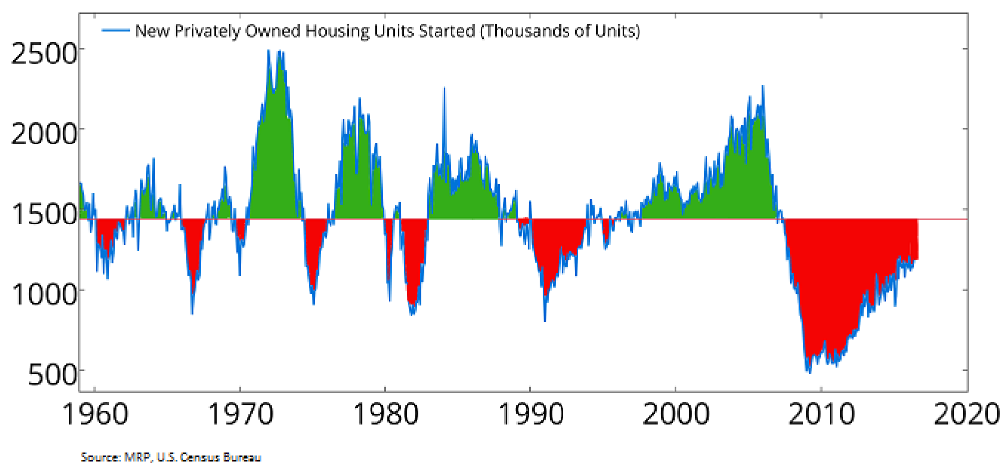
NEW Pig in the Python

Market Viewpoint: August 5, 2016

In June, MRP made the case for a return of stagflation in the years ahead. We also stated our expectation to see "periodic growth surges" and a stronger housing market that would soon contribute to better economic growth numbers. Indeed, MRP has argued that the housing sector is on the verge of a second leg up. In recent months, we have already seen a steadily building recovery in the sector. This report focuses on the forces driving long-term demand. In addition, it will examine the positive cascade-like effect that the strengthening housing sector will have on the broader U.S. economy and the specific investment themes that are impacted by it.



Over the past decade, there has been a huge buildup in pent-up demand for housing. Housing starts hit a bottom in March 2009, and have sinced roared back 144%. However, the latest reading of 1.2 million housing starts is still below the long-term average of 1.5 million starts that is needed to keep pace with normal replacement demand, population growth, and new household formations. Since breaking the long-term trend in 2007, there has been a cumulative underbuild of 5.3 million units, a net shortfall that can be thought of as pent-up demand. At the current pace, that cumulative gap could rise to between 6 and 7 million units within the next couple of years.

So far, most of that potential demand has yet to materialize. New household formations, a key propulsive force behind actual new housing demand, have failed to keep up with population growth. Last year, we had reasoned that millennials, generally thought of as born between 1982-2004, would be driving household formation at this point. But data from the Census Bureau suggests that has yet to be the case. The 2015 household formations for those 34 years of age and younger was de minimus while Americans over 55 accounted for more than 90% of all households formed.

Wait .... what? Those baby boomers are forming most of the new households? Well, that's what the census numbers unequivocably show. Once described as a "pig in a python", the baby boom generation, born between

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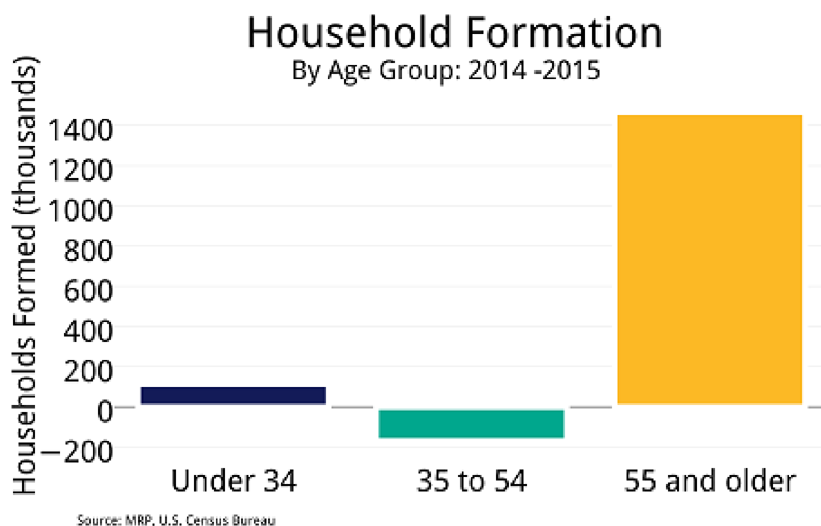
1946 and 1964, is still impacting the U.S. economy in unexpected ways. For instance, although the overall divorce rate is down, boomer couples are breaking up at unprecedented rates: The divorce rate for couples over 55 has doubled since 1990, and for 65 and older it has tripled. Also, the labor force participation rate for those aged 55 and older has been rising and job growth for this generation has been much stronger than for the rest of the population during the recovery.

