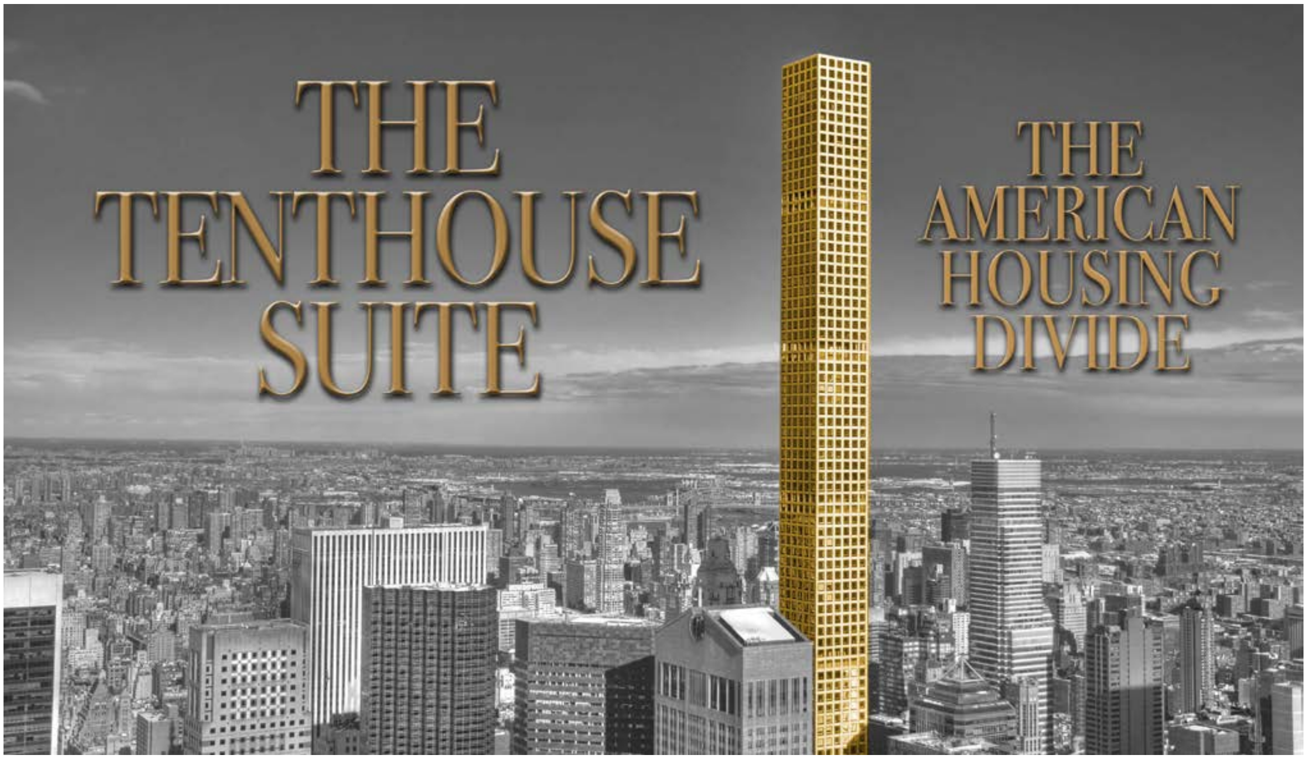


The Tenthouse Suite

The American Housing Divide

Everything has an origin, be it orthodox, obscure or even obscene. Gestures are no exception. Consider the occasion of Passover circa 66 AD, when God's first commandment to the Jewish people required they mark the new moon. According to ancient historian Josephus' recounting in *The Jewish War*, upon encountering a huge crowd celebrating the holiday, a Roman soldier, "pulled back his garment and, cowering down after an indecent manner, turned his breech to the Jews, and spake such words as you might expect upon such a posture." Let's not speak of said "spake" emanating from the orifice exposed during this first mooning. Instead, know that mayhem ensued as a riot broke out, inciting the Romans to a military response that killed thousands of pilgrims.

Is it any wonder mooning is punishable by law in some places? Luckily, in the modern era, violence is no longer associated with exposed backsides. Mooning is more likely to involve fevered soccer fans networks hope aren't captured on camera. And then there is the "Bras d'honneur," French for "arm of honor," dating back to the 100 Years War when the French were intent on showing their reviled English rivals exactly where they could put their weaponry. My first sighting of this gesture came from one of my older Italian relatives which prompted my copycatting it to my parents and asking what it meant. Oops.

The most famous of gestures involves the raising of the middle finger and dates back to ancient Greece. As to its original Greek origins, let's not go there and Google it if you must. Moving on in our history books, by the time the offensive gesture reached the Romans, it was cloaked in superstition and feared as a tool of black magic. Clearly, the visual equivalent of dropping an 'f-bomb' has come of age, accepted as the universal gesture of contempt.

It was with similar scorn that millions of New Yorkers regarded 432 Park Avenue as its slim silhouette rose to lord over the Manhattan skyline, an insult hurled by the super-rich, an affront visible to all five boroughs at once, a middle finger aimed at the unwashed masses. Back in November 2014, Rafael Viñoly, the building's architect was quoted as saying, *"There are only two markets, ultraluxury and subsidized housing."*

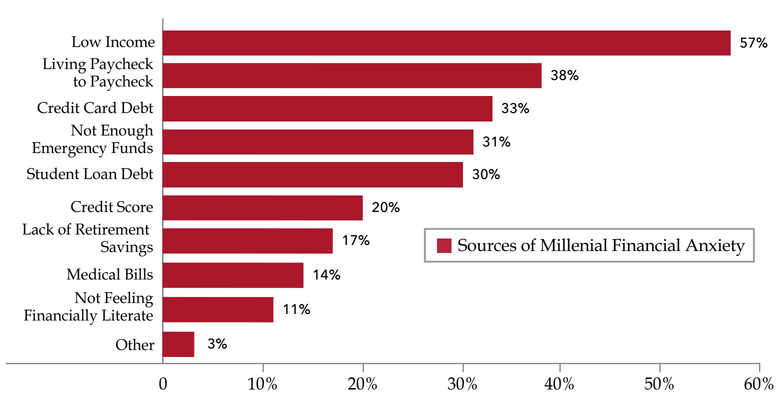
One can only imagine the satisfaction at the recent headline that the penthouse in the irritably iconic building had sold for $31.5 million, a pittance compared to the $95 million the 94th full-floor unit commanded in 2014. As far as the mighty have fallen, the divide on the housing front remains and in some ways is worse than it was five years ago.

