The Current U.S. Housing Market
Where to Invest & Where to Use Caution

As the price of U.S. housing reaches historic highs and continues to climb, financial experts and investors alike are questioning the reasons behind this continuous growth. Have we reached a peak, signifying a future decline? Is another housing crisis on the horizon?

We believe the answer to both of these questions is no, at least in the short-term. Throughout 2016, the U.S. housing market experienced steady growth in home sales. In Q1 of 2017, prices remained stagnant, yet growth persists. This uptick is just one indicator signaling that the U.S. housing market remains in a period of recovery, albeit slow.

In this Thinking Man, we will be providing our thoughts on key demographic trends, supply & demand expectations, and investment views & considerations for navigating this U.S. housing market.

Demographic Trends

The demand for existing and new-construction homes is picking up all over the country due to several factors. Two main trends which play a significant role include a demographically changing population driven by increased immigration and the millennial generation. Current data projections indicate these numbers will continue to rise.

Increased Immigration

Immigration trends continue to grow after hitting a low in 2011. As a whole, the attitude in America towards immigration has not changed significantly since President Trump's campaign promises – the general desire to decrease immigration is near its historic low in Gallup's trend over more than half a century. We expect immigration trends to continue benefitting the U.S. housing market.

According to the United States Census Bureau, Hispanics are the largest minority in the United States (56.5 million in 2015), comprising 17.6% of the total U.S. population. The Hispanic population is the second-fastest growing, with a 60% increase between 2000 and 2015.

The U.S. Asian population grew 72% between 2000 and 2015 (from 11.9 million to 20.4 million), making it the fastest growing amongst any major racial or ethnic group, according to the same source.

The Thinking Man's Approach

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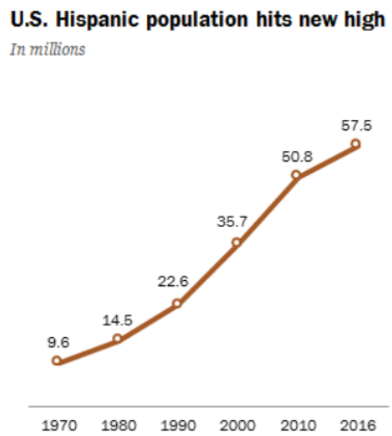
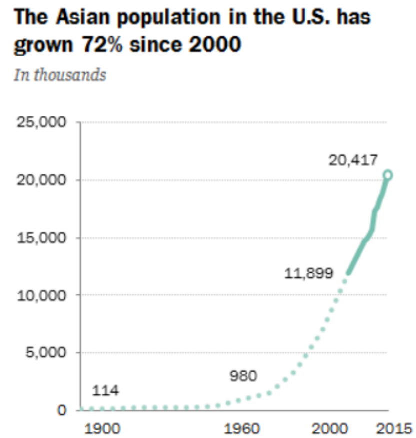
- U.S. housing market will enjoy further growth as it continues its slow recovery
- Demand for existing and new homes is picking up due to demographic factors
- Supply is low for existing single-family homes and new projects
- However, new and existing home sales are expected to increase into 2018 as supply slowly catches up
- We recommend clients to be cautious on the oversaturated high-end segment of the market
- In most markets, overall demand continues to grow faster than the supply. We don't expect this trend to change anytime soon
- Investment opportunities can be found in rental properties, particularly in middle-to-lower income areas with a supply-and-demand imbalance

For more on how we are positioning our portfolios, please contact your investment advisor or email: ideas@bigsurpartners.com

According to the Joint Center for Housing Studies of Harvard University, "In 2014, foreign-born Asian households aged 25-44 had a median income of $82,000 – more than twice the $38,000 median of similar aged, foreign-born Hispanic households."



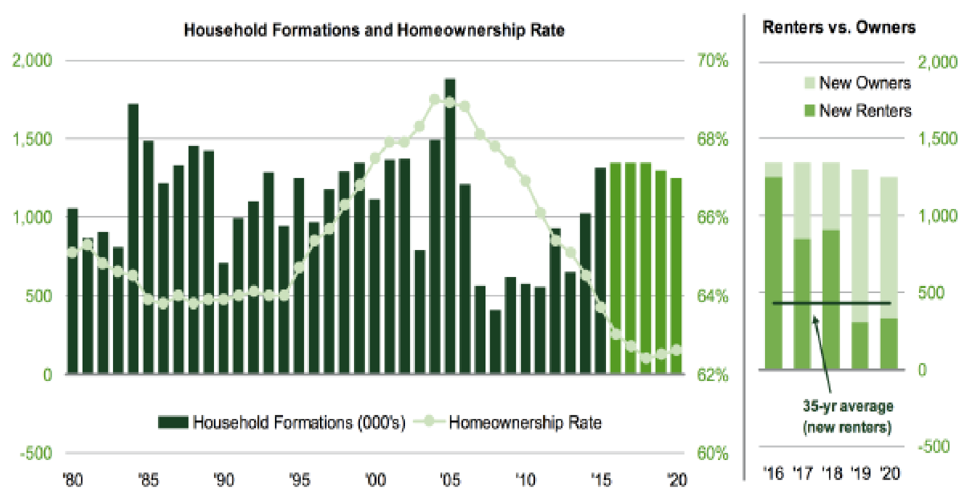


Source: Pew Research Center / U.S. Census Bureau

Millennials

The growing presence of Millennials (the largest cohort in history) in the U.S. housing marketplace has also had a strong impact on the face of demand. Millennials are coming of home-buying age as this generation reaches their thirties. In 2016, there were an estimated 79.8 million Millennials (ages 18 to 35 in that year) compared with 74.1 million Baby Boomers (ages 52 to 70), according to the U.S. Census Bureau. Additionally, the Millennial population is expected to continue growing until 2036 as a result of immigration.

