

Episode 36

The keys to the housing market

The research team tackles the hot topic of the housing market, the impacts of rising rates + where it could go from here.

[00:00:00] Kara O'Halloran:

Welcome back to Fireside, a podcast from FS Investments. My name is Kara O'Halloran. I'm a director on the investment research team here.

[00:00:06] Kara O'Halloran:

And today I'm really excited to bring you a conversation all about the housing market. I think most people have some sort of vested interest in the housing market. Whether you own a home, you want to own a home, or you just find all those stories about the crazy bidding wars extremely entertaining. But now more than ever, the housing market has a huge macroeconomic impact, especially when it comes to the ongoing conversations that we've all been having around inflation and the Fed's hiking cycle.

[00:00:32] Kara O'Halloran:

So today we're going to walk through where the housing market stands now, what we see moving forward and what impact it has on the broader economy. So, to walk through all of this, I am joined by Lara Rhame, our Chief U.S. Economist and Andrew Korz, another director on the team.

[00:00:46] Lara Rhame:

Hey Kara!

[00:00:47] Kara O'Halloran:

Thank you both for joining me. I'm so excited to do this. I think if listeners heard, actually both of the episodes that we recorded for the macro outlook and the commercial real estate outlook, we kind of went down a housing rabbit hole because I think we just all really wanted to talk about it. So I'm excited that we're doing a full episode dedicated to it. So to start out, Lara, give us the 10,000 foot view. So even if you're like, I just bought a house a year ago, I'm nowhere near active in the housing market, but why do I care? You know, why do all of us who are not actively trying to buy or sell homes? Why do we care about the housing market at this time?

[00:01:23] Lara Rhame:

Sure, so I want to call out an excellent article that Andrew wrote last July, um, has been sitting really at the center of so many economic trends that we've seen since the pandemic began. And I think right now, the primary policy driver that is impacting the markets and our expectations is the Fed rate hike cycle. So from even 30,000 feet, Kara, the Fed's goal right now is to address inflation by raising interest rates to slow economic growth. How do higher interest rates slow economic growth? Well, they raised the cost of borrowing for companies, tightening financial conditions and impacting households by raising borrowing costs for cars, for even credit cards and for housing.

[00:02:12] Lara Rhame:

Another way to put that is housing is ground zero for where rate hikes meet the economy. And when you think about the ways that Fed rate hikes and Fed policy really puts a damper on growth. It is because housing is at that forefront of being such an interest rate sensitive market. The move that we've seen so far in interest rates, higher long-term yields, rising mortgage rates

has already had an impact on housing. And I think because the last recession was so focused on housing, it's something that everybody is just hyper aware of. We had an incredible increase in housing prices and the big question that everybody has is where does it go from here? And what does it mean for my personal home valuation? You know, that wealth increase has been something that a lot of people have been really riding off of in a lot of ways.

[00:03:08] Kara O'Halloran:

100%. There's so many threads that I want to pull on from that answer. So, we'll just dive in. Andrew, I want to toss it over to you now. Just really briefly, so Lara, you already mentioned the low mortgage rates that I think we all saw, we know we saw during the pandemic. So Andrew, what other factors went into creating that really red hot market? Remind us just quickly to set the stage.

[00:03:31] Andrew Korz:

Yeah, I think that's a great idea to just set the stage on kind of where we are now. And then we can talk about where the market might be going. And I think Lara made the crucial point there of like, housing has been just at the nexus of all of these different pandemic trends and ultimately from the highest level.

[00:03:48] Andrew Korz:

It's been a large mismatch between demand and supply, right? So when you think about the supply side, there's this secular factor of, we just did not build enough homes, nearly enough homes during the 2010s. Home builders were scarred during the last recession in 07' - 09'. They didn't want to take risk and buy land and so they didn't build enough homes. We built half the number of homes per person, during the 2010s than we did during the 80s, 90s and 2000s. So you have this significant hole in terms of supply and then you also have this sort of more cyclical factor where we've had people see huge run-ups in their home prices. And they've said, you know what, I'm going to hold onto this a little bit longer and try to get some more appreciation before I go to sell my home. Then on the demand side, you also have these sort of secular versus cyclical factors. So on the secular side, millennials are a really big, generation. Much bigger than the Gen Xers. And they've been a bit delayed in entering the housing market because a lot of them grew up and were entering the labor market during the worst time of the global financial crisis.

[00:04:48] Andrew Korz:

They're finally starting to buy homes. you have this multi-decade decline in interest rates, which has allowed home prices to increase, while keeping mortgage payments lower and more affordable. And then you have the cyclical stuff, which we've talked about ad nauseum in relation to COVID you have the work from home, you know, you have the stimulus, this really strong job market.

