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REMEMBERING THE FUTURE
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The Real Estate Market: An Assessment While the U.S. Prepares to Take-off

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Introduction

Let's start with the subtitle of our theme. We are of the opinion that within the next 12-18 months we shall see significant growth in the United States. Such an assessment is based on the following facts, among others: The healing of the economy from the great recession should have been completed by then; the jobs numbers which are already encouraging will continue improving; the deleveraging will start its reversal; credit creation will move into an upswing state; money supply and the money multiplier are already moving higher; balance sheet cleansing will almost be done; discretionary spending has been reversing upwards; consumer and business confidence is building up; production has been increasing; business investments are rising; and maybe most importantly, the US will be closer than ever in becoming an energy independent nation with enough natural gas reserves to carry the country forward for the next several decades.

At the same time the US will be positioning herself for the collapse of the Euro zone, for the ascent one more time of the dollar that will reign supreme in the international markets, and for a harmonious symbiosis with China despite temporary hiccups in the relationship between the two nations.

In such an environment, we are of the opinion that it would be worth looking at the real estate market as a viable option in the portfolio of investors. In this newsletter, we will review the basic facts related to real estate and we will make the case that it may be time to start accumulating that sector again.

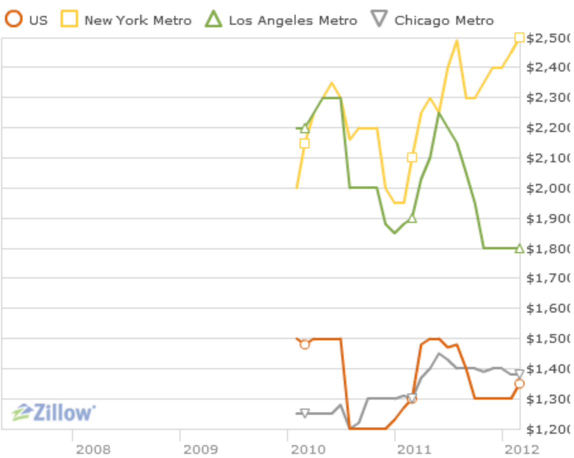
The Phoenix of Real Estate

Home prices have been declining since 2007. However, the last report shows that the decline actually has been reversed. Is it something temporary? We believe that it is not, and out of the real estate ashes, opportunities in that sector will start rising at a steady pace. The first – not necessarily the most important - reason we could cite is the historical low and steady mortgage rates. As the following figure shows, the national (for local market we chose Michigan) mortgage rate is at historical low levels. The Fed's actions and commitments to keep the rates low will revive the sector.

Figure 1: Average National Mortgage Rate

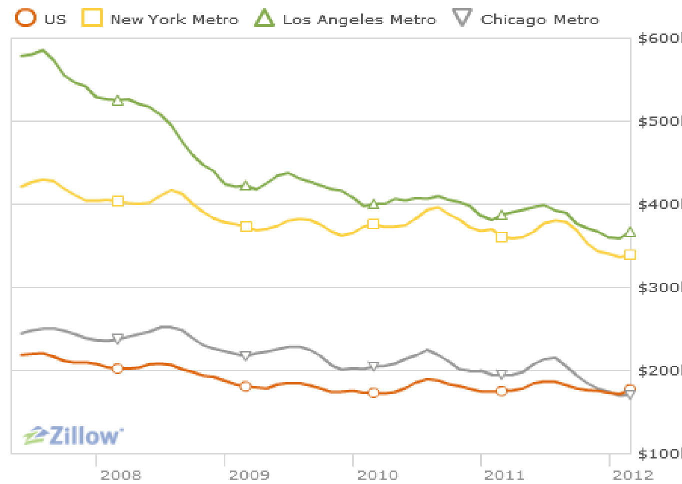
At the same time, and as the figure below shows, we see rentals not only stabilizing but also actually rising in some markets, which make it a rational choice for renters to start seeking home purchases.

