Bottoming Housing Market Supports Growth

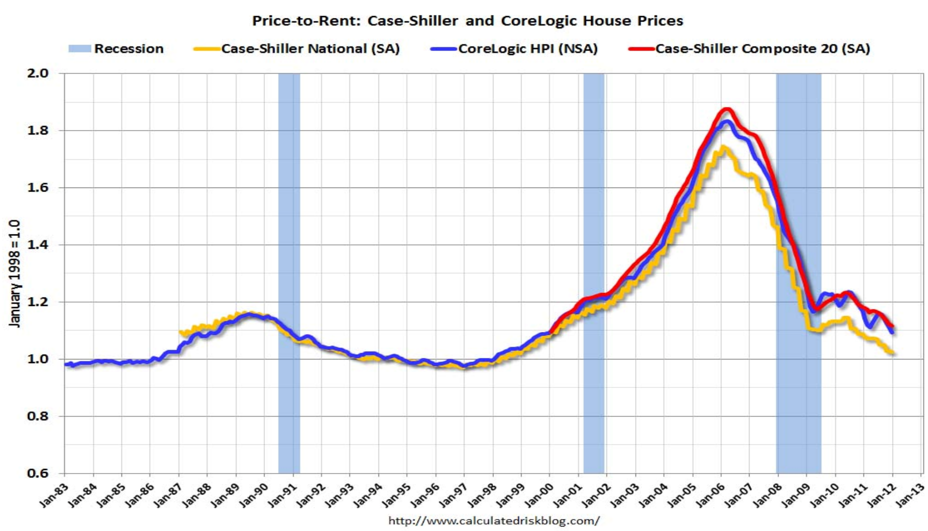
From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

- **Housing activity is slowly bottoming and contributing to economic growth for the first time in years.** The overhang of housing and mortgage debt has been one of the biggest factors impeding the US economic recovery since the 2008/2009 'great' recession. We believe a bottoming process has begun, as evidenced by a significant drop in new and existing home inventories and a pick-up in the building of rental units. Home prices are likely to remain under pressure in markets where there is little turnover and prices have not fallen enough to attract first-time buyers and/or investors, but prices are fundamentally supported by rising household income and (for investors) current rental levels in the nation as a whole. The chart below from *Calculated Risk* shows three measures of house prices divided by current rents. The result is a price/rent ratio, (similar to a price/earnings ratio for stocks). For comparative purposes, the data are indexed to 1 in 1998. This measure of value is back to pre-boom levels, following house prices' boom (2003-2006) and bust, and the steady growth in rents, as the chart illustrates.

