Bridgewater®

Daily Observations

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What a Bubble Looks Like:

A bubble is about to pop when the major players begin to unrealistically extrapolate their good fortune, despite the fact that real events are turning against them. This certainly appears to be what is happening with homebuilders. Homebuilders are falling all over each other to buy real estate to build on. Many are bragging that they have 3 to 4 years worth of property locked up. This rash increase in inventory is without precedent in the sector. While the builders often have some type of deposit from homebuyers on a portion of this inventory, most of these contracts have escape clauses for the homebuyers. Projecting recent closure rates into the future is a dangerous game. The inventory build has taken away all of the record reported profits for homebuilders turning them ***cash flow negative***. When record earnings are spent acquiring record levels of inventory, there is no room for error. The following consolidated financial statements for the major homebuilders tell the story (virtually every publicly trading homebuilding company looks identical to this overall picture).

Homebuilders Income Statement & Cashflow Statement

Income Statement

	2004	*2003*
Sales	23,141	18,567
- Cost of Goods Sold	17,345	14,246
- SG&A	2,484	1,945
Operating Income Before Dep.	3,313	2,376
- Depreciation	126	119
- Interest Expense	488	376
+ Nonoperating Income	409	297
+ Special Items	-3	-23
Pretax Income	3,104	2,154
- Income Taxes	1,151	802
- Other Charges	26	13
+ Extraordinary Items	8	6
Net Income	1,935	1,344

Record net income

Cash Flow Statement

	2004	*2003*
Income before Extraordinary Items	1,912	1,349
+ Depreciation	133	123
+ Extraordinary Items	13	2
+ Deferred Taxes	20	-19
+ Equity in Net Loss (earnings)	94	-44
+ Sale of PP&E	-17	-10
+Funds from Operation (other)	90	109
- Chng in Accts Receivable	370	-328
- Chng in Inventories	2,928	1,675
+ Chng in Accts Payable	192	136
+ Chng in Accrued Taxes	69	15
+ Other	510	272
Operating Cash Flow	-283	584

But huge increase in inventories leading to negative cash flow

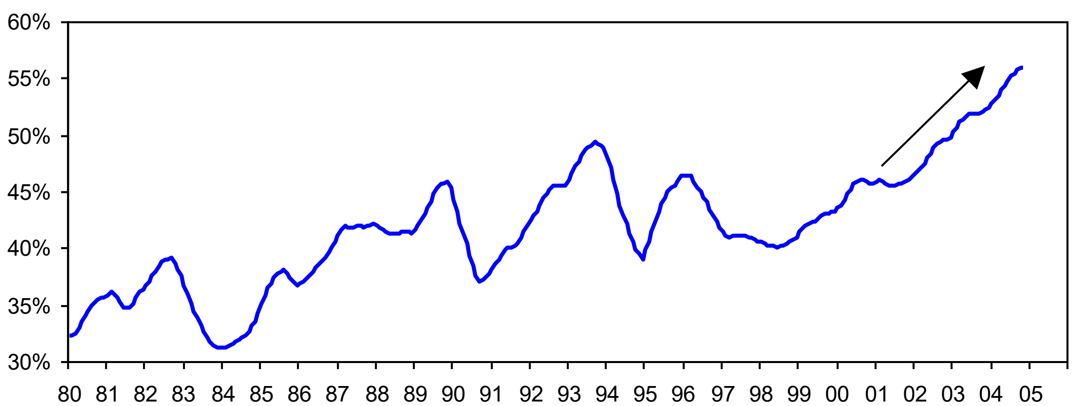
Homebuilders Balance Sheet

Balance Sheet

	2004	*2003*	
Assets			
Cash & Cash Equivalents	4,217	3,896	
Inventories	53,163	39,679	
Accounts Receivable	11,658	9,044	Massive increase in inventories
Other Current Assets	44	44	
Total Current Assets	69,083	52,663	
Property, Plant, and Equipment	1,031	1,436	
Other Assets	9,445	8,226	
Total Assets	79,559	62,324	
Liabilities			
Current Debt	4,731	3,366	
Accounts Payable	7,736	6,881	
Income Taxes Payable	349	220	
Other Current Liabilities	2,604	1,717	
Total Current Liabilities	15,420	12,184	
Long Term Debt	33,984	26,595	Massive increase in debt to
Total Liabilities	49,404	38,778	finance them
Shareholder Equity	30,155	23,546	

The following chart shows total inventory to sales ratio in the homebuilding sector. The current inventory build is without precedent.

Homebuilder Inventories/Sales



Perhaps this will all play out well for the homebuilders with current demand holding for the next few years such that this inventory build turns out to be worthwhile, but it sure looks like the end of a bubble to us.

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