Investment Update

BNY MELLON
WEALTH MANAGEMENT

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There's No I in Team

Michael Jordan is considered by many to be the greatest basketball player who has ever lived. Yet even he struggled in his early professional career to win championships, reinforcing the lesson that no one player—even one of basketball's best—can win alone. It was not until he was surrounded by teammates who complemented his many talents that Jordan was finally able to go on to win six NBA titles.

In prior *Updates*, we often looked at broader issues driving the economy and the markets—the team, if you will. While those larger issues are important and produce the strongest results when working together—just like a team—the occasional "star" player can have a significant impact on elevating overall performance, too. So in this *Update*, let's take a look at one of the economy's rising stars—housing, which has shown some notable strength over the past few quarters.

You Can Go Home Again

Housing, narrowly defined as residential buildings, only makes up 3% of GDP. Thus, by itself it cannot carry an economic comeback. It can, however, and most likely will, play a substantial role in laying a foundation from which the remainder of the economy can rebuild. Housing can cast a fairly long economic shadow. When a home is purchased, the purchasers tend to buy durable goods to decorate and furnish their new property, with positive economic downstream impacts.

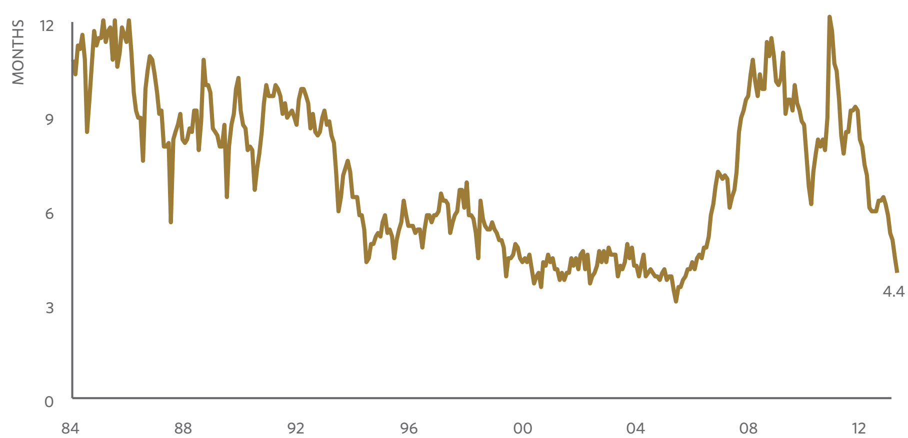
The housing market suffered greatly during the last financial crisis. In fact, 2007–2008 was the first time that housing decreased in value on an annual basis in more than 50 years. Of course, this strong history was part of housing's ultimate undoing. Banks extended credit, and individuals felt confident enough to borrow, because all parties believed this collateral only could move in one direction. Economic theory teaches that when something cannot go on forever it will eventually end. The ending came in 2007-2008 and that impact helped, in great part, to unravel the rest of the U.S. economy.

"While success breeds failure, failure also breeds success." We are now seeing evidence of the truth behind this old adage. As housing became more and more toxic, it eventually led to prices that attracted value investors. This, in turn, stabilized the price of homes for traditional buyers. Finally, home owners are again willing to take the risk of property ownership.

The Recovery Begins

Evidence that housing continues to recover can be found in many places. One instance of this is the amount of time that it takes to sell a home once it's placed on the market, as illustrated in Exhibit 1. This is a wonderful indicator of housing strength as it shows how long a seller needs to wait before a legitimate buyer is presented. Thus, it indirectly indicates who is more aggressive: the buyer or the seller. In better housing markets, the buyer becomes the aggressor, and the time to sell one's home declines measurably. Over the past year, this figure has declined from more than 12 months to its current reading of less than 5 months. This is an extremely strong improvement.

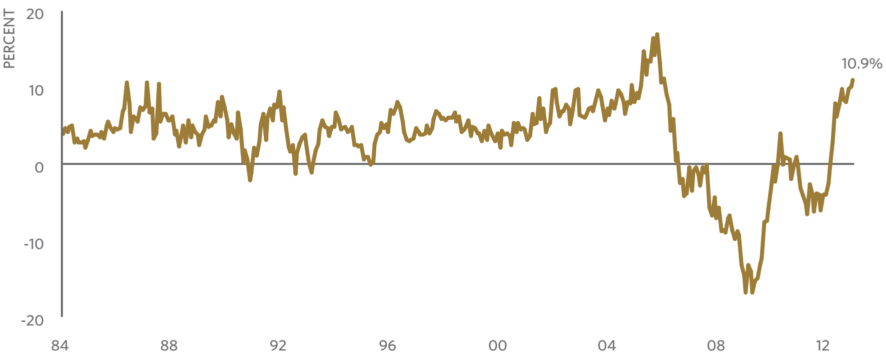
Exhibit 1—Month's Supply of Existing Homes



As of 12/31/12. Sources: Ned Davis Research, Haver Analytics and National Association of Realtors.

