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CAPITAL INSIGHTS

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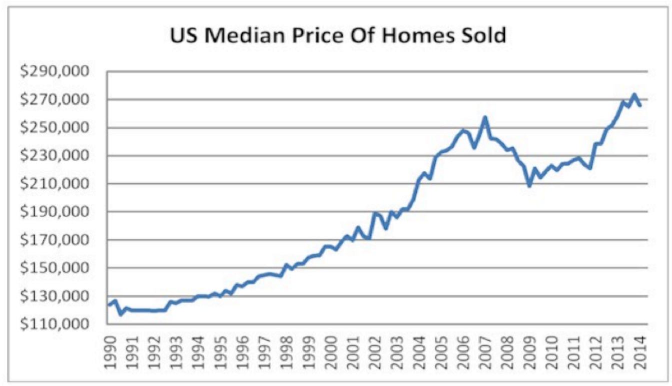
The Housing Cycle Of A Generation

When looking at residential real estate, we often tend to focus almost solely on price movements in assessing the health of the housing market at any point in time. The fact is that housing cycles have for decades been an integral part of total US economic growth on many levels. Housing construction has been meaningfully additive to overall US GDP in virtually every economic expansion cycle on record. Moreover, sales of home furnishings, appliances, landscaping and gardening equipment, etc. have contributed to expansion in consumer spending, the largest singular component of US GDP. And maybe most importantly, residential real estate investment has been a key wealth generation asset for the middle and lower classes for decades. Residential housing has typically been purchased with leverage that has been paid down over time accompanied by a commensurate increase in household equity as homeowners age and mortgages are paid off. Particularly for the middle and lower classes, residential real estate investment has been the single largest contributor to net worth expansion of any household investment asset class.

In the clarity of hindsight we know that the prior 2006-2009 period witnessed the most serious downturn in residential real estate prices in a generation. Few saw it coming as it was an event never experienced in their lifetimes. One would have to travel back to the 1930's Depression period to find a similar occurrence. There is an old saying in the markets – people do not repeat the mistakes of their parents, they repeat the mistakes of their grandparents. And this was certainly true in residential real estate markets in the middle of the prior decade as the buildup of excess and often reckless leverage was ultimately the key provocateur leading to price declines, as was the case in the 1930's.

Accompanying the current economic expansion that began in June of 2009, residential real estate prices have recovered. Depending on specific geographic area, such as many parts of the San Francisco Bay Area, current prices have exceeded the prior cycle peaks of 2006. The following chart using data from the US Census Bureau shows us that the median price of a single family home actually sold in the US has recovered just above the prior cycle peak. Remember, this incorporates meaningful and often anomalistic sales activity in very high priced areas such as New York and San Francisco, skewing the median numbers higher.



Data Source: US Census Bureau

In one sense, the recovery in price is at least graphically pleasing and simplistically suggests a return to longer term normalcy, or trend, in the overall residential real estate market. But as we look a bit deeper beyond just price into the important components of housing activity as they relate to the real economy (GDP) and household balance sheets, we see something very different. As the prior cycle downturn was a once in a generation event, so too is the character of the current housing recovery. The anomaly of the current recovery has implications for both the real economy and investment activity ahead. Let's look at some important data.

The contribution of housing to US economic growth is found in new home sales and housing starts. Demand for new homes drives demand for building materials and construction work, both important in prior cycles in driving job growth, the bedrock foundation for consumer spending. Again, if one only looked at residential real estate price trends, one would assume a very normal recovery. But the data below show us that actual new home sales and housing starts currently rest very near half century lows. How can this be? What we see at present with new home sales and construction starts is what we saw at the depths of every US recession of the last 50 years. These data points suggest that the current is anything but a normal housing recovery. The numbers are current through April of this year.

