September 30, 2021

Assessing the Housing Market in 2021

Over the past 15 years, housing in America has gone from boom, to bust, and back to a boom again. Coming off the COVID-19 recession last year, median U.S. home prices have risen steadily, increasing 28% over the last two years alone. This upswing is no new phenomenon. Home prices have been appreciating ever since the Great Recession ended in 2009. Today's housing market clearly reflects a supply-demand imbalance. Simply put, there is not enough inventory for sale or rent in communities across the country, and this is driving prices up in every segment of the real estate market. Going forward, several factors will shape the future of housing in America: the impact of favorable demographics on demand, solving the supply shortfall, and the path of interest rates. In this *Investment Strategy Update*, we will identify what we consider attractive investment themes in light of these dynamics.

Persistent Demand

Demographics are a boon for the housing market. Because the Millennial generation—more than 70 million people currently 25 to 40 years old—continues its ascent of the socioeconomic ladder, household formations are on the rise. As their economic prospects improve and their debt burdens are whittled down, Millennials are increasingly becoming financially stable enough to take on home ownership and its associated costs. Before COVID, the big question in the housing market was when more members of this generation might finally begin buying homes of their own. Now, according to the National Association of Realtors, Millennials are the fastest growing segment of buyers. As one real estate investor put it, "the largest adult group in America went from no interest at all to all the interest in the world."

The subsequent generation, now known as Gen Z, is expected to increase further the demand for housing in the short term. Gen Z constituents are twice as likely as Millennials to have bought or want to buy a home before the age of 25. 97% want to own a home in the future and 87% want to buy before the age of 35. There are an estimated 61 million members of Gen Z. With ages ranging from 9 to 24 years old, this cohort's elders are just now beginning to enter the age at which household formations typically begin.

The strength of the economy coming out of the pandemic certainly is playing a role in demand. Consumers are flush with cash, and employment opportunities continue to improve. Monetary policy is also adding fuel to the fire. With short-term interest rates still hovering near zero, the average 30-year fixed rate mortgage is at a historically low 3.05%.

Investor demand is further absorbing real estate in the U.S. These non-occupants purchased $87 billion worth of houses in the first half of 2021; in the second quarter alone, investors bought 68,000 single family homes. Since June of this year, Wall Street firms Blackstone, Invesco, and Goldman Sachs have committed another $11 billion to fund purchases through the remainder of the year. With one in six homes being sold to an investor in the second quarter, would-be homebuyers are now having to compete with deep-pocketed individuals and corporations loaded with cash paying little or no interest. The attractive returns available on real estate simply mean that, until something changes, an ever-larger number of investors will continue to chase after the same limited supply.

Supply Shortage

Homebuilding collapsed during the housing crisis of 2008 and is only recently gaining momentum. Going back as far as 2009, homebuilders have not been constructing enough homes. In that year 550,000 new homes were built, the lowest pace on record. Housing inventory is presently at its lowest level since the 1970s. When BTR last wrote about housing, in 2016, we concluded that the U.S. would need to build 1.7 million homes a year to keep up with likely demand through 2030. Yet according to the U.S. Census Bureau we are only on pace to start 1.6 million units this year. Estimates are that we are currently short anywhere from four to six million homes. At this rate it will take multiple years of accelerated building even from this level to catch up with the current deficit.

Construction of high-end homes and apartments recovered first, with builders responding to the quicker rebound in demand by more affluent households, and the more attractive returns they can achieve in that segment of the market. It wasn't until 2015 that supply at the very top end of the market began to meet demand nationwide. Current backlogs for homebuilders in the high-end market are up 50% year over year and show little signs of depleting. Construction of affordable housing, however, has been slower to recover from the Great Recession.

Low and moderate-income households took longer to recover from the financial crisis of 2008, only returning to their pre-recession levels of economic standing approximately 12 to 18 months before the pandemic hit. Profit margins on affordable housing have been too low to incentivize much investment, so inventory has been scarce. With the rapid rise in prices across the country, there is now sufficient return for builders to take on the risk of new projects in this segment. One of the nation's largest homebuilders has taken aim at the first-time home buyer, committing nearly one-third of the new houses it builds to this market.

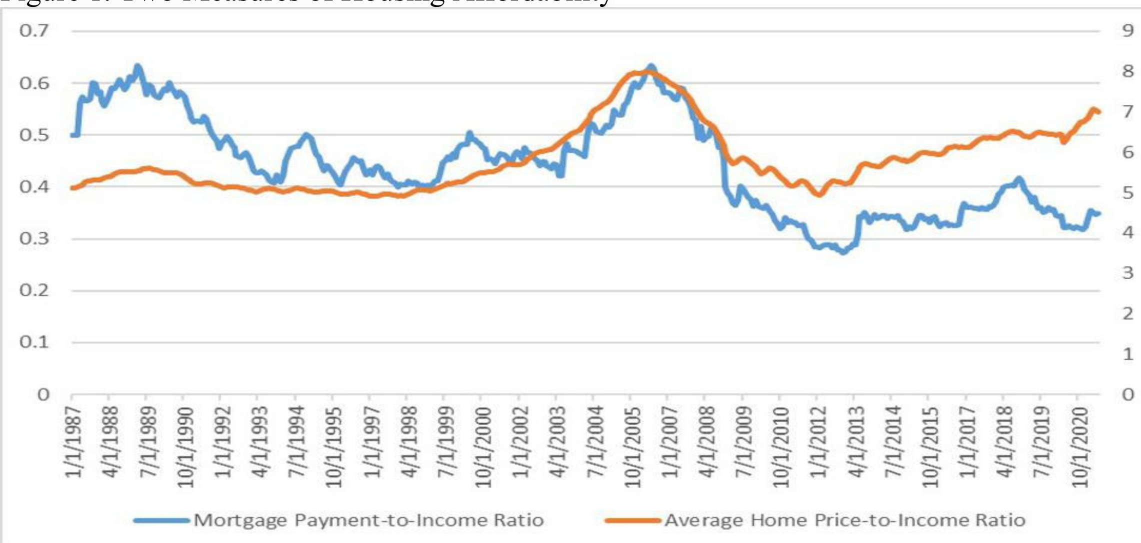
Anti-growth policies have had a negative effect on supply in the past. In California, for example, huge swaths of urban land are essentially off-limits to new development. In areas where development is allowed, mandates such as solar panels limit flexibility and can add thousands to the cost of a new home. On the flip side, however, is a newly signed law that would allow more than one unit on a lot previously zoned for single-family housing. That should support supply in the most populous state.

