Kara O'Halloran (00:05):

Welcome back to FireSide, a podcast from FS Investments. My name's Kara O'Halloran, I'm a director on our investment research team here. Today we're going to talk about something that a lot of people have been talking about for the last year, and that really impacts almost everybody, and that is the housing market. I think most, if not everyone out there, has heard about just how red hot the market is right now. There are stories about people buying properties sight unseen. Waiving inspections is almost the norm. It's really just crazy out there. I am excited to dig into what caused this really red hot market, whether we are in another real estate bubble, and where we think things can go from here. I am joined today by Andrew Korz, who is another director on our team who focuses a large part of his time on the real estate market. And Lara Rhame, our chief US economist. Welcome.

Lara Rhame (00:54):

Hi.

Andrew Korz (00:54):

Hey, Kara.

Kara O'Halloran (00:55):

To me, the housing market has really been one of the more surprising side effects of the pandemic. In a way, it makes sense. We all sat at home for the better part of a year. I know I became very critical of my space. But there was also a lot of economic uncertainty, especially back in March of 2020. There were risks of even just touring other people's homes or allowing people into your home to tour. But I think a lot of these trends really started before the pandemic. So Lara, I want to start with you, as always, to walk us through the macro backdrop of what has helped create this market.

Lara Rhame (01:30):

100%. There's no market that really has included virtually every narrative of the pandemic economy like the housing market. One of the hallmarks of that is just the extraordinary growth that we've experienced since the bounce that we had in the third quarter of 2020. We had this massive decline. The growth has been just extraordinary. It continues to track at levels far beyond our potential GDP growth. And specific to the pandemic, has been this big shift in workers. We've had people moving from urban centers to the suburbs. People in the suburbs moved to the exurbs. The very expensive cities saw a lot of movement and migration to lower cost localities, or lower tax localities even.

Lara Rhame (02:24):

Finally, one of the big policy responses to the pandemic was the Fed policy of lowering interest rates. These rock bottom interest rates have fed through to housing one of the most interest rate sensitive sectors of the economy. Clearly, pandemic forces have driven housing from a strong market to just over the top. But very quickly, prior to the pandemic, we saw housing already experiencing structural tailwinds. I'm sure Andrew's going to go more into some demographics, but the household formation trends were already pointing to the need for more houses, and construction has lagged. So, for all of those reasons, housing was already experiencing strong tailwinds. Those have just been fueled exponentially by the pandemic.

Kara O'Halloran (03:24):

Andrew, I want to talk about some of the crazy stats out there. I know you have some interesting supply and demand stats. I just bought my first home. I honestly felt that there was a period in time where I was going to have to be sitting on the front steps before these properties went on the market in order to find one. It was so, so competitive. Anecdotally, I experienced that. But walk us through a little bit about what's going on in today's market.

Andrew Korz (03:47):

Yeah, sure. Congrats on your big purchase. Very exciting.

Kara O'Halloran (03:53):

Thank you. Thank you.

Andrew Korz (03:55):

Just like we've seen in the broader economy, what's going on in the housing market is really a combination of demand and supply factors that have combined to create this perfect storm for a red hot market. As Lara said, it really is, to me, the macro narrative that encapsulates a lot of the pandemic trends that we've seen in a lot of different sectors of the economy. On the demand side, even pre-pandemic, you had millennials, which have been sort of the sleeping giant in the housing market for years. Young millennials are finally hitting those peak household formation years. It's happening a little bit later than other generations-

Kara O'Halloran (04:32):

We're buying too much avocado toast. Isn't that what they tell us?

Andrew Korz (04:35):

That's right. That's right.

Kara O'Halloran (04:35):

We can't afford houses, we bought too much avocado toast.

Andrew Korz (04:37):

Those two products are always substitutes for each other. Yeah. Yeah.

Kara O'Halloran (04:40):

That's what all the articles said.

