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A NEW HOUSING BUBBLE?

In our March 2012 Investment Strategy Update, *Housing – the Bubble, the Collapse, the Recovery?*, we assessed the U.S. housing market, concluding that we had seen the bottom and were likely to witness a reasonable recovery. Today, most people would acknowledge that the recovery in home prices has been more than reasonable. In fact, some fear that we're in another bubble. Have home prices once again gone out of bounds? Are long-term demographic trends and the strength of the financial system consistent with a strong contribution by this sector to economic growth? Our conclusion is positive, and therefore continued investment in this area is warranted.

The Strong Recovery

Median U.S. existing-home prices rebounded 58% between the low in February of 2012 and this past July. Early in the recovery, both potential homeowners with a chunk of cash in hand and well-capitalized investors (including foreign buyers) had the opportunity to snap up perfectly good real estate at extremely attractive prices. Foreclosures are down to under 1.1 million compared to the 2010 peak of nearly 2.9 million. Short sales and foreclosure sales (which bring in far less than non-distressed sales) were once more than 19% of all transactions but are now far lower.

If the easy money has been made for investors, then the onus is on traditional buyers to keep housing prices moving upward. The obvious reason for the concern that we have re-entered a bubble is that the national existing-home median sales price is actually higher than the 2006 peak. But affordability isn't just about price, it's about the ratio of payments to income. National median household income is close to the prior peak, yet interest rates are far lower. In the boom years of 2002-2006, rates on a typical 30-year mortgage were in the 5.8-6.5% range, whereas they are well below 4% currently. By that standard, we don't appear to be in a bubble, not even in the San Francisco Bay Area.

The Demand Side

Besides low interest rates, what would enable the bull case for housing? In large part, it hinges on the favorable demographic profile of our country. There are different ways to define the various cohorts, but the simplest may be to point out that over an eighteen-year span, starting in 1946, approximately 72 million Baby Boomers were born. The next span saw the birth of only 62 million Gen-Xers. Then along came the so-called Millennials, nearly 70 million of which were born between 1982 and 1999. The current as-yet-unnamed generation is on track to surpass 73 million births. This is good news for all of us, in light of the big deal that has been made about the negative impact of the retirement of the Baby Boom generation on housing, the stock market, health care costs, etc.

Regarding the Millennials, about half are now in their 20s and early-30s, and therefore in the prime years for establishing households. Looking forward, the middle of the Millennial generation should hit their mid-30s to early-40s – the typical peak of home ownership attainment – between 2025 and 2035. While a lot has been said about this generation's employability, sense of entitlement, and tendency to live in their parents' basements, we believe they are not inherently different from prior generations. A recent *Consumer Reports* survey found that while only 26% own a home now, 71% wish to. One big problem is that so many of them entered the job market loaded with student debt during the Great Recession and the not-so-great recovery. That makes it hard to accumulate a down payment, particularly with house prices rising.

That's not to say there isn't ongoing demand for housing. The current ownership rate of 63% isn't that low by historical standards. For the first half of the 20th century, home ownership rates were below 50%. It wasn't until easy securitization joined up with government policies which effectively compelled lending to weaker borrowers that the ownership rate peaked at 69% in 2004. While the ensuing crash wreaked havoc with both the financial system and consumer credit, a lot of repair work has been done. Mortgage debt is once again increasing, but it is still down more than $800 billion from the peak in 2008. Mortgage delinquency rates have also fallen to the lowest level since 2006, and those 30 days overdue are at the lowest level since 1979. The level of long-term delinquencies tells us that there are still some folks really struggling out there, and with more than 13% of homeowners still underwater (a level more than twice what's considered normal) that's not surprising. But for the most part, borrowers are in good enough shape to stay current on their loans.

For those who wish to get into the market at this stage, there are opportunities to borrow. The Senior Loan Officer Survey shows that lending standards have been loosening steadily for two to three years. Fannie Mae and Freddie Mac will approve mortgages now with 3% down. These deals require mortgage insurance, but if the down payment is the hurdle rather than the monthly payment, that's a pretty generous offer. Finally, for many consumers who went through short sales or bankruptcy, the impact of those events on credit scores has been dissipating for years. So, many potential borrowers who were blocked from the market a few years ago may once more be eligible. Even if homeownership rates were to decline more over time, overall demand for housing will increase; it will simply shift toward the rental/multifamily market. After all, our growing population needs to live somewhere. If the Urban Institute's projections are correct, there will be a need for 19 million more occupied housing units by 2030, two-thirds of which will be rented.