Another positive housing story is captured in Exhibit 2, which shows the year-over-year median home price change. This chart illustrates how much the median home costs and the current figure of more than 10% appreciation in the last year illustrates how far the general housing market has improved. Of course some parts of the country continue to struggle, but this number clearly shows that generally prices are rising.

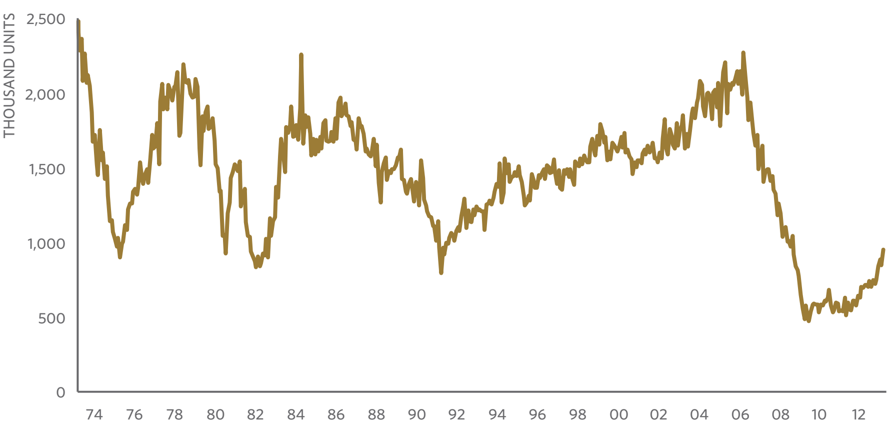
Exhibit 2—Median Price of Existing Homes Percent Change from a Year Ago



As of 12/31/12. Sources: Haver Analytics and National Association of Realtors.

Perhaps the most powerful support that the housing market has improved, however, is illustrated in Exhibit 3, which looks at housing starts going back to 1974. Over that time, we have had recessions, oil price spikes, economic expansions, peace and war. We had the boom of the 1980s and the RTC (Resolution Trust Corporation) bust of the early 1990s. This time period represents a varied historical experience, to say the least. Let us draw our attention to the fact that housing starts bottomed out at a 1,000,000 run rate per year only four times across this period. They attempted to bottom a fifth time during the financial crisis, but instead dropped below that historical support level like a hot knife through butter. Housing starts fell to the low 500s and climbed back to our current level of about 950,000. Any time supply is constrained, upward pressure ultimately is exerted on price. Therefore, this prolonged, reduced supply of new housing starts should further support home price increases going forward.

Exhibit 3—Housing Starts Seasonally-Adjusted Annual Rate



As of 12/31/12. Source: U.S. Census Bureau.

Greater Economic Ramifications

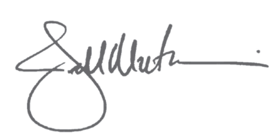
While housing is directly only a small part of GDP, it has a broad importance as an economic indicator and influencer. People tend to buy houses only when their own jobs and income are secure. This also is true regarding the potential to get a loan, as qualifying has become very difficult for many mortgage applicants. With this in mind, the strong housing market can be interpreted to suggest that the job market continues to improve and that those who have been able to borrow have a very good likelihood of not defaulting on their loans, as credit standards are high and banks are only lending to those who are near the top of the credit worthiness scale.

In fact, the job market does continue to show signs of improvement. In early February, the four-week moving average of weekly initial claims for unemployment benefits was the lowest since March 2008. As we have discussed in this *Update*, while real estate can't do it alone, continued strength in the housing market bodes very well for the overall economy.

It Doesn't End at Residential

While this *Update* has focused mainly on residential real estate and its ramifications for the overall economy, real estate investment trusts (REITs) were the strongest performers of all major asset classes in 2012. REITs represent the "investment" side of real estate, and comprise property types such as apartments, office, retail and warehouse space. Worldwide, as a group, this asset class was up nearly 30% for 2012. When this 30% gain is compared to the -47.7% decline of 2008, it serves to reinforce a positive, albeit possibly bumpy, road for housing's (and real estate's) recovery.

To summarize, the real estate sector has evidenced many positive developments over the past few quarters, from high home builder confidence to continued improvement in the level of housing starts. There are positive long term trends supporting home prices including low interest rates and modest job creation. Overall, real estate sends an encouraging message about the economy. Certainly, our economy also needs some other good players on its team but real estate has begun to play an MVP role.



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