CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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"More House Renters"

A. Gary Shilling, February 2012

Americans' attitudes toward homeownership have changed significantly following the collapse of the U.S. housing market. Declining home prices, increased foreclosures, high unemployment, and tight lending standards make the outlook for housing particularly bleak. The rate of homeownership in the United States will likely continue to decline as more and more Americans re-examine the case for owning a home.

Americans' attitudes toward homeownership have changed significantly following the collapse of U.S. housing market. Still, Washington continues to pursue an alphabet soup of programs aimed at helping distressed homeowners stay in their homes or refinance their mortgages through a combination of principal reductions and lower interest rates. The cumulative effect of all these programs cannot be known for sure, but the government is not allowing the market to clear by keeping people in homes they can't afford. Further, many efforts will prove futile, and the rate of homeownership in the United States will continue to decline as more Americans re-examine the case for owning a home.

Following the bursting of the housing bubble, the U.S. government has played an ever-increasing role in attempting to revive the housing market. With programs such as HAMP, EHLP, and HARP, the U.S. government has tried to help keep homeowners in their houses and make their current mortgages more affordable. Unfortunately, many underwater homeowners could not afford their houses in the first place, having purchased and then withdrawn equity in the expectation that housing prices could only go up. As the housing bubble burst and the recession unfolded, many homeowners found themselves underwater and lost the incentive to continue paying their mortgages. In fact, many of the people who are technically homeowners should really be thought of as renters with an option on their home's price appreciation. It is estimated that 3.1 million people are currently not paying their mortgages and an estimated 12.5% of all residential mortgages are past due.

A key assumption regarding any rebound in the residential real estate market is that people who are currently not paying their mortgage or are underwater on their house will be willing to come back to the market. However, given the incredible bursting of the housing bubble and the current glut of supply it seems unlikely that homeowners that just lost a significant amount of money on a house would hurry to buy another. Struggling homeowners now realize housing prices do decline and may indeed have more room to fall. As much of the bias to own a house during the bubble was based on the belief that housing prices would only continue to rise, it is illogical to assume these homeowners will now be willing to re-enter the housing market.

Another issue dogging any rebound in the housing market revolves around affordability. Compared to the 1990s and early 2000s, the current economic landscape is categorized by falling real wages, negligible payroll employment growth, and a decline in median family incomes. Key assumptions regarding residential real estate's current level of "affordability" include

households supplying 20% equity and taking out a 30-year fixed rate mortgage. Where and how all the underwater homeowners will get that 20% for a down payment remains to be seen. Interest rates are at record low levels and for those people with good credit scores and ample savings, buying a house certainly does appear affordable. However, for some or most that are currently past due or delinquent on their mortgage, a shift toward renting and away from owning appears more likely.

Notwithstanding the efforts of the government and even the Federal Reserve to keep homeowners in their homes, the level of homeownership in the United States is already falling. As of fourth quarter 2011, homeownership in the United States had fallen to 66.0% from a peak of 69.2% in 2004. Declining home prices, increased foreclosures, high unemployment, and tight lending standards make the outlook for housing particularly bleak. An estimated 3.6 million mortgages are delinquent as of second quarter 2011 with estimates of that number approaching 5.0 million mortgages in the coming years. With housing prices falling significantly for the first time since the 1930s, many homeowners are abandoning or re-thinking homeownership. As people begin to re-consider their living situations and separate their housing decisions from their investment decisions, more Americans will find themselves renters as opposed to owners.

"The Road to a Self-Reinforcing Housing Recovery: The Outlook for U.S. Housing and Non-Agency Mortgages"

Tom Teles, Dennis Kraft, and Matthew Maciaszek, Goldman Sachs Asset Management, February 2012

U.S. housing prices have stabilized. However, credit availability, constrained by unresolved legal issues, is the main roadblock to a sustainable recovery. As these issues are resolved, an environment of increased bank lending and a decline in inventory should lead to a virtuous cycle in housing. While housing-related securities markets have primarily focused on shadow inventory and other challenges, investor focus may soon shift to the potential for a housing recovery.

The U.S. housing market has completed the first step in the road to a self-reinforcing recovery—price stabilization. Even though prices have been volatile on an intra-year basis due to seasonal demand swings, since 2009 the average annual change has been less than 1%, compared to 13% during 2003–08. Looking ahead, seasonal factors will likely cause a mild price decline in early 2012, before a gradual, but self-sustained, recovery begins in 2013.

