MAI VIEW

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Not the Same River

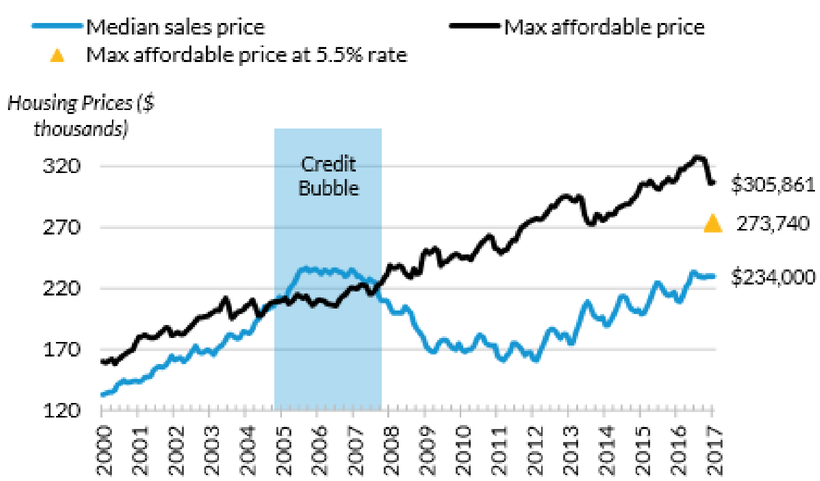
We have been negative on US housing for about a year and have expressed it through a hypothetical homebuilder short position in the MAI Tactical model portfolio. The position has worked against us by about 18 percent since January 2016, with most of the damage occurring last year. We remain resolute, believing homebuilder shares will fall. Our negative outlook is based on our view that a healthy *housing finance* sector – which likely has led to optimistic homebuilder equity valuations – is not enough to overcome a new and different set of macro dynamics.

To be sure, new home sales rose 5 percent in March, an eight month high. Optimism surrounding the housing sector generally and homebuilders in particular centers on affordability. The illustration and explanation below show that home prices are currently very affordable by historical standards.

National Housing Affordability Over Time

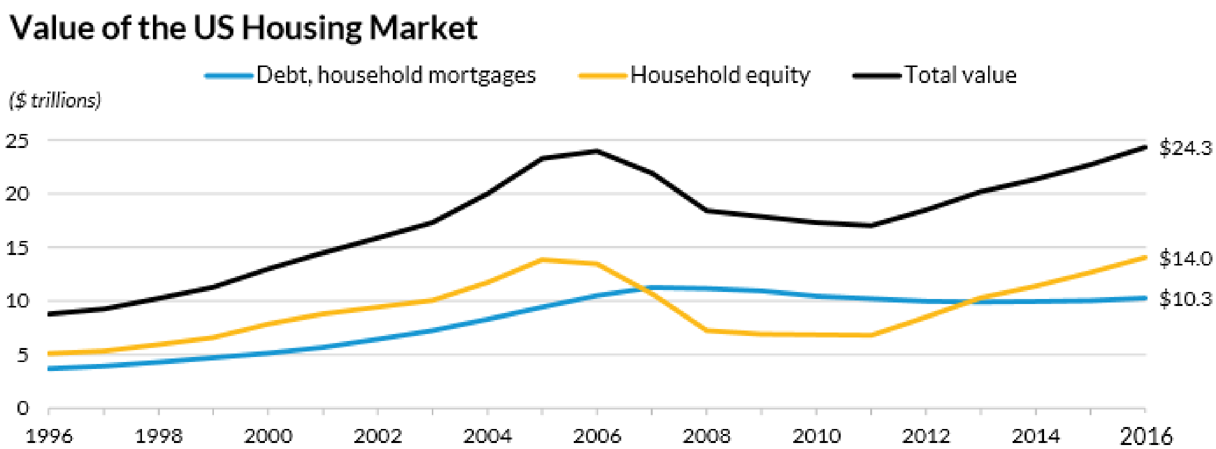
Home prices are still very affordable by historic standards, despite increases over the last four years and the recent interest rate hike. Even if interest rates rise to 5.5 percent, affordability would still be at the long term historical average. The bottom chart shows that some areas are much more affordable than others.

Sources: CoreLogic, US Census, Freddie Mac and Urban Institute.
Note: The maximum affordable price is the house price that a family can afford putting 20 percent down, with a monthly payment of 28 percent of median family income, at the Freddie Mac prevailing rate for 30-year fixed-rate mortgage, and property tax and insurance at 1.75 percent of housing value.



While this may be true, the likelihood of again using one's home (and second home) as levered equity plays – even if new pro-debt legislation passes – seems unlikely to be repeated anytime soon, especially given the Fed's intention to raise rates. A different set of circumstances exists today.

To begin, US home values amount to about $24 trillion, of which equity is almost 60 percent. This may seem quite healthy at first glance, but it is very dangerous in our view. Basically, there is $14 trillion of perceived home equity today without a corresponding $14 trillion deposit base. So, $14 trillion of home equity today cannot be $14 trillion of home equity tomorrow unless there is actually $14 trillion in new dollars or credit to serve as proceeds for it when homeowners seek to monetize the present value of their homes. The process of monetizing homeowner equity must reduce its value unless there is an expansion of the money supply, homeowner debt, or both.



Sources: Federal Reserve Flow of Funds and Urban Institute..

