SIGNATUREFD

THE HOUSING MARKET: CHALLENGES AND OUTLOOK

A SIGNATUREFD WHITEPAPER

abstract

Home values account for one quarter of household assets for the average American family. As such, nearly everyone is affected by the housing market and that fact underscores one big reason that the housing crisis had such broad reaching impacts. The bad news for homeowners is that from the peak of the market in 2006 to 2010, the crash in real estate values erased nearly nine trillion dollars in homeowners' equity. The good news for home owners and prospective home buyers is that the combination of lower home prices, favorable financing rates, and improving supply/demand characteristics have produced an era of home affordability and opportunity. If it meets a consumer's financial and personal goals, in our opinion, now is a good time to purchase real estate.

Three key aspects underscore our view on housing:

- Better functioning credit Markets
- Increasing housing affordability
- Improving supply/demand characteristics.

This paper is intended to expound on these points, serve as an analysis of the current residential real estate market, and outline reasons why we believe now may be a multi-decade opportunity to purchase real estate at attractive valuations and favorable terms.

INTRODUCTION

The housing market affects nearly everyone. Whether you are among the two thirds of Americans who own a home, or are part of the one third that rents, real estate prices affect both your balance sheet (net worth) and your income statement (budget). Housing accounts for one quarter of household assets[1] and the corresponding mortgages make up three quarters of household debt.[2] The rise and fall of home prices has a significant effect on homeowners, both financially and psychologically. The wide reach of homeownership is one main reason why the recent real estate boom and bust was such a substantial event nationally.

The bad news for homeowners is that from the peak of the market in 2006 though the end of 2010, the crash in real estate values erased nearly nine trillion dollars in homeowners' equity, including nearly three trillion dollars over the past two years.[3] The good news is that, in our view, lower home prices, favorable financing rates, and improving supply/demand characteristics have ushered in a unique era of home affordability and opportunity.

LOWER HOME PRICES, FAVORABLE FINANCING RATES, AND IMPROVING SUPPLY/DEMAND HAVE USHERED IN A UNIQUE ERA OF HOME AFFORDABILITY AND OPPORTUNITY.

This paper is intended to serve as an analysis of the residential real estate market and to outline reasons why we believe now may be a multi-decade opportunity to purchase real estate at attractive valuations and on favorable terms. While this research paper focuses on the state of the residential real estate market, some of the positive trends are beginning to show up in the commercial real estate market as well. The paper is not intended to serve as a singularly influential argument to purchase real estate. Moreover, each individual's circumstances and goals need to be taken into account when making a real estate decision. Each specific real estate opportunity also needs to be evaluated on an individual level as regional and specific property variables can vary substantially. While it is dangerous to paint too broad of a stroke when drawing general conclusions, the current environment provides a very supportive backdrop for real estate purchases.

BOOM AND BUST

REAL ESTATE REVISITED

It is important to understand the factors that contributed to the housing bubble and ultimately sowed the seeds of the housing bust, how they changed, and how they look today. In some respects, the system that produced the latest housing cycle can be traced back to four origins: a political and societal desire to increase homeownership, relaxed underwriting standards, creative financing, and mismanaged risk.

In 1992, President George HW Bush signed into law the Housing and Community Development Act, essentially amending the charter of both Freddie Mac and Fannie Mae to include in their mandate the obligation to facilitate affordable housing to low and moderate income families.[4]

In 1994, President Bill Clinton and then Housing and Urban Development (HUD) Secretary Henry Cisneros developed a strategy document aimed at increasing home ownership to an all time high level. An excerpt from the document reads:

Homeownership climbed from 64% to 69% nationally from 1995 to 2006—a record high.

"For many potential home buyers, the lack of cash available to accumulate the required down payment and closing costs is the major impediment to purchasing a home. Other households do not have sufficient available income to make the monthly payments on mortgages financed at market interest rates for standard loan terms. Financing strategies, fueled by the creativity and resources of the private and public sectors, should address both of these financial barriers to home ownership."[5]

George W. Bush furthered the political agenda aimed at home ownership during his presidency by encouraging lending by Fannie Mae and Freddie Mac to low-income borrowers.

These initiatives worked. Home ownership rates from 1995 to 2006 climbed from 64% to 69% nationally, a record high.

To accommodate more borrowers, new, creative types of financing were needed and the private and public sectors combined to create an engine for generating affordable lending. As constructed, the system allowed financial institutions to initiate loans, which were passed on to other institutions (Fannie Mae, Freddie Mac, Ginnie Mae, and Private Institutions) that would package the loans into investable securities to then be sold to investors all over the world. In theory, this system allowed the financial institutions to make loans while spreading the risk and reward among investors. In reality, because the loans and the risk could be sold off to other institutions, there was little incentive to maintain high underwriting standards, yet a strong incentive to increase transaction volume. As more borrowers qualified under relaxed underwriting standards, artificially high demand for homes was created. This self-reinforcing system resulted in higher real estate prices and large investments in Mortgage Backed Securities (MBS), backed by poorly underwritten loans, on the balance sheets of financial institutions worldwide. This raised the level of unintended risk throughout the financial system.

Because the MBS market was a relatively new phenomenon, determining the credit quality of these assets proved difficult. Mortgage payments are considered relatively stable, typically being one of the first debts that homeowners service. Consequently, ratings agencies had many of these securities rated at AAA. In fact, during the height of the real estate securitization, there were 37,000 AAA rated structured products (including investments backed by mortgages) compared to just nine AAA corporations.[6]

This financing mechanism worked until real estate values flattened out and began to decline at around the same time the economy began to falter. As mortgage delinquencies picked up, the securities backed by these mortgage payments started to plummet in value. By that time, investment funds, banks, and other financial institutions across the globe had either direct or indirect exposure to these securities that was larger than generally recognized. This was really one of the first dominos of the Great Recession.