But now there is a NEW pig in the python! The millennials already outnumber the boomers and are set to have a major impact on household formations. For one thing, the oldest members of the millennial generation have only recently begun to hit the average age at which Americans form new households. As each day goes by, more and more millennials cross into their late 20s and early 30s, ready to strike out on their own. Also, while job growth for the young has lagged the rest of the population throughout the recovery, that appears to be changing according to the latest payroll numbers.

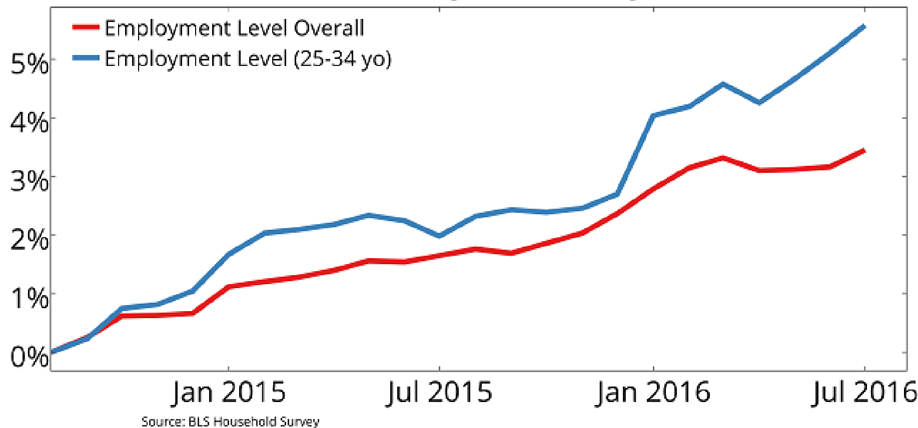
In addition, it is important to understand the idea of "headship rate" or the rate at which adults live independently as heads of individual households (ratio of households to adults). As a general rule it follows that a higher headship rate implies there are fewer adults per household on average. Statistically, 24 year olds tend to not be heads of independent households and are more likely to live at home or with friends, while 65 year olds tend to live on their own or with a significant other.



Yet the surging "gray" divorce rate is driving a change. Households are the product of the overall adult population and the headship rate. Therefore, a rise in either population or headship rate produces a rise in households, and vice versa. A change in population reflects normal accretive trends while a change in headship rate indicates a behavioral change within an age group. Translation: headship rates for boomers have been strong, but for millennials, quite weak.

Following the last recession, if millennials had moved out of their parents' homes and become heads of households at the same rate as previous generations, the data would register higher headship rates and thus higher household formations for this group. Instead, the rise in household formations is due to the transition of boomers, a large segment of the U.S. population, into older age groups that have higher headship rates. This does not discount the fact that rising household formations from any age group increases home demand.

The millennials are now the largest age cohort in the labor force. As their unemployment situation continues to improve and their savings rate increases, their ability to afford their own place will rise. While the younger portion of the millennial employment level has performed poorly, over the past two years, the change in the older portion (age 25-34) of the millennial employment level has outperformed the change in the overall employment level.