The Supply Side

Assuming demand comes through, will there be supply? Low inventory appears to be an issue in some locales and there hasn't exactly been a building boom lately. There are barely four months of supply of houses right now, versus a normal level of six months, and a number of other statistics imply that there is a real need for housing investment. First, the housing stock is old. The median owner-occupied house is 37 years old, compared with 27 in the mid-1990s, and hundreds of thousands of units are lost each year due to disasters or just dilapidation. Second, residential fixed investment is only 3.6% of GDP, compared with approximately 5% in the 1980s and 90s, when the middle of the Boomer generation entered their 30s and 40s. Third, after six years of recovery, housing starts are still low by historical standards, as seen in this chart from the U.S. Bureau of the Census.

Average annual housing starts per decade have been consistently in the 1.4 million range since the 1950s. The exception was the 1970s, when it was meaningfully higher. We are now at 1.16 million, coming up from a low in 2009 that was lower than any point since 1945, when our population was less than half the size and the country as a whole had other things on its mind. Assuming 19 million new occupied housing units by 2030 and annual losses of 250,000 units implies the need for 1.7 million housing starts per year for the next 13 years. Now *that* would provide an economic boost.

One last word: Is the financial system underlying the housing market safe? *The Economist* recently noted with alarm that nearly half of U.S. mortgage debt is owned or guaranteed by five severely undercapitalized government agencies. We take a different view. Fannie Mae and Freddie Mac are majority-owned by the government, and therefore have an explicit guarantee. While lending at 3% down is a little too reminiscent of the aggressive practices of the 2000s, we believe lending standards are also remarkably improved. Anyone who has purchased or refinanced recently knows that documentation requirements don't allow for any more "liar loans." If you can get a loan now, you're very likely to remain current on payments as long as economic growth remains at least stable. And we believe that is the highest probability scenario.

Investment Implications

When investing in the housing theme we are more concerned with household formation than with who owns a particular property. Our basic thesis is that there is a clear need for more of both single-family and multifamily housing. Ownership of land is one obvious way of increasing wealth in the context of a growing population. Since they're not making any more of it, owning Real Estate Investment Trusts ("REITs") that in turn own buildable land is of interest to us. If that land happens to be covered with trees that could be converted into lumber for building, all the better.

Currently, the majority of households live in a home they own. Even if it's not one's dream house – or perhaps especially if that's the case – expansion and remodeling projects can get it a little bit closer to that status. Home improvement retailers have been the strongest part of the retail space for some time, having the benefit of being less likely to lose sales to Amazon.com. Housing turnover is good for these businesses, as sellers need houses to show well and buyers want to put their own stamp on them. On the other hand, aging Baby Boomers who want to stay put could drive a meaningful remodeling of the housing stock over time to make it more senior-friendly.

For all those Millennials who haven't yet established their own household, an affordable apartment is likely the first step. While single-family housing starts are still very low, multifamily starts are near the peak of the prior cycle. For an apartment REIT, there is of course a balancing act between supply and demand, but we suspect that if enough supply came on line such that rents were viewed as reasonable, new renters would appear. If you build it, they will come.

Finally, at the other end of the demographic spectrum, there will be ever more people that, despite their wishes, will not find it practical to stay in their own homes. Multiple health care REITs offer meaningful exposure to senior housing situations of all kinds.

Market Update

Equity markets have continued their gradual upward climb this quarter partly in response to ongoing growth in employment and consumer spending, along with continued support from Federal Reserve Bank rate policies. While volatility was rather subdued over the summer months, there was a measurable shift in market leadership away from the defensive sectors in favor of cyclicals, despite lackluster capital spending and trade data. Uncertainty remains elevated due to both the possibility of the Fed raising interest rates this year and our upcoming elections. We could see increased stock market volatility as we approach these events, but still view the intermediate term as modestly positive for stocks.

It remains to be seen if the decisions by the Fed and other central banks to maintain low rates will be sufficient to lift sluggish global growth without additional fiscal stimulus. At its most recent meeting in September, the Fed's Open Market Committee voted to hold rates steady but indicated a greater willingness to hike rates in December. However, with inflation running below its target and tepid economic growth, it continues to watch and wait. Given the current rate environment, we prefer short- to intermediate-term bonds for client portfolios.

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