

## U.S. HOUSING: FROM LEAKY ROOF TO FLOODED BASEMENT

The situation surrounding U.S. residential real estate has predictably gone from ugly to worse since the start of the year. The key area to focus on is the impact of this trend on the U.S. economy. In this week's edition of the Marker, we provide an update on these trends, and attempt to place the current situation in context.

### HOUSING'S IMPORTANCE GOES BEYOND SHELTER

There are 110 million homes in the U.S., 76 million of which are owner-occupied. As in most countries, U.S. homeowners maintain a strong emotional connection to their home. People do not sell frequently and when they have to, they will go to great lengths to avoid taking a loss. All of those points make the current environment even more extraordinary. The U.S. is in the midst of the greatest home price correction in at least 20 years. The main price index (S&P/Case Shiller) is down almost 13% from the previous year, foreclosures are booming, and some reports point to 9 million Americans having negative equity in their homes at present.

The importance of house values extends beyond the obvious plight of underwater homeowners. Housing is perceived by Federal Reserve staff as the greatest unknown in the American economic picture. Investors agree that a bottoming out of the housing sector is a key pre-requirement to a return to somewhat normal conditions in the Financial Services sector and consumer-spending areas. Representing some 70% of U.S. GDP, consumer spending will likely remain weak until individuals gain a better sense of how home rich/poor they have become.

### HOW MUCH FURTHER CAN IT GO?

Much effort is being invested in determining the likely path of housing values over the coming months. The consensus calls for a sustained downward trend. Goldman Sachs' Economics produced an interesting study comparing International Housing Busts - defined as real price declines in excess of 15% - through time. The summary table below highlights their findings. There were 24 such busts over the past 35 years. Interestingly enough, two occurred in Canada. The average duration was 6 years, and the average peak-to-trough price move was -31%. We emphasize the fact these results are based on after-inflation prices. A homeowner's practical experience would have most often involved slow/no appreciation, while inflation worked to reduce the real value of a home. Very seldom have homeowners experienced gross price declines as is presently the case in the U.S. On the key issue of how much further prices could decline, respected forecasters point to a further 10 to 12% decline south of the border as the requirement to re-establish the long standing ratio between home values and disposable income when adjusting for interest rate levels.

Real House Prices in Selected Housing Busts

Country	Peak	Trough	Duration (quarters)	Decline in Real House Prices (%)
Average			25	-31
U.S. - Now			4	-3
Canada	Mar-81	Mar-85	16	-21
Canada	Dec-89	Sept-98	35	-16

Sources: OECD, Goldman Sachs, and Natcan

### CHOOSING SIDES BETWEEN REALISM AND PESSIMISM

The housing picture is indeed bleak in the U.S.; yet in the world of investing, the realist typically beats the optimist and the pessimist in the long term. We cannot forget that the already unprecedented declines in home values have occurred without triggering a recession. Housing sector stocks appear to have stabilized after significant drops in valuation, and the extreme speculation at play during the years 2005 and 2006 has ended. Perhaps most significantly, we must remind ourselves of the strength in economic growth being experienced outside of the U.S.

### NATCAN WEEKLY MARKER

The real estate picture in the U.S. keeps getting uglier. Policymakers and consumers are responding by adjusting to a new reality of low/no real home value appreciation for some time to come. The international experience demonstrates that real estate down cycles are long-duration events, but that the economy and markets begin to move up again long before the final trough. In difficult times, a realistic assessment should always guide investor action.

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## FINANCIAL MARKETS

RETURNS AS AT MAY 2, 2008 (%)	MTD	QTD	YTD	RATES AS AT MAY 2, 2008	
S&P/TSX	2.46	7.17	4.13	CAD/USD	1.02
S&P 500	3.29	6.28	-0.60	CAD/Euro	1.57
S&P/TSX Small Cap	1.50	3.54	-0.65	US Treasuries yield 10-yr/30-yr	3.85/4.56
Russell 2000	2.56	4.85	-2.43	GOC bond yield 10-yr/30-yr	3.61/4.10
MSCI EAFE	2.21	5.77	0.17	Fed Fund Rate (target)	2.00
MSCI World	2.73	6.13	0.35		
DEX Universe Bond	0.08	-0.44	2.50		

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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