Episode 100

Golden handcuffs: The latest on the housing market

[00:00:06] Lara Rhame: Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist here at FS. And today we are diving into a hot topic, the housing market. I'm joined by Andrew Korz, an Executive Director on our research team and my partner in macro and podcasting.

And he also has special insights into this because he just bought a house. You haven't closed yet, right?

[00:00:31] Andrew Korz: I have not closed. So, please, don't jinx it.

[00:00:33] Lara Rhame: All right. Oh, we're going to, we're going to talk about it. Housing is this fascinating piece of the economy that sits at the center of inflation, consumer sentiment, Fed policy.

We need to talk about renting, you know, because apartment and apartment construction availability is a huge piece of this story. So we want to dive into all of this, but I can't think of a topic that is just coming up all of the time with advisors. You know, their clients...their children can't buy homes.

Even if you have the money, you feel like you can't buy one. So, Andrew, you're under contract, haven't closed yet. Without getting too personal, what was your mortgage rate?

[00:01:20] Andrew Korz: So, I did just get some good news yesterday. My initial mortgage rate that I locked in about a month ago was about 7.1%.

[00:01:28] Lara Rhame: And time stamp, this is July 12.

[00:01:30] Andrew Korz: This is July 12.

[00:01:30] Lara Rhame: So, yeah.

[00:01:31] Andrew Korz: I got a call yesterday that I was able to exercise a float-down option. So my new mortgage rate is 6.625%, so I'm happy about that.

[00:01:40] Lara Rhame: So it's great, but it's still well above the sub-3% bragging rights.

[00:01:46] Andrew Korz: Yeah.

[00:01:46] Lara Rhame: People now have tattoos with their mortgage rates.

[00:01:49] Andrew Korz: I think they call them the golden handcuffs.

[00:01:51] Lara Rhame: Yes, the golden handcuffs, right. And it sounds amazing. Okay. So I want to emphasize to everybody that there are multiple prongs to the problem of the housing market today. And one of them is secular, like a structural problem. The other one is cyclical.

So Andrew, I'm going to ask you this question twice. How did we get here? Structural problem.

[00:02:22] Andrew Korz: Yeah. So this is such a unique market we're sitting in right now, because there seems to be a lot of things happening that don't necessarily, you wouldn't think go together, right. You've got right poor affordability, and you've got low transaction activity, but you've still got high prices, right.

So, how did we get to this sort of unique housing market situation? And I think a lot of it does go back 15 years, post-GFC. Yeah. We had a sluggish recovery out of the Global Financial Crisis, homebuilders after building like crazy for about seven years prior to that, stopped building homes.

As a result, we didn't build enough homes in the 2010s. We built, by our calculation, about half the number of homes as we should have, given the population growth during that period.

[00:03:05] Lara Rhame: Right. So from 2008, really to 2019 we really weren't building enough.

[00:03:12] Andrew Korz: Yeah, and part of that was just because the demand wasn't necessarily there.

[00:03:15] Lara Rhame: Yeah.

[00:03:16] Andrew Korz: People were licking their wounds from the GFC and weren't all interested.

[00:03:19] Lara Rhame: Financing was ghastly.

[00:03:20] Andrew Korz: Yeah. And the people who did buy homes, the Fed was at zero, right? Mortgage rates were really low. So everybody who did buy a home bought it at a low 30-year fixed rate mortgage. Sure. So that's sort of your supply side issues, right? The other supply side issue is just the aging of the population, where we now have almost two-thirds of houses, about 60% of houses owned by people 55 and older.

Those people don't tend to move very often. On the demand side, we have this groundswell of the Millennial cohort, who's actually a very big generation. They were delayed in their home-buying years, partially because they came out of the GFC and didn't have the wealth, but partially because Millennials are getting married later, they're having kids later, so we've more delayed the home buying years than we have gotten rid of them.

[00:04:06] Lara Rhame: And I think we don't appreciate that, right, because we have the Baby Boomers, a large cohort, Generation X, that's me, was a smaller cohort. The Millennials are bigger than the Baby Boomers, there are more of them. And to your point, maybe they've gotten a later start, but they want to buy homes, to be clear. They would like to buy homes, they want to participate.

[00:04:26] Andrew Korz: And there's two myths that we've found to be completely wrong. Number one, to your point, that Millennials don't want to buy houses, that's turned out to be very false. And number two, the Millennials don't have any money. The Millennials are actually ahead of the Boomers in terms of wealth, total wealth creation at this point in their lifetimes.