The decline in home price volatility reflects the stabilization in mortgage credit creation. For example, the first part of a typical housing market cycle sees rising prices lead to credit creation, which boosts demand and leads to more price increases. This "virtuous" cycle eventually overshoots, leading to excesses in credit, leverage, and prices. At that point, the cycle reverses and becomes "vicious." Here, falling prices lead to reductions in mortgage credit, which reduce demand and lead to further price declines. While this part of the cycle likely ended in early 2009, a new cycle has yet to begin, leaving the housing market without an overriding credit creation

trend. As a result, seasonal factors have become the main influence on home values.

In a normal cycle, price stability should lead to an increase in mortgage availability, as the risk of making a mortgage loan is much lower, compared to an environment of falling prices. With improved credit creation, demand could grow, excess supply could be absorbed, and the market could enter a self-sustaining recovery. The current cycle, however, has seen outstanding legal and regulatory issues (i.e., "put-back" risk) create a roadblock to new credit creation. Importantly, however, there have been signs of progress. As these issues are resolved, the housing market can move to the next step toward a self-sustaining recovery: an expansion in credit availability.

Many of the pieces are already in place for an expansion in credit, largely due to the Fed's policy. First, the Fed has pledged to maintain a low short-term policy rate through 2014 and has shifted its Treasury holdings into longer-term bonds through "Operation Twist." Second, the Fed has reduced borrowing costs for homeowners by reinvesting the proceeds of its mortgage portfolio into mortgage-backed securities (MBS). In fact, the "primary" 30-year mortgage rate (i.e., the rate that homebuyers pay) and the "secondary" mortgage rate (i.e., the rate on MBS) have declined to record lows. Further, the rate on MBS has fallen more sharply, leading to an increase in the spread between the two rates. Larger spreads imply a greater potential profit from originating mortgages, as lenders can originate loans at the primary rate and then sell those loans at the secondary MBS rate. Improved margins, combined with the fall in house price volatility, should lead to increased credit creation.

On the demand side, low primary mortgage rates have contributed to a significant increase in the affordability of housing. According to the National Association of Realtors affordability index as of November 30, homes are now more affordable than they have been at any other point over the past 25 years. By their estimates, a family earning the median U.S. salary can afford to pay 1.8 times the monthly mortgage payment on a median-priced home at current mortgage rates. As a result, demand for mortgage credit should increase. In addition to affordability, pent-up demand for housing should help to support banks' willingness to lend. The number of new households declined significantly during the recession—the Census Bureau reported in September that the number of "doubled-up" households increased by two million, or 10.7%, between the springs of 2007 and 2011. However, household formation is now experiencing a cyclical rebound.

The next major step in the road to a housing recovery is a reduction in the amount of excess supply. While credit creation can help new buyers absorb some of this demand, investors will also need to play a role given the size of the overhang. Indeed, at the current rate of home sales, it would take nearly 20 months to clear the current 7 million unit overhang of excess supply, which includes new and existing homes for sale as well as the "shadow" inventory of distressed and bank-owned homes. One possible solution is converting existing homes to rental units to reduce the number of distressed, vacant homes. There is strong investor demand to facilitate the transition of vacant properties to rental units, given the potential yield from rental properties is highly attractive, even on an unleveraged basis. Government initiatives could facilitate this process.

Clearly, U.S. home prices still face formidable headwinds. However, legal and regulatory issues are abating, while the reduction in excess supply is slowly continuing. These positives will likely lead to a gradual, but self-sustaining, recovery in house prices beginning in 2013. Housing-related

securities could begin to discount such a recovery well in advance should investors shift their attention from these negative factors to more positive ones (e.g., affordability). For instance, a turn in sentiment could have an outsized impact on non-Agency mortgage securities, given these assets have significantly lagged both equities and high-yield bonds since the March 2009 bottom, due in part to uncertainty about home prices. Underperformance has left these assets relatively attractive—for example, loss-adjusted yields in many non-Agency segments (e.g., option adjustable-rate mortgages) are well above other fixed income sectors, including high-yield and emerging markets debt. Thus, non-Agency mortgages have significant upside potential in a more stable environment, particularly one marked by progress toward a sustainable housing market recovery. ■