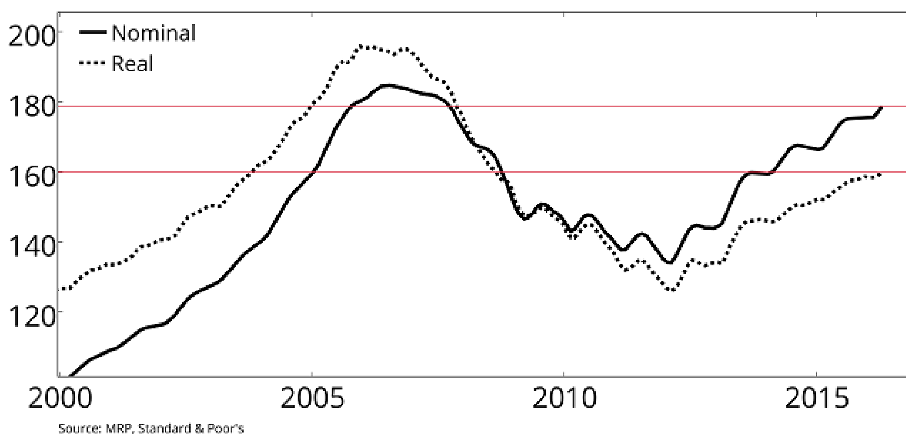


Almost all the outperformance has been in the past 7 months. Although seeing the effects of improved employment will take time, a powerful impact on U.S. household formations is imminent.

Given the improving job environment, the millennials represent a substantial amount of pent-up demand that could be unleashed as behavior shifts to fall more in line with historical norms. When this happens, housing demand will rise in line with a surge in new household formation, spurring a boom in construction activity and growth in all housing-related sectors. So the next few years may see two pigs in the python, the unlikely duo of boomers and millennials, together driving household formations sharply higher.

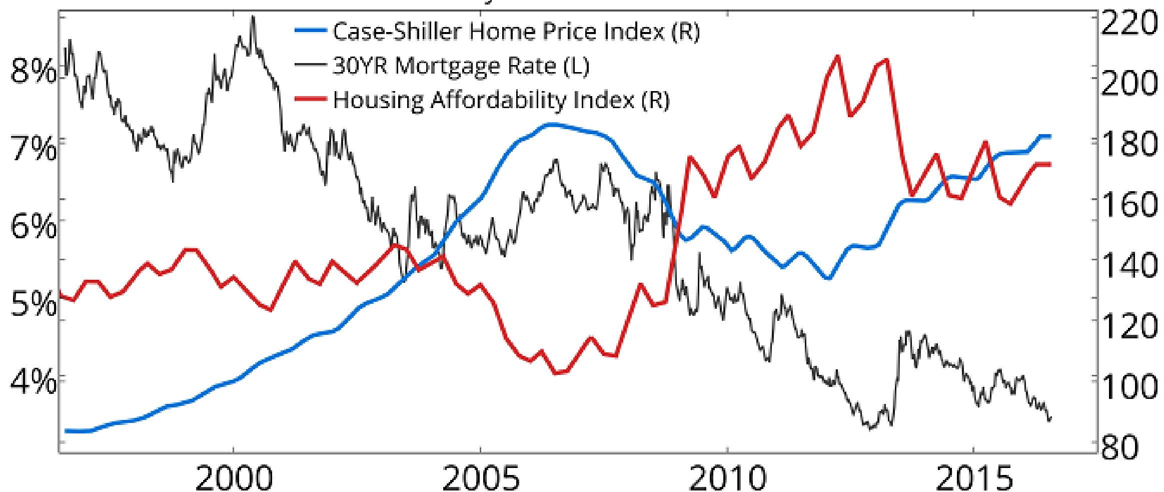
Booming demand, however, is running head on into short supply. The months' supply of houses for sale is 4.9 for new homes and 4.6 for existing homes; both metrics are at historically low levels. As home ownership demand increases, the number of new units that need to be built will also have to rise in order to keep pace, requiring annual starts in the 2-2.5 million range for an extended period.

Although the recent homeownership rate hit a 51-year low, it is due in part to a higher percentage of potential homeowners opting to rent than buy and continued negative sentiment toward homeownership following the housing crisis. While it has been cheaper to rent than buy in recent years, the trend is starting to reverse and we'd expect to see homeownership rates increase – pushing demand higher. Recent data shows that in 42 out of 50 states, it is cheaper to buy than rent.

