Settling in

Mark Kiesel | PIMCO | December 2013

People often ask me about my outlook for the US housing market – my friends and colleagues at PIMCO, clients and consultants, and readers of our Global Credit Perspectives. Over the past eight years, I have written several pieces on housing, including "For Sale, "Still Renting" and "Back In". I have lived in Southern California for over 17 years, renting for almost half of them. In the second quarter of 2006, I sold my home after owning for eight years, and then rented for six years until I bought my current home in the second quarter of 2012. Throughout my career at PIMCO, I have learned a great deal from many of our firm's housing experts in credit research and portfolio management. This has helped shape my real estate views, outlook and home address (whether I own or rent).

So, what do I say when asked about my outlook on US housing? Well, put it this way: I don't plan on selling my home in Newport Beach anytime soon. In fact, over the past year and a half. I've been "settling in" and doing what many homeowners have to do given the aging of America's housing stock – repair and remodel.

The outlook for US housing is improving and that is constructive for consumer spending, confidence and jobs. Higher housing prices should lead to a pickup in home sales, more housing starts, a gradual increase in bank lending and a boost in remodel activity. The mortgage market, previously refinance-driven, should increasingly "hand off" to growing home purchase loan originations. And, a gradual recovery in the labor market shouldn't change the outlook for US Federal Reserve policy, which will likely remain dovish and support the housing market, particularly given today's low inflation and still-elevated unemployment.

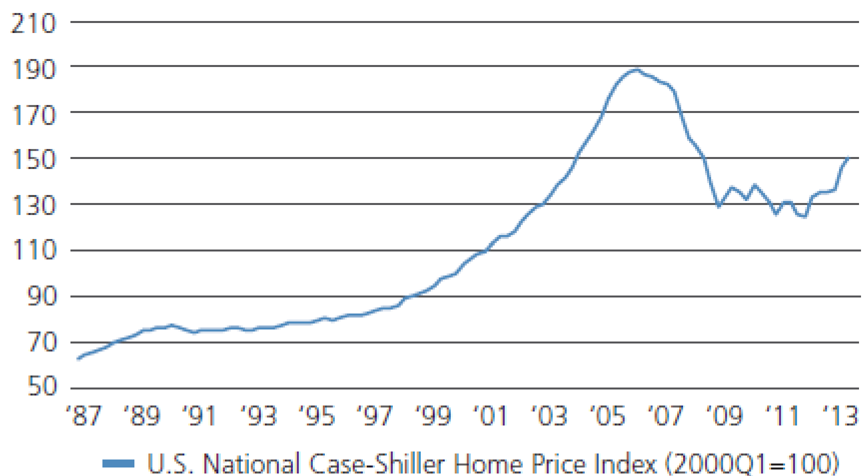
Investors looking to capitalise on an improving outlook for US housing have several options – there are many ways to invest directly and indirectly in companies that should benefit from higher housing prices, a pickup in repair and remodel activity, and residential investment spending. We continue to favor select investments in homebuilders, building materials, appliance manufacturers, lumber, home improvement, banks, title insurance, mortgage origination and servicing, and non-Agency mortgage-backed securities (MBS).

THE OUTLOOK FOR US HOUSING

US housing prices recovered 22% over the 18 months through the end of the third quarter of 2013 (Figure 1). However, they are still 21% lower than the peak hit during the second quarter in 2006. While future double-digit annual gains in home prices are unlikely, the housing market could still experience mid-single-digit annual gains for the next few years,

particularly if low inflation allows the Federal Reserve to maintain accommodative monetary policy.