[00:05:06] Andrew Korz:

I think COVID, has from a more anecdotal standpoint, really made people appreciate their space more. They want an outdoor space, they want more room to possibly have a home office. So I think all these factors have come together to really just create this huge mismatch between supply and demand. And that's the starting point of the market coming into this Fed rate hike cycle.

[00:05:30] Kara O'Halloran:

So it seems like the easiest solution would just be to increase supply. Right. But that's obviously not an actual easy solution. We can't just build millions of more homes at the drop of a hat and especially with our supply chains right now.

[00:05:44] Kara O'Halloran:

So. I want to talk now, I guess more about the demand side. So Lara you already alluded to the

fact that we've seen the ten-year treasury increase and we've seen the thirty year mortgage rate increase alongside that actually at a higher rate than the increase that we've seen in the 10 years. So mortgage rates are above 5% now. have we started to see demand destruction? How have you seen that impact the housing market so far?

[00:06:08] Andrew Korz:

Yea, It's so interesting, right? Because the magnitude of the move has been so significant, but the speed has been incredible too. So I think we're sort of in uncharted territory here, at least from, my experience and Lara, I'd imagine your experience too, in terms of just the speed of them. So we haven't had that much time to see the pull through of these higher rates into the housing market. We've had a couple months of some data and what we are seeing is yeah, there's, there is some deterioration in demand, whether you look at, weekly mortgage applications, for example, what you're down by about a third.

[00:06:40] Andrew Korz:

That's some of that is refinancings, which have essentially gone to zero. but certainly, a mortgage application for purchases of new homes are down. existing home sales to fall in about 13% from their highs again from a really high level. But they're down, construction starts, basically when a builder starts, breaks ground. That's down, roughly 15% from highs. All of these levels are still strong, but they are down from the incredibly high levels that we saw during say mid to late 20 21. what you are seeing also is, sort of a leading indicator in terms of sentiment. Whether you're talking about buyers or builders, have fallen.

[00:07:16] Andrew Korz:

So builders are stating in these soft data sort of surveys that they are seeing demand from potential buyers start to wane. Will we see that pull through into sort of construction starts, and eventually the availability of new homes. We'll see. The consumer surveys for months have been incredibly negative in terms of is now a good time to buy a home? We've been seeing that I think since I wrote that article, last July, and it's almost for like a different reason now. Right? Cause then it was home prices were not different reasons, but then it was home prices were so high, but now it's oh, home prices are still high and now my mortgage is going to cost me so much more.

[00:07:51] Andrew Korz:

Yeah. And it's actually funny. You mentioned that cause they ask, why do you think now is a bad time to buy a ton to buy a house And most people said back then home prices too high. And now most people [00:08:00] say interest rates are too high. So it's obviously the combination of those two things.

[00:08:03] Lara Rhame:

It's affordability, right?

[00:08:04] Kara O'Halloran:

That's what it comes down too.

[00:08:05] Andrew Korz:

Exactly. And this is a crazy stat, if you look at the average, mortgage payment on the average new home, it's gone from about a thousand dollars a month in January of 2021 to 1500 today, an increase of 50% in a year and a half. and certainly, wages have not gone up by 50%. people's wealth has not gone up by 50%. So what you have now is you have an affordability problem, right? now I think we talked about this earlier where, it's you know, homes are much less affordable now than they were during the 2010s, but we're about average compared to the '90s and the '80s. So I guess the...

[00:08:39] Kara O'Halloran:

Well also the mortgages they're actually at or near long-term averages right now, it's just this recency bias that is really impacting us.

[00:08:47] Andrew Korz:

Yeah. Yeah, no, I totally agree. I will say the question is like how much of this demand is secular? How much of it is cyclical? Right? How much of it is due to the stimulus and the strong labor market? How much is due to the boom and millennial demand, how much is due to these fundamental changes brought on by COVID

[00:09:06] Lara Rhame:

The work from home migration...

[00:09:07] Andrew Korz:

Exactly. Exactly. And that's the question that we're going to have to struggle with here, because it's going to be incredibly important for the next 12 to 18 months of the U.S. economy.

[00:09:17] Kara O'Halloran:

Yeah. Well, I think that's a good segue. Yeah. Do you think that the housing market now is going to be less interest rate sensitive? do some of these demographic trends that we've talked about mean that we could see these elevated home prices? Or do you think that they're going to come off a little bit?

