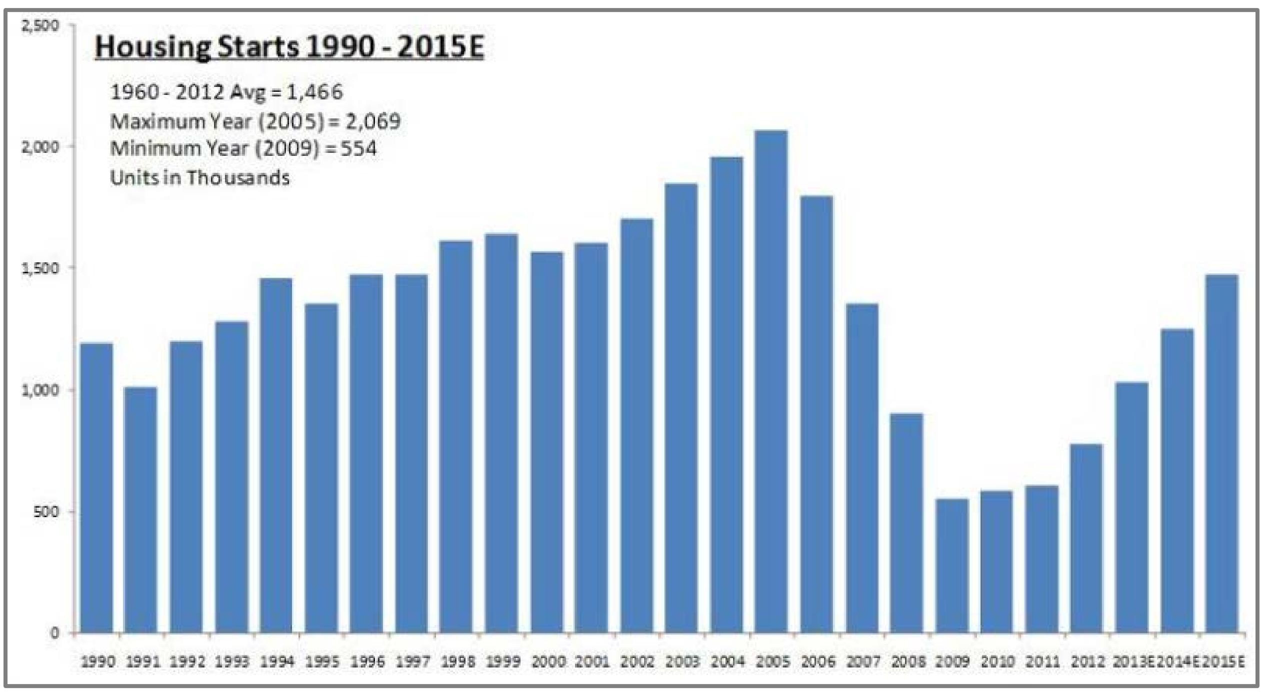
Implications of the Housing Rebound

The U.S. housing recovery is likely to be a bright spot for the economy over the next 2-3 years. Low inventory levels, increasing prices, declining foreclosures, and improving credit conditions all signal that the housing rebound should continue. The housing market peaked in 2005 at a level significantly above long-term demand as virtually anyone with a pulse seemed able to secure a mortgage with no money down. This overbuilding caused the worst housing downturn since the Great Depression. Housing starts dropped all the way down to 554,000 in 2009, which was substantially below long-term demand levels of 1.5 million starts per year. Prior to this downturn, the worst year for housing starts in the last 50 years was over 1 million units, which coincidentally is the same level we expect to achieve in 2013. So while housing starts have turned up in 2012 and 2013 they still remain very depressed and further improvement will likely benefit the economy for the next few years.