A WELL FUNCTIONING MARKET THAT MATCHES AVAILABLE PROPERTIES WITH CREDITWORTHY BORROWERS SHOULD RESULT IN A MORE STABLE HOME OWNERSHIP BASE AND PROVIDE A MORE STABLE FRAMEWORK FOR THE RECOVERING HOUSING MARKET.

Looking at the home financing market today, Fannie Mae and Freddie Mac still play an immense role. While ultimately we believe that a strong private sector led home financing mechanism will surface, currently 90%+ of new US mortgages are still guaranteed by these Government Sponsored Entities (GSEs).[1] This makes extracting these entities from the mortgage market essentially impossible until a sustainable private market solution surfaces.

While the fallout from the real estate bubble bust is too vast to fully cover in this paper, some key changes have come about that make the current market much more sound than the market existing prior to 2006.

One notable long-term positive outcome from the housing crisis has been a strengthening of overall credit underwriting standards. Many lenders that focused strictly on financing for subprime borrowers are no longer in business. A well functioning market that matches available properties with creditworthy borrowers should result in a more stable home ownership base and provide a more stable framework for the recovering housing market.

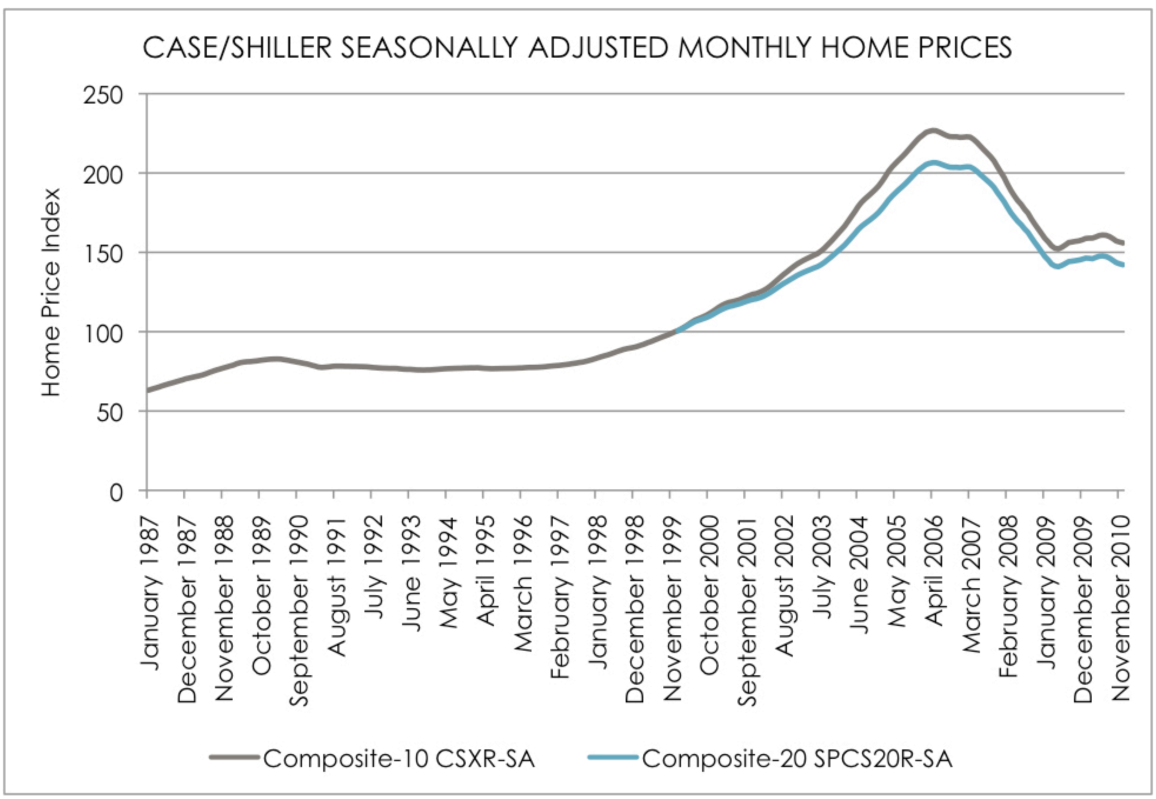
Another positive development is the return of the down payment. As the drive toward home ownership gained momentum during the mid to late 1990's and especially during the early to mid 2000's, down payments on home purchases fell, with an increasing number of homeowners purchasing real estate with 95%+ financing. According to a recent Wall St. Journal article, in nine major metro regions, the median down payment on homes has risen to 22%, triple the level during the housing boom. [1] While this may be a temporary drag by eliminating fringe borrowers from the pool of buyers, it will help the long-term stability of home prices by better matching homes with suitable purchasers.[11]

While acknowledging the challenges that lie ahead, the system today is in a better position to sustain reasonable home ownership growth and price stabilization.

