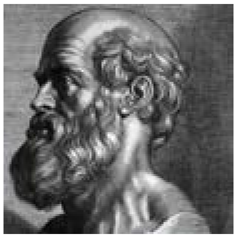

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Lumber Prices Fall Sharply: Implications For Bonds And Different Stock Market Sectors

Apr. 14, 2015 9:52 AM ET | 29 comments | Includes: AAPL, GILD, IEF, ITB, LEN, PTLA, RY, SPY, TLT
Disclosure: The author is long AAPL, GILD, PTLA. **(More...)**

Summary

- Lumber prices are often leading indicators of trend changes in the markets and economy.
- Lumber prices have entered a new bear market.
- Other data are also consistent with a trend change.
- Implications for stocks and bonds could be profound.

Introduction

I like to watch breakouts in either direction that Mr. Market is ignoring. In these days of unceasing money creation out of the Fed's "thin air," we have gotten used to asset price melt-ups. Deflationary crashes, which generations ago were just as common as upside breakouts, may be more noteworthy. That could be because while asset prices have been booming for years, the real economy as a whole has not boomed.

When a crash occurs in a strategic sector of the economy but few pundits pay attention, it's like the proverbial tree that falls in the forest where it's debatable whether a noise was made.

Which brings us to the lumber market, where prices have been dropping sharply lately, and the advent of spring has been met with, if anything, an acceleration to the downside rather than recovery.

Lumber prices - a lightly-followed leading economic indicator

A 5 1/2 year chart of lumber prices, going back to late, 2009, shows a great deal of volatility. Since trees grow no matter what, over time most of the price changes are from changes in demand. Although there has been some deterioration in export demand from China, this has been well advertised, so the ongoing bear market in lumber simplifies to U.S. demand. Because lumber's major use is in residential housing, and housing has led economic turns, moves in lumber prices have led economic turning points. This has been true even during the mini-cycles that the U.S. economy has experienced since the Great Recession ended in 2009. Thus lumber is much more important to investors than its small sales relative to the economy would suggest.

If interest (mortgage) rates are not spiking, then a sudden, sustained and large drop in lumber prices, as is seen now, should correlate with decelerating or declining buying interest. If this is a surprise to Mr. Market, stock prices and interest rates may follow. Lumber price trends have been excellent predictors over the years. probably better than the Fed or the stock market (NYSEARCA:SPY) as leading indicators. Here's the FINVIZ chart of lumber on the futures market, first for the past year and then since late 2009 (click on "weekly" on the FINVIZ linked site to see that longer view):

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Let's look at the peaks and troughs. The major drop in the first graph before the ongoing crash that began in December 2014 was in May-June. This was followed later in the summer and fall by down stock markets and dropping interest rates. Of course, that's unpersuasive. Once is happenstance, and the drop in the spring was brief and mild.

So let's go back to the lower graph, which goes back to just beyond the ending of the Great Recession. We can compare this to long term interest rates:

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The big drops in lumber prices early in 2010 and 2011 preceded the big drops in interest rates. Also, the upturns in lumber prices preceded rises in rates. (They also correlated with the Fed's QE programs.) The 2013 example is less persuasive, where lumber prices fell but rates dropped only mildly from their summer peak.

Overall, though, the big corrections in the stock market since 2009, and the resumption of the bull trend, were preceded by sharp moves down and up, respectively, in lumber prices, with lag times of not weeks but months.

This correlation is not just a QE phenomenon post-Great Recession.

For example, the same phenomenon is seen in 2006-8. The severe, relentless drop in lumber prices presaged not just the housing bust but the recession.
A multi-decade chart shows the same principle. From FuturesBuzz:

This is interesting, and covers too many years to discuss in detail. In recent times, the boom of the '90s was preceded by the sustained surge in lumber prices after the 1991 recession ended. Then, as 1999 turned into 2000, lumber began a crash with a gap down. Respecting that gap and subsequent bear market action would have saved investors the stock market crash and 2001 recession that followed. The surge off the 2003 bottom in lumber prices "predicted" the sustained boom that followed.
My interim conclusion is therefore that the current sustained weakness in lumber's price is a bearish indicator. It is consistent with - but not proof of - a bearish trend reversal coming in the economy and stock prices, and is consistent with a continued downtrend in Treasury bond prices, though with a bear move likely in low-grade junk bond prices (rising interest rates on the worst quality bonds).

