Quarterly Market Outlook & Strategy

"Home is Where the Heart is"

First Quarter of 2019

Mike Costa

Executive Summary

- US stocks enjoyed a strong start to the year, nearly erasing the decline of late 2018. After a dovish Fed policy shift and a quarter of inconclusive economic data, stock market investors are anticipating a return to the "Goldilocks" environment of easy monetary policy, slow (but positive) growth, low inflation, and high profit margins. Despite the market's wild oscillations over the past year, the data we monitor have been consistent - US equity valuations remain extreme, the global economic cycle is mature, and risk-taking is unlikely to be rewarded properly until these things change.

- One sector that seems to be getting a second wind - thanks to the recent drop in mortgage rates - is housing. We're all a little crazy when it comes to our homes. We expect those humble walls of timber and sheetrock to be our safe havens, status symbols, star investments, ATMs and retirement kitty - all at once. It's an enormous responsibility for a single asset. No wonder they generally fall short.

- If houses tie us in knots, it's not really our fault. Houses are 'passion projects' that sit at the awkward intersection of our daydreams and cold, hard retirement planning.

- Owning a home is not the no-brainer we're taught to believe it is. For many of us, renting can beat owning a home, in purely financial terms. But the decision to buy (vs. rent) is only one part math problem. The other part is intangible. We're here to help you do the math and put the whole story together.

- Many of us grapple with the question of whether to prepay a mortgage when we come into a little extra cash. There are a number of issues to consider here. We outline a simple framework to help you decide.

- Advisors have different ways of describing how your home fits into your retirement portfolio. The banks have worked hard to get us to view our homes as investments (or ATMs) but the equity in your home is qualitatively different than other assets. It should be treated as a *contingent asset*, rather than a direct source of retirement funding.

- No one knows where the housing market is going for sure, but we think there are good reasons to believe house prices will cool in over the next couple years, likely falling in real terms. We outline our thinking, and provide a rough framework for how to evaluate future real estate prices.

Easy Money

Last spring while doing laps around a park (at a really amateurish pace) my cycling buddy leaned over the side of his bike, wobbling dangerously close, and in a conspiratorial tone, half shouted over the wind: "my house made more money than I did last year!" He then leaned back on his bike, one eyebrow raised, grinning - waiting for a reaction. Separately, and later that year, another acquaintance, a language tutor by trade, confidently informed me that, after studying the matter in depth, I could double my money in a year by going in on some vacation property with him in Eastern Europe. More recently, no less an authority than my own wife reassured me that, even in the midst of the dumpster-fire that is BREXIT, our sad little 2 bedroom flat in London should easily command 25% more than we bought it for just 3 years prior.

It's never polite to contradict a friend, and I've been told it's unwise to contradict one's wife. So mostly, I just smile and nod. But it's got me thinking: *What is it about real estate that makes us all a little bit crazy?*

"It would be so easy to flip this house."

It's no exaggeration to say that many (most?) of us make house-buying a central part of our vision for financial and personal success. We fantasize about our dream homes. We [furtively check Zillow](#) each month to see if our 'Zestimate' has inched upwards. We sneak into our neighbors' open-houses, even when we're not in the market (or maybe that's just me…). And of course, there is an entire genre of reality TV shows designed to fulfil our desire to peer in, voyeur-like, on [couples making life or death real estate decisions](#). We're obsessed. And like many unhealthy relationships, our house dreams are often built on unrealistic expectations.

We expect those humble walls of timber and sheetrock to be our safe havens, our status symbols, our outperforming investments, our ATMs, and our retirement nest egg – all at once. It's a ridiculous responsibility for a single asset. No wonder they fall short. Poor houses… we ask too much of them!

But how did we get here? And are we really so crazy? What does your house look like under the cold, unflinching gaze of an investment analyst?

