# Encountering Resistance

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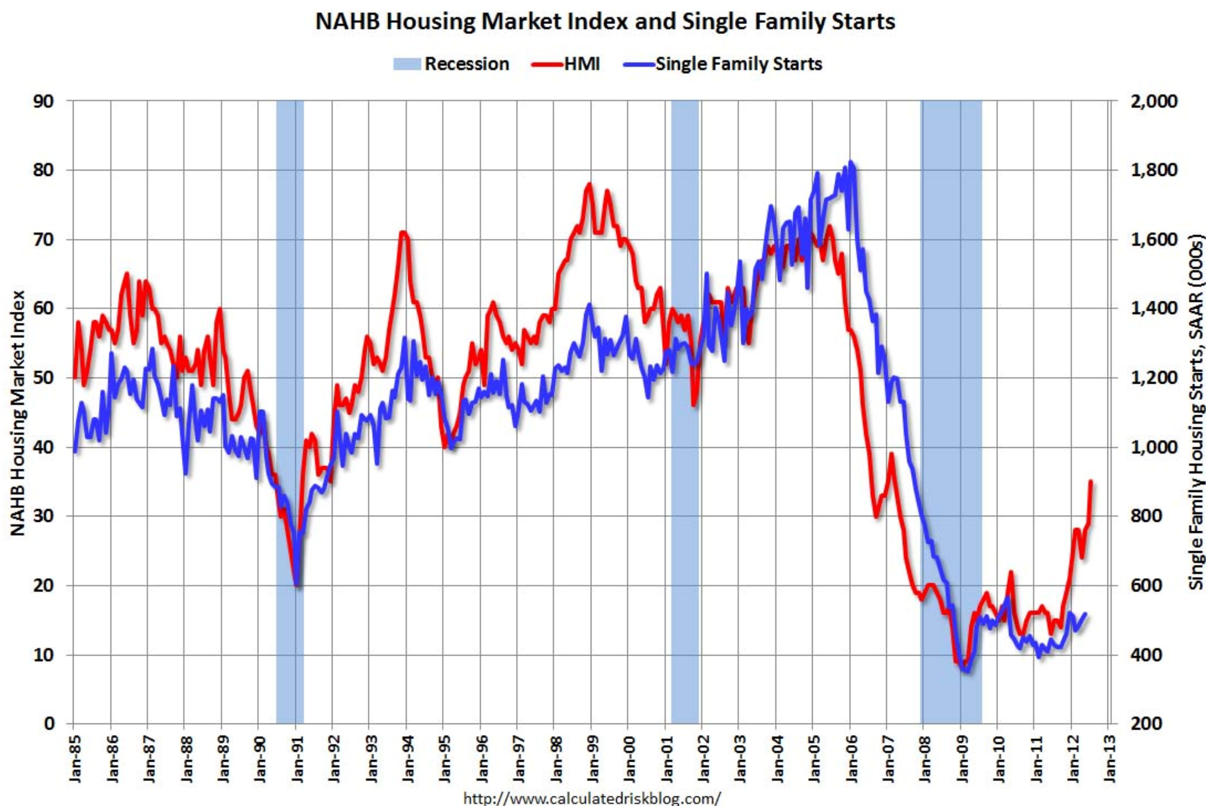
- Fundamentally, technically, and from a policy perspective, stocks are running into resistance — we think 1360 to 1400 on the S&P 500 will be tough to breach as ongoing policy uncertainty from the Eurozone, China, and the US weigh on investor confidence. Last week we suggested a cap at 1360 over the next month and although that level was breached, the break was not decisive. We take some comfort in the fact that while last week's earnings announcements reflected slowing global growth, the S&P 500 posted a slight gain.
- Pressure is increasing for the European Central Bank (ECB) to intervene and buy Spanish bonds, but the ECB would rather have the (temporary) European Financial Stability Facility (EFSF) make those purchases because it was already fiscally agreed upon and established for such purposes. However, the EFSF is currently transitioning to become the European Stability Mechanism, a permanent bailout fund with requisite ECB oversight and explicit Eurozone banking supervision. This change will take some time, requiring constitutional approval and ratification. Additionally, last week's statement from Germany's finance minister that Spain should ultimately be responsible for repaying its loans offers little hope for a quick resolution. Meanwhile, Spanish, Italian, and major European bank yield spreads have widened substantially, and markets are reacting negatively to the lack of any decisive action by policymakers. This reflects frustration with empty rhetoric and attempts to kick the can down the road. Our portfolios remain defensively positioned and will become more so if we believe the odds of a global recession have risen to more than 50%.
- Investors appear to be pinning their hopes on further accommodation from the Federal Reserve's next meeting on July 31 and August 1. Fed Chairman Bernanke acknowledged that the Fed has the tools for further easing in last week's Congressional testimony: further balance sheet expansion (QE3) in the form of more Treasury and/or MBS (mortgage backed securities) purchases, extending the zero interest rate policy through 2015, cutting interest on excess reserves to zero, and providing 'funding for lending.' However, we think the Fed wants to see inflation expectations fall below 2% before they act.
- Headline CPI (Consumer Price Index) has fallen from a peak of 3.9% year over year last September to 1.7%, but 'core' inflation (excluding food & energy) is still 2.2% due in no small part to rising rents, which make up about 40% of core CPI. Signs of financial stress in Europe, particularly with Spanish 10-year bond yields once again above 7%, and further economic deterioration in the US, such as in employment, income, and purchasing manager surveys, could prompt the Fed to act more proactively but, as Bernanke's testimony seemed to imply last week, the Fed would much prefer a fiscal response (requiring congressional action) to stepping up its already considerable and extraordinary monetary stimulus.
- As we wrote in our May 7 *Weekly View,* housing remains a bright spot for the US economy, especially given rent increases and investor interest, which is working to clear excess inventories. While the recovery seems to be concentrated in low-end