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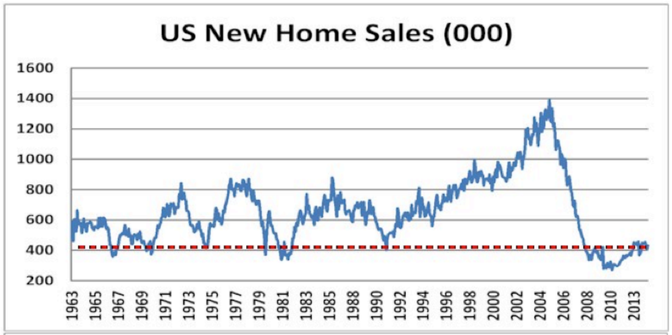
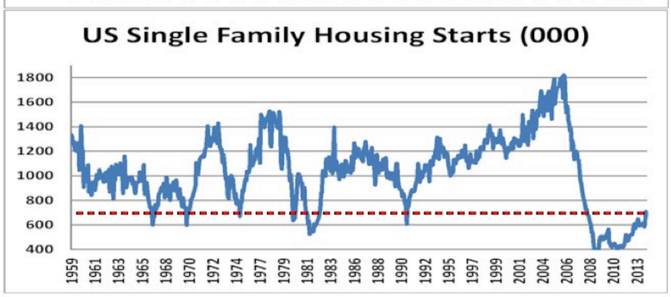
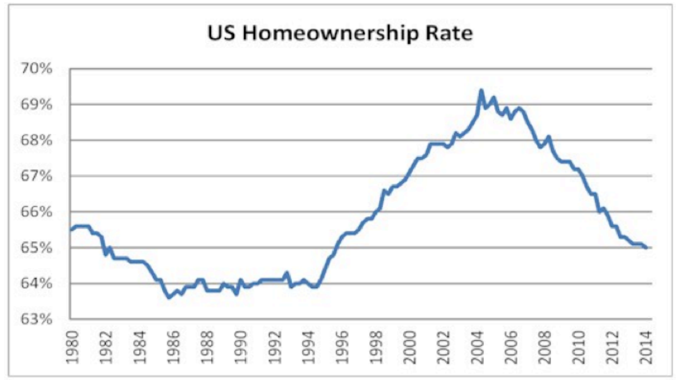
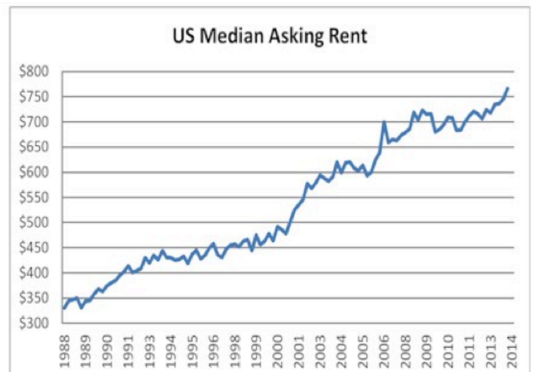




Data Source: US Census Bureau





Data Source: US Census Bureau

Accompanying the dearth of new home sales and starts is the fact that the number of new mortgage purchase applications currently rests near the lows seen since 2009. Just how can prices be ascending so spectacularly when new home sales are in prior recession territory, new housing starts have not recovered, and the number of new mortgage purchase applications has not climbed from the depths seen in 2009-2010?

Accompanying these trends is the fact that the US homeownership rate post the peak seen in 2004 has fallen to a near 19 year low. The message is that although total household formation has marched forward, households are increasingly choosing to rent their primary residence as opposed to own residential real estate. Of course this is the reason that median rents in the US, seen in the bottom clip of the next chart, have incrementally marched to new all-time highs.

How do we make sense of the current residential housing cycle, whose apparent recovery looks nothing like the character of real estate cycles seen in a generation at least? And what are the implications for the broader economy and household consumers specifically as we look ahead?

We believe the key macro in the current cycle is that we are not witnessing a "normal" residential real estate recovery at all, but rather an investment cycle driven by actions of central bankers (think the Fed), global flows of capital, and a new entrant to the residential real estate market that are institutional investors. First, we are currently seeing something in residential real estate markets that has not occurred in our lifetimes – the magnitude of all cash offers. 40-50% of residential real estate purchases have been for cash in recent years. This phenomenon has no precedent in recent economic history. Why is this happening? We need to remember that a primary goal of the Federal Reserve in setting short

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term interest rates near zero was to induce investors to buy "risk assets" – think real estate and common stocks. By eliminating rate of return in safe securities such as Treasury bonds, CD's, etc., the Fed essentially forced formerly conservative investors to purchase higher risk assets in order to get any acceptable rate of return. In good part, the all cash offers are coming from investors buying to rent, intent on obtaining an acceptable cash on cash rate of return as yield can no longer be found in safer investments.