Businesses or Bungalows

If you really want to hear from a hardened curmudgeon on this topic, we recommend JL Collins's blog post "Why your house is a terrible investment" or James Altucher's hate letter to home ownership. They make the point that if your primary view of your home is as an investment asset, you may want to reconsider. To wit:

	Stocks	Your Home
Liquidity	Liquid as H_2O	Liquid as drying cement
Transaction costs	Low transaction costs	6% commission for a realtor – really?!
Mobility	Mobile/portable	Only if you live in a doublewide
Maintenance	Hands off, no maintenance	Mowing, shoveling, mowing, shoveling…
Taxation	Taxed on gains and income only	Taxed on value of the asset itself every year
Volatility	Volatile prices	Stable (but mostly an illusion)
Leverage	Accepts limited leverage	Accepts lots of leverage (5x)
Price appreciation	5-7% over the long term	3% over the long term
Income	1-3% yield	Cash flow negative

Of course the comparison is a little bit of a straw man. Your home provides you with valuable tax-free services and benefits (like, well…*housing*) that your shares in Apple just aren't going to match. If you want to do an Apple to Apple comparison, you'll need to compare stocks to a home that you are *renting out*, not *living in*. From that perspective, things look a lot better for owners of real estate investment properties. Rental units generate income with gross yields that often range from 4-8%, and while they are illiquid assets that require hard work and entail real risk, they also tend to be cash-flow positive. Moreover, you can leverage them much more easily (and safely) than you can a portfolio of stocks. So if you know how to buy cheap and can swing a hammer, you could do quite well in the real estate business over time.

So really, the issue isn't with residential real estate as an investment *per se*. It's that we tend to imagine that the real estate *we call home* will make us rich, *in addition to* providing us a place to comfortably live our lives.

Homes are something we 'consume' or enjoy, but they are also a real asset that we expected to appreciate over time. It's that weird combination of characteristics that muddies the water. Like collectible wine, nice old cars, and that $10k you lent your buddy Stewie to start his organic mushroom farm, houses are 'passion projects'. They sit awkwardly at the intersection of our daydreams and ruthless retirement planning.

Mark versus the American Dream

"Don't be like Mark." That's what I was told by a friend when I found myself still renting at the ripe old age of 34. Mark, a mutual acquaintance of ours, surfed couches like the Beach Boys surfed waves. He made a statement of not committing…to anything; not to girlfriends, not to jobs, and *certainly* not to a mortgage. Mark also rarely brushed his teeth, so I bristled at the comparison. But there you have it. There is definitely a stigma to renting unless you're in your twenties or (heaven forbid) mid-thirties at the latest. And if you should say you prefer to rent forever? You might as well be a card-carrying communist.

But what do the numbers say? Is renting better than buying? Frankly, answering that question is a truly wonderful excuse to spend a day or two of quality time with Microsoft Excel. The answer (even from a purely numbers perspective) varies based on the prices of homes, levels of rent, how much tax you pay, and more. Here are some of the big swing factors:

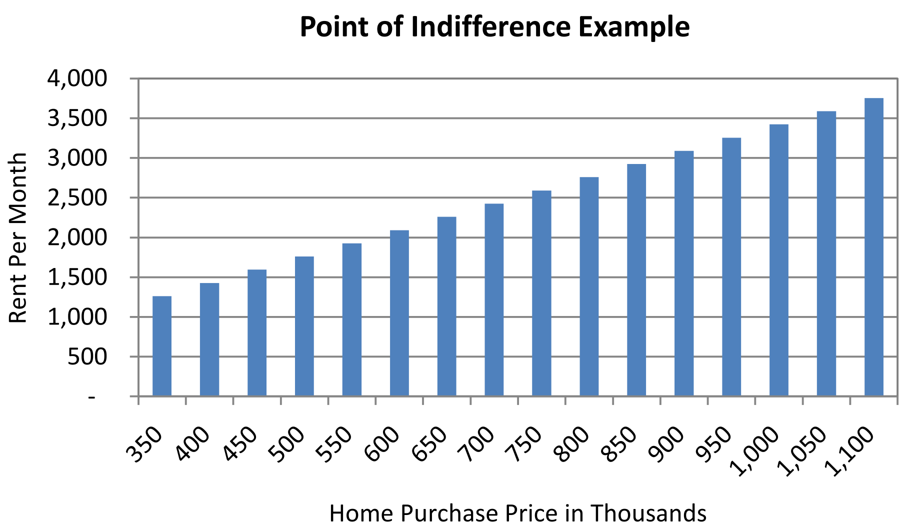
Factors Which Favor Buying	**Factors Which Favor Renting**
Home prices low relative to rents	Rents low relative to home prices
Low mortgage rates	High mortgage rates
High marginal tax rate	Low marginal tax rate
High inflation	Low inflation
Low expected returns on investment	High expected returns on investments
Long holding period (spreads out high transaction costs)	Short holding period
Lower property taxes	Higher property taxes (hello New Hampshire!)
Do-it-yourself attitude (cuts maintenance costs)	Someone-else-please-do-it attitude