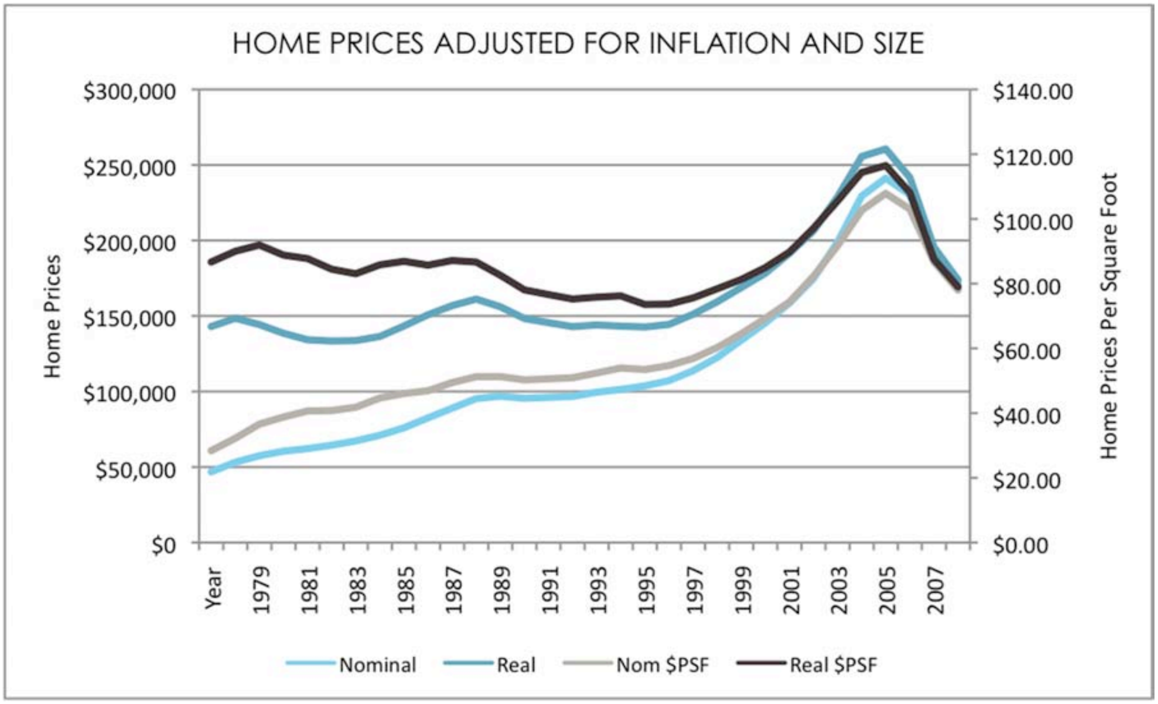
HOUSING IS AT MULTI-DECADE LEVELS OF AFFORDABILITY

The two most significant variables that affect housing affordability are home prices and mortgage rates. The drop in both of these variables has significantly improved the current affordability of housing.

One way to gauge the value of an asset is to look at its current price relative to history. The Case Shiller Index, established by economists Karl Case and Robert Shiller, is one of the most widely respected and followed measurements of nationwide home prices. Their composites dates back to 1987 and their monthly report outlines the level of current home prices in twenty of the country's largest metro areas. After reaching a seasonally adjusted peak in June 2006, aggregate home prices in their target markets have declined over 30%.[7] Using Case Shiller as a guide, home prices have fallen to their nominal level from eight years prior (see chart). Prices have shown some stability over the last two years, although prices in aggregate still remain close to their post bubble trough, with some markets at their lowest level since the burst.



Source: Case/Shiller



Nominal home prices are up approximately 300% since 1978 (light blue line). Inflation has played a large role in the price appreciation and if you back out that inflation component, home prices are up approximately 20% from 1978 levels (dark blue line). Homes have also been increasing in size over that time period, with an average square footage of 1650 square feet in 1978 to over 2200 square feet in 2009.[8] If the price data is adjusted to account for the increase in square footage, real home prices are actually cheaper on a per square foot basis in 2009 than they were in 1978 (dark brown line).

Another interesting aspect of this housing correction has been the duration of the downturn. This summer will mark five years since the peak of the housing market. Finding a floor in home prices can take longer than the price discovery in more standardized, liquid assets as transaction costs are higher and transactions are less frequent. That said, both the significant magnitude and duration of this downturn point to much of the price correction having already occurred.

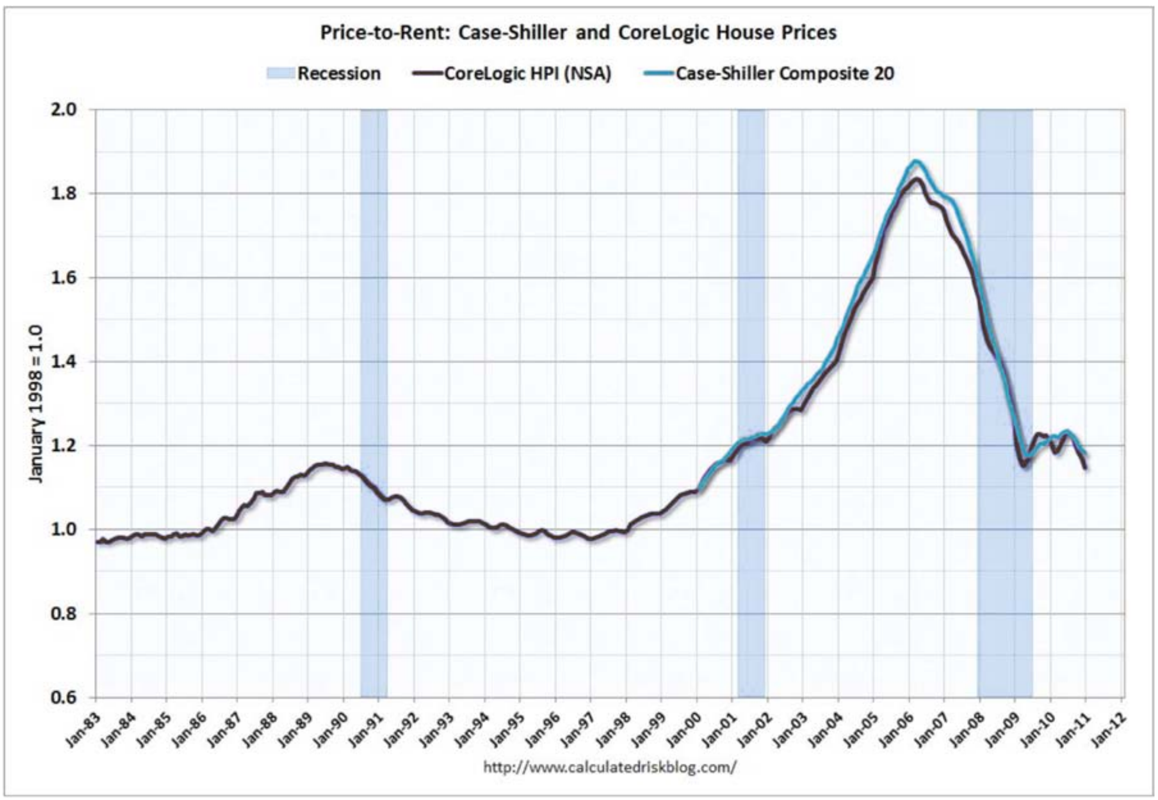
RELATIVE AFFORDABILITY METRICS: Comparing home prices against their historical values is important for existing homeowners, as it is the primary driver in generating and destructing homeowner equity. However, it is only one metric when gauging housing affordability and does not in and of itself indicate value. Looking at housing prices against other metrics, such as prices versus income and prices versus rent, helps paint a more complete picture on current affordability.