As a contextual baseline, housing comprises a third of the average household budget, or at least that's the aim. When this level is breached, all sorts of things start to go wrong. That brings us to the millennials who hold the key to reinvigorating the housing market, but have been economically missing in action for over a decade.

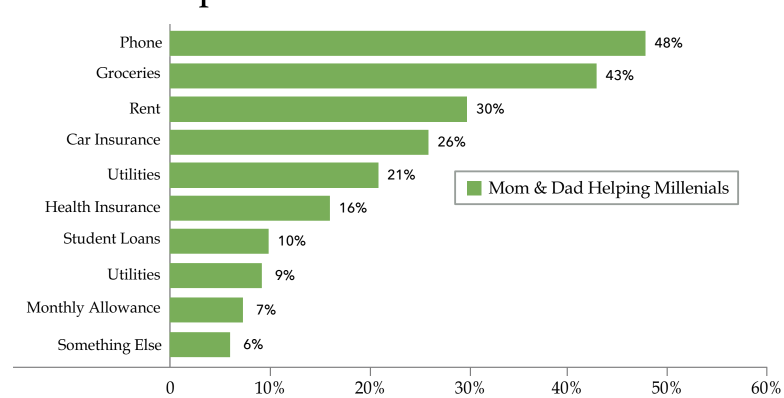
It's a storyline with which we're all too familiar. Still, some fresh statistics help frame what the future (still) holds. A just-released TD Ameritrade survey found that about two-thirds of millennials rely on their parents for financial assistance. Recent Zillow data found that 21.9% of adults between the ages of 23 and 37 live with their parents, up from 12.7% in 2000.

As you can see, a majority of millennials worry the most about their incomes, or lack thereof. That helps explain why 38% live paycheck to paycheck and a third harbor anxieties about their credit card and student loan debt. What truly boggles the mind is the next panel showing how important, and expensive, a phone has become such that mom and dad are still footing the bill for nearly half their grown children. This is followed by those other two essentials – food on the table and rent.

Millennials' Worries While Mom & Dad Help Make Ends Meet



Source: MagnifyMoney Survey Note: Participants could select more than one answer.



Source: MagnifyMoney Survey Note: Participants could select more than one answer.

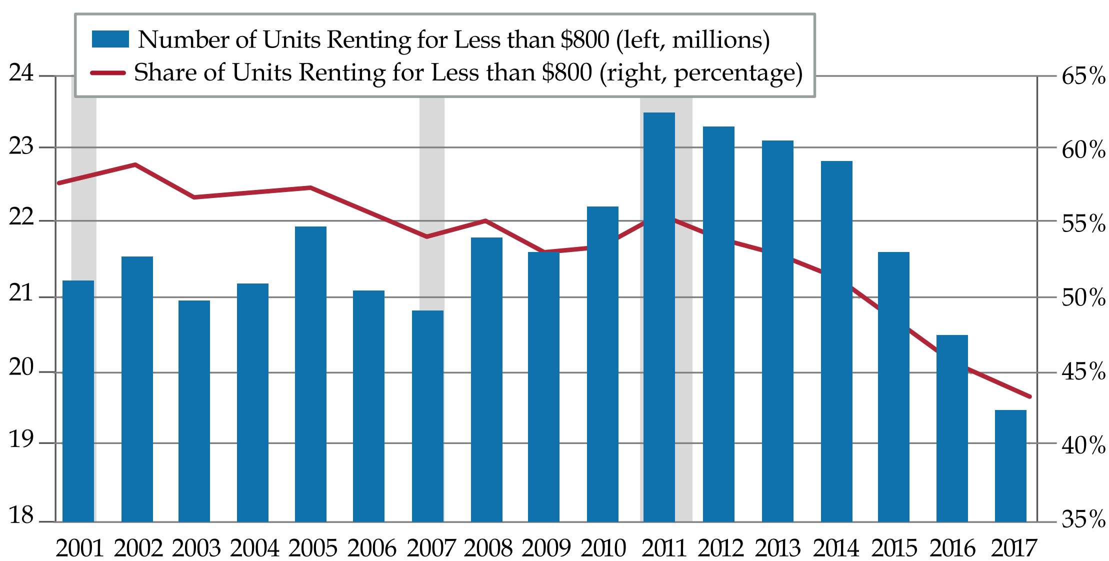
Every year, Harvard University's Joint Center for Housing Studies releases its splendidly comprehensive "**The State of the Nation's Housing**" report, **linked here**. If you've a bit of time, I highly recommend a full read. The best news is that after falling for 12 consecutive years, homeownership has been on the rebound these past two years. Better yet, the largest increase was among households in the critical 25-39 age group, a.k.a. millennials, whose ownership rate rose by 2.0% percentage points, or 1.1 million owners.

While in the right direction, that figures pales in comparison to the 14 million who still live at home. As per the Harvard report, the crux of the challenge remains with the vast majority of homes being built for the higher end market: "The relative lack of smaller, more affordable new homes suggests that the rising costs of labor, land, and materials make it unprofitable to build for the middle market. Restricting the supply of land available for higher-density development, regulatory constraints and not-in-my-backyard (NIMBY) opposition may also add to the challenges of supplying more affordable types of housing."

Working in millennials' favor is the fact that their income growth has come off the floor. Median incomes for those in both the 24-34 and 35-44 age cohorts have grown by a cumulative 11% after adjusting for inflation in between 2013 and 2017. That's encouraging but the paycheck growth has only partially offset that of the inflation-adjusted monthly payment on a median-priced home, which has swelled from $1,176 in 2012 to $1,775 at the end of last year.

Even if that house payment works within the confines of millennials' budgets and their incomes are sufficient to move away from home (assuming you're good with living in the Midwest or the South where those payments actually exist), it's increasingly difficult to save up for that down payment. These next two images best capture why the vacancy rate for lower-quality rentals has sunk to 4.8% vs. 6.7% at the end of 2011. That compares to a 7.0% vacancy rate overall. Put differently, the number of units renting for under $800 fell by 4 million in the six years ended 2017. As you can see, this decline has gained momentum in recent years.

