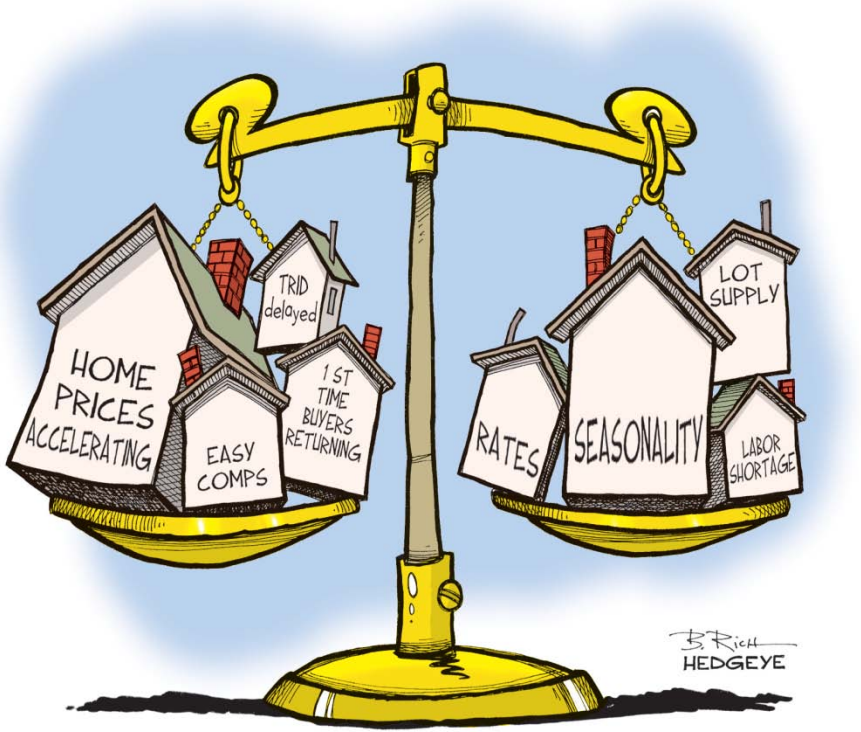
JOSHUA STEINER, CFA
CHRISTIAN B. DRAKE

HEDGEYE

HOUSING: 3Q15 THEMES

IS GOOD, GOOD ENOUGH?



JULY 9, 2015

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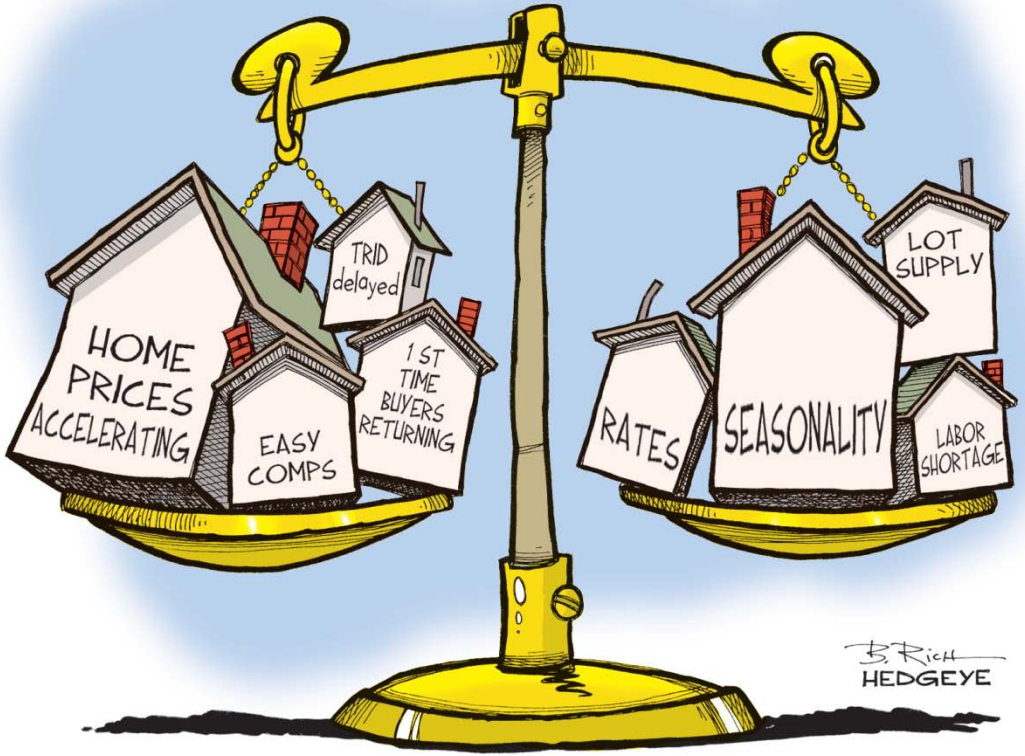
PLEASE SUBMIT QUESTIONS* TO

QA@HEDGEYE.COM

*ANSWERED AT THE END OF THE CALL

3Q15: IS GOOD, GOOD ENOUGH?



The goal of the call today is to explain why we think the housing sector is unlikely to perform as well in 3Q15 as it did in the first of the year.

OUR PROCESS: RATE OF CHANGE

HEDGEYE HOUSING

07/30/14 08:32 AM EDT
HOUSING: A LOWER LOW FOR 3Q14 MORTGAGE DEMAND

HEDGEYE HOUSING

08/27/14 08:43 AM EDT
HOUSING: DEMAND ANEMIA PERSISTS

HEDGEYE HOUSING

09/02/14 12:44 PM EDT
HOUSING: CORELOGIC HPI DATA - THE DILEMMA

HEDGEYE HOUSING

11/18/14 11:37 AM EST
HOUSING: NAHB - HOUSING BEGINS TO TURN THE CORNER

HEDGEYE HOUSING

12/02/14 10:31 AM EST
HOUSING: CORELOGIC | HPI STABILIZATION CONFIRMATION

HEDGEYE HOUSING

12/11/14 09:12 AM EST
HOUSING: SWITCHING FROM BEAR TO BULL FOR 2015 | CALL INVITATION

HEDGEYE HOUSING

03/03/15 09:39 AM EST
HOUSING: CORELOGIC HPI | RE-ACCELERATION ENGAGED

HEDGEYE HOUSING

03/24/15 11:51 AM EDT
HOUSING: NHS | THE BEST ROC CHART IN U.S. MACRO

INVESTING IN HOUSING IS A MATTER OF "BETTER/WORSE", NOT "GOOD/BAD"

We closely track all housing data and do our best to make it clear to investors when we think the data is showing signs of a pivot. The above note titles/dates are intended to convey some sense of our process in this respect.

SIMPLIFYING THE COMPLEX

HEDGEYE HOUSING COMPENDIUM

		Most Recent Data			TRADE/TREND/TAIL			Rate of Change		
					Short Term	Intmed Term	Long Term	Short Term	Intmed Term	Long Term
		Period	Latest Data	Last Price	Prior Period	3M Ago	12M Ave	MoM Chg	3M Chg	vs 12M Avg
Home Prices	Case-Shiller 20 City HPI YoY NSA	Apr-15	Worse	4.9%	5.0%	4.4%	6.0%	0.0%	0.5%	-1.1%
	Case-Shiller 20 City HPI MoM SA	Apr-15	Worse	0.3%	1.0%	0.8%	0.4%	-0.7%	-0.5%	-0.1%
	Corelogic HPI - NSA YoY % Chg	May-15	Better	6.3%	5.7%	4.8%	5.8%	0.6%	1.5%	0.5%
	Corelogic (Ex-Dist.) HPI - NSA YoY % Chg	May-15	Better	6.3%	5.7%	4.6%	5.1%	0.6%	1.7%	1.2%
	FHFA HPI - NSA YoY % Chg	Apr-15	Worse	5.3%	5.3%	5.1%	4.9%	0.0%	0.3%	0.4%
Supply & Demand: Existing	MBA Purchase Apps Index (Mo. Ave)	Jun-15	Better	207	202	178	179	2.3%	16.3%	15.4%
	NAR: Pending Home Sales (Index)	May-15	Better	112.6	111.6	107.4	105	0.9%	4.8%	7.0%
	NAR: Existing Home Sales (SAAR)	May-15	Better	5.35	5.09	4.89	5.1	5.1%	9.4%	5.6%
	NAR: Existing Home Inv. (millions units)	May-15	Worse	2.29	2.22	1.90	2.2	3.2%	20.5%	6.5%
	NAR: Existing Home Inv: Months Supply	May-15	Better	5.14	5.23	4.66	5.1	-1.9%	10.2%	0.8%
Supply & Demand: New Homes	NAHB: HMI	Jun-15	Better	59	54	52	55	5.0	7.0	0.1
	Census: Total Starts	May-15	Worse	1036	1165	900	1023	-11.1%	15.1%	1.2%
	Census: SF Starts	May-15	Worse	680	719	600	664	-5.4%	13.3%	2.5%
	Census: Total Permits	May-15	Better	1275	1140	1098	1071	11.8%	16.1%	19.0%
	Census: SF Permits	May-15	Better	683	666	626	647	2.6%	9.1%	5.6%
	Resi Construction Spending (in Billions)	Mar-15	Worse	357	361	355	357	-0.9%	0.6%	0.0%
	Census: New Home Sales	Apr-15	Better	534	494	521	469	8.1%	2.5%	13.8%
	Census: New Home Inventory (000)	Apr-15	Worse	202	201	206	204	0.5%	-1.9%	-0.9%
Miscellaneous	Interest Rates (30 Year FRM)	Jun-15	Worse	4.2%	4.0%	4.0%	4.1%	0.2%	0.3%	0.1%
	NAR: Affordability Index (Composite)	Apr-15	Worse	164.9	171.6	180.8	166.7	-3.9%	-8.8%	-1.1%
	ITB Price (EOP)	Jul-15	Better	27.56	27.09	27.64	25.6	1.7%	-0.3%	7.7%
	XHB Price (EOP)	Jul-15	Better	36.74	36.51	36.07	33.8	0.6%	1.8%	8.7%

Source: Hedgeye Risk Management, S&P, Corelogic, FHFA, MBA, NAR, NAHB, Census Dept., Factset, Bloomberg

HEDGEYE

Our Hedgeye Housing Compendium table (left) aspires to present the state of the housing market in a visually-friendly format that takes about 30 seconds to consume.

As of: 7/7/15

HOUSING – IS GOOD, GOOD ENOUGH?

1

2Q15 – A LOOK BACK AT WHAT HAPPENED

Our main call for 2Q15 was that housing demand and home prices would show notable acceleration on a Q/Q and Y/Y basis. Our call played out as expected, but rising rates in April drove some underperformance that was largely recouped in May and June.

2

3Q15 – A LOOK AHEAD AT WHY WE'RE CAUTIOUS

We expect ongoing acceleration in HPI and further strength in volume in 3Q15, but we think the seasonality headwinds are too well-entrenched and should be sidestepped. Meanwhile, labor shortages, lot supply, and rates optionality pose additional risks.

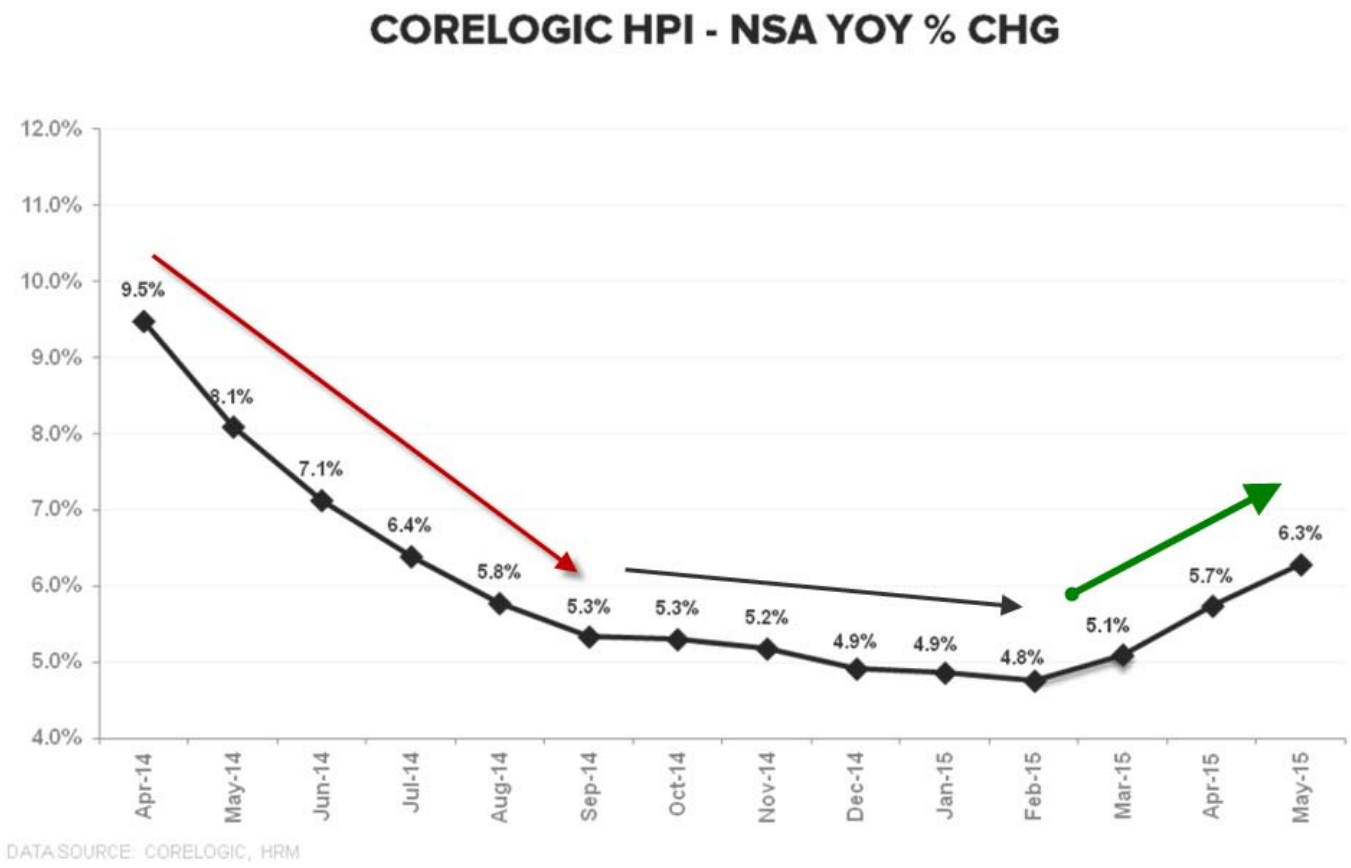
3

TOP IDEAS – "HIDING OUT"

We'll run through the names and groups that we think are best positioned despite our expectation for headwinds in the third quarter.

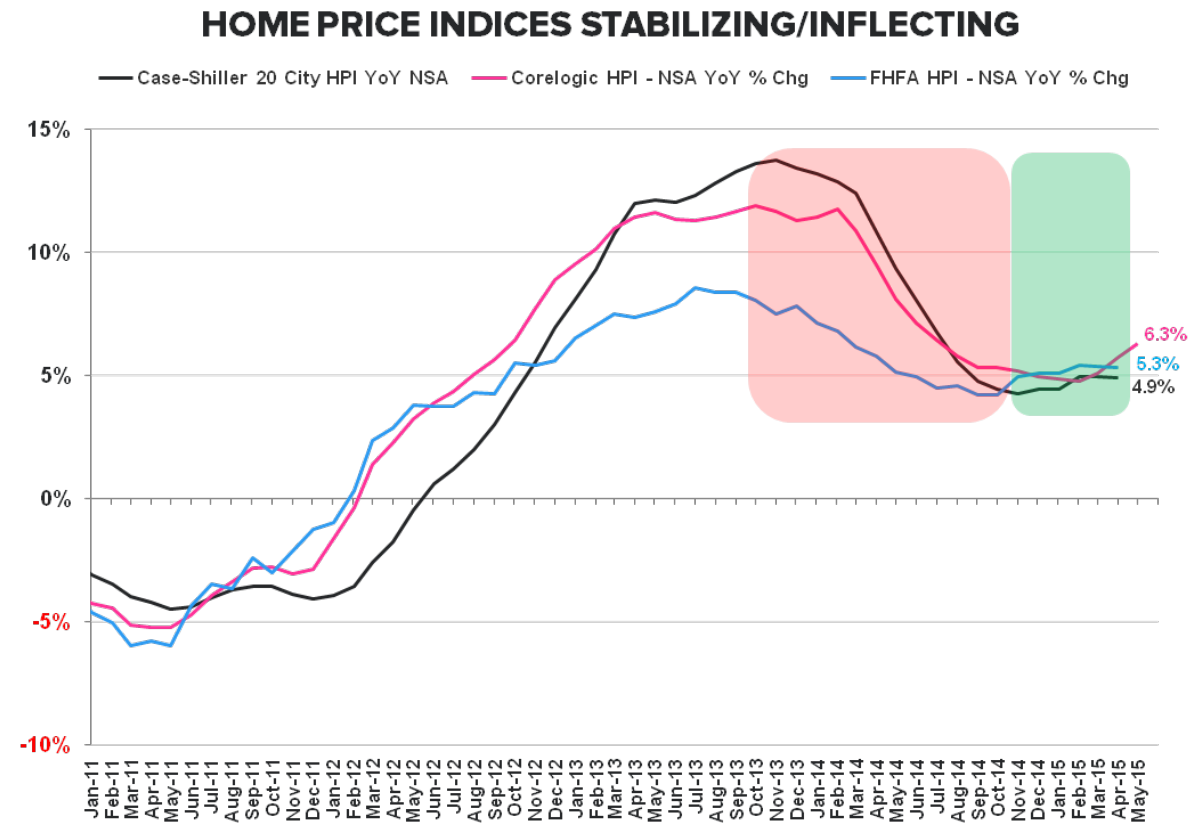
2Q15 – A LOOK BACK

2Q15: RE-ACCELERATING HPI (GOOD)



The second quarter saw HPI begin to re-accelerate after stabilizing throughout 4Q14/1Q15. HPI has accelerated 150 bps, from +4.8% to +6.3% in the last three months.

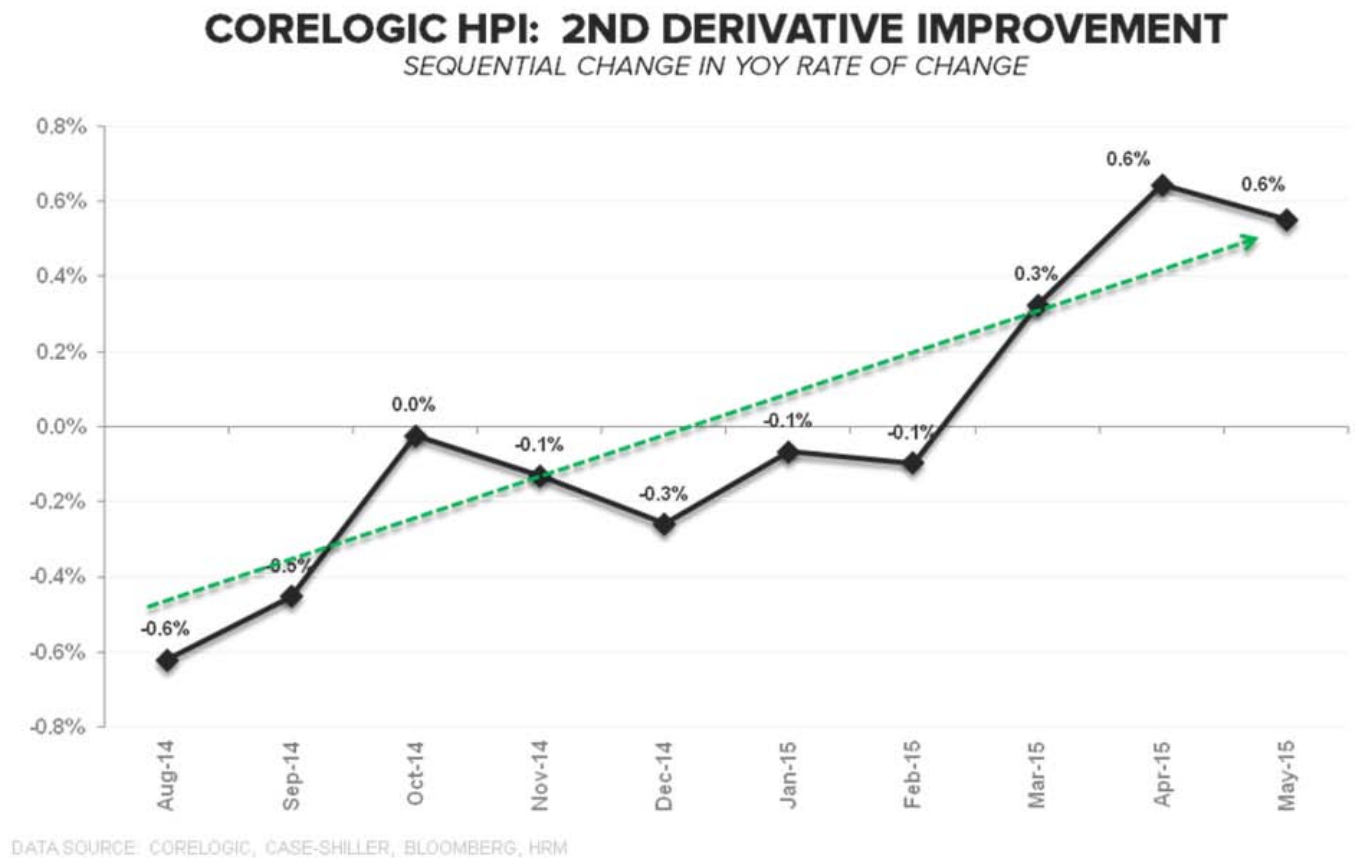
2Q15: RE-ACCELERATING HPI



DATA SOURCE: CORELOGIC, CASE SHILLER, FHFA

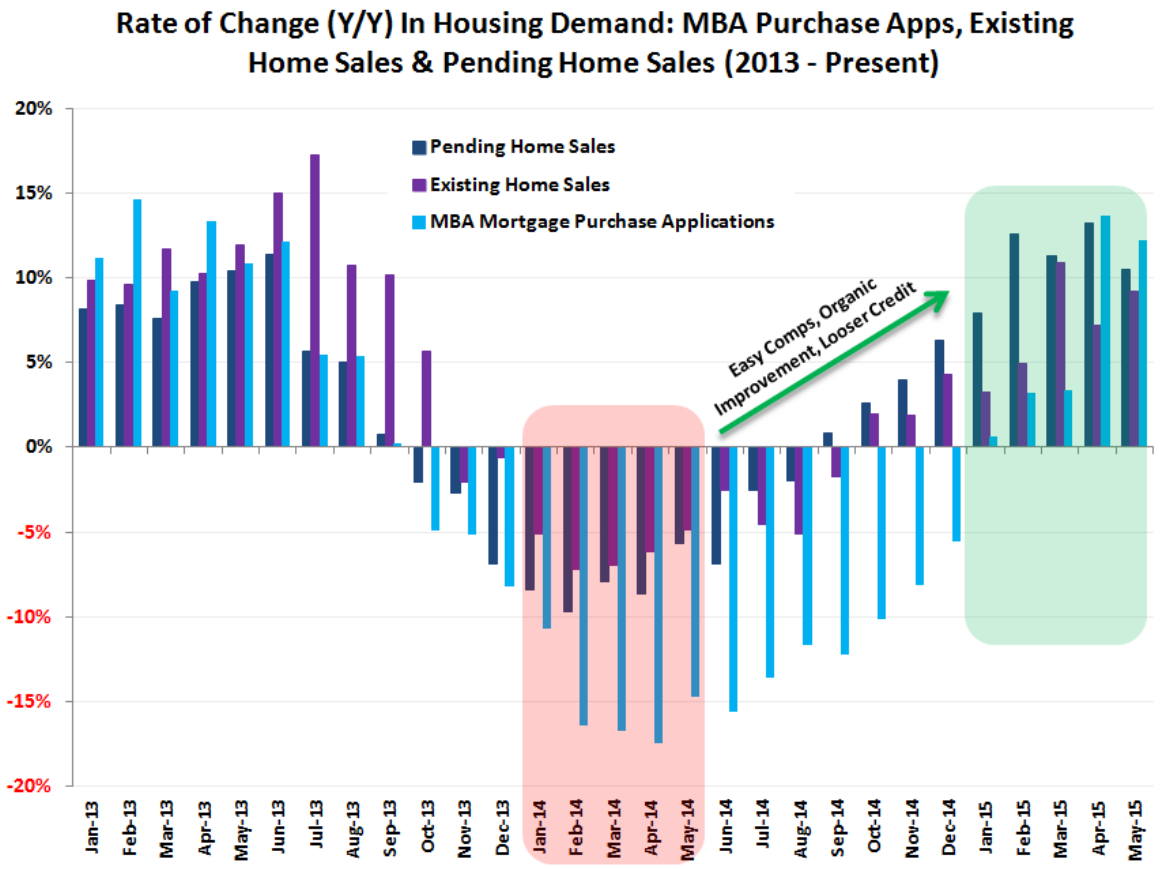
Interestingly, the market doesn't really get that prices have begun to re-accelerate. This is because only CoreLogic has shown it. Case-Shiller and FHFA are still showing things going sideways.

2Q15: RE-ACCELERATING HPI



Sequential improvement in second derivative rate of change is also evident in the CoreLogic data.

2Q15: IMPROVING VOLUME (GOOD)



Year-over-year growth in all volume measures – PHS, EHS, MBA – was evident again in the second quarter.

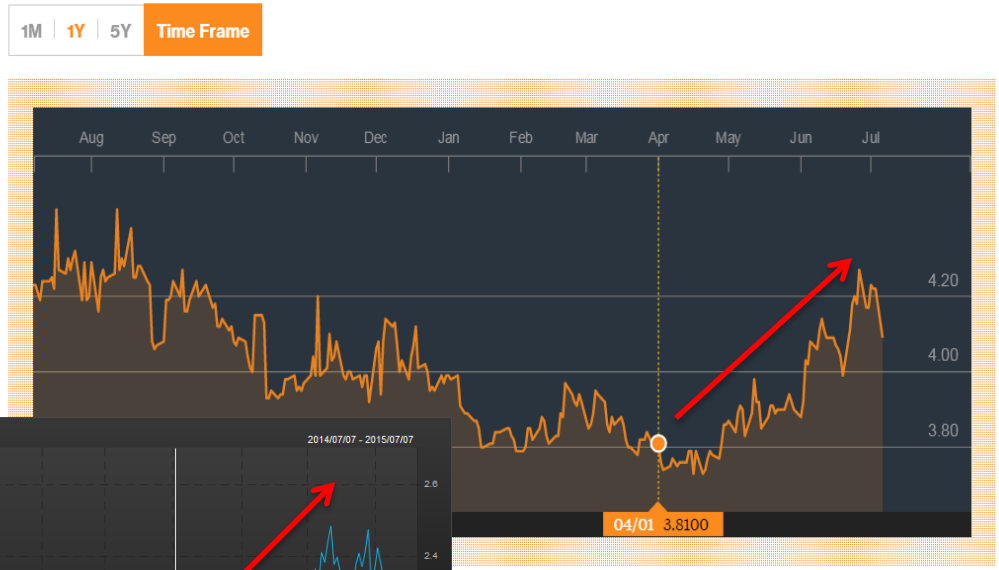
Data source: Bloomberg, NAR

2Q15: RISING RATES (BAD)

Bankrate.com US Home Mortgage 30 Year Fixed National Avg

ILM3NAVG:IND

↓ 4.09 -0.13 -3.08%

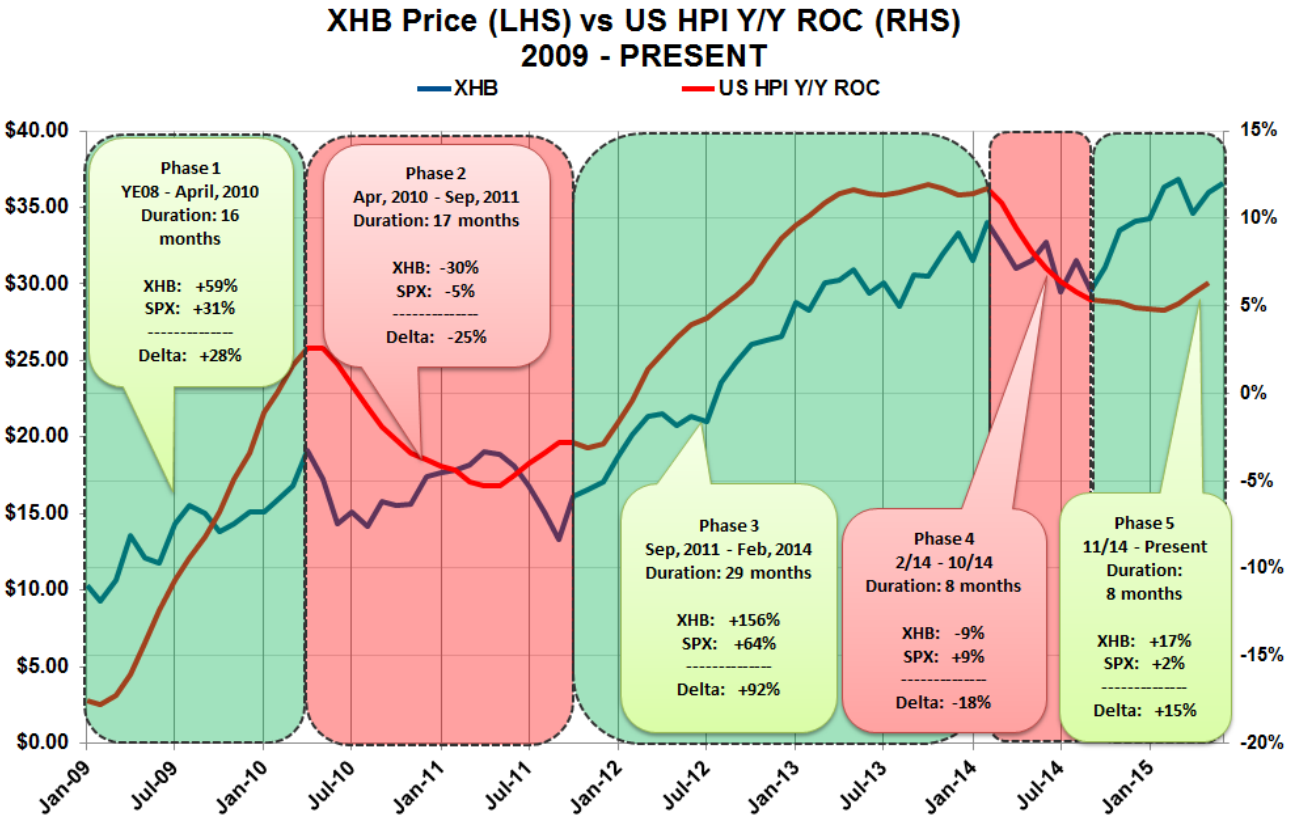


Source: Bloomberg, Bankrate, Factset

During the second quarter, 10-year treasury yields rose +44 bps to 2.36% from 1.92%. Rates currently sit at 2.19% (July 8).

Meanwhile, 30Yr Conforming Mortgage Rates rose +38 bps to 4.17% from 3.79%. Rates currently sit at 4.08%.

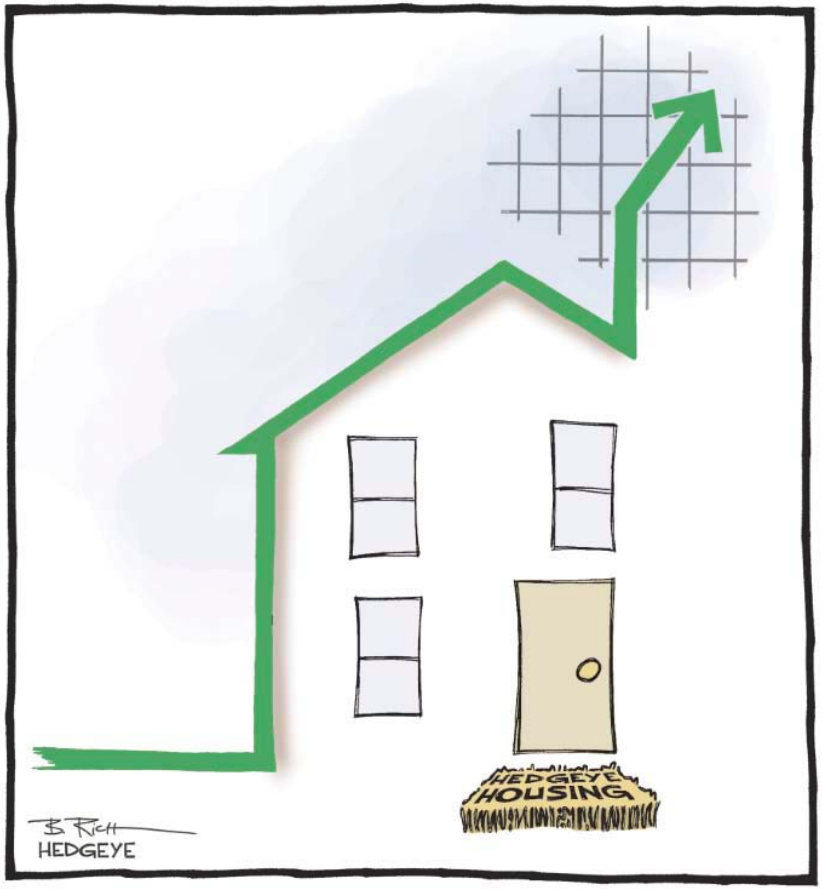
PHASE 5 OF HOUSING, POST 2008



DATA SOURCE: CORELOGIC, FACTSET

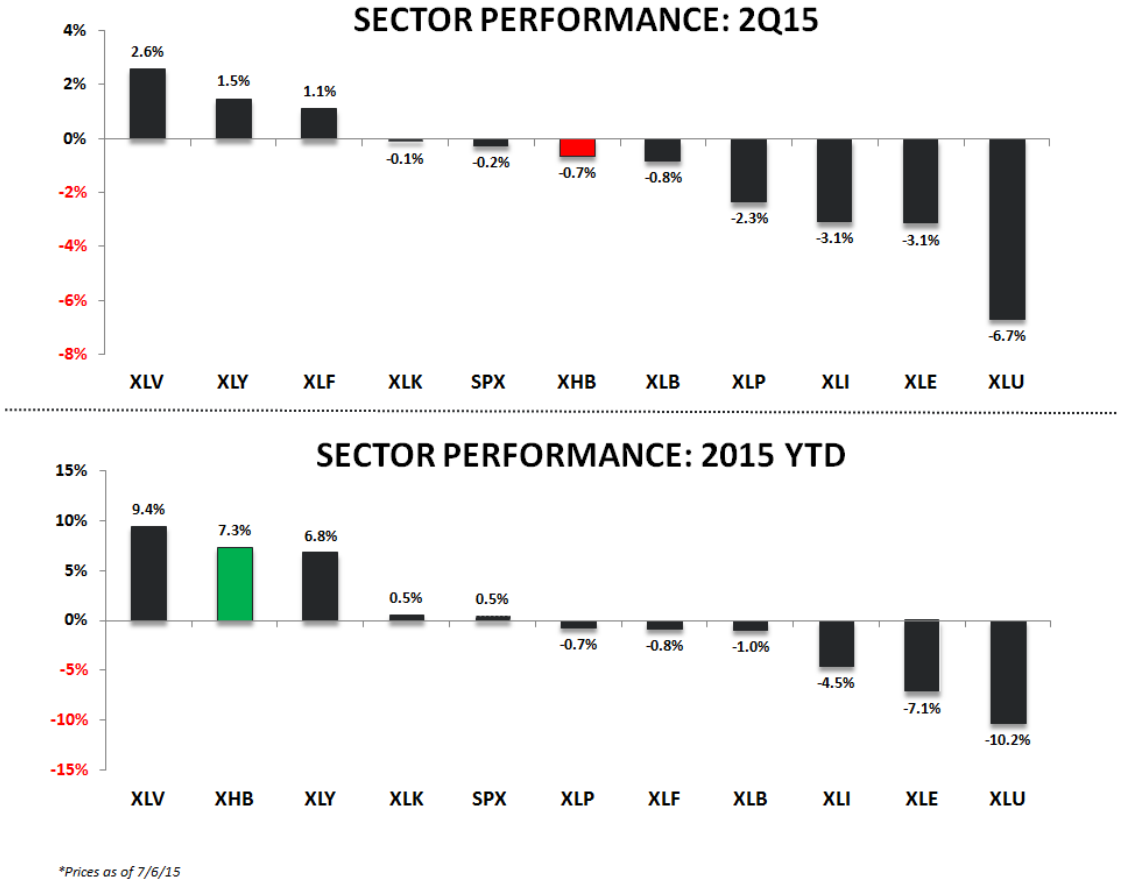
Phase 5 has been underway since November last year with the XHB outperforming the S&P by 1500 bps.

OUR CALL LAST QUARTER



After turning bullish in late-2014, we remained bullish in the second quarter.

FROM 1Q HERO TO 2Q MIDDLING



*Prices as of 7/6/15

Housing went from being the best performing sector through 1Q15 to mid-pack in 2Q15. Nevertheless, it remains near the top of the leaderboard on a YTD basis, currently outperforming the S&P 500 by ~700 bps.

DATA SOURCE: BLOOMBERG

3Q15 – WHY WE’RE CAUTIOUS

3Q15: WHY WE'RE CAUTIOUS

1

IS GOOD, GOOD ENOUGH?

Housing had a strong first-half of 2015 and both price and volume data look poised to continue to improve in the third quarter, but will that be enough to offset multiple 3Q headwinds?

2

NEGATIVES: SEASONALITY & RATES

Housing stocks follow a very distinct seasonal trading pattern that offers a lot of alpha opportunity. Meanwhile, the #1 fear among Housing investors remains rising rates.

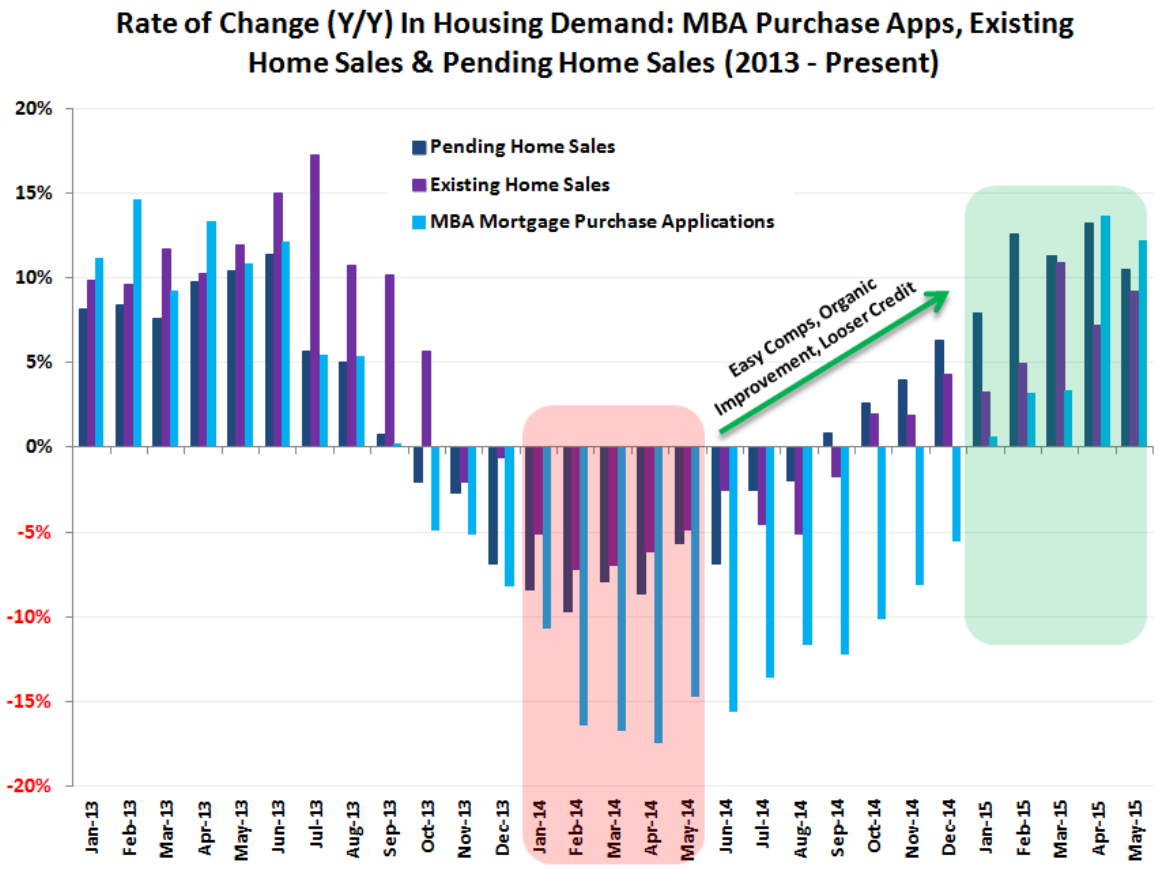
3

POSITIVES: HPI & 1ST TIME BUYERS

We've found that HPI trends have historically been one of the strongest corollaries of stock price performance for the Housing complex and our outlook for HPI in 3Q is positive. Separately, 1st time buyers are coming out of the woodwork.

IS GOOD, GOOD ENOUGH?

