The View From The Outer

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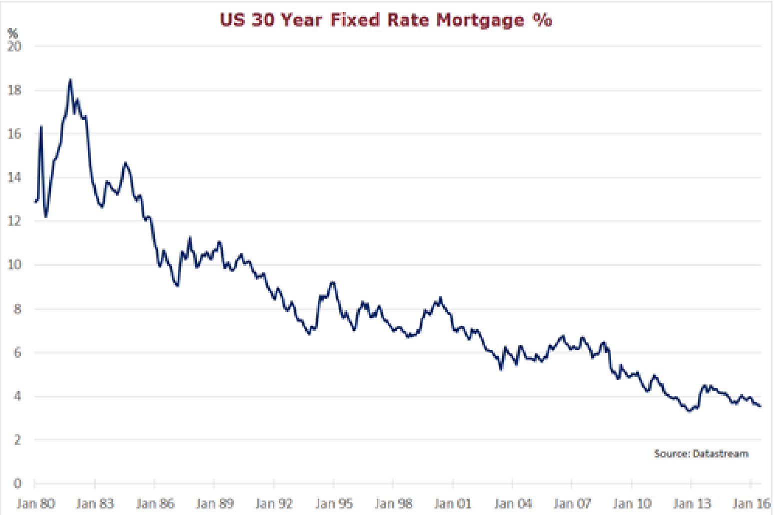
Thursday 28 July 2016

EVANS & PARTNERS

US Housing: A cyclical sector with a robust growth runway

The US economy enters the 8th year of economic recovery this quarter, with an Unemployment Rate of less than 5%. The prevailing 30 year fixed rate mortgage is again approaching late 2012 levels; the lowest seen in some 50 years.



Evans and Partners Building Materials Analyst Ben Chan estimates underlying demand for new US Housing Starts at 1.45 million per year. This suggests both substantial remaining upside and longevity of the cycle given the magnitude of the cumulative underbuilding relative to underlying demand. Ben estimates this at 3.9 million Housing Starts net since 1988. Given the current level of Housing Starts, this is continuing to increase. See page 2 for relevant charts, a further discussion and investment recommendations. (**JHX Positive).**

The rise of populism: Despite the current favourable macro picture, populist disenchantment with perceived "ruling elites" and the "political establishment" seems stronger than ever even in the United States. This is clear from the enthusiastic support generated by the "outsiders" Donald Trump and Bernie Sanders in the Primaries. As with elsewhere in the developed world, this has little to do with the rate of economic growth per se. It is more attributable to a sense of disenfranchisement from the broader beneficial economic impact of globalization and free trade. Years of Quantitative Easing (QE) pumping up financial asset values and increasing inequality is also a factor.

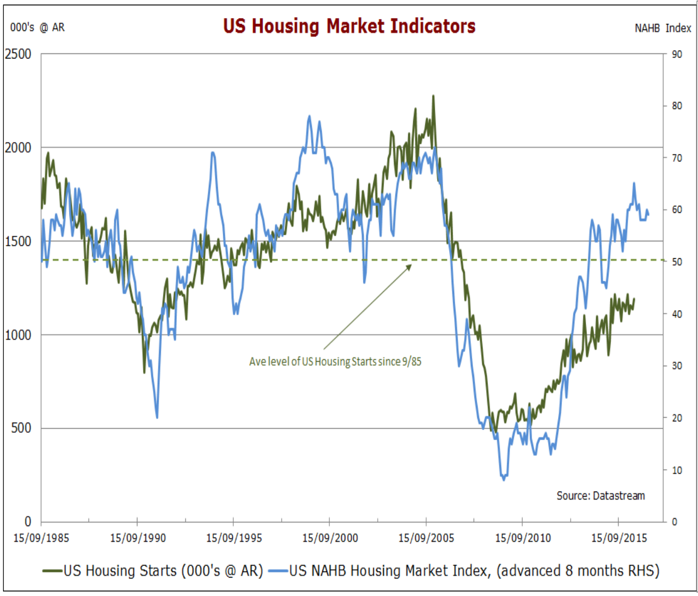
The supporters of what one might term "outsider" candidates and causes tend to view globalization as a root cause of adverse structural changes, depressed basic wages, social dislocation and rising income inequality. They regard the political establishment as either complicit in this and/or unresponsive to their concerns.