During the housing bubble, income gains did not keep up with housing price gains.

Easy credit and rising home prices served as a mechanism for some homeowners to refinance existing mortgage to monetize the accrued equity through "cash out refinances." This contributed to home prices rising much faster than incomes and helped fuel the bubble in housing prices, specifically in more speculative housing markets. During the downturn, the opposite held true, with prices falling faster than income. Income growth has slowed during the recession, but has not fallen to the extent that home prices have dropped.

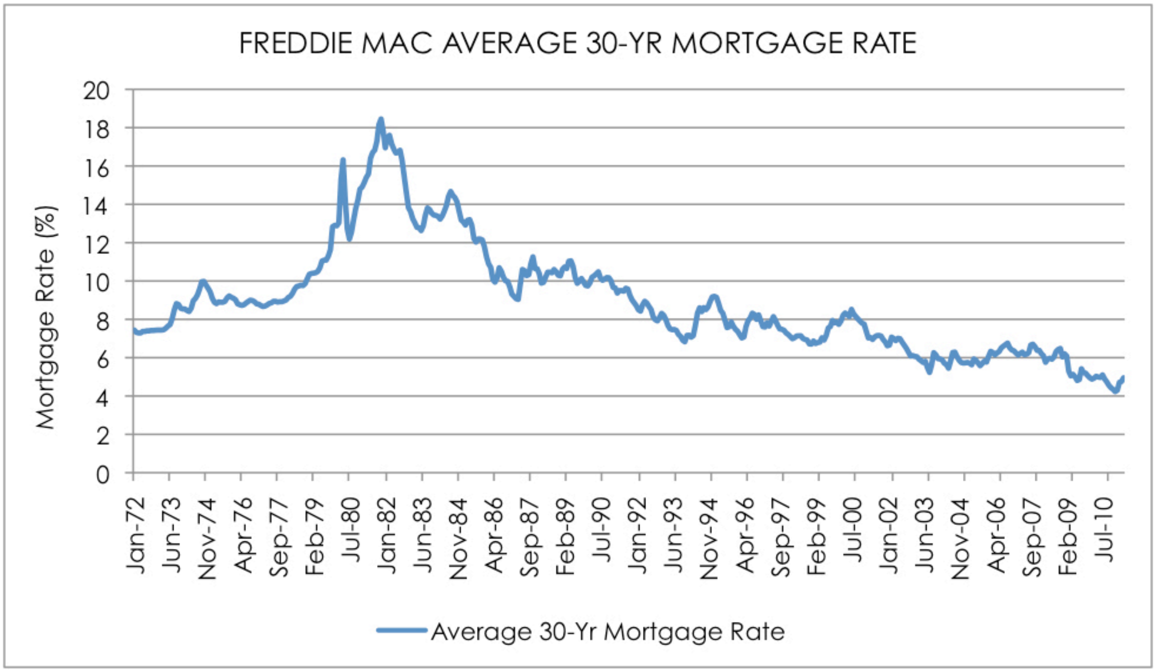
Nationally, the cost of a house is equivalent to roughly 19 months of income for the average household, the lowest level in 35 years. Historically, median home values have averaged approximately 22 months of median household income. Driven in part by speculation and loose credit underwriting, the ratio of Home Prices / Income reached a peak of 28 months in 2005.[9] The ratio indicates that home prices are now more in line with historical income expectations. Mark Zandi, chief economist at Moody's Analytics, recently stated, "Based on incomes, this is as affordable as it gets…these are pretty good times to buy." [9]

Another metric to evaluate home prices is to examine the price of the home versus the annual cost to rent that same property, the price versus rent metric. Simply put, people have a choice between purchasing and renting and when the ratio of home price to rents is elevated, the risk/reward shifts towards renting. Conversely, when the price to rent ratio falls, purchasing real estate becomes relatively more attractive. At the end of September, the price to rent ratio stood at 14.85, slightly above its average from 1989-2003.[9] More recently, rents are showing signs of firming and any pick up will continue to pull the ratio lower, making purchasing that much more affordable relative to renting.



MORTGAGE RATES ARE NEAR HISTORICALLY LOW LEVELS

The typical US home buyer finances the majority of a home's cost. Historically, lenders have required a 20% down payment on home purchases. This down payment ensured that the homebuyer had enough money invested in the property alongside the bank and ideally would ensure that the borrower would continue to pay their mortgage debt and not walk away from the asset. With 80% of the purchase price financed through a financial institution, the *affordability of financing* plays a significant role in determining the attractiveness of real estate assets.



Source: Freddie Mac[10]

The chart above outlines the average Freddie Mac rates on conforming 30-Yr mortgages dating to 1971. Mortgage rates have ranged from 4.25%-18.25% over that span and currently stand at 4.95%, near the very bottom of that 40 year range.

To put some context on the impact that rates have on home affordability, consider the following examples. For someone looking to purchase a $500,000 home, with 20% down and a fully amortizing 30-year mortgage, a 2% difference in interest rates (from 5% to 7%) results in $500 increase in the monthly payment.

Looking at this one other way, someone that can afford a $2,000/ month mortgage payment can afford a $465,000 house at a 5% mortgage rate, and a $375,000 house at a 7% mortgage rate, again assuming a 20% down payment.

Clearly, mortgage rates play a significant role in home affordability. Considering that mortgage rates are currently at such low levels, it is important to analyze what factors influence mortgage rates, what direction mortgage rates are likely heading, and how this fits into our thesis of affordable housing.