So those two things have turned out to be completely false. And it's turned out actually that the Millennials have become an incredible force in terms of driving demand for housing, so I think those things all together, not having enough homes built. Obviously the golden handcuffs that we talked about, people stuck in their homes because they have a sub-4, sub-3 percent mortgage rate.

You know, aging sort of population, those people not moving as often. And then you add in this groundswell of demand for Millennials. Those things coming together have created this sort of lopsided housing market where you have generally more demand than you have supply, even when mortgage rates are this high.

[00:05:24] Lara Rhame: So that's the structural problem. Yeah. Let's talk about the cyclical. How did we get here? Cyclical version because I think that's really important to the last four years...have been extraordinary.

[00:05:34] Andrew Korz: Well, part of it is because in 2021, the housing market went crazy, right? Because mortgage rates were sub-3 at that point.

So we had a ton of people buy houses during 2021 at sub-3% mortgage rates, right? Then the Fed jacked up interest rates. And all of a sudden, none of those people were looking to sell, right.

[00:05:52] Lara Rhame: And I want to be clear that one of the extraordinary pieces of the pandemic was a huge churn in housing activity.

You know, we all saw people on lockdown wanting more space. I think in terms of transaction volume, that must have been an absolute surge in movement. There was migration from the Northeast to the Sun Belt states. We had migration from cities to suburbs. I mean, the fun thing about real estate, it's always a local story.

But after that, it was just rush of activity. All of a sudden, it was almost like concrete got poured on everyone's feet because this massive amount of activity landed everybody with sub-3% or 3% mortgages. And that's where everyone's now stuck in the landing, their landing space.

[00:06:49] Andrew Korz: So what ends up happening is the Fed jacks up interest rates that hammers home affordability...

[00:06:54] Lara Rhame: ...yup, kicks housing straight in the teeth. We saw that.

[00:06:57] Andrew Korz: Construction activity went way down. Actually, it went way down at first. Then homebuilders, I think, noticed there's no resale activity here. We can take some market share, right.

There's nothing on the market. We can build some new homes. We can offer mortgage rate buydowns to make the mortgage rates a little bit more affordable. Palatable. And they saw an opportunity. And actually during the second half of last year, homebuilders were actually pretty active. Now new homes are only about 10%–15% of the market.

[00:07:25] Lara Rhame: Sure. Most people buy an existing home.

[00:07:28] Andrew Korz: Yes. Yes, correct. And that market continues to be really, really tight. but we're now in a situation sitting here in mid-2024, where homebuilders have sort of a glut of inventory actually on the market.

So they're starting to pull back, right? So we're at this interesting time in the housing market where prices are still going up. Inventory is slowly creeping up, but not to a point where it's sort of meeting demand. And a lot's going to depend on where interest rates go from here.

[00:07:55] Lara Rhame: Yeah. And I think this has had a big impact on the economy, on many different places in the economy. It's impacted inflation. What was your statistic that rents accounted for half of inflation?

[00:08:08] Andrew Korz: Yeah, rents nearly are, what are they, about a third of CPI?

[00:08:11] Lara Rhame: Yeah.

[00:08:11] Andrew Korz: They've accounted for about half of the increase in CPI since 2022.

[00:08:15] Lara Rhame: Which I think is something, like it or lump it, the reality is when you look at this blended effort to capture the cost of shelter, it's all more expensive.

It's really driven inflation. It's also really impacted household sentiment. I get asked a lot about why households are really gloomy around how the economy is doing, despite the fact that the labor market's strong and the unemployment rate's low. And certainly household spending seems very robust.

And inflation is the pain point. And I really feel that inflation and housing affordability—housing availability—are really being conflated in that it's not just the price of eggs or the price of a baseball ticket. It's also the problem of rents and really, I think this…

[00:09:09] Andrew Korz: …mortgage rates…

[00:09:09] Lara Rhame: …yeah, and mortgage rates. Exactly. It's affordability issue. So, you know, that's a huge piece of it. And then there's the policy piece, and I think that's something we want to talk about, but it's just impacted so many places in the market.

[00:09:24] Andrew Korz: There's a lot of crosscurrents because on one hand, yes, consumers are really displeased with this. Construction activity looks pretty sluggish. That's bad for the economy. Right. But on the other hand, home prices are still high, from a wealth effect standpoint that should make people feel pretty good, along with high equity prices. How do you kind of square how this has impacted the economy on net?