The Plight of Low-Income Renters

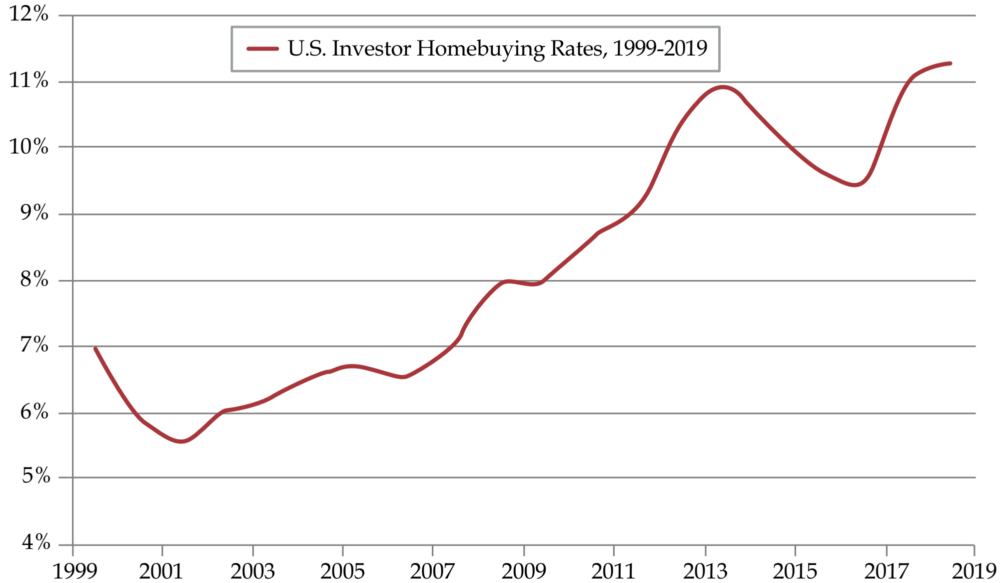


Source: JCHS tabulations of US Census Bureau, American Community Survey 1-Year Estimates.
Note: Contract rents are adjusted to 2017 dollars using the CPI-U for All Items Less Shelter.

Part of the deterioration in affordability owes to investors swarming the low-end single-family housing market and jacking up rents. These reliable sources of inflated cash flow are what many renters cum would be homeowners refer to as "starter homes." Clearly the allure of above-market rents has been too much to resist.

One of the worst consequences of the affordability crisis is that it feeds off of itself. The higher the number of natural buyers investors succeed in shutting out of the market, the more pricing power they have over those same individuals who can't compete to buy a home but still need the proximity to good school districts for their families. As you can see, after taking a brief pause, investors have resumed their ascent among homebuyers and now sit at record levels.

Investors Swarm the Market in Record Numbers

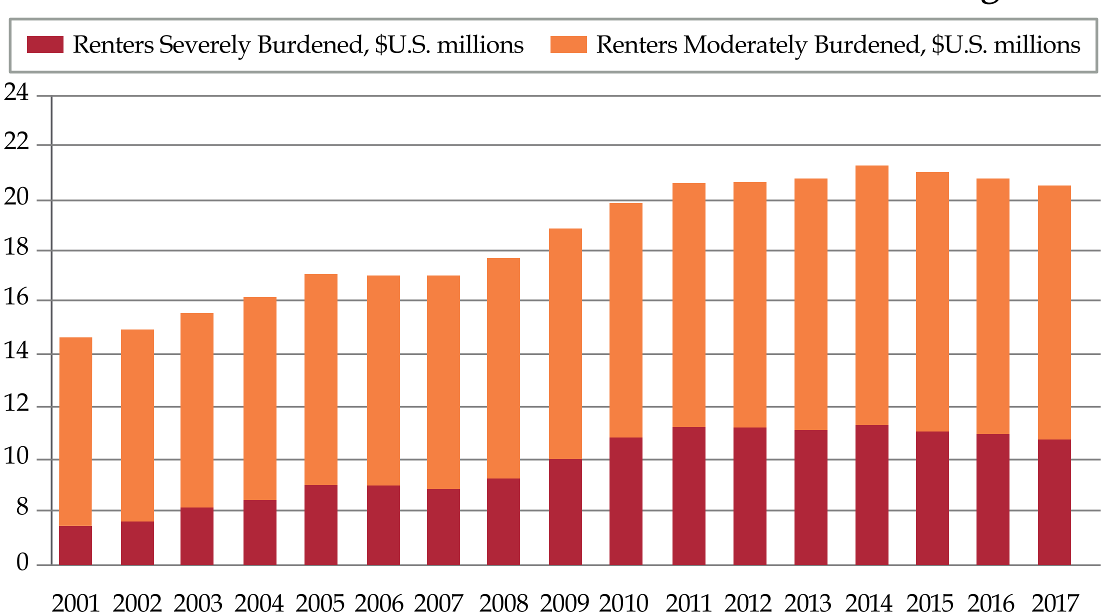


Source: CoreLogic, DB Global Research

Among mortgage holders, those who were lucky enough to beat investors at auction have seen their "cost burden" rate decline to 22.5% from 47.4% between 2010 and 2017, its lowest level of this century. (A household is considered "cost burdened" if they spend more than 30% of their income on housing.)

The mirror image of this is reflected in the rental pool, the target of investors on the single-family side and the victim of luxury builders in the apartment market, both of which are outgrowths of Federal Reserve policy. In stark contrast to homeowners, the percentage of cost-burdened renters stood at 47.4% of renters, a proportion that has only improved by 3.4 percentage points since its worst level in 2011 as the economy was crawling out of recession. The upshot is cost-burdened renters now outnumber their cost-burdened peers with mortgages by more than 3 million. Moreover, renters comprise 10.8 million of the 18.2 million who are "severely burdened," shelling out more than half their incomes for housing.

Glacial Improvement Among Those Spending More than 30% and 50% of Their Incomes on Housing



Source: JCHS tabulations of US Census Bureau, American Community Survey 1-Year Estimates.
Notes: Cost-burdened (severely cost-burdened) households pay more than 30% (more than 50%) of income for housing. Households with zero or negative income are assumed to have burdens, while households paying no cash rent are assumed to be without burdens.