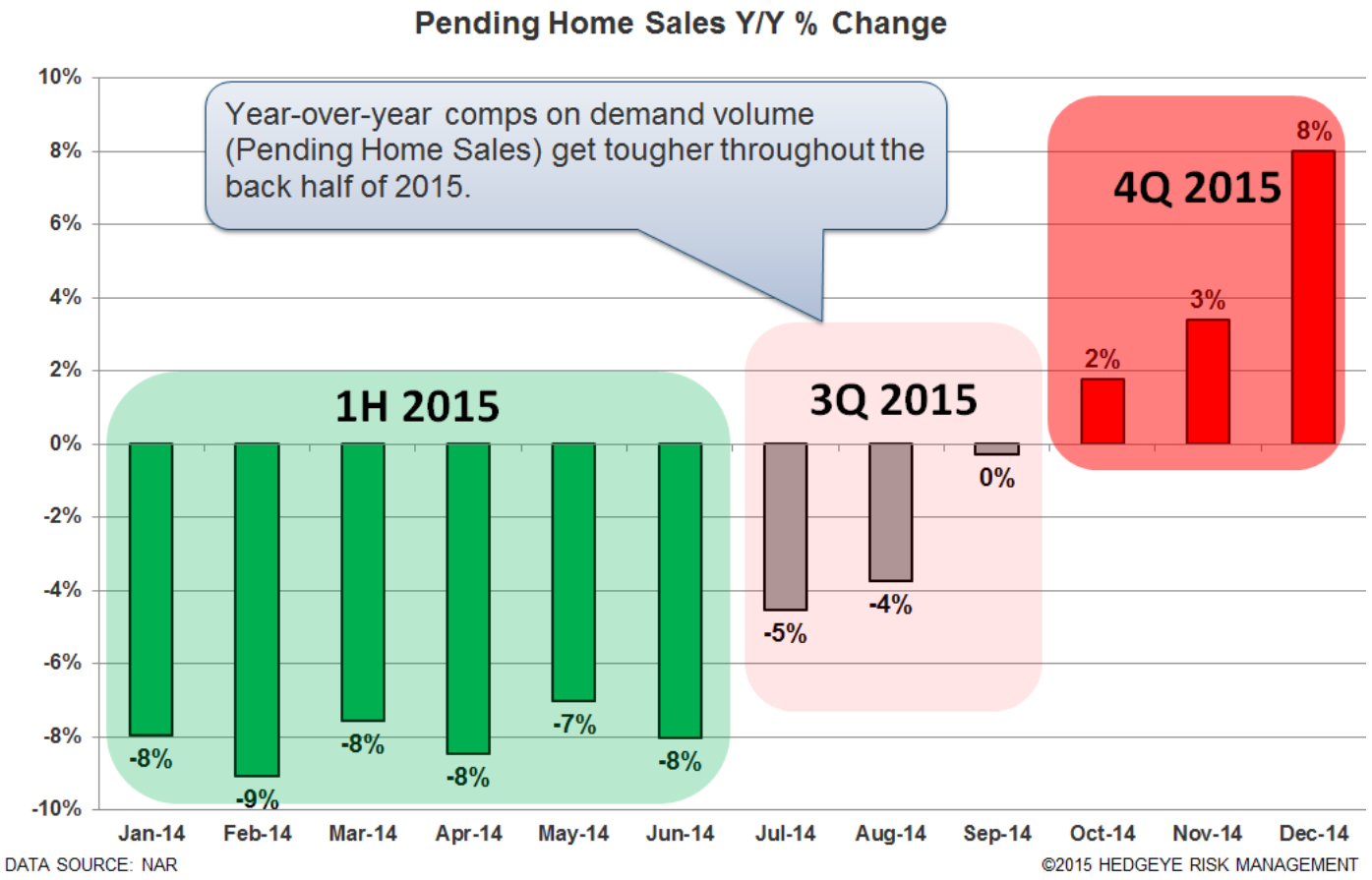
VOLUME DYNAMICS HAVE BEEN GOOD



Year-to-date the volume dynamics have been very favorable for housing. Going forward, however, we'll start to lap tougher comps.

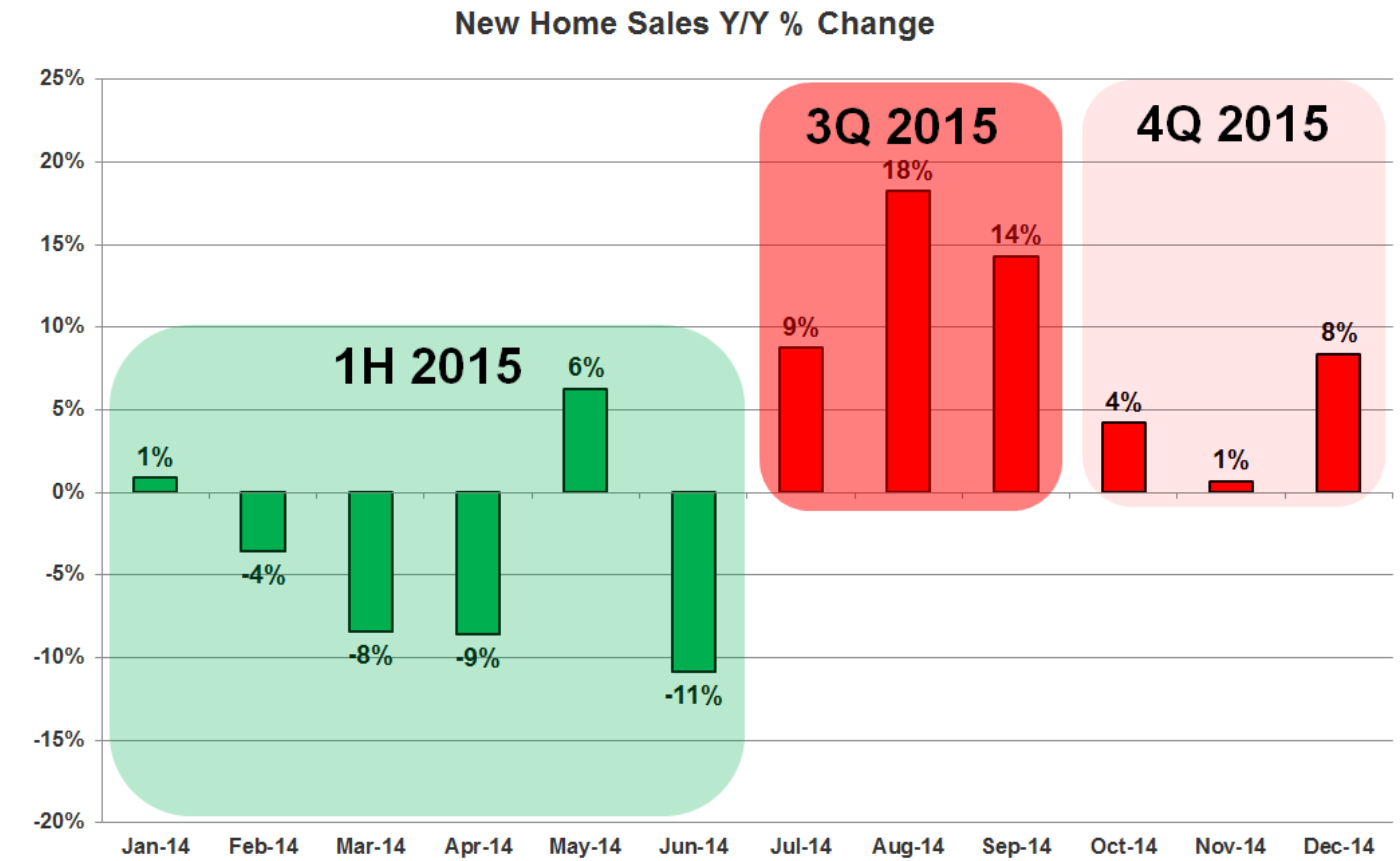
Data source: Bloomberg, NAR

COMPS OUTLOOK – PHS 2H 2015



The first half of 2015 had a very favorable comps dynamic that will get slightly less favorable in 3Q15 and turn from tailwind to headwind in the fourth quarter.

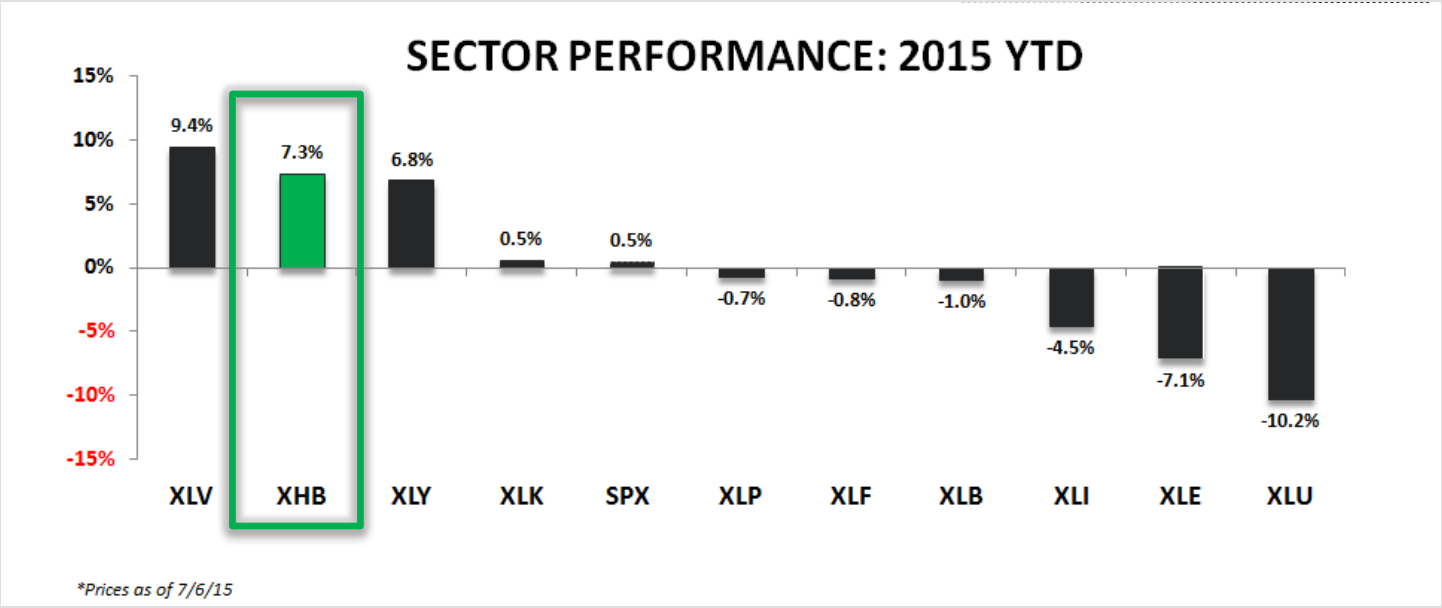
COMPS OUTLOOK – NHS 2H 2015



DATA SOURCE: NAR

New Home Sales comps go from sizeable tailwind in the first half to sizeable headwind in the third quarter and then modest headwind in the fourth quarter. Remember that we're still waiting for the June print, however.

OUTPERFORMANCE IS ALSO A FACTOR



The other factor to consider is that Housing has had solid performance through the first half of the year. That's not to say there's isn't still a long-term bull case – there is – but it's something to keep in mind when considering the shorter-term outlook.

Data source: Bloomberg

SEASONALITY: REAL & RECURRENT

QUARTERLY SEASONALITY

Housing Seasonality

*Average Performance by Quarter: Trailing 5Y**

Average Absolute Performance

Security	1Q	2Q	3Q	4Q
ITB	4.4%	-1.1%	-0.7%	3.3%
XHB	3.8%	-0.7%	-0.2%	3.1%
S5HOME	5.7%	-1.0%	-0.8%	3.8%

Average Relative Performance

Security	1Q	2Q	3Q	4Q
ITB	2.2%	-0.9%	-1.4%	1.6%
XHB	1.6%	-0.5%	-0.9%	1.4%
S5HOME	3.5%	-0.8%	-1.5%	2.2%

*Calculated using average performance by month

Quarterly seasonality is pretty apparent. This looks at average monthly returns in each quarter over the last five years across the three major housing indices/ETFs.

QUARTERLY SEASONALITY BY BUILDER

Absolute Returns by Builder Per Calendar Quarter (2010-2014)

	BZH	KBH	MTH	RYL	DHI	HOV	PHM	LEN	TOL	MDC	NVR	Overall	S&P 500	Relative
1Q:	-1%	6%	3%	2%	4%	2%	4%	5%	2%	2%	3%	3%	2%	1%
2Q:	-1%	-3%	-1%	0%	0%	1%	0%	-1%	0%	0%	-1%	0%	-1%	0%
3Q:	-3%	-2%	-1%	-1%	-1%	-4%	-2%	-1%	-1%	-2%	-1%	-2%	0%	-2%
4Q:	9%	4%	5%	6%	5%	10%	7%	7%	4%	1%	4%	5%	2%	3%

Relative Returns by Builder Per Calendar Quarter (2010-2014)

	BZH	KBH	MTH	RYL	DHI	HOV	PHM	LEN	TOL	MDC	NVR	Overall
1Q:	-3%	3%	1%	0%	1%	-1%	1%	3%	0%	0%	1%	1%
2Q:	0%	-2%	0%	1%	1%	1%	1%	0%	1%	0%	0%	0%
3Q:	-4%	-2%	-2%	-2%	-2%	-5%	-3%	-1%	-2%	-3%	-2%	-2%
4Q:	7%	2%	3%	3%	3%	7%	4%	4%	2%	-1%	1%	3%

3Q Absolute By Company By Year

	BZH	KBH	MTH	RYL	DHI	HOV	PHM	LEN	TOL	MDC	NVR	Overall
2010	6%	1%	6%	4%	5%	4%	2%	4%	5%	3%	0%	4%
2011	-23%	-16%	-12%	-13%	-7%	-20%	-19%	-9%	-11%	-12%	-6%	-14%
2012	6%	15%	4%	6%	4%	8%	13%	4%	4%	6%	0%	6%
2013	1%	-2%	0%	1%	-3%	-2%	-4%	0%	0%	-2%	0%	-1%
2014	-5%	-7%	-5%	-4%	-5%	-10%	-4%	-2%	-5%	-5%	-1%	-6%
Average	-3%	-2%	-1%	-1%	-1%	-4%	-2%	-1%	-1%	-2%	-1%	-2%
Median	1%	-2%	0%	1%	-3%	-2%	-4%	0%	0%	-2%	0%	-1%
STDEV	12%	11%	7%	8%	5%	11%	12%	5%	7%	7%	3%	8%

Source: Factset (Monthly Return Averages)

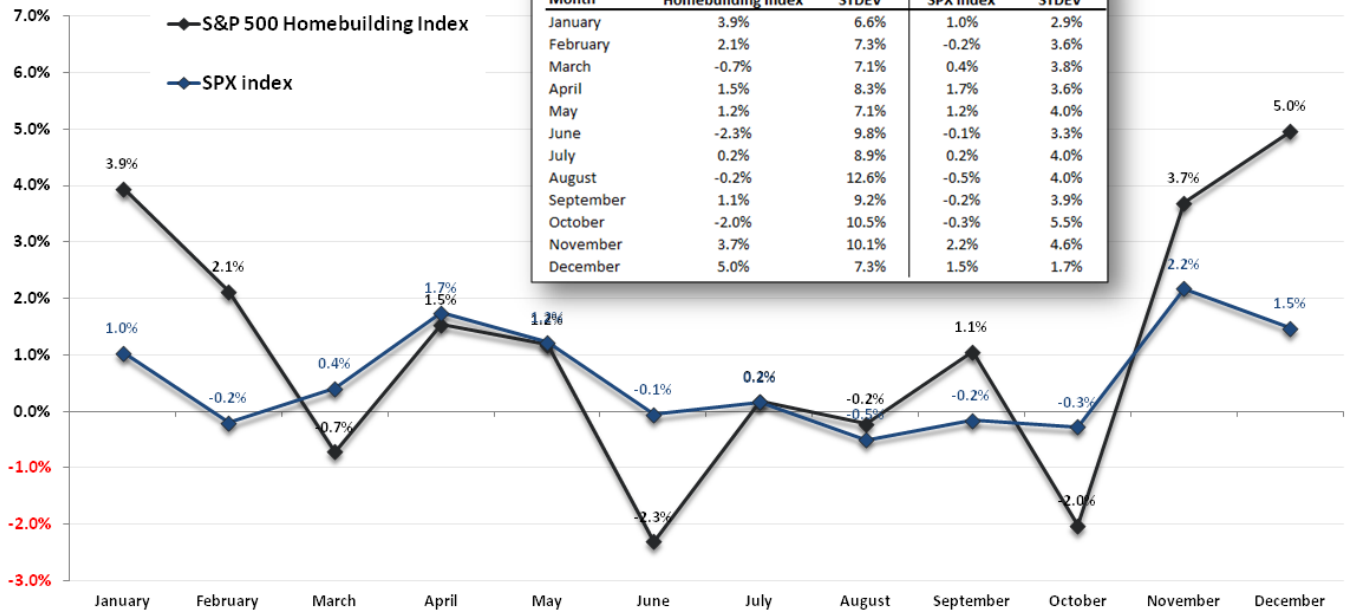
Every builder has posted negative 3Q stock price performance on both an absolute and relative basis when looking at the average returns from 2010 through 2014.

2013 is an interesting compare given the rate environment.

BUILDER SEASONALITY IS REAL

HOMEBUILDER SEASONALITY

Ave Performance by Month, 1996-2014



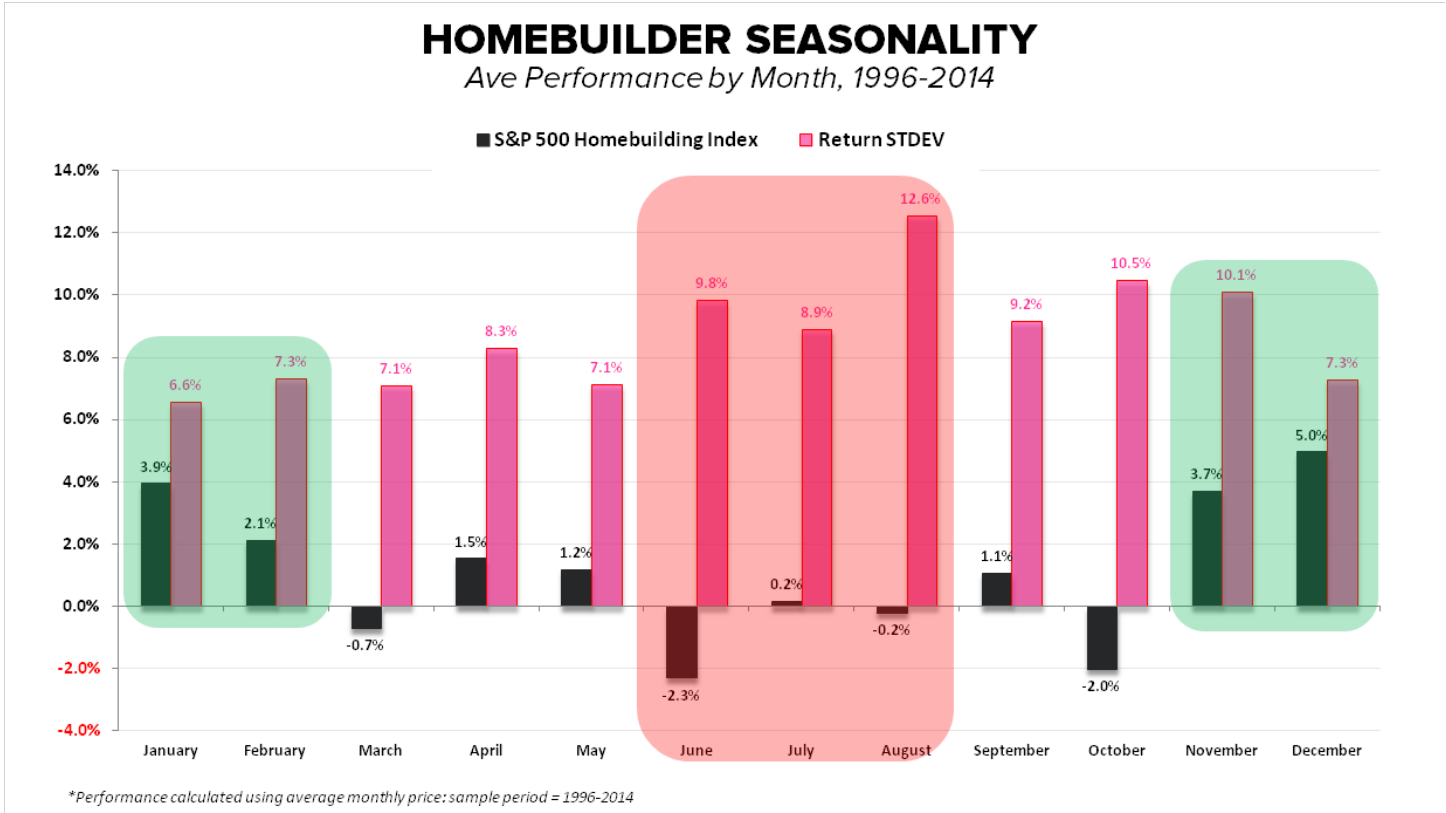
Month	S&P 500 Homebuilding Index	Return STDEV	SPX index	Return STDEV
January	3.9%	6.6%	1.0%	2.9%
February	2.1%	7.3%	-0.2%	3.6%
March	-0.7%	7.1%	0.4%	3.8%
April	1.5%	8.3%	1.7%	3.6%
May	1.2%	7.1%	1.2%	4.0%
June	-2.3%	9.8%	-0.1%	3.3%
July	0.2%	8.9%	0.2%	4.0%
August	-0.2%	12.6%	-0.5%	4.0%
September	1.1%	9.2%	-0.2%	3.9%
October	-2.0%	10.5%	-0.3%	5.5%
November	3.7%	10.1%	2.2%	4.6%
December	5.0%	7.3%	1.5%	1.7%

**Performance calculated using average monthly price: sample period = 1996-2014*

Everyone knows that housing is seasonal, but fewer realize that the stocks are very seasonal as well.

DATA SOURCE: BLOOMBERG, HRM

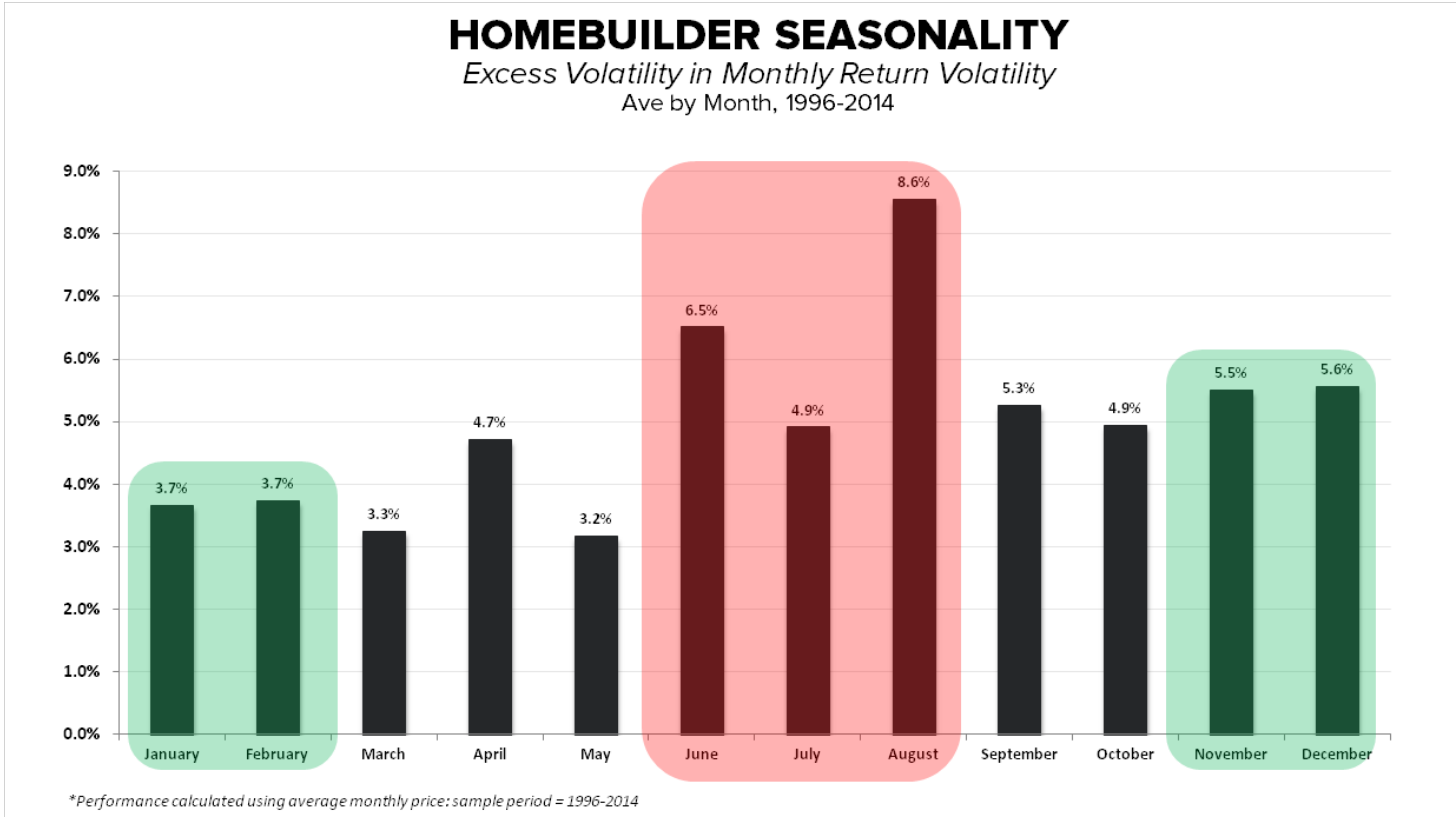
VOLATILITY IS SEASONAL AS WELL



Seasonality isn't just pronounced in the returns, but also in the volatility of returns.

DATA SOURCE: BLOOMBERG, HRM

VOLATILITY SEASONALITY CONT'D



This chart shows volatility of builder returns relative to the the underlying volatility of market returns.

SEASONALITY IN THE LAST FIVE YEARS

3Q

ITB US Equity | 95) View | 96) Edit | Seasonality Chart

Last Price | USD | Spread | <Type security> | Last Price | High/Low/Avg

5 years Ending 2014 | Percent Change | Net Change

Calendar Year | Trailing 12M | 01/01 - 12/31 | Monthly | Line | Heat Map | Securities/Lines | Map Options

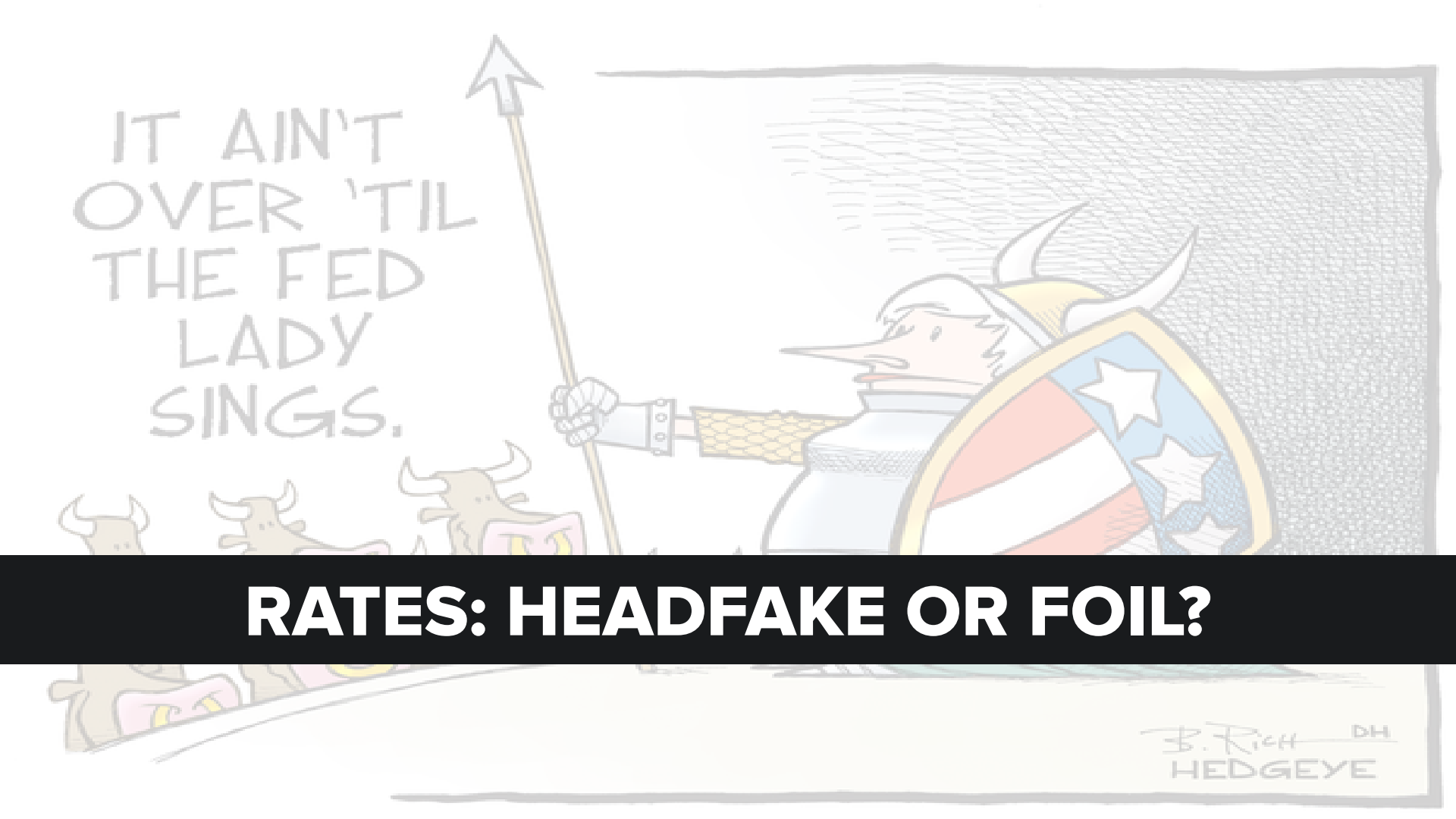
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Average (Monthly Change)	5.24	2.33	1.66	3.50	-1.94	-3.48	-3.58	-1.29	1.21	5.58	3.49	5.96
2014	.00	5.92	-7.87	-3.43	2.74	3.20	-10.44	8.37	-6.56	7.03	7.81	-.27
2013	10.73	-4.01	6.22	1.55	.29	-8.01	-.45	-7.72	8.66	.81	2.75	7.26
2012	9.93	6.74	5.60	5.03	-1.23	10.09	-3.63	12.16	6.49	6.07	-.12	3.22
2011	2.81	-1.48	-.75	2.04	.00	-6.07	-7.32	-13.42	-12.17	19.66	7.10	3.57
2010	2.75	4.46	5.12	12.32	-11.50	-16.63	3.92	-5.83	9.65	-5.64	-.09	16.02

-19.66 19.66

The last few charts looked at 20 years of seasonality trends, while this one looks at the last five years.

July is almost always a terrible month to own Housing stocks. August is not so good, either.

DATA SOURCE: BLOOMBERG, HRM



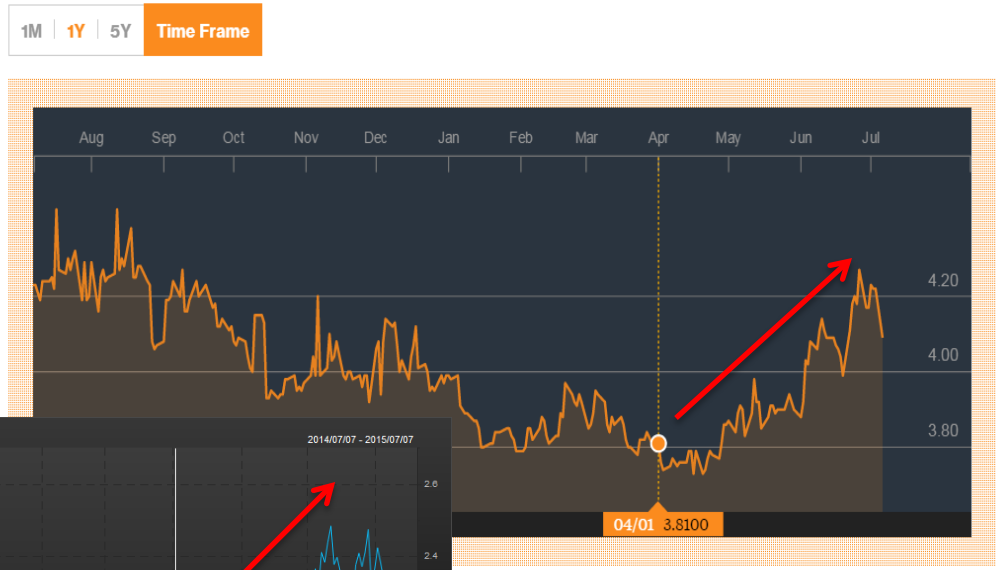
RATES: HEADFAKE OR FOIL?

2Q15: RISING RATES (BAD)

Bankrate.com US Home Mortgage 30 Year Fixed National Avg

ILM3NAVG:IND

↓ 4.09 -0.13 -3.08%

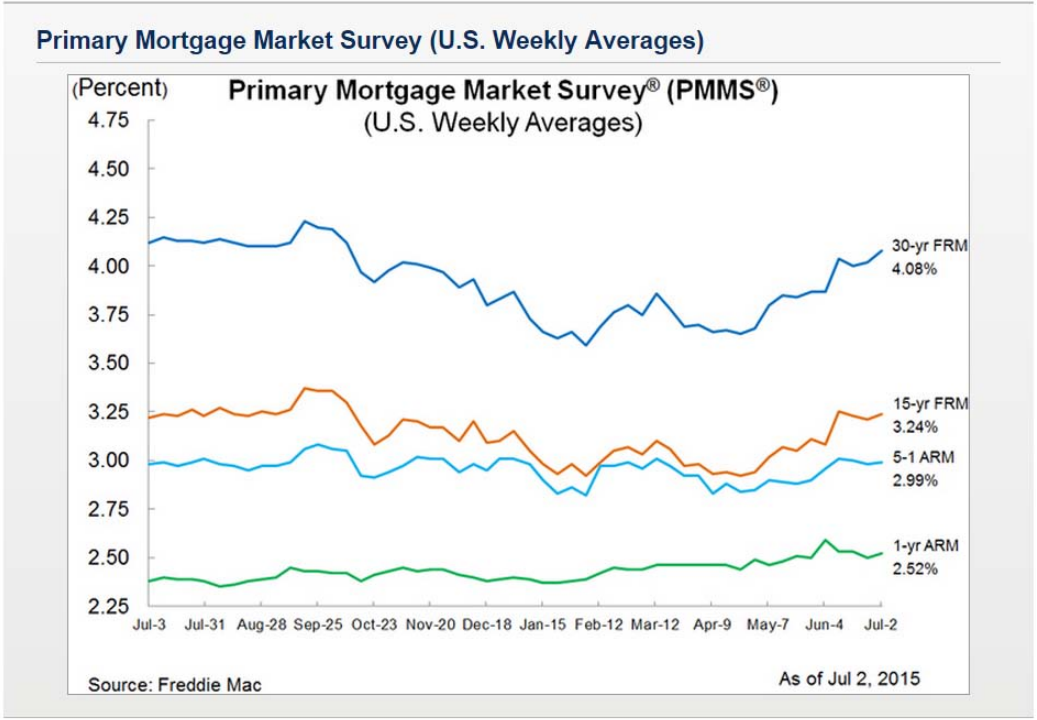


Source: Bloomberg, Bankrate, Factset

10-year treasury yields rose +44 bps to 2.36% from 1.92% during 2Q. Rates currently sit at 2.19% (July 8).

Meanwhile, 30Yr Conforming Mortgage Rates rose +38 bps to 4.17% from 3.79%. Rates currently stand at 4.08%.

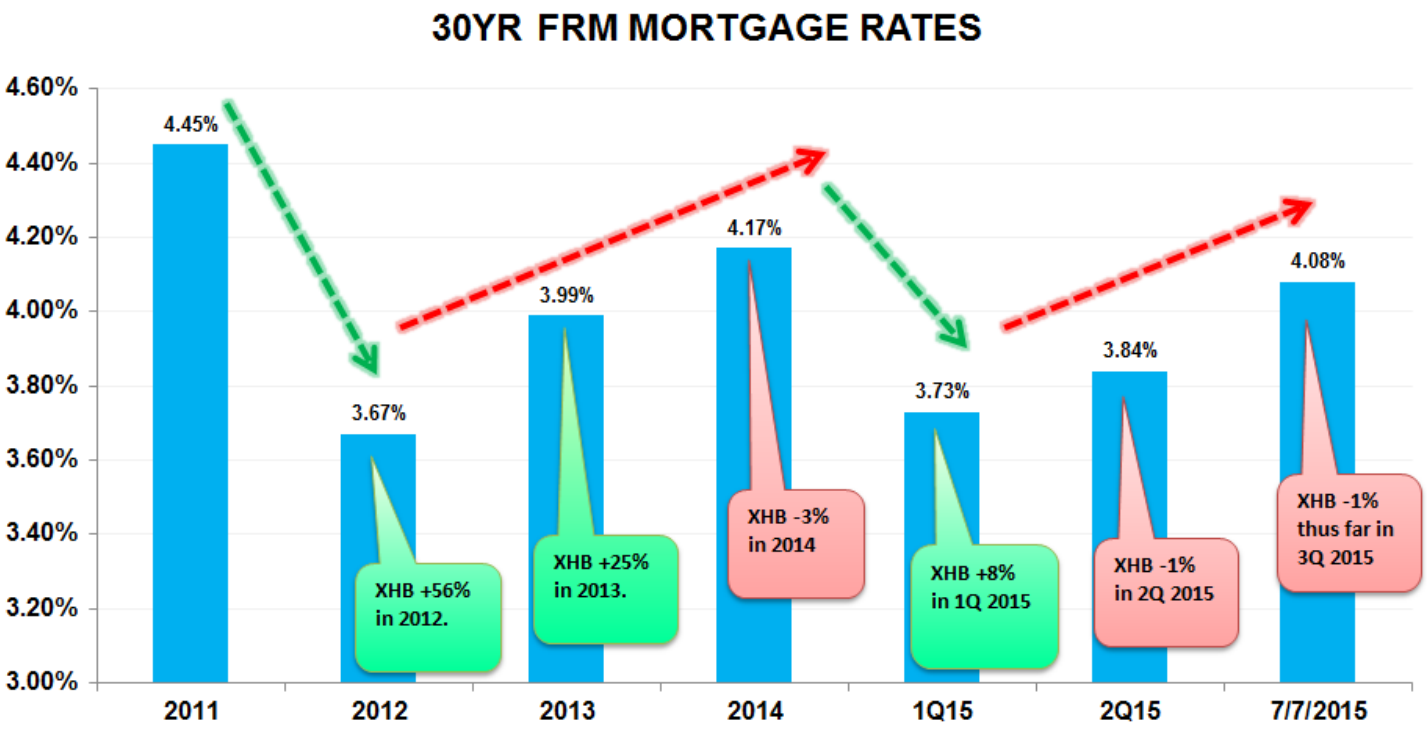
AFFORDABILITY HEADWIND: RATES



Regional Breakdown	30-Yr FRM	15-Yr FRM	5/1-Yr ARM	1-Yr ARM
Average Rates	4.08 %	3.24 %	2.99 %	2.52 %
Fees & Points	0.6	0.6	0.4	0.3
Margin	N/A	N/A	2.73	2.74

Mortgage rates have risen steadily over the last 3 months and are now at 4.08% on the 30-year fixed, but the recent drop in 10-yr yields will likely exert some downward pressure on mortgage rates in the coming weeks.

AFFORDABILITY HEADWIND: RATES



DATA SOURCE: FREDDIE MAC

As most would expect, the chart to the left shows that most of the time housing stock price performance is negatively correlated with directional moves in rates.

AFFORDABILITY: RATES

AFFORDABILITY: INTEREST RATE SENSITIVITY

30-Year Fixed Rate	Monthly Mortgage Payment*	Purchasing Power: PV of Mo. Payment	$ Chg in Affordability	% Chg in Affordability	Relevance
1.0%	$1,234	$383,560	$131,583	51.6%	
2.0%	$1,234	$333,770	$81,794	32.1%	
3.0%	$1,234	$292,616	$40,639	15.9%	
3.89%	$1,234	$261,875	$9,898	3.9%	2015 YTD Ave
4.0%	$1,234	$258,408	$6,432	2.5%	
4.11%	$1,234	$255,009	$3,033	1.2%	Current
4.21%	*$1,234*	*$251,977*	*$0*	*0.0%*	*2014 Average*
5.0%	$1,234	$229,812	($22,165)	-8.7%	
6.0%	$1,234	$205,767	($46,209)	-18.1%	
7.0%	$1,234	$185,431	($66,545)	-26.1%	
8.0%	$1,234	$168,130	($83,846)	-32.9%	
9.0%	$1,234	$153,324	($98,653)	-38.7%	
10.0%	$1,234	$140,579	($111,398)	-43.7%	
11.0%	$1,234	$129,544	($122,432)	-48.0%	
12.0%	$1,234	$119,936	($132,040)	-51.8%	
13.0%	$1,234	$111,524	($140,452)	-55.1%	
14.0%	$1,234	$104,119	($147,857)	-58.0%	
15.0%	$1,234	$97,567	($154,410)	-60.6%	
16.0%	$1,234	$91,740	($160,237)	-62.8%	
17.0%	$1,234	$86,533	($165,444)	-64.9%	
18.0%	$1,234	$81,859	($170,118)	-66.7%	
19.0%	$1,234	$77,644	($174,333)	-68.4%	
20.0%	$1,234	$73,828	($178,149)	-69.9%	
21.0%	$1,234	$70,359	($181,617)	-71.2%	

Source: Bloomberg, Census, NAR

** Represents monthly mortgage payment at 28% DTI of Median Household Income*

HEDGEYE

Inclusive of the recent increase, current rates still compare favorably to the 2014 average.

