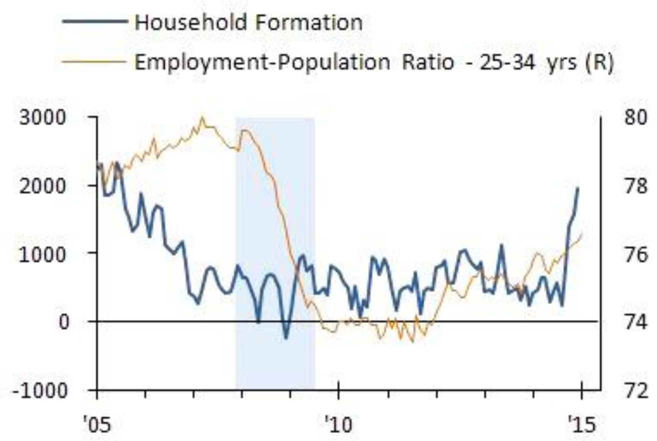
Millennials Ignite Housing

Joe Mac's Market Viewpoint: March 4, 2015

The U.S. housing sector is on the verge of a major second leg up. The stage has been set for a while. Mortgage rates remain near record lows, credit availability is improving, and employment has been surprising to the upside. Now, a real game-changer has emerged: household formations are surging. Following a long plateau, new home sales, housing starts, and residential employment will soon follow.

The first leg of the recovery came in 2012, when house prices bottomed, home sales turned up, and the homebuilder stocks soared. Then the housing recovery stalled. Many factors were at work, but one critical piece was needed to keep the recovery going: new household formations among younger Americans. The narrative has been something like this: Millennials can't find a great job, and unlike generations before them, many have opted not to go out on their own and set up housekeeping, but rather to stay put with their parents. Household formations, which had averaged 1,250,000 before the crisis, bumped along a bottom of around 500,000 to 600,000. That is, until now.

EMPLOYMENT–POPULATION RATIO VERSUS FORMATION VERSUS STARTS



Source: Bloomberg, McAlinden Research Partners

Just in the last 3 months, household formations surged to a 2 million annual rate, back to pre-crisis levels. That surge follows a dramatic improvement in employment among 25-34 year olds. Even if the formation data cools, we see it as an important signal and a likely harbinger of things to come in other housing datasets.

Meanwhile, mortgage rates have settled back below 4%, the Mortgage Bankers Association (MBA) Mortgage Credit Availability Index has risen to a cycle high, and the Fed's Senior Loan Survey shows some easing in

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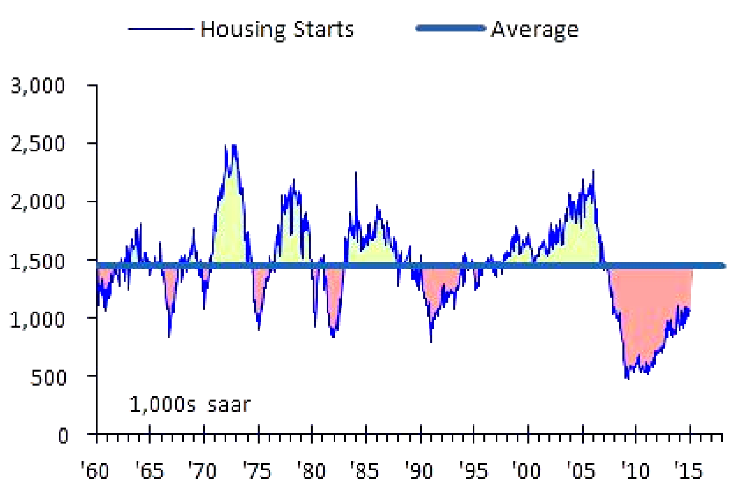
lending conditions. Just recently, Fannie Mae announced a program in which they will be buying mortgages with Loan-to-Value ratios of 97%. Yup, 3% down is back. Freddie Mac will start doing the same next month.

HOUSING STARTS PENT-UP DEMAND



Source: Bloomberg, McAlinden Research Partners

The upside potential of a second leg to the U.S. housing recovery is huge. Prior to the bubble and the crash, housing starts in the U.S. oscillated around a long-term average level of 1.5 million units. Because about 250,000 units are lost each year to natural disasters, fires, teardowns, fall downs, etc, the net additions to the housing stock averaged more like 1.25 million per year – roughly in line with the natural demand that comes from long-run population growth and normal household formations. But in this cycle, there has been a cumulative deficit of almost 5 million units below the long-term trend.

Now that household formation appears to be getting back to normal, that pent-up demand can drive new construction and house prices higher for years to come. We believe that over the next few years, starts will move back into the 1½-2 million units range and stay there for a sustained period in a pattern of renewed strength. Many securities – stocks, bonds, and commodities – will be beneficiaries of the construction boom. The relative strength breakout in homebuilder share prices appears to confirm that a change is at hand.

HOMEBUILDER STOCKS – ACTUAL VERSUS RELATIVE STRENGTH

Source: Bloomberg, McAlinden Research Partners

Back in the Spring of 2012 we wrote: "Not only do we see an imminent strong pickup in home sales and new construction, but our own view is that house prices have bottomed and will start going back up before the end of the year and then rise significantly over the next three years." Near-term market turbulence notwithstanding, the second leg up of the housing recovery appears imminent, not just for homebuilders, but also for home furnishings, appliances, building materials, title insurers, and real estate brokers.

Joe Mac

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