Figure 1: US housing prices improving

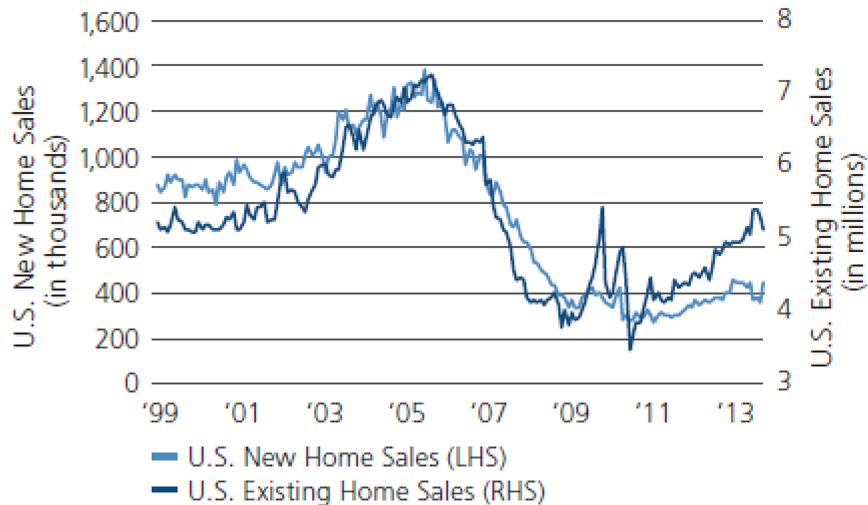


Source: S&P/Case-Shiller through 3Q2013

Higher interest and mortgage rates are a risk for housing, which is why investors are focused on the Fed and when it will start to taper and reduce the size of its balance sheet. However, if mortgage rates rise, it would most likely be because the Fed tapered due to an improving economy and solid recovery in job growth. A stronger labor market and improving private sector would likely offset a gradual rise in interest rates as consumer confidence and banks' willingness to lend would likely improve. As such, gradually rising mortgage rates in the context of stronger job creation should not have a significant impact on a housing recovery. Finally, the Fed understands the importance of housing to the overall economy and will therefore likely err on the side of easy policy, which should support a continued recovery in both the labor market and real estate prices.

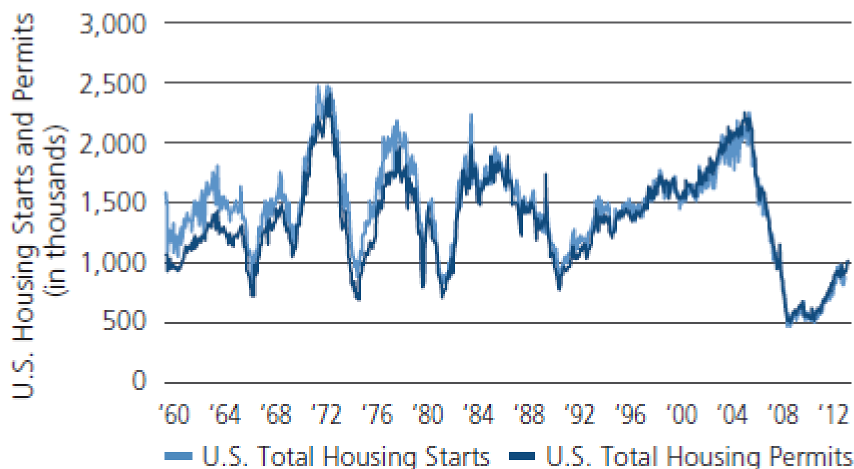
In terms of consumer and housing activity, rising confidence, gains in consumer net worth and improving job growth are leading to a recovery in sales (Figure 2). Sales of existing and new homes are up 6% and 22% year-over-year, respectively. Housing starts and permits have picked up, but they remain significantly below long-term averages (Figure 3). Starts are currently less than 900,000 annually, compared with a long-term average of almost 1.5 million. As a result, there is further upside in new construction and residential investment spending with improving consumer fundamentals.

