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Subject: US Equity Strategy : An Idea Levered to the Housing Recovery

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Inline-Images: image1.gif

Brad

New Investment Theme: US Housing Recovery

This has been one of our top themes since April and we continue to add exposure with the US job market strengthening (demand), consumer confidence staying elevated (demand), new and existing home inventories low (supply) and interest rates remaining low (credit).

We would recommend \$2MM in a delta-1 note linked to the JPM Housing Basket.

- **J.P. Morgan US Housing Basket (JPAMHOUS <Index>): a preferred way to play the recovery in housing.** The J.P. Morgan US Housing Basket is composed of a diversified portfolio of companies that have direct or indirect exposure to the US housing market and should benefit from the continued pick-up in residential investment. Basket constituents are screened for liquidity (trade at least \$10M ADV), and include direct beneficiaries of housing (e.g., Homebuilders, Building Products) as well as derivative industry plays (e.g., Durables, Retail, Financials). The basket contains 65 names, and the weights are optimized to replicate as closely as possible to an equal-weighted basket, subject to a maximum of 10% of ADV traded in any single name within a \$100M basket. The basket can be accessed on Bloomberg via ticker JPAMHOUS <Index>.

Paul

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Global Equity Strategy and
Quantitative Research

US Equity Strategy: 100 Ideas Levered to the Housing Recovery

Housing market fundamentals remain constructive with a pick-up in demand, tightening supply, high affordability, low household leverage, and easing credit standards. Taken together, we believe these are likely to be drivers of an outperformance of equities levered to the housing recovery. In this report, we identify 100 such companies with direct or indirect exposure to housing from a diverse list of industries — the mix ranges from the obvious Homebuilders and Building Products to derivative plays in Durables, Retail, and Financials, see Figure 3. **After more than six years into this recovery, we believe there are few opportunities in US equities that offer stronger growth and cheaper valuation than housing.**

Key variables for housing recovery — the job market continues to strengthen, consumer confidence remains elevated, level of interest rates remains relatively low and risk to housing from rising rates should remain contained over the coming quarters. We recognize housing is interest-sensitive and the Fed is about to embark on a tightening campaign. However, long rates which matter more for housing are already pricing in Fed rate hikes. Even if the Fed surprises by

tightening faster than what the market anticipates, J.P. Morgan expects to see a curve flattening and conventional mortgage rates should not move nearly as much as the funds rate.

Historically, bear flatteners are not associated with negative performance for housing stocks. As shown in Figure 34, homebuilders have outperformed the market during bear flatteners. On the contrary, bear and bull steepeners carry worse implications for performance, underlining the importance of long rates for the housing market.

J.P. Morgan Economists expect residential investment growth of 8% this year and 7% in 2016. Despite the 63% increase in residential investment from \$366b at the bottom (3Q10) to \$595b, current activity remains depressed at 3% of GDP (vs. 4.7% avg since 1949). Outside of key macro level data suggesting significant residential investment growth, commodities linked to housing are rising and the recent search trends point to an improvement in homebuyer interest (see Figure 22). The following drivers bode well for a continued recovery and growth in residential investment:

- **Demand: should firm on strong labor market trends (declining unemployment rate + expected rise in wages), high consumer confidence, stronger household formation, and low vacancy rates.** Since the start of the recovery, the economy has created more than 11 million net jobs with the unemployment rate approaching 5%. This combined with near-peak consumer sentiment is encouraging household formation. Due to the severity of the last recession, we believe there is pent-up demand for housing, with household formation at a deficit of around 5 million, see Figure 20. Also, buying vs. renting is becoming increasingly more attractive with the median home price to rent ratio at the lowest level in 15 years, see Figure 32.
- **Supply: tighter with new and existing home inventory sharply lower.** The existing home supply declined from ~4 million units at peak to 2.3m recently, which is similar to levels seen prior to the housing boom. As for new home inventory, the supply is even tighter at 215k units compared to 570k at last peak and 300k prior to the last housing boom, see Figure 23. If adjusted for population growth, the current supply picture looks even more constructive.
- **Credit: household balance sheets at best level in more than a decade as lenders easing standards.** During this recovery, households have significantly delevered, with current household debt at the lowest level in more than 10 years and mortgage service ratio at an all-time low, see Figure 36. Also, a higher percentage of homebuyers are likely to qualify for a mortgage loan with more lenders easing rather than tightening credit standards. And for some, credit scores should be improving as foreclosure related hits on credit reports cycle through after 7 years on record.
- **Value: compared to most asset classes, relative valuation more attractive for housing.** Residential homes sell at a discount to equities, gold, and oil (i.e., it takes 137 units of S&P 500 index to purchase a median priced home in the US, which is a 48% discount to its long-term median of 260 units, see Figure 39). Even after the recent decline in commodities, Homes are a cheaper hard-asset alternative to Gold, see Figure 40.
- **Risk: rising home prices to household income ratio and higher rates a concern.** While the job market outlook has improved homebuyer sentiment, the tepid rise in household income (+5% since 2010) compared to a more significant rebound in home prices (up 34% from the low) is a risk to a more robust housing recovery, in our view. Consequentially, the new single-family home price to household income ratio has risen to near record (5.4 years vs. 4.0 median since 1966), see Figure 42.
- Also, as the Fed begins to raise rates, this could be a further negative for affordability given that every 50bp increase in mortgage rates is equivalent to roughly 5% increase in home prices. However, we feel that the most likely scenario is a bear flattener under which the mid-to-long portion of the curve (which is more important for mortgage rates) is less affected.