Figure 2: Median Rent List Price



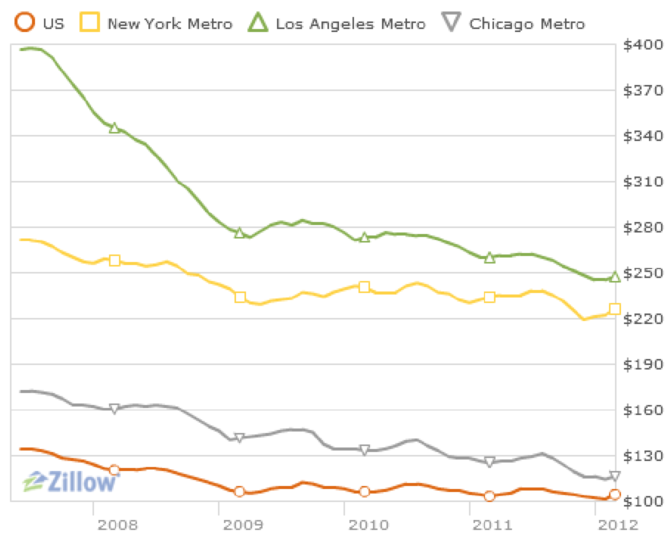
Coincidentally then, we observe in the next graph that home prices have started stabilizing which is the most important element in the expected reversal. Once the hemorrhaging stops, price increases should follow within 12 months.

Figure 3: Median Sale Price



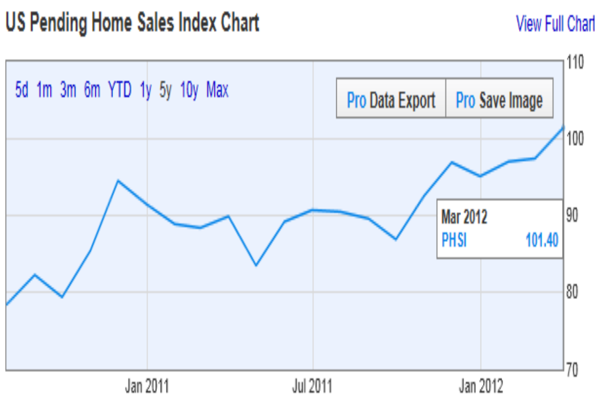
Actually, the sale price per square foot has already started its reversal, as the following figure shows, which makes us more confident that the real estate reversal will soon be knocking at the door.

Figure 4: Median Sale Price/sq. ft.



The low mortgage rates, the higher rental prices, and the economy's continuous strength will put a floor in home prices and will advance home buying and hence the commercial real estate sector too. As the following figure shows, the Pending Home Sales Index (a forward looking real estate measure) increased by 12.8% in the last twelve months, and it stands now at 101.4. It should be noted that any reading above 100 signifies an expansion in that sector. Rising sales (the first quarter in 2012 was the highest of the last five years) will clear inventories and will rebalance the market.

Figure 5: Pending Home Sales



Are there any reasons for concern that could point out that the real estate market has a long way to go still? Without a doubt, there are three main reasons for concern: First, real incomes are not rising that much, making consumers cautious as to their spending habits. Second, there is a backlog of foreclosures (known as shadow housing inventory) that when it hits the market, it could drive prices down. Finally, credit standards are still tight, while history of bubbles teaches us that normalcy's return takes a longer time than four-five years.

However, all in all, we are of the opinion that the positives outnumber the negative factors, and thus we believe that the real estate market is heading for an upswing.

Real Estate Renewal with Value and Prospects

The renewal of the real estate market (at least in the US) is a value proposition. Historically it coincides with an improved labor market. While there is still room for growth, labor conditions have been improving and unless the EU crisis snowballs the US, we anticipate the unemployment rate to drop below 7.4% within a year. The millions of jobs already created and those to be created will be a boost for the real estate market.

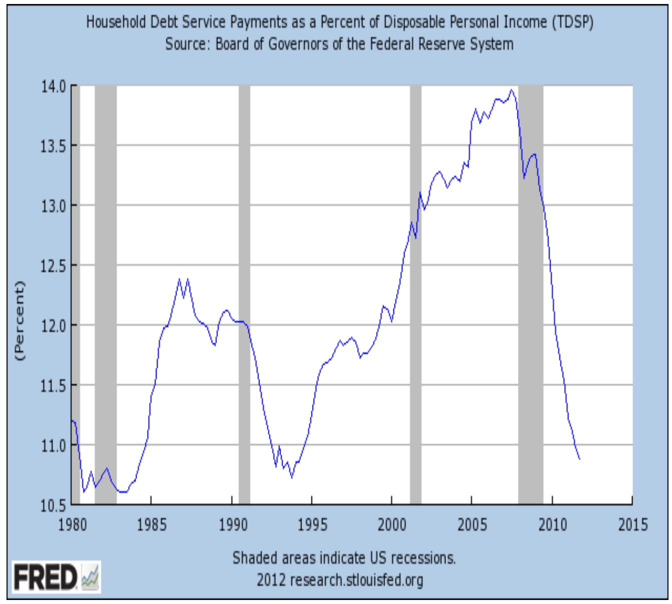
The net new homes built (new construction minus demolitions) in the last four years has only averaged 595,000 annually, and all have been absorbed by new household formations. When we take population dynamics into account, then we can see that in the next 8-10 years 25 million people will be added in the US census. Such population growth justifies alone the optimism for a real estate market renewal. As labor market conditions improve, household formation will return to its normal levels of about 1.1 million per year, and hence excess inventory will be absorbed through the evolution of demographics.