There may be relief for renters in the works though it will involve a delicate balancing act. Declining rents can be great news for the cost burdened. The catch is the economy needs to be growing at the same time.

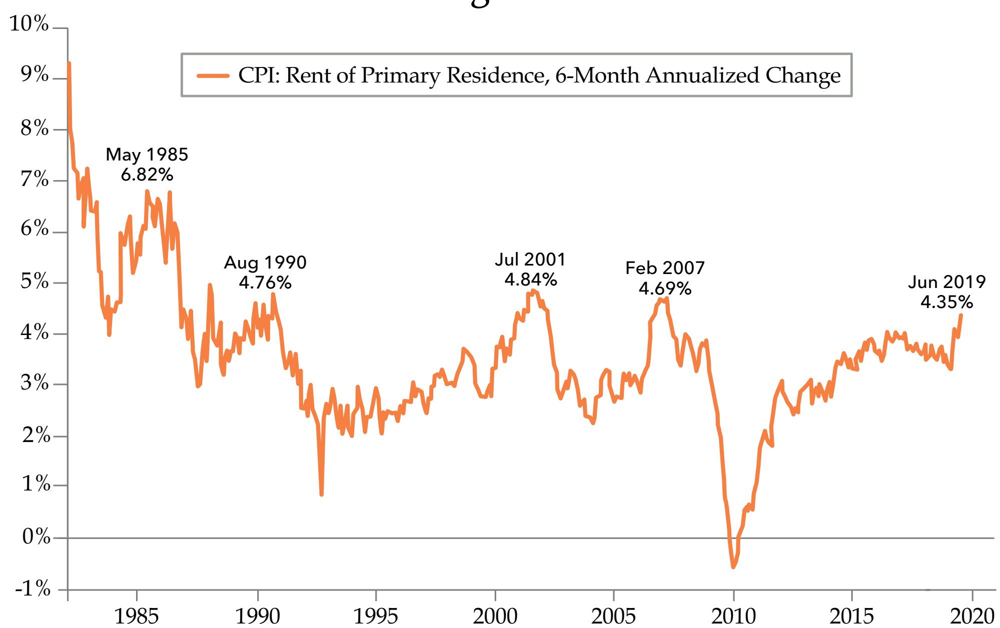
First, some context. Since 2006, the ranks of U.S. households that own a home has fallen by about a million to 75 million households while renters have grown by nine million to roughly 43 million. If the rental pool continues to grow in the coming years as Generations Y and Z come of age, the percentage of renters could easily grow from today's 36.6% and surpass 1965's record of 37%. Indeed, Harvard estimates that beginning in 2019, rentership will expand by 400,000 per year and continue at that pace through the end of the next decade.

In the here and now, the growth of renters has taken a breather, a good thing. After 12 straight years of average annual increases of nearly 850,000, the number of renters fell by 239,000 between 2015 and 2017. Whether there is follow through remains to be seen. Developers are, if anything, going to be fortified by headlines lauding apartment rental demand hitting a five-year high. Many millennials whose career trajectories were thrown off a normal course by choice or circumstance can attest to those in the generations behind them being akin to salt in the wound.

Employers are keen to hire fresh out of college to attain workers they perceive to have better attitudes and skill sets as well as stronger work ethics vis-à-vis millennials. These relative youngsters have no desire to even consider homeownership, nor should they just yet. What they do have is the financial wherewithal to rent the units that continue to come online.

What's perhaps hardest to fathom is that rental inflation has continued to roar even as apartment construction hit a 30-year high. Rental inflation as gauged in the CPI remains at its cycle highs, which is hard to fathom given incomes have certainly not kept pace throughout the current expansion. Is it purely a supply/demand thing?

Rental Inflation Weighs on Near-Record Numbers of U.S. Renters' Budgets



Source: The Bureau of Labor Statistics

I'm thinking no. Some of this goes back to the type of multifamily units that have been built. If you take one tidbit away from today's *Quill*, let it be that in 2012, 54% of apartment units completed were high-end; in 2018, that number stood tall at 87%. It's the composition of apartments that's held up rents and made commute times unbearable for those who haven't been able to afford to call one of those shiny towers in metro centers "home."

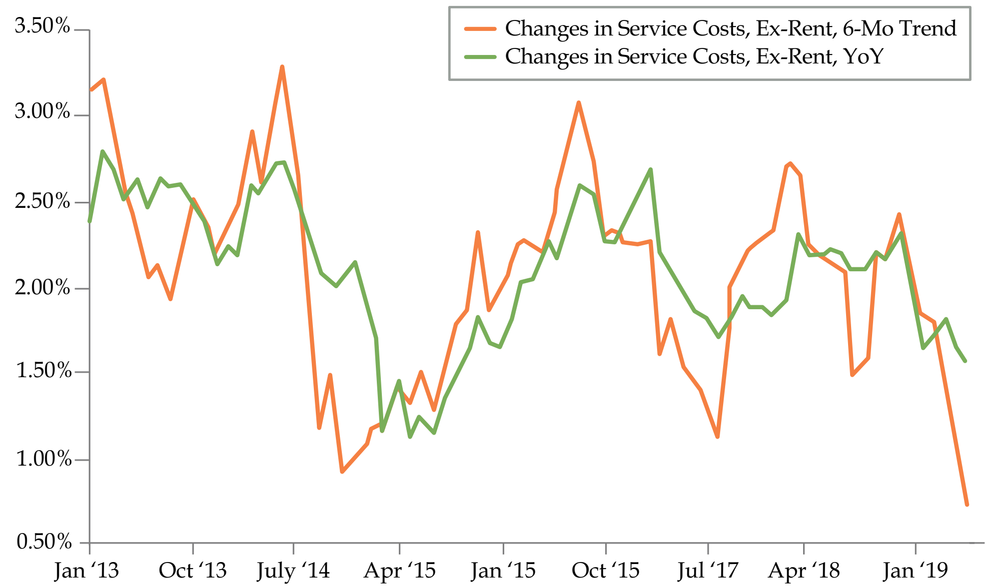
We may not like it, but populism's roots are of our own making, albeit with a huge assist from Fed policy killing the economics of middle- and low-end home and apartment construction. In the interest of deeply slighting those most injured by the dearth of reasonably-priced housing, Fed officials openly lament the lack of inflation. Try communicating inflation being too low to a hard-working, red-blooded American who spends more than half of his or her income to live in an apartment that's over an hour's drive from work.