[00:09:34] Andrew Korz:

So I would say I'm a kind of gonna split it down the middle here and make a call without making a call. I would say the housing market this time, for a given rise in interest rates is probably less sensitive than it would have been in your average cycle, looking throughout the decades. I think the difference is the increase in rates that we've seen has happened so quickly. And the magnitude [00:10:00] is so large that, if it just because the market is less sensitive per 1% rise in rate, if the fed hikes to 3% in the next year, it won't matter because they're hiking so quickly and so aggressively.

[00:10:11] Andrew Korz:

So, I think it remains to be seen. but again, like we were talking about I do believe that, the secular demand is there. I do think a work from home is going to be, permanent for a lot of knowledge workers.

[00:10:25] Lara Rhame:

I do think we just really need to also remember how extraordinary the last housing cycle, the last recession was so acutely focused on housing, because I think, we've seen this strong price appreciation and a lot of people are worried that home prices across the country at the most macro level are really going to suffer some significant decline.

[00:10:47] Lara Rhame:

Normally in a housing cycle, home prices do not fall. They just stop rising and stop rising as fast. So I'm not here to make some big call. it's important that [00:11:00] everybody remember what a more normal interest rates sensitive against a normal financial market backdrop is it's not housing prices plunging.

[00:11:10] Kara O'Halloran:

And a big reason for that was the fact that back in 06', 07', 08', all of the 20, I have data right here, 21% of the outstanding us agency, MBS debt. So basically 21% of outstanding mortgages, let's call it that or adjustable rate. So the Fed's hiking and that mortgage adjusts up and your mortgage is no longer affordable. And then a lot of people were forced to sell their homes at depressed prices. So now 2% of the mortgage market roughly is adjustable rates. So I think that's, A lot less forced to selling.

[00:11:42] Kara O'Halloran:

The question is ultimately supply. Right now, we have less than two months' worth of sales, of supply on the market. and to your point, when the Fed started hiking last time, it made a lot of people's mortgages, which were variable rate, a lot less affordable. That's not going to be an issue this time. And now it's actually the [00:12:00] opposite where if you're going to sell your house and you need to get a bigger mortgage.

[00:12:03] Andrew Korz:

All of a sudden you're gonna be paying a higher, blended mortgage rate. So it disincentivizes you to sell actually.

[00:12:08] Kara O'Halloran:

Exactly people are essentially locked into their homes at their really low rates.

[00:12:13] Andrew Korz:

Figuratively...

[00:12:13] Kara O'Halloran:

Figuratively. We have not yet worked. We're not actually... excellent clarification...yes, thank you. But no, I mean, it's just good to contribute to keeping that supply really low.

[00:12:25] Andrew Korz:

Yeah. And that's like w without a significant increase in supply, it's really hard to see. Home prices, like you said Lara, falling materially.

[00:12:33] Kara O'Halloran:

And just to make one other clarification between last cycle and now is just the underwriting standards that we've seen. So we're not in a situation where we're, we have all of these subprime mortgages and that's also going to lead to those forced sales and whatnot. so hopefully we've clarified that we are not, we are hopefully not facing another, 07' 08' situation.

[00:12:51] Andrew Korz:

Nope.

[00:12:52] Kara O'Halloran:

Okay. So we talked a little bit about at the front end about how the housing market ties into the economy and how we care. Andrew, talk a little more nitty-gritty. Cause I know you're our data guy. Like let's talk about kind of actually how housing impacts things like GDP and things like, and we're getting into inflation.

[00:13:10] Andrew Korz:

Yeah, so it's a great question because on its surface, the housing market is not all that big of a contributor so, if I go sell my house and buy another existing house, it actually doesn't show up in GDP.

[00:13:23] Kara O'Halloran:

I always like to say that my excuse for shopping so much is that I'm contributing to the economy. So I'm really devastated. I was devastated to learn that my home purchase didn't have. Contributed GDP, but now I think I might need to redo a bathroom or something.

[00:13:35] Lara Rhame:

Right. All the furniture that you bought and the Peloton that you put in your bedroom

[00:13:39] Kara O'Halloran:

True. That's true. I can justify anything let me tell you

[00:13:42] Andrew Korz:

Coming from all of us, you're doing your part.

[00:13:44] Kara O'Halloran:

Oh no! Okay. So let's bring it back, reel it in. So like I said, the housing market in general is about 4% of GDP and that includes new home construction. Right? It includes, like you mentioned, home renovation, which is a fairly significant part of that 4%. It includes multi-family construction, which is another kind of sliver and that it also includes brokerage commissions, which, is kind of the only way that existing home sales enter into the GDP calculation.

