



SPECIAL COMMENTARY

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Pass-Through Effect of Housing Weakness

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Early Sectoral Weakness

Over the past few years the United States has witnessed incredible economic and financial fallout from declining home values and the vast oversupply of homes. Weakness in the housing sector has had serious implications for other parts of the economy. The repercussions from falling home prices showed up almost immediately in the mortgage market, and it did not take long for the knock-on effects to take down the global financial markets. While the financial markets received most of the attention, other housing-related sectors also began to feel the effects of a weak home market early on and many continue to struggle today. As the housing sector slowed in late 2005 and early 2006, well before the recession began, demand for building products, furniture and other durable goods—those big ticket purchases needed to build, remodel, or fill a new home—declined sharply.

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Figure 1

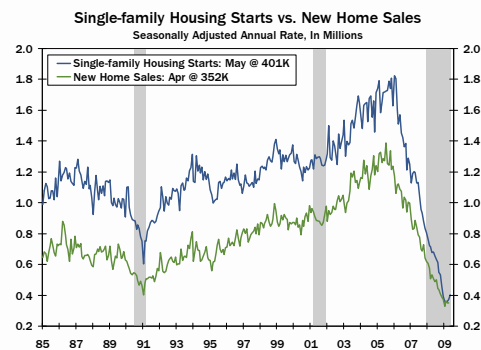
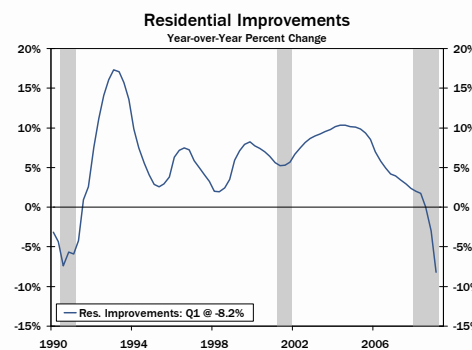


Figure 2



Source: U.S. Department of Commerce and Wachovia

The housing market is still very much in correction mode. Builders are striving to reduce inventories any way they can, and the extreme weakness in sales and massive oversupply of homes means pricing power for sellers is practically nonexistent (Figure 1). This predicament also applies to sellers of housing-related goods. While there are some tentative signs housing starts and home sales have bottomed, both are doing so at appallingly low levels, in our opinion. Moreover, home prices are still falling and are likely to continue to do so for at least another year. The continued

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weakness in housing means producers and purveyors of lumber, furniture, appliances and other building supplies will likely continue to struggle. Demand is no longer falling, however, which means producers should be able to better align production and inventories with sales.

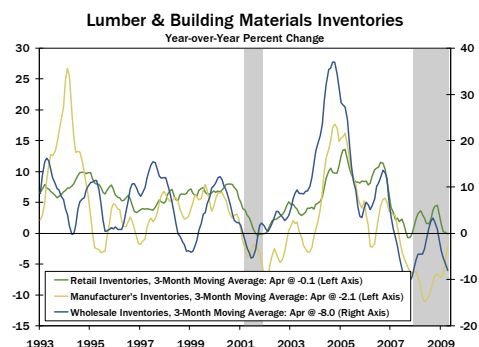
Renovations and Home Improvement

During the housing boom, homeowners could be quite confident they would recoup any investment they made in their homes and a substantial portion of home equity borrowing went to additions and repairs of existing homes. The prospect of a quick payoff from home improvements meant that spending on home improvements rose faster in areas where home prices were rising rapidly, particularly Florida, California and Arizona. This assurance led to a rise in speculative buying and house flipping. Indeed, several television shows such as TLC's *Flip That House* and Bravo's *Flipping Out* picked up on the trend and became quite popular.

When such speculative investment strategies become a national pastime alarm bells should start ringing. Sure enough, once home prices stopped rising, residential improvements slowed dramatically. When prices started falling outright, spending for additions and alterations tumbled. Spending for residential improvements peaked at a 10 percent year-over-year pace during 2004/2005. Residential improvements slowed significantly once prices started tumbling in California and Florida and fell into negative territory once prices started falling nationwide. The latest data show spending for additions and alterations contracting more than eight percent year over year (Figure 2).