Let's see if other data support an upcoming trend reversal. Here are some that are not consistent with the general upbeat story that Wall Street is following.

1. Credit conditions may have deteriorated recently.

The veteran blogger Mish ran a blog post Monday with some surprising data I had been unaware of. I was actually impressed enough by this data to go a little more risk off later Monday. He reported on national credit conditions from the NACM (then click on "View Latest Report" for the source document). The NACM features this on its home page:
A Powerful Tool
Since its inception, the CMI has been a startlingly accurate economic predictor, proving its worth most notably during the recession.

Quotes from Mish's post, with his italics, follow:

There is quite obviously some serious financial stress manifesting in the data and this does not bode well for the growth of the economy going forward. These readings are as low as they have been since the recession started and to see everything start to get back on track would take a substantial reversal at this stage...

The combined score is getting dangerously closer to the contraction zone and has not been this weak in many years (going back to 2010). It is sitting at 51.2 and that is down from the 53.2 noted last month.

The most drastic fall took place with the unfavorable factors that indicate the real distress in the credit market. It has tumbled from 50.5 to 48.5 and that is firmly in the contraction zone-a place this index has not been since the days right after the recession formally ended. The signal this sends is that many companies are not nearly as healthy as it has been assumed and that there is considerably less resilience in the business sector than assumed...

The real damage is showing up in the unfavorable categories. *By far the most disturbing is the rejection of credit applications as this has fallen from an already weak 48.1 to 42.9. This is credit crunch territory-unseen since the very start of the recession. Suddenly companies are having a very hard time getting credit*...

This indicates that more companies are in such distress they are not bothering to dispute; they are just trying to survive...

The *rejections of credit applications fell out of the 50s with a resounding thud-going from 50.3 to 43.8. There is most definitely a credit crunch underway and it is now easy to determine what the prime factor is. There are many companies seeking credit that are too weak and there is obviously an abundance of caution showing up in those that issue that credit*.

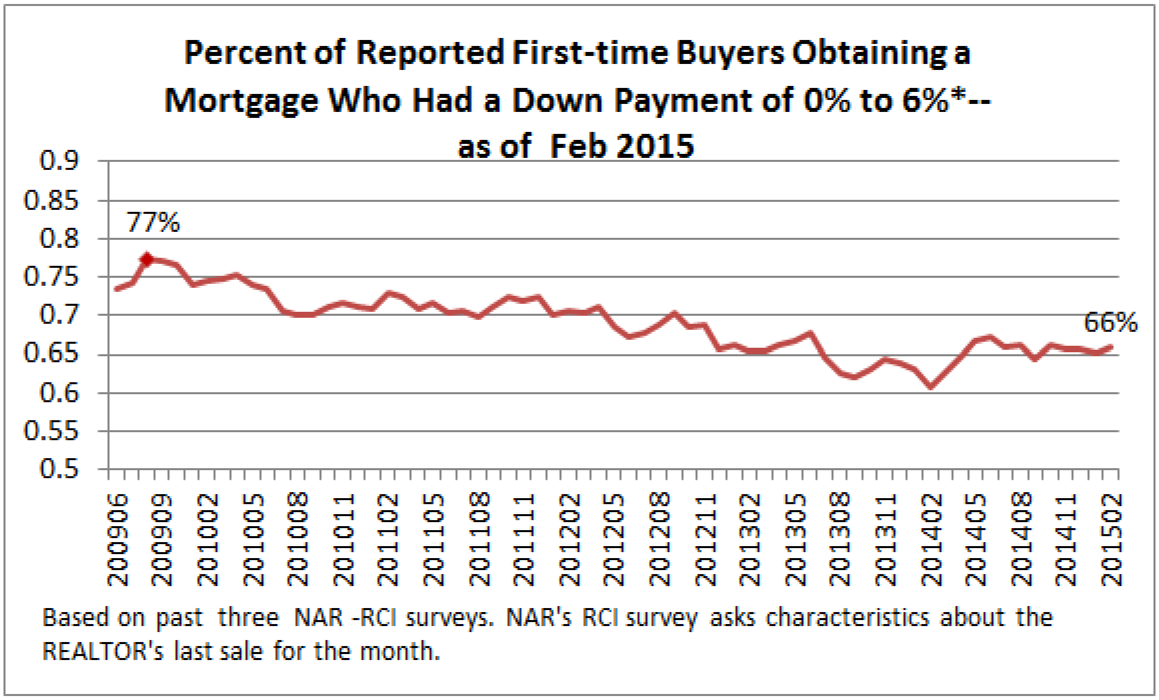
The big news is access to credit. It is suddenly very hard to get and this looks like the situation that existed at the start of the recession in 2008[2007 actually].