For those of you who know someone considering whether (or when) to buy, we highly recommend playing around with some of the better buy/rent calculators available online. As a learning tool, their essential insight is that owning a home is a heck of a lot more expensive than most of us appreciate. And when we talk about how much money our houses have 'made for us', *we rarely factor in all those expenses*.

These calculators can help you estimate the price 'point of indifference' between renting and buying. That is to say, they can tell you the maximum price you could pay for a home and still come out on top, financially speaking, vs. renting. In the example below, a person with a 4%

mortgage paying 20% down and staying in their home about 10 years, could pay up to $900k to buy a home and end up roughly in the same place as someone paying $3k per month for rent.

If they pay less for the home, they'll end up ahead. If they have to pay more? Well, then they'd be better off renting.



For most of our clients, owning a home *does* make sense. They're relatively highly-taxed, well-settled in their careers and communities, and thus unlikely to move for a while. They enjoy good access to (relatively) cheap credit, and probably have a more conservative stance in their investment portfolios - meaning they have less to lose by plunking their money into a nice home. By contrast, imagine someone in their 30s, living in a low tax state, with an aggressive investment profile and a job that demands *geographic* mobility in exchange for *upward* mobility. For them, renting may make more sense both from a numbers perspective, as well as from a lifestyle perspective. Equally, seniors with changing needs may benefit from the flexibility that comes from renting. Thinking of retiring to Costa Rica on your 70th birthday? Rent. Please.

In the end, you can't quantify everything. Many of us derive a sense of security from home ownership. We like knowing we have a place to go back to. We like the predictability of a fixed mortgage payment. We like knowing we're doing the 'right thing'. We like to not be compared to Mark.

But aren't most people who own homes financially better-off in their later years? Those who buy homes early, tend to be the conventional, diligent types, who *also* tend to save and make conventionally prudent choices in other areas of their life. But a more direct explanation for why most homeowners end up with more at retirement is that owning a home *imposes* a prudent lifestyle upon you. Every time you make a mortgage principal payment you are effectively *saving*. It's money in the bank (so to speak). For most of us, anything that takes money out of our weak little hands and directs it steadily into savings will have a powerful impact on our net worth over time.

Keep in mind however, that you're only really paying down principal if you stay in your home for a quite a while. In the early years, most of your mortgage payments are devoted to interest; the serious savings only kick-in 5-10 years down the line. That's why; unless you plan to stay in your home at least that long, the closing costs, points, and other expenses tend to outweigh the savings (home equity) that you're accruing.

"My mother says pay that darn thing off!"

One of the most common questions we get from our clients is whether they should pay down their mortgage. Now or later? All at once or slowly? Some advisors recommend *against* paying down a mortgage on the basis that you don't want all your wealth concentrated in a single asset. Others say that if your investments grow quickly enough, you may pay it down faster and easier by staying invested for a time. Still others don't want to recommend anything that would reduce the size of your investment portfolio (and their advisory fee!) Clearly, there are different schools of thought out there. Here is ours:

1. <u>Don't use your emergency funds to pay down debt.</u> If you have excess cash, it is quick and easy to put it into your home, but can be time consuming and costly if you need to get it back out. So, first things first: is your emergency fund large enough to meet almost any eventuality? How much of your extra cash is truly 'extra'?
2. <u>Is your current mortgage rate close to the best rate available to you?</u> If rates have fallen dramatically since you last refinanced, you might be able to reduce the cost of that debt entirely aside from, and *before* considering prepayment.
3. <u>Compare the mortgage rate to other debt you have.</u> There's no point paying down your mortgage if you've got $40k in credit card and personal loans outstanding. Always pay down the most expensive debt first.
4. <u>Compare the cost of your mortgage to what you could earn on your investments.</u> If your mortgage is less than $750k, all the interest should be tax deductible. On that basis you can make a simple comparison. Plug your mortgage rate into this formula: mortgage rate * (1 - your marginal tax rate). If the resulting number is higher than the *realistic* return you expect from your investments, *on an after-tax basis*, listen to your mother. Otherwise, you can ignore her as usual.

