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Housing Recovery to Continue

We expect the increase of new home sales to continue, at least towards its 51-year average of 657,000 a year, in large part to meet demographic demand as ‘millennials’ (the largest age cohort surpassing even the baby boomers) graduate, get jobs and start families. Millennials have been a boon to the rental market, but surveys suggest that ownership remains the eventual goal of young adults.

We think employment and credit are currently the main obstacles for first-time homeownership – wage growth is slow and pristine credit is necessary to obtain a loan. However, the labor market continues to improve, with job openings and hiring at six-year highs. Moreover, Fed Chair Janet Yellen has made clear her overwhelming focus is on restoring job market conditions to health.

Credit remains tight particularly for home loans, but we see some evidence of loosening mortgage lending standards. For example, nonbank mortgage lenders are stepping up to the plate, originating 23% of mortgages in the first half of the year, up from just over 10% in 2012, according to *Inside Mortgage Finance*. Furthermore, baby boomers are increasingly helping their kids buy their first house, with 27% of first-time home buyers receiving cash assistance from their “relatives or friends,” up from 24% in 2012, according to the National Association of Realtors.

Residential investment at 3.2% of GDP remains well below its 4.7% average since 1950. Residential investment reached 6.7% of the economy at its peak in the fourth quarter of 2005 and troughed at 2.4% in 2010. While housing’s share of the economy seems relatively small (personal consumption expenditures represent 68.5%), the housing market has an outsized effect on consumer behavior and spending. We see residential investment gradually recovering over the next several years, providing ongoing support for economic growth, as labor markets improve and credit conditions normalize. Thus, we maintain an overweight position to homebuilders, and to consumer discretionary stocks in general, for our growth portfolios.