Mish's post and the blog post he links to have additional historical perspective. Clearly the NACM writer is not happy. But that's only one data point, and matters might reverse.

However, there are fundamental issues with the housing market that lumber primarily is used for in the U.S. For example:

2. Why are first-time home buyers nearly broke?

From economist Anthony Sanders:
2/3rds of first-time home buyers use 0-6 percent down payment mortgages.



While the trend since 2009 is improving this looks like a warning sign. It looks like bubble era housing finance has never really ended.

In a healthy recovery, first-time home buyers (primarily young folks) would have been saving like crazy. Also, in a sound housing financial ecosystem, few to no lenders would be financing these buyers. After all, it usually costs a seller more than 6% of the sales price to sell a house, so even a 6% down payment leaves no equity if the buyer quickly needs to sell.

Yet...

3. The mainstream view is that a housing boom is imminent:

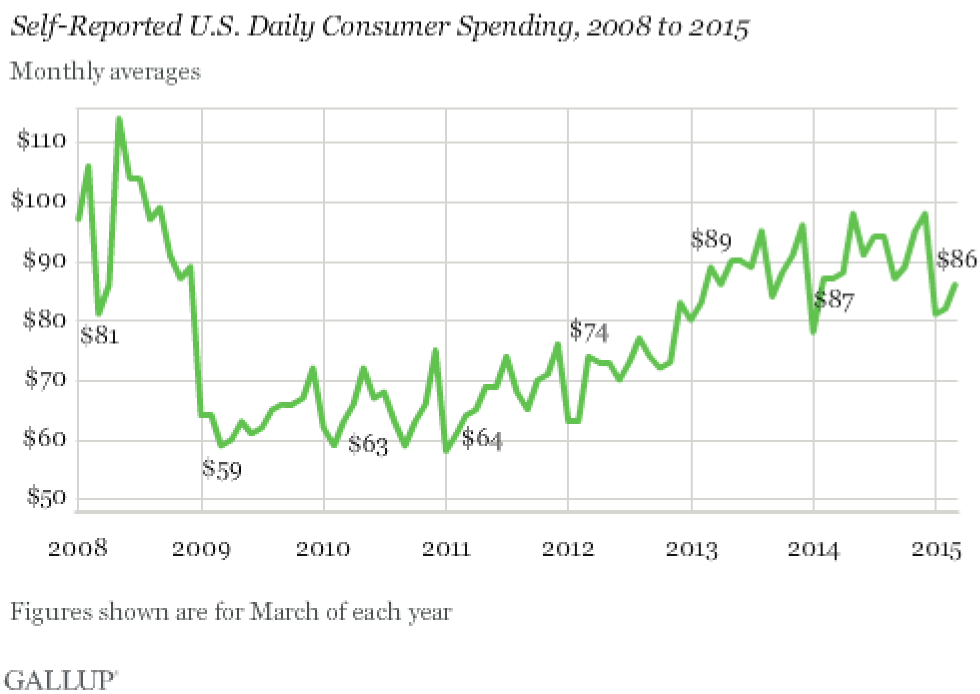
Bloomberg News reports that: Spring Fever for Homebuilders Bodes Well for U.S. Stock Market.
Well, maybe, but the article is mostly a puff piece rather than the occasional solid, investigative reporting that Bloomberg is capable of. The Royal Bank of Canada (NYSE:RY), one of the enablers of what some believe is a Canadian housing bubble, is cheerleading these pathetically weak lending standards. The key bullish argument from the article is:
The drop in the unemployment rate to 5.6 percent among 25- to 34-year-olds, from almost twice that level during the recession, along with easing credit standards and rising rental prices caused analysts at RBC Capital Markets to make a bullish call on homebuilders today.