Continued Boom, or Another Bust?

With home prices appreciating at breakneck speed, the specter of another bust like that of 2008 is on a lot of minds. The widely followed Case-Shiller Index is the leading measure of U.S. residential real estate prices. In June of this year, the index showed year-over-year home prices increased by 19.1%, the fastest pace in 30 years. According to the National Association of Realtors, the median existing home sale price was $359,900. In July of 2020 it was $305,600.

Adjusted for inflation, one could argue that U.S. housing prices today are higher than they were at the peak of 2006, just before the crash. Some fear that the Federal Reserve is replicating the conditions that preceded the last housing bust by keeping interest rates artificially low. However, surging home prices alone don't make a housing bubble, which the chart below puts into perspective. The orange line represents the ratio of the average home price to income (right axis) while the blue line shows the ratio of average mortgage payment to income.

Figure 1. Two Measures of Housing Affordability



Source: Fort Washington, Bloomberg, Freddie Mac, S&P CoreLogic Case-Shiller, and Bureau of Labor Statistics

Historically, an average house in the U.S. cost around 5 times yearly household income. During the bubble of 2006 that ratio exceeded 8 times. Today, we are approaching the same pre–financial crisis levels. However, the ratio of monthly mortgage payments to income shows we are in the lower half of the range on a longer-term basis. What this tells us is that low mortgage rates have kept housing prices affordable despite surging prices.

It doesn't appear that we are on the precipice of another housing crash in America. Homebuyers today have a lot more skin in the game. Not only have underwriting standards tightened, but large down payments are also now required, embedding 10% to 20% of equity on purchases. With such large sums invested, people are less likely to walk away under worsening market conditions. If interest rate policy stays in a relatively attractive range, home buyers should continue feeling comfortable purchasing a home that fits within their budget.

Investment Implications

At 16.9% of GDP, housing represents a large segment of our economy. Our overriding thesis is that persistent demand should be in place for many years to come. That demand coupled with homebuilders' current backlog of new projects, implies there could be a Goldilocks situation unfolding in housing. The CEO of at least one leading home builder thinks we have settled into a long-term secular bull market for housing. With improving margins, builders are showing signs they are increasingly eager to meet demand.

As projects near completion, paint, flooring, appliances, and other goods will be in high demand as well. As such, home improvement retailers should still show solid growth, given they sell these kinds of goods to professional contractors as well as the DIY crowd.

Residential REITs are attractive on two fronts: the income they generate, as well as strong underlying growth in household formation. With backlogs for new construction projects, timberland REITs are also interesting due to the increased amount of once-again affordable lumber that will be required.

Regional banks are another group that benefit from a strong housing market. Most buyers must borrow money to buy a home, and mortgage loans typically make up anywhere from 15% to 25% of a regional bank's loan portfolio. During a rising rate environment, new money mortgages can pick up the slack even if refinancing activity is depressed. With the much stricter underwriting standards of today, we feel having exposure to lending is a safe way to benefit from the secular trends in housing. These banks should also have reserves tucked away that were ultimately not needed after the COVID recession, which will flow back into earnings over time.

Finally, the next generations of home buyers have been raised with technology as a centerpiece of their lives. With more transactions of all kinds taking place online, it was only a matter of time before real estate went digital. Today, many real estate companies are adopting big data, blockchain, CRM, predictive analytics, and AI to advance operational processes. Online brokerages are seeing increased utilization. Video tours of homes became more common during the pandemic, making people increasingly comfortable buying a home sight unseen. Many of the leading online brokerages are now offering to buy and sell homes for clients, offering a suite of products ranging from creating video tours, mortgage services, and the preparation of documents needed to close; signed electronically, of course.

Market Outlook

The U.S. stock market has become increasingly volatile in recent days as concerns about China's overheated real estate sector have spilled over into other financial markets and stock valuations look a bit stretched. The Federal Reserve has also finally indicated that it is likely to begin to pull back soon on its massive Quantitative Easing program. It may start to raise short-term interest rates a bit earlier than many expected, as well, although a gradual increase from zero starting in 2023 should hardly be cause for panic.

Continuing economic growth and the peaking of the delta variant of COVID-19 should allow the stock market to grind still higher, although it could pause or correct as it digests the latest developments. We believe inflation will be more persistent than some have forecast, which, along with the Fed moving toward somewhat less accommodation, could cause bond market interest rates to drift upward. In this environment, we would expect the stocks of companies that benefit from the re-opening of the economy to provide additional profit potential as we look for further opportunities at reasonable prices.