And yet, you must acknowledge the dangers of declining inflation as (**mis**)measured by the Fed. Even if it rears its ugly head falsely due to the Fed's reliance on the broken core PCE, deflation invites all manner of monetary policy misfeasance. Think negative interest rates.

Be that as it may, economic cycles break down when services deflation kicks in. As you can see, if you net rents out of the equation that they dominate, services costs are fast approaching deflation, a development that would prove to be a rude awakening for one Jay Powell who harbors hopes of the recent declines in inflation being "transient." (Bless his heart.)

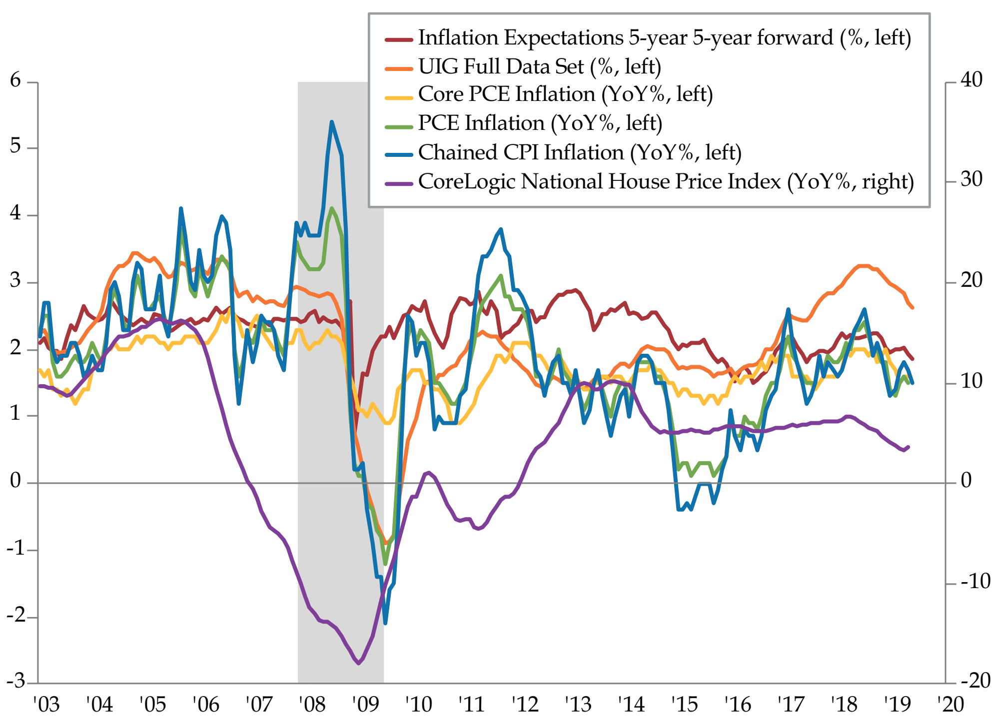
Rents Propping Up Inflation

As invalid as the core PCE is, its general direction got QI's Dr. Gates to wondering whether it was the sole outlier among its inflation peers. Take a mental snapshot of this busy graph. Every inflation metric we could throw at the wall and make stick has turned for the cycle. We even elongated the scales just to include home prices which have no exception to the trend. Tuck that one into the "Just saying" file.



Source: BLS, FTN Financial

You Name It, All Inflation Headed in Same Direction



Source: BEA, BLS, CoreLogic, Federal Reserve, FRB-New York, U.S. Treasury. Recession shaded.

Of course, while deflation makes central bankers break out in hives, falling home prices are the goal to relieve the housing crisis, or at least they should be. If nothing else, they'll flush the speculators out of the market hopefully to natural buyers' benefit. There is one sure fire way to get rents and home prices down. It's called recession, which is exactly what Powell hopes to avoid by lowering interest rates that are already too low. One of the primary aims is to pull housing out of its 15-month slump over which time home price gains have rolled over, sales have fallen and permits to build a new home have slumped by 6.6% to the lowest level in more than two years.

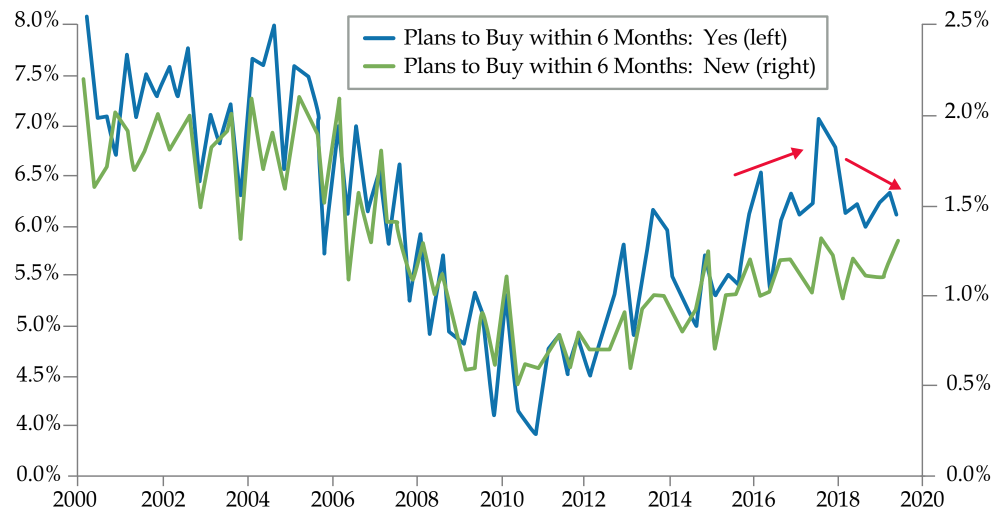
While a noble aim, you have to ask yourself what will be accomplished with the 30-year mortgage rate at a 3.75% starting point? Bloomberg's Fed reporter asked Powell just that at his last post-FOMC press conference and it was painful to witness the Fed head twist in the wind trying to come up with an answer (he couldn't).

As you can see, plans to buy a home within six months are at multi-year lows and look to have turned for the cycle. As for new home construction specifically, which is down 11.2% over the last 12 months, there is a decidedly renewed appetite to make a purchase, albeit off a very low base (see right-hand scale). And while off its lows from last year's spike in mortgage rates, buyer traffic in those model homes has been negative for nine consecutive months.