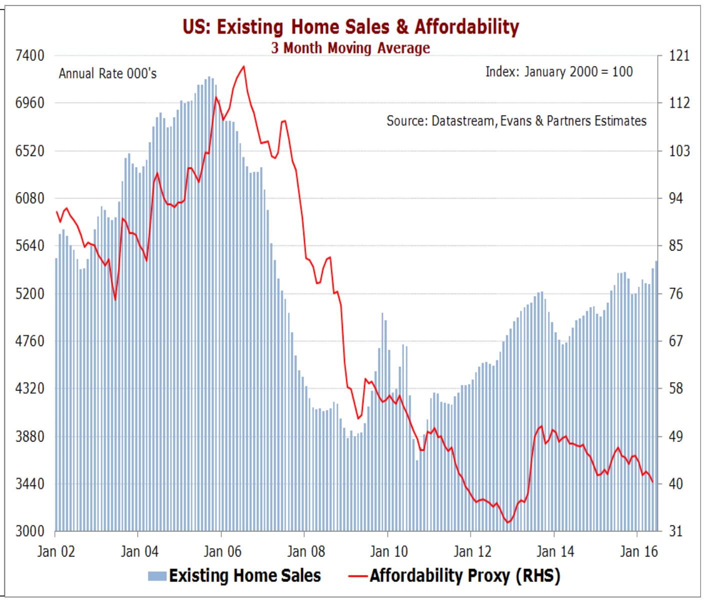
President Trump? The Brexit vote showed that emotion can triumph over economic self-interest. As in the UK, non-compulsory voting in the US heightens this risk. It would therefore be foolish to write off Donald Trump's chances. This US Presidential election therefore poses greater event risk than usual, particularly given it is hard to establish what he would do and whether he could implement it. What is clear, however, is that his Administration would seek to be more protectionist, interventionist and inward looking than any recent Administration. This is the direction in which American politics is moving. Even Hillary Clinton's recent campaign rhetoric has been couched in a more protectionist hue. Further, even if there were a Republican majority in the House and Senate that is no guarantee of passage in the US legislature, where party allegiance is no guarantee of legislative support.

So what would a potential Trump Administration mean for the markets? Equity markets trading on elevated PE Ratios are unlikely to welcome uncertainty; and a Trump Presidency would certainly be unpredictable. Would this, however, significantly change the outlook for economic growth and domestically sourced corporate profits? Here we feel there is a meaningful distinction to be made between the short and longer-term impacts. We suspect the short term impact on US economic growth is likely to be modest. Were the short term growth impact to be more significant; there remains a dovish Federal Reserve in the background presumably ready to step up (yet again) if "required." Further, were the US Dollar to depreciate, the hefty foreign earnings component of the S&P 500 would benefit.

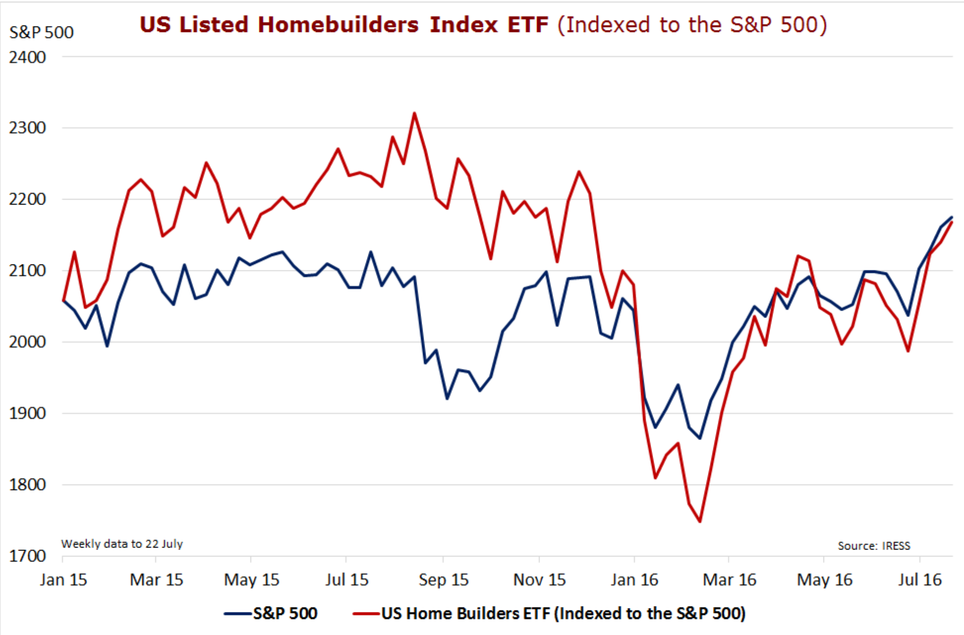
Hypothetically, it is the longer term implications of an Administration that increases trade barriers and reduces immigration that are more concerning. Put simply, and all else equal, higher tariffs and lower levels of labour immigration are negative for longer term GDP growth, productivity growth (and therefore aggregate living standards), the domestic corporate profit share and equity market returns on a common currency basis. All else equal they also suggest a higher rate of inflation for a given rate of economic growth. This is also before we consider the potential impact of possible retaliatory policies by other trading partners. In this environment, and with starting point of elevated Price Earnings Ratios and near record low US long bond yields, this re-enforces the view that longer term real equity market returns would be below historical averages.