Figure 2: New and existing home sales recovering



Sources: US Census Bureau, National Assoc. of Realtors through 10/31/13

Figure 3: US housing starts and permits picking up but remain historically low

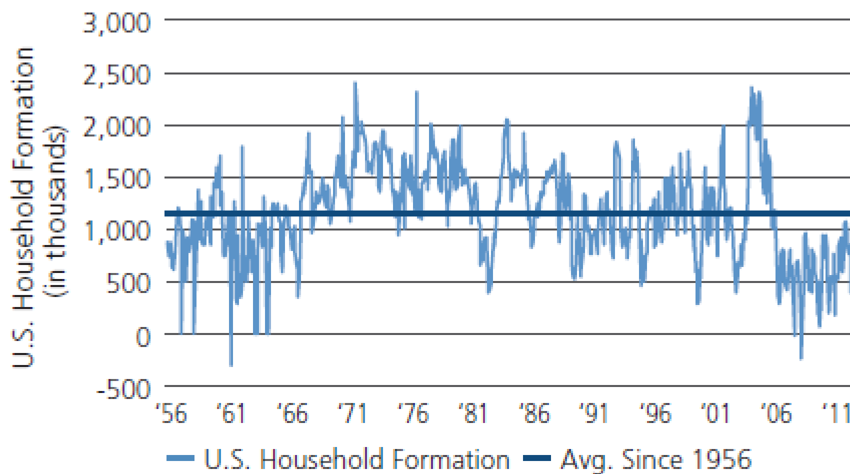


Source: US Census Bureau, through 10/31/13

On the demand side, household formation is critical to monitor. Currently, the US economy is forming just over 400,000 new households per year as of the third quarter of 2013, significantly below the long-term average of just under 1.2 million (Figure 4). Given current population growth, America should be forming roughly 1 million new households each year. However, the latest recession was so severe that it continues to suppress household formation. One piece of evidence - a growing percentage of young adults aged 18-34 are living with their parents (Figure 5). Fortunately, the labor market outlook is improving (Figure 6). Jobless claims are near six-year lows and private sector employment is picking

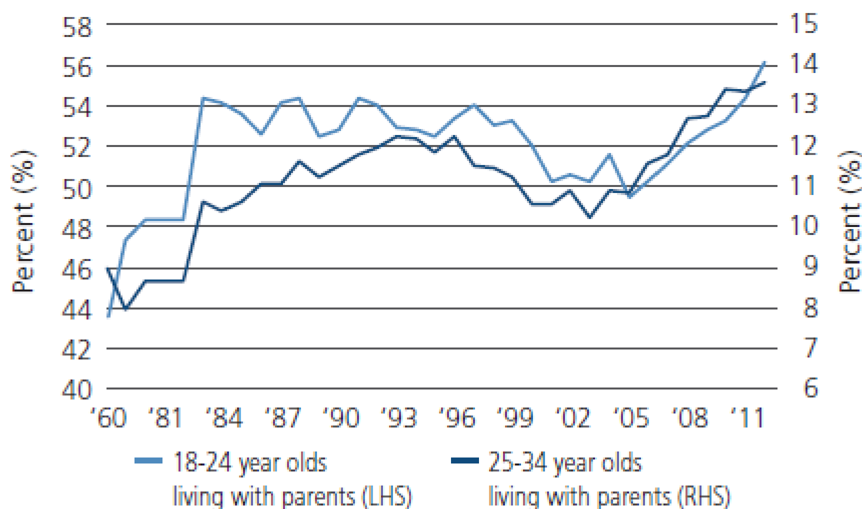
up. US household net worth has also improved and has increased $14.2 trillion or 10.7% annually over the past two years, according to the Federal Reserve as of the third quarter of 2013. We believe the "American Dream" of home ownership is intact and note the recent uptick in the home ownership rate as evidence of pent-up demand and an improving outlook for household formation given rising wealth and stronger job creation.