Housing stocks enjoy stronger fundamentals with domestic exposure at a cheaper multiple than the market: growth at a reasonable price. After more than six years into this recovery, we believe there are few opportunities that offer stronger growth and cheaper valuation than housing. In fact, if housing stocks were a unique GICS sector, it would offer the strongest earnings growth and second cheapest valuation. Based on consensus estimates, housing stocks are expected to grow earnings by roughly 50% vs. 30% for S&P 1500 companies during 2015 through 2016. As for valuation, we believe the domestic linked housing sector does not deserve multiples inline with the cheapest Materials sector, which has meaningful exposure to China.

- **Improving sentiment implies that investors no longer view housing as toxic and there could be additional accumulation by institutional investors.** Whether you gauge the sentiment by the Street's analyst ratings or short interest, housing stocks have seen market participants slowly turn more constructive. Housing stocks have an elevated short interest as % of float (4.6% current vs. 17% at peak) compared to rest of the market at 3.6%, see Figure 10. The Street's sentiment has also been improving with the average stock rating now similar to the rest of the market, see Figure 11.

- **Higher revenue growth and margin expansion is expected to drive double-digit earnings growth.** Housing stocks on average offer stronger revenue growth between 5-6% in the coming quarter compared to low single-digit growth for S&P 500 (ex-energy). This combined with margin expansion is expected to drive double-digit earnings growth in the upcoming quarters.
- **Significant margin expansion:** the Street is expecting significant expansion for housing with net margins expected to increase from 6.4% (last four quarters) to 7.1% over the next four quarters (3Q15-2Q16), see Figure 50. Based on estimates, margin expansion is expected to be driven by declining commodity prices while SG&A expenses are expected to rise.
- **Shareholder yield now near 5%, higher than S&P 500.** Perhaps due to the uneven growth and highly cyclical nature of most companies levered to housing, the shareholder yield has been volatile. In the last twelve months, the total shareholder yield increased to 4.7%, which is higher than the S&P 500 at 4.1%, which is attractive for yield-seeking investors in a scarce yield environment.
- **J.P. Morgan US Housing Basket (JPAMHOUS <Index>): a preferred way to play the recovery in housing.** The J.P. Morgan US Housing Basket is composed of a diversified portfolio of companies that have direct or indirect exposure to the US housing market and should benefit from the continued pick-up in residential investment. Basket constituents are screened for liquidity (trade at least \$10M ADV), and include direct beneficiaries of housing (e.g., Homebuilders, Building Products) as well as derivative industry plays (e.g., Durables, Retail, Financials). The basket contains 65 names, and the weights are optimized to replicate as closely as possible to an equal-weighted basket, subject to a maximum of 10% of ADV traded in any single name within a \$100M basket. The basket can be accessed on Bloomberg via ticker JPAMHOUS <Index>.
- **Basket Performance:** An examination of hypothetical performance shows the basket – JPAMHOUS <Index> – would have returned +17.7% on an annualized basis over the last three years, narrowly outperforming the S&P Homebuilders Select Industry Index (SPSIHOTR Index), which returned +17.3% over the same period. The correlation of the basket to the SPSIHOTR Index is 93%, and the recent 6M realized volatility of the basket is 11.9% (the realized volatility of the SPSIHOTR Index over the same time frame is more than 2 vol points higher at 14.1%).

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