THREE CASE STUDIES IN RISING RATES

1

OCTOBER 1993- DECEMBER 1994

Mortgage Rates rose +240 bps over the span of 14-months. The S&P 500 Homebuilding index lost 33% of its value over that 14 month span. By contrast, the S&P 500 was flat over the corresponding period.

2

OCTOBER 1998 - MAY 2000

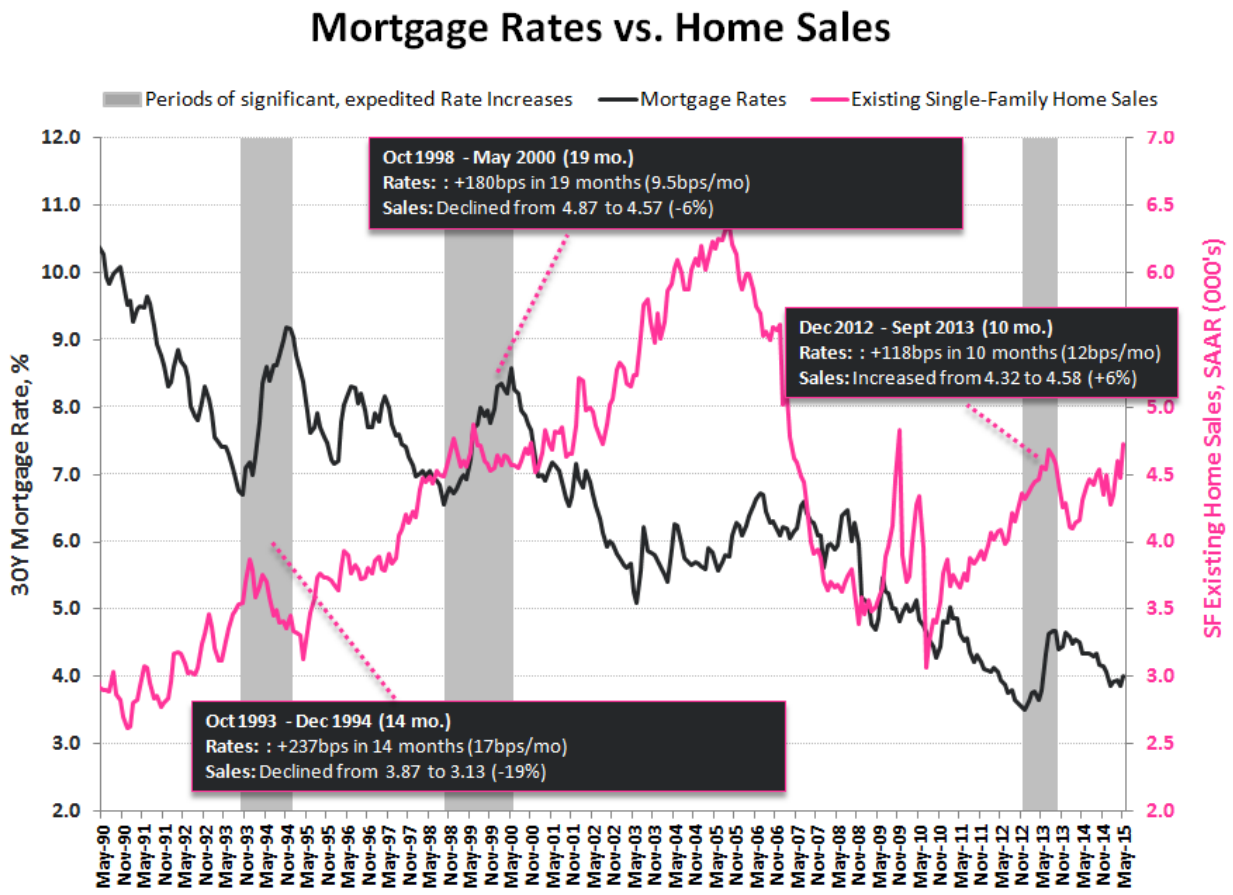
Mortgage Rates rose +180 bps over the span of 19-months. The S&P 500 Homebuilding index lost 29% of its value over that 14 month span, but the S&P 500 was up 44% making the relative underperformance a whopping 73%.

3

DECEMBER 2012 – SEPTEMBER 2013

Mortgage Rates rose +120 bps over the span of 10-months. The S&P 500 Homebuilding index lost 3% of its value over that 14 month span. By contrast, the S&P 500 was up 19% over the corresponding period so the relative underperformance was 22%.

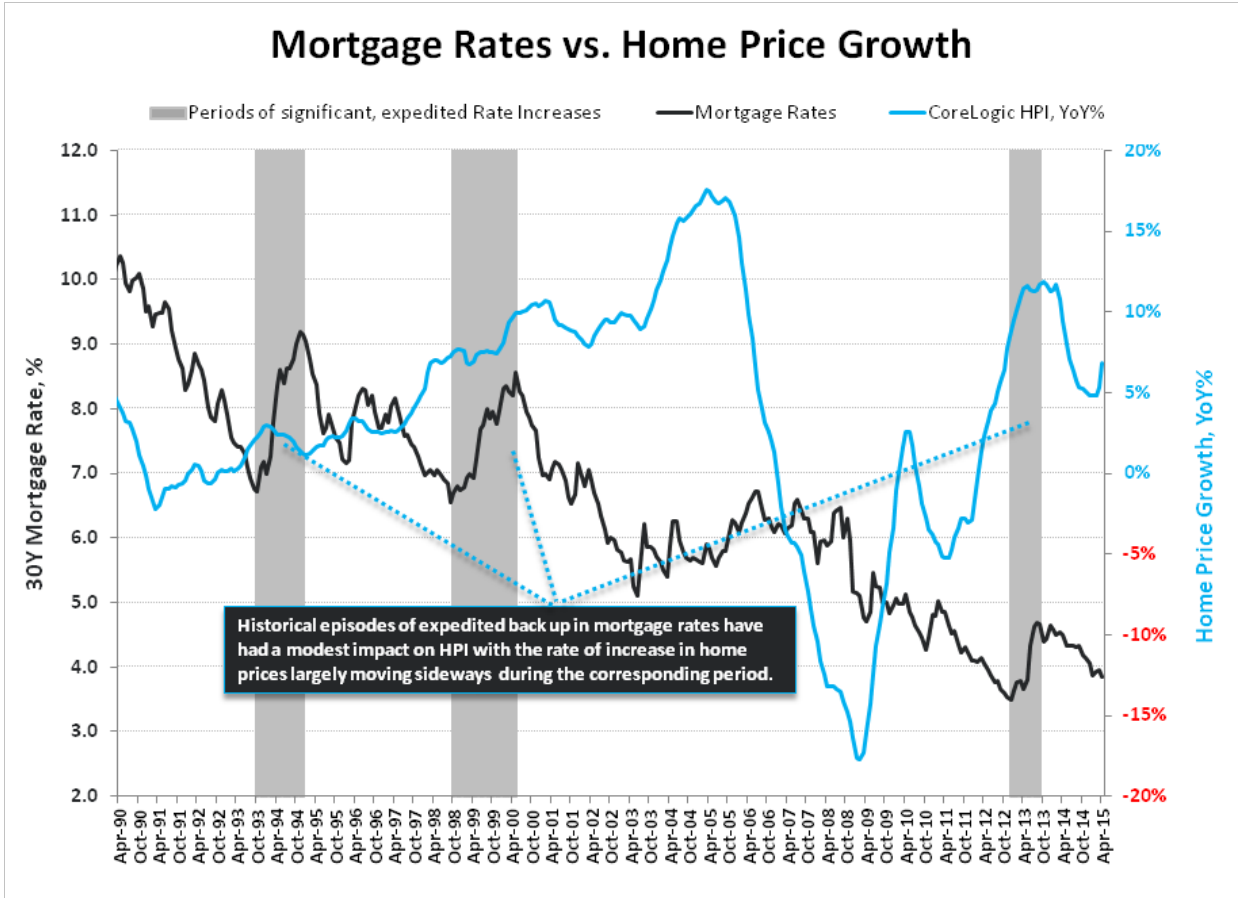
MORTGAGE RATES VS HOME SALES



Mortgage rates rose by an average of 180 bps over an average of 14 months in the 3 historical periods of rapid rate rise. In the current instance, mortgage rates have risen ~40bps.

Data source: Bloomberg, NAR, HRM

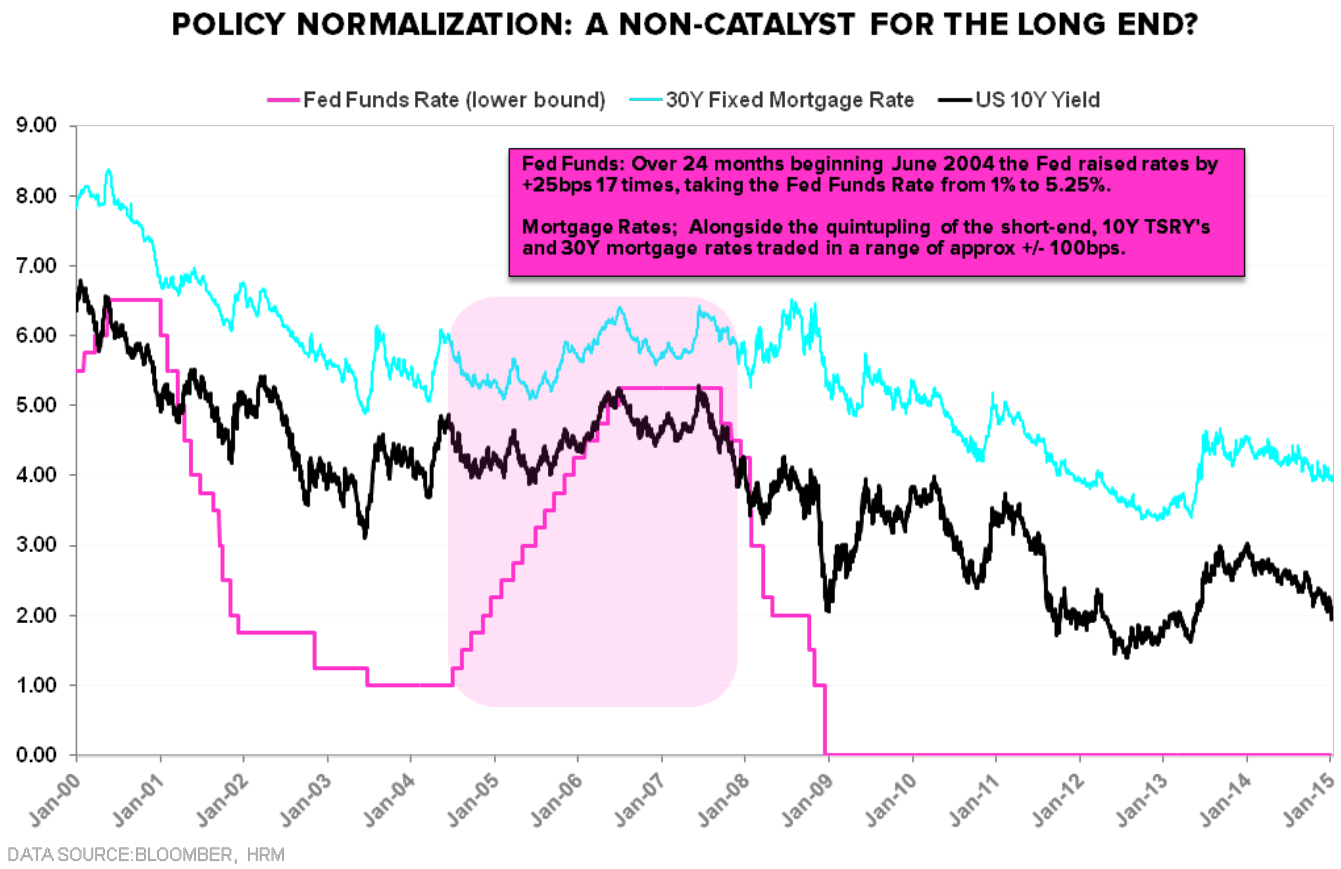
MORTGAGE RATES VS HPI



Historically, Home Prices have stabilized from a rate of change perspective during periods of expedited rate increase.

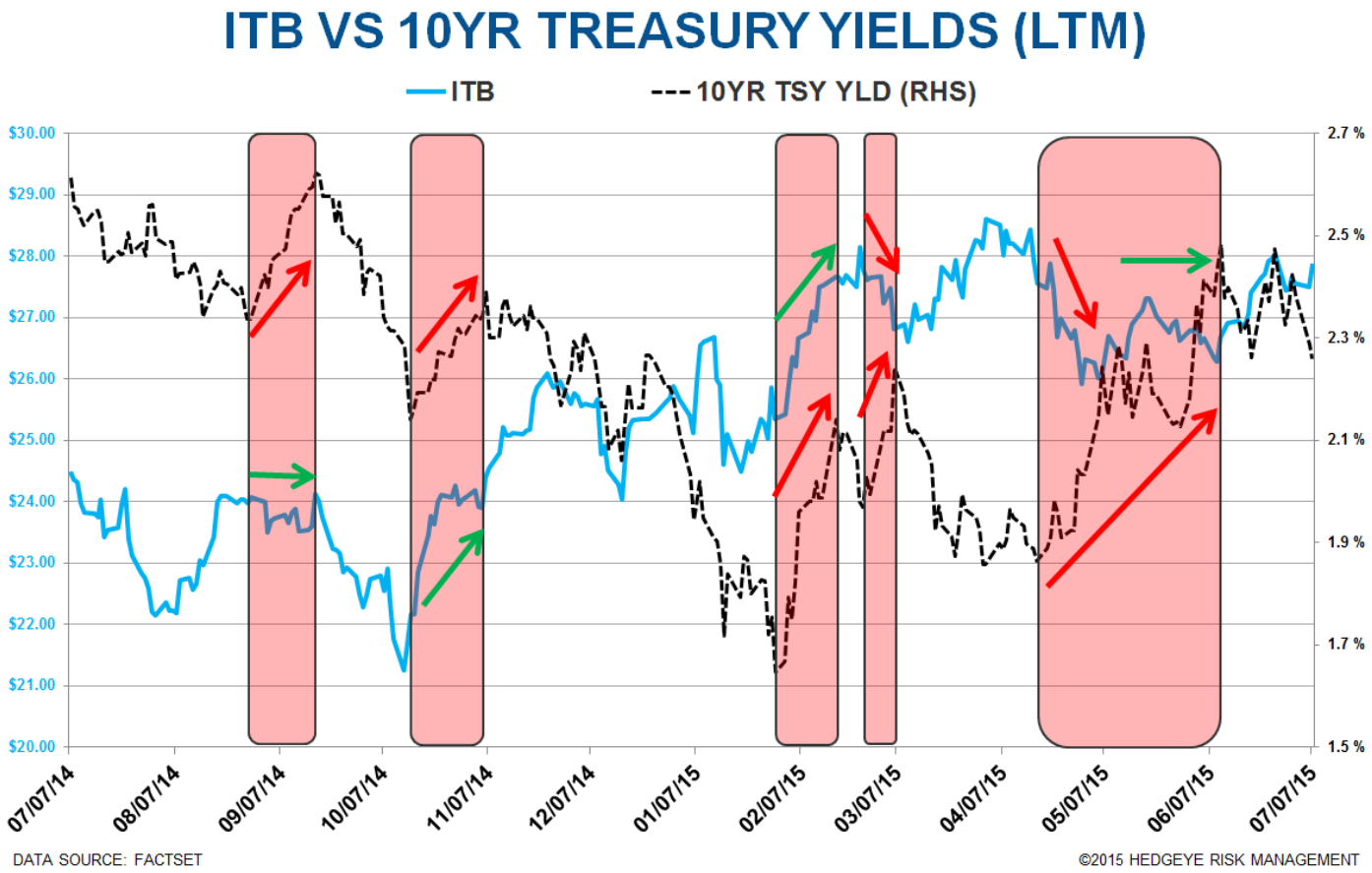
Data source: Bloomberg, BankRate, CoreLogic, HRM

WHAT IF THE FED TIGHTENS?



In the last period of Fed tightening, the Fed raised rates 25 bps every meeting for 17 straight meetings. The mortgage rate, however, essentially went sideways during this period.

EMPIRICALLY → A MIXED LTM MESSAGE



The first three episodes of rates moving higher corresponded to ITB's share price moving higher. However, the last two times, the share price has moved inversely.

NAVIGATING THE NEXT 12 MONTHS

NAVIGATING THE NEXT 12 MONTHS

1. The mid-2013 Taper Tantrum saw mortgage rates rise 100-120 bps in ~3 months (2Q13).

2. This immediately depressed PHS Y/Y growth beginning in July 2013.

3. The Y/Y RoC in PHS worsened steadily through 2H13, dropping from +11% in Jun 2013 to -8% by Dec 2013.

4. Meanwhile, Y/Y HPI peaked at +12.9% in Feb '14 (Dec/Jan contracts), decelerated to +12.4% in March (Jan/Feb activity) and then slid to +4.4% by October.

5. In other words, HPI decelerated beginning in March '14, which was a 9mo lag vs the slowdown in PHS Y/Y that began in July '13.

6. XHB & ITB peaked in late Feb/early March 2014 → coincident with HPI Y/Y peak and normal seasonality, which favors the Nov-Feb period.

7. So, the real question is when will PHS y/y peak? For that we need to look at the comps setup.

8. Comps begin getting tougher in July of this year, and get steadily tougher through December.

9. Assuming the same ~9mo lag for HPI trends, that would imply that HPI will begin to decelerate in the 2Q 2016 period.

10. This will also dovetail well with the normal negative seasonality dynamics associated with housing stocks.

11. The magnitude of the rate impact is likely to be around half what we saw from the taper tantrum and there won't be a QM component this time around.

12. What To Do?

3Q15 → 4Q15 → 1Q16 → 2Q16

OUR PROCESS

The above flow chart depicts what we think is most likely to come down the pike for Housing for the next year based on what we know today. Obviously, things can, and do, change, but this is how we see things today.

1: TAPER TANTRUM (2Q13): RATES ↑

Bankrate.com US Home Mortgage 30 Year Fixed National Avg

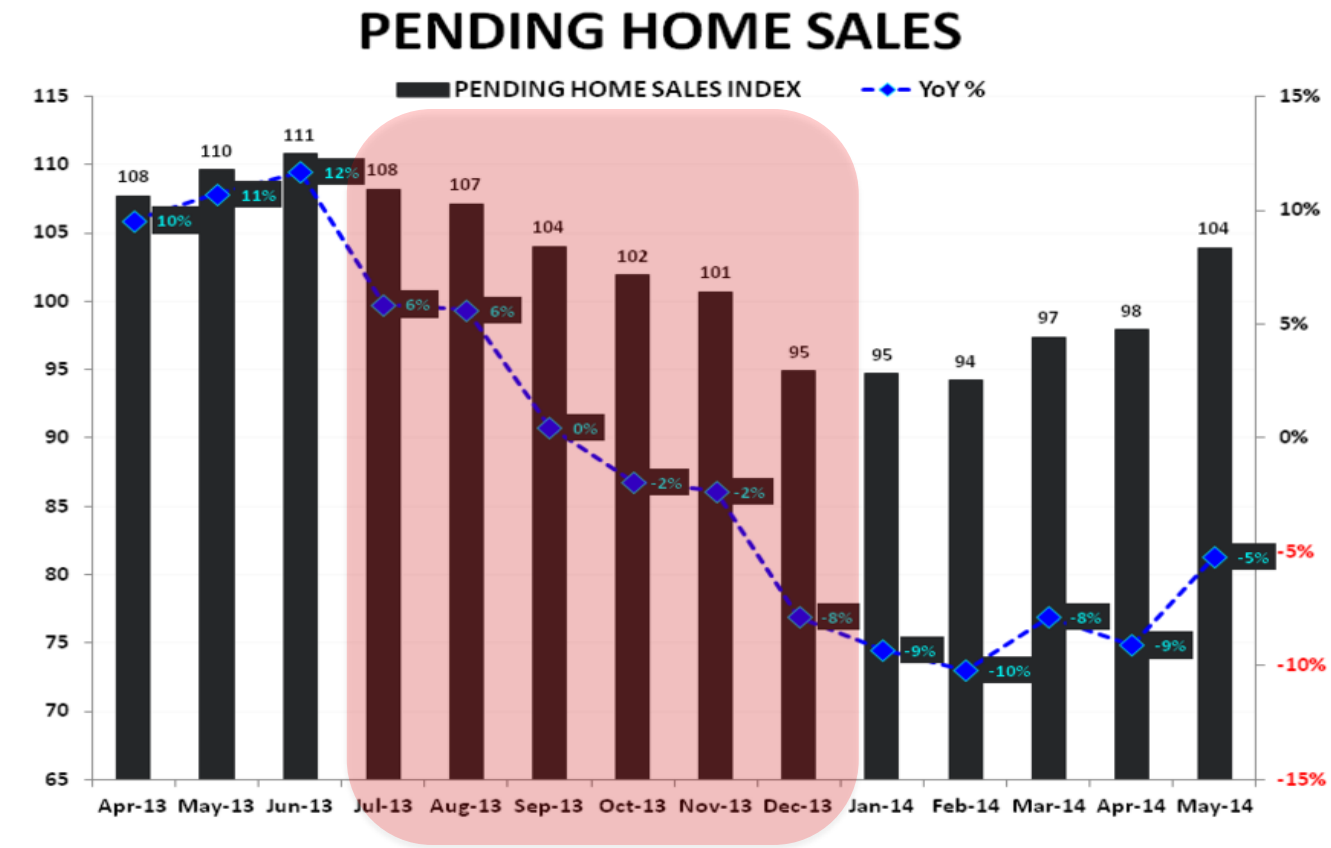
ILM3NAVG:IND

↑ 4.11 +0.02 +0.49%

Source: Bloomberg, Bankrate

In the second quarter of 2013, mortgage rates rose by roughly 100 bps from 3.5% to 4.5% as the fixed income market reacted to the Fed's plan to taper asset purchases.

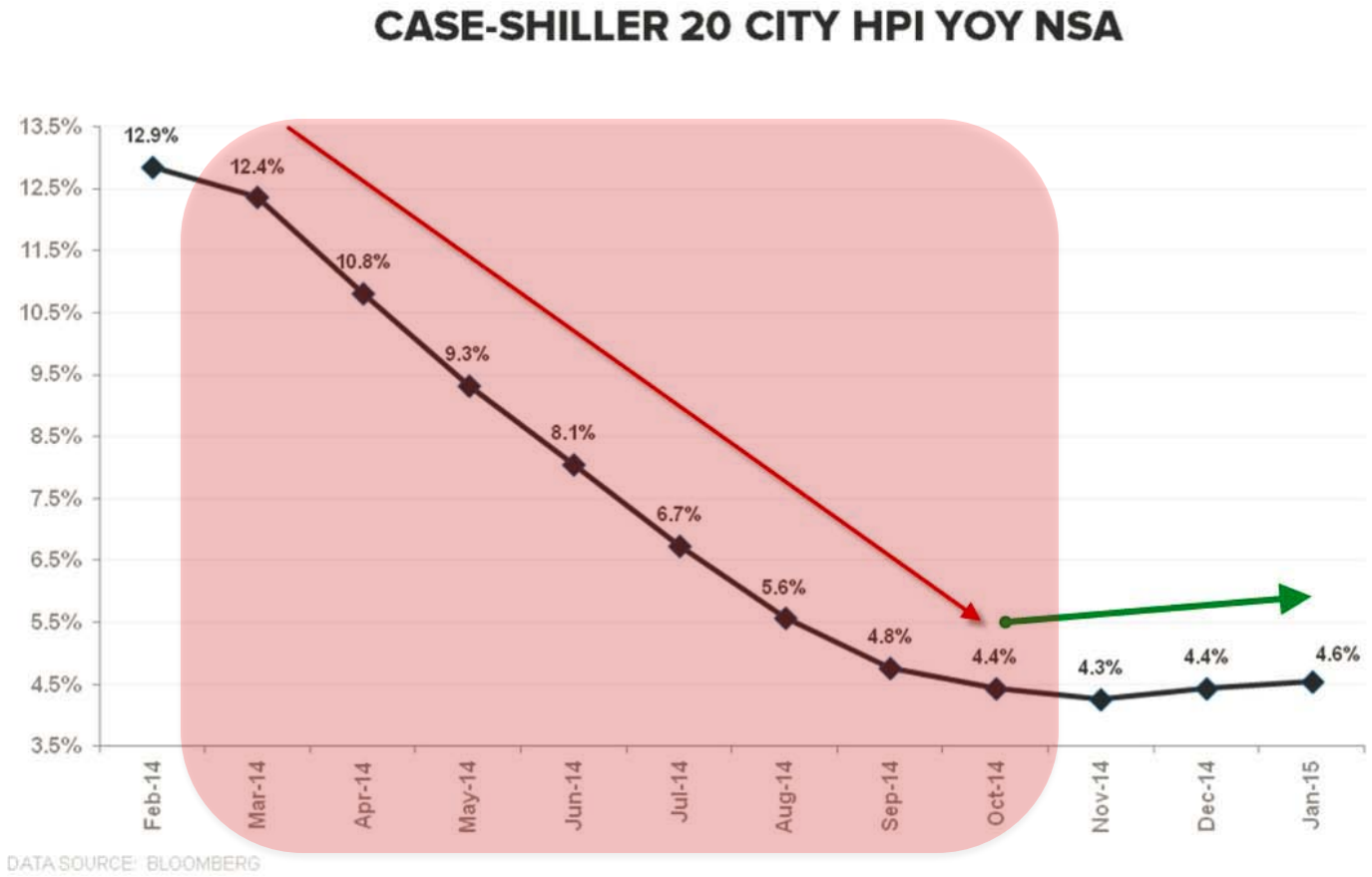
2+3: PENDING HOME SALES ↓ (2H13)



DATA SOURCE:BLOOMBERG, NATIONAL ASSOCIATION OF REALTORS

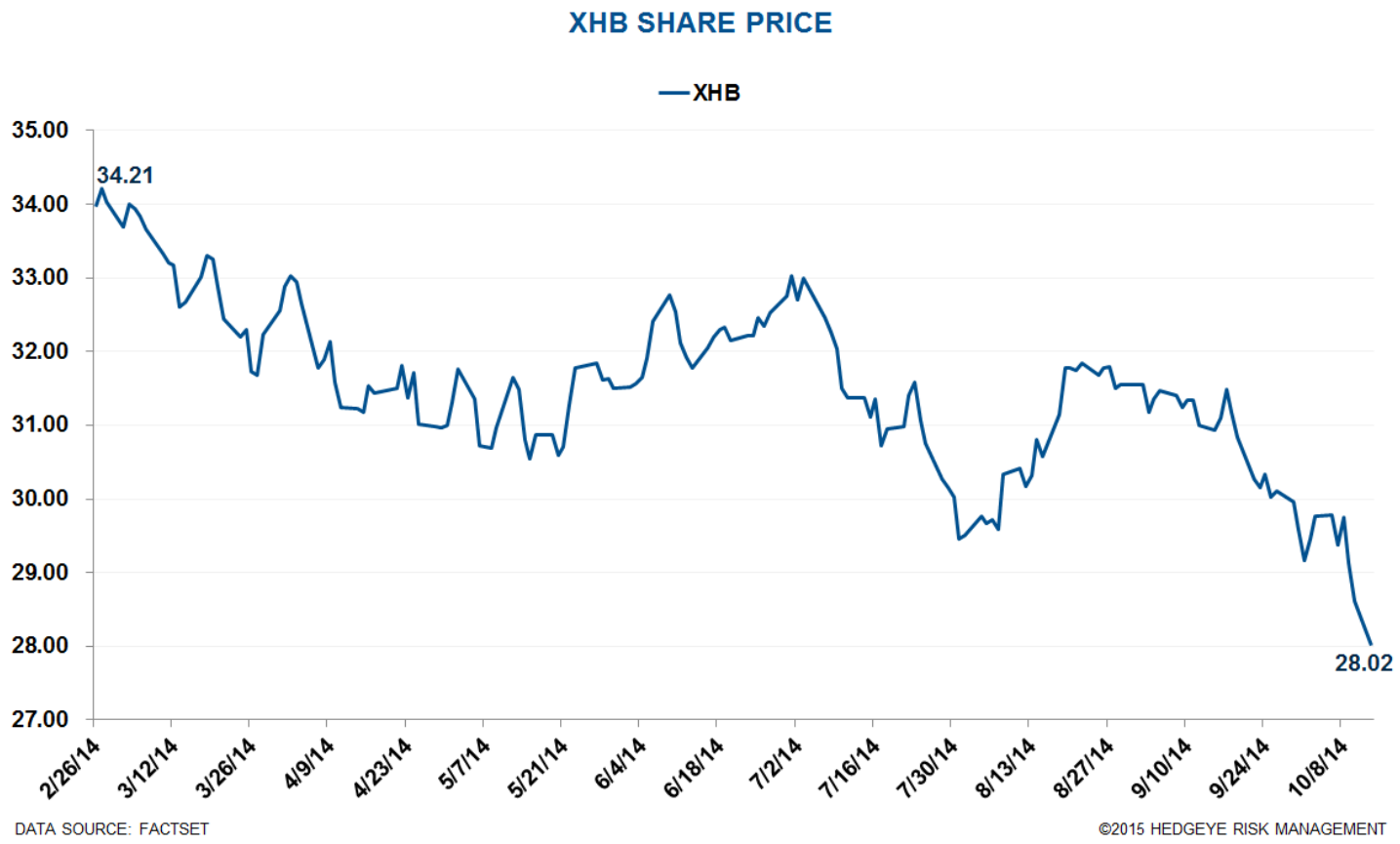
PHS fell sharply in 2H13. The only proximate cause was the rise in rates in 2Q13, as QM didn't kick in until January 2014. The important takeaway is that after rates rose, volumes fell for six months **after** rates stopped rising.

4+5: HPI ↓ (MAR 2014 – SEP 2014)



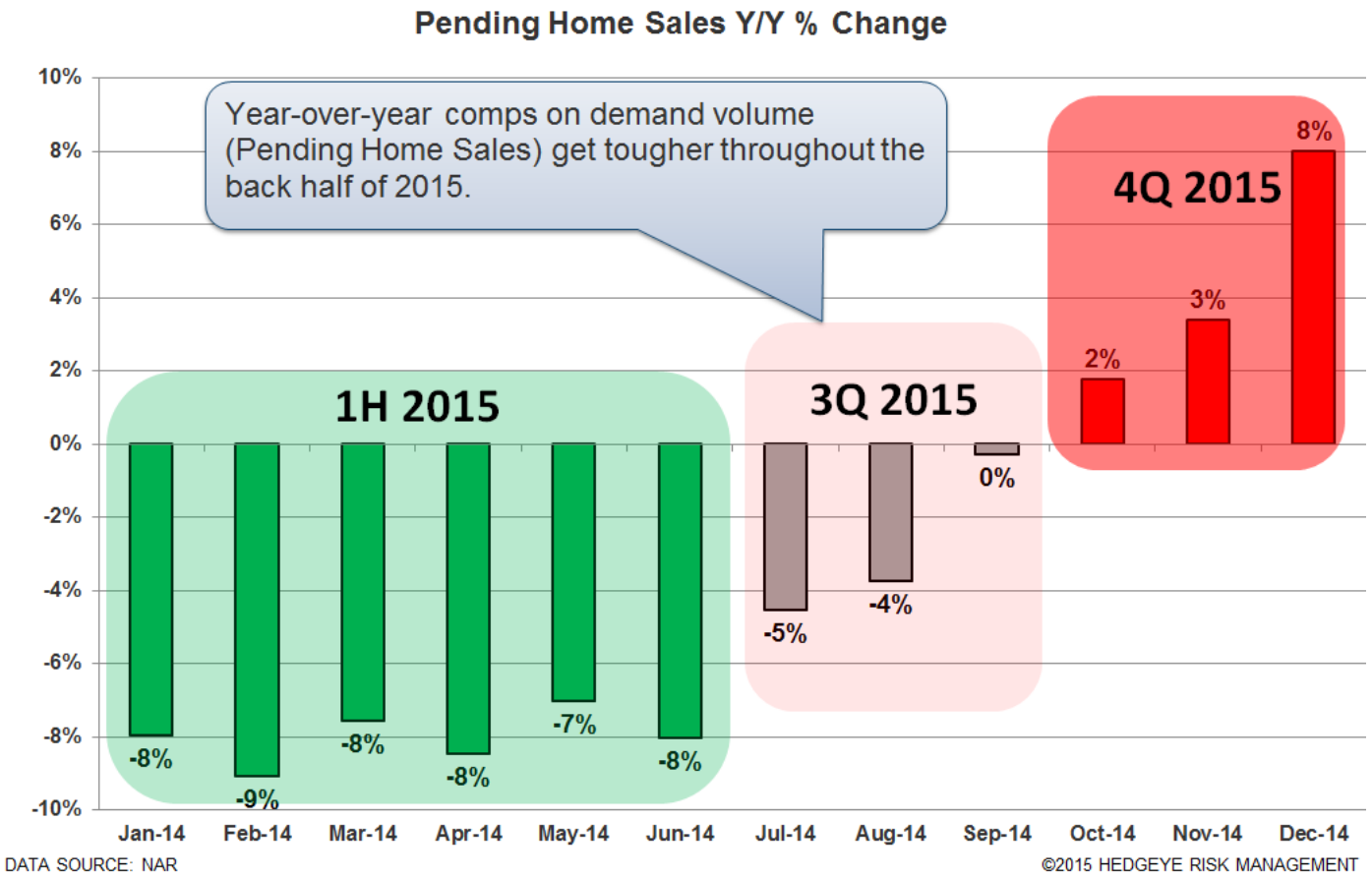
Home prices caught up to the fall in volume on a 9 month lag, dropping from +12.9% Y/Y RoC in Feb 2014 to +4.4% in Oct 2014.

6: XHB/ITB ↓ (MAR 2014 – OCT 2014)



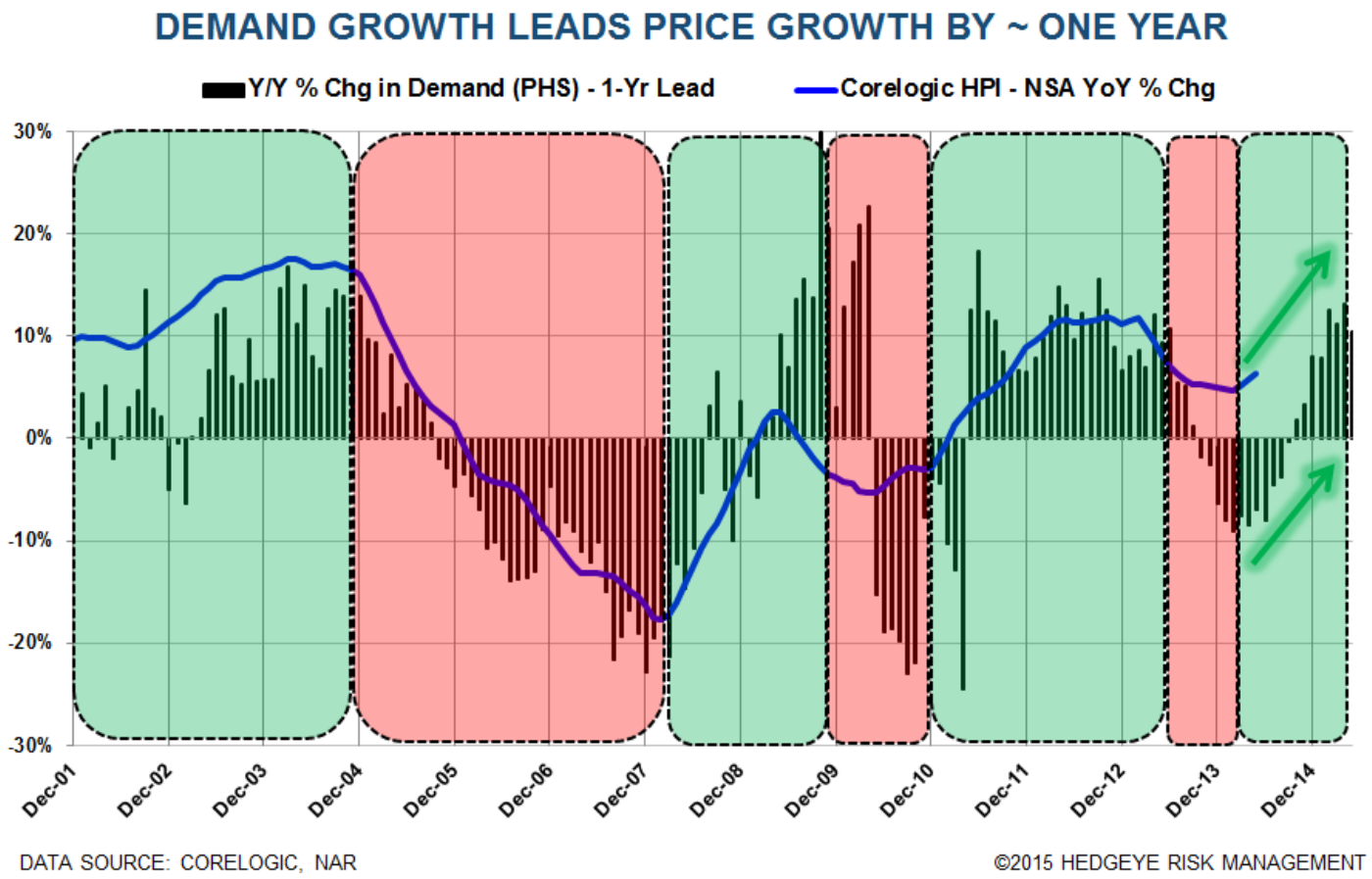
Meanwhile, housing equity prices followed HPI's deceleration almost perfectly, peaking in late Feb/early March 2014 and bottoming in October, 2014.

7+8: THE PHS COMPS (2H 2015)



So, the real question is when do PHS comps begin to get more difficult. The answer is right now. They'll get steadily harder through the back half of the year.

9: THE HPI IMPLICATIONS ↑ → ↓

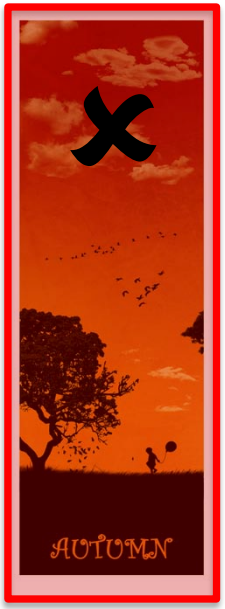


The net net of all this is that HPI should continue to accelerate through the back half of this year, and potentially through 1Q16 but will likely begin to decelerate sometime around the Spring of next year.

10+11+12: NAVIGATING THE SEASONS

12. What To Do?

3Q15 → 4Q15 → 1Q16 → 2Q16



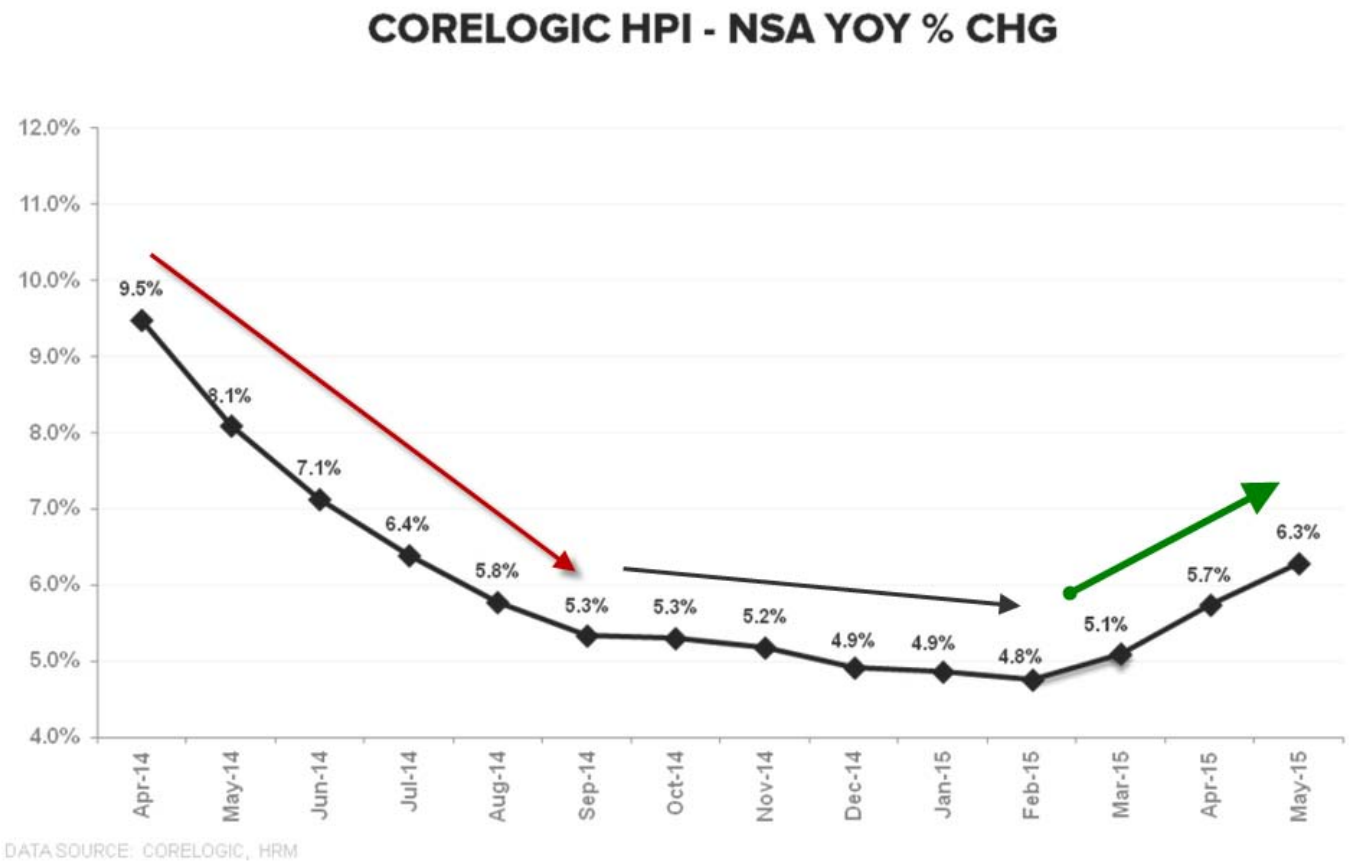
Here's how we see the setup based on what we know today.

