Economic INSIGHT

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Weakness in Housing Potentially Mitigated by Lingering Undersupply

The old adage among economists that "*what goes up, may not continue to rise indefinitely, at least not at the same elevated pace,*" is particularly applicable when it comes to assessing the most recent activity in the U.S. housing market. While demand has slowed from peak levels and supply has risen off earlier lows, there remains a sizable gap between existing inventory and current housing needs. This is perpetuating still positive price appreciation. Higher mortgage rates and elevated costs coupled with negative real income growth and increased market uncertainty have served to dampen activity somewhat, resulting in a slower pace of price growth; however, with a multi-year deficit in housing supply and still positive demand, the cost of homeownership remains historically elevated.

FUELING THE MARKET

Heading into the COVID crisis, the existing housing inventory was already at an extremely low level, largely reflecting a decade of what industry insiders consider "*under building*" in the aftermath of the Great Recession. Pandemic conditions, meanwhile, only exacerbated the shortage amid a flurry of home buying as Americans attempted to navigate and adapt to the new constraints of a global shutdown.

Some potential buyers jumped into the housing market early on seeking more space to accommodate a home office or at-home learning. Others were quick to take advantage of record low interest rates or the new "*work from anywhere*" environment. Other buyers were simply fleeing the rising violence of the cities or seeking political safe havens. Additionally, there was an entire generation of Millennials that had previously delayed a home purchase that were now dipping a toe – nay, an entire foot – into the market. So, for a variety of reasons, home sales skyrocketed during the pandemic and in the immediate aftermath, resulting in an equally fantastic rise in housing prices.

Compounding the precipitous increase in housing costs was an arguably less organic component – investor demand. It was also a solid contributor to the massively

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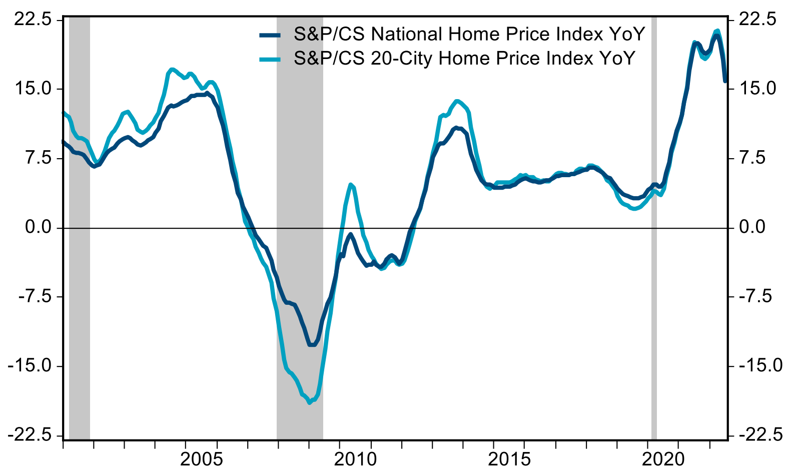
inadequate inventory, perpetuating the divide between market demand and available supply. Investors moved aggressively into the single-family market over the past two years, buying up homes, particularly those more moderately priced, with an intention to convert single-family dwellings into rentals or to renovate, upgrade, and resell such properties at a profit. According to CoreLogic, investor activity in the single-family market reached record highs throughout 2021 and 2022, with investment dollars accounting for more than a quarter of all single-family purchases, the highest proportion since 2011.

Amid years of insufficient construction, coupled with historically elevated demand, the supply of homes dropped to a low of 1.6 months at the start of the year. While monthly supply has recovered somewhat to 3.2 months as of August, it remains roughly half of what industry insiders consider a balanced market.

SCARCITY LEADS TO HIGHER PRICES

As with most markets, when demand outpaces supply, prices will rise and establish a new – higher – equilibrium. In the case of housing, with demand *far* outpacing the existing supply, home prices pushed precipitously higher, reaching a peak of 20.8% growth in March. Looking forward, as the economy slows and consumers are increasingly unable – and unwilling – to make large-ticket purchases, will the upward trend of housing costs persist or soften?



Source: Standard & Poor's/Haver Analytic

Perhaps, a little of both. After all, supply has improved somewhat. Some would-be sellers are still motivated to offload in what is still considered a hot market. Of course, this could also work against building inventories and cooling prices if some would-be sellers sense a weakening and opt to hold off until there are more firm conditions, particularly during the traditionally more sound spring market. At the same time, with mortgage rates rising to a 16-year high, there is a growing incentive to keep a historically low-rate mortgage in this environment rather than sell and purchase alternative housing at a much higher borrowing rate.