How your home fits into your retirement plan

At Paladin, we treat your home as a 'contingent asset'. That's a fancy way of saying that, for the purposes of planning for your retirement, we pretend it doesn't exist. Our primary objective is to assess the sustainability of your spending patterns in the context of your prospective income and investment flow - with an eye to establishing what adjustments may be required to allow you to continue to live in the manner to which you're accustomed. We assume that not running out of money in retirement is one the more important (if not *the* most important) goal and so we're looking to help you arrange your affairs such that you can be relatively certain that you can fund your retirement *with your liquid investments alone*.

Illiquid assets, like the equity in your home, are considered 'contingent' resources. We treat them as a source of income that you can fall back on in the event that your circumstances deteriorate markedly later on in life. There are good reasons to treat your home as a *fallback* rather than a primary source of retirement income. To start with, it's a lot easier to draw down retirement accounts than apply for a home equity loan or reverse mortgage. Secondly, the availability and cost of those financial products may vary in the future. Generally speaking, the more you need a loan, the harder it is to obtain one. Lastly, many people feel insecure about selling down equity in their home in old age, want to be sure they can stay put, and would ideally like to pass on their property (free and clear) to their children.

To people who are house-rich and income-poor in retirement, this might sound too cautious. These are probably the same folks who use their home as an ATM, thinking someone else will magically replenish the equity. That's not a good look. We want our clients' retirement plans to be bullet-proof.

Where are house prices going next?

My colleague Jeff and I are both in need of some new digs. Jeff is moving north to NH to be closer to his Bloomberg terminal, and I am setting up my home base in Northern Mass. Jeff, being our macro-maestro, accepts nothing less than calling the market correctly. It's a matter of principle. True to form, he is patiently waiting for a correction in home prices. I, on the other hand, am looking urgently for a home for my toddler and wife, and will happily swap all my savings (plus a kidney) for the first decent dwelling that comes my way. Choices are pretty constrained on the North Shore!

Despite that difference in approach, Jeff and I are in agreement on the basics. Over the years, house price growth may run hotter or cooler, but over the very long term you should expect them to roughly match the rate of inflation (say 3%). Over the coming years, we believe price growth is likely to run cooler - as in slow down, or decline in real terms.

Before we go into *why*, a huge disclaimer is required: there is *no such thing* as a national housing market or even a regional market! Rather, there are thousands and thousands of local markets. Dynamics can differ dramatically from one to the other. Indeed, you can have very different trends playing out simultaneously *within* a single market. For example, in my area, smaller homes (of the type a millennial might buy) have been selling like hot-cakes, with prices moving briskly upwards, while larger much more expensive homes (those being sold by wealthy boomers) are flat or even gently falling in price.

However, while generalizing about real estate prices is hazardous, there *are* factors that influence *all* US housing and we find it useful, as a starting point, to think about those trends.

Our framework for evaluating home prices is similar to any other asset. It starts with supply & demand, and the many drivers for each. We look both at the absolute levels and more importantly, at changes at the margin. Here are some of the more influential factors driving house prices over the short to medium term:

<u>Demand</u>

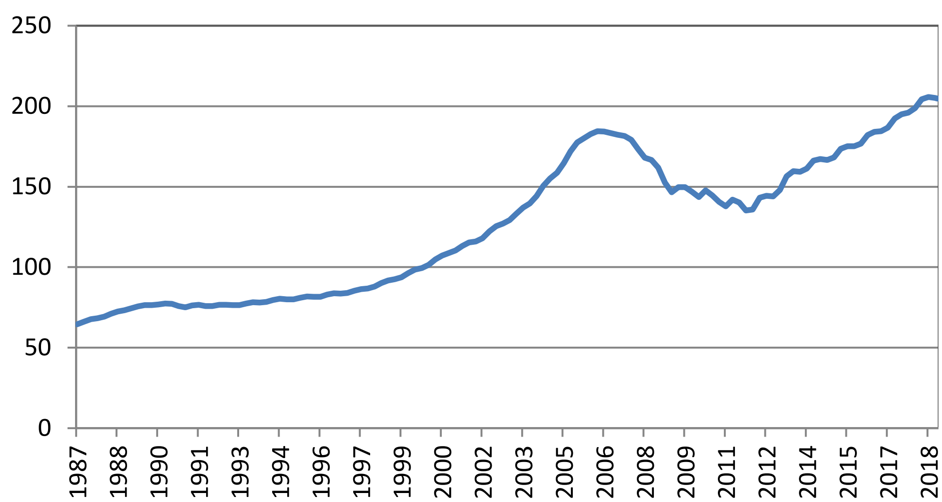
- Affordability
    - Mortgage interest rates
    - Employment, wage growth, GDP growth
    - Public policy (tax deductions, homebuyer credits, underwriting standards)
- Access to financing & bank lending terms (looser / tighter)
- Enthusiasm / animal spirits / price momentum
- Foreign capital in certain high-end submarkets (e.g. NYC, Vancouver)
- Demographics / buyer age cohorts / family formation rates

<u>Supply</u>

- Cushion (or lack thereof) in housing inventory
- Cost of labor and materials
- Availability and cost of financing for developers
- Local zoning and permitting requirements
- Environmental disasters and home destruction

Demand for housing today remains fairly robust in most places, particularly for more affordable starter homes and in metro areas more generally. That's demonstrated by rapid price appreciation we've experienced from the bottom of the market in March of 2012 through today. Over that period, prices have risen 7% annually in major cities and 4% nationally, outstripping inflation. Inventories of homes for sale are relatively low – and there are plenty of young folks who would love to get on the home buying ladder.

Case-Shiller US National Home Price Index

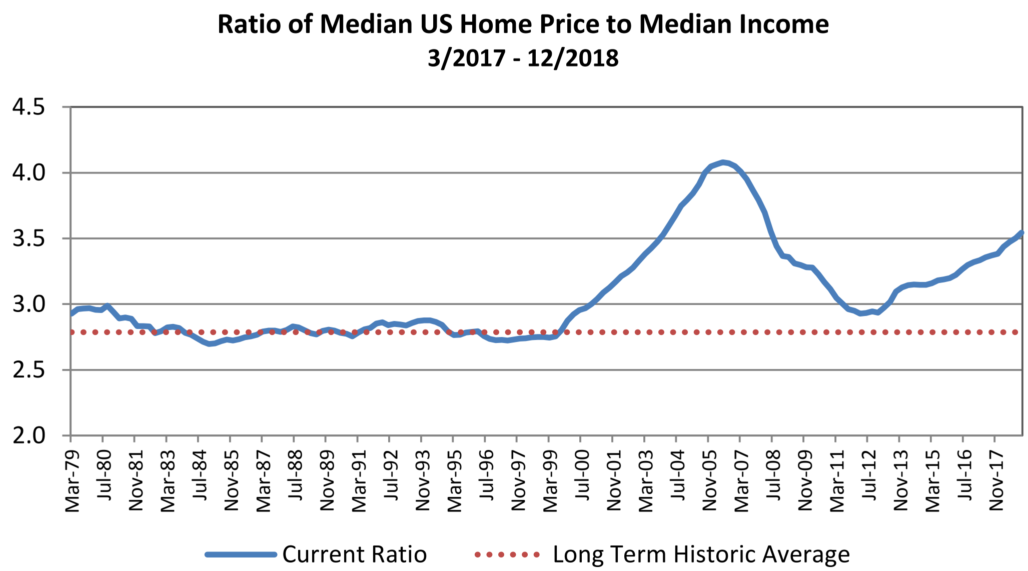


In certain cities, overseas buyers and the beneficiaries of today's most productive sectors (e.g. Tech) have fueled local real estate price increases. But nationally, the growth has been driven primarily by very low interest rates, declining unemployment and our collective recovery from the trauma of The Great Recession. People have been buying big, because low rates equal lower monthly mortgage payments. Measures that focus on affordability that incorporate mortgage rates still describe housing as 'affordable', if much less so that a few years ago.