Again, maybe. Bull fundamental trends are good, but only if they are not built on poor lending (and borrowing) practices.

An alternative explanation for the points that RBC interprets bullishly is that the drop in the unemployment rate has been exaggerated by labor force drop-outs, part-time work, and massive and financially unsound student loans. Its second point about eased lending standards is giving the thumbs up to a return to bubble era lending practices. Their third point can be turned around to say that unaffordable rentals are driving young people to, in desperation, buy unaffordable homes. Is this a good thing? In any case, this article may be an example of hope rather than sound analysis.
I took the "under" on that point because:

4. There is evidence that "the consumer" is weak.

My favorite quick and dirty data of the strength of consumption comes from Gallup. Their polling data is never revised, unlike government data that gets revised years later. Here is Gallup's March discretionary spending results:



These numbers are in nominal dollars. Adjusting for inflation indicates that compared to merely two years ago, measured spending was down from March 2013. Compared to 2008, and noting the spike in April 2008 after the weak March data, 2015 spending measured by Gallup is way down on a *per capita*basis.
The Gallup data is consistent on trend with the official data that has shown surprising weakness in national retail sales in the past few months.

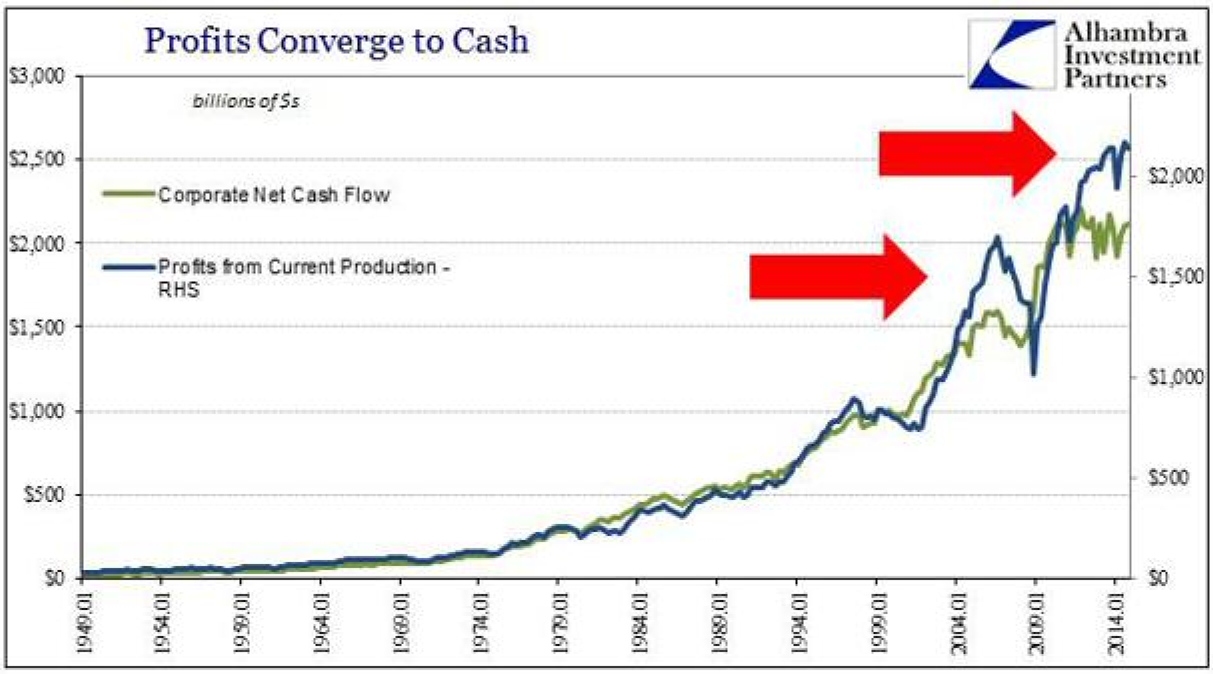
To sum up so far, data relating to individuals makes the deflationary signal sent by collapsing lumber prices plausible.

But it all could change for the better.