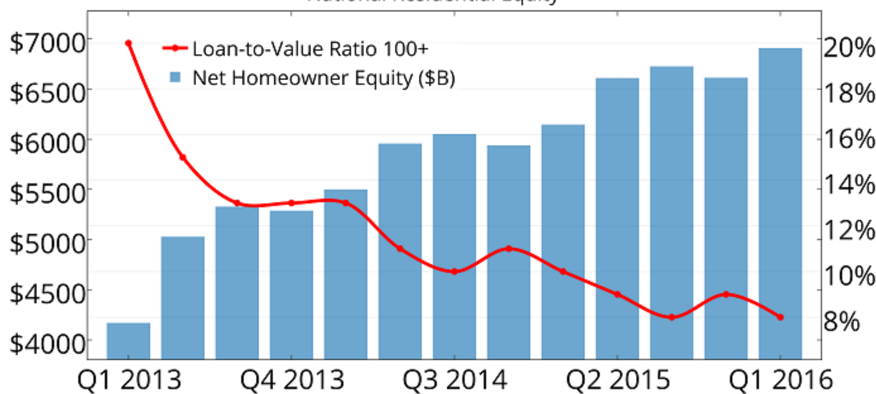


Meanwhile, U.S. home prices have enjoyed a steady recovery over the past four years, notwithstanding the weakness in millennial household formation. Prices in many cities have already exceeded their pre-housing bubble highs. The widely-followed Case Shiller National Home Price Index plummeted over 30% from its peak in July '06 to its spring '12 lows, but has since recovered a whopping 90% of its lost ground. Similarly, the Federal Housing Finance Agency (FHFA) Index, Case Shiller's less volatile cousin, plunged 20% in the aftermath of the housing bubble and has also recovered 90%.

The current economic environment provides solid incentives for consumers of all ages to purchase a home. The national average for a 30-year mortgage rate is now 3.4%, just above their cycle low of 3.3% and half of the level before the housing crisis. Lower mortgage rates, of course, improve home affordability, which will be an additional spur to the already strengthening U.S. housing sector. Though the Fed hiked rates in December for the first time in seven years, many are skeptical about further increases given Brexit fallout, unmet inflation targets, and general global economic malaise. Even now the futures market is pricing in only 39% probability of another rate hike by the end of the year. Furthermore, a low unemployment rate has created an excellent economic environment for consumers with steady income and improved credit scores to purchase a home at a low interest rate. In short, while home prices have moved up a lot, they are partly offset by other favorable factors. The National Association of Realtors (NAR) produces a Housing Affordability Index that measures the ability of an average family to afford the monthly mortgage payments of an average home. Currently, the index is down 14% from its all-time high but it is still well above the worst point of the housing bubble. At this point, the typical American household has almost twice the income needed to qualify for a purchase of a median priced home.



While more Americans are increasingly capable of purchasing a home they can afford, it is also the case that many are now able to sell homes they had bought or refinanced during the 2005-2007 period. CoreLogic reports quarterly statistics of homes "underwater." A home underwater is defined as a home where the loan to value ratio is above 100, meaning that the homeowner owes more on their mortgage than the current estimated value of the property. Since the beginning of 2013, the percentage of homes with negative equity has more than halved. Many homeowners with more positive home equity can put their house on the market now that the probability of repaying their mortgage is much higher.



The rise in home prices has other effects as well, especially with regard to consumer psychology. A homeowner who intends to sell his/her house sometime in the future looks at the home as an asset whose value will appreciate over time. If the value of the house increases, the homeowners may opt to consume a percentage of the increase in the value of the eventual sales earnings. They can do this by borrowing against the value of their home through a home equity loan or simply saving less and consuming more. It isn't as unequivocal as this but the idea of the wealth effect has significant appeal and data to support it. While there is variability in spending habits between person to person, it is safe to assume that enhanced wealth perception increases consumer confidence and willingness to spend.

In conclusion, **MRP is affirming its Long U.S. Housing theme**. Several specific industries will benefit from rising home prices, increased existing home transactions, and new home construction. The major beneficiaries are **homebuilders**. With the construction of new homes, it logically follows that they will need to be furnished, while existing homes will be modified and improved. The *Dow Jones U.S. Select Home Construction Index* contains a diverse basket of securities that effectively captures an acceleration in home building. The *S&P Homebuilders Select Industry Index* contains securities that take advantage of the housing retail sector that includes **home improvement** products and **retailers**. There are ETFs for both indices. Furthermore, with increasing new and existing home sales, it would follow that there would be an increase in the volume of title **insurance applications** and **real estate broker** commissions – boosting revenue for both.

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