Technically, the seasons start one month before the calendar quarters that most overlap with them, i.e. Spring occurs from March 1 through May 31.

LONGER-TERM → STILL BULLISH

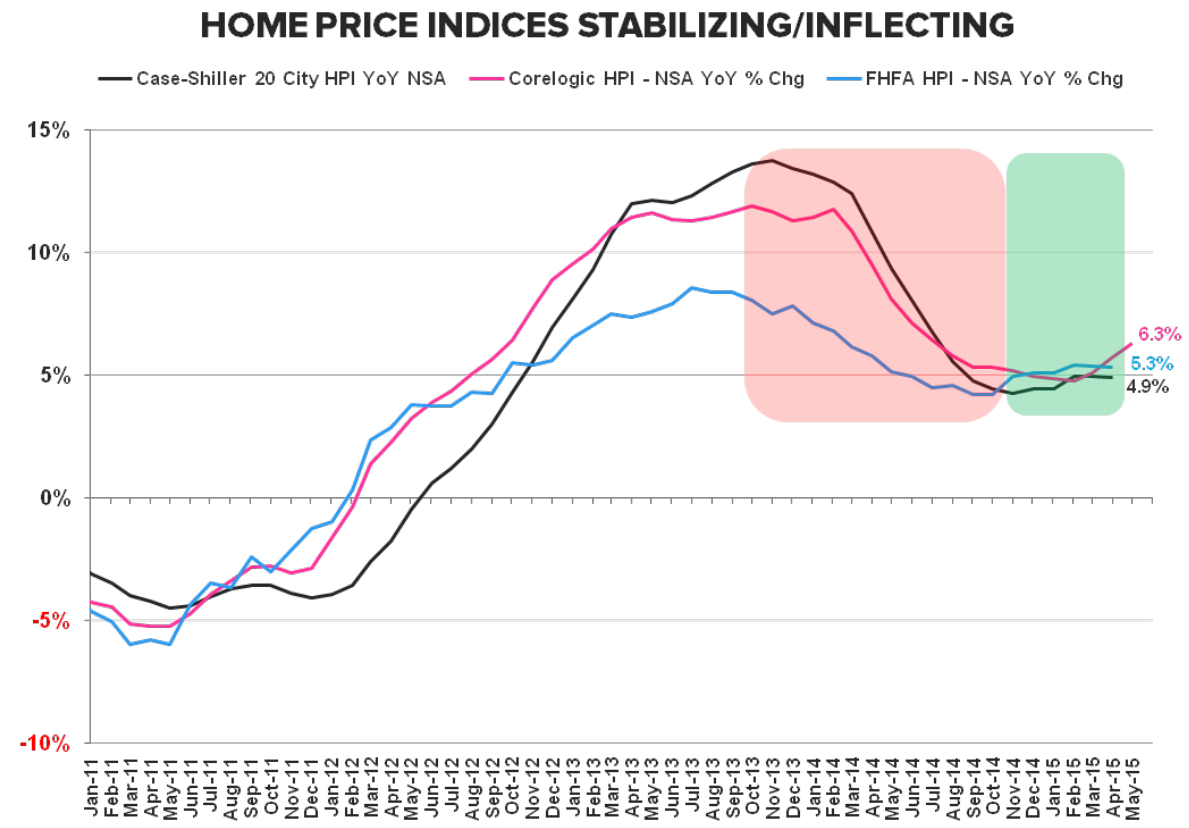
HPI & 1ST-TIME BUYERS

RE-ACCELERATING HPI



The second quarter saw HPI begin to re-accelerate after stabilizing throughout 4Q14/1Q15. HPI has accelerated 150 bps, from +4.8% to +6.3% in the last three months.

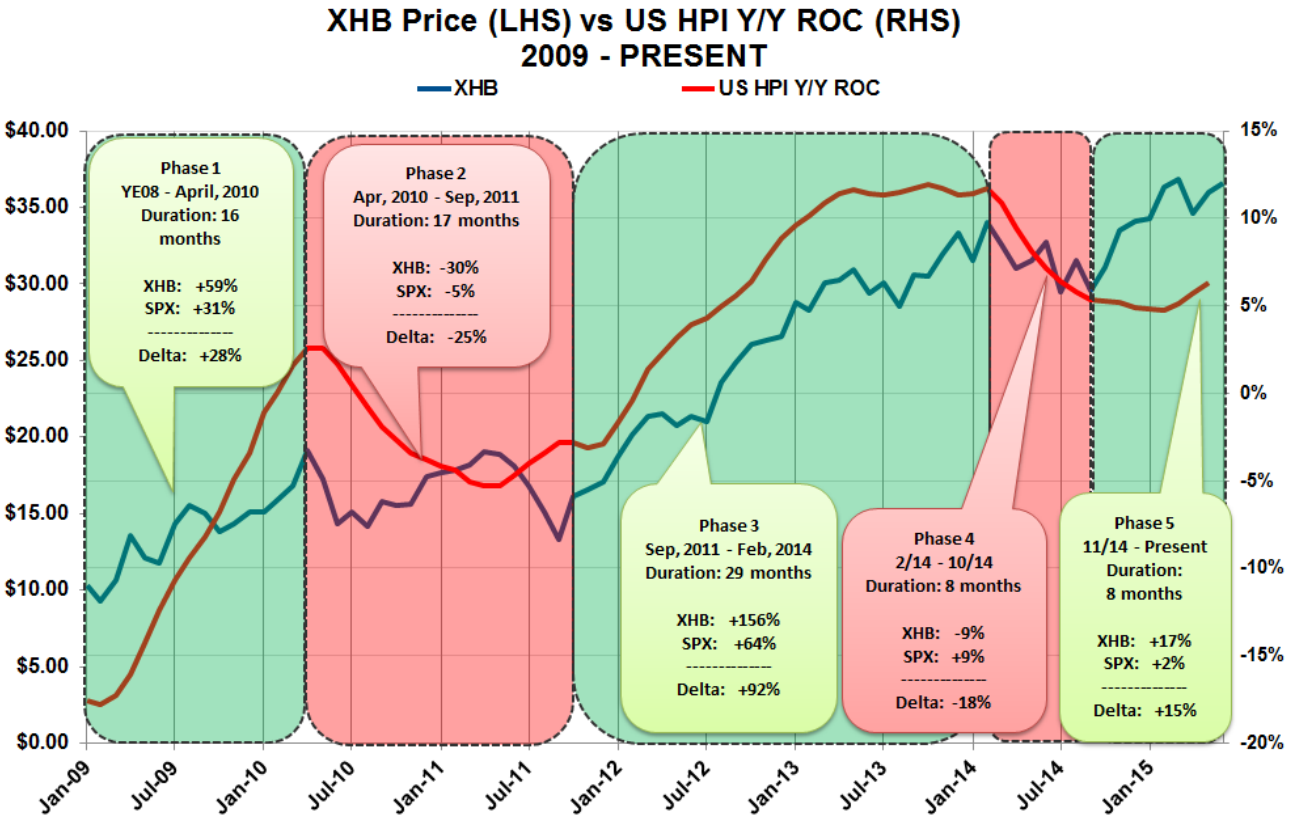
CORELOGIC LEADS CASE SHILLER



DATA SOURCE: CORELOGIC, CASE SHILLER, FHFA

Rate of change in home prices has positively inflected over the last few months. Since CoreLogic leads Case Shiller and FHFA we expect to see these other indices follow suit in the coming months.

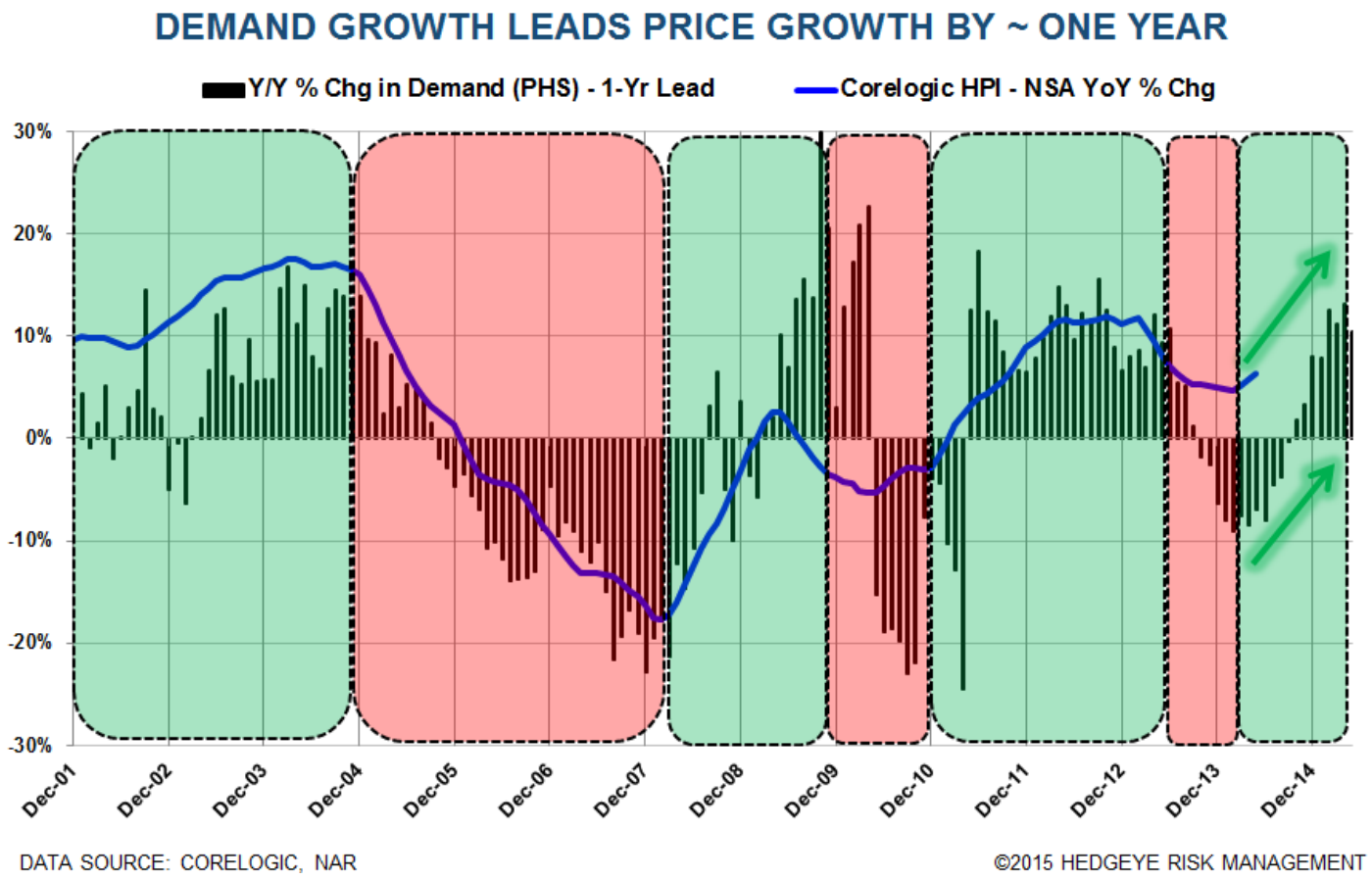
RECAP: HPI → BETTER, HPI → XHB



DATA SOURCE: CORELOGIC, FACTSET

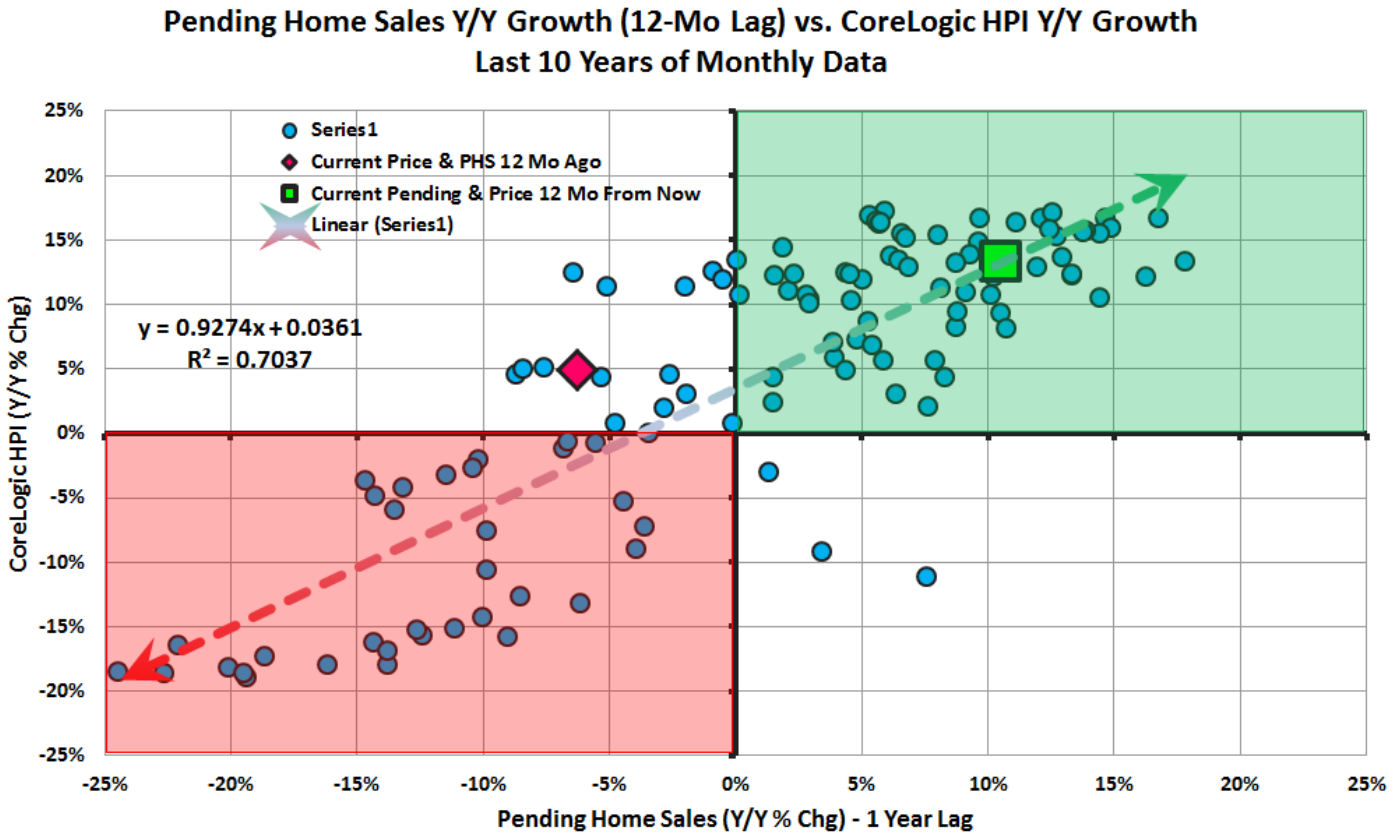
Housing stocks have reflected the path of the rate of change in home prices since 2008. The R-value between these two series has been +0.90.

MORE ACCELERATION LOOKS LIKELY



The past fifteen years have seen demand growth lead price growth by one year. The relationship suggests that HPI should continue its recent trend of re-acceleration as the volume comps remain favorable.

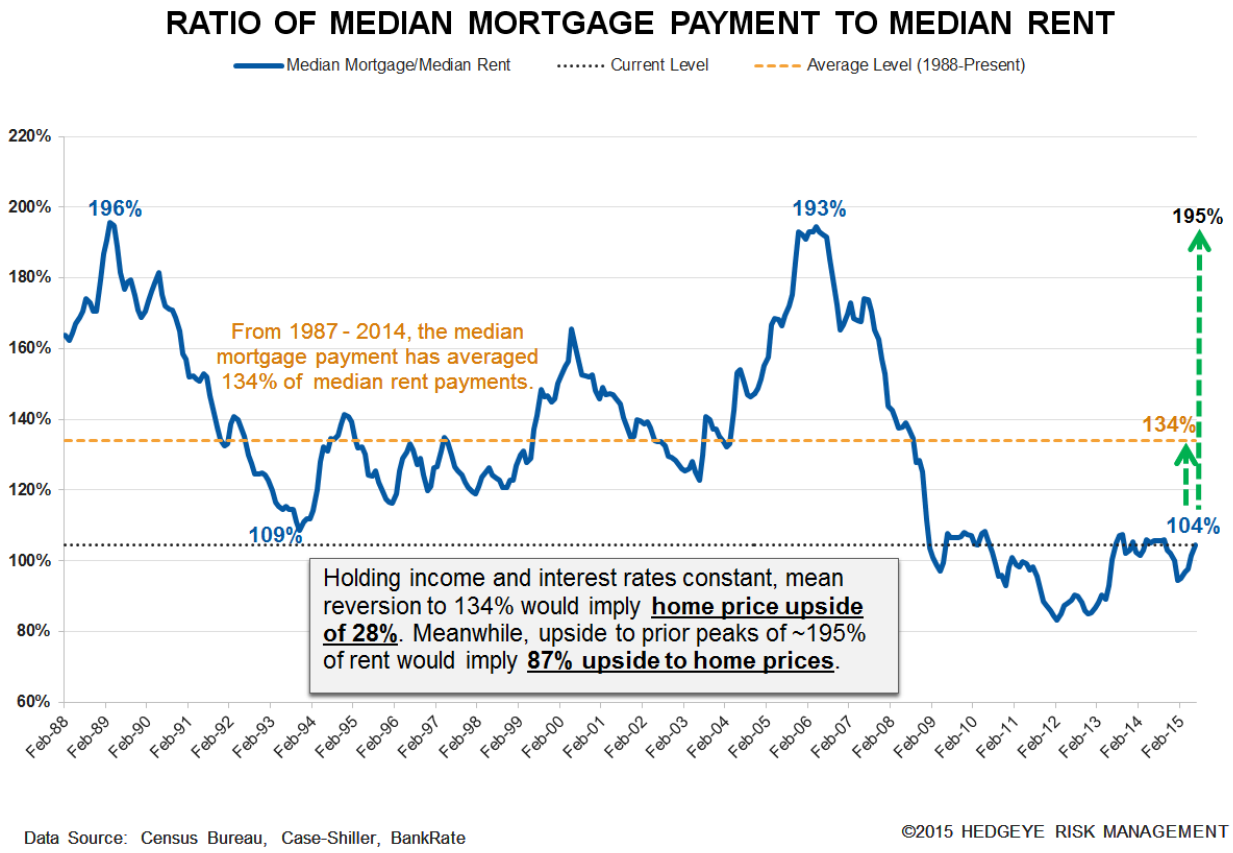
HPI ACCELERATION LOOKS LIKELY



Data Source: CoreLogic, NAR
* Excludes Periods Just Before & After Late-2009 & Early-2010 Tax Credits

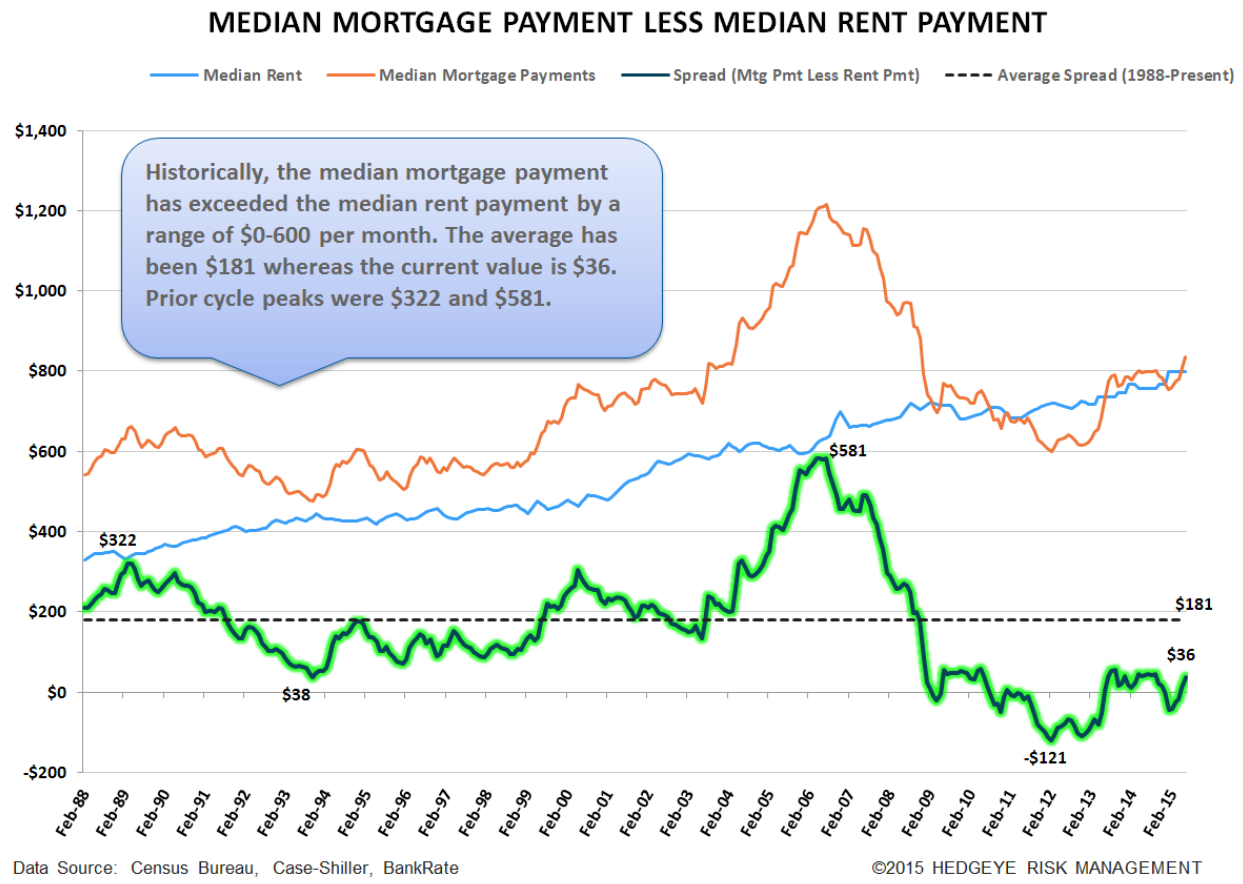
Pending Home Sales are up 11% Y/Y in the most recent data. Demand growth in the low-teens correlates to rate of change in prices in the low-to-mid teens on a 1yr lag. This is well above the current rate in the mid single digits.

AFFORDABILITY DYNAMICS: 1



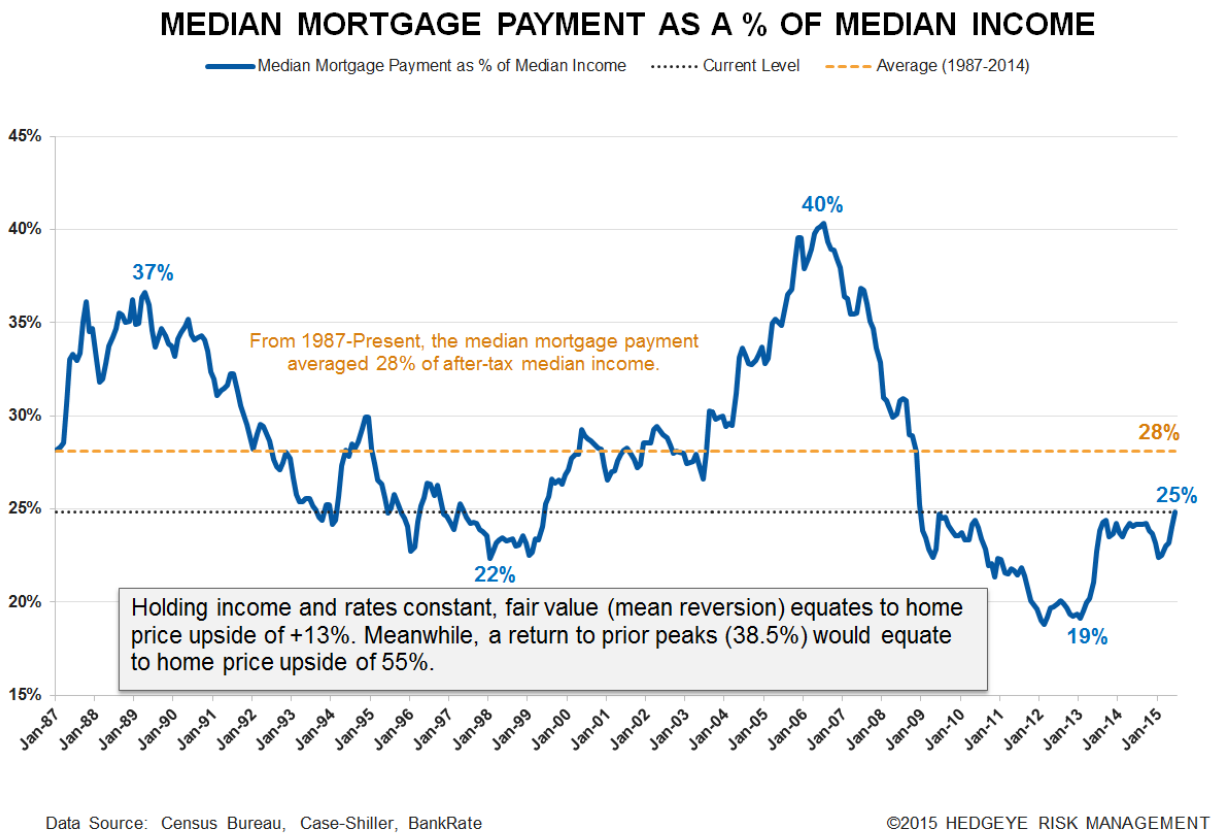
The average ratio of median mortgage payment to median rental payment has been 134% from 1988-Present. The current level of 104% implies **home price upside of 28%** from a mean reversion standpoint.

AFFORDABILITY DYNAMICS: 1 CON'T



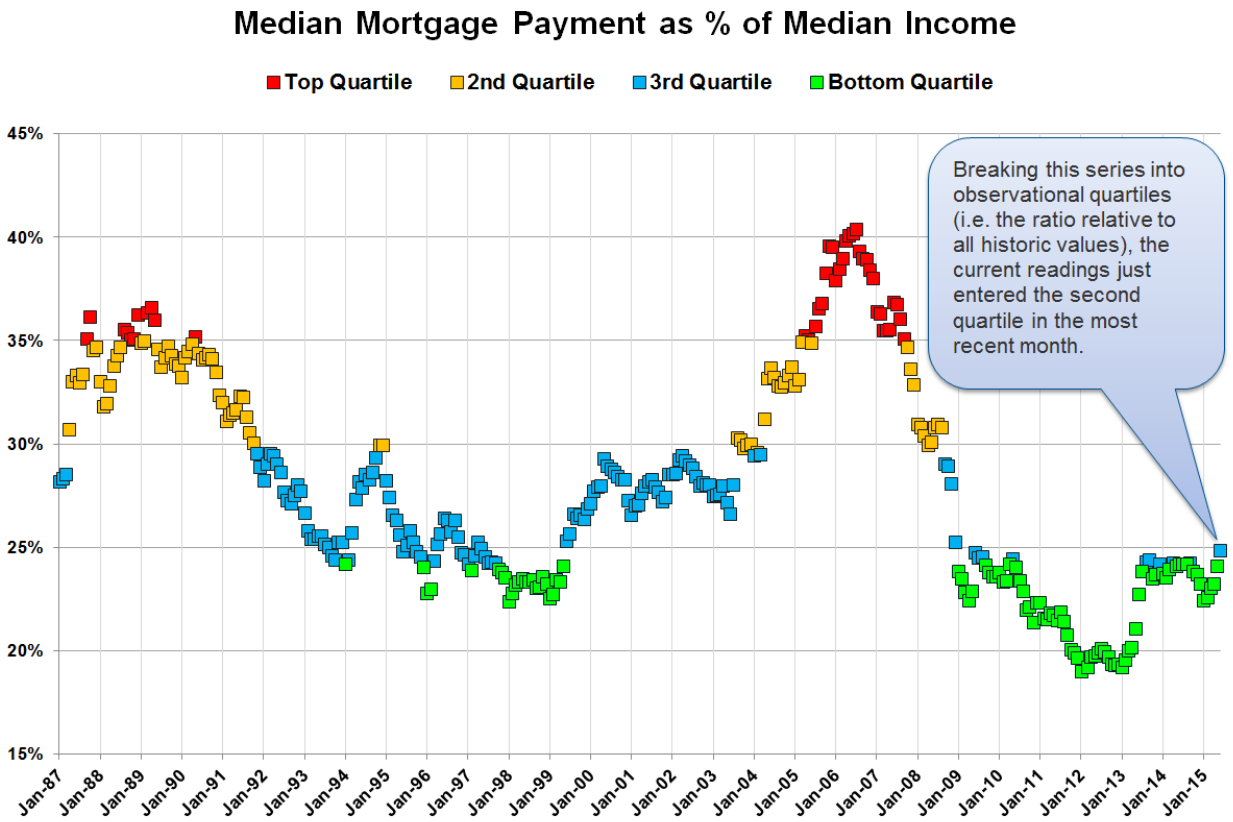
The green line shows the amount by which median monthly mortgage payments exceed median rent payments. **The long-term average here is $181, but the current value is $36 with prior peaks of $322 and $581.**

AFFORDABILITY DYNAMICS: 2



The median mortgage payment to median monthly income ratio has averaged 28% from 1988-present. The current level of 25% implies **home price upside of +13% to the mean and +55% to the prior peaks**.

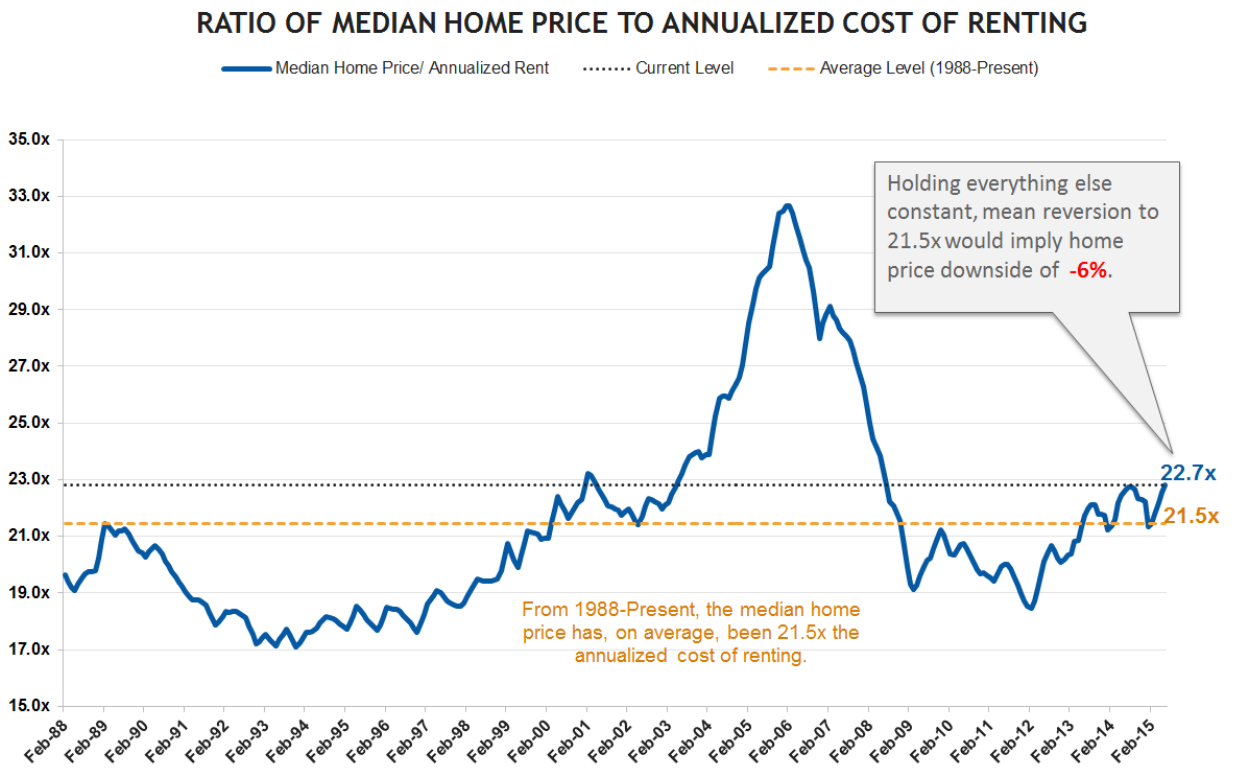
AFFORDABILITY DYNAMICS: 2 CON'T



DATA SOURCE: CENSUS BUREAU, CASE SHILLER, BANKRATE

The June numbers pushed the affordability readings into the second (from the bottom) quartile, but only just barely as the second quartile ranges from 25-30%.

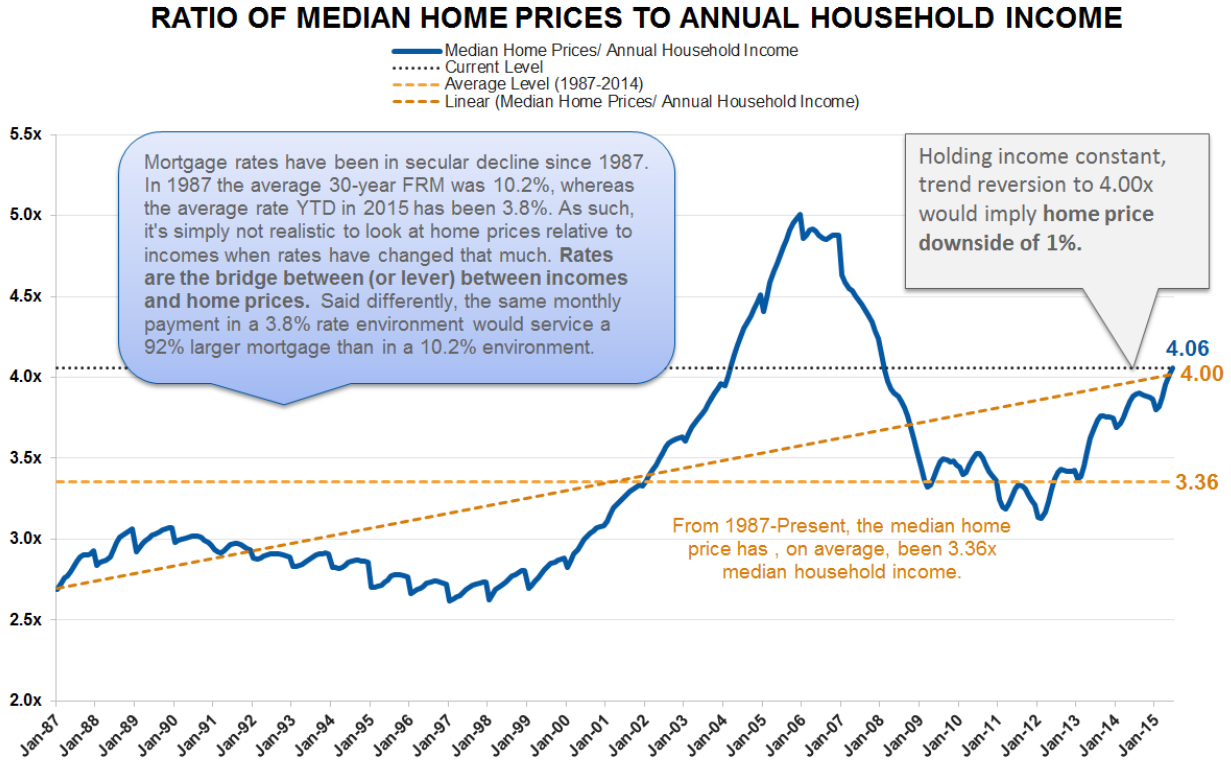
AFFORDABILITY DYNAMICS: 3



Data Source: Census Bureau, Case-Shiller, BankRate

Median home prices relative to annual median rental cost has averaged 21.5x from 1988-Present. The current level of 22.7x implies home price downside of -6% from a mean reversion standpoint.

AFFORDABILITY DYNAMICS: 4



Median home prices relative to household income would be a useful measure if rates remained static over time, but one must account for the change in the cost of money over the long-term.

AFFORDABILITY – SUMMARY

Mean Reversion Framework (Base Case):

1. Affordability Measure #1: Mortgage Payments Vs. Rent (Upside of 28%)
2. Affordability Measure #2: Mortgage Payments As % of Income (Upside of 13%)
3. Affordability Measure #3: Home Prices Vs. Annulaized Rents (Downside of 6%)
4. Affordability Measure #4: Home Prices Vs. Incomes (Downside of 1%)

Mean Reversion Framework Average Upside: +9%

Prior Peak Framework (Bull Case):

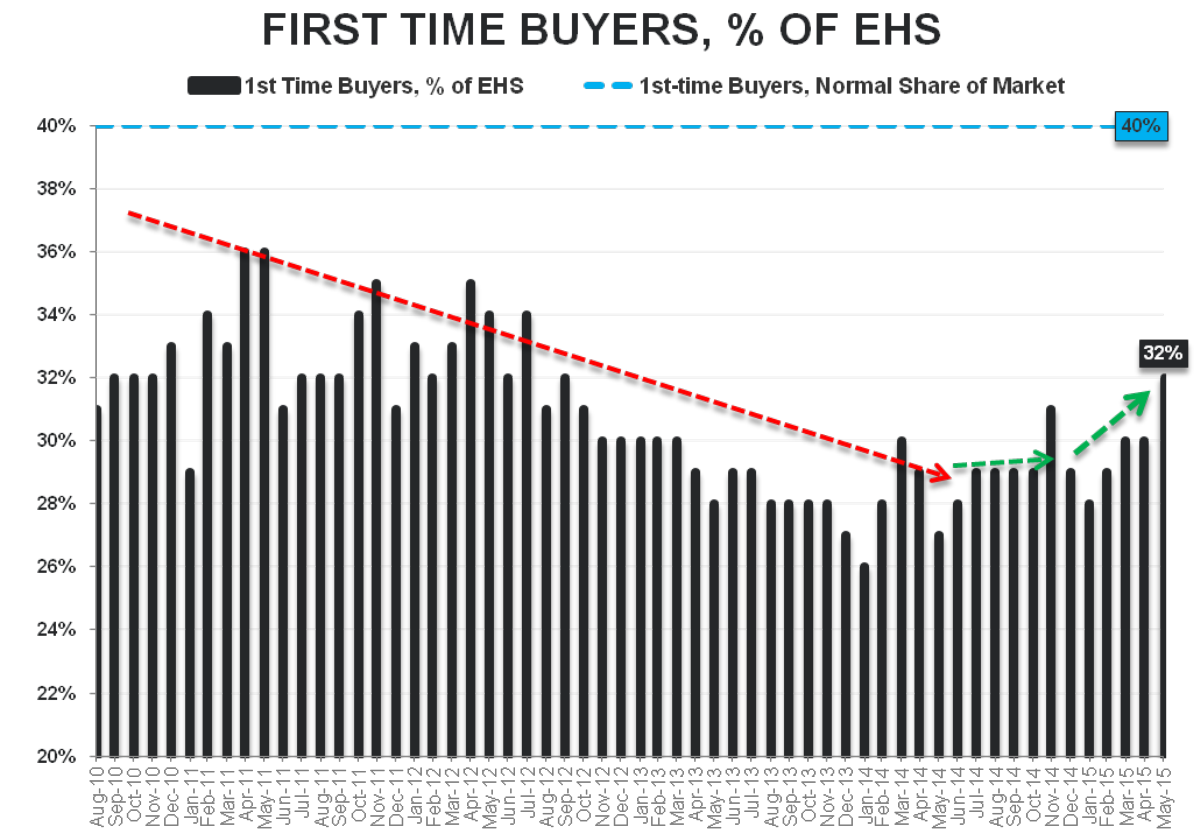
1. Affordability Measure #1: Mortgage Payments Vs. Rent (Upside of 87%)
2. Affordability Measure #2: Mortgage Payments As % of Income (Upside of 55%)
3. Affordability Measure #3: Home Prices Vs. Annulaized Rents (Upside of 45%)
4. Affordability Measure #4: Home Prices Vs. Incomes (Upside of 23%)

Prior Peak Framework Average Upside: +53%

Mean reversion offers a range of outcomes from +28% to -6% with an average of +9%.