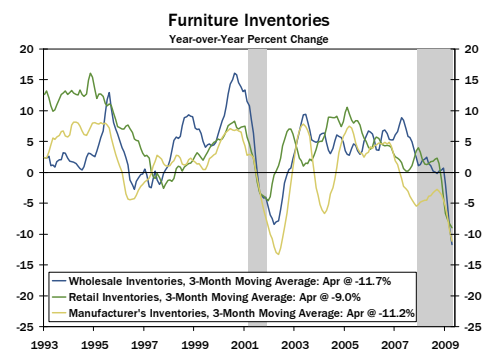
Investor purchases made the underlying demand for new homes appear to be stronger than it actually was and led to a dramatic rise in home prices. Builders responded by ratcheting up home construction. As long as sales remained robust, the month's supply of homes stayed at a manageable four-five months, meaning the pace of sales would consume all available homes in that time period. When sales slowed, the month's supply rose steadily, climbing to more than a one year supply, despite a collapse in new building activity.

Figure 3



Source: U.S. Department of Commerce and Wachovia

Figure 4



Across the supply chain, from manufacturers to wholesalers to retailers, it is evident that housing-related or housing-dependent industries peaked and weakened well ahead of the rest of the economy.

Housing-Related Industries Strained

A wide assortment of industries were supported, and subsequently let down, by the housing boom. Across the supply chain, from manufacturers to wholesalers to retailers, it is evident that housing-related or housing-dependent industries peaked and weakened well ahead of the rest of the economy. Focusing on inventories is an

effective way of looking at this outcome. For retailers in the building materials, garden equipment and supplies sector, inventories peaked in early 2005 and have since been on a downtrend (Figure 3). Inventories of wood products for manufacturers, and lumber for wholesalers peaked in 2005 as well, from which point a steady drawdown process began.

Retailers, being closest to the end consumer in the supply chain, felt the first effects of the housing slump. Without the steady rise in home prices fueling gains in home equity, homeowners at first became less comfortable spending on big-ticket items like high-end appliances and fancy furniture (Figure 4). Later, when home values started declining, consumers' ability to spend for such items became impaired. Falling home prices had an even greater immediate impact on investors, many of whom could no longer afford to upgrade the homes they hoped to flip.

Manufacturers and wholesalers felt the slack in demand from homebuilders and developers reacting to weakening market conditions. Wood products, lumber and other building supplies were all weak early in the cycle, and inventories peaked earlier than other sectors less directly affected by the housing slump. Declines in inventories of building products began well ahead of sectors not related to the housing market. For example wholesale inventories of hardware, plumbing and heating equipment & supplies began trending down well before machinery equipment & supplies, which saw inventories peak in early 2009. Similar early drawdown effects are evident in the furniture sector. The decline in inventories shows a slowing trend by 2005, which has accelerated markedly in the midst of the current recession. This is a clear case of consumer demand, or lack thereof, feeding through the supply chain, and businesses acting accordingly.

Retailers felt the first consumer effects of the housing slump, while manufacturers and wholesalers felt the slack in demand from homebuilders and developers reacting to weakening market conditions.

Figure 5

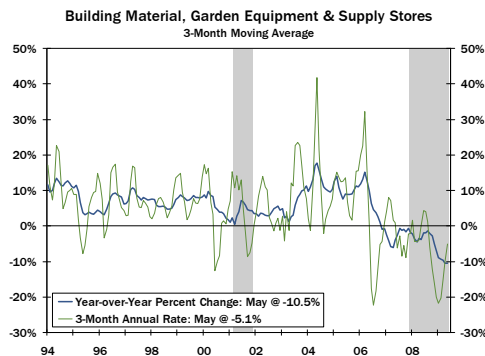
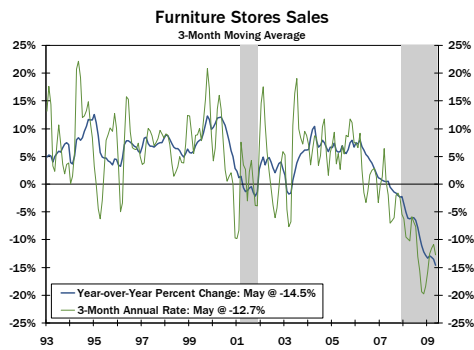


