November 21, 2016

Impact of Trump Election on Housing

—Significant likely change in fiscal stimulus impacting markets already, but many additional questions to explore

Key Conclusions / Implications:

1. Higher mortgage rates following the election are an immediate headwind to affordability. Longer-term, economists expect proposed tax cuts and infrastructure spending will boost economic growth (including employment and wages). Pro-growth policies should increase demand for shelter especially among Millennials who delayed household formations during and after the recession.
2. Federal housing policy going forward is a question mark, but recent Republican housing legislation (Corker-Warner, PATH Act) proposed winding down Fannie Mae & Freddie Mac and limiting government role in mortgage market. We think these proposals would be at least near-term disruptive to the lending markets and unlikely to expand mortgage credit to lower credit borrowers.
3. Infrastructure spending is likely to increase building costs including construction materials and labor. Further, immigration reform would further tighten labor supply as a recent Zelman & Associates report estimates that 26% of construction workers were born outside of the US. Higher construction costs impact affordability and the ability of builders to produce entry-level housing.[1]
4. While fiscal stimulus should be a positive for employment and wage growth, headwinds to homeownership remain, including affordability (not helped by higher rates or construction cost for new supply), mortgage credit availability, and not enough construction of entry-level housing. These factors should lead to strong demand for occupancy and rent growth for housing.

Initial Market Reaction to 2016 Election[2]

On November 8th, Donald Trump won the presidential election. Coupled with a strong showing by Congressional Republicans the election results have led investors to expect Republicans will use their control of the government to enact significant fiscal stimulus (lower taxes, more infrastructure spending) and to roll back regulation.

In the five trading days following the election, the 10Yr Treasury yield increased by 35bp to 2.22%, the 30Yr Treasury yield increased 30bp to 2.92%, the Federal Reserve's five year inflation break-evens increased by 12bp to 2.03%, and the S&P 500 rose 1.7%.

Importantly for housing, the Freddie Mac 30yr mortgage rate rose 37bp w/w to 3.94% as the long-end of the curve moved more dramatically than the short end and mortgage spreads inched wider, in contrast to corporate borrowing spreads which narrowed (Bloomberg Barclays Corporate Index spreads narrowed by 6bp to 128bp). Therefore, the immediate

[1] Zelman and Associates, "Framing Potential Impact of Immigration Reform," November 21, 2016.
[2] Bloomberg for equity and bond market data from 11/9 - 11/16/2016. Mortgage rates from Freddie Mac's Primary Mortgage Market Survey, as of 11/17/2016.

impact to housing affordability is negative, as the cost to own and finance a home has risen substantially in one week's time albeit from low levels.

Long-Term Implications for Housing Market

During the campaign, President-elect Trump gave little detail behind his economic growth policies, views on housing, or how these will dovetail with priorities for Republican lawmakers. Therefore, there is uncertainty surrounding the outlook for federal housing policy (GSE reform, desire to push for greater mortgage credit availability, mortgage interest deductions) and the impact spending / social programs will have on employment growth, mortgage rates, construction cost inflation and labor availability, and other factors critical to forecasting housing costs and demand.

One area we are watching closely is mortgage credit availability and the willingness and ability for banks to step up lending to low credit borrowers. In our view, simply removing regulations surrounding lending to lower credit borrowers will not entice additional lending. Rather, the government needs to legislate a safe harbor for lenders to extend credit to currently non-QM borrowers so they feel comfortable they will not be exposed to litigation in the future.

Topics & Questions to Explore Further

While it is too early to say definitively what impact "Trumponomics" may have on residential and related credit investments, we believe there are several areas where a dramatic change in policy would impact the housing market. Below and in reports to follow, we attempt to frame the big questions we're thinking about, and what next steps we are watching to understand the direction Mr. Trump is taking the economy and the federal government's role in housing finance policy.

- **Economic -** The impact of significant fiscal stimulus on job growth and wage growth, which are key drivers to housing demand and rental rate growth. Comprehensive corporate tax reform could improve business confidence, while lower personal income taxes would be a positive for discretionary spending.
- **Inflation / Rates -** The impact of significant, unfunded fiscal stimulus on inflation expectations, rates (including mortgage rates), and monetary policy. For the potential size of the stimulus package we will use the baseline projections from two highly ranked sell-side economists/firms: Evercore ISI's Krishna Guha's base case is for $400bn of infrastructure spending over five years and $2.5tn of corporate and personal tax cuts over 10 years; and Goldman Sachs' Jan Hatzius' base case expects far less impact, with $50bn of spending increase per annum coupled with $100bn of tax cuts per annum.[3]
- **Housing Supply -** On housing production, there is already a shortage of skilled construction labor. Increased competition for labor from infrastructure projects, coupled with potentially restrictive immigration problems could drive costs higher and limit new construction at a time when the US is already not building enough housing vis-a-vis incremental demand.
- **Housing Policy -** Mr. Trump's appointments to run Treasury & HUD could have a significant impact on the government's role in mortgage finance and expansion of credit availability. Senator Corker and Congressman Hensarling have in the past few years argued for an end to Fannie / Freddie and reform of FHA (see: Corker-Warner 2013,

[3] Evercore-ISI, "The Trump Paradigm Shift", November 14, 2016. Goldman Sachs, "Economic Implications of the Trump Agenda", November 12, 2016.

and PATH ACT 2013).[4] Reducing government's role in the mortgage market would be at least near-term disruptive.

- **Credit Availability -** Less regulation (including repealing parts of Dodd-Frank, lowering capital requirements for banks, rolling back CFPB lending rules) could spur banks to lend more, but it is impossible to know if they will relax lending standards and write lower credit loans after significant litigation and credit losses in the last recession.

Outlook for Housing Market

- If fiscal stimulus / lower regulations improve business confidence, that should benefit employment growth and wage growth. That in turn is good for renter income growth and rent growth for housing as the economy grows.
- At the same time, unfunded fiscal stimulus expectations has increased the cost of financing home purchases well in advance of tangible economic growth.
- Higher inflation increases the cost of producing new housing (land, labor, materials, financing). As a real asset, real estate values have a positive correlation with inflation.
- According to Freddie Mac, the US is not producing enough housing relative to net demand, and has not for several years. We would expect that labor cost inflation and potential disruption to immigrant labor growth would further exacerbate constraints on housing supply.[5]
- Leading Republicans for Treasury/HUD have in the past proposed legislation to wind down Fannie Mae and Freddie Mac and reform FHA. In the near-term, overhauling the housing finance system would likely introduce uncertainty for borrowers and lenders.
- Less regulation without legislative action to provide safe harbor is unlikely to drive meaningful mortgage credit availability.

[4] For more details on the bills, see https://www.corker.senate.gov/public/index.cfm/housing-finance-reform and http://financialservices.house.gov/news/documentsingle.aspx?documentid=342165

[5] Freddie Mac, Investor Update, August 2016.

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