Prior peak analysis suggests a range of outcomes from +23% to +87% with an average of +53%.

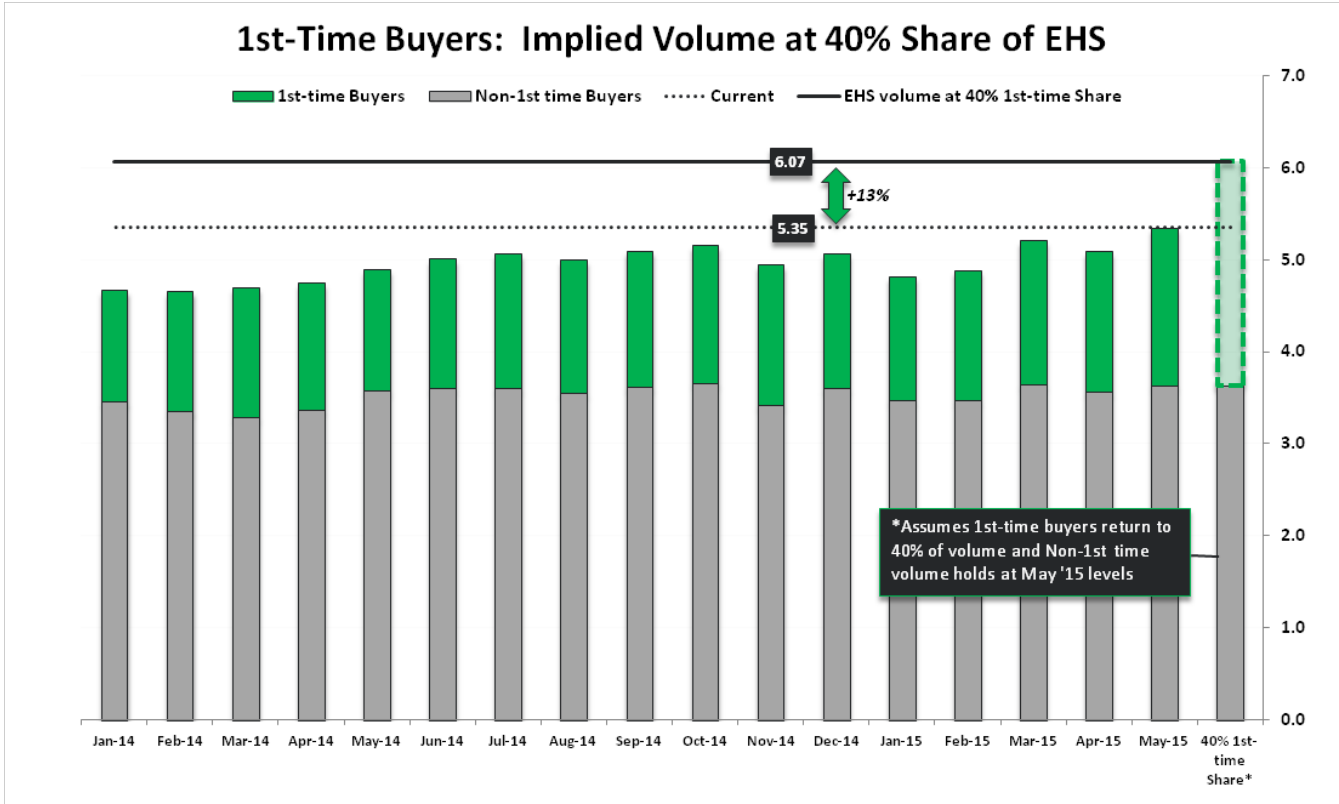
FIRST TIME HOMEBUYER TAILWIND



DATA SOURCE: NAR, HEDGEYE RISK MANAGEMENT

First time buyer demand re-emerged in May, representing 32% of EHS but remains depressed relative to the long-term average of ~40% of existing home sales.

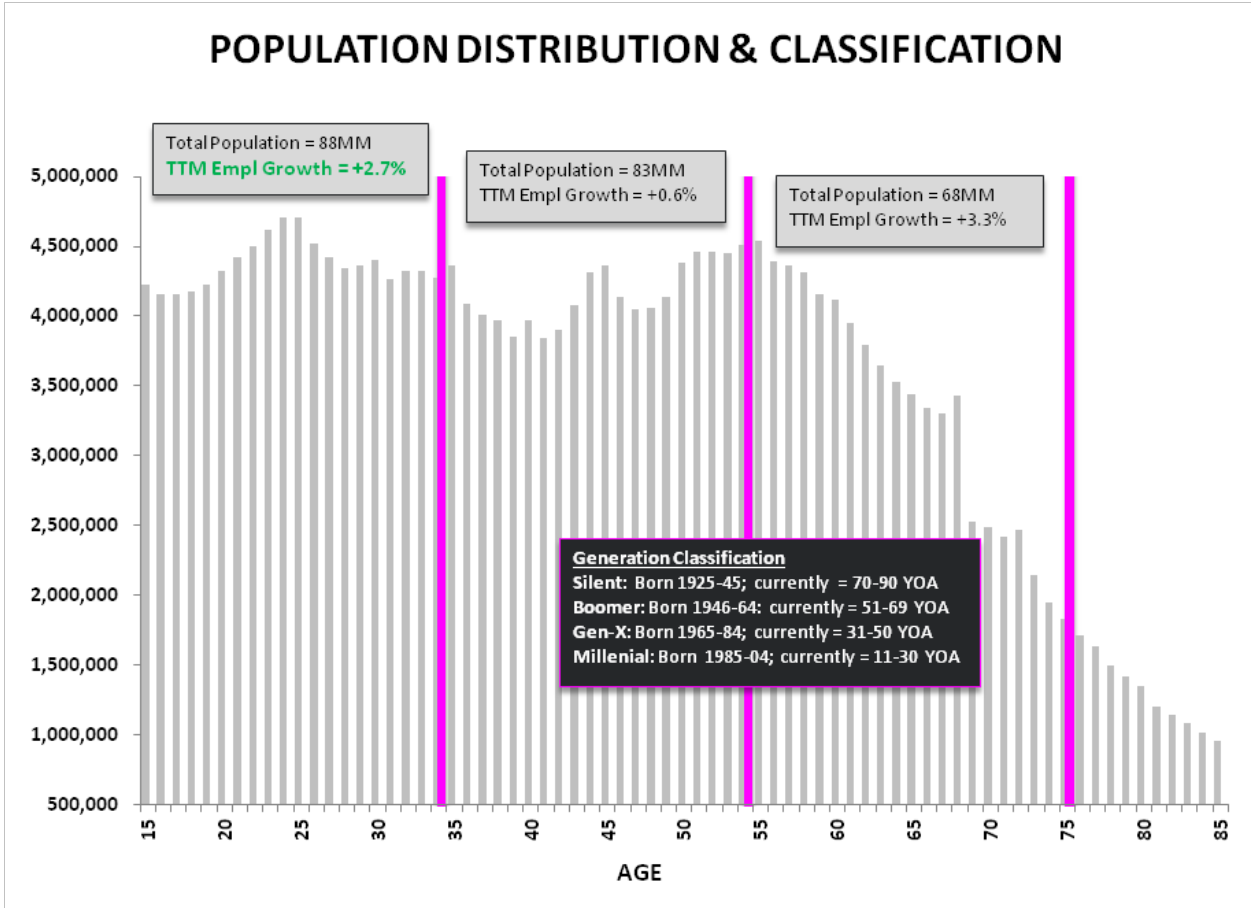
FIRST TIME HOMEBUYER TAILWIND



Mean reversion to 40% Share for 1st-time buyers implies upside of ~13% from current levels for EHS.

Data source: Bloomberg, NAR, HRM

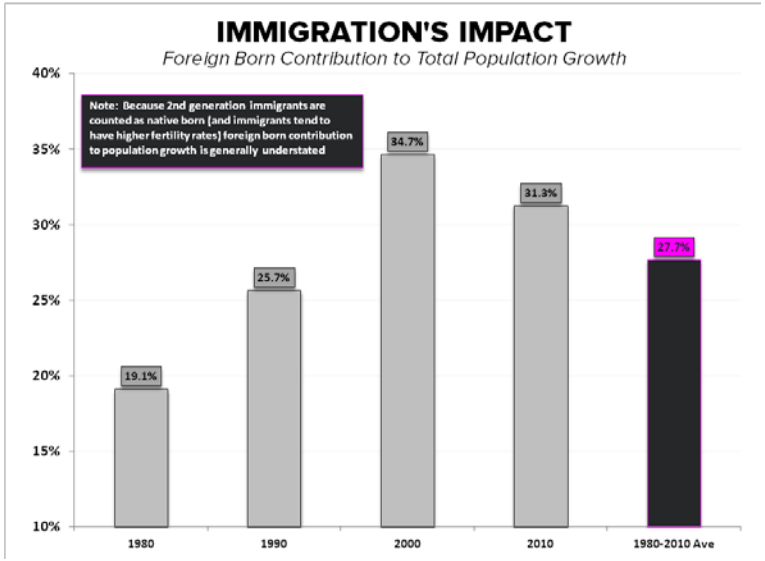
DEMOGRAPHICS OF DEMAND

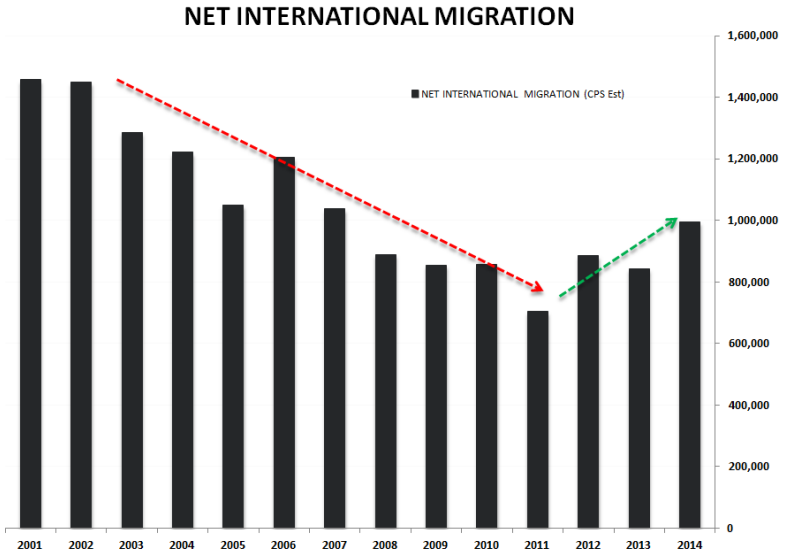


The Millennial wave has been well advertised but that doesn't diminish the economic gravity associated with it.

Data source: Census Bureau, HRM

IMMIGRATION MATTERS & IT'S INFLECTING





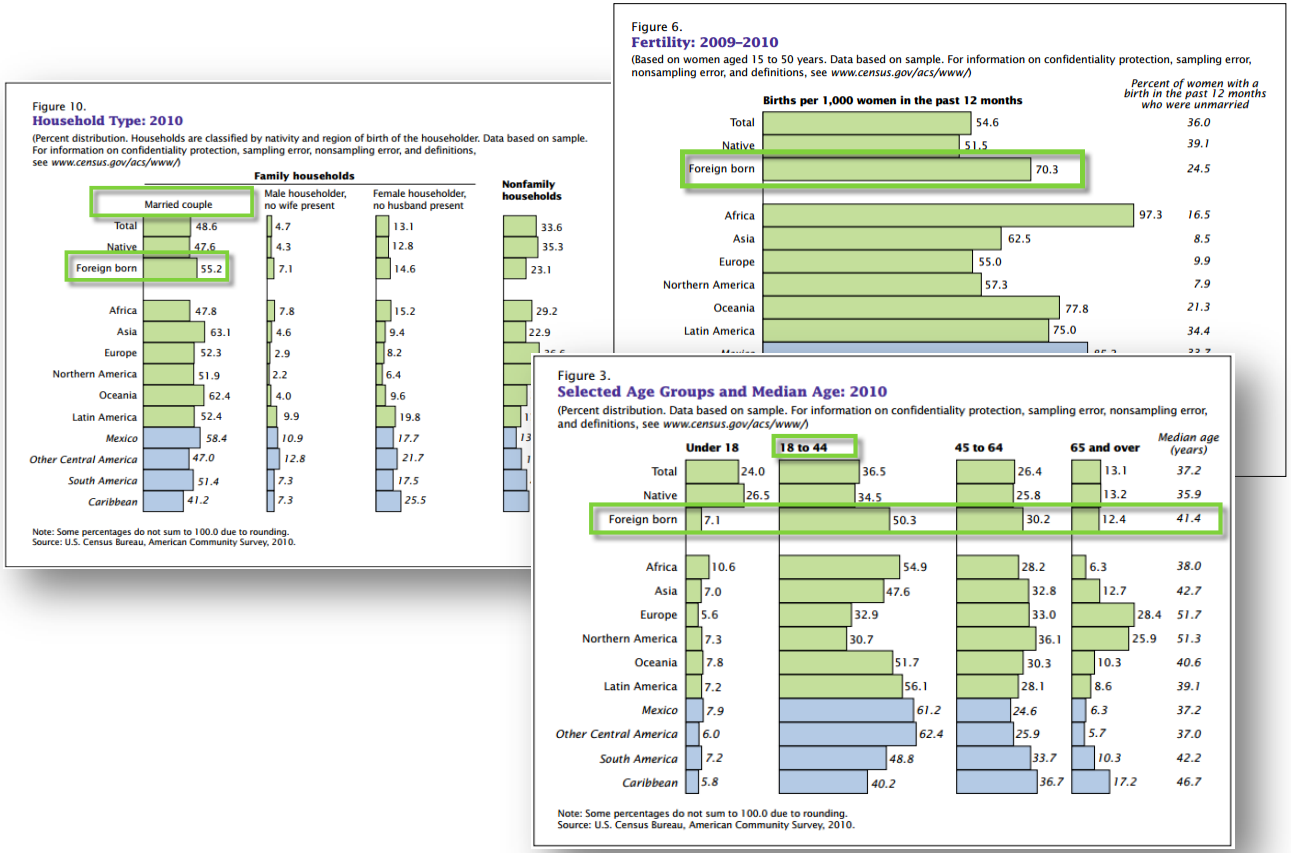
Secular Support

Immigration has accounted for ~30% of total population growth over the last three decades.

Cyclical Strengthening

Initial 2014 immigration estimates show a return to 1MM for the first time since 2007.

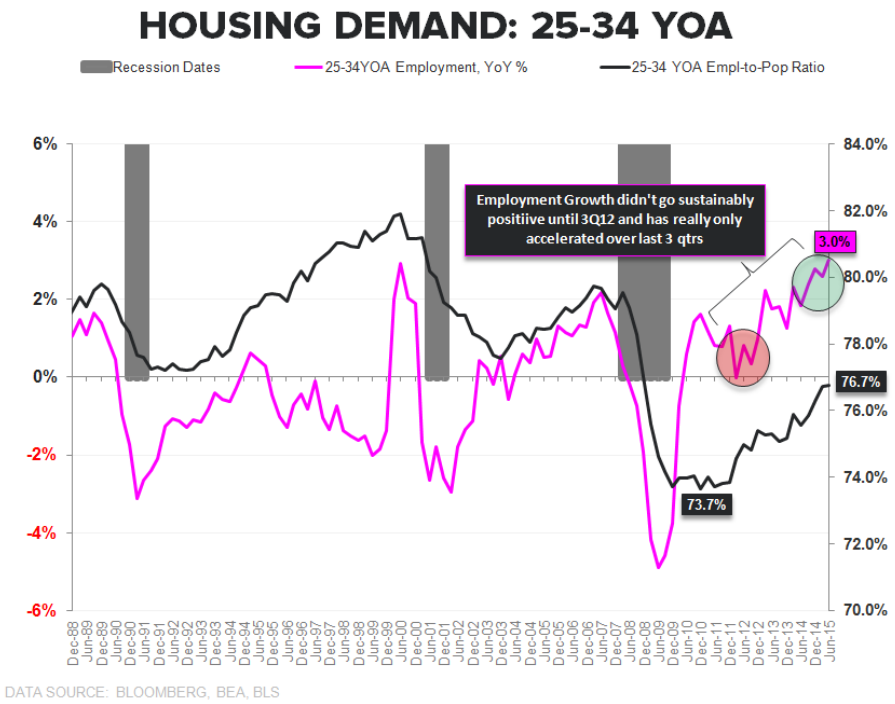
THE DEMOGRAPHIC TURN HAS A LONG TAIL

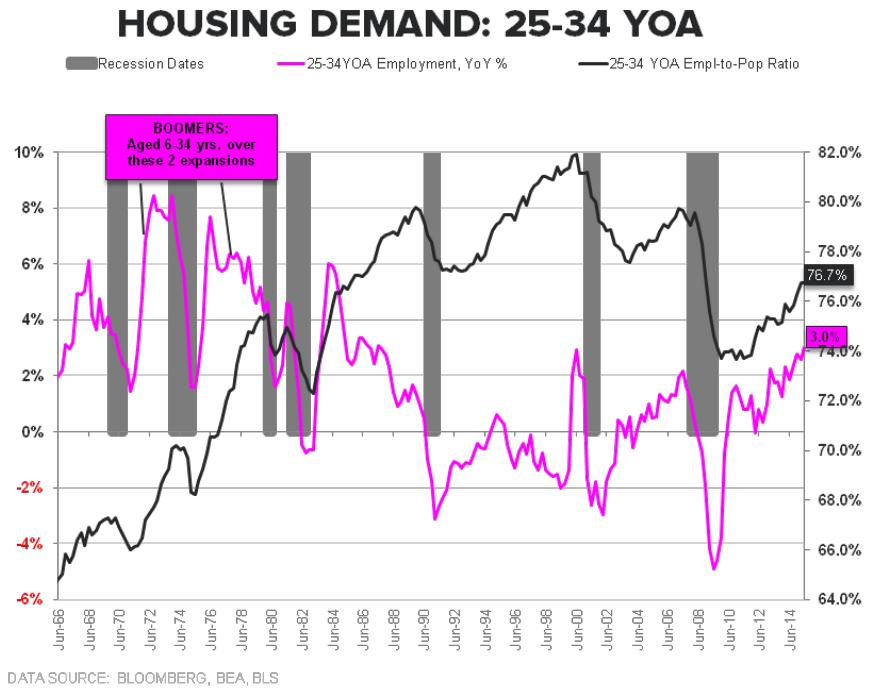


Foreign born residents are young, carry higher fertility rates and are more likely to be married – all characteristics supportive of household formation.

Data source: Census Bureau

MILLENNIAL JOBS → ACCELERATING





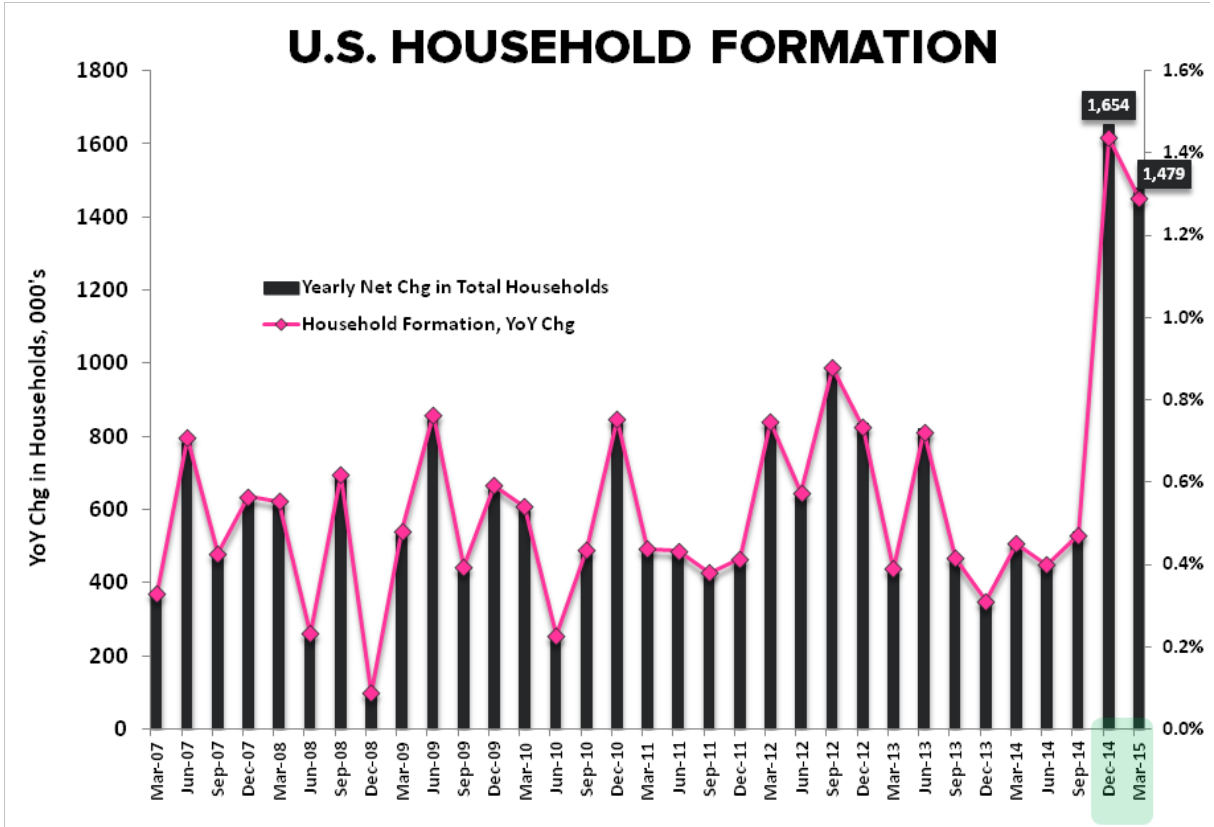
Short-Term

The employment recovery for the 25-34 YOA cohort is now ~2.5 yrs old and has accelerated over the last 3 qtrs.

Long-Term

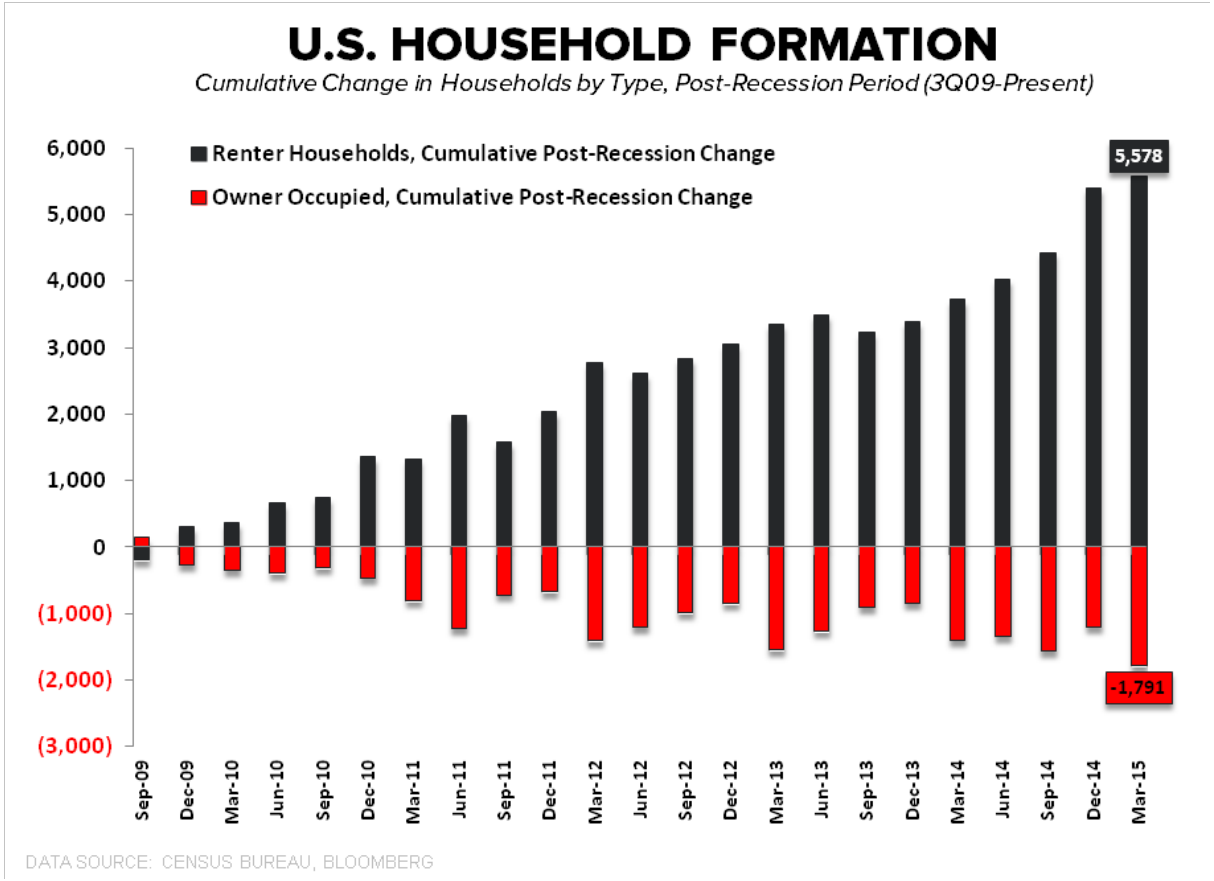
Employment growth is now above the peak of the last two cycles but below peak growth during the Boomers entre to prime working age.

HOUSEHOLD FORMATION IS FOLLOWING



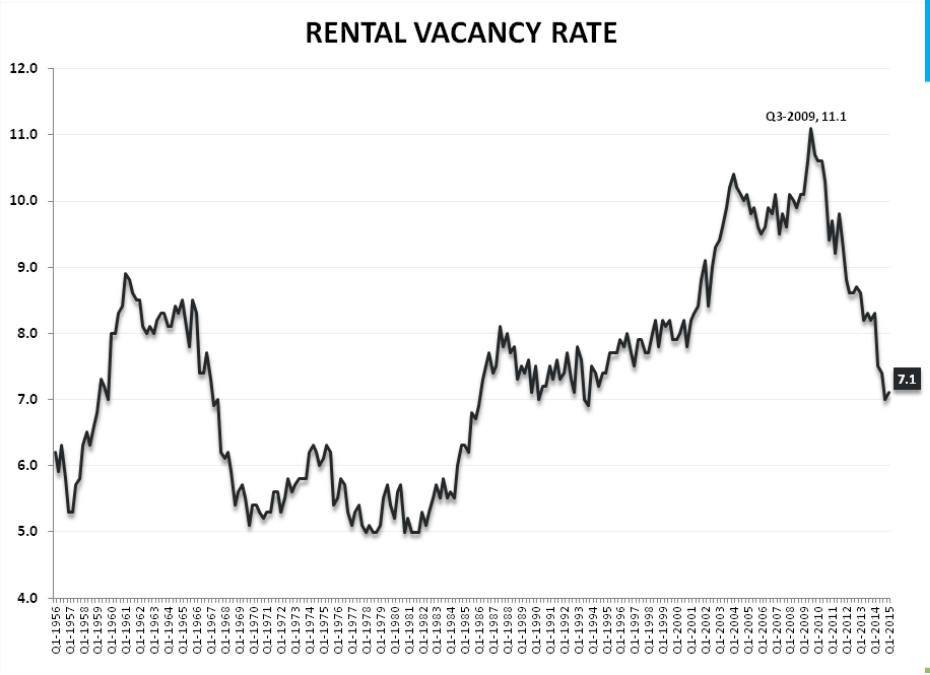
HH formation showed a marked acceleration in 4Q14/1Q15. While the magnitude of increase is probably overstated, the preponderance of empirical evidence suggests it is directionally correct.

RENTAL DEMAND HAS PREDOMINATED



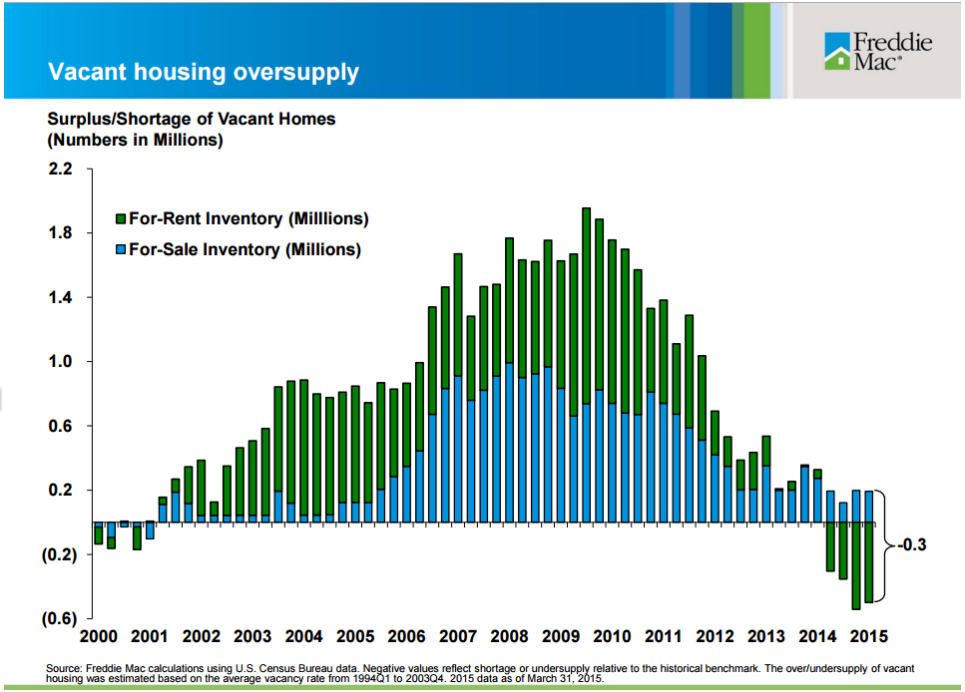
The formation of renter households has driven positive net HH formation as creation of owner occupied households remains net negative in the post-recession period… at least according the Census Bureau's HVS Survey.

DRIVING EXCESS RENTAL SUPPLY NEGATIVE



RENTAL VACANCY

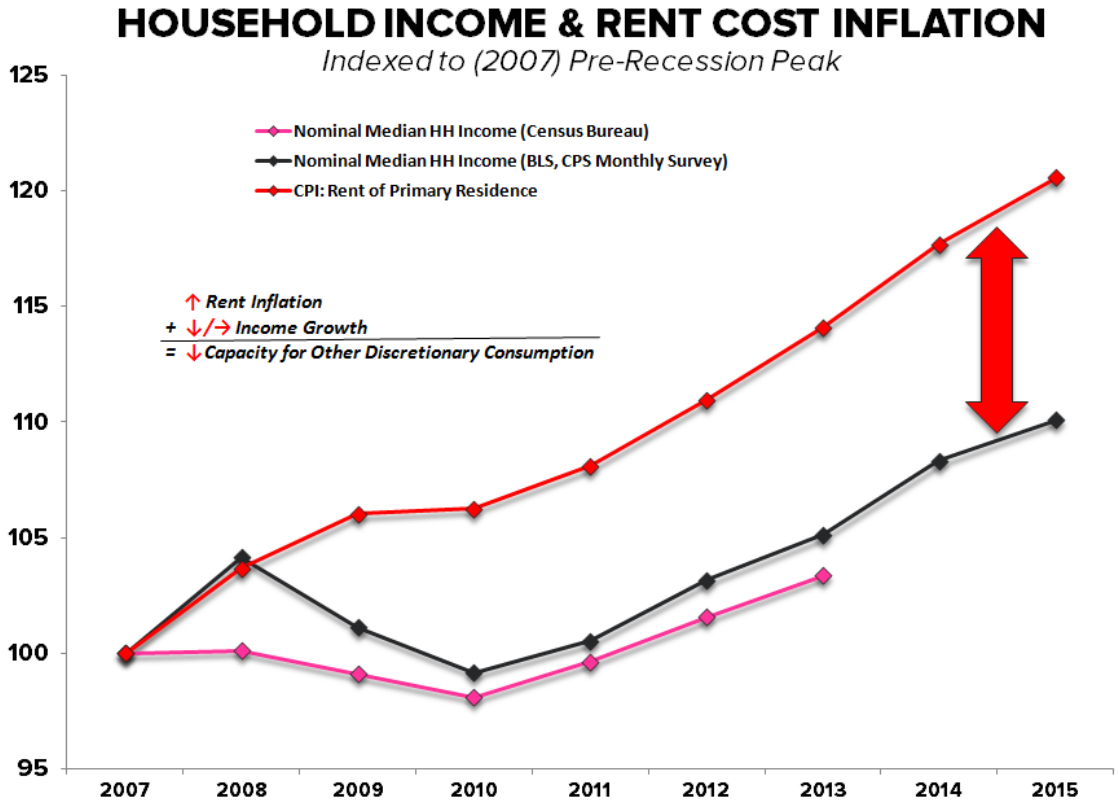
After peaking at 11.1% in 3Q09, the Rental Vacancy Rate stood at 7.1% in 1Q15 according to Census Data.



SHORTAGE IN FOR-RENT INVENTORY

For-Rent inventory remains in deficit to the tune of ~0.5mm units relative to historical (non-bubble) averages.

RENTAL COST PRESSURE HAS BEEN REAL

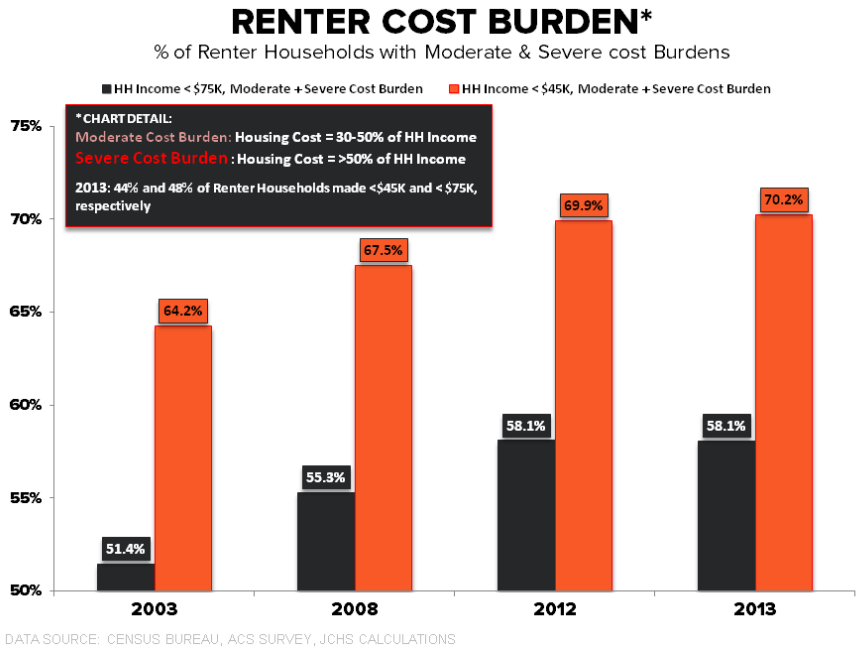


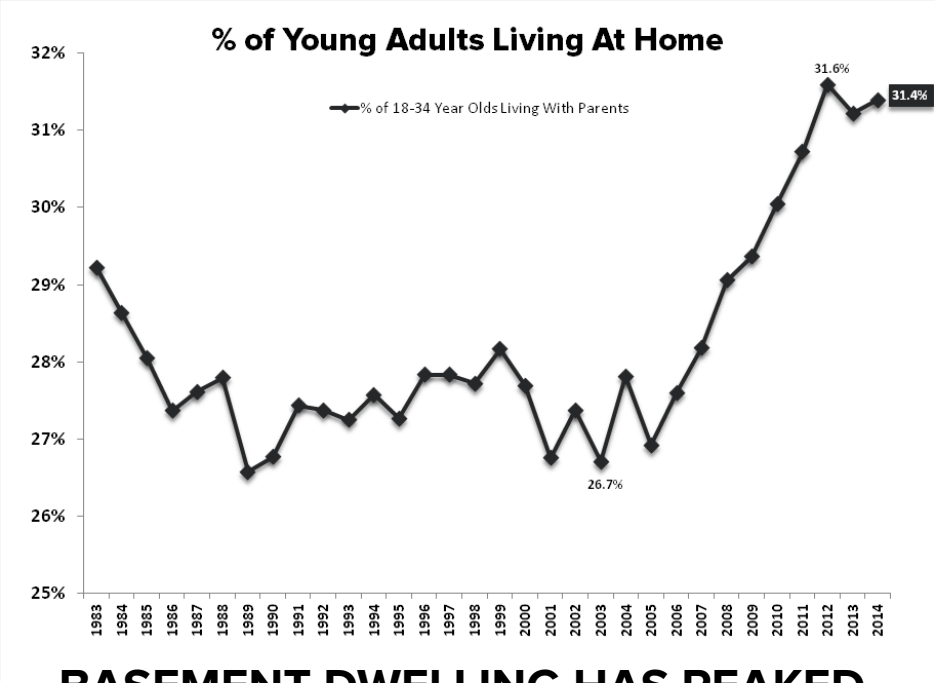
Household income growth has been negative on a real basis across all the primary survey's for most of the post-crisis period and rental cost inflation continues to grow at a premium to nominal wages.

*Rent of Shelter carries a ~32% weight in the CPI Index with Owners Equivalent Rent (OER) carrying a ~24% weight in the basket .

Data source: Bloomberg, BLS, Census Bureau, Sentier

THE BURDEN VS THE BASEMENT





RENTER COST BURDENS

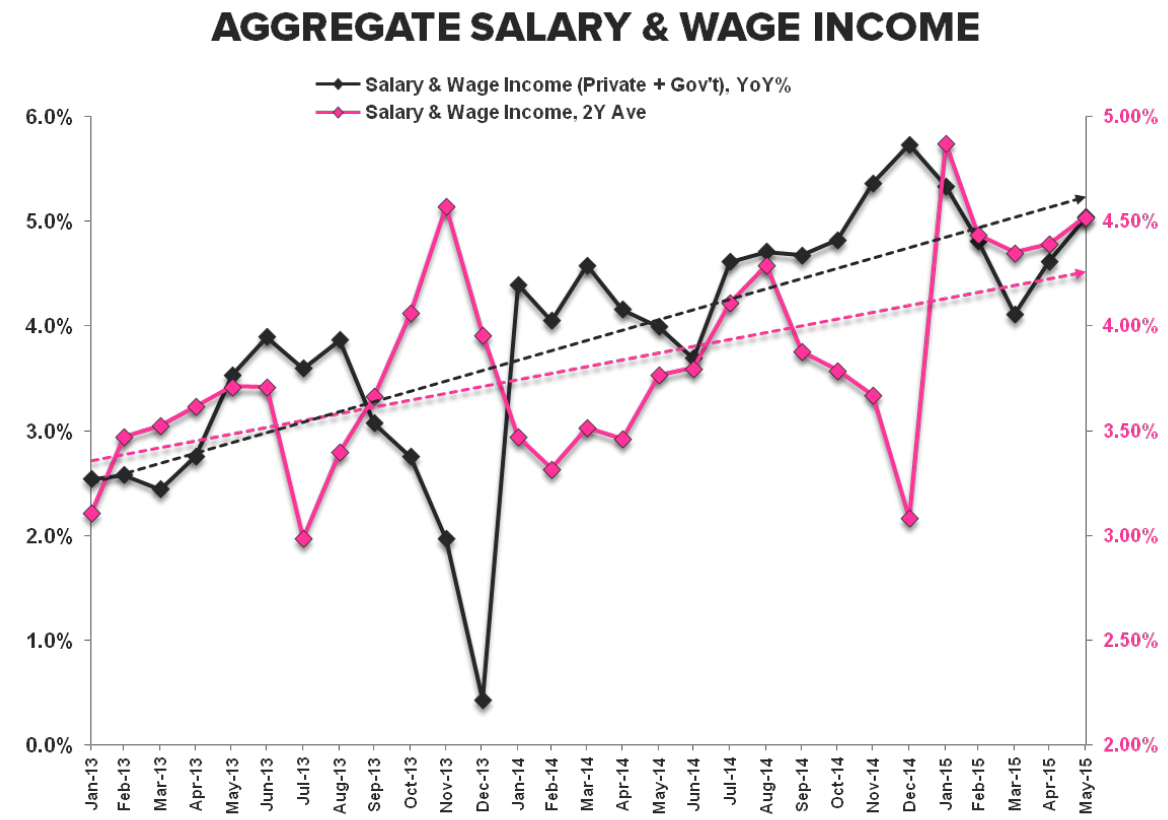
As of 2013, ~41% of Households making < $45K paid more than 50% of income towards housing costs while over 70% of households paid more than 30% of income towards rent.

BASEMENT DWELLING HAS PEAKED

Rising Incomes and the maturation of the employment recovery for 20-34 year olds should drive an ongoing recover in headship rates from here.

