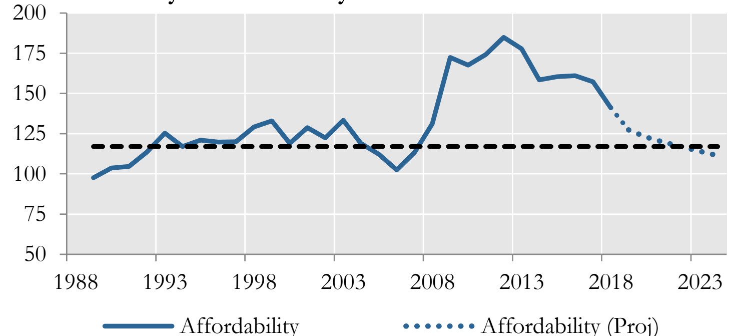
U.S. Housing Outlook: The Case for Continued Strength

September 2018

The U.S. economy has experienced strong growth in recent years, led in part by a booming housing market that has significantly recovered from the years following the financial crisis. Higher home prices and increased homeowner equity have fueled consumer confidence, serving as a foundation for robust economic growth. However, recent macroeconomic data has indicated potential cracks beginning to form in the housing market, worrying homeowners and investors alike. We dig deeper into the data to get a more accurate view of the various dynamics driving these numbers, showing why we believe that the U.S. housing market is poised to show continued strength, especially in the context of legacy non-agency RMBS.

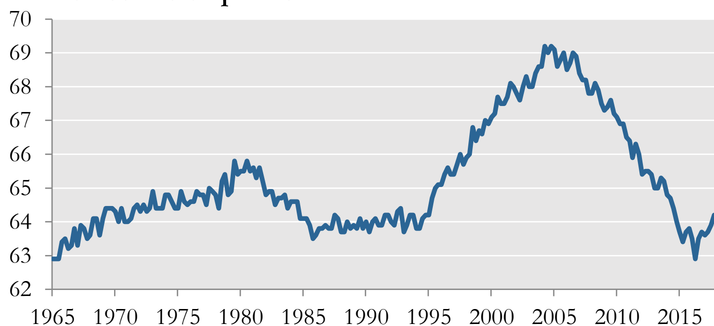
Reading the current news can lead to a bleak view of U.S. housing. Recent information tells us that housing demand has been hampered as affordability is deteriorating, driven in part by higher interest rates. The 30-year Freddie Mac conforming mortgage survey rate has increased over 50 basis points this year and is poised to go even higher with further rate hikes expected from the Federal Reserve. Home builder stocks have suffered as orders for new homes greatly underperformed expectations. Existing home sales decreased for the 4th straight month in July, leading to bloated inventories. The total for-sale inventory of U.S. existing homes has steadily increased this year and is currently sitting at 1.71 million units. But with such negative news on both the supply and demand fronts, what has been the impact on prices in the market?

The answer is contrary to what these recent data points would lead us to believe. Home prices continue their march upwards in spite of the negative news. The median sales price for existing home sales hit an all-time high in June, up 5.4% from the previous year. We believe there are several factors behind the headline numbers responsible for these price moves.



Source: NAR; Ellington

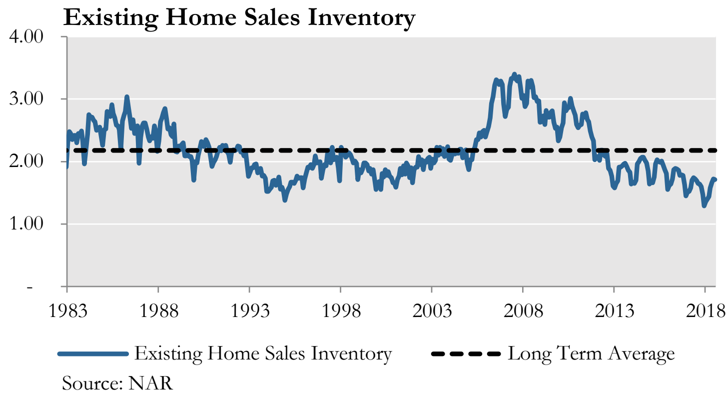
For one, recent information must be viewed in historical context, not simply in terms of the last several years. Even with its recent declines, home affordability is still much higher than its average over the last 30 years. Mortgage rates would have to increase almost 2% from current levels in order for home affordability to simply return to its long-term average. Similarly, assuming home prices continue to grow at 5%, wages continue to grow at 2.5%, and mortgage rates are indexed to Fed Funds futures, we project that homes will remain more affordable than the long-term average prior to the housing bubble through the middle of 2022 (see Figure 1). Existing home inventories are also still well below their average over the last 30 years. While these numbers have come off their recent extremes, they are still at very attractive levels from a historical perspective and continue to support home price growth.