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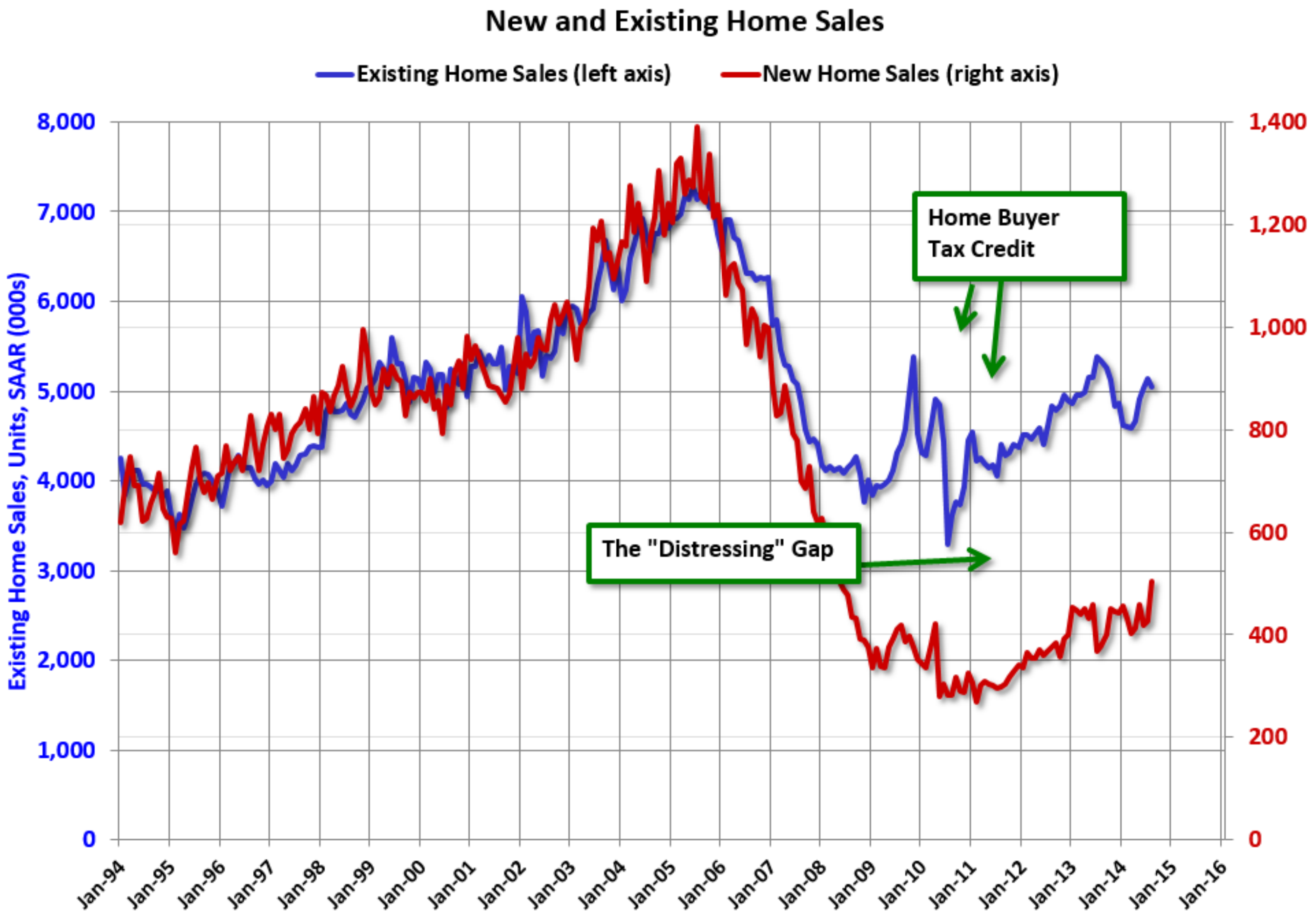
The secondary market in homes — existing home sales — is not directly counted in GDP (except for brokers’ commissions and transfer costs), but it constitutes the bulk of the US housing stock and over half of household wealth. In the second quarter, household real estate was worth around $23 trillion according the Federal Reserve’s Flow of Funds (stocks and mutual funds were about $21 trillion). The approximately $5 trillion increase in household real estate value since 2010 has been enormously beneficial in repairing consumer balance sheets and restoring economic growth. Less than 11% of homeowners with mortgages remain underwater (the home value is lower than the mortgage), down from 15% last year and nearly 25% four years ago, as home prices nationally have risen almost 20% since they bottomed in 2011.

The decline in underwater mortgages has helped lower the amount of distressed sales — foreclosures and short sales — but has also increased housing inventory and conventional sales because homeowners now feel more comfortable listing properties. Our Weekly Chart shows existing homes sales mostly moving sideways over the last two years as a result, with some volatility (as interest rates rose and then fell).

Existing home sales have been somewhat ‘padded’ since the housing crash with distressed sales, which are now being replaced by conventional sales. *New* home sales have been extremely depressed until recently. New and existing home sales were closely correlated up to the housing market peak in 2005, from which new home sales fell by 80% and still remain below normal (but off their 2011 lows). Data released last week showed new home sales rose to a 504,000 annual rate in August, a six-year high.

THE WEEKLY CHART: NEW HOME SALES RECOVERING



Source: www.calculatedriskblog.com. Past performance is no guarantee of future results.

Up until the 2005 housing peak, new and existing home sales were relatively closely correlated. While this chart only goes back to 1994, the relationship has been mostly intact since the early 1970s (and through several housing cycles). We think this is because house prices rarely fell during that time frame, and never to the degree from 2007 to 2012 when housing prices fell by 26% nationally. With distressed debt sales starting to trail off, we expect *conventional* existing home sales and new home sales to reestablish their historical relationship, which should benefit homebuilders and support residential investment over the next several years. Bill McBride of Calculated Risk writes: “I expect existing home sales to decline or move sideways (distressed sales will continue to decline and be partially offset by more conventional/equity sales). And I expect this gap to slowly close, mostly from an increase in new home sales.”