The second source of investment capital coming to US residential real estate markets is foreign capital. The crackdown on corruption in China has witnessed the equivalent of literally trillions of investment dollars leave the country over the last few years, in search of global safe haven investments. We have seen a portion of this capital find its way into both commercial and residential real estate in the US, again, usually all cash offers. This capital is not necessarily driven by investment attraction, but rather the desire to avoid home country confiscation. In Japan, investors and households have witnessed a 25% decline in the value of the Yen relative to global currencies over the last year and one half. For a Yen based investor, this equates to a 25% loss of global purchasing power. Currency debasement is driving Yen based capital into US real estate. Implicitly a foreign purchase of US real estate is a purchase of the US dollar. Global capital wishing to avoid currency debasement is in part finding a home in US real estate. We especially see this in high-end New York and West Coast real estate. We also see this in foreign markets such as London.

Finally, the plunge in residential real estate prices over the 2006-2009 period attracted institutional capital. Private equity firms such as Blackstone in the US were not major investors in US residential real estate until the current cycle. Over the last four years they have now amassed ownership in over 40,000 residential properties and become one of the country's largest residential "landlords." In the last two years alone, Bloomberg estimates institutional investors have purchased over 200,000 properties. Of current note is that we are seeing recent institutional investment activity in the residential market start to cool as price increases have now diminished implied rental rates of return.

Is the apparently anomalistic residential real estate cycle of the present starting to make sense now? The cycle is not being driven by younger families getting better paying jobs, taking on mortgages, buying new and existing homes and allowing trade up buyers to do the same. The current is an investment cycle as opposed to one rooted and driven by traditional broad economic expansion. This is very important as what is driving price are the dynamics of investment demand, not tone and rhythm of the real economy, very much unlike prior economic cycles. As that very character of demand changes, so will price. As mentioned above, institutional demand has already peaked for the current cycle.

Looking ahead, we need to watch the level of interest rates. As alternative investments offer marginally higher returns, especially what have been traditionally deemed safe securities, this will have an impact on residential real estate demand and price. Likewise, the weight and movement of global capital is a key dynamic to monitor. For now, global capital is coming to the US driven by fear – fear of potential confiscation and currency debasement. As those dynamics also change over time, so too will the weight and magnitude of global capital flows currently supporting US residential real estate prices.

Finally, what are the implications of the current real estate cycle for US households? One major benefit has been the ability of creditworthy households to refinance existing mortgage debt at once in a lifetime lows. But roughly 20% of current US homeowners have not yet been able to refinance due to housing values at or below current mortgage levels, a legacy of the prior cycle. Below is a table taken from the quarterly Federal Reserve Flow of Funds report. The Fed chronicles household balance sheet values in this report. In terms of real estate, the Fed is only looking at "owner occupied housing" and not housing held as investments. You can see that the increase in household real estate values

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since the lows of year end 2008 simply pale in comparison to the increase in household equity values and financial assets as a whole.

Household Asset Class	4Q 2008 Value (trillions)	4Q 2013 Value (Trillions)	% Change
Real Estate	$18.3	$19.4	6.0%
Equities	5.5	13.9	152.7
Total Financial Assets	40.8	67.0	64.2

Data Source: US Federal Reserve

In terms of what this implies for the US economy and perhaps US consumer spending, we need to remember that again real estate by far makes up the bulk of middle and lower class net worth. It is the top 15% of the wealth demographic in the US that owns the vast majority of common stocks. What these numbers tell is us that investors have largely enjoyed the benefits of the real estate price recovery, but not necessarily US households in aggregate.

Neither good nor bad, as investors we always need to look for the reality behind the headlines, in this case residential price only data. Residential real estate has been very important to the tone and rhythm of the real US economy over time as well as the dynamics of consumer spending. Importantly, in prior cycles increases in housing activity have driven jobs and increases in housing "wealth" have helped drive consumption. Those two dynamics are now dissimilar in the current cycle. As such, we need to incorporate these important differences into investment thinking and actions as we navigate the current financial market and economic cycle. In many senses, the current is a housing cycle unseen in our generation. ■

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