Speaking of housing inventories, the numbers are straight forward: Five years ago we had 4.5 million unsold housing units. The current number is about 2.6 million. That's an improvement of 42%. With current sales rate, it will only take 6-7 months to absorb the excess inventory. Moreover, the shadow inventory of homes in foreclosure has declined by 23.5%, which is a very encouraging sign, given the number of short sales pending and the investment activity around the housing sector. Distressed sales which still make up 24% of total sales are made at prices that are 30% lower than non-distressed sales, however their impact on housing prices will be diminishing as the inventory clears.

We showed earlier (see figure 2) that rents have been increasing. We could say that given housing affordability, rising rents, low mortgage rates, and lower consumer debt level, the prospects for the real estate sector starts becoming brighter.

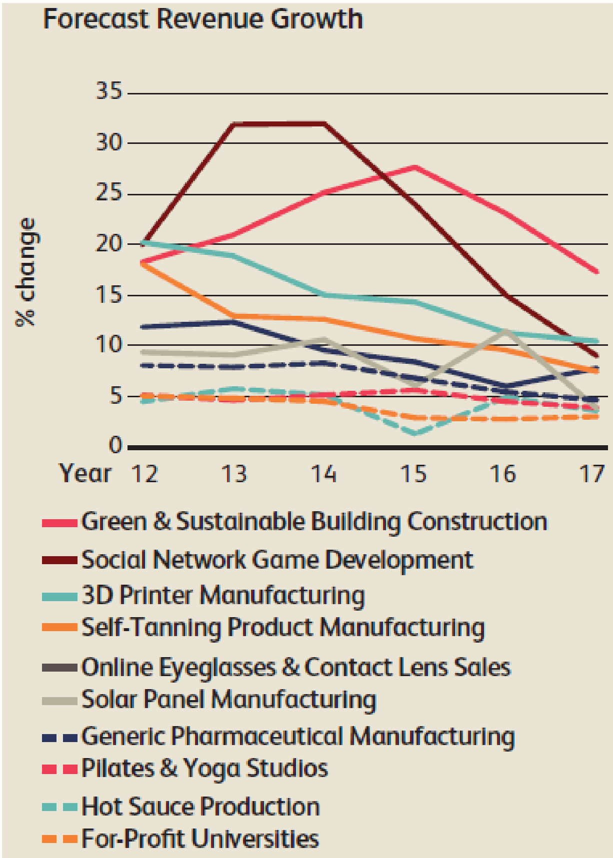
At this stage, we need to tie our introductory comment about a US-take off with consumers who count as 70% of US GDP. As the graph below shows, the household debt service ratio (mortgage plus consumer debt payments as a percentage of disposal income) is approaching a twenty-year low. US consumers' deleveraging is working, and when we take into account that approximately 2.1 trillion dollars worth of mortgages will be refinanced in the next 18 months, we will most probably see this ratio dropping to the levels not seen since the early 1980s. The low debt service ratio will add a new dynamic to the US preparation for a period of sustained growth and prosperity.

<u>Figure 6: Household Debt Service Ratio</u>



As the economy grows, new businesses will grow, demand for energy will grow (and hence again the natural gas play) employment will improve, incomes will rise, profits will be boosted, and the upswing will set foot for good. While the purpose of these newsletters is to identify promising asset classes or regions (next newsletter will focus on Burma), we should also be remembering that a new upswing advances particular industries, and thus in that rationale, we present the next graph courtesy of the IBISWorld, where the most promising industries are presented.

Figure 7: Most Promising Industries



From the list above, an investor who recalls the future might want to identify companies in the 3D printer manufacturing sector, the green and sustainable building industry, and the generic pharmaceutical one.

Concluding Remarks

The next 12-18 months will be most critical for the EU and the trajectory of the Euro. If the latter survives it will be due to money printing, financial repression, the bailout of the bankrupt EU banking sector, and also because of political manipulations. We believe that all these measures that try to hide the toxic assets and the unsustainable balance sheets of banks and central banks in the EU, will drive precious metals higher, and will also advance real assets such as the US real estate sector, especially when we take into account the capital flight away from the EU. We also believe that the US will be able to insulate herself of an impending EU disaster while its co-existence with China will draft the history of the 21st century.