Mortgage rates are influenced by two market factors: current treasury yields and the spread of mortgages over these yields. Both of these factors are near historically low levels.

Spreads between mortgages and treasuries remain tight. In fact, in a very unusual move late last year, the 30-year Fannie Mae Mortgage rate actually dropped below the rate on the 30-year treasury.[12] Essentially, this means that homebuyers could borrow at a better rate than the United States Government.

WHERE ARE RATES AND SPREADS GOING

At its purest, rates are driven by market participants that weigh the risk and reward of lending money and set levels that provide capital to borrowers and adequately compensate lenders. In theory, lower interest rates encourage borrowing and spending while higher rates encourage saving and investing. Provided capital is available to willing, creditworthy borrowers, the current low rate environment should be stimulative to housing activity.

The United States Federal Reserve (the "Fed") has a number of traditional monetary policy tools to influence interest rates. In late 2008, during the height of the crisis, the Fed embarked on a series of quantitative easing steps, essentially an exercise of purchasing bonds (including mortgage backed bonds) to keep rates low and home financing available and affordable. They embarked on a second round of quantitative easing in late 2010. While the merits of the program may be debated, their actions served to support asset prices and keep rates, including mortgage rates, suppressed. The second round of quantitative easing is set to expire June 2011. How the bond market handles this transition has great economic implications, including its effect on financing rates.

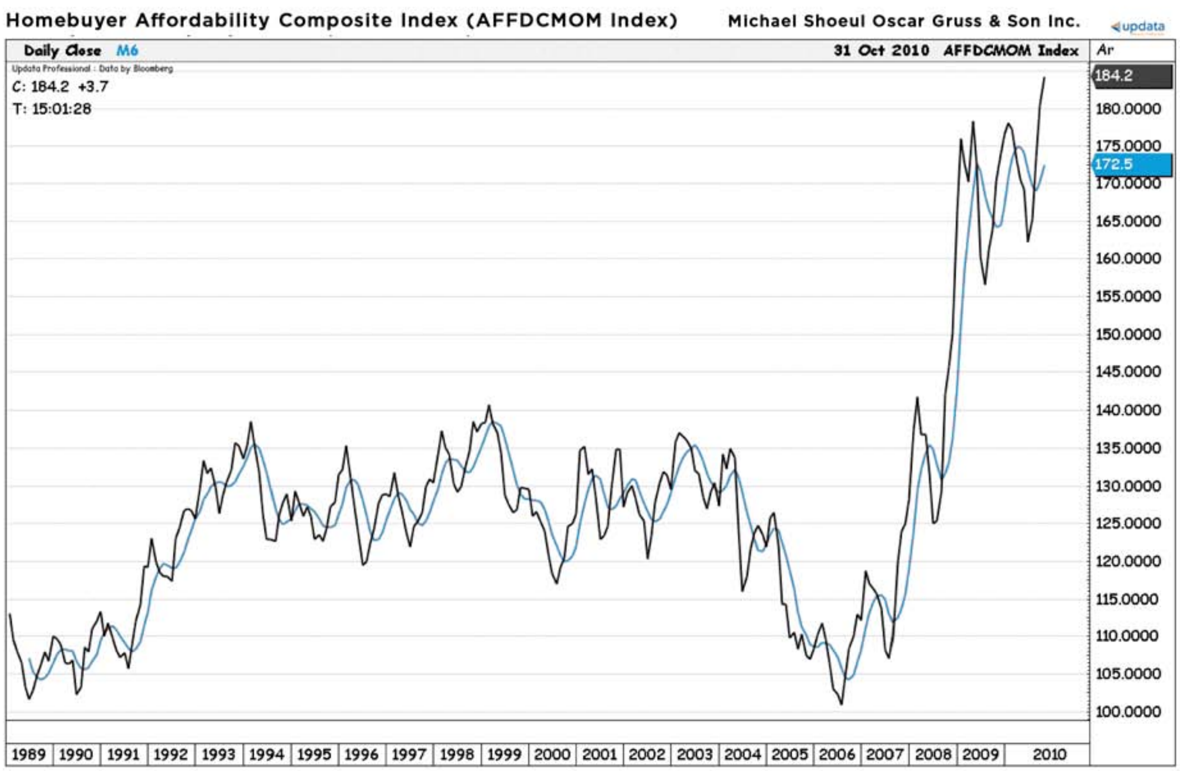
As mentioned previously, the current system of Fannie and Freddie underwriting the majority of home mortgages is not a sustainable system. Recently, the White House rolled out a proposal on the future of home financing. The three options varied in their degree of public and private influence, but the main takeaway is that all three options were directionally moving toward a more privatized system. This process is likely to take a couple of years to be fully mapped out and implemented, but the end result is likely going to be higher financing costs for borrowers. In our view, the reduced level of federal backing and the increase in paid, private guarantees could drive the spread on mortgages over treasuries higher by 0.5%-1.5%.

In March 2011, the Treasury indicated that they will begin to sell some of the mortgages that they purchased during the height of the financial crisis. This additional supply of mortgages back onto the market should also provide upward pressure on mortgage spreads to treasuries.[13]

While it is impossible to definitively predict when and how quickly mortgage rates will rise, the risk to rates is clearly to the upside. In our opinion, the most immediate risk to housing affordability is not a quick increase in home prices, but rather a substantial increase in mortgage rates.

AFFORDABILITY

When combining the raw housing data and low rate financing, housing affordability has improved significantly. The National Association of Realtors publishes a Monthly Housing Affordability Index. The measure looks at median single family home prices and mortgage rates to measure whether or not the typical median income family can qualify for the typical nationally-priced home. The chart below shows that this affordability index is up over 60% since 2006.[14] According to their measure, housing is significantly more affordable that any other period over the past twenty years.