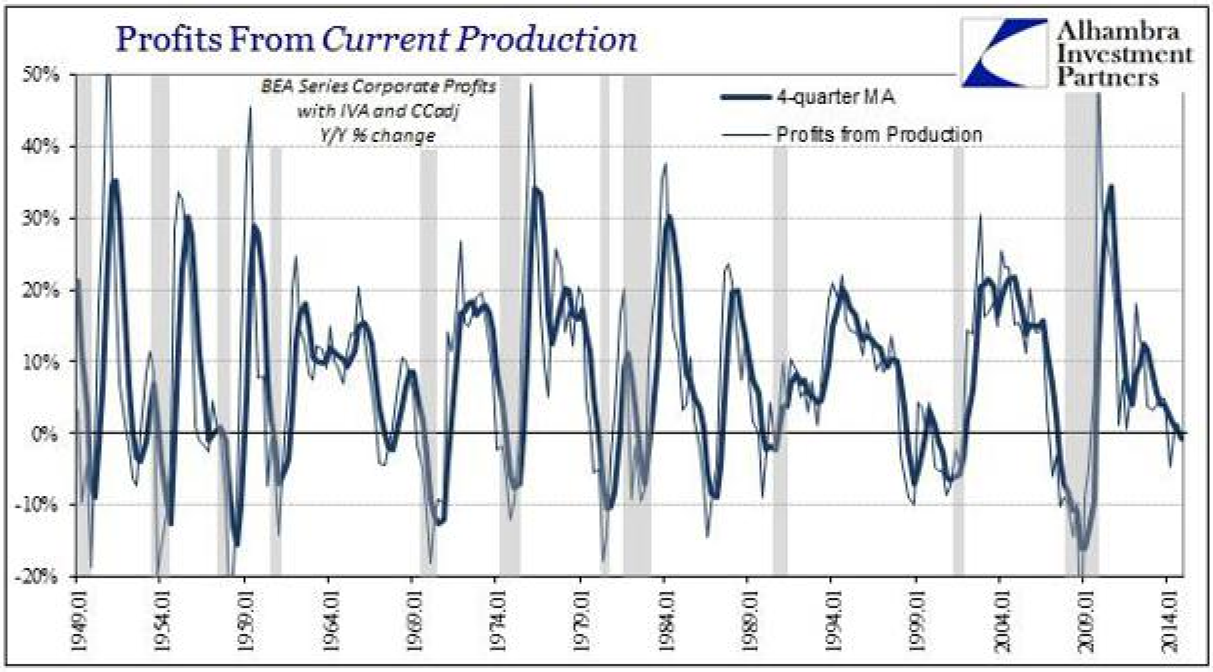
That said, there are some worrisome trends for stock market investors in the macroeconomic data relating to profits and cash flow.

5. Corporate profits versus cash flow are stagnating and are dangerously divergent

On March 27, economist Jeffrey Snider wrote an article that presented an interesting series of graphs based on government data. A summary slide shows a divergence between profits and cash flow. This is unusual. It was seen to a small extent in the late '90s and to a large extent in the run-up to the Great Recession. Now it's back:



From the same article, here is his representation of the profits trend, taking depreciation charges and inventory valuation changes into account:



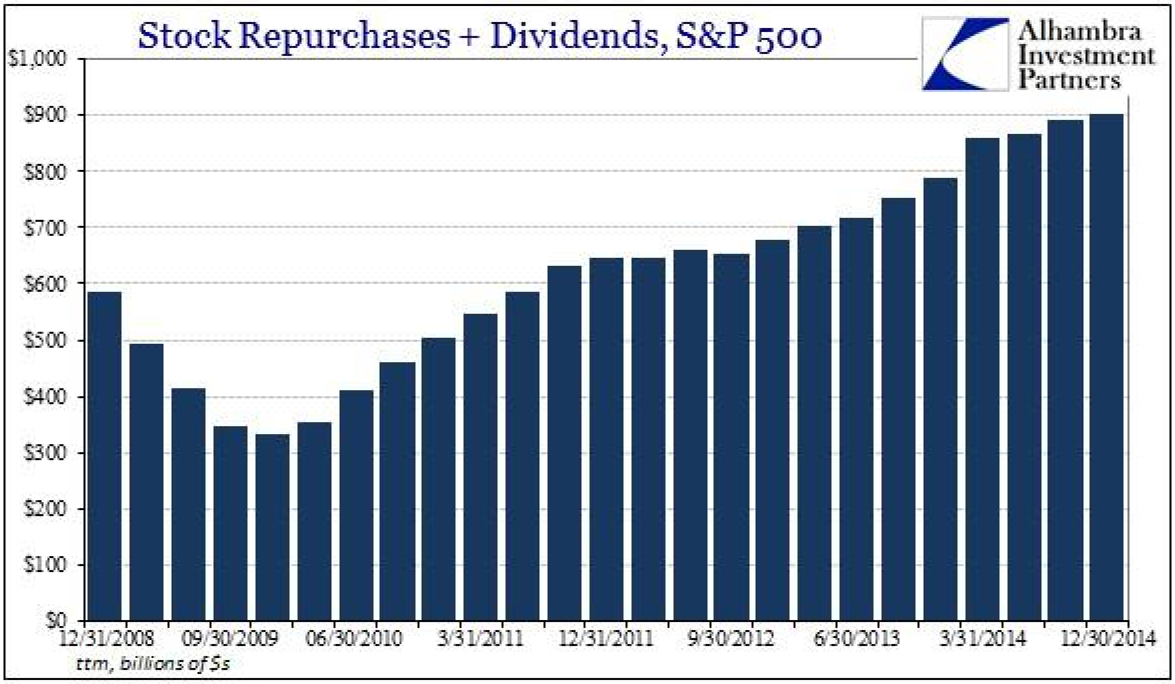
None of these two charts looks good for stock market bulls.

The ongoing weakness not only in lumber and in the price of precious metals suggests an enhanced chance of a deflationary resolution in which profits drop toward cash flow rather than cash flow rising to meet profits.

(Snider also writes about the NACM report discussed earlier.)
In addition to the profit and cash flow trends:

6. Money returned to shareholders has begun to stagnate

The same economist was out Monday with another graph I found interesting. This shows a surprising correlation of QE with money returned to shareholders:



The *y*-axis is on an arithmetic scale, not log. Thus the sharp increase in this metric since the Taper of 2013 has also tapered. This repeats the pattern that began in Q4 2011 after QE 2 ended and was not replaced by a new money printing program. Look how stagnant the total returns to shareholders were from Q4 2011 until Q1 of 2013, when the gigantic QE 3 began to pump cash into the financial system.
And now QE 3 is over. Is a correction looming, as one followed the endings of QE 1 and 2?

Investment implications of the above

The SPY is looking toppy as we head to the weakest six-month part of the year for stock prices based on many years of data:

There is a steady loss of upward momentum going back to the resumption of QE 2 near the end of 2010. Look how sharp the 2010-2011 surge was. The 2013 relentless bull move was strong but a bit weaker. In 2014, when the Taper steadily diminished the money flow into the markets, had a much weaker move up than 2013. Since QE 3 reached *de minimis* levels in the summer of last year, look how little progress has been made (via a closer look):

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QE 3 was down to very low levels by September, and since Sept. 1, only small gains in the SPY have been seen when compared to the entirety of the post-recession bull market.

More dramatically, QE 3 ended for good by Nov. 1. Look at the average level of SPY in November and December and compare it to the $209 it closed at Monday. On that basis, the SPY is down to marginal gains.

In contrast, long Treasury bonds suffered a major bear market in 2013. To my eyes, their charts are safer and more promising (which is not to say that they are safe or that interest rates are appropriate compensation for actual and potential inflation). For example, here is the five-year chart for the 10-year T-note:

It remains in its downtrend. In retrospect, it got ahead of itself during 2012, when the Fed's Operation Twist deliberately targeted the 10-30 T-bond complex. But QE 3 stimulated a risk-on economy and psychology, a correction occurred but, of critical importance, rates stayed within the downtrend that began years ago.

Not only do I like the chart of the 10-year T-note better than that of SPY, I like the continuous speculative bearishness about it expressed on the futures market, also per FINVIZ:

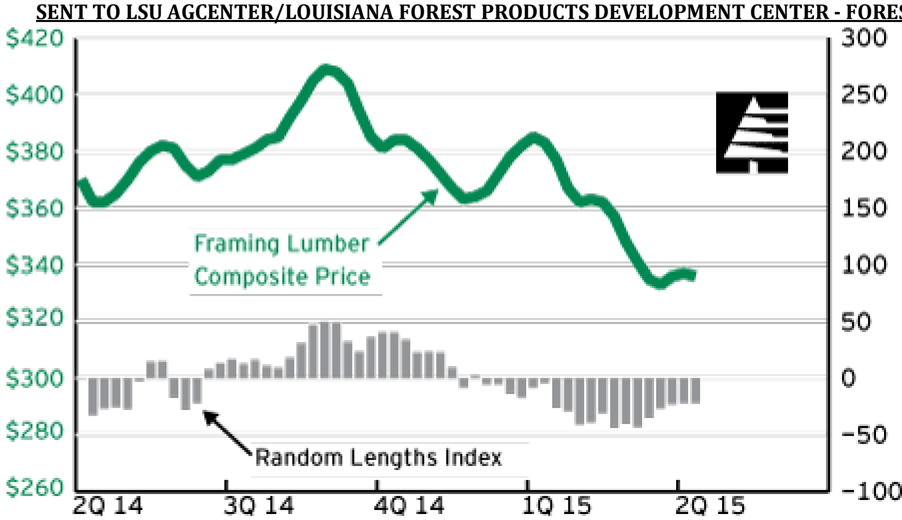
The green line at the bottom of the chart represents the sum of the large and small speculative positions. Presumably, these speculators have been counting on growth and/or inflation to force rates to finally "normalize," whatever "normal" really is these days. I'd love to be a fly on the wall when the funds (large speculators) have their meetings and evaluate why the heck they are bothering to bet against a boring government bond that eventually will pay off at par, cannot default without the world as we know it ending, and costs a good deal of money simply to bet against.

I am waiting for the shorts in the 10-year T-bond to capitulate and cover. If that happens, there are no guarantees that rates will collapse, but they *might*.

More on lumber prices

Now it's time to begin to sum up by returning to lumber prices. One of the free sources for info on these prices comes out after 4 PM every Friday. Here is a cut and paste from this past Friday's Random Lengths:
Random Lengths Lumber Market Report

Frustration and angst grew among traders of framing lumber, as the market remained in the doldrums. Oversupply was cited as the primary culprit, but demand fundamentals were also getting closer scrutiny.



This is a broader-based index than that which trades on the futures market. The price decline in RL's composite index since late in Q3 of 2014 has correlated with a decline in interest rates. This is the opposite of the decline in lumber prices seen in 1979-82 (see FuturesBuzz chart near the beginning of this article). Then, a booming economy and housing boom were throttled by rising interest rates. Despite generally moderate-high inflation in those three years, lumber prices dropped in response to rising interest (mortgage) rates. The current situation is the opposite. It is consistent with a deflationary lack of buying power.

The weakness in solid wood (lumber) is now being matched by weakness in OSB, oriented strand board, which is used mostly for structural panels and is a less expensive alternative to plywood. From the same RL issue:

Random Lengths Panel Market Report

Structural panel prices faded amid lackluster demand. The downward drift in OSB prices continued unabated, with northern markets especially sluggish. Most buyers continued to purchase hand-to-mouth, even though prices were approaching four-year lows. Moderate downward price pressure persisted in Southern Pine plywood. Buyers lacked urgency, and confined activity to sparse replenishment when inventories had run bare. After last week's strong finish, western Fir plywood traders were disappointed in the lack of follow-through this week.