Figure 4: US household formation significantly below long term average



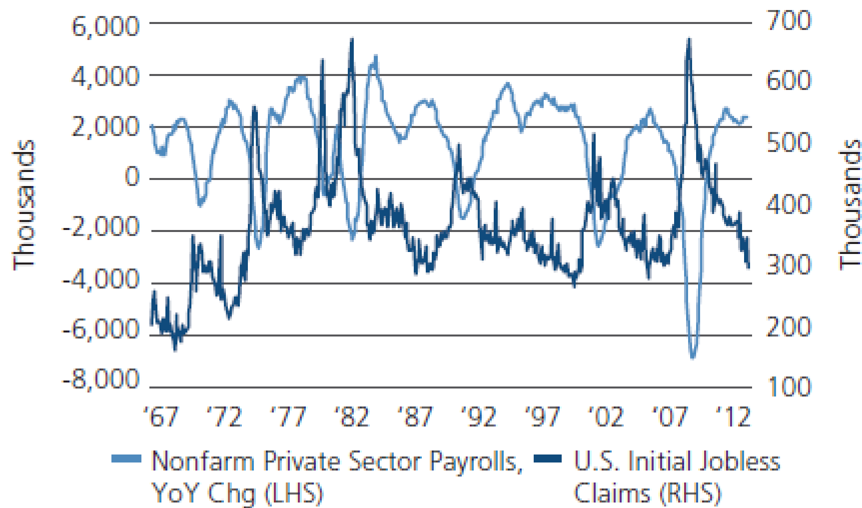
Sources: US Census Bureau, Haver Analytics, through 9/30/13

Figure 5: Percent of young adults living with parents continues to rise



Source: US Census Bureau, as of 2012

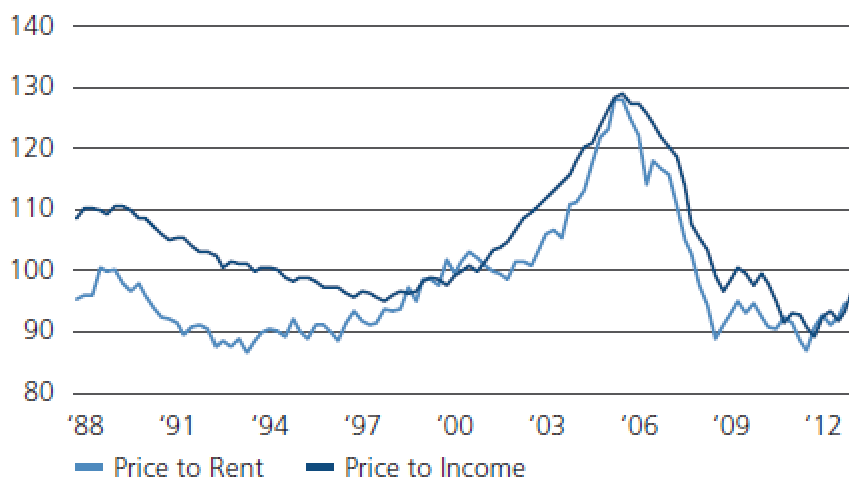
Figure 6: US labour market is improving



Sources: Bureau of Labor Statistics, Department of Labor, through November 2013

In terms of valuations, home prices remain attractive on both a price-to-rent and price-to-income basis (Figure 7). US housing also looks increasingly attractive relative to international housing markets. It's no surprise that foreigners have been a significant source of support for many regional markets across the country. Another contributor may be potential homeowners who increasingly see houses as attractive "stores of value" particularly should inflation or inflationary expectations rise.

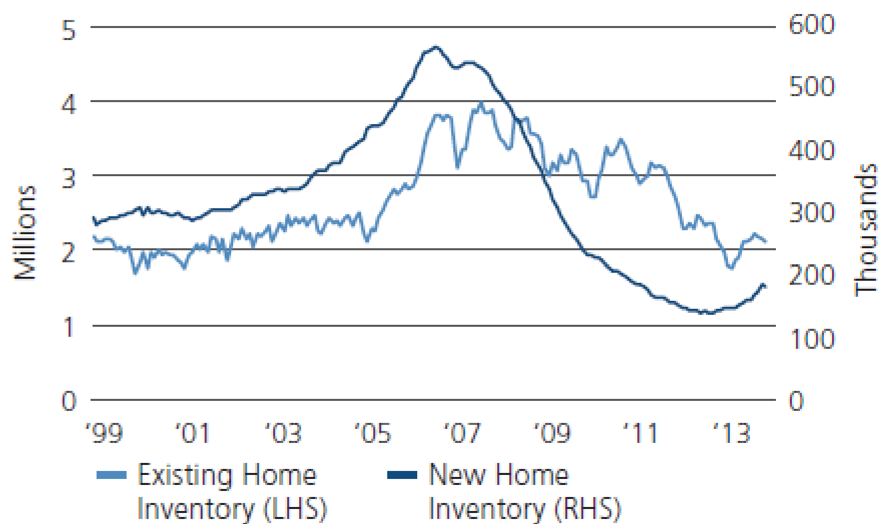
Figure 7: US housing valuation remains attractive