But, the reality is that tomorrow's buyers are more indebted than ever; weighed down by student and car loans, and facing already-inflated prices. Partly as a consequence, we're now seeing a return of that pre-crisis trend: the 'exurb' where people priced out of the city in which they work resort to buying homes further and further beyond traditional suburbs. This is a good indicator that we're near the end of the housing cycle.

If rates resume their climb, measures of affordability will plummet. That is, until economics does its thing and causes house prices to drift lower in response. Affordability, like valuation for stocks, is the giant rubber band to which home prices are immutably tethered. It can stretch and stretch, but at some point becomes taut and holds firm. We think that housing is near that point today. The chart below showing the ratio of home prices to incomes for average Americans makes a similar point.

On the supply side, anyone who has recently hired a contractor knows that construction and renovation costs are sky high. Tariffs are increasing the volatility in supply costs, and there is some evidence that is translating to higher costs already. Banks have already begun pulling back from lending to developers on account of end-of-cycle jitters; although non-traditional lenders have so far been happy to fill that void.



There are some early technical indicators that a softening in the market is already occurring, though seasonality obscures the picture a bit. Volume (or number of sales) started to plateau last year and look to have been falling nationally. When transaction volume declines it is often a sign that buyers and sellers are finding it harder to agree on a fair price. That type of widespread disagreement most often coincides with a turning point in the outlook for prices. Consequently, even market cheerleaders like Trulia are sounding a note of caution.

The wild-cards in the short term are mortgage rates and sentiment. And of course, stock markets influence the sentiment of home buyers. While we're reaching limits in terms of affordability, it's possible that increased dovishness from the Fed will continue to push down mortgage rates. If that coincides with a late-cycle rebound in growth and a buoyant stock market, buyers may well come back out this summer, and push prices higher in the short term. We don't expect a crash in the housing market. But if you're not in a hurry to buy… there may well be better opportunities in the coming years.

Paladin Investment Strategy

US stocks enjoyed a strong start to the year, nearly erasing the prior quarter's decline. The Fed acknowledged growing risk to the business cycle (in line with our views), adopting a dovish stance toward monetary policy. The bond market currently anticipates no further interest rate hikes over the next two years – and many expect a rate cut as early as this year. Global economic growth has certainly slowed, but the data haven't yet pointed uniformly towards recession. Stock market investors have taken the bait, and are awaiting a return to the "Goldilocks" environment of accommodative interest rate policy, slow (but positive) economic growth, low inflation, and a profits recovery from US corporations.

Meanwhile, equity valuations remain extremely high (especially in the US), and late-cycle dynamics suggest that growth could be hard to squeeze out of the global economy going forward. Our indicators point to meaningful risk of a stock market drawdown (i.e., 30%+) over the next few years, and muted long-term (i.e., 5-10 year) US stock market return potential. In other words, despite the market gyrations of the past year, not much has changed on the fundamental front.

Against this backdrop, Paladin continues to employ a three-pronged strategy for our clients:

1) We continue to carry below-target exposure to stock markets until valuations improve and our business cycle indicators suggest that risk-taking is likely to be rewarded. Our primary aim is to protect our clients from severe portfolio drawdowns.

2) We seek strategies that can generate reasonable returns in flat markets and preserve capital in down markets. We've been emphasizing short/medium-duration fixed income as of late, which has panned out well. Our equity income/covered call investments are also fulfilling this objective, to great effect. Now that interest rates have fallen, we're on the lookout for ways to further diversify our clients' portfolio income streams.

3) In the absence of broad stock market opportunities, we have been increasing the resolution of our research in order to uncover asset-specific and thematic opportunities. We've done this in our Opportunistic Investments portfolio with great success, including a long oil position we implemented late in Q4 and exited in Q1 at a healthy profit. Currently, we hold profitable long exposures to both the US$ and gold. We'll look to continue and expand this effort in the years ahead. We've also identified two attractive investments in the environmental/climate change space, positions which we'll continue to build over time.