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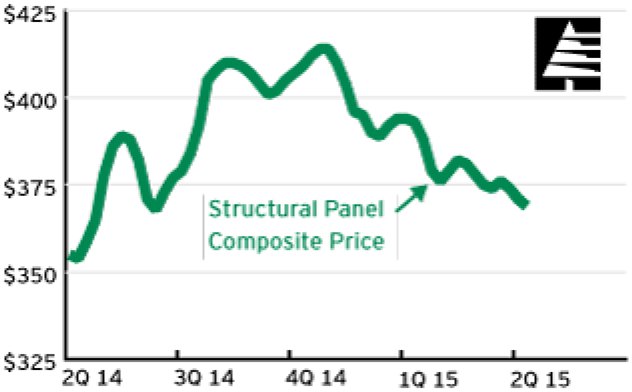
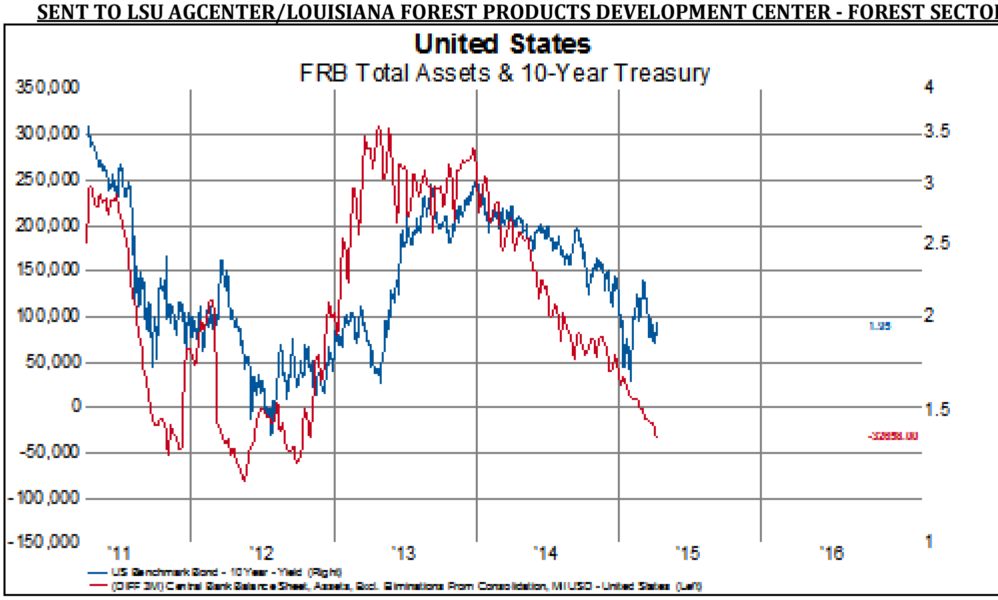


The big decline in prices the next business day (Monday), with good weather here again, suggests to me that there is something bad going on in the housing market.

Detailed thoughts on how to play these trends

Based on the above investment thesis, I want to be as far away from housing and other credit-dependent stock market sectors as possible. I am short, or own puts, on a housing ETF (NYSEARCA:ITB) as well as Lennar (NYSE:LEN). These are very small positions, however.
Since shorting stocks can very well b hazardous to your wealth, the flip side of the coin is that there is no special reason for biotech companies to lose sales just because some cyclical, credit-dependent aspects of the economy are weakening. If anything, even the onset of a mild recession would tend to simply drive even more investors into the "safe haven" of pharmaceutical stocks, of which biotech is the most dynamic. I am thus overweight in Gilead (NASDAQ:GILD) as well as the development-stage, speculative stock Portola Pharmaceuticals (NASDAQ:PTLA), plus several other "horsemen."
I also think that Apple (NASDAQ:AAPL) is reasonably far away from whatever economic weakness that might be brewing. While Apple sells premium-priced hardware, the cost is of a different order of magnitude from that of autos and at least two orders of magnitude from the cost of a house. I am heavily overweight AAPL.
All the above are with patience as the guiding attitude.

Within the bond complex, if some bad economic news occurs, then at least a temporary focus on return of capital rather than return on capital could occur. Within the safe stuff, one economic blog was out Monday with an interesting graph, namely that with the Fed on hold and even allowing its balance sheet to shrink a little, the 10-year T-note may be relatively undervalued. Here's the graph, with the entire brief post worth a look:



This correlation between changes in the Fed's asset level and the 10-year interest rate suggests that a new record low of perhaps 1.25% on the 10-year bond could be seen.

Concluding thoughts

Market timing is not for everyone. On balance, it has worked for me since I began investing in 1979. The major trend that has been in force since the 1981-2 recession has been that both stocks and bonds have taken turns leading in their own and interlinked bull markets. Right now, the trends and high frequency data I follow are leading me to favor a risk-off approach. Naturally, this includes being long Treasury bonds, such as via the iShares long bond ETF (NYSEARCA:TLT) and the shorter-duration ETF (NYSEARCA:IEF). It also, however, includes stocks of companies that are in secular bull market trends and that are largely unaffected by the ongoing weakness in commodities and any possible new credit crunch.

The Great Recession and experimental monetary policy of the Fed and most other major central banks have provided investors with new challenges, so all the above is written with great humility. As Keynes said, if the facts change, I hope to change my views with them.

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