Sources: S&P/Case-Shiller, US Census Bureau, Bureau of Economic Analysis, Haver Analytics, as of Q2 2013

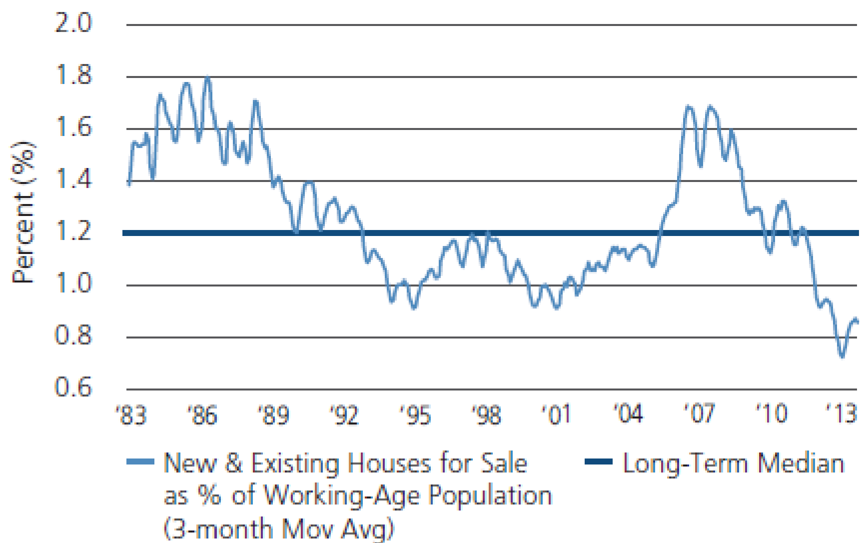
On the supply side, inventories are probably the most important driver of housing prices. Only 2.1 million existing homes and 183,000 new homes are for sale (Figure 8). The absolute level of inventory is near a 14-year low. In addition, the combined total of today's existing and new inventories for sale divided by the working age population is near 30-year lows (Figure 9). And foreclosures and distressed inventory levels and homeowner vacancy rates are improving significantly. New home supply will also be constrained by lot inventory, as builders have quickly absorbed their existing inventory of pre-crisis finished lots and development of new lots has been constrained since 2006. Overall, tight supply, gradually increasing demand and attractive valuations remain supportive for US housing prices and residential investment spending.

Figure 8: Existing and new housing inventory is low...



Sources: National Assoc. of Realtors, US Census Bureau, through October 2013

Figure 9: ...and so is housing inventory divided by working age population



Sources: US Census Bureau, National Association of Realtors, Bureau of Labor Statistics, Haver, Bloomberg, through 3Q 2013

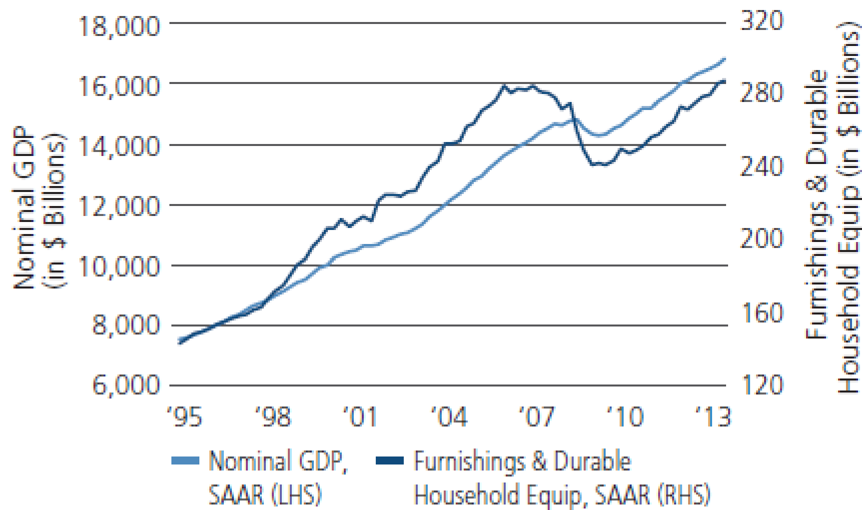
INVESTING IN US HOUSING

Given the improving outlook for U.S. housing, where can investors find attractive opportunities?