[00:09:47] Lara Rhame: Well, and I think that this is an important piece just as a side note for those who track GDP. When you buy an existing home, it actually doesn't go into gross domestic product. It's the new home construction that we consider a sliver of investment. But all of the durable goods, the kitchen remodel that you do when you buy a new home and you kind of want to make it your own.

All of that activity has really fallen off. And I think we've also seen that in some of the demand for new appliances, new home construction that we do when we either want to sell a home and we're primping our home up or…

[00:10:25] Andrew Korz: …the DIY stuff is kind of, you see it in sales at like Home Depot and Lowe's. Those types of things have kind of got a little more sluggish and we've seen it in inflation data, too.

[00:10:34] Lara Rhame: Yeah, absolutely. So when we look at this backdrop, I want to now talk about multifamily because I think that is a huge piece of it. Most people in this country own about 60%. That leaves an enormous amount that rent.

[00:10:51] Andrew Korz: It does. It does. So yeah, about 35-ish percent of Americans over 18 rent, to your point. It is a significant number of folks, mostly young people. And I think when you think about who affordability is hurting most, it really is that apartment-to-home buyer, right. That first-time home buyer.

So I think the outlook for the housing market and how we think that's going to develop in the coming years is really, really crucial to how we view the multifamily sector of commercial real estate and what are the fundamentals going to look like there.

[00:11:24] Lara Rhame: So, I think your outlook for the fundamental backdrop of multifamily is probably a little bit different. And here's where I think we're going to start now looking ahead and it's important to recognize that we have really good actual visibility into the supply side of this. Because something that we think about is when is supply going to come online? How are we going to move the needle on the supply side of this? The reality is it takes…how long does it take to build a home?

[00:11:52] Andrew Korz: It takes about six to eight months on average to build a home.

[00:11:54] Lara Rhame: And how long does it take to build an apartment building?

[00:11:56] Andrew Korz: About a year-and-a-half to two years.

[00:11:58] Lara Rhame: So, you know, it's not like the strategic petroleum reserve. We can't just open the pipeline and deliver the gallons when there's a shortage.

We can see today looking ahead that multifamily construction has ground to a halt. And we had a bolus of multifamily construction in '21, '22. A lot of apartments came online. There was a lot of talk of a supply glut of apartments. The reality is that did not overshadow or didn't offset the decade of underbuilding that we did.

And going forward, I think something you have really highlighted to me is that we can see very clearly we are going to have a new shortage of apartments in a couple of years.

[00:12:47] Andrew Korz: We are. And look, I mean, the reality is, despite that, I call it a construction boomlet that occurred in 2021.

[00:12:52] Lara Rhame: Boomlet. I like that.

[00:12:54] Andrew Korz: Because you had rock-bottom interest rates and you had rent growth that was soaring. What developer wouldn't want to take advantage of that? Sure. So you had a ton of new projects started in 2021, the beginning part of 2022. A lot of those projects are coming online today, right.

So that's kind of what we've seen over the past 12 to 18 months…is rent growth has slowed in the apartment sector. Just because of this, right, we've had a record number of apartment buildings finished, and it's a pure supply-demand thing, right. When you have that much supply coming online, it's gonna have an impact on the price that people pay for that shelter, right.

The problem is that when the Fed jacked up interest rates the way they did in '22 and '23, that had the perverse impact of making it really challenging to finance new construction. And to your point, supply works with significant lags. It takes a year-and-a-half, two years. Developers have no idea what the market's going to look like.

They're kind of taking a leap of faith when they start a new project. So when the Fed started increasing interest rates, new starts on new projects absolutely plunged, and they're still plunging today, actually. So what that tells us is when we look ahead 12 months, 18 months, 24 months, to your point, there's going to be an absolute supply crunch in the apartment sector, not just in the apartment…actually, across real estate, across industrial, retail, certainly office, but that's kind of for different reasons.

But focusing on multifamily, there's going to be…I think I saw the stat, the forecast is to a 2011 or 2012 level of new apartment completions in 2025 and 2026. So you're putting this against the backdrop of what will probably still remain a really challenging housing market, right.

From an affordability standpoint. So all those people who want to buy houses, but can't afford it yet need to save up for another year or two, they're going to end up renting for longer. So in our view, demand is still going to remain really strong for apartments, right. But you're running into a supply glut, right?