Andrew Korz (04:41):

Stop buying your Starbucks coffee. You have this big cohort of millennials finally ... a little bit later, like I said, than other generations, but they're finally starting to form households and look to buy a home. And then of course, interest rates, which have been going lower for years, but really plunged in 2020, which helped keep affordability intact, even as housing prices rose. So you have demographics and interest rates, which are really those core secular tailwinds. And then the pandemic hit and everyone's stuck in their homes. You had the government pump $5 trillion of stimulus into households, which kind of kept the fiscal state of the household afloat. This combination of fiscal stabilization and a newfound

appreciation for every extra square foot of space, of having outdoor space, really created this unexpected surge in demand, that really started right away in April of 2020.

Andrew Korz (05:39):

And then of course you have the supply side as well. That's a mixture of factors that are both secular, longterm, as well as some pandemic-driven factors. The biggest secular factor that's really driving the supply side is a significant under-building during the 2010s, that has really left us under housed, and certainly has left the market unequipped to deal with this large surge in demand. For context, during the 1980s, 1990s, and 2000s, in each of those three decades, we built roughly 41,000 new homes per million people. So 41,000 new homes, each decade, per million population. In the 2010s, we only built 21,000 per million people.

Kara O'Halloran (06:29):

Is that just kind of like a hangover from the great financial crisis or ... what's driving that [crosstalk 00:06:34]?

Andrew Korz (06:34):

Yes. It's a lot of things. Home builders were really scarred by the housing bubble when land prices went through the roof and everybody felt like they needed to go buy land to build new homes. And then the crash happened and home builders felt the need to be much more conservative with their assumptions of home price growth, of their ability to sell houses. That's one reason. Then of course, the demand side as well. The global financial crisis really hit these older millennials hard. These people who are just entering the workforce and then had to go through this really scarring recession. Obviously we saw it in GDP data. The economy never really recovered to its pre-crisis trend. So the demand side was hit as well. You had home builders who were unwilling to go out there and take risks, and you had the demand side that was really hurt as well. That contributed to this, what we saw for a decade, which was, really, half the number of homes that we should have been building were actually built during the 2010s.

Andrew Korz (07:42):

That's, like I said, the big kind of secular trend that's hit home in 2020 and 2021. And then the pandemic really had an acute impact on supply of both new homes and existing homes. Supply chain disruptions that we've talked about and labor shortages have challenged new construction. And then the pandemic really hit the willingness of people to sell their homes. Like you said, you didn't really, in summer or fall of 2020, want somebody touring your house. Of course, there's just broad financial uncertainty around the pandemic, that people may not have wanted to make such a big financial decision. So there's a lot of factors here that have kind of combined to create what has now been 17% year-over-year home price growth, which hasn't happened since 2004.

Lara Rhame (08:27):

Lumber prices [crosstalk 00:08:29]. Shock.

Andrew Korz (08:31):

Yeah. Yep. They're back, I think, to not quite pre-pandemic levels yet, but it's been an extremely volatile market and has made it really hard for builders to plan.

Lara Rhame (08:40):

Yeah. I'm sure.

Kara O'Halloran (08:42):

Speaking on the demand side, I know I was looking at things that I never would have thought to look at pre-pandemic. I'm like, "Okay, well I need ... If I can't have a designated home office, I at least need a workspace with a good Zoom background and place for the pandemic Peloton that I bought." All this stuff that wouldn't have crossed my mind a year or two ago.

Andrew Korz (09:01):

Yep.

Lara Rhame (09:02):

Does Grubhub deliver to you?

Kara O'Halloran (09:04):

Yeah, exactly. Exactly.

Lara Rhame (09:06):

[crosstalk 00:09:06] checking out, real estate.

Kara O'Halloran (09:08):

100%. All right. We touched on the great financial crisis a little bit. 2008 is really still fresh in a lot of people's minds. It was not all that long ago. If we look purely at price appreciation, you just said 17% year-over-year price growth. The question obviously comes up, are we in another bubble?