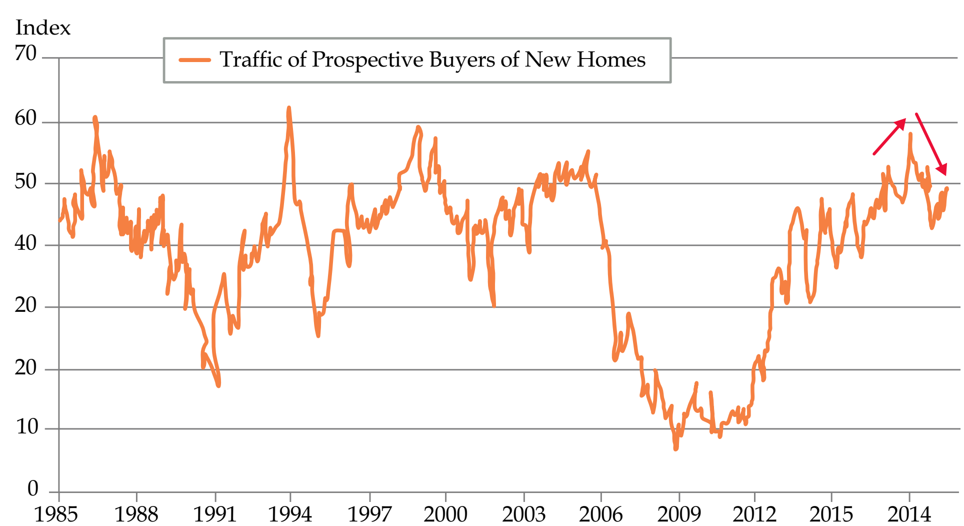
To revisit a theme on which I've written for many years, there can be benefits to a true housing recession. If the Fed can manage to contain itself and hold the line on negative interest rates, the recession should be severe enough to flush millions of speculators out of the housing market. The market has become perverted on many levels because of these unwelcome and unnatural players.

Stories abound of investors' bare-bones maintenance and delayed repairs to their investment properties. Think of the millions of homes swept up at auction that might have otherwise been razed, as in eradicated from the housing stock altogether. Rather than torn down, they were sustained.

Got Low Rates?



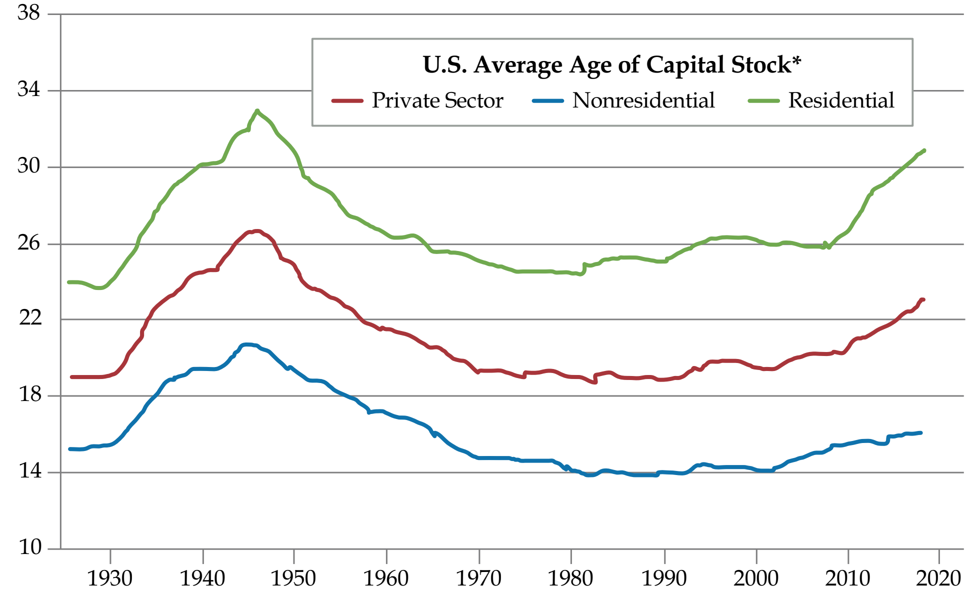
Source: The Conference Board, Haver Analytics, DB Global Research



Source: NAHB, Haver Analytics, DB Global Research

Think of these dwellings as the equivalent to the zombie firms kept in business by the Fed's policies which kept open the junk bond market via artificially low rates. Now have a look at that green line which has shot off its upward trend since investing in homes became the rage in the financial crisis era that gave new meaning to the never-ending quest for yield. The divergent trend in nonresidential is striking, reflecting malls across America being bulldozed and the build out of a warehouse nation, two sides to the same coin.

Homes Decay While Nonresidential Renews

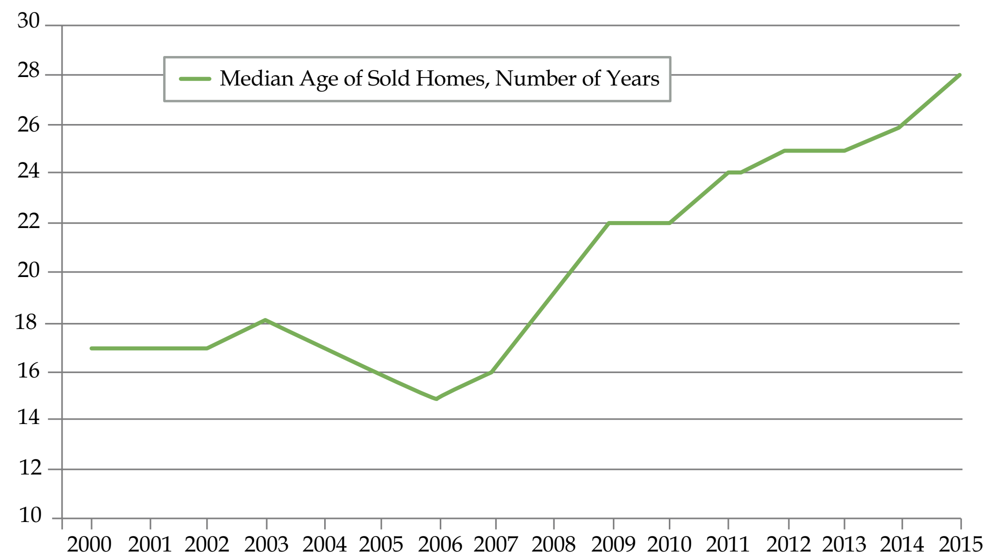


Source: The Daily Shot. *Current-Cost Average Age at year-end.