One area is homebuilders, given our view that housing prices are likely headed higher over the next several years. We have focused our investments on select homebuilders that either serve a niche market (e.g. luxury) or have an advantageous land position in key markets where job growth is healthy and land position in key markets where job growth is healthy and land supply is constrained. We believe these factors have allowed homebuilders to report healthy order backlog growth. Given improving demand, homebuilders should continue to enjoy strong pricing power on new developments in markets with strong employment growth.

We also favor appliance manufacturers and lumber, home improvement and building material companies that should benefit from a pickup in new construction as well as in repair and remodel activity. Few homeowners put money into their homes when their mortgages were underwater. They delayed large-scale projects, such as replacing the roof or the heating, ventilation, and air conditioning (HVAC) system, for as long as possible. As homeowners went into a negative equity position, remodel spending underperformed the overall economy (Figure 10). However, today's outlook for repair and remodel is significantly brighter, with home prices, homeowner equity and consumer confidence rising.

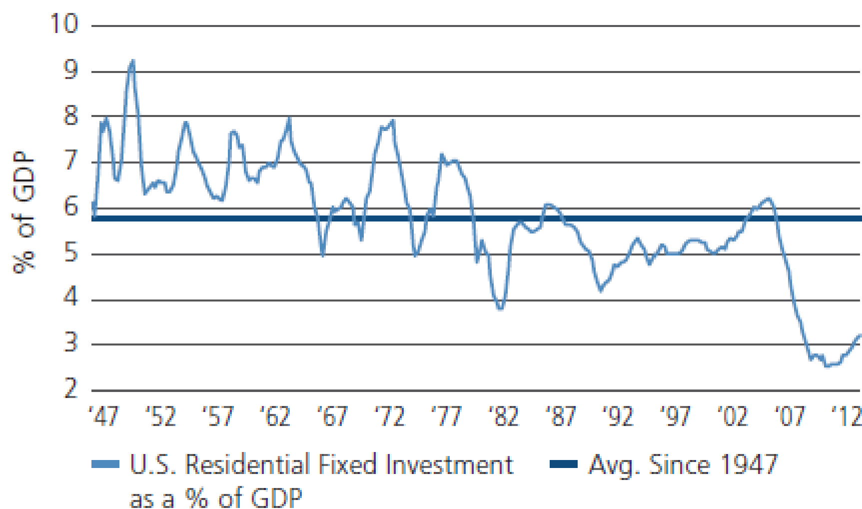
Figure 10: Homeowners have delayed remodeling their homes



Source: Bureau of Economic Analysis, through 3Q13. SAAR - Seasonally adjusted annual rate

Residential investment spending as a percent of the US economy is now at 3.2%, which is significantly lower than the long-term, 65-year average of 5.7% (Figure 11). An eventual recovery in new home construction and home sales would be positive for many other industries. Rising real estate prices should support banks' willingness to lend more broadly as asset quality metrics continue to improve. Banks and non-Agency MBS will likely benefit as a result, as would mortgage originators and servicers and title insurance firms.

Figure 11: US residential fixed investment as a % of GDP below 65-year average



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Sources: Bureau of Economic Analysis, Haver Analytics, through 3Q 2013

SETTLING IN

US real estate should remain an attractive place to invest as the economy and private sector heal. Home prices will likely remain supported by an improving labor market, accommodative Fed, healthy pent-up demand, gradually easier credit and bank lending, supportive valuations and low inventory.

Rising home prices will also help repair and remodel activity pick up as homeowners "settle into" their homes. They will also encourage new construction given a favorable supply and demand outlook.

It is clear that investors looking to capitalise on companies that benefit from these trends have many options.

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