Andrew Korz (09:27):

Despite that data, this current environment is significantly different than what we saw pre-global financial crisis. I'm going to just quickly go through two reasons why we see this as a really hot market, but certainly not a bubble akin to what we saw in '04 to '06. The first reason is affordability. We like to think of housing in terms of prices. People like to quote the median home price or home price growth, but really, a lot of buyers focus on the mortgage payment when assessing how much house they can afford. If we think about it in that way, the average mortgage payment right now is roughly 16% of average family household income. In 2005, it was 25% of household income. That is a significant difference in terms of how much coverage a company has to pay their mortgage debt service. The big factor there, as Lara mentioned, is interest rates, which are flown through to mortgage rates. Today you can get a 30-year fixed mortgage rate for below 3%. Just three years ago that was 4.8%.

Kara O'Halloran (10:35):

I managed to tie mine to that little spike in interest rates that we had in March.

Andrew Korz (10:38):

Yeah. You've always been good at timing the market, Kara.

Kara O'Halloran (10:40):

Oh yeah, that's what I'm known for.

Andrew Korz (10:44):

Just for reference, 4.8 to 3 for the average family buying the average home, that's a savings of almost $4,000 per year on mortgage payments. So you have low rates that have really allowed home prices to go up without really hitting affordability when you look at that monthly mortgage payment. And then the second thing we look at when we're trying to spot a bubble is the amount of debt in the system. Households are in much healthier financial position today than they were pre-global financial crisis. Consumer leverage is near a multi-decade low, whether you look at it as a percentage of household assets or as a percentage of GDP. You also have lenders that are much more careful with who gets a mortgage. Less than 5% of borrowers getting mortgages today have a credit score below 660. 5%. In '05 and '06, that was almost 25% of people getting mortgages.

Lara Rhame (11:40):

I remember those days, mortgage for everybody.

Andrew Korz (11:42):

Yeah. Yeah. "You get a mortgage." It's like Oprah.

Lara Rhame (11:43):

Right.

Kara O'Halloran (11:44):

Yeah. I'll never forget the Michael Lewis quote in The Big Short. They said they were one broken refrigerator away from default.

Andrew Korz (11:52):

Yeah. Yeah.

Kara O'Halloran (11:53):

That'll always stick in my mind.

Andrew Korz (11:54):

Yeah. Yeah. Sounds like hyperbole, but I'm not sure it was.

Kara O'Halloran (11:56):

I don't think it was.

Andrew Korz (11:59):

So not only is system aggregate leverage lower, but the debt that is being originated is going to people with a much better ability to service that debt. Part of that is because mortgage rates are so low. I think when we look at this market compared to pre-global financial crisis, the affordability metrics and the level of debt in the system are just completely different than what we saw 15 years ago.

Kara O'Halloran (12:26):

All right. So we're not in another bubble. I feel good. Or, Andrew Korz is not calling for another bubble.

Andrew Korz (12:31):

You know what that means.

Kara O'Halloran (12:33):

No, no, no. Don't scare everyone.

Kara O'Halloran (12:35):

All right. Let's talk about the future now. July 26th, we got new home sales data that was well below expectations. I think, well below May's rate and significantly below the June 2020 data. I already saw a handful of headlines calling for the end of the housing boom, definitively. What is your take?

Andrew Korz (12:54):

Yeah, it's a tough question. Forecasting is always harder than looking backwards. It's particularly difficult to suss out the data right now, like it is in a lot of parts of the economy. For example, like you said, we got new home sales yesterday that were surprisingly low. Which at first looks like, "Hey, maybe high prices are starting to make people think twice about wanting to buy a home." But what we're seeing is builders are capping sales because there's tremendous uncertainty around their ability to get the materials they need, to get the labor they need to actually construct these homes. So it's a really dynamic and complicated market right now.

Andrew Korz (13:31):

Overall, there are some signs that the market is in the beginning stages of stabilizing. I would not say normalizing, I would say stabilizing in terms of balancing supply and demand. The inventory of houses available is starting to creep up a bit, although it's still historically low. If you're somebody looking to sell. On one hand, it's a great seller's market, as we've obviously seen with the home price growth. On the other hand, you see prices going up 17% annually, and you're saying, "Hey, you know what? Maybe I want to wait this out another year and see if I can get another 15 to 20% premium on my house." That's complicated.

