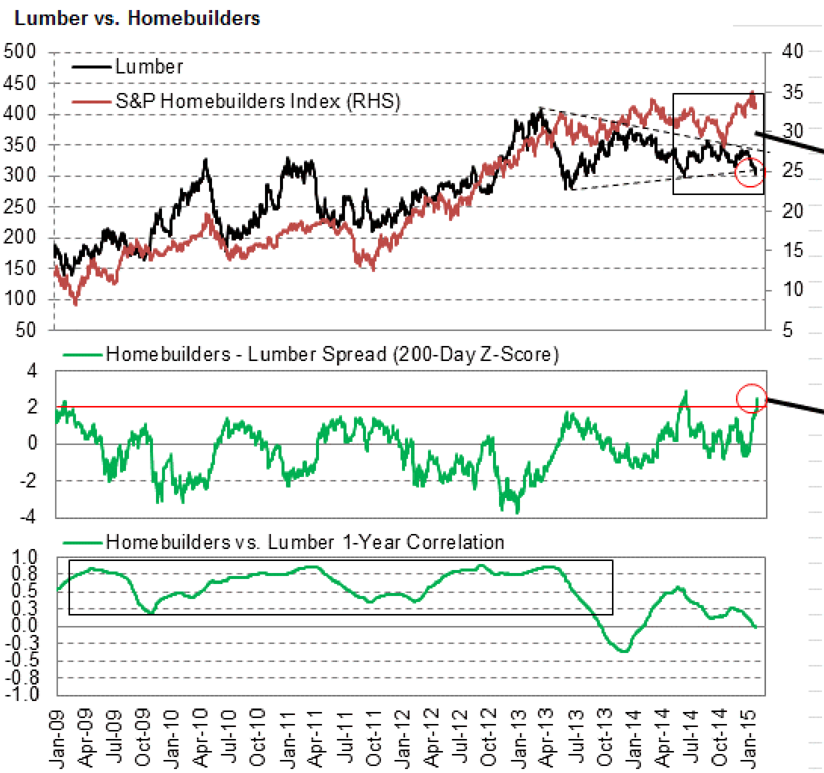
Chart of the Day: Lumber Raises Caution Flag For Homebuilders

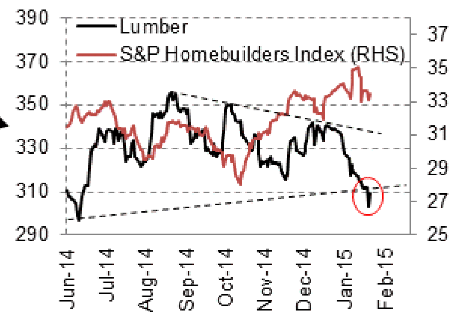
by Michael Sacchitello, CMT

January 22, 2015

--Stone & McCarthy (Princeton) – On Wednesday, SMRA's Nancy Vanden Houten presented her analysis of December Housing Starts (go here for report). The highlight of the report came from the single-family sector, where starts increased a better than expected 7.2%, to the strongest pace since March of 2008. While the December report clearly adds a bit of good news to what has been a mostly disappointing pool of U.S. economic data of late, today's Chart of the Day highlights the risk that the recent breakdown in lumber prices may present to homebuilders.

In the past, we've written about the strong correlation between homebuilders and lumber prices, and the tendency for lumber prices to lead homebuilders (go here for more details). Before we continue, however, we should acknowledge that, since the latter part of 2013, the relationship between these two markets has been uncharacteristically weak, as shown by the updated 1-year correlation study at the lower left corner of the chart below.





Homebuilders Index (XHB) Performance Following XHB - Lumber Spread 200-Day Z-Score Close >= 2.0 (Since 2006)	10 Days Out	40 Days Out	60 Days Out
Occurrences	5	5	5
Total XHB Increase	3	0	1
Total XHB Decrease	2	5	4
% XHB Increase	60.0%	0.0%	20.0%
% XHB Decrease	40.0%	100.0%	80.0%
Max XHB Increase	3.6%	N/A	21.8%
Max XHB Decrease	-35.4%	-40.6%	-42.8%
Average XHB Increase	3.4%	N/A	21.8%
Average XHB Decrease	-24.0%	-13.8%	-22.3%

One reason homebuilders have been bolstered relative to lumber prices since late 2013 probably has to do with the trend towards lower mortgage rates, which has been accelerating since the late days of 2013. The benefit from lower rates has been especially noticeable since the S&P 500 completed a 10% correction on 10/15/14. Since the start of the US equity market's post-10/15/14 up-cycle, the S&P Homebuilders Index is up 16% vs. a gain of just 9.1%

by the S&P 500, while Lumber and the U.S. 10-Yr yield are down by -8.0% and -13.2%, respectively, through Wednesday's close.