A new debt-fueled housing bubble, in which home prices again rise significantly, is possible; however, we seriously doubt lenders, borrowers, bank regulators and the shareholders of shadow bank entities would allow balance sheets to expand on the backs of borrowers with dubious credit (e.g., millennials, sub-prime homebuyers, etc.) so soon after the 2008 financial crisis. *In short, the homes of older empty nesters looking to downsize and take out gains from their marked-to-market home equity are unaffordable to the younger population cohort that would have to take them out whole*.

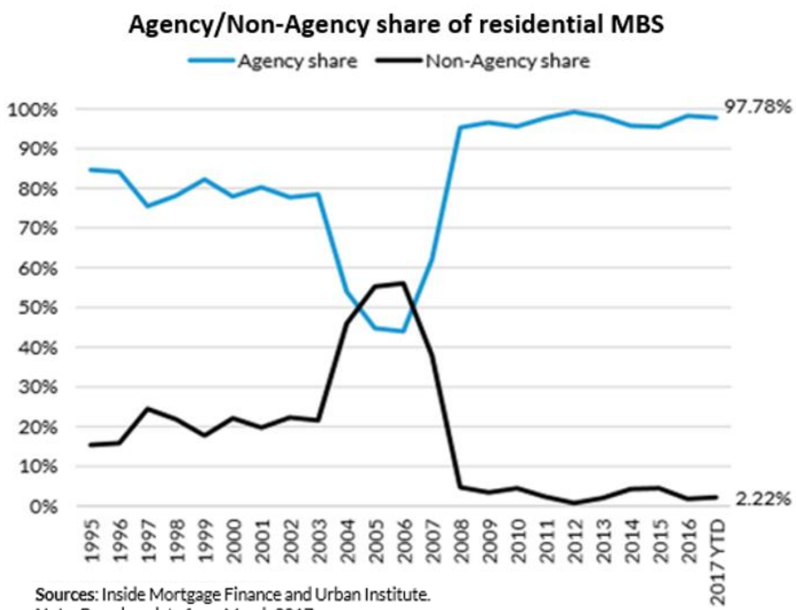
Further, even if another round of significant monetary and credit inflation were to occur, it would surely be accompanied by goods and service inflation, which in turn would directly feed into the cost of building new homes. An example of the impact of higher costs on homebuilders came this week. Homebuilder shares fell one percent Tuesday, as the rest of the market rose 1.5 percent, following an announcement of a Canadian lumber tariff. Lumber accounts for 12 percent of the cost of a new home.

iShares Dow Jones US Home Construction ETF (ITB)

Sources: Google Finance; Yahoo Finance; MSN Money

Declining homebuilder margins would either stop home production in its tracks or steer housing construction towards high-end homes and multi-family projects. We believe demand for new construction of larger homes will drop materially, given the demographic dynamic discussed above. As a result, multi-family home construction may become the best option for homebuilders. Homebuilders forced to compete to build and sell sun-belt condominiums would have their margins shaved considerably.

Another major factor behind our pessimism for housing is the paradigm shift in the mortgage finance business. As the nearby graphs show, the ease with which homeowners are able finance home purchases with guarantees from government or government-sponsored enterprises (GSEs) has fallen quite dramatically since the 2008 financial crisis. The non-agency mortgage business, which includes both higher end and lower end non-conforming mortgages (including sub-prime mortgages), is a shadow of its former self.



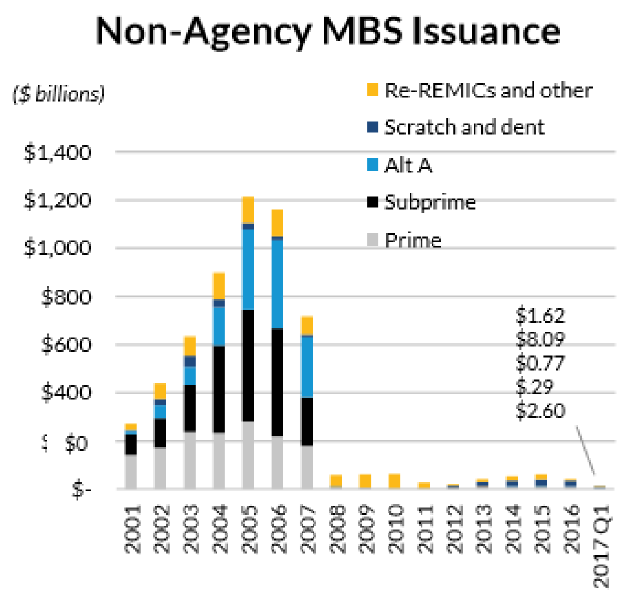
Sources: Inside Mortgage Finance and Urban Institute.
Note: Based on data from March 2017.

Another nation-wide, debt-driven housing expansion that reaches down to include middle income and working class homeowners is unlikely to occur again anytime soon.

The reason for positioning a homebuilder short boils down to incentives that worked in the past will not work in the future. Specifically, *housing finance* may be in comparatively good shape today, but it only deals with the debt component of home values, not with the equity component.

No man steps in the same river twice, for it's not the same river and he's not the same man. (Do Heraclitus' words make us a financial philosopher king a la [Surely, You Jest]?)

Paul Brodsky
Macro Allocation Inc.



Sources: Inside Mortgage Finance and Urban Institute.

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