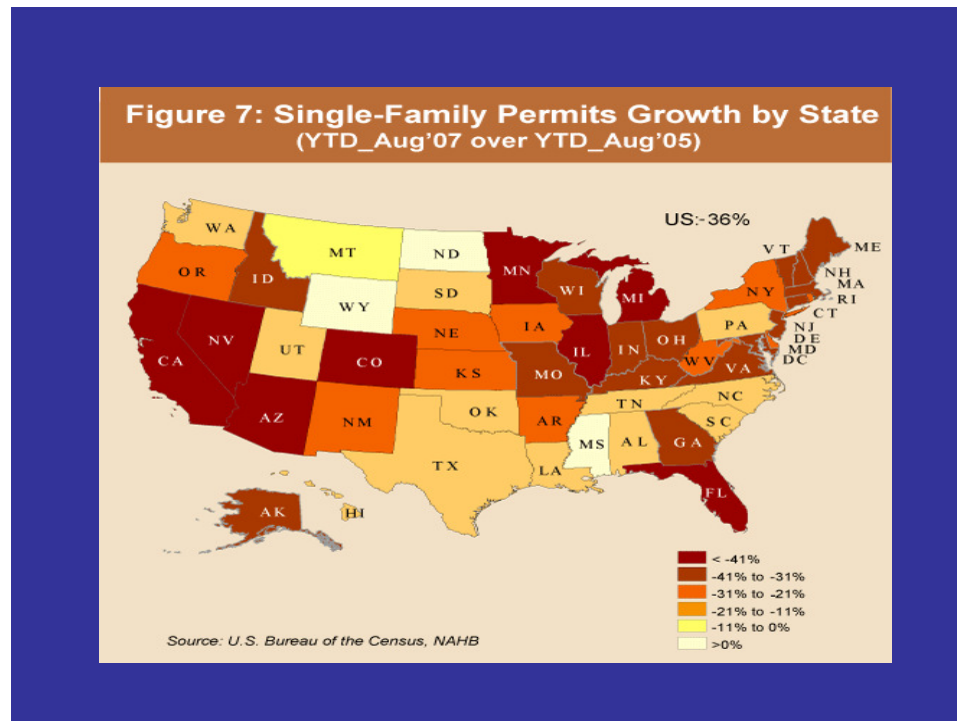
September housing starts decreased 10.2 percent, to 1.19 million (SAAR). The 33.4 percent decline in multi-family starts was the main reason, as single family starts were off a more modest 1.7 percent. Regionally, starts were off the most in the Midwest (-28.4 percent) and the West (-10.1 percent). They were up 45 percent in the Northeast while they were essentially flat in the South (-0.2 percent). Permits continue to slide, down 7.3 percent to 1.226 million SAAR as builders focus on reducing inventories.



**Analysis and outlook:** The housing correction continues; both total starts and single family starts are off 31 percent from levels from a year ago (September 2006). Inventories of new homes for sale remain at 8.2 months supply (August) while existing homes have a 10-month supply. The total inventory is 529,000 new homes and 4.56 million existing homes – that’s 5.1 million homes for sale – about double the typical inventory over the past decade. Until that inventory comes down, there will be little incentive for builders to increase the pace of building homes. To date, new home prices are coming down faster than existing homes, probably because there is more incentive (inventory carrying cost) for the builders to unload bloated inventories. However, a common problem is that many of the potential buyers of new homes are owners of existing homes, and in most cases they need to find a buyer for their home before they buy a new home. That means existing home prices have to come down quite a bit which would make them more affordable, eventually reducing inventories, and this would support a turnaround in the “new home market,” which is so critical to building material manufacturers – ie., lumber, OSB, plywood.

The chart below from the National Association of Homebuilders (NAHB) shows the extent of the slowdown in permits across the country using U.S. Census data. Fewer permits lead to fewer starts, and that means weak wood product markets. The

slowdowns in most cases are more rapid in those regions where previous house price increases were the greatest. In addition, we can see relatively more rapid decreases in permits in regions where employment is suffering due to problems in the domestic auto and related industries – MI, OH, IN.



The message to me is that builders are really trying their best to lower inventories – by lowering prices and offering other incentives to prospective buyers. However, in my opinion, until existing home prices show more of a downward correction (thus improving affordability), the overall housing market won't pick up much momentum. As mentioned in previous editions of this report, existing homes (often called the "resale market") represent about 85 percent of the housing market, and because the inventory overhang is greatest there (ten months versus eight months for new homes – and many of these "existing homes" are newly bought (speculation), but now vacant, thus competing directly with "new homes"), the overall housing market won't reverse course until the problems (inflated prices) in the "resale market" are fixed.

When will things get better? I wish I knew. For more insight, there is an excellent report in NAHB's Builder magazine (October, p.186-189) outlining recent "forecasts" by industry experts. The consensus is that there was too much overbuilding between 2004 and 2006, plus a relaxation of lending standards and regulatory oversight and this resulted in the bloated inventories we have today. Prices are still too high in many regions of the country, particularly when factoring in higher interest rates and tighter lending standards, which reduces the potential pool of buyers. The consensus forecast is for a bottom in the second half of 2008, with modest recovery beginning in 2009.

The "obvious solution" is a significant fall (ten percent or more) in prices for existing homes. Will it happen, and will it adversely affect the rest of the economy, is the \$64,000 question. Personally, I believe the economy is strong enough to absorb the recession in the housing market and further fall in existing home prices. As long as prices don't "free fall" (which can cause panic throughout the economy), the economy is large enough and diversified enough to remain buoyant. The job market remains solid – the weak numbers in August were revised upward significantly as were weak numbers

in earlier summer months. Corporate balance sheets are still solid; exports are picking up thanks to our weakening dollar; and inflation is subdued and this translates to relatively attractive mortgage rates on a historical basis.