Source: US Census Bureau

Additionally, strong tailwinds on the demand side of the home price equation work to offset the recent increase in mortgage rates. The U.S. has seen steady growth in household formation, led by an ageing millennial generation. Moreover, these newly formed families are deciding to become homeowners instead of renters. The

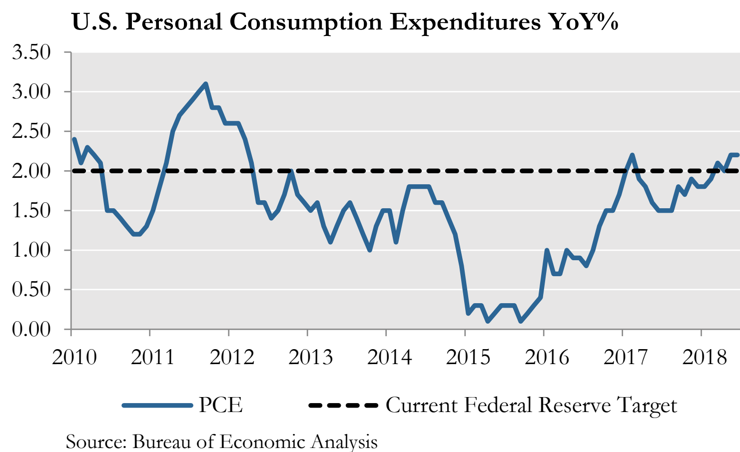
U.S. homeownership rate has been rising since 2017 as it recovers from the lowest levels seen since the 1960s. This was the first meaningful increase in the U.S. homeownership rate since 2004 (See Figure 2). Although there are many economic factors playing into this, we believe this rebound is partly driven by a tapering of the foreclosure crisis. After seven years, a foreclosure demerit drops off one's credit report, meaning that millions of borrowers who experienced foreclosures prior to 2012 may now have a higher credit score and thus a higher likelihood of homeownership.



On the supply side, we believe that higher existing home inventories, while still low historically, have been offset by a decrease in new construction (See Figure 3). Home builder stocks have suffered not necessarily because of weakness in the housing market but because of the rising costs associated with building a new home. According to the National Association of Home Builders, 60% of the costs of building a new home are associated with labor and materials, two areas that have been increasing due to continued shortages of skilled laborers along with increasing costs of materials such as lumber.

This brings up another important point for investors. Not every investment that offers exposure to the U.S. housing market comes with the same risks. The home builder sector perfectly illustrates this fact. While the sector is clearly exposed to housing demand, it also is exposed to the cost of materials and labor, which can be affected by a wide range of events, including tariffs and immigration. Although home demand has been strong, the sector has suffered because of these risks.

Additionally, for the first time since 2012, inflation is running at the Federal Reserve's target (See Figure 4; PCE tracks overall price changes for goods and services purchased by consumers). Real assets, such as commodities and houses, tend to be the best performers in a higher inflation environment. Assuming inflation continues to lead commodities higher and labor costs continue to increase, home builder margins would compress if they are unable to raise their prices to keep pace, adding additional layers of ambiguity to the question of their forward value. As discount legacy non-agency RMBS are essentially interests in real assets, we believe they avoid many of these issues and offer some of the purest investor exposure to the U.S. housing market.



Recent data points, which have caused concern on the surface, show only a fraction of the total picture. Taking a step back provides a better view of the supply-demand dynamics. Negatives for home builders can actually be positives for U.S. home prices, dampening supply. Demand is growing, evidenced by steady growth in household formation and a homeownership rate that has finally turned the corner after 11 years of decline since its historic peak. Affordability, though off the highs, is still significantly above its pre-crisis average while real assets tend to show strong performance in rising inflation environments. Going forward, the supply-demand imbalance appears poised to persist and should be very constructive for not only the U.S. housing market, but for legacy non-agency RMBS as well.

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PRINCF-20190924-0025