Source: Census Bureau, Zelman & Associates

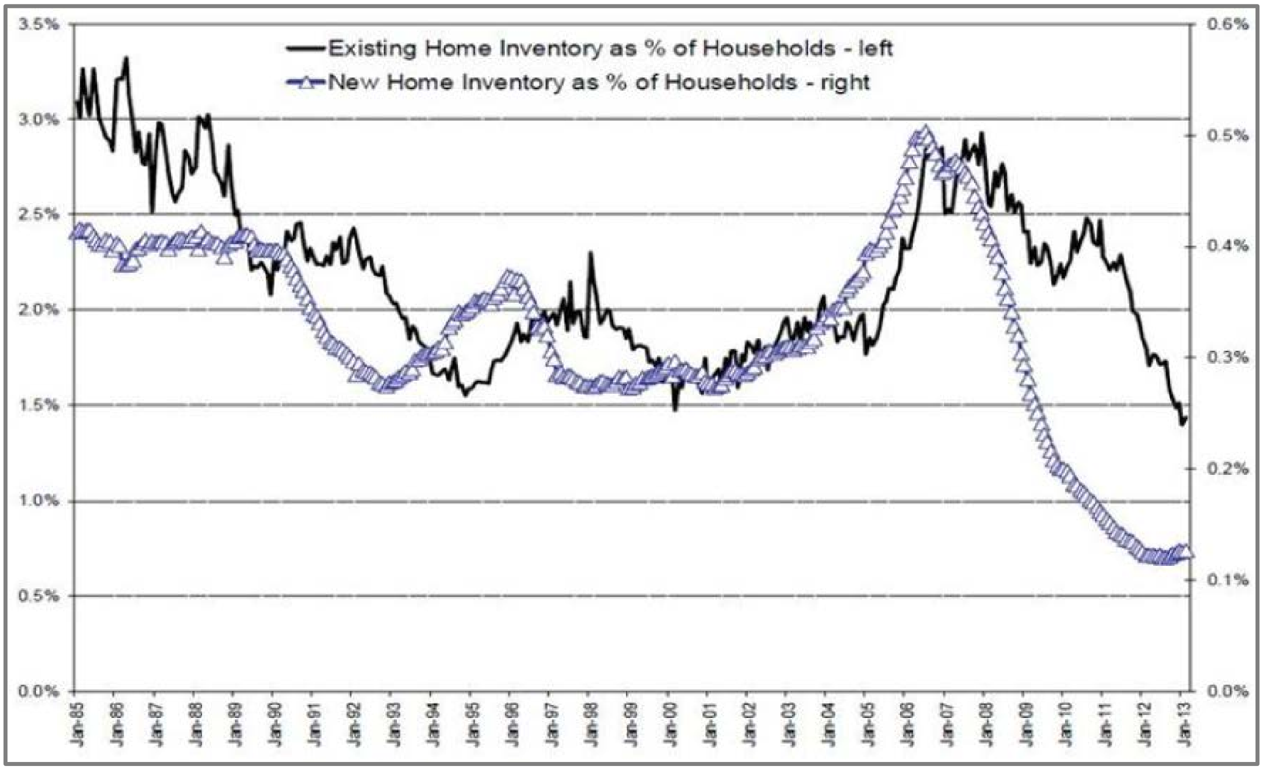
How much would a rebound in housing help the economy?

In terms of Gross Domestic Product (GDP), residential construction accounted for 2.4% of economic output in 2012. The historical average range since 1990 was more in the 4.0%-4.5% of GDP and that excludes the housing bubble which peaked at 6.1% of GDP in 2005. So in terms of GDP, we expect a tailwind of approximately 0.5% per year from 2013-2015. If we look at jobs, the National Association of Homebuilders estimates that each single family housing start produces 3 jobs. This estimate includes direct construction jobs as well as other housing related jobs such as realtors, mortgage brokers, home inspectors, and security system installers. We estimate that the housing recovery could add roughly 500,000 jobs per year from 2013-2015 if we return to the 1.5 million housing starts per year that we expect.

The recovery in housing will also have additional benefits. The increase in housing prices improves consumer net worth, confidence, and reduces foreclosures. Home equity is the largest asset for most Americans and as home prices increase consumers feel wealthier and spend more. According to Case-Shiller, home prices rose 10.2% year over year in March 2013, which was the biggest increase since the hosing bubble burst in 2005.

Source: S&P / Case Shiller

We expect home prices will continue to rise since inventories of both new and existing homes are near 30 year lows. Add in rising demand from low interest rates and we have a recipe for further price gains.



Source: Zelman & Associates, Census Bureau, NAR

How much is the Federal Reserve supporting the housing recovery?

The housing sector has been and continues to be one of the biggest beneficiaries of the Federal Reserve's aggressive policies. In addition to maintaining a target fed funds interest rate of 0%-0.25% (the rate that sets all other short-term interest rates), the Federal Reserve is also purchasing $40 billion per month of mortgage backed securities and $45 billion per month in longer dated treasury securities. These purchase programs reduce long-term interest rates, which also lowers the interest to make a home purchase or to refinance. The current average 30-year mortgage rate of 3.88% is among the lowest rates on record. This makes monthly housing payments much more affordable and increases demand. According to the National Association of Realtors, U.S. housing affordability is at an all-time high. We expect the Federal Reserve to remain extremely accommodative through at least late 2013. In addition, we would still expect housing starts to return to nearly 1.5 million starts over the next few years as long as 30-year mortgage rates remain below 6%.

Source: ISI, NAR

What investments benefit from the housing rebound?

The housing recovery is boosting the prospects for numerous industries and asset classes. The most direct exposure includes the homebuilders, building product companies, and home improvement retailers. Next, financial companies with exposure to mortgages or mortgage backed securities benefit as delinquencies and foreclosures decrease. High foreclosure levels have been a major burden for many banks and rising home prices would greatly reduce this cost. Lastly, companies that own mortgage backed debt and other mortgage related securities such as collateralized debt obligations, should benefit as well.