and multifamily properties, 'jumbo' originations are also rising on the margins at the higher end, helping median home prices (derived from the mix of homes sold every month) rise 10% year to date through June, according to ISI. Negative equity and elevated delinquencies (not to mention tight credit and stagnant incomes) will continue to provide a headwind to housing activity, but as the New York Federal Reserve noted last week: "the median county is now experiencing stable house prices on a year-over-year basis. Transaction volumes in most markets, while still far below normal, have steadied. Finally, the share of distressed sales, although still very high in many markets, appears to have peaked. If these trends continue, then local housing markets are making progress."

- Conventional 30-year fixed mortgage rates fell to a record low 3.74%; while this has been a boon to refinancing activity (reducing household debt service), it has not translated much to purchase activity, which remains mired at 1996 levels according to the Mortgage Bankers Association. Indeed, existing home sales in June declined 5.4% to a 4.37 million annual rate, below consensus expectations for 4.65 million. However, as Calculated Risk remarks: "those focusing on sales of existing homes, looking for a recovery for housing, are looking at the wrong number. For existing home sales, the key number is inventory — and the sharp year-over-year decline in inventory is a positive for housing... It is active inventory that impacts prices (although the 'shadow' inventory of potential foreclosure sales will keep some downward pressure on prices)." For new homes, sales will be important, and judging by housing starts (new home construction) and builder confidence (see chart below) a bottom appears to be forming. Although the magnitude of housing starts (blue line, right axis) has not followed the rise in the NAHB Housing Market Index (red line, left axis), this index – a national survey of homebuilders rating their sales of new homes currently and over the next six months – suggests growing potential for starts to increase significantly in the next few months. The nascent improvement in housing is helping to keep our odds of a US recession below 50% for now. ISI Group argues the housing starts still have a lot of catch-up potential, and strength in housing is helping to offset weakness in other areas and reduce the odds that the economy is worse than their forecasts.

## THE WEEKLY CHART: HOUSING STARTS SUPPORT GDP

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