[00:14:10] Andrew Korz:

So, it's a cyclical market. 4% is not nothing, but the direct impacts. from this type of spending are not huge. But there are also some significant indirect impacts. The first would be, through cash out refinancing, which is very volatile based on prevailing mortgage rates. And right now, I think the mortgage rate you can get in the market right now of, roughly five and a half percent is almost two and a half percent higher than the average mortgage rate on an existing mortgage. so nobody's going out and refinancing right now, obviously. Last year in 2021, it was the complete opposite. We had almost \$300 billion in equity, cash out refinancings, which is about one and a half percent of GDP. It's that...

[00:14:47] Lara Rhame:

That's huge addition to household balance sheets...

[00:14:49] Andrew Korz:

Exactly. Yeah. which could impact consumption and, we'll kinda what kind of see, but that'll probably go to, if not zero close to it this year. Then the second one, which we've talked a lot about is of course the wealth effect. Which it's nebulous. I'll let Lara kind of a pine on how to quantify that. But it's something we have a hard time measuring, but people, when they are richer, tend to spend more.

[00:15:08] Andrew Korz:

I think we can say that at the very least.

[00:15:11] Lara Rhame:

Well, and I think the third impact of course, is through the employment side of things. when you have a strong construction, cycle that clearly is just employing a lot of construction workers. And we know that there's a shortage. That demand is also not going to go anywhere.

[00:15:25] Kara O'Halloran:

Right. I mean, back to the wealth effect remember this is also coming at a time when equities are down as of today, over 15%. you know, if we're looking at intraday, so, it's getting hit on that side as well in investors portfolios,

[00:15:37] Andrew Korz:

That's the vast majority of people's wealth right there, right? Yeah.

[00:15:40] Kara O'Halloran:

Right. All right. I want to turn the conversation now to inflation. we've been here before, we've obviously been talking about this for well over a year now. when we first started talking about inflation, we saw a lot of supply chain disruptions that were causing it. We've seen the price of cars skyrocketing. That's gotten a lot of attention.

[00:15:57] Kara O'Halloran:

We've seen goods prices more broadly. [00:16:00] We've seen energy inflation food inflation. It's really, it has been coming from everywhere, but now we're really also seeing it come from the cost of shelter. So owner's equivalent rent is how we measure that. It makes up a really large part of headline CPI.

[00:16:15] Kara O'Halloran:

It's about a third of headline CPI. It's an even larger portion of core CPI. So really the impact of this type of inflation cannot be overstated. the fed is hiking to try to combat that inflation, right? but a lot of those things that I talked about, the fed can't necessarily fix with a rate hike.

[00:16:32] Kara O'Halloran:

You can't fix a supply chain with an interest rate hike, but housing is the most interest rate sensitive sector of our economy. So I want to get your thoughts on, how this fed hiking cycle could impact the inflation that we're seeing in the housing market. And then more broadly, how that can feed into just kind of our economic outlook.

[00:16:55] Andrew Korz:

This is the critical question owner's equivalent rent and it's cousin, I would say, the measure of renting a property, a makeup, at least a third, if not more, I can't remember the exact number of, the headline CPI number. and what started out as more of a goods driven inflation story has broadened out to include services. The vast majority of which are included here, with shelter, we're not going to go into exactly how owner's equivalent rent is calculated, but it's basically meant to measure, the cost of, your home as purely a shelter good. Right. And in recent months...

[00:17:27] Kara O'Halloran:

Its' basically as if someone came to me and I said, Kara, how much would you rent your home out for

[00:17:31] Andrew Korz:

Exactly we're trying to take out the capital appreciation aspect of a home and purely measure the cost of shelter. and it tends to track very closely with rent for an apartment, for example. but essentially what we've seen in the last couple of months is. rent and OER together are rising at roughly a 6% annualized rate, which is far too high. And, I think the Fed would say that this type of inflation, that is clearly driven by really strong demand is both, potentially the [00:18:00] stickiest type of inflation. And it's probably the, as you mentioned, the type that they are most equipped to try to address. so when they see this type of inflation, they say, okay, certainly, you could argue that there's some supply chain issues with trying to build new homes, but by and large, this is a demand driven market right now.

[00:18:18] Andrew Korz:

And the Fed looks at it and says, okay, this is a big part of CPI. This is something that we can have an impact on in my view, the cost of shelter is really the primary channel through which the fed hopes to bring down inflation. now that's is, you know, are these rate hikes going to be enough to do that? We'll see, to me, and I'll kind of give you my quick three scenarios that, could sort of happen here. number one, I think. The first scenario that could happen is the housing market sort of plunges. and we go into a recession. I think that's highly unlikely. Like I think there's too much secular demand.