Source: National Association of Realtors (NAR), Marketfield

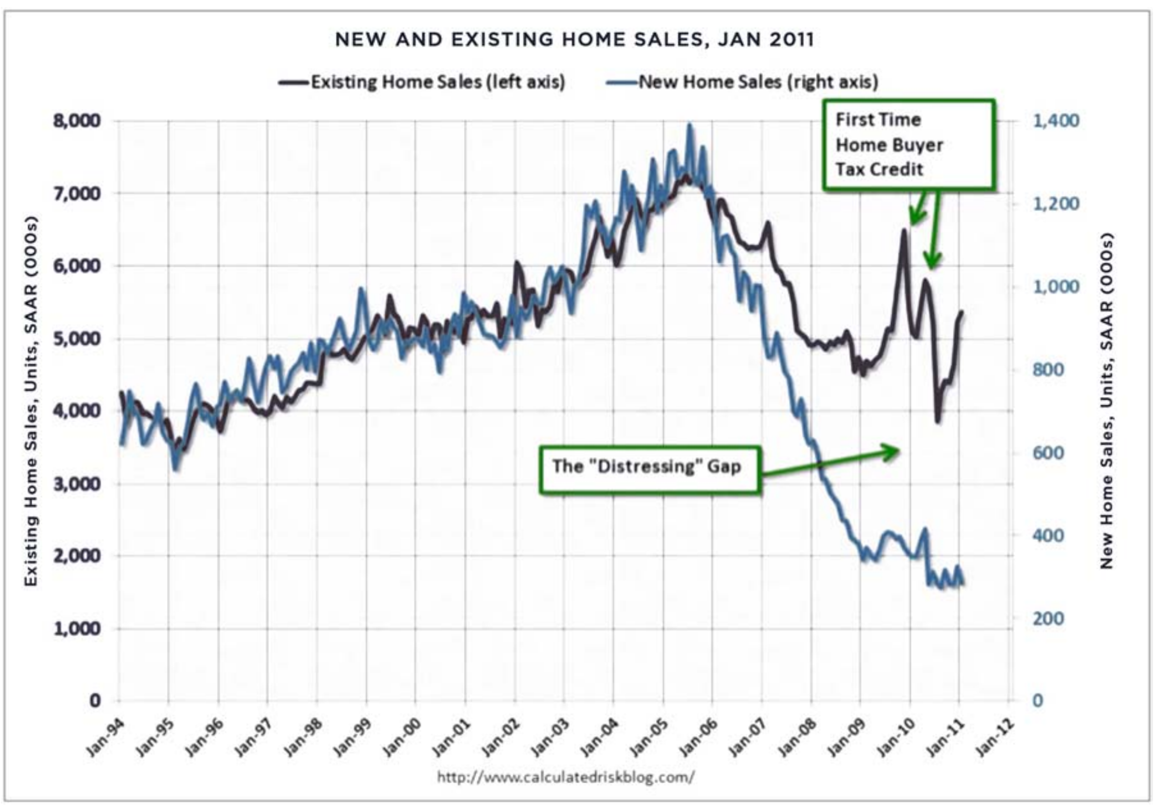
CURRENT SUPPLY/DEMAND HOUSING DYNAMICS ARE TURNING MORE FAVORABLE

The housing market, like all free markets, is essentially governed by the current supply and demand dynamic. During the early part of this decade, inflated demand for homes created an incentive for suppliers to ramp up efforts and increase the available supply to the market. With the benefit of hindsight, we know that this led to a significant oversupply of housing. When a significant imbalance develops between supply and demand, prices adjust to help bring the relationship back to equilibrium. This can happen relatively quickly in liquid, easily traded assets. For more illiquid assets, like real estate, the process can take a bit longer. There are significant transactional costs and other factors associated with real estate that cause delays in price discovery. These imbalances have worked through the correction process. As a result, in our opinion, there are a number of current favorable supply and demand dynamics beginning to surface that point to signs of a stabilizing and recovering real estate market.

NEW/EXISTING HOME SALES DYNAMIC

Over the past 25 years, the pace of new and existing home sales has exhibited a relatively strong correlation. Typically that relationship holds close to 5.7 times as many existing home sales as new home sales. This relationship held until 2006. Since then, both new and existing home sales have fallen off of their peak levels, but new home sales have fallen at a much more aggressive pace. In January 2011, the existing/new home sales ratio had ballooned to 17.5X+.

As illustrated, this has created a gap between new and existing home sales. This phenomenon can be explained largely by the existing housing inventory overhang. Because so many homes were built during the 2000-2006 housing boom, there were more homes built than true demand could satisfy. Since demand has come down to reasonable levels, this glut must be worked off before new home sales can pick up. In addition, existing homeowners who have equity in their homes have more pricing flexibility than many of the builders who are handcuffed by their cost of construction. Thus, existing home sales have cannibalized much of the demand for new home sales and will continue to do so until the inventory overhang is reduced.



