

Reflections[®]



About this Newsletter

Reflections is a monthly publication written by John Gilbert, CIO, GR-NEAM. Each issue focuses on current capital markets and investment topics. Our clients find it somewhat unique from many investment publications typically received.

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American Housing: Falling Prices, But Rising Value

American house prices are approaching a bottom. In certain cases, they are already there. For the better part of the last year we have watched the improving economics of rental cash flow with interest, as monthly rents have risen rapidly while purchase prices have languished. The Federal Reserve issued a paper in early January reviewing conditions in the U.S. housing market for the purpose of imploring Congress to make structural changes that would remove barriers to a more rapid recovery.¹ For the Fed's pump priming to work, the pump must be capable of functioning properly, they said essentially.

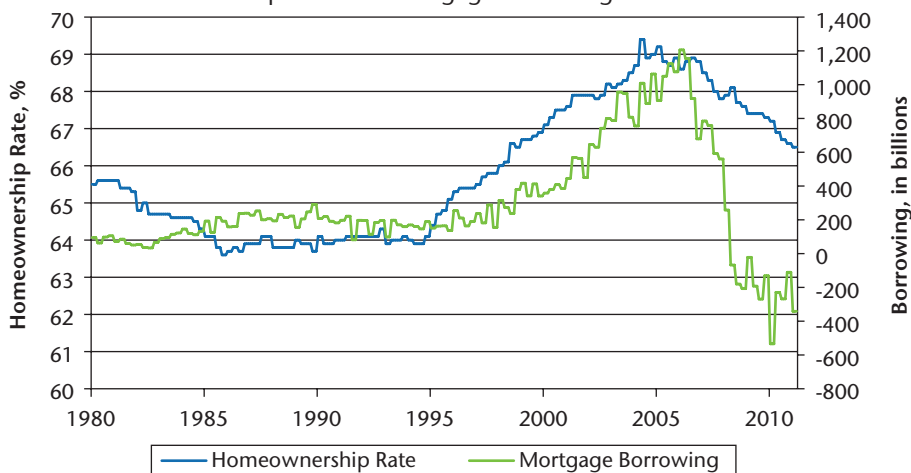
The paper reviewed the three pillars of trouble in the housing market: excess supply, in part due to widespread foreclosures, credit availability and friction in the foreclosure process. The most important, from an investment position, is the supply problem. If the price of anything is depressed it is because there is something amiss at the intersection of supply and demand. The Fed's paper encourages structural steps to convert foreclosed properties to rental units. There is anecdotal evidence that this has occurred on a small scale. The Fed's position may impart some momentum to increasing the scale of multi-property investment.

¹ Federal Reserve Board of Governors, The U.S. Housing Market: Current Conditions and Policy Considerations, January 4, 2012.

Housing ownership commingles two cash flows. Monthly payments for occupancy take the form of mortgage payments for some people, and rent for others. Those who prefer, or must, live in apartments and pay monthly rent. Ownership, however, requires in addition a large, single cash flow at the time of acquisition. Important parts of the population do not have the capital to produce that initial cash flow, or may prefer not to do so. A transition of homes from ownership to rental would aid in clearing the market by making available more single family units to those households who are renters by circumstance or choice. What is needed is a new source of capital to answer the capital intensity of ownership.

The imbalance in the American housing market is due to a massive judgment error. Mortgage credit was made available to people who were and are renters by financial circumstance, financial habits or both. This is the fault of financial markets, but the error's ancestry was the decision by the federal government in 1995 to reduce the large initial cash flow, or down payment, for low income potential buyers. The implied financing requirement was higher, and the mortgage industry obliged with accelerating credit creation that deteriorated in quality over time. The result, shown in Chart 1, was a rise in the home ownership rate.

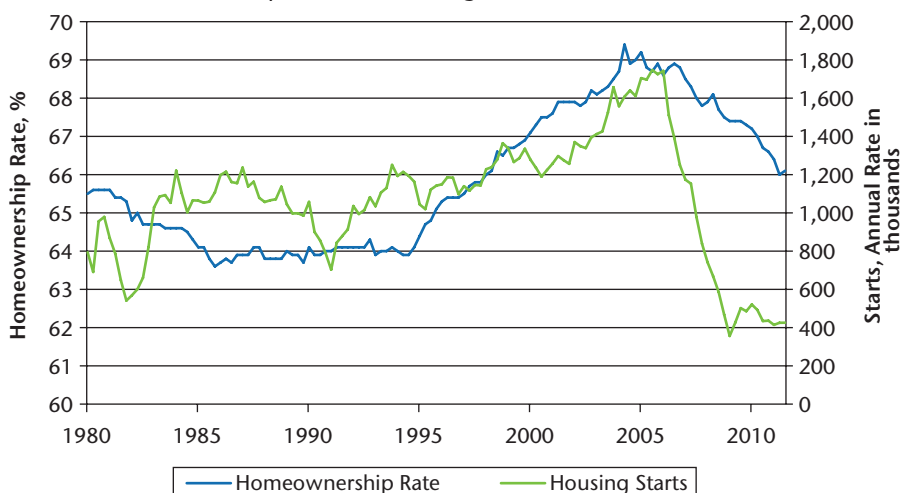
Chart 1. Homeownership Rate and Mortgage Borrowing



Sources: Census Bureau Federal Reserve and GR-NEAM

The unfortunate truth is that many of the incremental owners were, in substance, renters all along. They held title temporarily. That would have led to credit problems as their financial stress became apparent, but would not have created oversupply had not the building industry believed that the rising ownership was a permanent change. They did, however, and built furiously to satisfy the apparent but illusory demand as shown in Chart 2.