Projected to make up 75% of the global workforce by 2025, Millennials will be finally striking out on their own over the next ten years, moving out of their parents' households and into the home-buying market.



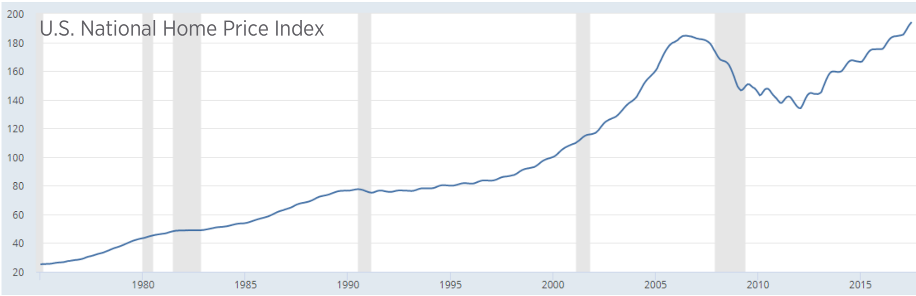
Source: U.S. Census Bureau

Homeownership amongst millennials has come down significantly, and this has translated into strong rental demand. We expect this tendency to persist for a couple of years before the homeownership rate stabilizes.

Baby Boomers

Baby boomers are hanging onto their homes longer, and as their generation hits retirement age, they are driving down inventory. This low inventory is squeezing the market. Although the retirement markets of Florida and Arizona are not seeing the same inventory shortages because they are typically construction hotspots, the baby-boomer factor could certainly impact future inventory.

So, while low inventory pushes up prices – presenting a barrier to first-time home ownership for both Immigrants and Millennials – both new and existing home sales are still expected to increase into 2018 as supply catches up (slowly but surely). This lack of homebuilding in metropolitan areas is the strongest factor behind any lag in the market's pace. Furthermore, home price appreciation is expected to remain at 5% or higher for 2017.



Source: S&P/Case-Shiller U.S. National Home Price Index

Supply & Demand Expectations

We believe that there will be a robust demand going forward, but that supply is low for both existing single-family homes and new projects. Why the low supply? After reaching a peak of 2,000,000 new housing permits in 2005, new construction in the U.S. has drastically dropped due to the aftermath of the 2007-2008 financial crisis. Although the pace of new construction has picked up again since 2010, it remains well below the historical average, thus pushing supply levels lower.

In the Southern, Western and Midwestern U.S., particularly in urban centers, the inventory of new homes simply isn't meeting demand. The only areas of supply oversaturation can be found in high-end condominiums and single-family dwellings in pockets of slower economic growth. This can especially be noticed in suburban areas with new construction.

Since builders aren't building a greater number of new homes, they are creating higher-priced properties in dense, metropolitan areas to compensate for their inability to increase sales revenues.

Resulting in some oversaturation in the high-end segment of the market. This is particularly true in areas that are in periods of economic recovery and growth, where builders have swooped in to meet the growing market.

The resulting over-bidding and under planning has caused an upsurge in luxury condos and large single-family homes – pricing them out of executive and upper middle-class price ranges. According to Barron's, 54% of new home sales in the last two years have been priced at or above the $300,000 level, supported by historically low mortgage interest rates, economic recovery and solid job growth.

Unfortunately, in certain areas, there's simply an excess of luxury units that have outpaced demand. Excess supply in certain submarkets has caused a decrease in both home prices as well as rental rates. Even though buyer's appetite is increasing, it's still advisable to proceed with caution in the higher-end real estate markets.

Investment Views & Considerations

In most markets, the overall demand continues to grow faster than the supply – and we don't expect this trend to change anytime soon. Buyers should use caution when investing in high-end condominiums and single-family homes, particularly in areas with an excess of new construction, which may quickly outpace demand.

Opportunities to invest in rental properties may arise, particularly in middle-to-lower income areas where the balance of supply and demand continues to be askew. Over the last few years, BigSur clients have had the opportunity to get exposure to multifamily properties in secondary markets with compelling fundamentals. The growth of these submarkets has resulted in a stable tenant base. Additionally, BigSur clients have invested in Freddie Mac K-Notes, securities backed by recently-originated multifamily mortgage loans with strong collateral and credit qualities. We continue to seek investment opportunities in these areas and will present them to our clients once we find a suitable one.

Overall, the U.S. housing market has stabilized. As capitalization rates are compressed and property prices are reaching new heights, it is important to be extremely selective. There are pockets of concern, but also areas with strong fundamentals as long as demand continues to outpace supply.

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