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Housing, Homebuilders, and Corrections…

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April 2019

In the ten years since the financial crisis, housing markets have recovered, stock markets have eclipsed their prior highs, and the U.S. economy is on the cusp of its longest expansionary period to date. Despite these remarkable gains, the emotional impact of the financial crisis remains in the forefront of many investors' minds, leading to irrational concerns of the crisis repeating – a phenomenon referred to as the availability bias. Despite the rare nature of the financial crisis, the fact that it is so easily recalled, or "available," results in people overestimating the likelihood of a subsequent similar event. In this economic memo, we seek to ameliorate these fears. We begin with a review of current housing market conditions, discuss the rationale of our recent investment in homebuilders, and conclude with our outlook for housing and homebuilders.

The Bay Area perspective on the housing market is distorted due to soaring prices and affordability issues locally. The fundamentals of the national housing market remain healthy – affordability is improving, mortgage rates are falling, and existing housing supply and starts are trending below long-term averages.

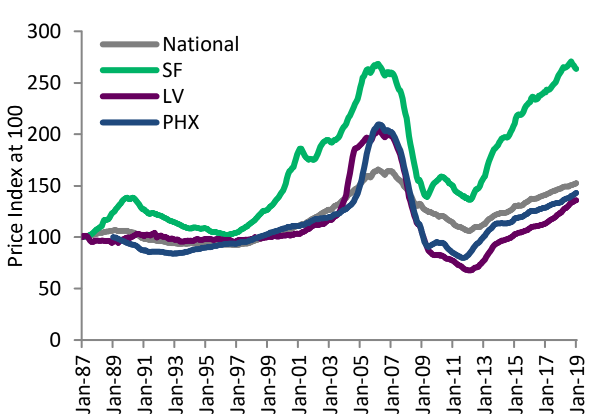
	Current Reading	6 months ago	Recession Trough	Pre-crisis Levels	Comment
Affordability	155.8	140.3	207.9	101.1	Higher is better
Mortgage Rate	4.3%	4.6%	3.4%	6.8%	Lower is better: 30 rear fixed rate mortgage
Months Supply	3.5	4.3	11.3	8.9	30 year average is 6 months
Housing Starts	1,162	1,280	543	2,151	30 year average is 1,300 starts

Sources: FactSet; Affordability & Existing Months Supply: National Association of Realtors; Mortgage Rates: Freddie Mac; Housing Starts: U.S. Census Bureau

Affordability measures the ratio of the median family income to the mortgage cost of a median priced home. At its current level, it indicates the typical family has 155% of the income necessary to qualify for a mortgage on a median priced house, well above pre-financial crisis levels and an indication that housing is still readily affordable for many Americans. Falling mortgage rates have driven the recent improvement in affordability. The interest rate on a 30-year fixed rate mortgage fell recently after the Federal Reserve indicated that it is halting interest rate increases while it assesses the underlying health of the economy. The supply of housing on the market and monthly housing starts remain below long-term averages and pre-crisis levels, further supporting our view that housing prices will continue to see modest growth.

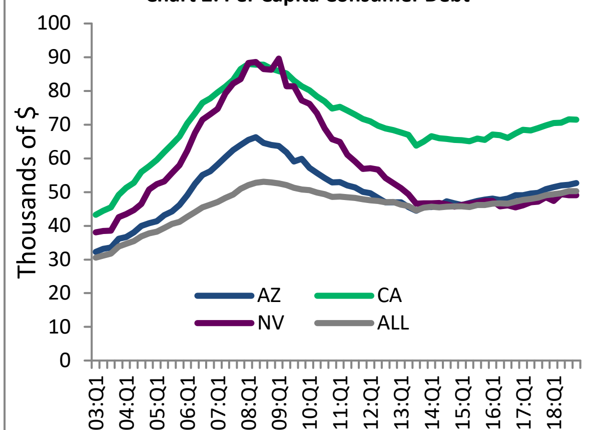
A further differentiator between today's housing market and the pre-financial crisis market is that price gains today are not as broad based as before. Today, significant price appreciation is primarily confined to locations with supply constraints such as geographic limitations or permitting issues (e.g. San Francisco); whereas, areas without these constraints (e.g. Las Vegas, Phoenix) have experienced more moderate appreciation with prices still well below their inflation adjusted peaks, as shown in Chart 1. On an inflation adjusted basis, housing prices in San Francisco are just 3% below their prior peak, while Las Vegas and Phoenix are more than 30% below. Additionally, as shown in Chart 2, per-capita debt levels are generally much lower today than they were in the lead up to the financial crisis.

Chart 1: Inflation Adj. Housing Prices



Source: S&P Case-Shiller, FactSet, Osborne Partners

Chart 2: Per Capita Consumer Debt



Source: FRBNY

Immediately preceding the financial crisis, increasing housing prices led to increasing consumer debt levels, creating a dangerous negative feedback loop with disastrous results. We are not seeing this dynamic in the current market. Given the healthy market indicators noted above and the more sustainable consumer debt levels, we remain confident that the housing market will continue to see pricing gains.

In late October, we invested in this positive outlook by adding exposure to homebuilders in our real estate holdings. We took advantage of the fourth quarter selloff in homebuilding stocks to initiate a position in the industry while valuations were at the lower end of their historical ranges. We expect improving home affordability and low interest rates will lead to a solid selling season this spring, helping homebuilders increase the number of homes delivered this year versus last year.

Homebuilding stocks in the first quarter had their best quarter since 2012. The industry’s rally has been driven by better than expected financial results and guidance coupled with declining mortgage rates. Even with the strong performance year-to-date, the industry still trades at a discount to average historical valuations and we believe there is still upside for homebuilders in this generally healthy housing market.

Despite our positive outlook, the increasingly dour headlines about the San Francisco Bay Area market and the indelible pain of the financial crisis are sure to cause a certain level of anxiety. We continue to highlight that the national housing markets are healthy with many showing stronger fundamentals than were seen before the financial crisis. We believe low mortgage rates, increasing affordability, and a strong labor market will lead to reasonable gains near-term. Over the longer-term, when a housing correction inevitably does occur, we expect it will be more analogous with the mid-90's, when prices declined 10%-15% in real terms, rather than with the nearly 50% contraction experienced during the financial crisis. When evaluating housing, or any other market, it's important to keep a long-term perspective and avoid the tendency of easily recalled painful memories driving your decisions.