Source: Calculated Risk

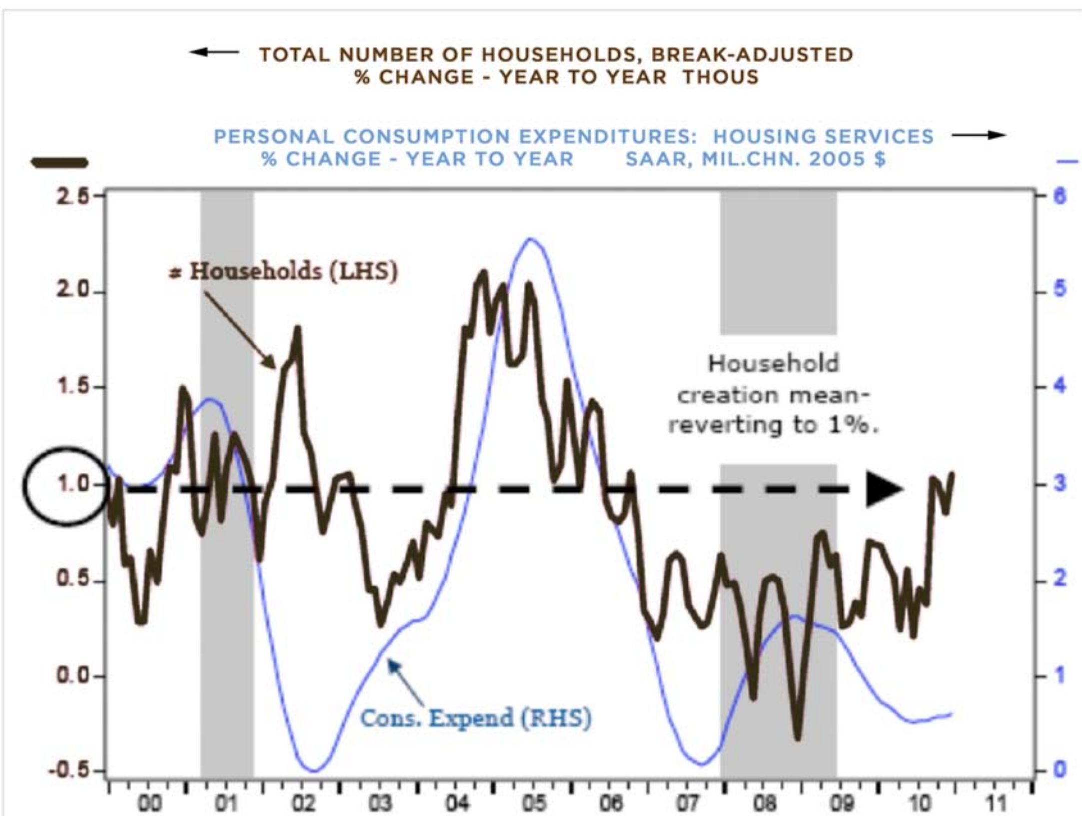
UNDERWATER HOMEOWNERS – PENT UP DEMAND?

At the end of 2010, 27% of homeowners were underwater, where the mortgage debt exceeds the home's market value. This compares to 23.2% at the end of Q3.[15] This increase underscores the difficulty that many current sellers and prospective home buyers face. Unless they are willing and able to bring cash to close, it is impossible to sell underwater real estate without a short sale or foreclosure. The broader implications of this phenomenon spread to other aspects of the economy, such as unemployment. The inability to sell their homes has limited the employment mobility of many families and kept many of these same families from purchasing real estate. While these current conditions have kept some potential buyers from entering the market, it also represents a pocket of pent up demand from potential homebuyers once home prices stabilize and climb.

WHILE CURRENT CONDITIONS HAVE KEPT SOME POTENTIAL BUYERS FROM ENTERING THE MARKET, IT ALSO REPRESENTS A POCKET OF PENT UP DEMAND.

NEW HOUSHOLD FORMATION:

One aspect of the recession that has not received much publicity is its effect on new household formation. According to the most recent census, there are approximately 113,000,000 households in the country.[6] Typically, the number of households grows at an annual rate of 1%, or a little over one million households annually. During the recession, household formation fell to a negative year-over-year level, indicating that the nominal levels of households were temporarily falling. New households are an obvious source of demand for homes and with household creation reverting to that 1% growth level, new household formation should bring incremental new demand into the market.



Source: Strategas

ECONOMIC RECOVERY

Given the substantial nature of a home purchase, sales tend to slow during economic slowdowns and pick up during periods of economic growth. With the country still recovering from the recession and continued high unemployment, it is not surprising that the pace of housing activity has been muted. However, recent economic and employment trends have shown signs of improvement and these situations bear close watching, as any continued improvement on these fronts would obviously support a continued recovery in housing.

HOUSING STARTS – HELPING CLEAR INVENTORY

During the housing boom, total housing starts, a measure of homes beginning construction in a given time period, peaked out around 2,000,000 annual units. Currently, housing starts have stabilized around 500,000 annual units.[6]

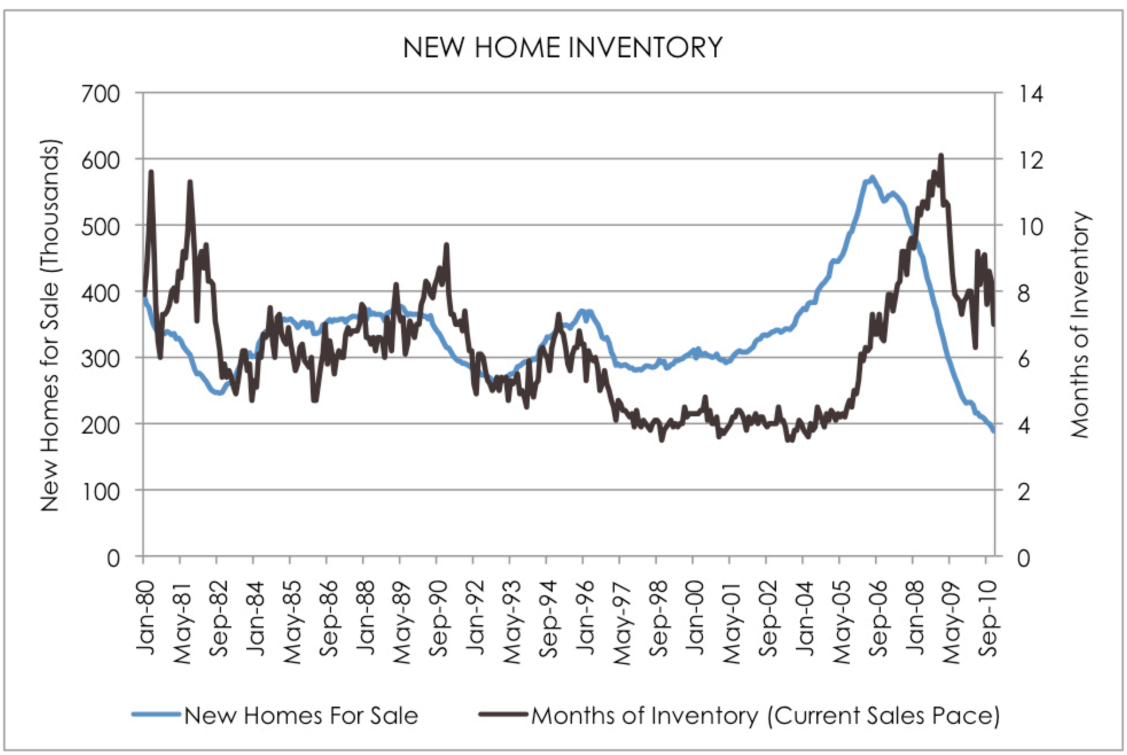
While this stabilization at a depressed level has wounded the health of the homebuilding sector, it has actually been a significant contributor behind bringing down the current housing inventory. Homebuilders are not going to return to the market in a meaningful way until home prices firm to a point where new homes can be constructed and sold for a reasonable profit. At present, the inventory of unsold homes has kept new supply from entering the market.