Andrew Korz (14:11):

On the demand side, I'd still consider demand from home buyers voracious. The reopening of the economy doesn't seem to have diluted people's desire for more space. At least not yet. Again, there are some early signs of balance in the market. In Q1, almost 60% of homes on the market received at least three offers. For context, the normal number during a normal environment would be roughly 25% or so. That started to come down a bit, which again, is a sign of better balance between supply and demand. We've also seen, in some of these consumer sentiment surveys, the percentage of people who consider this a bad time to buy a house is at its highest since the 1980s. Lara and I were just talking about this earlier. Whether that means that people will actually follow through and not look to buy a house is up for debate. You might think now is a bad time to buy a house, but you might also think-

Kara O'Halloran (15:06):

Don't tell me that.

Andrew Korz (15:06):

... in two years might be a really bad time to buy a house.

Lara Rhame (15:09):

I think the demographics that you talked about ... I mean, I laugh at the phrase "housing formation". I feel like the baby boomers just called it starting a family. That's a very clinical description of a really happy event. But we know that that's been delayed and that there's going to be this demographic demand. Contrary to another millennial narrative, people can't live in their parents' basements forever. So I think more and more they're wanting to [crosstalk 00:15:36].

Andrew Korz (15:36):

This really comes back to the broad financial position of the consumer. A lot of these millennials would have loved to buy a house five or 10 years ago, but the state of the economy and the timing of the global financial crisis made it really implausible. With the consumer in such good financial shape right now, it's become much more attainable for a lot of people. I don't think that's going away anytime soon.

Lara Rhame (15:58):

Yeah. Yeah.

Kara O'Halloran (15:59):

One thing I'm curious about is we definitely ... Lara touched on this. We saw this migration of people from cities to suburbs, suburbs to exurbs, whatever. People even moving completely geographic locations because of this availability of remote work. What if that pendulum swings back? What happens?

Andrew Korz (16:17):

Yeah, no, that's the $5 trillion question. I don't know, I just put a big dollar amount on it. That's a huge question in the market. You look at a lot of these cities, like Austin, like Denver, like Charlotte. They call it the smile cities because it kind of goes from Mideast coast down to Texas and then back up, Midwest coasts. A lot of these sunbelt, more affordable cities, or used to be more affordable, have been really attractive because, like we've said, a lot of knowledge workers, white collar workers, have been able to be much more flexible with their work environment. And have said, "Hey, you know what? Instead of spending $600,000 for a thousand square foot studio in New York, I can go spend that money and get a beautiful three bedroom in Austin or Dallas, Texas. And pay fewer taxes on it as well," which is always nice.

Andrew Korz (17:10):

So the relocation buyer has been a fundamental driver of this housing market. The way I see it, it's really going to be a power struggle between workers and companies. How much can these people in the tech industry, in the financial industry, in the law industry, how much bargaining power are they going to have to work remotely permanently in the future? That doesn't only have an impact on the housing market, it has an impact on commercial real estate, on the office market.

Lara Rhame (17:45):

Yeah, that's a whole separate podcast, Kara.

Kara O'Halloran (17:46):

[crosstalk 00:17:46] Oh, definitely. My wheels are turning.

Andrew Korz (17:46):

Yeah. Yeah. But I think it speaks to this broader trend of how much bargaining power do workers have today and will these workers be able to work from home permanently? If they can, I think we'll continue to see this broad migration from pricier cities, like New York, like San Francisco, to less expensive cities.

Kara O'Halloran (18:10):

Yeah, absolutely. All right. Well, I want to thank you both so much for joining me today. I thought that was a fascinating conversation. Andrew, I know you just published a research note about this. I admittedly did not understand the title at first, it's called The Race for Space, Analyzing the Red Hot Housing Market, but I get it now. One line in, I got it. I got it. It makes sense. That is available on fsinvestments.com. Thank you both so much.

Lara Rhame (18:32):

Yeah, [inaudible 00:18:33].

Andrew Korz (18:33):

Yeah. Awesome. Thanks, Kara.

Speaker 4 (18:42):

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