[00:18:46] Andrew Korz:

The economy is too strong right now. I don't think. It's likely that's going to happen this time around the second, scenario would be that, secular demand and low supply remain, interest rate hikes don't really do much to combat that. and the fed [00:19:00] has to hike more and more to try to get this down. And that raises the risk of as we like to call it a policy error, or I don't even know if it's an error in this situation. but that certainly raises the risk of a growth slowdown.

[00:19:11] Andrew Korz:

And then the final scenario would be, these sort of a soft landing that you hear or softish landing that you hear Jerome Powell talk about, where the data that we're seeing right now is

not housing, falling off a cliff it's housing moderating. And if, they can bring down this, sort of price of shelter to a more normal range, it could help them in their quest for this sort of soft-ish landing. Lara, I'll let you at pine on that, but that's sort of how I see the path here over the next six to 12 months.

[00:19:34] Lara Rhame:

Yeah, those are three, I think very clear scenarios. I agree with you. I see very low probability of a housing plunge just to be clear. and I think to me, it's an important touch point. I do love your phrasing of housing being ground zero for the place that fed rate hikes can impact the economy. The Fed is also watching wage price dynamic they're [00:20:00] watching, household sentiment. They're watching broader consumption. they're watching a lot of other. data, and I think especially in the fourth quarter and beyond, if we do have a fed that's more data dependent than the current posture, which is, 50 again in June 50 basis points again in July.

[00:20:19] Lara Rhame:

So, to that extent, I do think that how housing evolves is a really critical piece of that. There is other, things to watch. but I think the final thing I would say, and this is really critical too, is because housing is somewhat of an illiquid good illiquid transaction because it's near and dear to all of our hearts.

[00:20:38] Lara Rhame:

What you often see is the volume of housing transactions fall, but people reticent to make any kind of downward adjustment to their home price. You know, you saw your neighbors sell their house for \$500,000 last year. It's probably going to take your house sitting on the market for quite some time before you're willing to think. Maybe it's only worth 450K.

[00:20:57] Kara O'Halloran:

Their house is better than mine.

[00:20:58] Lara Rhame:

Maybe. Yeah. Maybe I should only be asking for 450K. So, these are all, I think dynamics that are going to play out. And I think one of the most important things I've heard Andrew say today is the fact that, mortgage rates have gone up 213 basis points since the beginning of the year. That's an extraordinary rate of pace of increase. It's going to take a little bit of time for all of this to feed through housing is not an equity. It's not like, a stock that reports bad earnings and wham you'll see the result that day. It takes time to feed through these statistics.

[00:21:31] Kara O'Halloran:

All right. So we've laid out our three scenarios, you know i think, Very obvious from this conversation that, we're all going to be continuing to watch the housing market very closely, partly for entertainment, because it is just like, I love hearing all those crazy stories about people trying to buy houses on sight unseen across the country, but what are you watching when it comes to the data? What are we really closely? Because this is now about to impact our economy in a major way or could, so what are we watching very closely when it comes to the data for the next few months?

[00:22:01] Andrew Korz:

Yeah. I think Lara reiterated that really the point we want to drive home here, which is like these rate hikes could take some time and, those investors who, know which sort of data tends to lead the cycle. I think, we'll have the best information and some of the things we're looking at, the monthly mortgage application data is really important. And like I said, does show, some significant moderation and demands. So. one thing we look at from a real estate brokerage Redfin is the percent of homes in the market that see a price cut.

[00:22:32] Andrew Korz:

And that's gone up from 1%, towards the middle to end of last year to almost 4% today. homes are still being sold above asking but these little things are, you're starting to see creep in, like price cuts could be sort of Harbinger's of some moderation in the market.

[00:22:47] Andrew Korz:

But I think ultimately, like I said before, It really does come down to supply. And I think, on the new home side, supply chains remain an issue. China certainly is not helping with what they're doing with a zero [00:23:00] COVID policy right now. And on the existing home side, a lot of these homes are owned by, boomers in their sixties or seventies. They mostly own their homes outright. Are they going to put their homes on the market anytime soon? I think the supply question is really critical because like I said, I think there's a baseline of demand. until we see the supply increase, it might be a while before you see housing really moderate materially.

[00:23:23] Kara O'Halloran:

All right. The perfect place to end. thank you both so much for joining and we'll have you back soon. Thank you.