NEW HOME SALES/INVENTORIES LOW

Prior to the housing boom in the 2000's, new home sales typically ranged from 400,000-800,000 annual units. Due to a confluence of events, including increased government incentives, increased home ownership rates, and easy credit, new home sales accelerated to a peak level of 1,400,000 annual units in 2006. Since that peak, new homes sales have fallen to approximately 300,000 annual units.

Despite the low pace of sales, the depressed level of new home construction has allowed new home inventory to fall to the current level of ~195,000 units, a 30 year low.[12] At an annual rate of 300,000 new home sales, this represents a seven month inventory of sales. That number is not historically unreasonable and could quickly drop to the lower historical range of around 5 months of new home supply.

While new home inventories remain near historically low levels, excess inventory remains for existing homes. According to Ned Davis Research, there are currently 1.4 million units of "excess" supply. Given their expectations on household formation and current new supply and scrappage, they calculate that the excess supply will be absorbed by the end of 2012.[16]



Source: Census Bureau

At such a low current level of construction, the inventory dynamic can change very quickly. Take Atlanta for instance, the inventory of finished homes in Atlanta currently stands at 5,000 units, roughly 6 months supply. However, with a pickup in recent sales activity, inventory in the area has fallen 36% in the past 12-months.[17]

PRICE TRENDS STARTING TO REGIONALLY DIFFERENTIATE:

Residential homes are unique assets. Unlike financial assets, which are often liquid and change hands via national and international exchanges, residential real estate is relatively illiquid and immovable. In contrast to other assets, this leads to regional dynamics that impact home prices, specifically local demographics, employment trends, and economic strength. The regional nature of real estate means that prices and trends can vary in different parts of the country and even in different parts of a geographical region. Markets that saw the most significant appreciation during the 2000s tended to fall the hardest, specifically Las Vegas, Florida, and parts of California. Areas that did not show as much speculative growth and were near regions of relative economic strength did not see as much price decline, the Northern Virginia/DC area for instance.

Prior to the housing boom in the early/mid part of this decade, regional housing market prices actually exhibited a slightly negative correlation to each other. As some markets exhibited periods of rising prices, other markets exhibited falling prices. During the housing boom, home prices began to exhibit an extremely high correlation and this correlation held as the housing market crashed in 2006. This is not unusual in a boom and bust cycle. Home price correlations are still high by pre-2000 standards but are starting to decline. This is a healthy indication that the market is emerging from the national boom and bust cycle.[18]

There is a lot of discussion about the country's current fiscal and monetary policies and the impact on inflation. While we believe that both the current spare capacity in the labor market and the deleveraging consumer will keep inflation relatively tame, we acknowledge that inflationary risks are present in the system. As a rule, inflation increases the nominal value of real assets, including real estate. Should inflation increase, real estate prices should rise as well.

GENERALLY SPEAKING, IT IS A GOOD TIME TO PURCHASE REAL ESTATE.

CONCLUSION

As is the case with any asset, it is impossible to call an exact bottom in prices and the precise bottom will only be evident well after prices start to rise. The housing market faces enough uncertainties and challenges ahead, namely dealing with extended high unemployment, working off the existing inventory, and ensuring available credit to creditworthy borrowers. It is reasonable to believe that prices could continue to be volatile or even slide a little further from current levels.

However, expectations are so low for housing, much of this uncertainty is well documented and factored into housing values. In our opinion, the current combination of nominal home prices, affordable financing rates, and improving supply and demand characteristics create an attractive environment for real estate and gives us the conviction to say that the bulk of the downside in prices has passed. Generally speaking, it is a good time to purchase real estate.

SOURCES

[1] " "An Uncertain Outlook," Financial Times, January 24 2010

[2] Lee and van der Klaauw, "An Introduction to FRBYN Consumer Credit," Federal Reserve Bank of New York, November 2010

[3] "Early 2010 Housing Fizzles," Zillow, December 9 2010

[4] "Housing and Community Development Act," October 1992

[5] "The National Homeownership Strategy," August 1995

[6] Coval, Jurek, and Stafford, 2008

[7] Case Shiller Index

[8] US Census Bureau

[9] Simon Constable, "Why 2011 May Be the End of the Housing Crash," Wall St Journal, February 28 2011

[10] Freddie Mac

[11] S Mitra Kalita, "Banks Push Home Buyers to Put Down More Cash, Wall St Journal," February 16 2011

[12] Marketfield

[13] Jeff Cox, "Treasury's Mortgage Debt Sale Comes at Tough Time for Housing," CNBC, March 21 2011

[14] National Associate of Realtors (NAR)

[15] Nick Tirimous, "Home Affordability Returns to Pre-Bubble Levels," Wall St Journal, February 9 2011

[16] Joseph F Kalish, "Is There Light at the End of the Housing Tunnel?," Ned Davis Research, October 5 2010

[17] John Jannarone, "Homebuilders Find Georgia Peachy," Wall St Journal, February 18 2011

[18] MP McQueen, "Housing: Is it Time to Buy," Wall St Journal, February 26 2011

SIGNATUREFD

1230 PEACHTREE ST., NE
SUITE 1800
ATLANTA, GA 30309
(404) 253-7600
WWW.SIGNATUREFD.COM