US Housing: A cyclical sector with a robust growth runway: Further to our observations on page 1, we remain confident in a robust and sustained ongoing recovery in US Housing Starts. Housing Starts in June were running at an annualized rate of 1.189 million, still well below the levels implied by Ben Chan's underlying demand estimate of 1.45 million starts per year. The National Association of Home Builders (NAHB) Index plotted below left is advanced 8 months and has proven a useful lead of Housing Starts. Despite US housing prices increasing steadily since early 2012, housing affordability is extremely favourable (see chart below right). The home ownership ratio seems to have bottomed, while the rate of household formation has been rising since 2014. Finally, comfort in the longevity of this cycle is provided by the magnitude of the cumulative underbuilding relative to underlying demand. Ben estimates this at 3.9 million Housing Starts net since 1988 (See chart bottom of page 3).



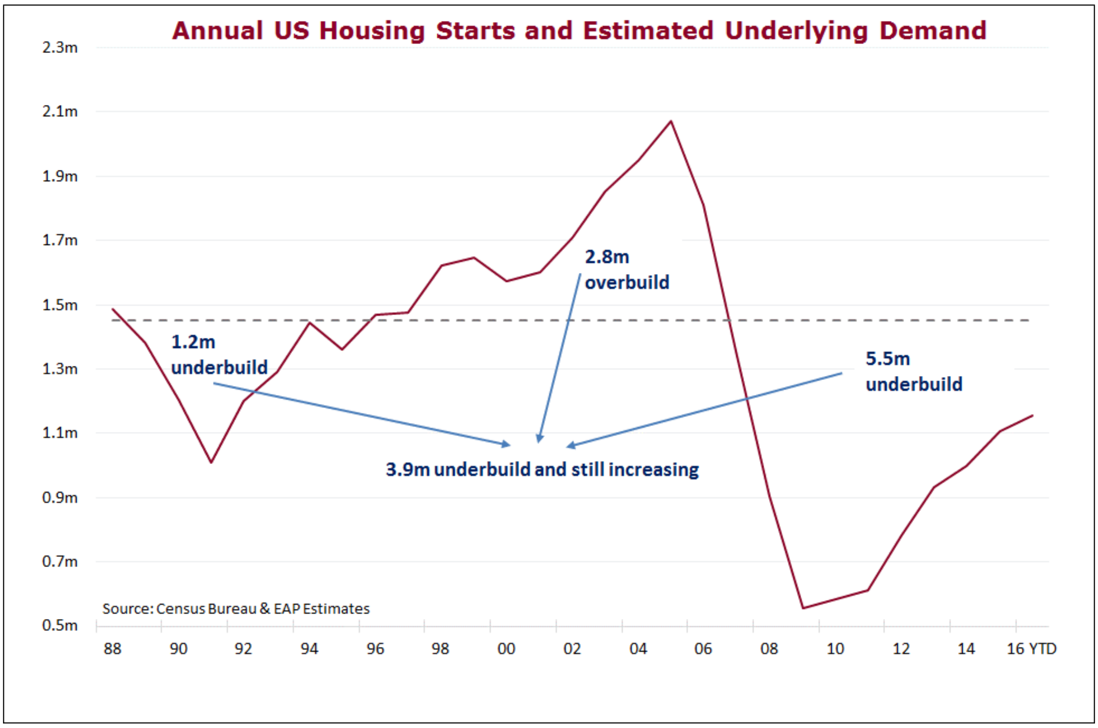


Investment exposure to the US housing cycle: Within listed Australian equities, Ben Chan's preferred exposure to US housing is via James Hardie Industries **(JHX Positive Recommendation).** In addition to leverage to the US housing cycle, JHX's key fibre cement product is expected to continue to gain market share as the primary wall material, largely at the expense of vinyl. While a premium rated stock, we believe the strong earnings growth outlook is supportive of current multiples.



More diversified US equity market exposure to the US housing cycle can also be obtained via a US listed Exchange Traded Fund (ETF) which seeks to replicate the underlying performance of the US Homebuilders Index (before allowing for fees).

You should seek advice from your EAP or financial Adviser before investing and read the Product Disclosure Statement.



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