The purpose of this discussion, however, is to highlight that the price action between these two instruments does not lend credence to the idea that the recent rally in homebuilders is poised to continue. In fact, in addition to the recent breakdown in lumber prices shown on the top chart directly above, a study of how homebuilders perform after the spread between the S&P Homebuilders Index (XHB) and lumber prices stretches to > 2 standard deviations above the 200-day moving average reveals very strong odds that homebuilders will be lower two and three months after the initial signal, which, in this case, occurred on Tuesday.

Serious Research For Market Professionals

Stone and McCarthy Research Associates (SMRA) offers comprehensive, independent macro-economic and financial market research for fixed-income and equity/macro market participants.

SMRA provides forecasts and analysis of the key economic data and financial market developments that are important to fixed-income traders and investors. We focus on the U.S. macroeconomic outlook, Federal Reserve policy, the market for U.S. Treasury securities and U.S. fiscal policy. We cover key developments in other fixed income markets, including the corporate, agency debt and MBS markets, and the short-term money markets.

Stone & McCarthy stands apart from the competition because we complement our economic research with the risk management benefits of technical market analysis. In addition to daily coverage of major stock, Treasury, currency, and commodities markets, our CMT-designated staff technician analyzes inter-market flows, sentiment and mathematical price relationships for significant developments that can change the broader market's risk profile.

Our research runs the spectrum from concise intraday updates to in-depth analytical research commentaries. We provide a running scroll of "snapshots" that keep subscribers current on developments in global financial markets. On a weekly basis, we published the results of the widely followed SMR Portfolio Managers' Survey.

Key reference materials are available on our website and on our Bloomberg product, including economic and market calendars, historical economic data, and historical auction result data.

Our research is delivered in a number of ways; subscribers can choose what works best for them. All of our research is on our website www.smra.com and on our Bloomberg product at SMRA GO. Subscribers can get the research that matters most to them delivered directly to their inbox; we also alert our readers via Twitter when we have posted new research to our website.

The SMRA analysts collectively have decades of experience in economic and fixed income research and technical analysis. Our analysts are always available to our subscribers to discuss our research and to respond to specific requests for research.

Contact A Regional Sales Office

(For North &South America Sales)	(For All Global Regions)
2 Research Way Princeton, NJ 08540	Please Contact the Princeton, NJ USA Office
Tel: 001 609 683 5237 **Fax:** 001 609 683 9580	**Tel:**001 609 683 5237 **Fax:**001 609 683 9580

DISCLAIMER

THE MATERIALS IN THIS REPORT ARE PROVIDED "AS IS" AND WITHOUT WARRANTIES OF ANY KIND EITHER EXPRESS OR IMPLIED. SMRA DISCLAIMS ALL WARRANTIES, EXPRESS OR IMPLIED, INCLUDING, BUT NOT LIMITED TO, IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. SMRA DOES NOT WARRANT THAT THE FUNCTIONS OR INFORMATION CONTAINED IN THE MATERIALS WILL BE UNINTERRUPTED OR ERROR-FREE, THAT DEFECTS WILL BE CORRECTED, OR THAT ITS SITE OR THE SERVERS THAT MAKE IT AVAILABLE ARE FREE OF VIRUSES OR OTHER HARMFUL COMPONENTS. WE DO NOT WARRANT OR MAKE ANY REPRESENTATIONS REGARDING THE CORRECTNESS, ACCURACY, RELIABILITY, OR OTHERWISE OF THE MATERIALS IN THIS REPORT OR THE RESULTS OF THEIR USE. YOU (AND NOT SMRA) ASSUME THE ENTIRE COST OF ALL RESULTS FROM USE OF THIS REPORT OR THE MATERIALS CONTAINED IN IT. APPLICABLE LAW MAY NOT ALLOW THE EXCLUSION OF IMPLIED WARRANTIES, SO THE ABOVE EXCLUSION MAY NOT APPLY. SMRA DOES NOT ENDORSE ANY OTHER WEB SITES LINKED FROM ITS WEB SITE OR MAKE ANY REPRESENTATION AS TO THEIR COMPLETENESS, ACCURACY OR COMPLIANCE WITH APPLICABLE LAWS.THE INFORMATION IN THIS SITE IS NOT INTENDED TO CONSTITUTE, AND SHALL NOT BE CONSIDERED, INVESTMENT ADVICE OR THE RECOMMENDATION TO PURCHASE OR SELL ANY SPECIFIC SECURITIES OR CATEGORY OF SECURITIES.

LIMITATIONS OF LIABILITY.

Under no circumstances shall SMRA be liable for any special or consequential damages that result from the use of, or the inability to use, the materials in this report, even if we or one of our authorized representatives has been advised of the possibility of such damages. Applicable law may not allow the limitation or exclusion of liability or incidental or consequential damages, so the above limitation or exclusion may not apply. In no event shall our total liability for all damages, losses, and causes of action (whether in contract, tort or otherwise) exceed the amount paid, if any, for accessing this site.