Next, close your eyes and picture a millennial's pad or that of a member of the even more hip and urban Generation Y. Now ask yourself if these tech-savvy minimalists have any interest in buying, and presumably renovating, a 28-year old home?

Again, it's no coincidence that investors swarming these markets is at the root of the increase in the median age of homes sold rising from a low of 15 years as the market last turned to where sold homes' age is today. The irony, as is always the case in tragedies, is that investors are so intent on maintaining their cash flow stream they've entered the business of buying new homes to rent out. As if entry level homebuyers needed competition from price agnostic buyers in the new home market as well.

The Aging of American Homes

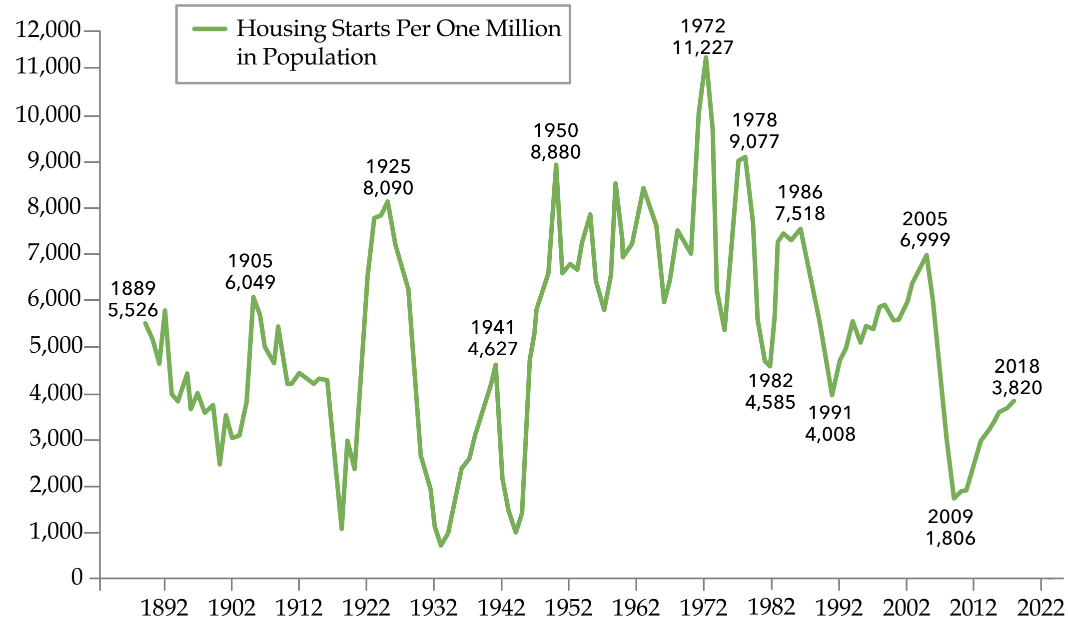


Source: Zillow, DB Global Research

If there is one trend that should reverse if we have a true housing recession, it's that of homebuilding. Between the need for Boomers to downsize and millennials who are due to procreate, demographics alone dictates housing starts be running at multiples of their current levels. And while the market has improved off its 2009 lows, fresh supply in sufficient numbers is conspicuous in its absence. Recall that the millennials will outnumber the boomers next year. It's thus hard to believe that housing starts per million Americans is running at a third the rate of 1972 around the time my parents bought their first home alongside millions of their boomer contemporaries.

Not to beat a dead horse, but to right the balance, the Fed will have to resist calls for negative interest rates. Heck, Powell might even draw the line at a positive fed funds rate though I won't hold my breath. The alternative is continued sclerosis in housing and the attendant increase in populism.

Home Construction Sorely Lagging in Current Cycle

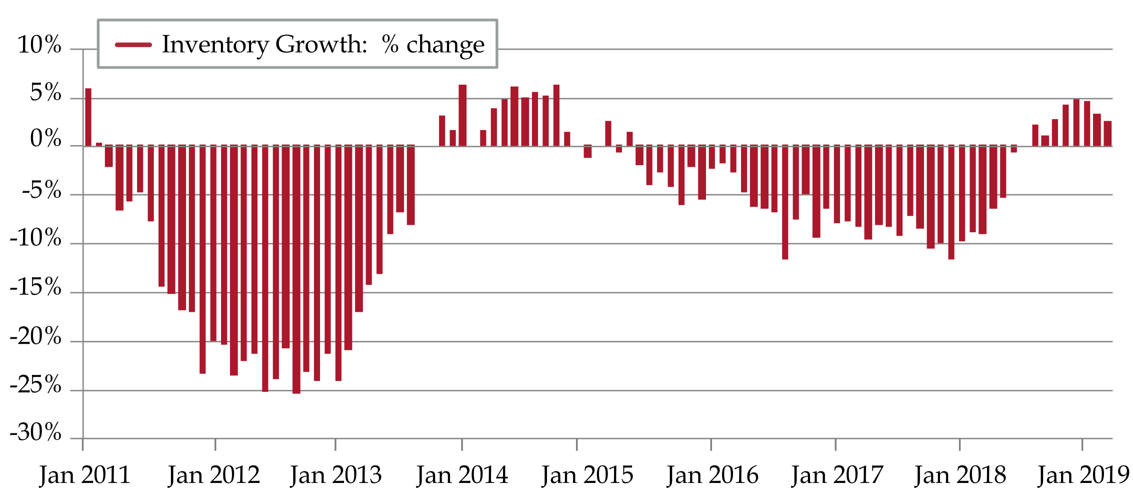


Source: Census.gov

The tricky part to writing a happy ending to the coming housing downturn is the complexion of the current housing stock, which we've already established is decrepit. Not only are millions of boomers' homes aged, they are also in areas millennials don't want to live. A best-case scenario would entail a slow descent in boomers' home prices that allowed a hand-off to slightly less reluctant Gen X-ers looking to buy their final homes as they age into their 50s.