GLOSSARY

YoY – Year over Year

FHLMC – Federal Home Loan Mortgage Corporation

Supply of new homes has also picked up with construction rising modestly in the past three months. Housing starts rose 12.2% in August, although to be fair – and understandably – building remains markedly below earlier highs, off 13% from the April peak. After all, new construction comes at a price premium, particularly amid elevated parts and materials costs, shortages and an ongoing lack of labor, particularly skilled labor.

Separately, on the demand side, the appetite for home purchases is slowing, again somewhat. Against the backdrop of negative real income, elevated costs, rising mortgage rates, and growing uncertainty regarding financial and economic conditions, many potential buyers have sidelined, at least for now, the prospects of purchasing a new home. Investor demand in the single-family market has also slowed, reportedly receding since February of this year. While still elevated, according to CoreLogic, investors' proportion of sales has dwindled eight percentage points from March (28%) to June (20%). Existing home sales, while still positive, have slumped from 6.49 million to a 4.80 million unit pace, reflecting seven consecutive months of slowing activity.

Source: Federal Home Loan Mortgage Corporation/Haver Analytic

Of course, even as demand slows off of first quarter highs and supply improves off 2020 lows, there remains a sizable divide between demand and supply. Thus, unlike the dramatic fall during the Great Recession, this will likely provide ongoing support to prices. That's not to say prices could not or would not move to a lower level going forward, but limited inventory is likely to provide a floor, implying a second-derivative decline or a slower pace of still-positive price appreciation.

A minimal softening in prices will expectedly continue to perpetuate somewhat solid – or at least not overly weak – conditions in housing, a welcomed outcome for existing homeowners. Of course, perpetually elevated prices, even at a relatively lower level, are likely to prolong a historically low level of affordability.

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A NOT-SO VIABLE ALTERNATIVE

Despite higher borrowing costs and somewhat of a slowing in demand, housing costs are still historically elevated. As a result, in search of less expensive alternatives, some would-be homebuyers are turning to the rental market. Unfortunately, there is little price reprieve for renters.

The housing shortage has been a sizable advantage for property owners, both owner-occupied and investor. As would-be buyers could not and still cannot find or afford a home purchase, demand for rental properties has risen precipitously over the past two years. In fact, with broader inflation driving higher costs elsewhere in the economy, rental prices have risen in lockstep with the single-family market. According to CoreLogic, several major cities have seen rental prices rise anywhere between 10% and 30%. Although, at least one report suggests rental costs may be cooling more notably in some areas, such as Manhattan where rental activity is down in the third quarter for the first time since 2020.

Nevertheless, despite best efforts, many have been unable to escape the burden of rising housing costs. Even as higher mortgage rates tamp down demand, prices have arguably budged only slightly – if at all – in some areas, while declining affordability has resulted in a rising level of demand for rental properties, perpetuating shelter costs even higher.

CONCLUSION

As the economy slows, the Federal Reserve (Fed) continues to raise rates and mortgage rates presumably push higher, the obvious conclusion is a slowdown in the most interest-rate sensitive sectors of the economy including housing with a decline, maybe even a collapse, in prices. However, such a thesis is based on the assumption of fundamentals beginning from a point of equilibrium. With a noticeable deficit in supply, however, prior to the COVID outbreak, and pandemic conditions only compounding the inventory shortfall, price pressures may prove more resilient this time around than in historical cycles, with the housing market as a whole on much firmer footing with a significantly higher credit quality among borrowers than in years past.

In fact, while speculative investment was a sizable component to sales, given the outsized gap between organic demand and supply, even with a material reduction in investor dollars, market momentum could be sufficient to perpetuate at least positive price appreciation – albeit below current double-digit growth. After all, much of the price acceleration in the last two years has been outside of the traditional hot urban centers where the majority of investors' dollars flowed, with double-digit gains in what would be considered secondary or even tertiary markets. Thus, less indicative of a

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housing market bubble as seen in ’07/’08, the recent run-up is perhaps more indicative of a structural adjustment in preferences as population flows move(d) from one location to another. Of course, a decline in prices is still possible and may even be necessary to reestablish longer-term stability, but at the very least, the stubbornly elevated level of housing costs is a welcome reminder that like most components of the economy in today’s unprecedented times, traditional relationships and expectations may not hold.

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