DATA SOURCE: BLOOMBERG, CENSUS BUREAU, JCHS CALCULATIONS

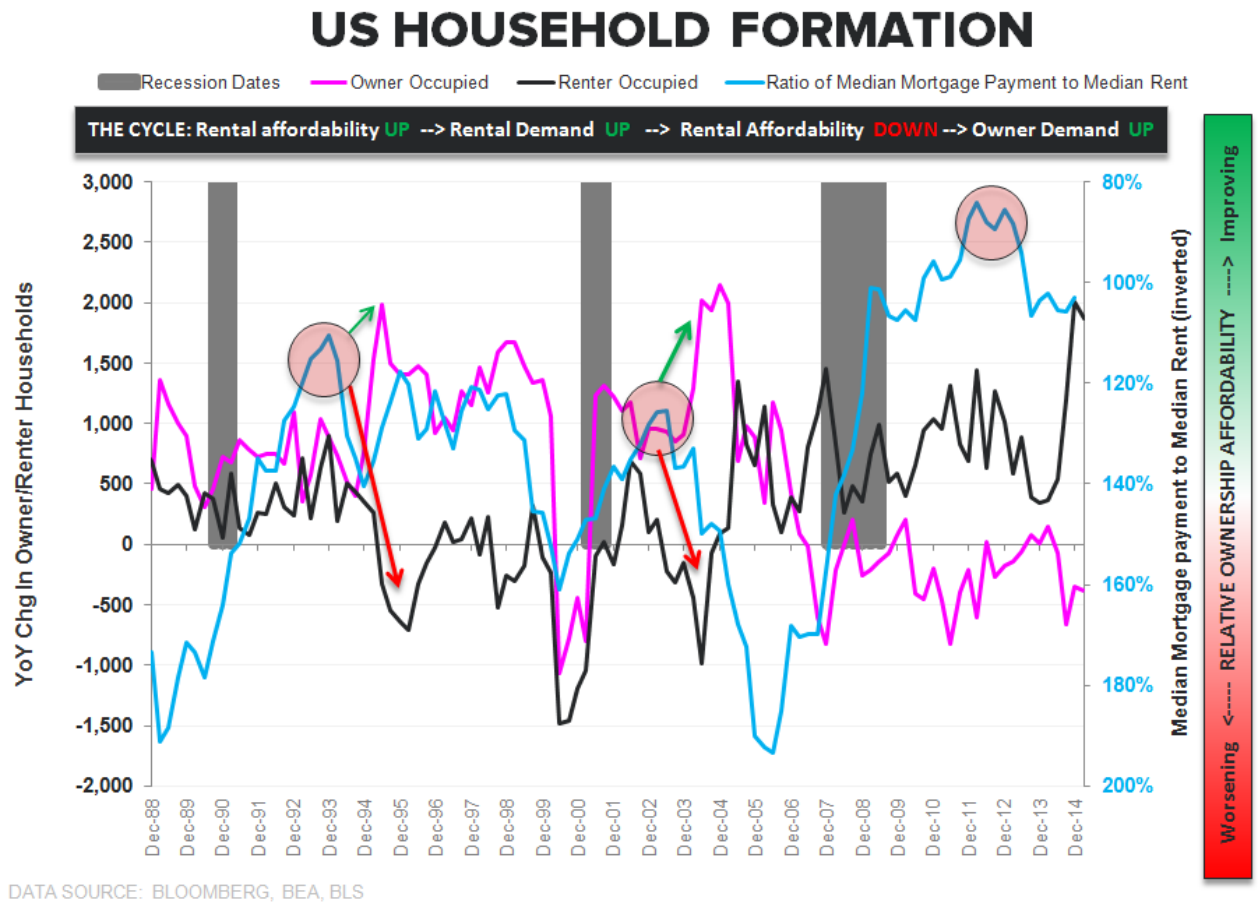
INCOME GROWTH IS ACCELERATING



DATA SOURCE: BLOOMBERG, BEA

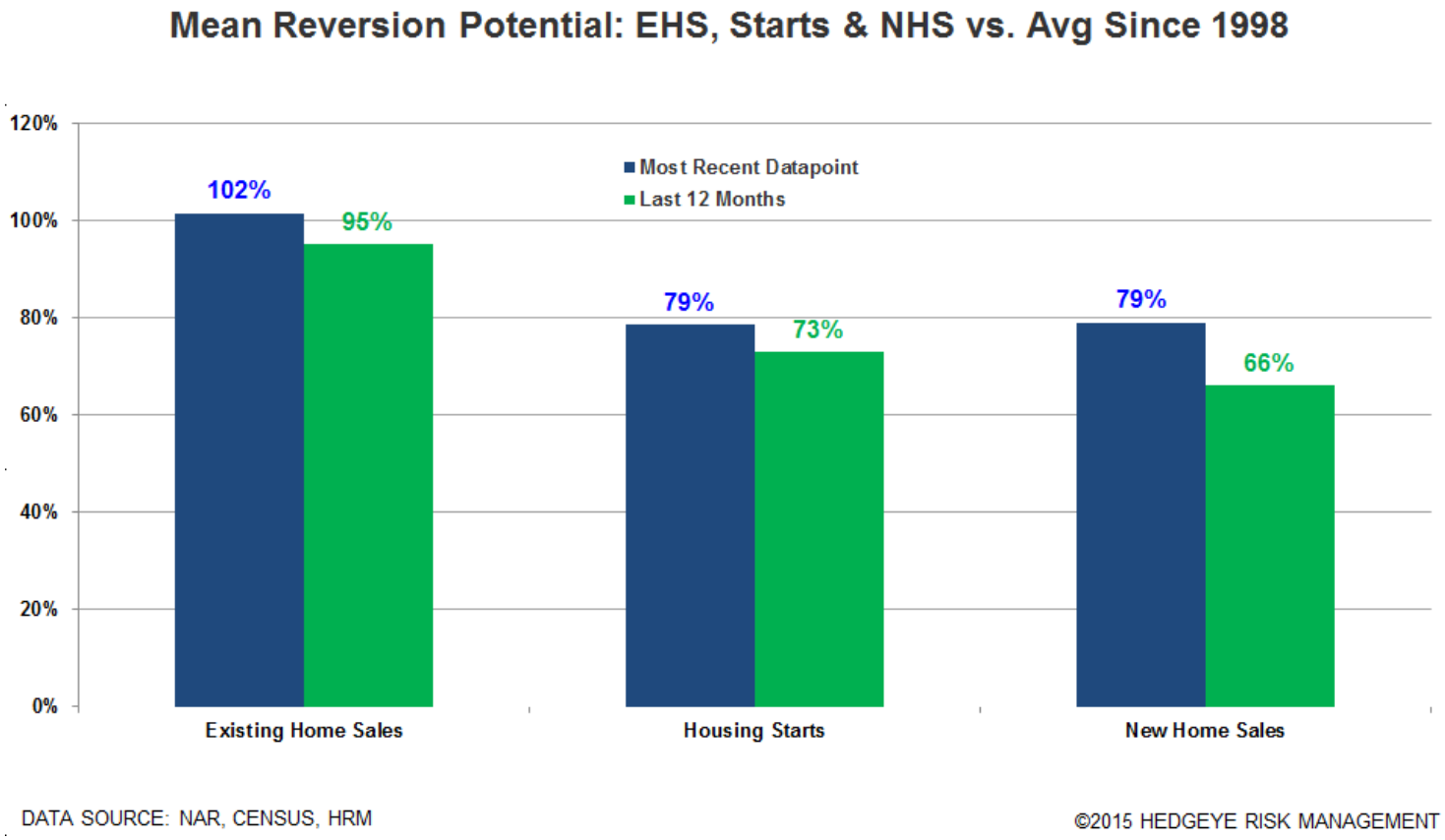
Accelerating employment growth and positive mix have supported acceleration in salary & wage growth and aggregate income.

RENTAL AFFORDABILITY ↓, OWNERSHIP ↑



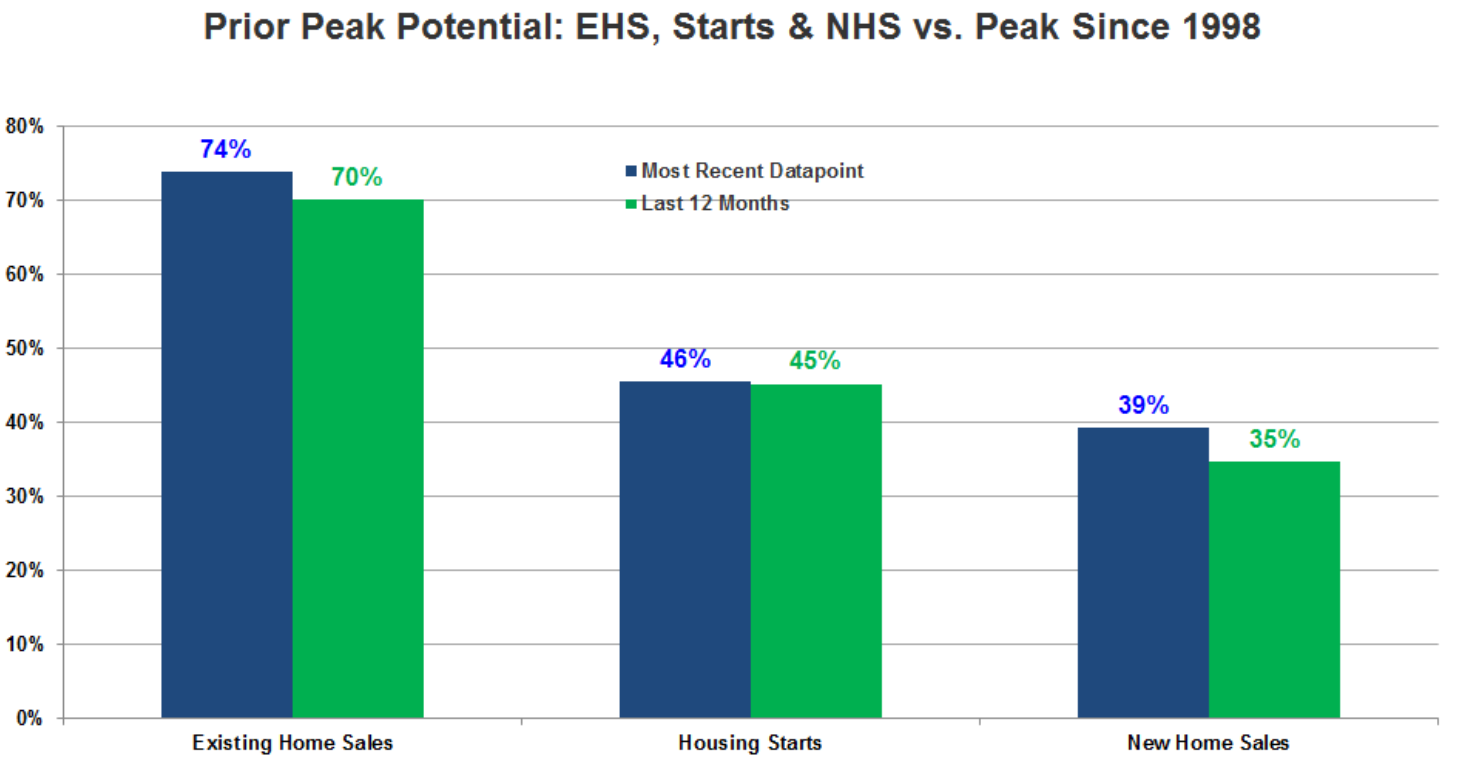
Historically, declines in rental affordability have driven households towards home ownership

BACK TO BASELINE



Taking a step back, here's how Existing Home Sales, Housing Starts and New Home Sales compare with the averages since 1998.

ONWARD TO PEAK



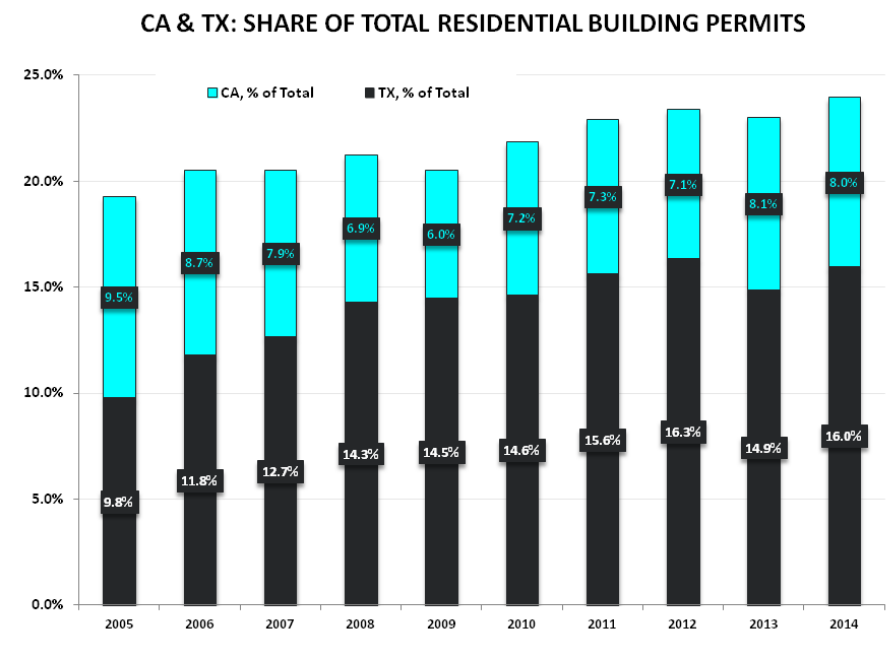
DATA SOURCE: NAR, CENSUS, HRM

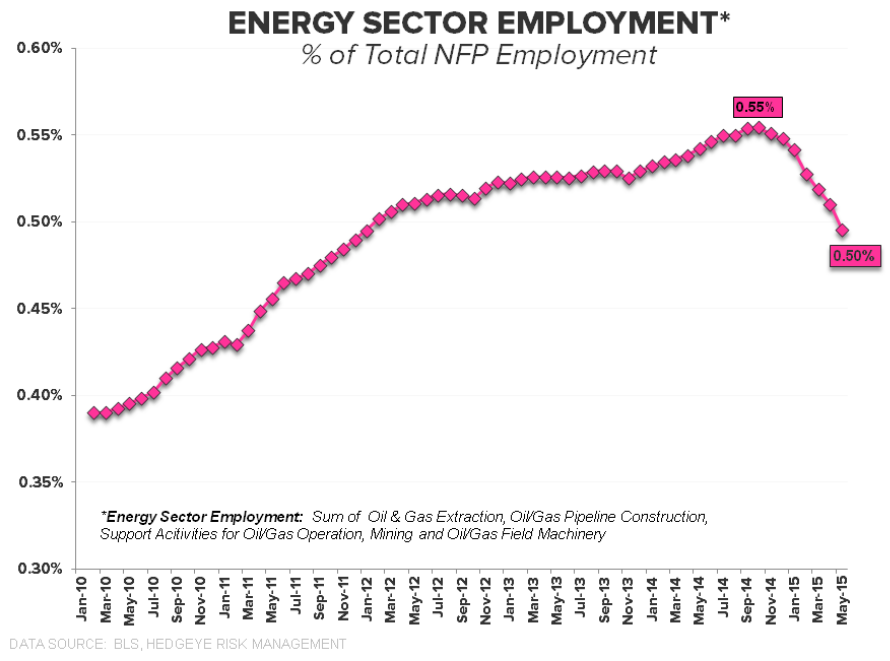
And here's how they compare with the prior peak since 1998.

For reference, we chose 1998 because that's how far back EHS goes and we wanted to show things on an apples-to-apples basis.

POTENTIAL HEADWINDS: CA/TX & TRID

CA & TX: DROUGHT & ENERGY DEFLATION





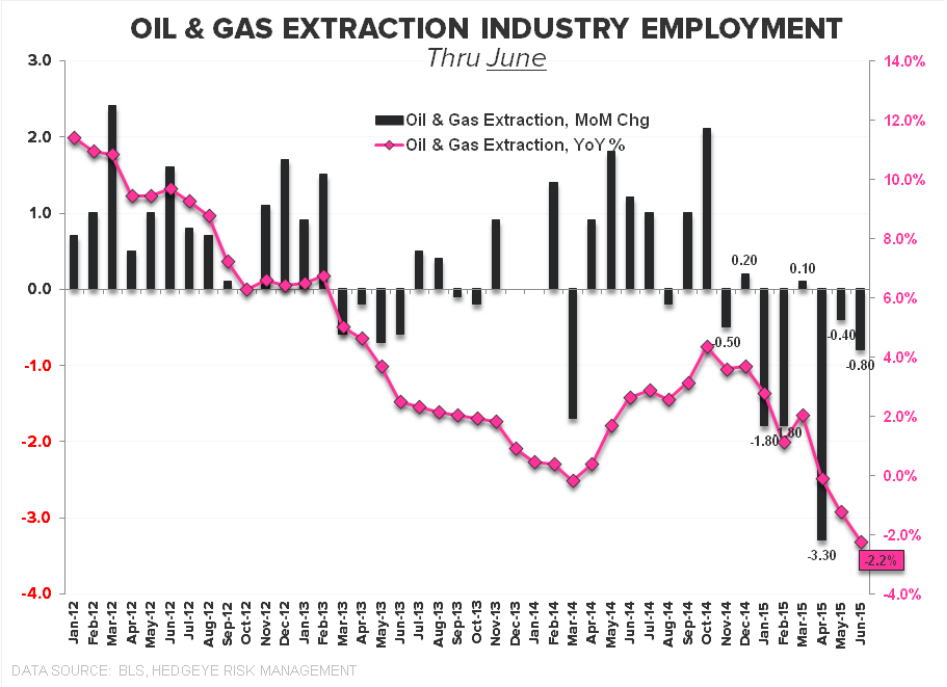
CA & TX: % OF NEW CONSTRUCTION

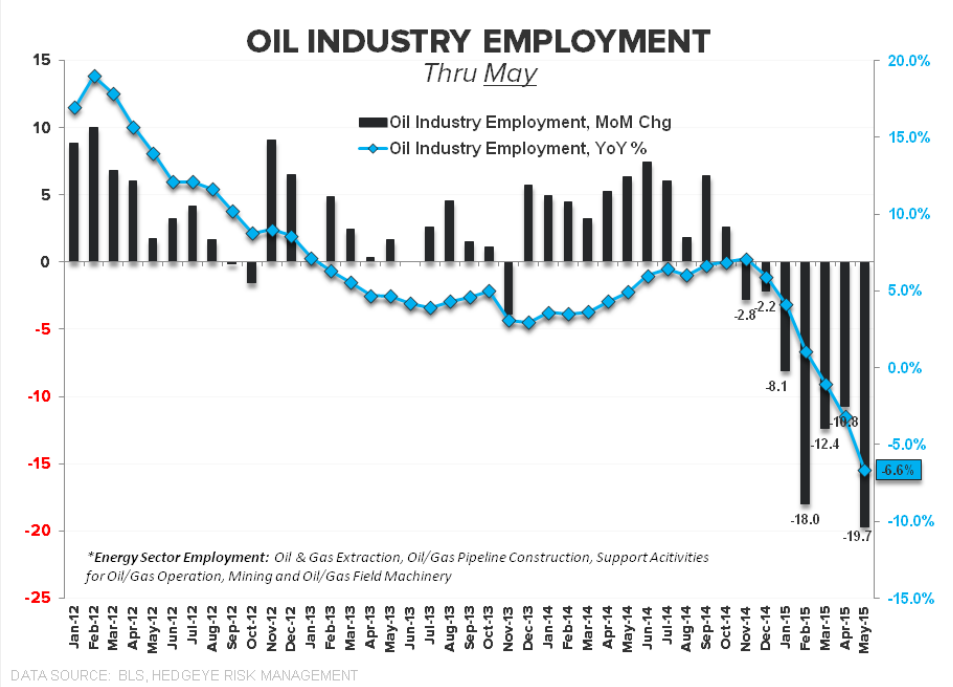
CA & TX represent ~23% of Total Resi Permits. Their share of single-family permits is similar.

TOO SMALL TO MATTER?

While energy employment is up ~+50% since trough, representing an outsized 2.6% of total employment gains, direct industry employment peaked at only 0.55% of Total NFP employment.

ENERGY: NET EMPLOYMENT IS FALLING





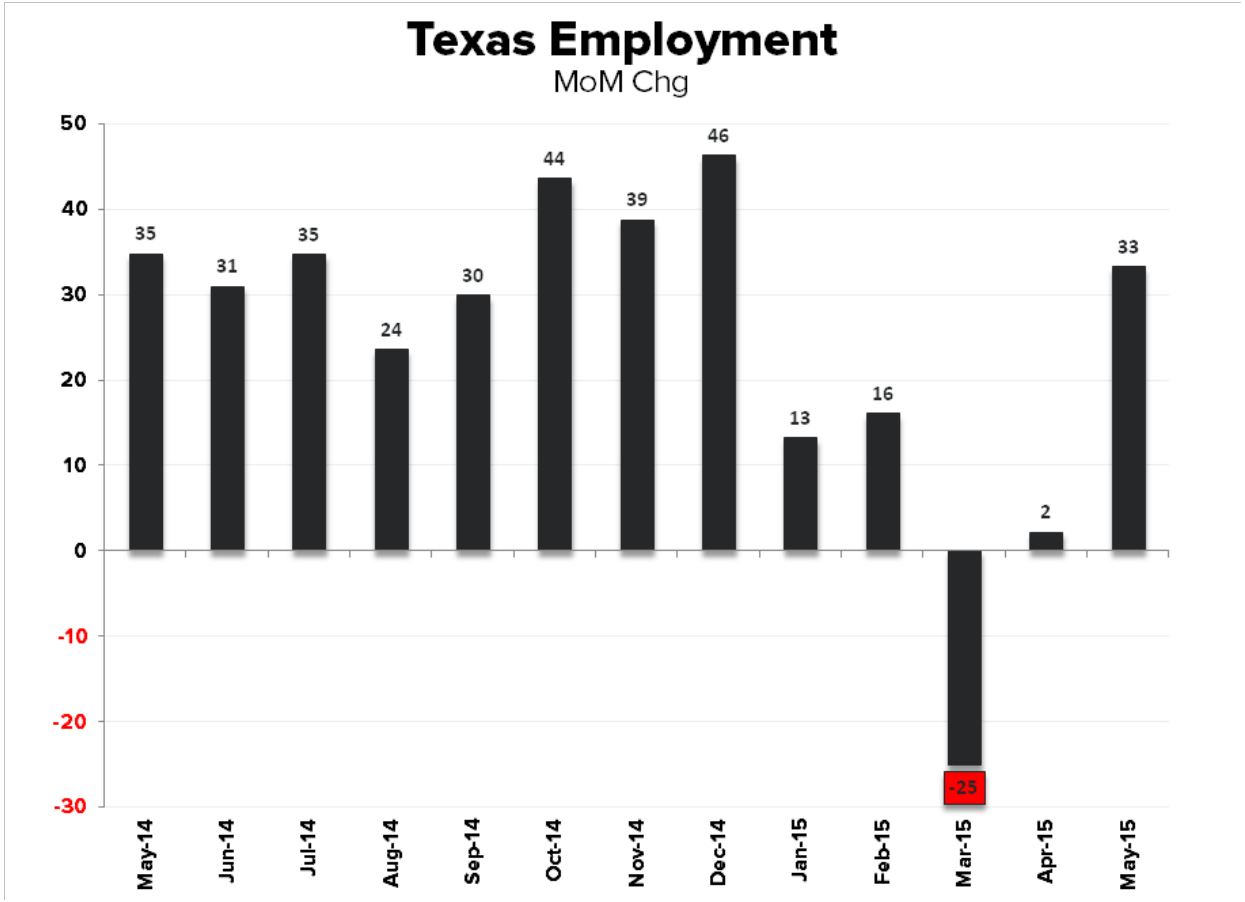
OIL & GAS EXTRACTION

Employment directly tied to oil extraction has declined in 6 of the last 8 months with growth declining -2.2% in June.

OIL INDUSTRY EMPLOYMENT

Broader Oil Industry Employment has declined in each of the last 7 months.

NET IMPACT IN TX = MARCH HICCUP

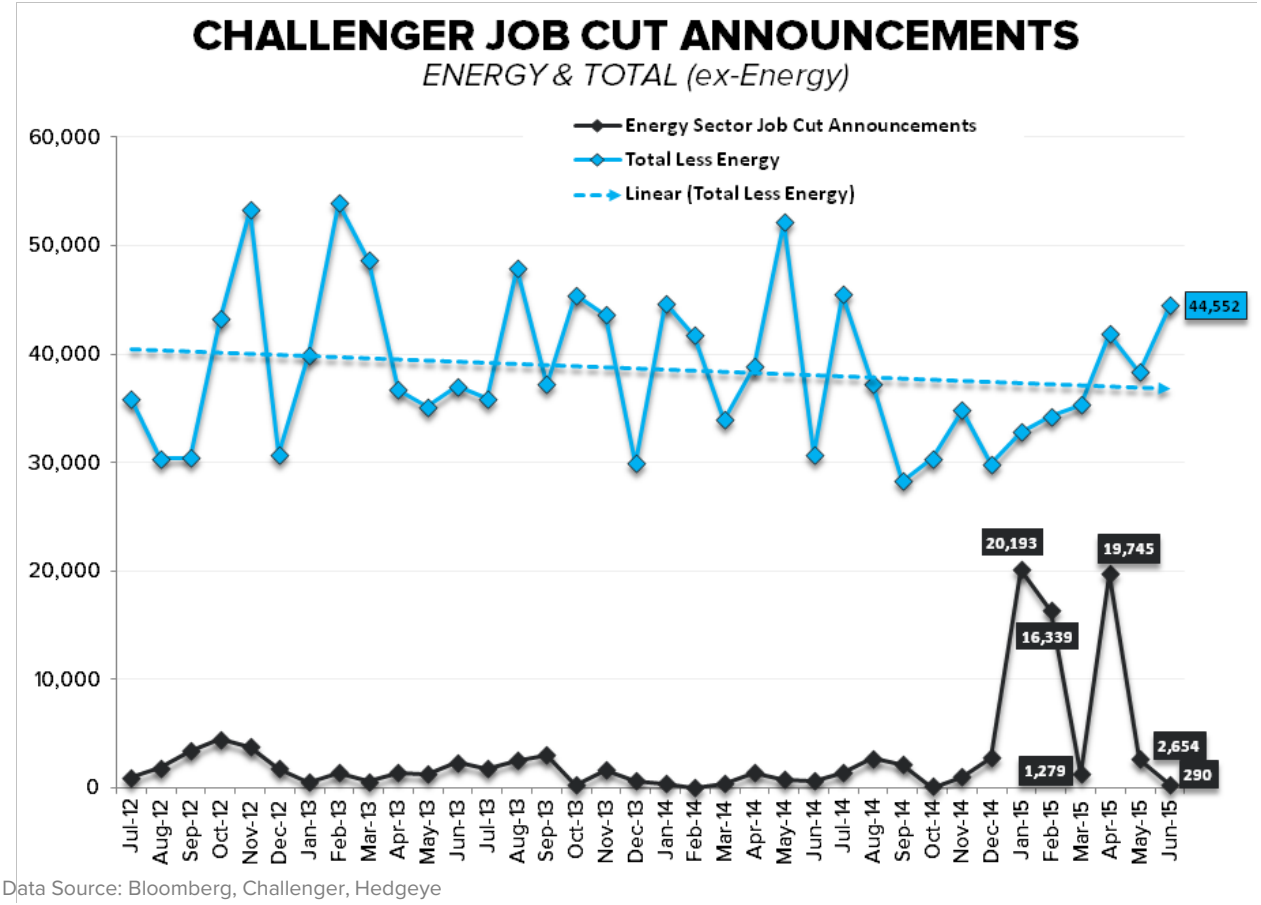


NFP employment gains in Texas slowed to start the year, but went negative in just a single month.

While the -25K drop in March was sizeable (equivalent to an NFP print of -305K at the National level) the weakness saw no follow through in Apr/May.

Data source: BLS, Hedgeye

JOB CUTS APPEAR TO BE PAST PEAK

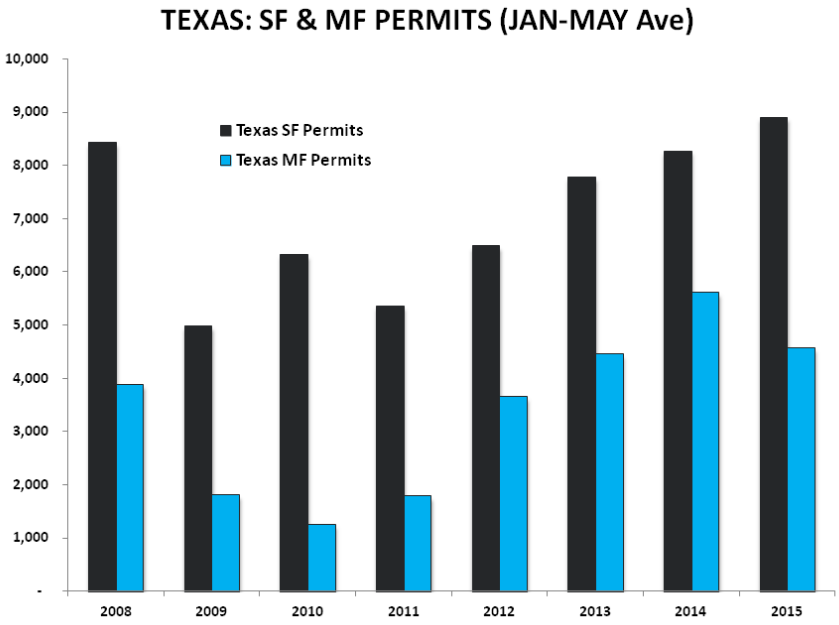


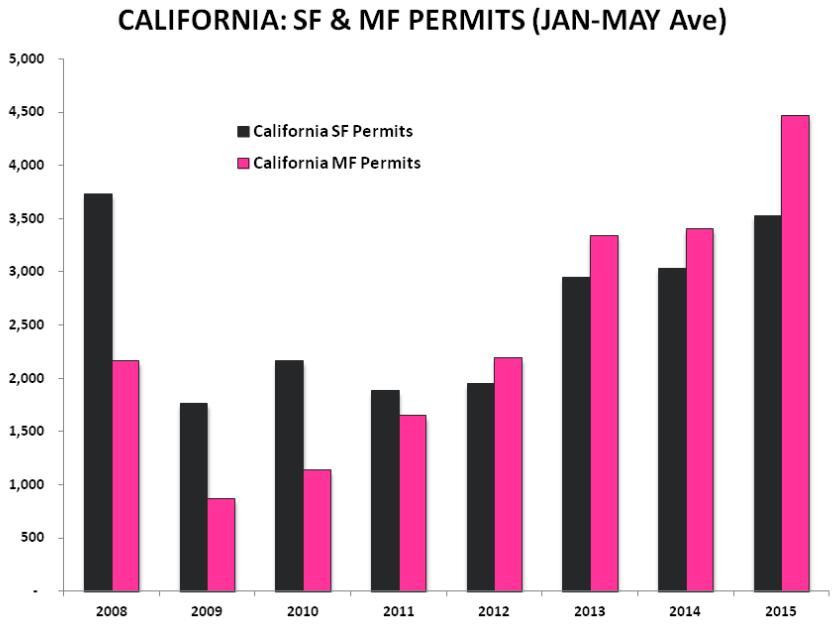
Data Source: Bloomberg, Challenger, Hedgeye

Energy Sector Job loss announcements fell to a 7-month low in June.

Data source: Challenger

YTD DATA SAYS … NON-EVENTS





TEXAS

SF permits are off small relative to 2014 but MF is up relative to last year and relative to the trend nationally

CALIFORNIA

Both SF and MF permit growth remains strong with no discernable dislocation from recent yr/qtr trends.

"TRID": WHO, WHAT, WHY, …

Overview of New "TRID" Disclosure Requirements

- **WHAT HAPPENED?** TILA-RESPA INTEGRATED DISCLOSURE – "TRID" – Integrates and replaces the mortgage disclosures consumers receive under the Truth in Lending ACT (TILA) and the Real Estate Settlement Procedures ACT (RESPA).

- **BACKGROUND:**
  - The Dodd-Frank Act transferred authority over TILA and RESPA, formerly administered by the Federal Reserve Board and HUD, respectively, to the CFPB and charged them integrating the rules and resolving any inconsistencies.
  - TRID replaces the current federal disclosure forms with two new forms:
    1. Loan Estimate: designed to provide disclosures that will be helpful to consumers in understanding the key features, costs, and risks of the mortgage loan. This form will be provided to consumers within three business days after they submit a mortgage loan application
    2. Closing Disclosure: designed to provide disclosures that will be helpful to consumers in understanding all of the costs of the transaction. This form will be provided to consumers three business days before they close on the mortgage loan.
    - Goal: Reduce paperwork, simplify and clarify language to improve consumer comprehension, make it easier for consumers to locate key information (rates/mo. Pmt/costs to close) and compare the cost of different loan offers.

- **WHEN?** TRID will cover transactions for which a lender receives an application on or after **August 1, 2015**

- **THE ISSUE:** The new disclosures are 1,888 pages long, contain 400 regulatory citation changes and require changes to lenders/servicers/title companies internal operations and procedures as well as changes to technology platforms (loan origination systems & software) used by all settlement parties.

- **THE (Industry) HOPE:** Stakeholders continue to push for a five-month restrained enforcement period so that new business processes can be adjusted to comply with these regulations.

TRID's implementation date, which had been scheduled for August 1st, was recently delayed by 2 months to October 3rd.

DATA SOURCE: CFPB, HRM

TRID: SPEED BUMP OR SPIKE STRIP?

"2015 will bring the most significant changes in industry's history with the implementation of the new CFPB regulations. These regulations which go into effect August 2015 are not only adding some regulatory costs and one-time implementation expenses this year, but they all have the potential to cause temporary operational delays across the industry later in 2015."

- Matthew Morris, CEO, Stewart Title, 2/12/15

"People will have had close to two years to get ready for this. Nobody should be surprised by this."

- Richard Cordray, CFPB Director, 3/3/15

"We have no plans to delay the deadline on the new mortgage disclosure forms. The industry should be prepared to begin using the new forms for loans with an initial application submitted on or after August 1."

- Sam Gilford, spokesperson for the Consumer Financial Protection Bureau, 3/25/15

MANAGING EXPECTATIONS

There are two components to TRID that matter. First, there's the back-office integration issues. **Second, there's the 3-day rule, which may prove to be the trickier element for parties to manage.**

3. TOP IDEAS → “HIDING OUT”

2Q15 PERFORMANCE IN REVIEW

				Absolute Returns		Relative Returns	
Indices/ETFs:	**12/31/2014**	**3/31/2015**	**6/30/2015**	**1Q 2015**	**2Q 2015**	**1Q 2015**	**2Q 2015**
S&P 500	2,058.90	2,067.89	2,063.11	0.4%	-0.2%	0.0%	0.0%
XHB	34.12	36.86	36.62	8.0%	-0.7%	7.6%	-0.4%
ITB	25.88	28.23	27.45	9.1%	-2.8%	8.6%	-2.5%
S&P HOMEBUILDER SUBINDEX	648.92	719.62	686.55	10.9%	-4.6%	10.5%	-4.4%
Mortgage Insurers:							
MTG	9.32	9.63	11.38	3.3%	18.2%	2.9%	18.4%
ESNT	25.71	23.91	27.35	-7.0%	14.4%	-7.4%	14.6%
RDN	16.72	16.79	18.76	0.4%	11.7%	0.0%	12.0%
GNW	8.50	7.31	7.57	-14.0%	3.6%	-14.4%	3.8%
Average				**-4.3%**	**12.0%**	**-4.8%**	**12.2%**
Title Insurers:							
FAF	33.90	35.68	37.21	5.3%	4.3%	4.8%	4.5%
FNF	34.45	36.76	36.99	6.7%	0.6%	6.3%	0.9%
STC	37.04	40.64	39.80	9.7%	-2.1%	9.3%	-1.8%
Average:				**7.2%**	**0.9%**	**6.8%**	**1.2%**
Homebuilders:							
BZH	19.36	17.72	19.95	-8.5%	12.6%	-8.9%	12.8%
KBH	16.55	15.62	16.60	-5.6%	6.3%	-6.1%	6.5%
MDC	26.47	28.50	29.97	7.7%	5.2%	7.2%	5.4%
NVR	1,275.33	1,328.66	1,340.00	4.2%	0.9%	3.7%	1.1%
LEN	44.81	51.81	51.04	15.6%	-1.5%	15.2%	-1.3%
TOL	34.27	39.34	38.19	14.8%	-2.9%	14.4%	-2.7%
MTH	35.99	48.64	47.09	35.1%	-3.2%	34.7%	-3.0%
DHI	25.29	28.48	27.36	12.6%	-3.9%	12.2%	-3.7%
RYL	38.56	48.74	46.37	26.4%	-4.9%	26.0%	-4.6%
PHM	21.46	22.23	20.15	3.6%	-9.4%	3.2%	-9.1%
HOV	4.13	3.56	2.66	-13.8%	-25.3%	-14.2%	-25.0%
Average:				**8.4%**	**-2.4%**	**7.9%**	**-2.1%**
Home Improvement:							
HD	104.97	113.61	111.13	8.2%	-2.2%	7.8%	-2.0%
LOW	68.80	74.39	66.97	8.1%	-10.0%	7.7%	-9.7%
Average:				**8.2%**	**-6.1%**	**7.7%**	**-5.8%**

Source: Factset

Mortgage Insurance stocks were very strong, handily beating the market. Title insurers also outperformed. Builders were mixed and narrowly underperformed, though KBH & BZH were our favorite two names.

TOP IDEAS: "HIDING OUT" FOR 3Q15

1

TITLE INSURERS ➔ OUR FAVORITE 3Q 2015 IDEA

The title insurers are a more defensive play on housing trend inflections. They've demonstrated a tendency to go sideways in slowing environments but move up sharply in favorable environments. **STC**, FAF, FNF
(Group Beta: Title vs S&P 500 ➔ 0.83 / Title vs XHB ➔ 0.52)

2

MORTGAGE INSURERS

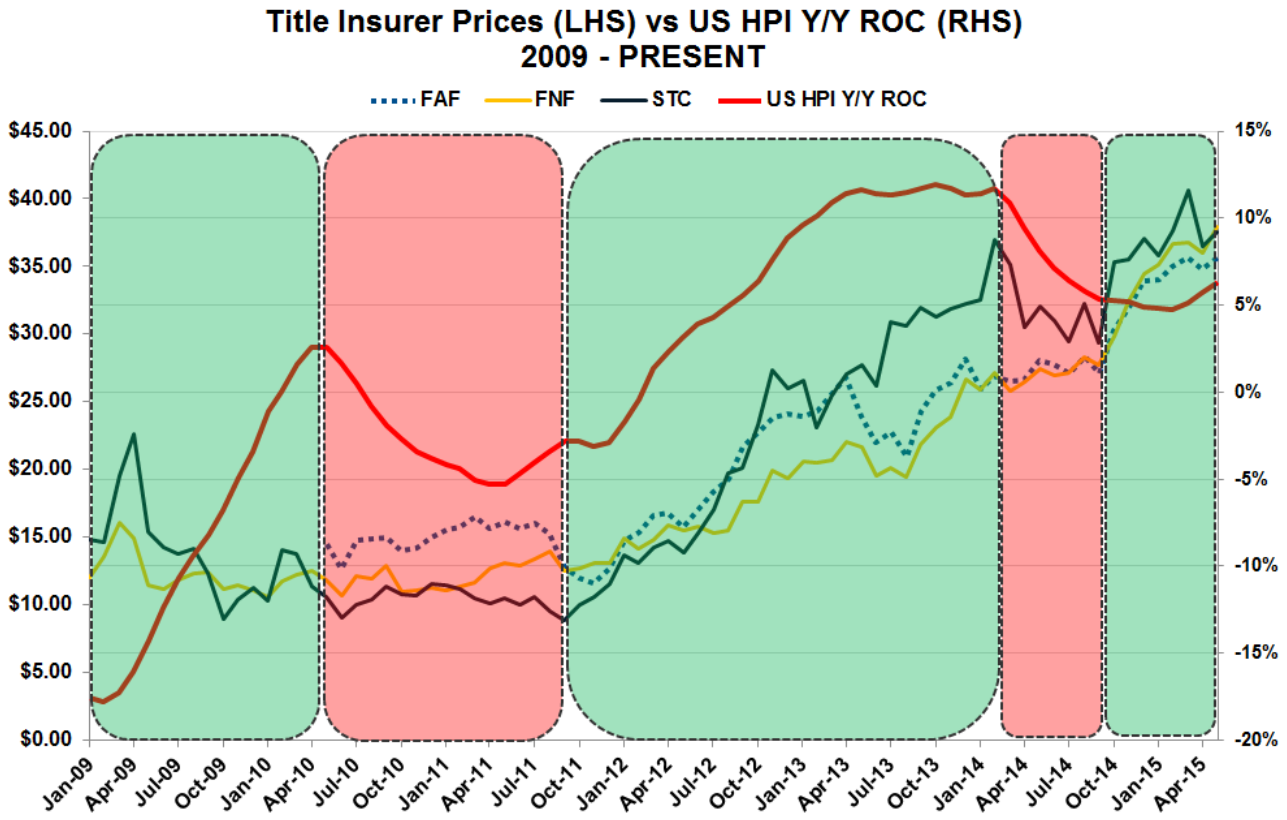
The mortgage insurers have historically been one of the higher beta categories to play inflections in housing trends. **ESNT**, RDN, MTG, GNW
(Group Beta: MI vs S&P 500 ➔ 1.01 / MI vs XHB ➔ 0.58)

3

HOMEBUILDERS & HOME IMPROVEMENT RETAILERS

The builders have historically performed poorly in the third quarter, while home improvement retailers have fared slightly better. We're rotating within the group away from higher beta toward more defensive names.
TOL, NVR, BZH, KBH, MTH, RYL, DHI, HOV, PHM, LEN, MDC, HD, LOW
(GROUP BETA: S&P 500 ➔ 1.14 / XHB ➔ 1.19)

TITLE INSURERS → DEFENSE



DATA SOURCE: CORELOGIC, FACTSET

Title insurers have had a very strong correlation to home price trends over the last five years. Interestingly, they go sideways in tough periods and up when the environment improves.