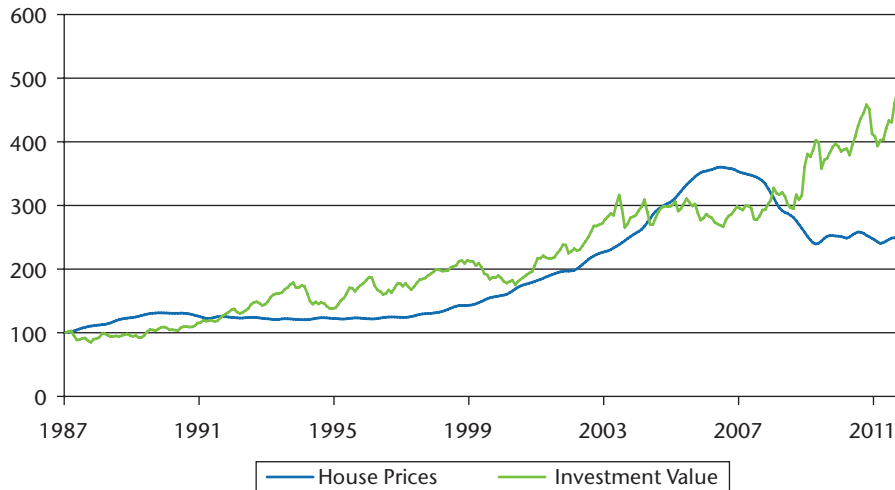
Chart 2. Homeownership Rate and Housing Starts



Sources: Census Bureau and GR-NEAM

As the resulting oversupply has depressed purchase prices, however, rents have risen rapidly. Households that were in substance renters all along, who may have been forced back into the rental market by foreclosure, are facing rising competition for such units from others in the same situation. We have developed a model of the monthly cash flow value of housing based upon rents and interest rates. This treats a house as an investment, similar to a bond, which rises in value if interest rates fall. But it also rises when rents rise. We compare such a value with purchase prices in Chart 3.

Chart 3. House Prices and Investment Value Based Upon Rents



Sources: Bureau of Labor Statistics and GR-NEAM

Two observations are apparent. First, while house prices have a life of their own, rising and falling in a cyclical pattern, the investment equilibrium value does exert a gravitational pull. Purchase prices over time have cycled around that value. Secondly, the market today is crying for more rental supply, higher house prices or both. Over the period for which we have the data to produce these calculations, there has not been a gap approaching the current level. The return to ownership for rental rather than occupancy implied by this relationship is attractive.

The Fed arrives at the same conclusion. In their paper they observe:

One method of gauging the profitability of renting a particular property is to calculate its capitalization rate, or cap rate—the expected annual cash flows from renting the property relative to the price at which the REO (real estate owned, by the lender following foreclosure) property holder could expect to sell in the owner-occupied market. Preliminary estimates suggest that about two-fifths of Fannie Mae’s REO inventory would have a cap rate above 8 percent—sufficiently high to indicate renting the property might deliver a better loss recovery than selling the property. Estimated cap rates on the FHA’s REO inventory are a bit higher—about half of the current inventory has a cap rate above 8 percent...

They suggest that a government program to encourage the rental of foreclosed properties would support the housing market. An 8% return in current financial markets is very high, but investment demand would turn on the question of the terms upon which capital would enter such a market. The question left unaddressed by the Fed is whether such entry should be encouraged with the offer of government support.

We expect that such a proposal will be reviewed with contention in Washington, since it will be viewed by skeptics as an averaging down by the mortgage agencies to extricate them from a problem for which they are in part responsible.

The economics are compelling, however, whether or not such an idea receives support. Eventually economics do matter. Housing in the U.S. is an increasingly attractive asset class, particularly as the same Federal Reserve devalues the dollar. Prices may fall somewhat more, but the large majority of the decline is over. We raised questions about housing finance in 2004, two years before prices peaked. It took New Century Financial, our poster child at the time, three years to go bankrupt. But the rotten economics were apparent before the peak. The U.S. is now at the opposite end of the cycle. It may be early to call a bottom in housing today, but it is a low risk conclusion at current valuations.

American housing values contain, in addition to attractive cash flow economics, an option for which a buyer today pays nothing. It is likely that over time, rising inflation is the implicit but effective answer to reducing the government's debt level. It will likely be years before there is another boom in American housing, but the intrinsic value of housing rises as the central bank stuffs the financial system with bank reserves. Eventually those reserves are the raw material for money supply. Single family housing supply over time is constrained by land supply, which is growing at virtually zero, while the banking system is drowning in reserves. In the 1970s it was an article of faith that housing was a reliable inflation hedge, at a time when the Fed paid inadequate attention to money creation. The option on such an outcome is given no value today in house prices. But the intrinsic value of that option is well in excess of zero.



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