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GLOBAL MACRO

U.S. Real Estate, Does It Still Matter?

The U.S. housing recovery, considered a slam dunk by the vast majority of economists since spring 2012, has sputtered since summer 2013. Even though most economic indicators have been pointed higher in recent months, real estate has been the odd man out. Housing starts have been wildly unstable from one month to the next and are hardly increasing at all. At less than 900,000 housing units in June, they are on par with end-2012 and still a long way away from returning to their long-term average, while many observers predicted they would do so by the end of this year.
How worried should we be? What would happen if activity in this sector failed to return to normal levels during the current cycle? What weight will the Fed give to these disappointments in its decision-making process?

Real estate, a core factor in the U.S. scenario

Three years were needed between the official end of the 2008-2009 recession and the return of a clearly more encouraging outlook for the American economy in 2012. Three years was also the time needed for the real estate sector to get back on the growth track, particularly with regard to home prices. In fact, it wasn't until spring 2012 that the U.S. situation brightened somewhat and that the possibility of an eventual monetary policy normalization was first discussed. Since then, markets have been incessantly vaunting the strength of the recovery, which we are led to believe does all of the following:

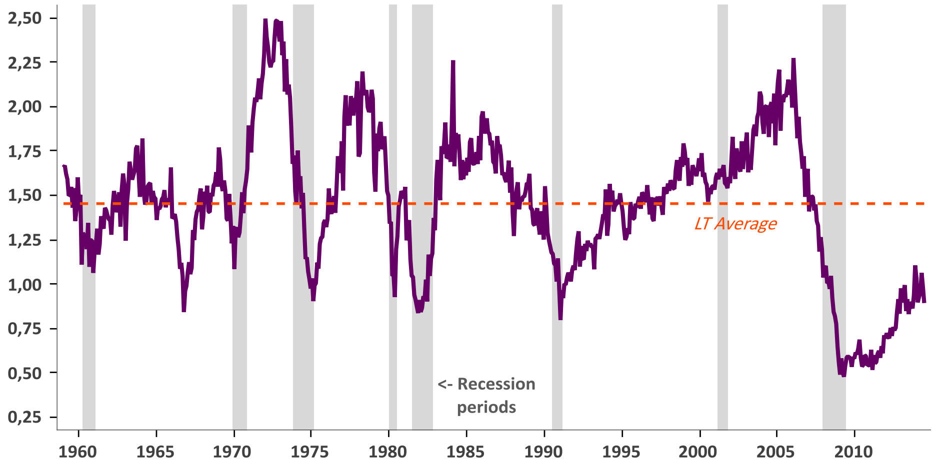
- Attests to elimination of the over-leveraging process and the cleansing of the banking system.

- Restores a growth and jobs driver (e.g. construction and services).

- Fuels the wealth effect and thus stimulates household consumption.

- And justifies, in the long haul, anticipations of a normalization of the Fed's monetary policy, which dovetail expectations of a rate hike in the long term…

U.S. Housing Starts, A.R., Million



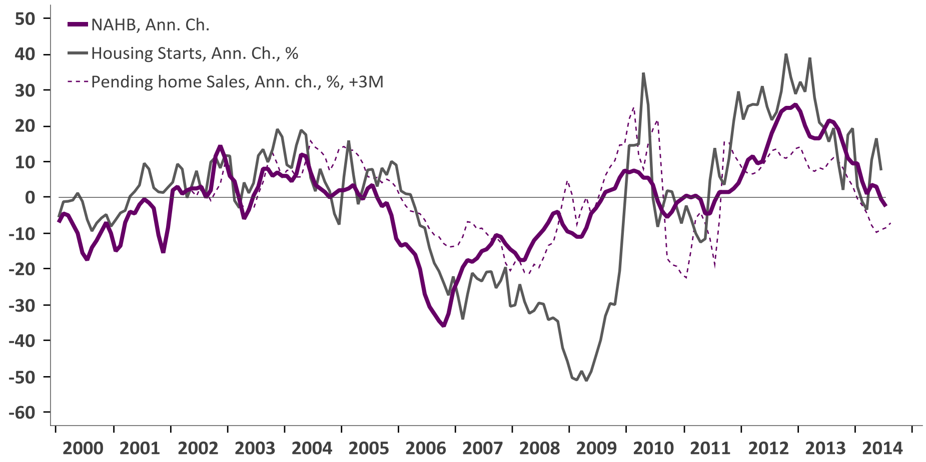
Sources: RichesFlores Research, Macrobond

Despite mediocre indicators portraying the reality of housing activity for nearly one year now, the ongoing rise in prices has continued to fuel confidence in this scenario. That was, until recently when even the Fed shared its disappointment in the sector's performance and the importance that it should be given. During Janet Yellen's latest communication, the subject of real estate in fact appeared as a new, and crucial, argument in favor of maintaining interest rates at close to zero, even after asset purchases have ceased. Once again, property has surged to the forefront and will most certainly play a decisive role in economic and monetary developments to come.