TITLE INSURER PERFORMANCE

				Absolute Returns		Relative Returns	
Indices/ETFs:	**12/31/2014**	**3/31/2015**	**6/30/2015**	**1Q 2015**	**2Q 2015**	**1Q 2015**	**2Q 2015**
S&P 500	2,058.90	2,067.89	2,063.11	0.4%	-0.2%	0.0%	0.0%
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Title Insurers:							
FAF	33.90	35.68	37.21	5.3%	4.3%	4.8%	4.5%
FNF	34.45	36.76	36.99	6.7%	0.6%	6.3%	0.9%
STC	37.04	40.64	39.80	9.7%	-2.1%	9.3%	-1.8%
Average:				**7.2%**	**0.9%**	**6.8%**	**1.2%**

Source: Factset

The title insurers have fared well on the back of the bullish setup in housing. We remain bullish on this group, as the outlook for further upside to demand and acceleration in HPI are direct benefits.

TITLE INSURER PERFORMANCE

Absolute Returns by Title Co Per Calendar Quarter (2010-2014)

	FAF	FNF	STC	Overall	S&P 500	Relative
1Q:	3%	2%	3%	3%	2%	1%
2Q:	-1%	0%	-3%	-1%	-1%	-1%
3Q:	2%	3%	4%	3%	0%	3%
4Q:	3%	3%	6%	4%	2%	2%

Relative Returns

	FAF	FNF	STC	Overall
1Q:	1%	0%	1%	1%
2Q:	0%	1%	-2%	-1%
3Q:	2%	2%	3%	3%
4Q:	1%	1%	3%	2%

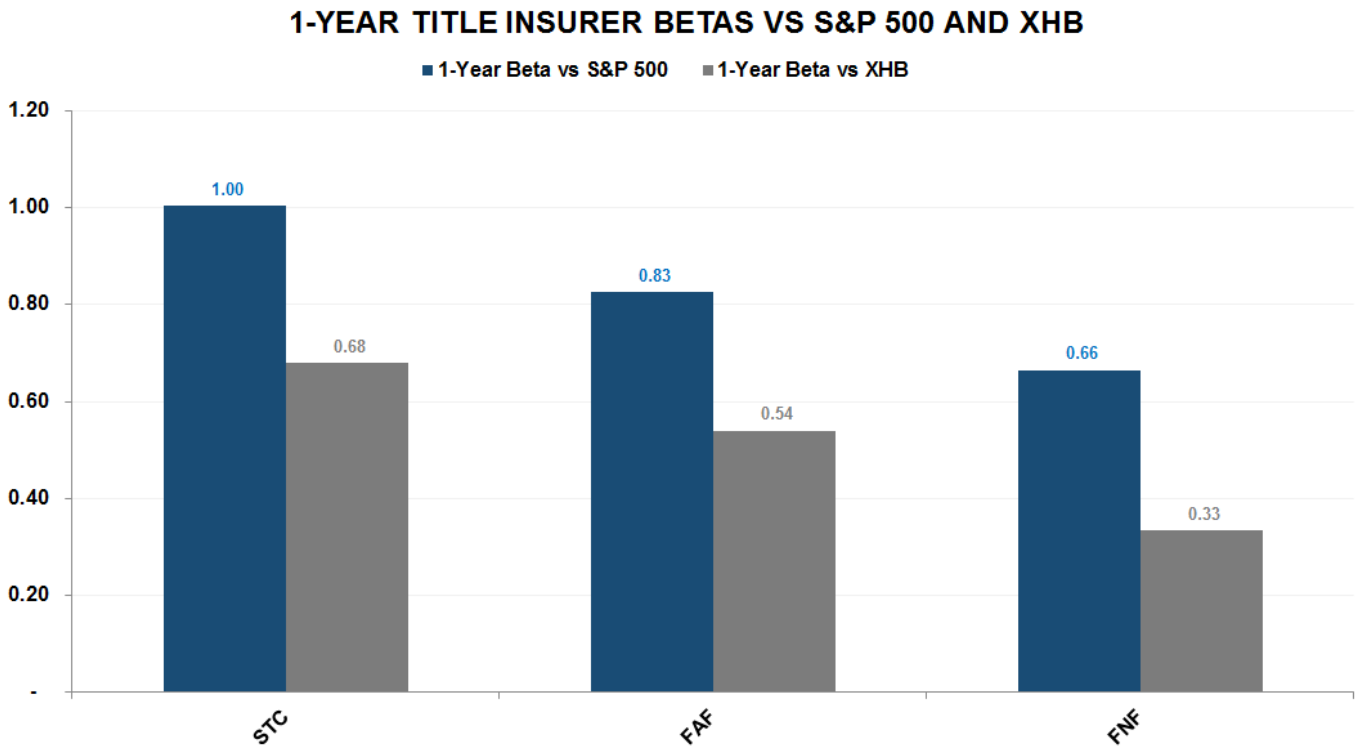
3Q Absolute By Company By Year

	FAF	FNF	STC	Overall
2010	6%	7%	8%	7%
2011	-6%	-1%	-4%	-4%
2012	9%	4%	10%	7%
2013	4%	4%	7%	5%
2014	-1%	1%	-2%	0%
Average	2%	3%	4%	3%
Median	4%	4%	7%	5%
STDEV	6%	3%	6%	5%

Source: Factset (Monthly Return Averages)

Title insurers usually outperform the market and generate positive absolute returns in the third quarter. 2013 was a good comp, following a sharp rise in rates. Stewart was the best performer.

TITLE INSURER TAILWINDS: STC



DATA SOURCE: FACTSET

Stewart benefits from having ~2/3 of its business tethered to the purchase market, which is where our call is focused.

TITLE INSURER TAILWINDS: STC

Performance Summary Table
Insider Buying As Buy Signal

	3-Mo	6-Mo	12-Mo
Average Absolute Return	6.1%	10.3%	15.8%
Average Absolute Batting Average	49.4%	44.7%	42.8%
Number of Observations	3,790	3,790	3,790

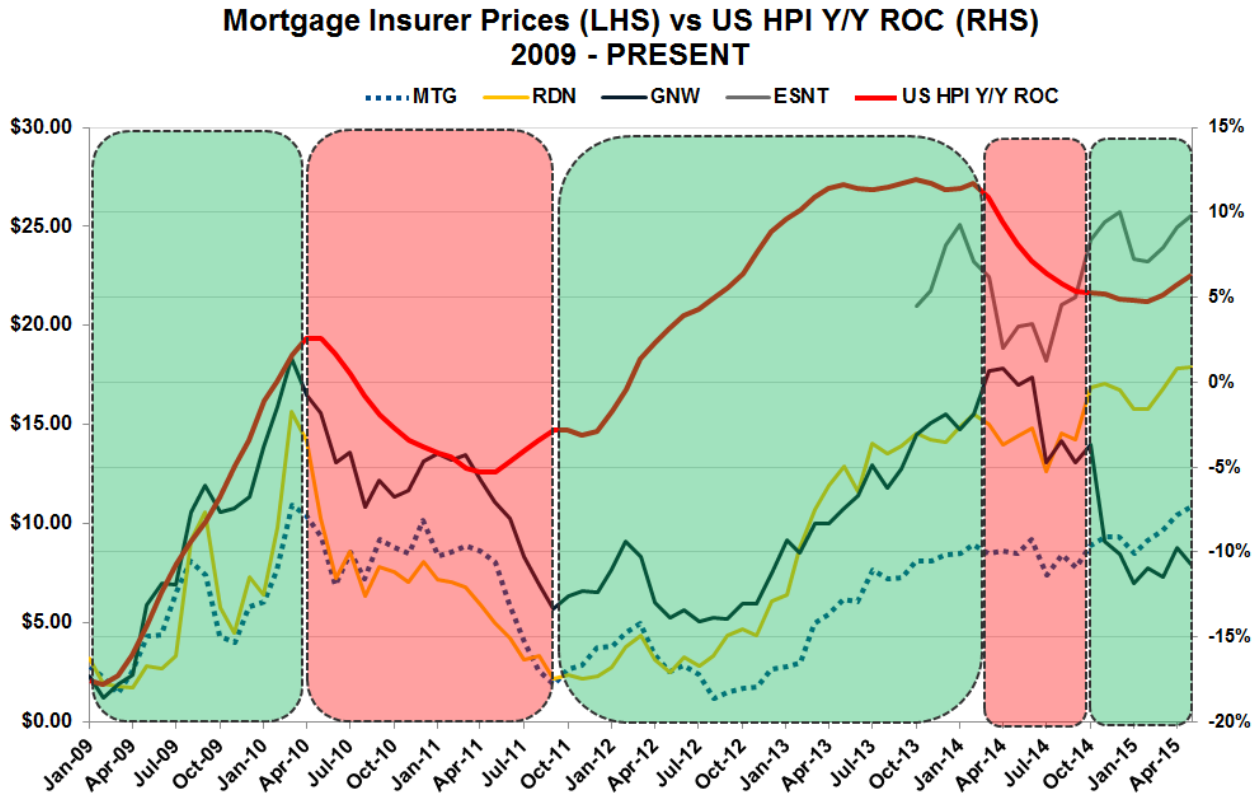
Source: Hedgeye Risk Management

Stewart also has seen multiple insider purchases over the last 12 months.

James Michael Chadwick, a Director, bought 30k shares ($1.1mn) in an open market purchase on 6/10/15 at $38.10.

DATA SOURCE: FACTSET, HRM

MORTGAGE INSURERS → MIXED



DATA SOURCE: CORELOGIC, FACTSET

The mortgage insurers have been some of the highest beta names relative to housing and home price trends over the past five years.

This has been a blessing YTD and in the second quarter.

MORTGAGE INSURER PERFORMANCE

				Absolute Returns		Relative Returns	
Indices/ETFs:	**12/31/2014**	**3/31/2015**	**6/30/2015**	**1Q 2015**	**2Q 2015**	**1Q 2015**	**2Q 2015**
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ITB	25.88	28.23	27.45	9.1%	-2.8%	8.6%	-2.5%
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ESNT	25.71	23.91	27.35	-7.0%	14.4%	-7.4%	14.6%
RDN	16.72	16.79	18.76	0.4%	11.7%	0.0%	12.0%
GNW	8.50	7.31	7.57	-14.0%	3.6%	-14.4%	3.8%
Average				**-4.3%**	**12.0%**	**-4.8%**	**12.2%**

Source: Factset

The mortgage insurers underperformed in 1Q15, but roared back in 2Q15, outperforming just about everything in sight.

MORTGAGE INSURER PERFORMANCE

Absolute Returns by MI Per Calendar Quarter (2010-2014)

	MTG	RDN	GNW	Overall	S&P 500	Relative
1Q:	8%	15%	9%	11%	2%	8%
2Q:	-4%	-8%	-5%	-6%	-1%	-5%
3Q:	-6%	1%	-5%	-3%	0%	-4%
4Q:	13%	5%	3%	7%	2%	5%

Relative Returns

	MTG	RDN	GNW	Overall
1Q:	6%	13%	6%	8%
2Q:	-4%	-7%	-5%	-5%
3Q:	-6%	1%	-5%	-4%
4Q:	11%	3%	1%	5%

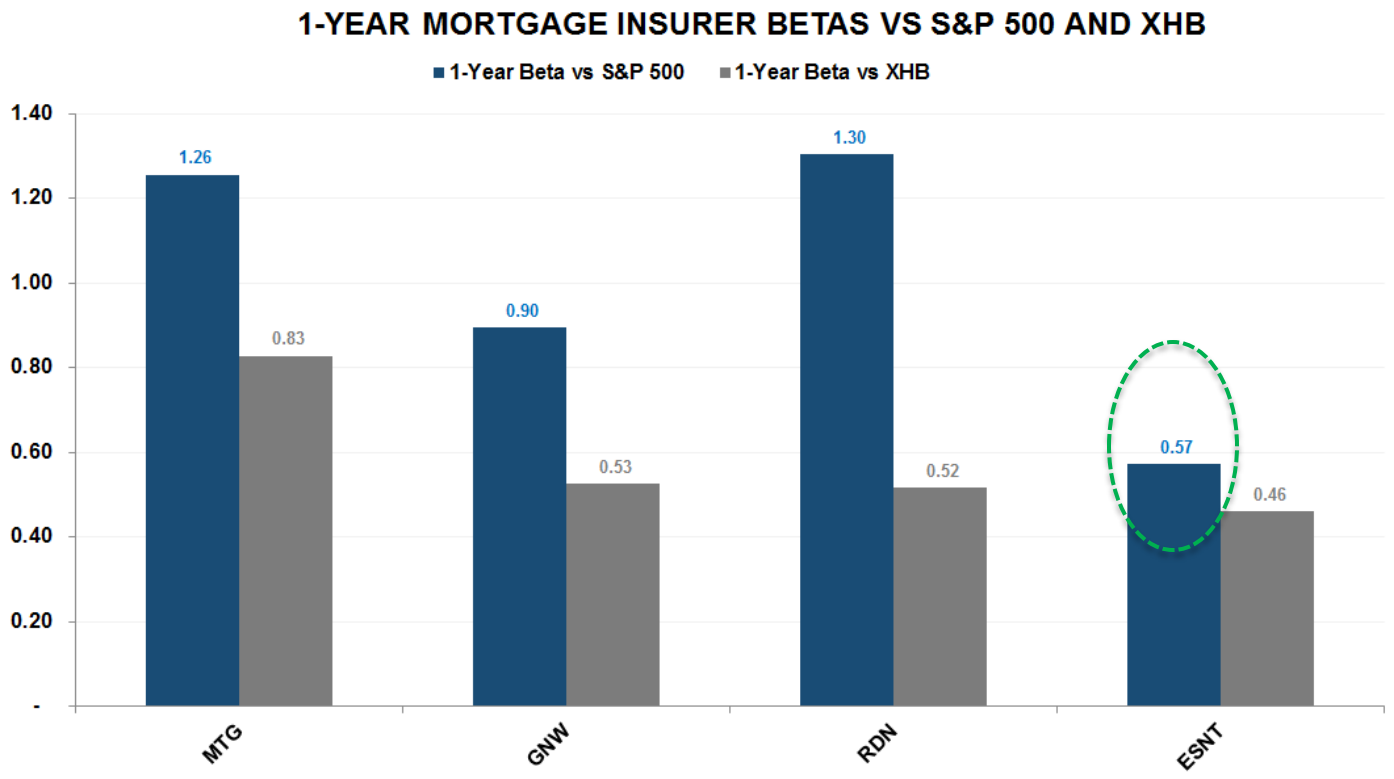
3Q Absolute By Company By Year

	MTG	RDN	GNW	Overall
2010	12%	5%	-1%	5%
2011	-32%	-18%	-18%	-23%
2012	-13%	11%	-2%	-1%
2013	7%	7%	4%	6%
2014	-4%	-1%	-8%	-4%
Average	-6%	1%	-5%	-3%
Median	-4%	5%	-2%	-1%
STDEV	17%	11%	8%	12%

Source: Factset (Monthly Return Averages)

Historically the MI stocks have underperformed in 3Q, but this is based on the average from 2010-2014 and is heavily impacted by one terrible year, 2011. 2013, which is arguably the best comp, saw solid 3Q performance from the group.

MORTGAGE INSURERS: ESNT



DATA SOURCE: FACTSET

We'll make the same argument here that we made before; namely, if you're looking for relative outperformers from an improving housing tape this is where to begin.

MORTGAGE INSURER: ESNT

Performance Summary Table
Insider Buying As Bullish Signal

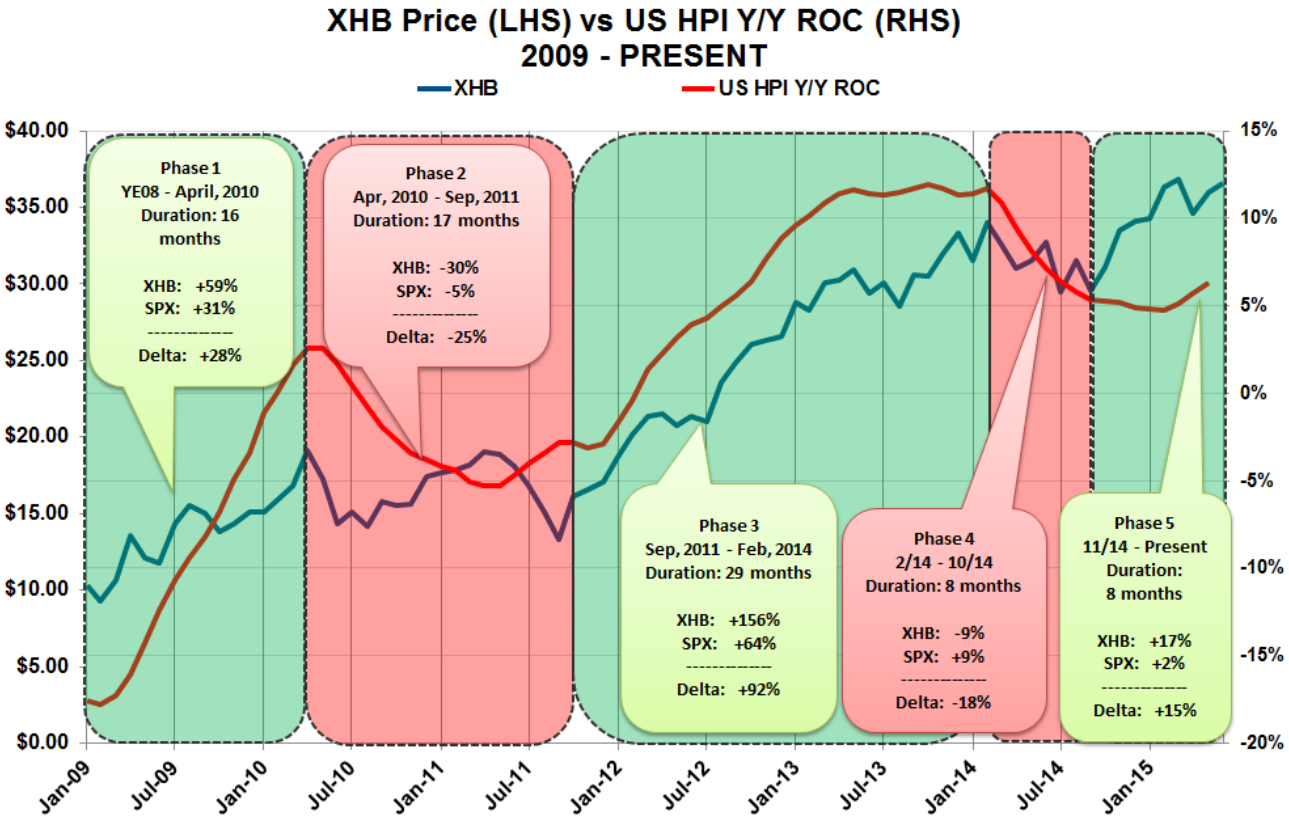
	3-Mo	6-Mo	12-Mo
Average Absolute Return	6.1%	10.3%	15.8%
Average Absolute Batting Average	49.4%	44.7%	42.8%
Number of Observations	3,790	3,790	3,790

Source: Hedgeye Risk Management

Essent has seen some recent insider buying.

DATA SOURCE: FACTSET, HRM

HOMEBUILDERS HEADWINDS



DATA SOURCE: CORELOGIC, FACTSET

Homebuilders exhibit a very strong correlation to the slope of home prices. Our call for a stabilization/ + inflection in HPI makes builders a prime beneficiary.

BUILDER PERFORMANCE

				Absolute Returns		Relative Returns	
Indices/ETFs:	**12/31/2014**	**3/31/2015**	**6/30/2015**	**1Q 2015**	**2Q 2015**	**1Q 2015**	**2Q 2015**
S&P 500	2,058.90	2,067.89	2,063.11	0.4%	-0.2%	0.0%	0.0%
XHB	34.12	36.86	36.62	8.0%	-0.7%	7.6%	-0.4%
ITB	25.88	28.23	27.45	9.1%	-2.8%	8.6%	-2.5%
S&P HOMEBUILDER SUBINDEX	648.92	719.62	686.55	10.9%	-4.6%	10.5%	-4.4%
Homebuilders:							
BZH	19.36	17.72	19.95	-8.5%	12.6%	-8.9%	12.8%
KBH	16.55	15.62	16.60	-5.6%	6.3%	-6.1%	6.5%
MDC	26.47	28.50	29.97	7.7%	5.2%	7.2%	5.4%
NVR	1,275.33	1,328.66	1,340.00	4.2%	0.9%	3.7%	1.1%
LEN	44.81	51.81	51.04	15.6%	-1.5%	15.2%	-1.3%
TOL	34.27	39.34	38.19	14.8%	-2.9%	14.4%	-2.7%
MTH	35.99	48.64	47.09	35.1%	-3.2%	34.7%	-3.0%
DHI	25.29	28.48	27.36	12.6%	-3.9%	12.2%	-3.7%
RYL	38.56	48.74	46.37	26.4%	-4.9%	26.0%	-4.6%
PHM	21.46	22.23	20.15	3.6%	-9.4%	3.2%	-9.1%
HOV	4.13	3.56	2.66	-13.8%	-25.3%	-14.2%	-25.0%
Average:				**8.4%**	**-2.4%**	**7.9%**	**-2.1%**
Home Improvement:							
HD	104.97	113.61	111.13	8.2%	-2.2%	7.8%	-2.0%
LOW	68.80	74.39	66.97	8.1%	-10.0%	7.7%	-9.7%
Average:				**8.2%**	**-6.1%**	**7.7%**	**-5.8%**

Source: Factset

The builders performed well since our call in mid-December last year, rising roughly 6x the market. That said, our preference for high beta (KBH & BZH) hasn't worked yet b/c of 4Q earnings and energy concerns.

BUILDER PERFORMANCE

Absolute Returns by Builder Per Calendar Quarter (2010-2014)

	BZH	KBH	MTH	RYL	DHI	HOV	PHM	LEN	TOL	MDC	NVR	Overall	S&P 500	Relative
1Q:	-1%	6%	3%	2%	4%	2%	4%	5%	2%	2%	3%	3%	2%	1%
2Q:	-1%	-3%	-1%	0%	0%	1%	0%	-1%	0%	0%	-1%	0%	-1%	0%
3Q:	-3%	-2%	-1%	-1%	-1%	-4%	-2%	-1%	-1%	-2%	-1%	-2%	0%	-2%
4Q:	9%	4%	5%	6%	5%	10%	7%	7%	4%	1%	4%	5%	2%	3%

Relative Returns by Builder Per Calendar Quarter (2010-2014)

	BZH	KBH	MTH	RYL	DHI	HOV	PHM	LEN	TOL	MDC	NVR	Overall
1Q:	-3%	3%	1%	0%	1%	-1%	1%	3%	0%	0%	1%	1%
2Q:	0%	-2%	0%	1%	1%	1%	1%	0%	1%	0%	0%	0%
3Q:	-4%	-2%	-2%	-2%	-2%	-5%	-3%	-1%	-2%	-3%	-2%	-2%
4Q:	7%	2%	3%	3%	3%	7%	4%	4%	2%	-1%	1%	3%

3Q Absolute By Company By Year

	BZH	KBH	MTH	RYL	DHI	HOV	PHM	LEN	TOL	MDC	NVR	Overall
2010	6%	1%	6%	4%	5%	4%	2%	4%	5%	3%	0%	4%
2011	-23%	-16%	-12%	-13%	-7%	-20%	-19%	-9%	-11%	-12%	-6%	-14%
2012	6%	15%	4%	6%	4%	8%	13%	4%	4%	6%	0%	6%
2013	1%	-2%	0%	1%	-3%	-2%	-4%	0%	0%	-2%	0%	-1%
2014	-5%	-7%	-5%	-4%	-5%	-10%	-4%	-2%	-5%	-5%	-1%	-6%
Average	-3%	-2%	-1%	-1%	-1%	-4%	-2%	-1%	-1%	-2%	-1%	-2%
Median	1%	-2%	0%	1%	-3%	-2%	-4%	0%	0%	-2%	0%	-1%
STDEV	12%	11%	7%	8%	5%	11%	12%	5%	7%	7%	3%	8%

Source: Factset (Monthly Return Averages)

The builders performed well since our call in mid-December last year, rising roughly 6x the market. That said, our preference for high beta (KBH & BZH) hasn't worked yet b/c of 4Q earnings and energy concerns.

HOME IMPROVEMENT PERFORMANCE

Absolute Returns by HI Per Calendar Quarter (2010-2014)

	HD	LOW	Overall	S&P 500	Relative
1Q:	3%	3%	3%	2%	0%
2Q:	1%	-2%	0%	-1%	0%
3Q:	2%	2%	2%	0%	1%
4Q:	4%	6%	5%	2%	3%

Relative Returns

	HD	LOW	Overall
1Q:	1%	0%	0%
2Q:	2%	-1%	0%
3Q:	1%	1%	1%
4Q:	2%	4%	3%

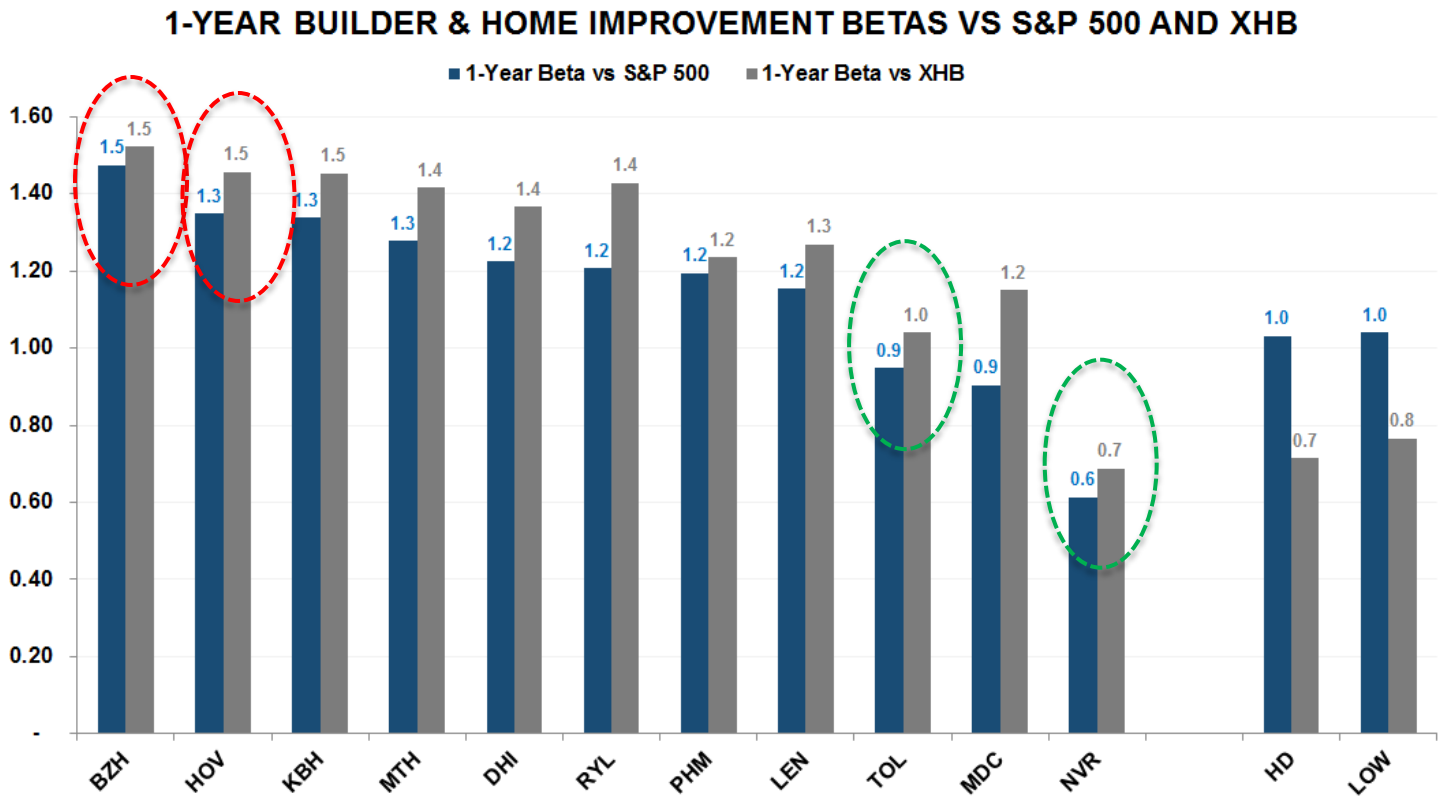
3Q Absolute By Company By Year

	HD	LOW	Overall
2010	4%	3%	2%
2011	-3%	-6%	-3%
2012	5%	3%	2%
2013	-1%	5%	2%
2014	5%	3%	3%
Average	2%	2%	1%
Median	4%	3%	2%
STDEV	4%	4%	2%

Source: Factset (Monthly Return Averages)

The builders performed well since our call in mid-December last year, rising roughly 6x the market. That said, our preference for high beta (KBH & BZH) hasn't worked yet b/c of 4Q earnings and energy concerns.

BUILDERS & HOME IMPROVEMENT



DATA SOURCE: FACTSET

The lower beta names within builders are a good place to look in 3Q15. After outperforming the group over the last quarter, we expect KBH & BZH to lag over the next 3mos.

HOMEBUILDERS: NVR

Performance Summary Table
Insider Buying As Buy Signal

	3-Mo	6-Mo	12-Mo
Average Absolute Return	6.1%	10.3%	15.8%
Average Absolute Batting Average	49.4%	44.7%	42.8%
Number of Observations	3,790	3,790	3,790

Source: Hedgeye Risk Management

We like NVR because it's lower beta and there's been recent insider buying YTD.

DATA SOURCE: FACTSET, HRM

HOMEBUILDER ASP'S

95) Peer Group BI North America Home Builder Valuation P... Curr USD Zoom 100%

	Name	Backlog ($)	Avg Backlog Price	Closings	Closings ($)	Avg Closing Price	Building GM	Community Count	# of Lots Controlled
	Median	915.20M	384.59k	1.36k	706.32M	369.00k	19.21	213.00	35.43k
	Average	1.11B	422.91k	2.33k	831.95M	400.52k	19.46	253.00	53.27k
100)	Toll Brothers Inc	2.74B	750.34k	1.09k	853.50M	782.30k	23.83	258.00	45.30k
101)	TRI Pointe Homes Inc	653.10M	632.84k	1.12k	622.96M	555.00k	20.06	108.00	29.72k
102)	William Lyon Homes	260.13M	544.20k	717.00	352.48M	491.60k	19.02	56.00	17.54k
103)	Standard Pacific Corp	916.38M	535.58k	1.48k	724.34M	491.00k	25.23	184.00	35.43k
104)	Taylor Morrison Home Corp	1.26B	486.78k	2.45k	1.12B	458.00k	19.41	233.00	38.85k
105)	MDC Holdings Inc	663.24M	436.63k	1.24k	493.07M	397.00k	16.46	166.00	2.42k
106)	Hovnanian Enterprises Inc	925.53M	385.80k	1.15k	433.47M	377.26k	15.54	199.00	36.77k
107)	NVR Inc	2.11B	384.59k	3.47k	1.31B	375.50k	18.06	483.00	68.70k
108)	Meritage Homes Corp	846.45M	400.40k	1.86k	688.29M	369.00k	20.33	229.00	30.30k
109)	KB Home	914.03M	314.21k	2.23k	783.46M	351.50k	17.31	227.00	52.20k
110)	Ryland Group Inc/The	919.00M	351.17k	2.49k	853.93M	351.00k	22.53	351.00	13.67k
111)	PulteGroup Inc	1.94B	332.28k	5.32k	1.78B	334.00k	23.07	598.00	130.79k
112)	Lennar Corp	1.97B	338.53k	6.95k	1.97B	329.00k	23.14	625.00	164.57k
113)	M/I Homes Inc	425.19M	347.94k	1.11k	355.36M	313.00k	17.78	149.00	20.73k
114)	Beazer Homes USA Inc	560.50M	316.49k	885.00	261.58M	295.60k	11.86	154.00	27.91k
115)	DR Horton Inc	2.73B	293.62k	7.97k	2.24B	281.04k	19.75	--	184.70k
116)	AV Homes Inc	85.75M	--	382.00	98.02M	257.00k	--	--	--

When positioning for defense, we think it makes sense to move upmarket.

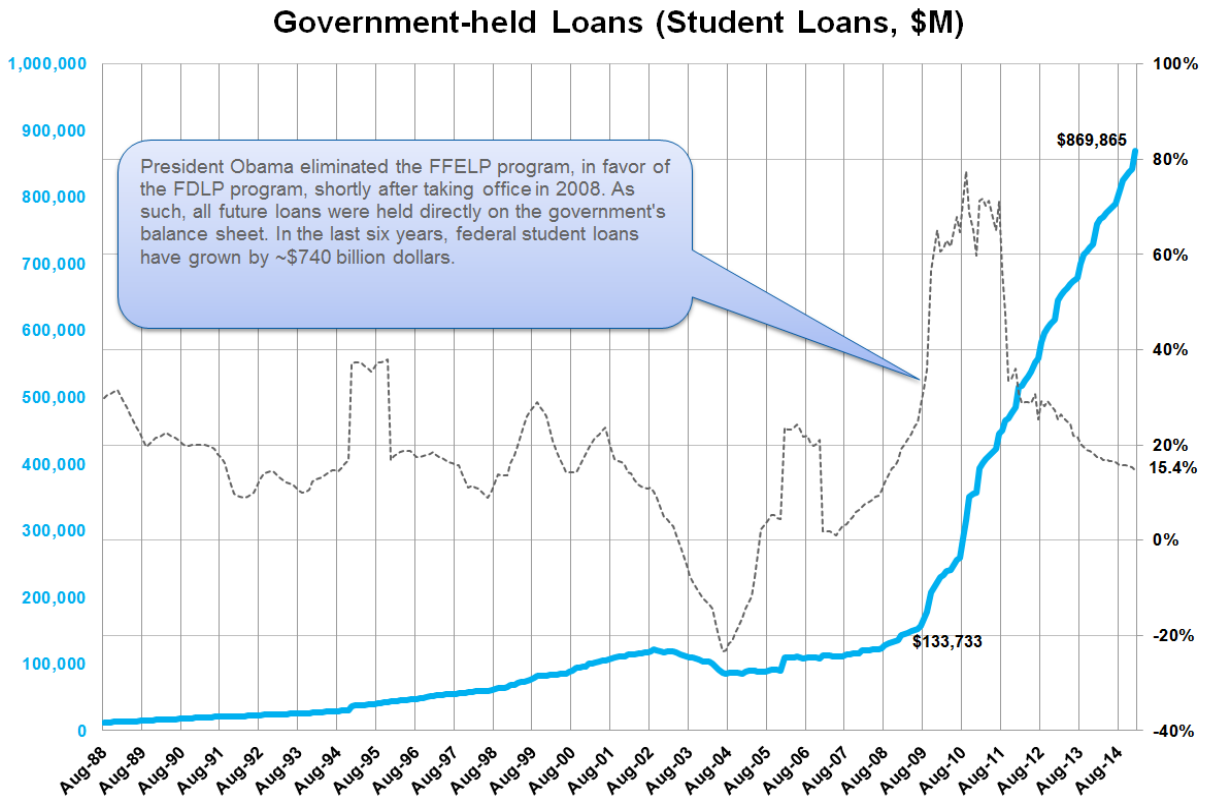
Data source: Bloomberg

APPENDIX

STUDENT LOAN HEADWINDS

Student loan debt is a major headwind to the recovery of housing. Much of what sounds like media hyperbole is, in fact, real.

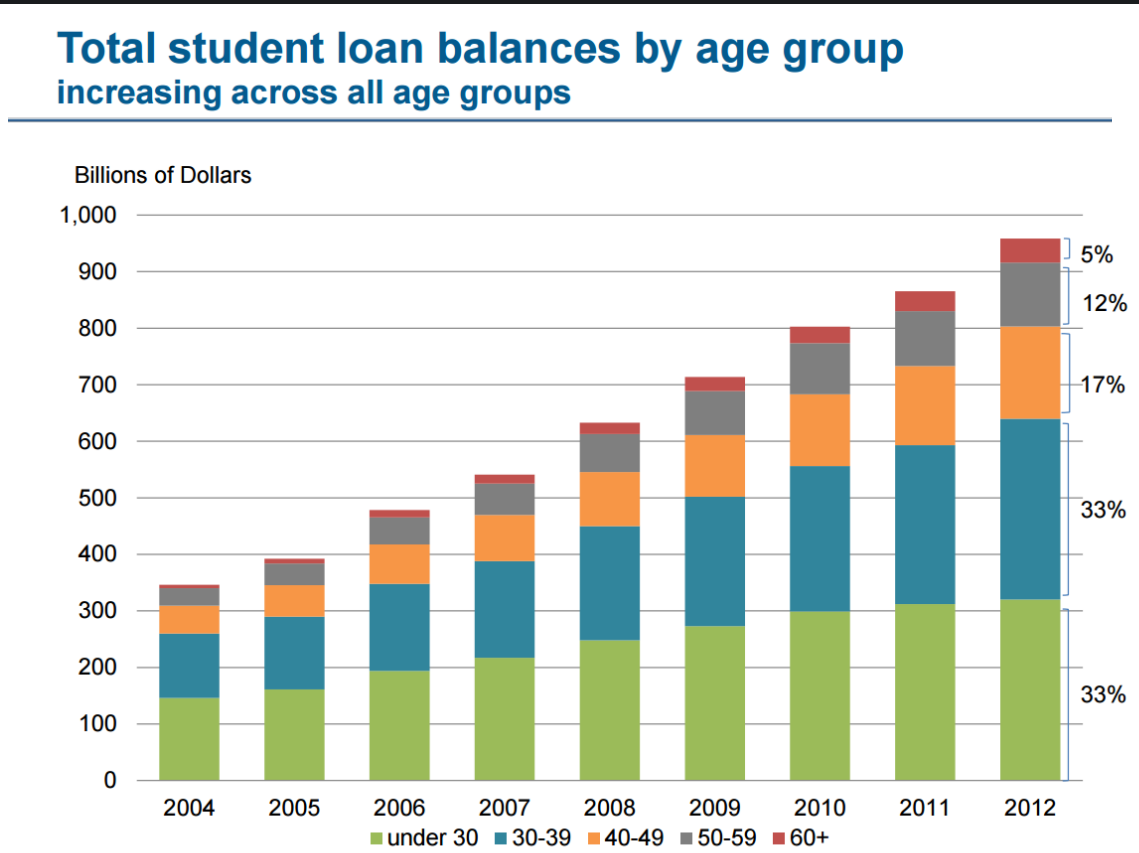
STUDENT DEBT: STRUCTURAL OVERHANG



Source: Federal Reserve

The meteoric ascent in student debt will remain a secular constraint to a sustained acceleration in purchase demand, particularly for 1st time buyers.

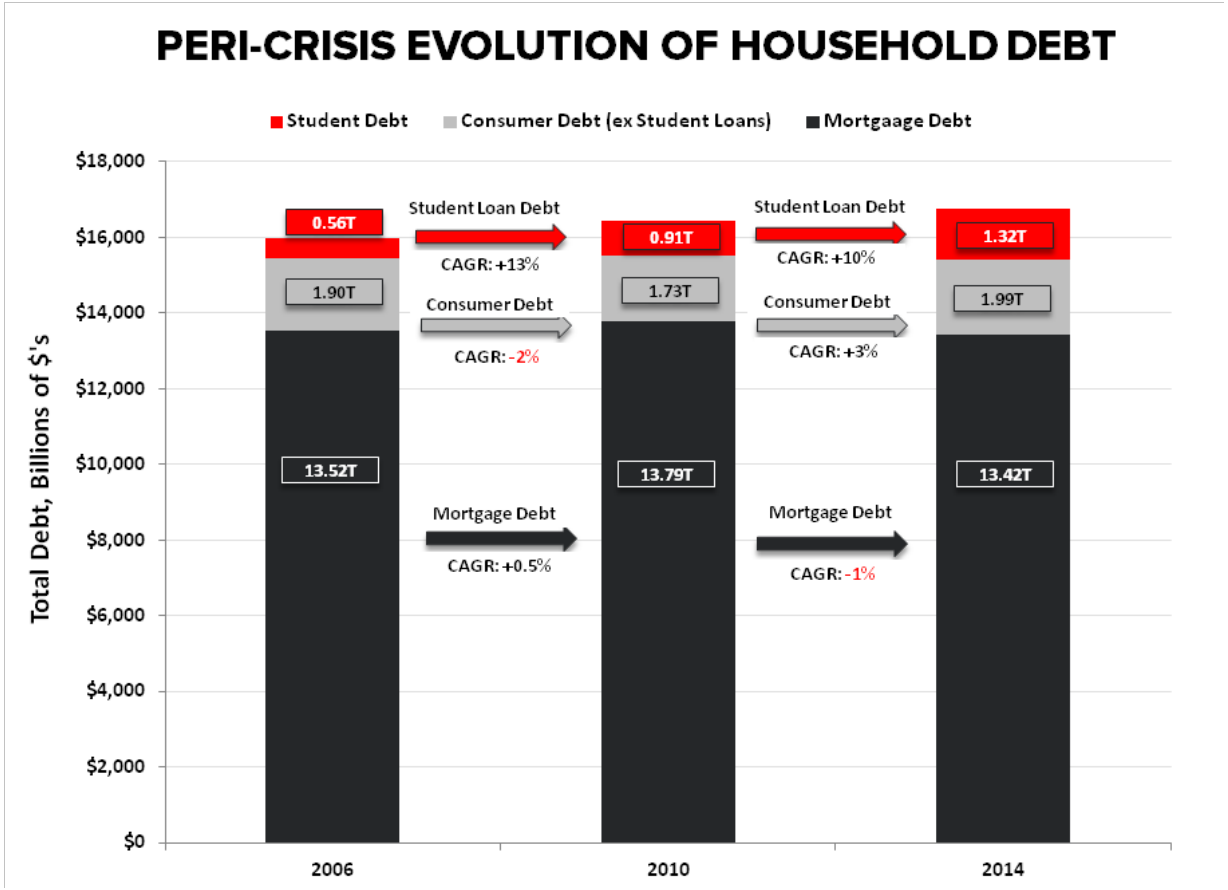
STUDENT DEBT: STRUCTURAL OVERHANG



Source: FRBNY Consumer Credit Panel / Equifax

Between 2004 and 2012, total US student loans almost tripled, growing from $364 billion to $966 billion. This works out to a ~14% CAGR over 8 years. Currently, total student loan debt stands at $1.32 trillion and is still growing at a mid-teens % rate.