At least the process is underway. <u>Existing home inventories have been on the rise since late last year. Coupled with the industrial recession, that trend of supply hitting the market should continue to weigh on prices until demand rises to close one deal at a time</u>. Boomers won't like taking the haircut, but it beats the alternative -- a disorderly downturn. It's all bets off if stocks or bonds or both correct taking a third swipe in as many decades at boomers' retirement savings and prompting housing speculators to rush the exits.

Housing Supply Slowly Coming Online in Hopeful Sign for Downside in Near-Record Prices

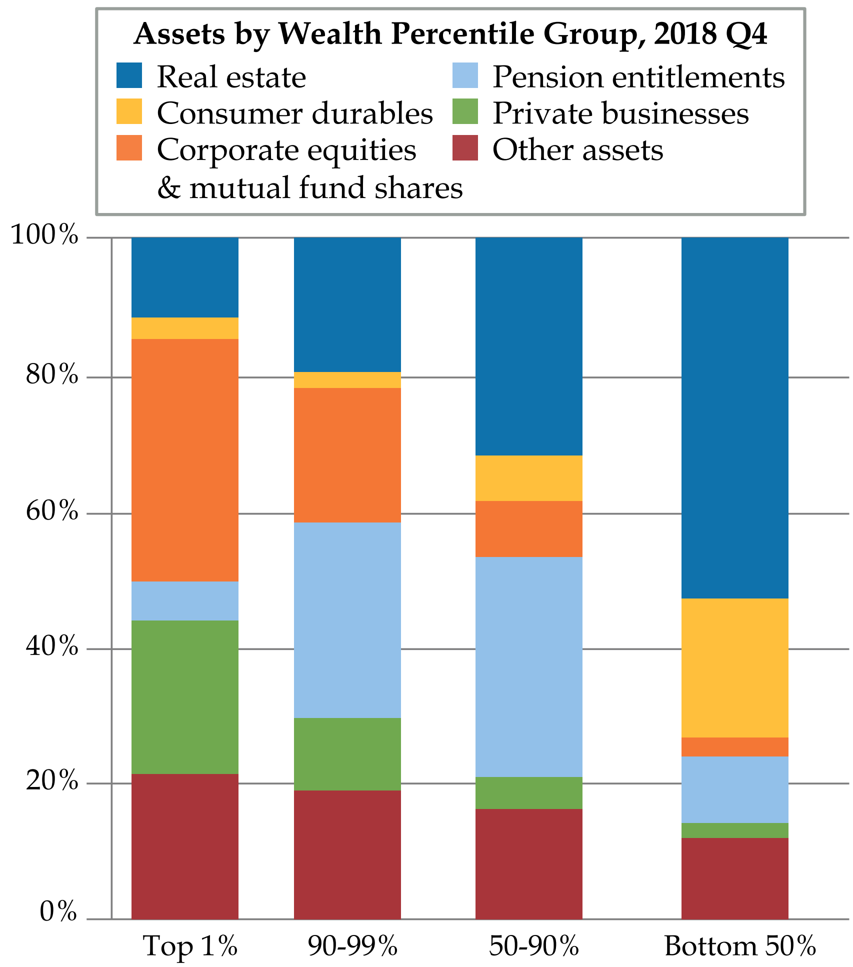


Source: NAR

Do boomers really need the equity locked up in their homes? A recent Gallup poll suggests as much. Some 47% of retirees say the equity they have built up in their homes will be either a minor or major source of their retirement income. A glimpse at this final chart backs that proportion. Real estate represents about a third of the net worth of those in the 50-90th wealth percentile and the bulk of the asset base for the bottom 50th percentile.

We won't know until we have the benefit of hindsight, but I suspect it's that 50-90th percentile that's the most vulnerable. Many are likely unaware of how at risk their pension savings are after the next correction hits the liquid and worse, illiquid holdings, populating their pensions. It is this cohort that presumably has the most equity built up in their homes and therefore will look to monetize it if the circumstances force listing their homes.

Is Real Estate the Last Dagger to the Heart of the U.S. Middle Class?



Source: Survey of Consumer Finances and Financial Accounts of the United States

As for that bottom 50%, many will find themselves reliant not just on social security in their retirement but other financial assistance programs. UBS recently released a report detailing that among the bottom 50% of consumers, their net worth has not improved since the crisis. Many carry heavy debt burdens and one can only imagine there is material overlap with the bottom 50% depicted above who don't own their homes outright.

The other quiet crisis that is unfolding involves the Medicaid law that requires those in need of federal assistance to live in nursing homes exhaust their assets before they qualify for the coverage. The median annual cost of a private room in a nursing home was $100,375 in 2015. Moreover, the inflation in these rates far outpaces that of healthcare, which is saying something. As boomers age into their 80s, homeowners burdened by mortgage debt but sitting on home equity will populate the forced sellers in the housing market.

There is something worse than being forced to sell your home and that's not having one at all. Homelessness has improved in recent years thanks mainly to programs targeted at veterans, families and the chronically homeless. Permanent supportive housing and the adoption of "housing first" models provide housing with no preconditions requiring changes in behavior.

It's key to distinguish the homeless from the unsheltered whose population is on the rise. These are the people you see in droves living on the streets of Los Angeles and San Francisco. Consider these staggering numbers care of the Harvard study:

> "The problem is most acute in California, where the number of unsheltered homeless grew by 25 percent in 2014–2018, to 89,500. Other states with sharp increases in their unsheltered homeless populations are Washington (up 80 percent over this period, to 10,600), Colorado (up more than 100 percent, to 4,300, and Oregon (up nearly 50 percent, to 8,900)."

As for New York, only 5% of its homeless population is without shelter compared to 75% in Los Angeles. That said, the $1.6 billion the city will spend to house its 75,000 homeless is staggering. Is it any wonder with average rents north of $3,500 that so many cannot afford to put a roof over their head?

As has been widely reported, in New York City and its surrounding area sales are under pressure. And many developers who got into the game too late in the cycle are getting their IRRs handed to them. As bad as things may be, they'll have to get a lot worse in New York and elsewhere to right the wrong that's prohibited the multitudes from renting or buying. It's time the average hard-working American had the privilege and satisfaction of raising their middle finger to those who would relegate them to the scourge of "subsidized housing." Let it be that the Fed stand down and finally let the housing market clear.