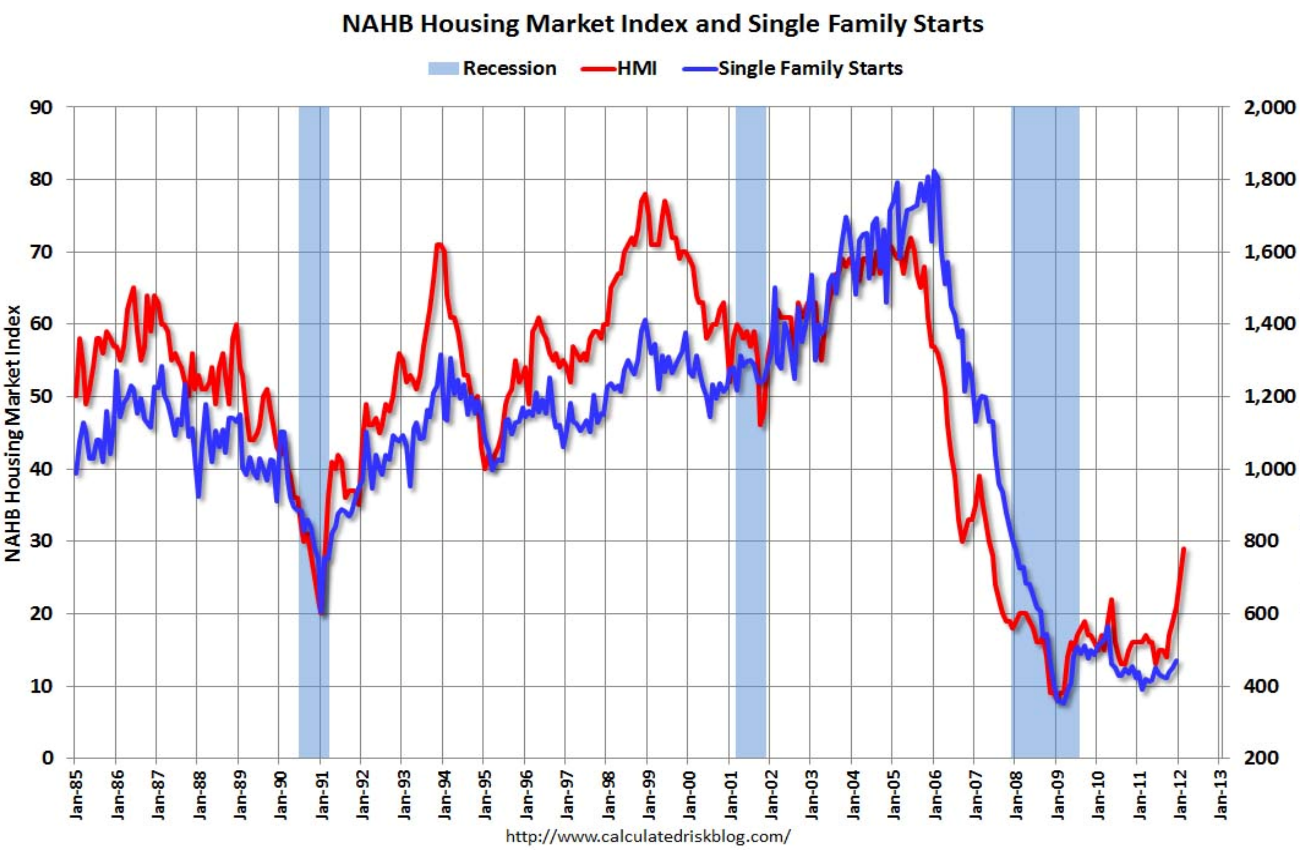


- Residential investment subtracted a significant 3.4 percentage points from GDP from 2006 to 2011 but has added marginally to growth in the last three quarters of 2012. From a portfolio perspective, we focus on housing because of the risk and opportunities it creates for growth, and for the central role it plays in Federal Reserve decision making. We conclude that ongoing foreclosures will continue to put downward pressure on house prices, but that valuation levels will contain the downside and eventually lead to stabilization and even price gains in regions with healthy economic growth. Furthermore, because housing's overall impact is likely to be neutral to positive for the economy in terms of containing inflation, we see the bottoming process as supportive for stocks.

- Rising rents are encouraging the build-out of multi-family properties, which are leading private residential construction higher. Low single-family home prices, for buyers with access to credit, are allowing stabilization and a small rise off a very low base for new home constuction, as seen in our Weekly Chart (darker line). Consequently, private residential construction spending has turned positive for the first time since 2006 (except for a brief period in 2010 due to the one-time home buyer tax credit). Lest we have painted an overly rosy picture, the biggest negative afflicting the housing market is high levels of 'negative equity' – investors who owe more than the value of their property – as it typically leads to delinquencies and foreclosures. Currently, $2.8 trillion in mortgages is borrowed against 11.1 million underwater properties, according to CoreLogic. Moreover, of those underwater properties: *"4.4 million upside-down borrowers had both first and second liens. Their average mortgage balance was $306,000 and they were upside down by an average of $84,000 or a combined LTV [loan to value] of 138 percent."*

- **Implications for markets:** The housing industry is no longer a drag on economic growth and will provide a small boost in 2012, in our view, but with the default prospects remaining daunting, we think the Fed will keep short-term interest rates close to zero through 2014. With the Fed supporting higher prices for stocks and the S&P 500's primary trend stable, only elevated short-term crowd optimism causes us to look for pullbacks in our favorite asset classes – emerging markets, quality global franchises, and US companies that stand to benefit from a recovering US economy. Specifically we have increased our exposure to US banks rather than homebuilders as bank share prices have not yet reflected the potential for a better housing environment.

THE WEEKLY CHART: AFFORDABILITY SPURS BUILDING AND CONFIDENCE



Incomes are rising and mortgage rates are near record lows, thanks to government support. In combination with the fall in home prices, affordability has never been higher. Add in a continued rise in household formation and job growth (falling unemployment) and you have a recipe for increasing home demand that is spurring construction and sales activity. As seen in the chart above from Calculated Risk, the National Association of Home Builders (NAHB) Housing Market Index — a measure of builder confidence — has shot up in recent months, which bodes well for future housing activity., in our view.