STUDENT DEBT = $1.32T

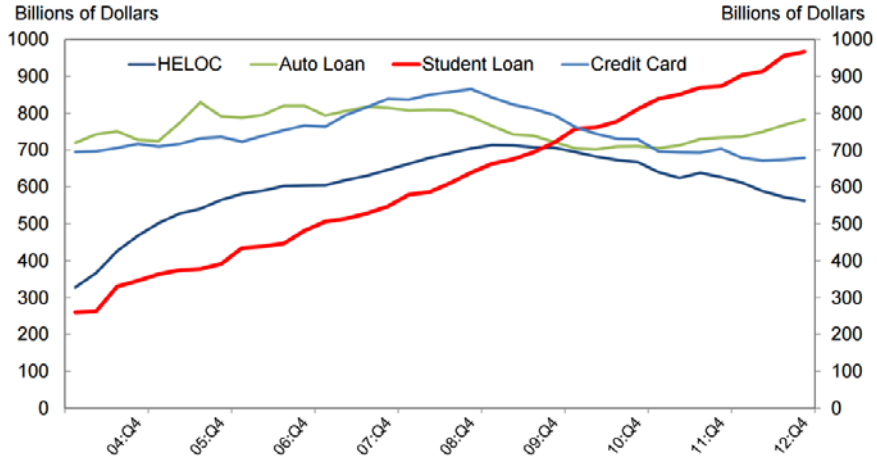


Student loan debt was the only major credit category to record positive growth in the peri-crisis period and now sits above credit card debt as the second largest category of household debt.

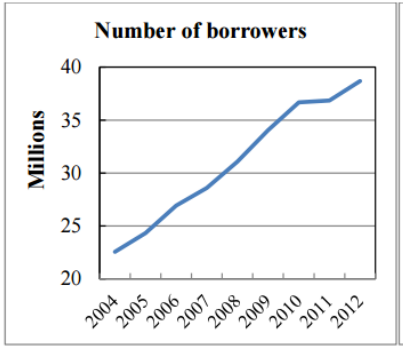
DATA SOURCE: BLOOMBERG, FEDERAL RESERVE, HRM

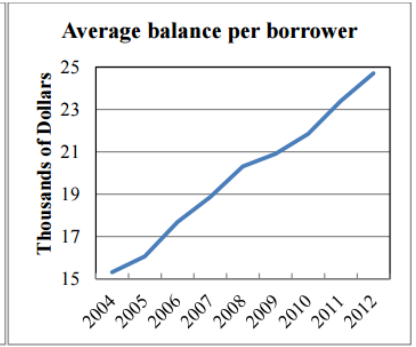
STUDENT DEBT: JUGGERNAUT

Non-mortgage balances



Source: FRBNY Consumer Credit Panel / Equifax

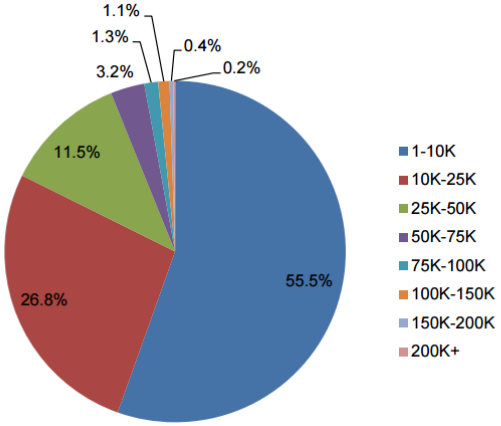




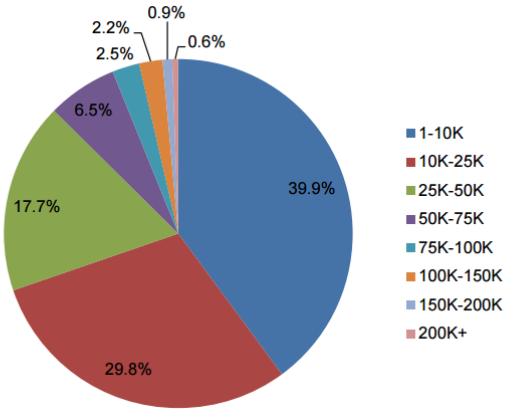
The 2004-2012 near tripling in student loans comes from both a 70% increase in borrowers (23mn → 39mn) and a 70% increase in average loan balances ($15k → $25k).

STUDENT DEBT: STRUCTURAL OVERHANG

Distribution of Student Debt balance, 4Q:2005



Distribution of Student Debt balance, 4Q:2012

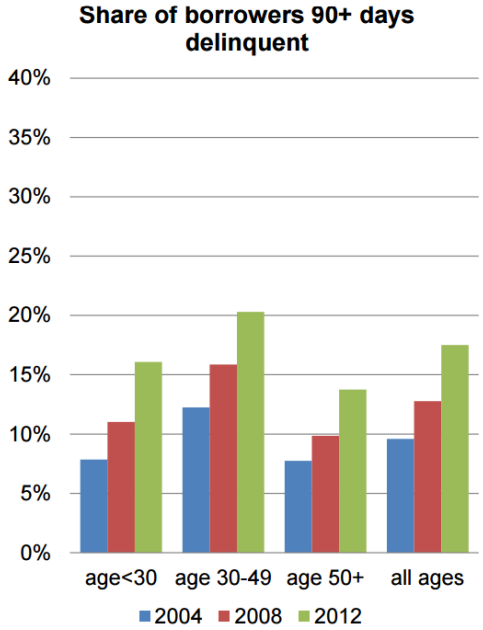


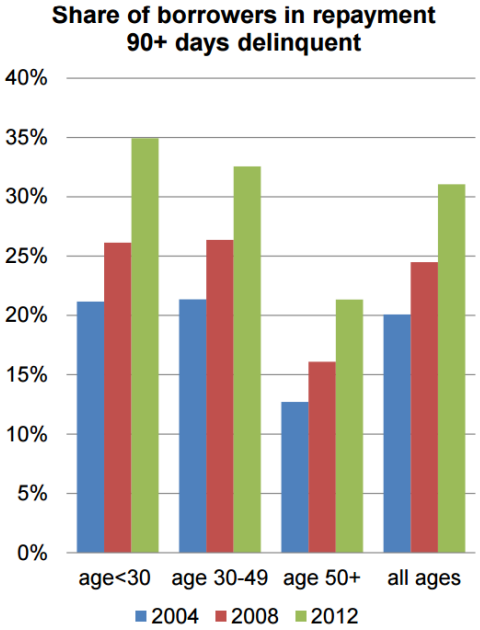
Source: FRBNY Consumer Credit Panel / Equifax

While student loans have become more common, there is still a lot of variation. 40% of borrowers owe less than $10k, while 70% of borrowers owe less than $25k. On the other end, just 12-13% owe $50k or more.

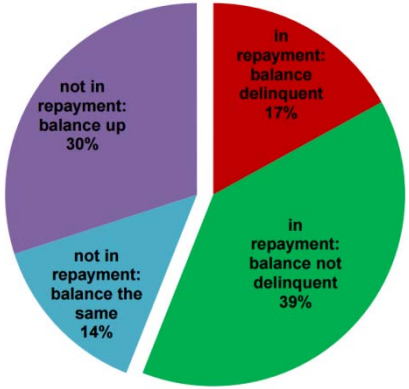
STUDENT DEBT: STRUCTURAL OVERHANG

Delinquency rates higher among borrowers in repayment





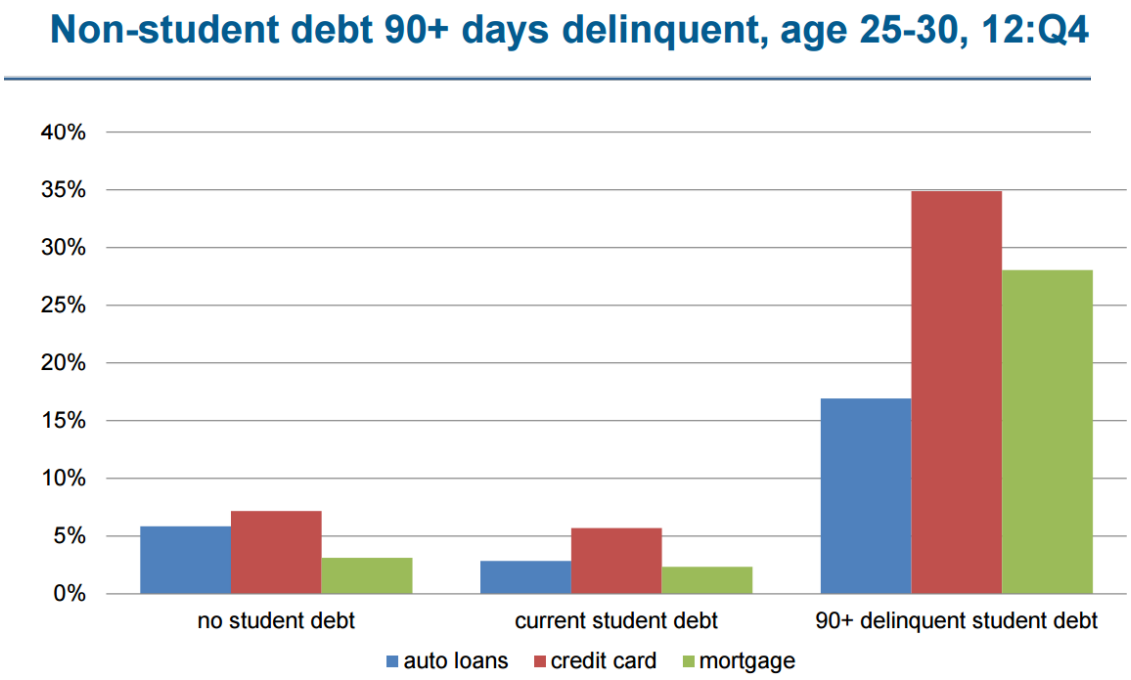
Source: FRBNY Consumer Credit Panel / Equifax



The delinquency rates on student loans are mind-boggling. 17% of borrowers are over 90 days late, but if you exclude the 44% of borrowers not in repayment, the actual DQ rate jumps to over 30%, and 35% for those under 30 years old.

Data source: FRBNY, Equifax

STUDENT DEBT: STRUCTURAL OVERHANG



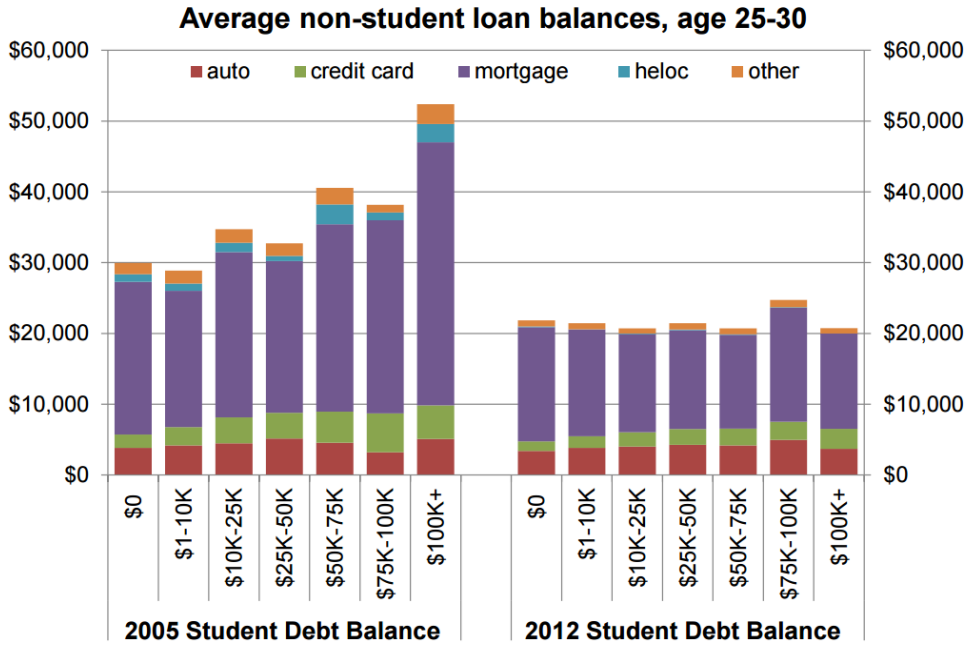
Source: FRBNY Consumer Credit Panel / Equifax

Not surprisingly, if a borrower is 90+ DQ on a student loan, they're very likely to be delinquent on other types of loans as well.

STUDENT DEBT: STRUCTURAL OVERHANG

Non-student debt declined for all borrowers age 25-30

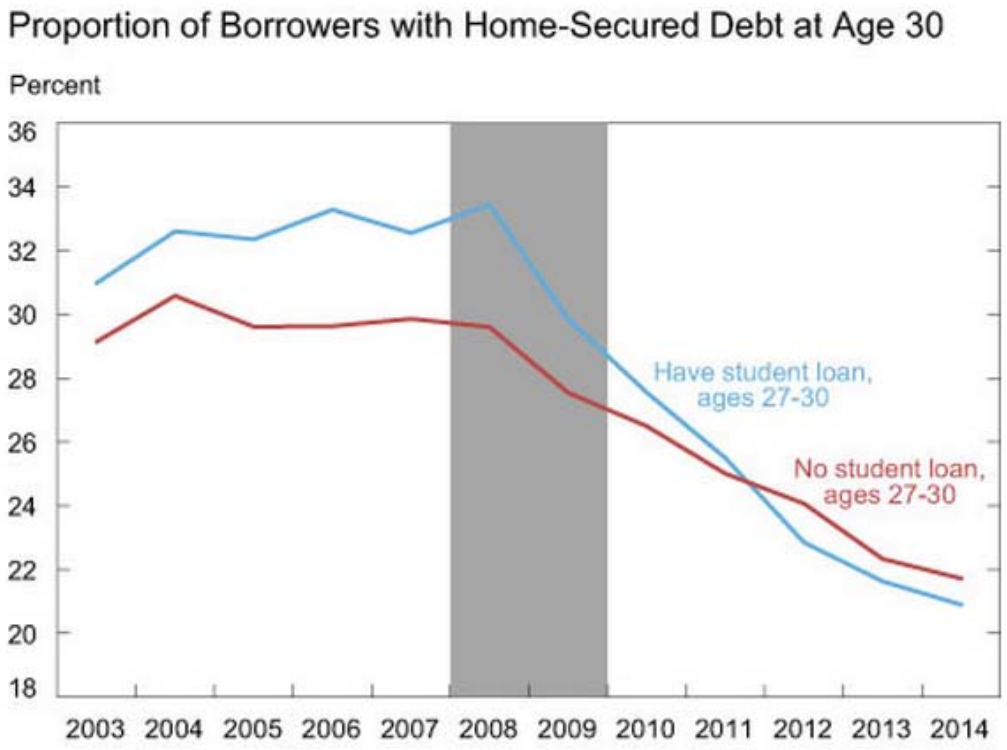
Decline particularly pronounced for borrowers with larger student debt



Source: FRBNY Consumer Credit Panel / Equifax

For all these reasons (higher % of borrowers with balances, higher balances per borrower, higher DQ rates and stricter underwriting rules), there has been an enormous decline in mortgage loans among those 25-30 years old.

STRUCTURAL IMPEDIMENT: STUDENT LOAN DEBT

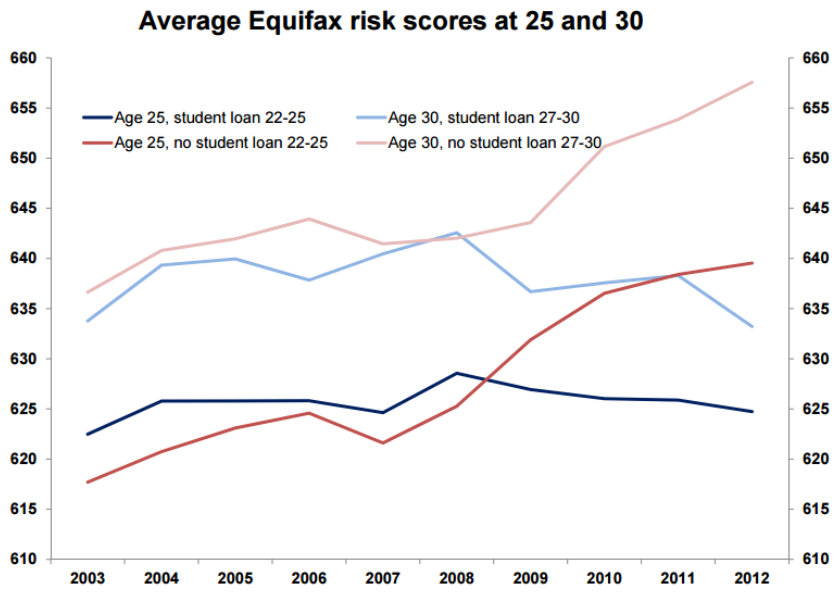


Source: Federal Reserve Bank of New York Consumer Credit Panel / Equifax.

Prior to the recession, those with student loans were more likely to be homeowners by ~3% vs those without student loans. Today, they're less likely by ~1%. Student loans have created a ~400 bps drag on the homeownership rate.

STUDENT DEBT: STRUCTURAL OVERHANG

Declining relative credit scores of student borrowers



Source: FRBNY Consumer Credit Panel / Equifax

One troubling aspect of the student loan dynamic is that it is preventing the upward migration in credit scores, on average, that are the norm for those without student loans. It is this upward migration that enables home ownership.

CREDIT IS EXPANDING

Credit expansion is a tailwind for housing that should benefit the sector across the short, intermediate and longer-term durations.

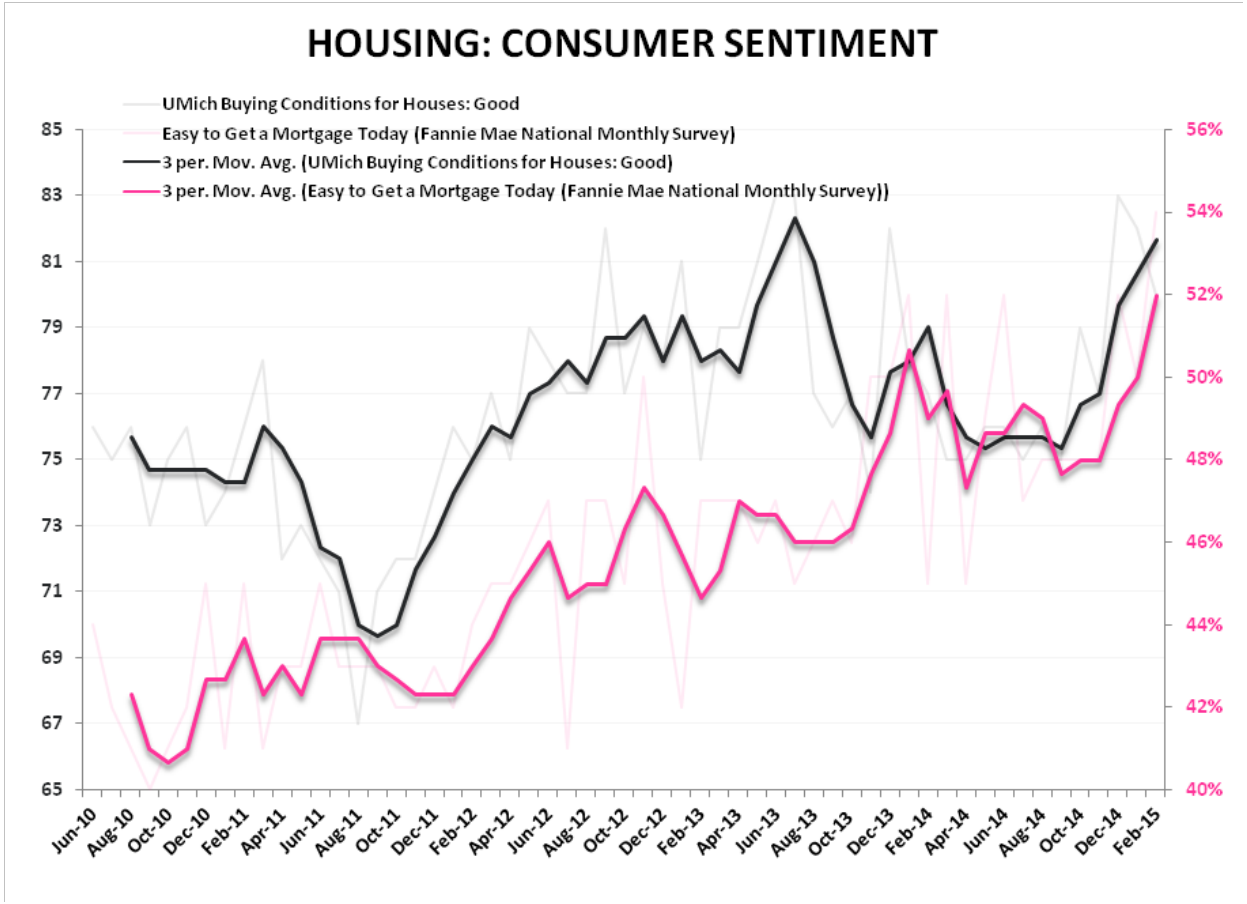
CREDIT IS EXPANDING

Senior Loan Officer Survey: Residential Mortgage Loans Standards Easing

In 1Q15 the senior loan officer survey changed the resi mortgage questionnaire substantially. Prior to 2007, only one questions was asked: "Are you tightening standards for Residential Mortgage Loans?" Then, beginning in 2Q07, the Fed began asking this question about three different loan categories: Prime, Nontraditional and Subprime. In 1Q15, the Fed broke the Prime and Nontraditional categories into six new categories and kept the Subprime category for a total of seven different categories. The six new categories include: (GSE-Eligible, Government, QM non-jumbo/non-GSE eligible, QM jumbo, Non-QM jumbo, and Non-QM/non-jumbo). **The categories we're most interested in are the GSE-Eligible (Fannie/Freddie) and Government categories (FHA/VA) since these two categories account for ~90% of all origination volume. <u>The GSE-Eligible category showed 12.5% of banks, net, eased standards Q/Q in 1Q15. Meanwhile, Government showed a 3.4% net easing</u>.** The other categories all showed net easing of standards as well.

The categories of mortgage lending that matter most – GSE & Govt – both saw easing, on the margin in the 2Q15 Senior Loan Officer Survey.

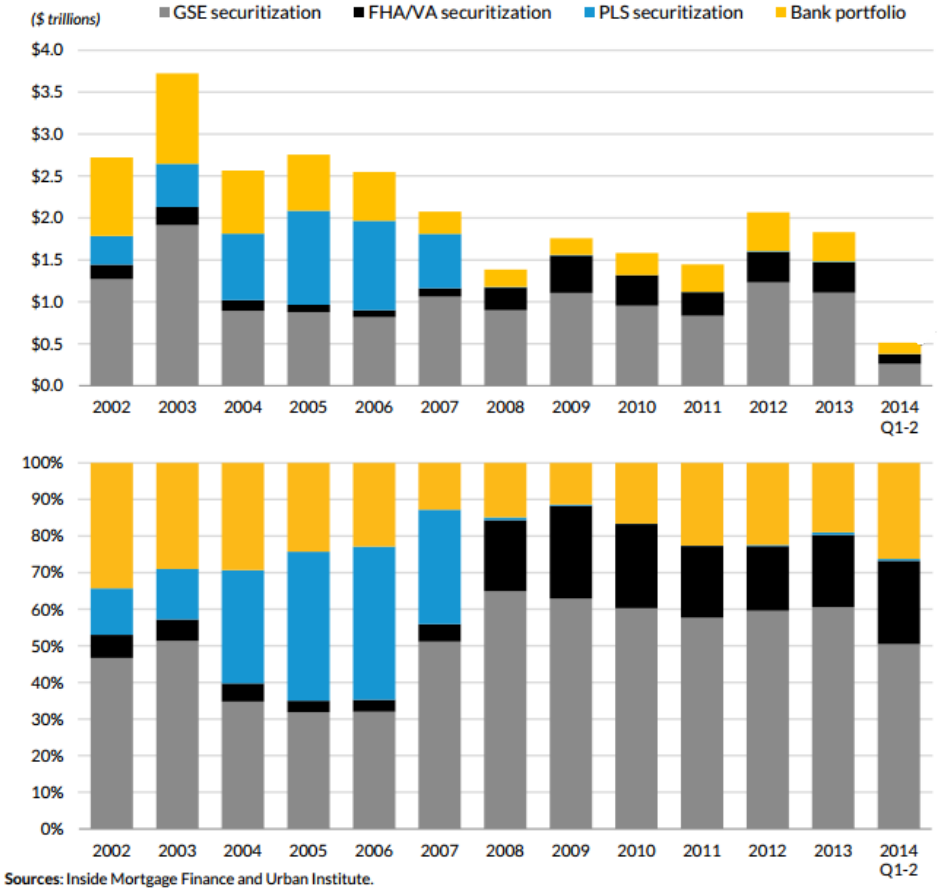
CREDIT IS EXPANDING



A good combination: the Michigan Confidence survey shows that consumers increasingly think that now is a good time to buy, and they also think that getting a mortgage is getting easier.

DATA SOURCE: BLOOMBERG, FANNIE MAE, UNIV. OF MICHIGAN

GSE'S STILL DOMINATE THE MARKET



Sources: Inside Mortgage Finance and Urban Institute.

GSE origination share in 1H14 was 50%, down from 61% in 2013. Bank portfolio and FHA/VA origination share stood at 26% and 22%, respectively, in 1H14. Private label origination share remains less than 1%.

GSE'S → LOWERING DOWN PAYMENTS

Overview of the New Lending Programs at Fannie/Freddie

- **What Happened?:** First time homebuyer minimum down payment drops to 3% from 5% at Fannie Mae and Freddie Mac.
- **When?:** The two programs have different implementation dates. **Fannie's is Dec. 13, 2014** & **Freddie's is March 23, 2015**.
- **Sizing the Impact:** There's a lot of uncertainty here.
  - FHFA declined to say how many borrowers might benefit from having a 3 percent down payment.
  - The effect [will] be modest. First-time buyers who qualified for similar low down payment loans accounted for only 3% of Fannie mortgages in 2013. It's another tool in helping the housing market, but not a huge one. – Inside Mortgage Finance
  - If mortgage availability were at "normal" levels, we could see an additional 1.2 million home loans per year. – Urban Institute
  - Robert Toll, CEO of homebuilder Toll Bros., called the idea "dumb".
- **Fannie and Freddie:** own or guarantee ~50% of all U.S. mortgages ($5 trillion). Along with FHA/VA, they back ~90% of new mortgages.
- **Market Size:** 29% of buyers in October, 2014 were 1st time homebuyers according to the NAR vs normalized levels of ~40%.
  - The program is designed to entice millennials as well as low-income consumers to take the plunge and become homeowners. The absence of young, first-time buyers from the market has weighed heavily on the industry's comeback from the housing crisis.
- **Winners:** Prospective 1st time homebuyers. Private mortgage insurers. Any operators geared to transaction volume.
- **Losers:** FHA

On December 8th, FHFA made it official that it was expanding access to credit for first time homebuyers through programs at both Fannie Mae & Freddie Mac. Here's a look at the key elements of the plan.

DATA SOURCE: FHFA, URBAN INSTITUTE, NAR

& GETTING THE WORD OUT HELPS

Bloomberg News Quick Markets Personal Finance Tech U.S. Politics Sustai

Fannie, Freddie Will Cut Down Payments for Some Homebuyers

Chicago Tribune

Fannie, Freddie cut down payments for some ebuyers

The New York Times

BUSINESS DAY

U.S. Lowers One Hurdle to Obtaining a Mortgag

By PATRICIA COHEN DEC. 8, 2014

FORTUNE

Fannie, Freddie announce plans to back 3% down-payment mortgages

by Fortune Video DECEMBER 9, 2014, 3:12 PM EST

THE WALL STREET JOURNAL. MARKETS

MARKETS

504

89

Fannie, Freddie and FHFA Detail L Payment Mortgage Programs

Borrowers Could Get Mortgages With Down Payments as Little as 3%

CNN Money

The 3% down payment mortgage ma comeback

By Les Christie @CNNMoney December 9, 2014: 9:29 AM ET

National Mortgage News

Fannie Moves Aggressively on New Low-Down-Payment Loans

BY KATE BERRY
DEC 8, 2014 3:13pm ET

HALF THE BATTLE IS SIMPLY MAKING THE MARKET AWARE

One of the keys to addressing the lackluster 1st time homebuyer demand is simply making prospective buyers aware that they might actually be able to get a mortgage. The GSE news on Dec 8 was important in that regard.

BIG PICTURE: CREDIT EXPANSION

How VantageScore 3.0 scores more people

Any lender's portfolio benefits from capturing the widest possible base of qualified and relevant prospects within the lender's target demographic and risk strategy. But traditional credit scoring models limit a lender's universe to a smaller percentage of U.S. adults.

However, the VantageScore 3.0 model gives lenders access to 30-35 million credit-worthy consumers who would be invisible to old credit scoring models. That's a group of prospects more numerous than the population of Texas!

- The model does this by using a broader and deeper set of credit file data as well as more advanced modeling techniques. This allows the VantageScore model to capture unique consumer behaviors more accurately.
- Nearly 25 percent of these consumers are actually prime or near-prime credit quality – excellent candidates for mainstream lending products.

The Washington Post

Real Estate

Fannie, Freddie block mortgages for many by relying on old FICO models, critics say

By Kenneth R. Harney September 26, 2014

BloombergBusiness News Markets Insights Video

Fannie-Freddie's Faith in FICO Tested by VantageScore

Don't Miss Out — Follow us on:

by Clea Benson

Oct. 31 (Bloomberg) -- Barrett Burns has been lobbying Fannie Mae and Freddie Mac to adopt his credit-scoring system, VantageScore, for

In 2008, Watt, then chairman of the oversight and investigations subcommittee of the House Financial Services Committee, held a hearing on credit scoring. In preparation, he ran his own scores.

His VantageScore was perfect. His FICO score didn't "begin to approach" the maximum, he said at the time.

"I mean, I got a VantageScore, I kind of stuck my chest out and said, 'Hey, I'm doing all right,'" Watt said during the hearing.

When he got his lower FICO score, he told the audience, "I said, 'I don't like that.'"

VantageScores are being evaluated by Fannie & Freddie.

Their adoption could open the door for another ~7-8mn homeowners.

BIG PICTURE: CREDIT EXPANSION

THE WALL STREET JOURNAL.

FICO Creates New Credit Metric for Risky Consumers

Banks could grant cards, loans to people previously unable to get a credit score

By ANNAMARIA ANDRIOTIS
April 1, 2015 12:11 a.m. ET

Millions of Americans unable to obtain credit cards, mortgages and auto loans from banks will receive a boost with the launch of a new credit score aimed at consumers regarded as too risky by lenders.

The new metric, set to be announced as soon as this week, is being developed by Fair Isaac Corp., creator of the most widely used consumer-credit scores, and is being tested in a pilot phase with credit-card issuers. Fair Isaac said it hopes to make as many as 53 million people who don't have credit scores more acceptable to lenders.

The new score, which isn't yet named, will be calculated based on consumers' payment history with their cable, cellphone, electric and gas bills, as well as how often they change addresses and other factors, according to Fair Isaac, also known as FICO. Traditional FICO scores that lenders use in the approval or rejection process are calculated based on the information in the credit reports from the three major credit-reporting firms, Equifax Inc., Experian PLC and TransUnion.

FICO and 10 credit-card issuers, which the firm declined to name, have been quietly testing the new score since November. The firm plans to roll it out nationwide by around year-end. Some 15 million of the 53 million unscorable Americans already can be scored using the alternative data, said Jim Wehmann, executive vice president of scores at FICO.

Not to be outdone, FICO isn't resting on its laurels. The WSJ reported yesterday that FICO was rolling out its own product that would score as many as 53 million additional borrowers.

BIG PICTURE: CREDIT EXPANSION

Attorney General
Eric T. Schneiderman

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A.G. Schneiderman Announces Groundbreaking Consumer Protection Settlement With The Three National Credit Reporting Agencies

Experian, Equifax, And Transunion, Which Maintain Consumer Credit Information On 200 Million Americans, Have Agreed To Increase Protections For Consumers Facing Credit Report Errors; Provide Second Free Annual Credit Report To Consumers

Agreement Increases Protections For Consumers With Medical Debt; Reforms Process For Correcting Report Errors; Improves Accuracy Of Reports

A.G. Schneiderman: This Agreement Will Reform The Entire Industry And Provide Vital Protections For Millions Of Consumers Across The Country

NEW YORK – Attorney General Eric T. Schneiderman today announced a settlement with the nation's three leading national credit reporting agencies, Experian Information Solutions, Inc., ("Experian"), Equifax Information Services, LLC ("Equifax"), and TransUnion LLC

FIGURE 1: COMPOSITION OF COLLECTIONS TRADELINES ON CREDIT REPORTS BY TYPE OF CREDITOR

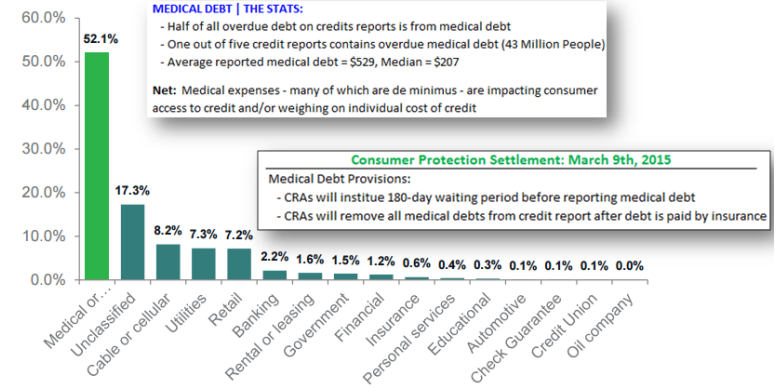
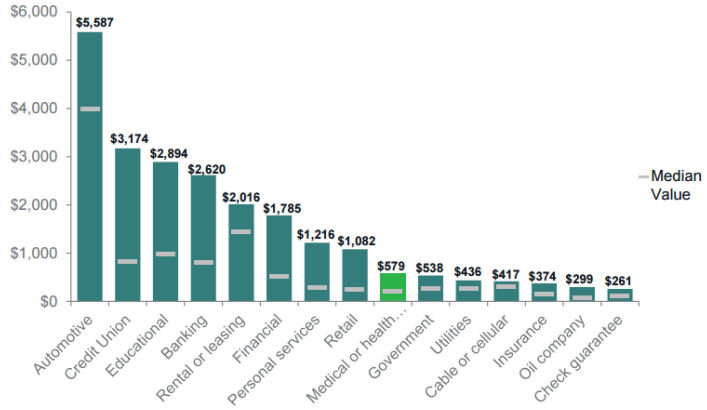


FIGURE 2: AVERAGE AND MEDIAN AMOUNTS OF COLLECTIONS BY CREDITOR TYPE



NY's AG just reached a major settlement with the credit bureaus, requiring easier dispute resolution and waiving medical bills for 180 days before considering them delinquent.

DATA SOURCE: CFPB, NYAG

CREDIT IS EXPANDING

A. Credit standards on mortgage loans that your bank categorizes as GSE-eligible residential mortgages have:

	All Respondents		Large Banks		Other Banks	
	Banks	Percent	Banks	Percent	Banks	Percent
Tightened considerably	0	0.0	0	0.0	0	0.0
Tightened somewhat	1	1.6	0	0.0	1	3.1
Remained basically unchanged	54	84.4	26	81.3	28	87.5
Eased somewhat	9	14.1	6	18.8	3	9.4
Eased considerably	0	0.0	0	0.0	0	0.0
Total	64	100.0	32	100.0	32	100.0

A slightly more detailed look shows that 14% of respondents reported that they eased standards "somewhat".

DATA SOURCE: FEDERAL RESERVE

THE GOLDEN RATIO: 1.35X

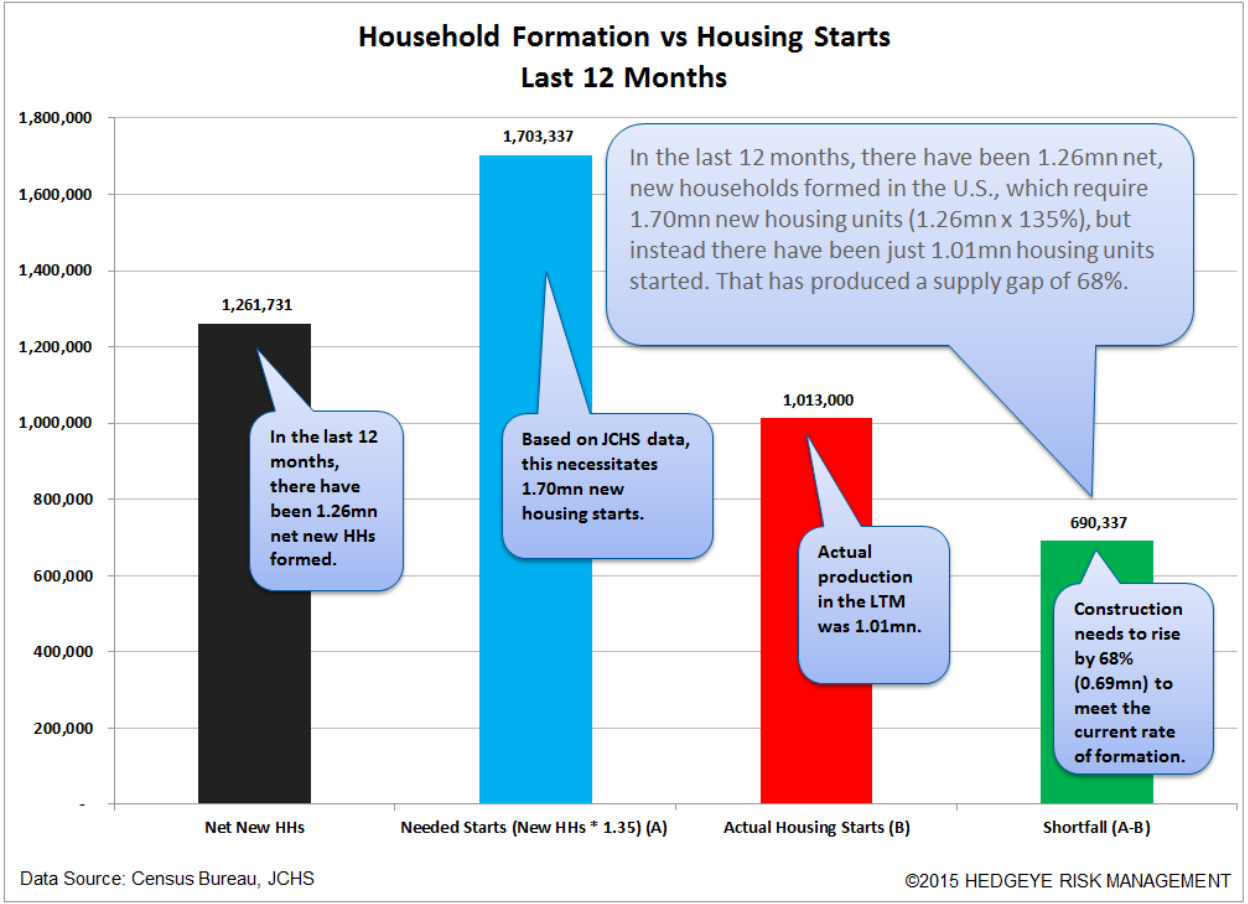
Table 6: Components of New Home Demand 2010-2020

	JCHS Low Immigration Projection	JCHS High Immigration Projection
Projection Period	**2010-2020**	**2010-2020**
Projected Household Growth (000s)	**11,802**	**13,828**
Projected Total Vacant Unit Demand (000s)	**1,361**	**1,595**
Vacant For Rent (000s)	*308*	*361*
Vacant For Sale (000s)	*119*	*209*
Second Homes (000s)	*934*	*1,026*
Projected Total Estimated Net Removals	**3,279**	**3,279**
*(Total Units * .025% / Year)*		
Projected Total Demand for New Units	**16,442**	**18,702**
Annual Average	*1,644*	*1,870*

Source: JCHS, Harvard University

As of February, 2015, Household Growth was +1.26mn on a year-over-year basis, or roughly at the midpoint of these two JCHS scenarios (1.28mn), but Starts are running at (1.01mn) – just 57% of the midpoint (1.76mn).

MAKING THE CASE FOR THE DOUBLE



There's 68% upside to current rates of construction based solely on the long-term ratios of construction to household formation.

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