"When housing is good, everything is okay", but is the opposite true?

Is the Fed right in focusing so heavily on developments in this sector? If we are to believe the arguments that have been cited regarding the housing recovery's work in lifting the greater economy, then the answer is undeniably yes. However, business volumes suggest that over indebtedness has not been resolved, that the banks are not lending like they used to before the crisis and that the wealth effect is simply not forthcoming. If this is the case, the rise in prices in the last two years should not be considered as a gauge of improved health but rather as a result of a market that is malfunctioning. If so, the sector could be a hindrance rather than a salvation for the future.

Indicators of U.S. Real Estate Activity



Sources: RichesFlores Research, Macrobond

Two reasons argue in favor of understanding the situation from this perspective rather than the generally-held point of view.

1. The notion that deleveraging has been sufficient enough to spark a housing recovery is highly contestable. Household indebtedness, which stands at 104% of disposable income, is persistently high and well above its long-term average (75%). In fact, compared with the wild excesses of the pre-crisis years, household leveraging has merely taken a half step back. It is plain to see that this factor is an obstacle to a recovery in both activity and mortgage lending.

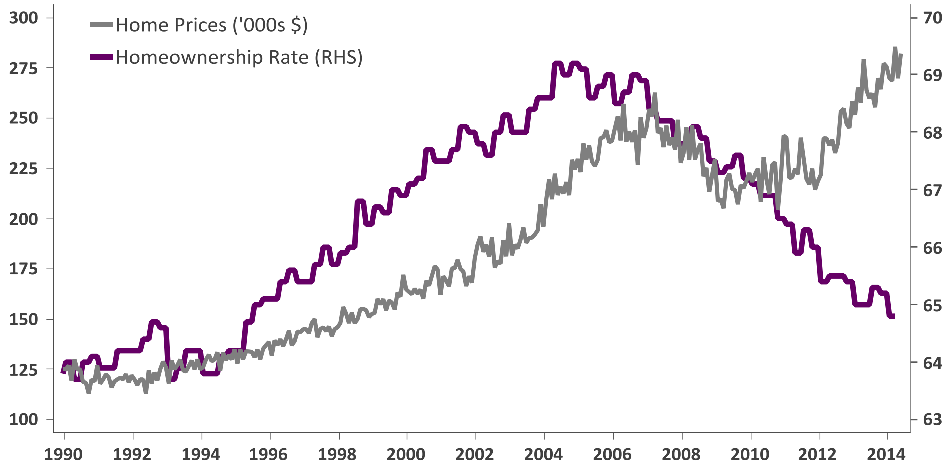
2. The argument that rising prices will drive sector activity is also very much up for debate. Housing prices seem to have been largely influenced by unusual malfunctions in both supply and demand.

- This observation could initially seem to be a paradox, supply, since the crisis, has been woefully insufficient, primarily for two reasons: owners are unable to sell their properties, the sales price of which would be less than what they owe to the bank (negative equity) and the sizeable percentage of properties for sale in devastated areas the majority of which will not be put back on the market.

- At the same time, demand has been artificially stimulated by broad-scale buying by professional investors.

The result of these malfunctions is reflected in an unusual disconnect between the direction of prices, especially for new homes, and that of demand from individuals, illustrated by the percentage of homes occupied by their owners, a rate which has yet to stabilize.

Sales Prices of New Homes Sold and Homeownership Rate



Sources: RichesFlores Research, Macrobond

Such a situation is naturally troublesome for the future capacity of Americans to own their own home.

A reality the Fed cannot under-estimate

This situation affects the economic outlook in several different ways.
- The first is housing demand's extreme sensitivity to interest rates, which is the only way to bolster demand given current conditions.
- The second, regarding the financial risk to which institutional investors are exposed if the bottom should fall out of prices.
- The last involves the strength of the economic recovery, which will obviously become more difficult if the housing sector is soft. The sector is an important factor in whether or not households buy consumer goods, which has traditionally been an important driver of the household consumption cycle.

We now understand better the importance the Fed has given to the housing sector's disappointments in recent months and the ramifications they could have on monetary policy decisions… at the risk of maybe maintaining abnormally accommodative conditions for other areas of the economy.

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