Figure 6



Source: U.S. Department of Commerce and Wachovia

Figure 5 and Figure 6 show the lack of consumer demand on the retail sales side, while Figure 7 and Figure 8 show the reaction on the supply, or production side. A recent uptick can be seen on both fronts; however we doubt these sectors will bounce back quickly. Both sectors remain in negative territory year over year. Part of the recent improvement is simply due to easy comparisons with the data from one year ago. The actual levels of sales and production are still down significantly.

Figure 7

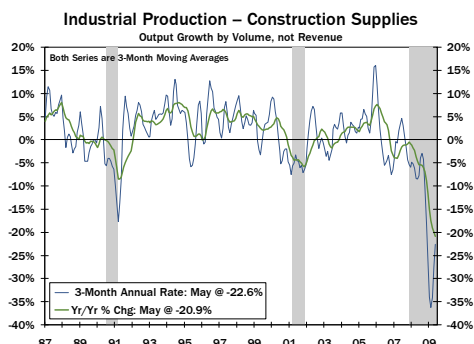
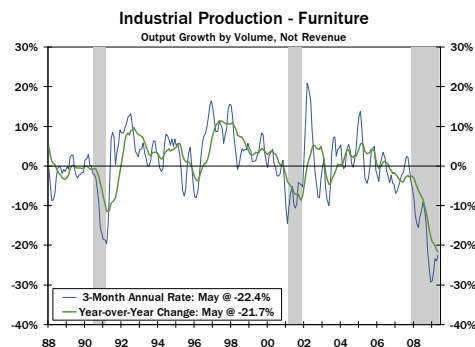


Figure 8



Source: Federal Reserve and Wachovia

Even if consumers wanted to leverage themselves further, they would have difficulty securing a loan or a new line of credit.

Consumer Credit Evaporated, Along with Net Worth

Falling home prices and last fall's collapse in the equity markets slashed household wealth by \$12 trillion. Almost all businesses are reporting credit is hard to get, and consumer credit is down substantially. Lack of credit is a supply and demand story that applies to businesses as well as consumers. First, consumers are unwilling or unable to take on additional debt in a weak economy where one in 11 is unemployed. Confidence is lacking and many are concerned about their employment and income prospects. For the most part consumers are more interested in paying down debt rather than increasing consumption. Debt had risen to unprecedented levels relative to income in the previous expansion when credit was cheap and easy. Banks and credit card companies on the supply side are tightening their lending standards and trying to reduce risk and exposure. Even if consumers wanted to leverage themselves further, they would have difficulty securing a loan or new line of credit.

Summary

With final demand growing less rapidly, businesses will likely continue to strive to maintain even leaner inventories than they did in the past expansion.

Even beyond the credit market and financial systems, weakness in the housing sector has fed through to many parts of the economy that also depend in part on housing. The impact from the loss of wealth and tighter credit conditions is expected to restrain the eventual recovery in home sales, new home construction and spending for big ticket items, especially those related to the home. Credit, in the form of mortgage loans and credit cards, is almost always used in such purchases, and in the current environment those goods are being shunned by scared consumers. The demand storylines are matched on the supply side, where production is still down significantly. Because of these storylines, few new homes are being built, and existing homes are not being renovated or remodeled, or refitted with new furniture and appliances. With final demand growing less rapidly, businesses will likely continue to strive to maintain even leaner inventories than they did in the past expansion. As inventory reductions continue and suppliers become more comfortable with their inventory levels with respect to sales, production can ramp up. We expect this to be a long grind, especially for the housing-related sectors.

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