So I think when we look ahead over the medium term, two, three years, what you're going to see is, the apartment market is really going to tighten back up. Rents are going to go back up. And certainly from a societal standpoint, we're not happy about that. Right. We should be wanting to build new housing units, but from an investor standpoint, when we think about the commercial real estate market, it's going to be really a good thing for multifamily fundamentals.

[00:15:20] Lara Rhame: It's still compelling for lending, investing in that multifamily space. Yeah, I think that's still a really positive backdrop today and going forward.

[00:15:30] Andrew Korz: And when you think about it, we've had a record number of apartments completed for the past 12 months.

[00:15:35] Lara Rhame: Yeah.

[00:15:36] Andrew Korz: The market's done fine. That's how strong demand has been.

[00:15:38] Lara Rhame: Vacancy rates have come right back down again.

[00:15:41] Andrew Korz: Yeah. I mean, they're at pre-pandemic levels. The fact that the market has been able to get through this supply surge over the past year, with still pretty strong fundamentals, just shows you how strong demand is.

[00:15:53] Lara Rhame: Yeah.

[00:15:53] Andrew Korz: Imagine what's going to happen when the number of new apartments completed gets cut in half.

[00:15:58] Lara Rhame: Yeah. Okay. So, here we are, in July, the Fed's likely to cut rates in September. They have clearly signaled they want to cut rates and we've just had two really friendly, cooperative and lower-than-expected CPI reports.

So I think they're going to take this opportunity and jump through this window and cut rates. Some markets are pricing in one rate cut in September, another rate cut by the end of the year. Is that going to solve the housing problem? I think this is something that, obviously, we're teasing up the big question, which is how do we solve it?

And I think I know the answer, which is it's a very long-run solution. It's absolutely not a quick fix. But talk to us about what happens when the Fed starts cutting rates a little bit.

[00:16:48] Andrew Korz: Yeah, I think interest rates impact both the supply side and the demand side. We've talked about that, right. So unfortunately, the impacts tend to cancel each other out.

If interest rates end up coming down, that's good for supply, because people won't feel as bad giving up that 3% mortgage rate, right. And they might put their home on the market. That increases inventory. That's good. It might incentivize new construction, which is good. On the other hand, it makes homes more affordable. So you have this groundswell of demand that'll come right in and probably drive home prices right back up.

[00:17:23] Lara Rhame: But this is something we need to be a little more specific about because your mortgage rate, 6%-plus, we cut interest rates 50 basis points, say over the next four quarters, we cut interest rates a hundred basis points. Yeah, we all know that mortgage rates paying off of longer-term interest rates, not shorter-term interest rates. But say mortgage rates even come down to 5 1/2, 5 3/4 . How does that incentivize somebody who's locked in at 3% to sell their home?

[00:17:54] Andrew Korz: Yeah, to me, it impacts demand more than it does supply.

[00:17:57] Lara Rhame: That, I think, is something that is so important for everybody listening to understand. Yeah. The initial, the convexity is looking totally different.

[00:18:07] Andrew Korz: That's such a good way to put it.

[00:18:08] Lara Rhame: From the supply and the demand side. Yeah. So, my view is that we may never see interest rates as low as we saw during the pandemic again, certainly not mortgage rates that low.

And I think the dual edge of that is if we do get the Fed funds back to zero and the tenure incredibly low again, that almost is a catastrophic economic slowdown situation.

[00:18:32] Andrew Korz: Something bad has occurred.

[00:18:33] Lara Rhame: Right. That's not a good outcome. And so I would argue that interest rates are likely to stay north of where they were to facilitate this pervasive golden handcuff concept. How many mortgages are below 4%?

[00:18:52] Andrew Korz: About 60% of outstanding mortgages today are below 4%, and about 35% are below 3%.

[00:18:59] Lara Rhame: [00:19:00] Yeah. So, taking that forward, I think this is the problem; we get 50 basis points of Fed rate cuts this year. You know, maybe another 50 next year. What that leaves us…in a place where you still have sort of strong demand, but supply is still really…I would say dribbling out. It's not really a shock in the supply curve.

[00:19:26] Andrew Korz: I think the secular things we talked about are set in stone, right. It's baked into the cake, the aging of the population, to your point, the golden handcuff phenomenon. The Millennial cohort, all of these things aren't changing. Yeah. So I don't think cyclical interest rate policy is necessarily going to fix this issue, right.

Because again it's kind of whack-a-mole. If rates go down, maybe supply goes up if demand goes up by more. If rates stay high, maybe demand isn't as strong, but there's nothing on the market to buy. So you're sort of in this situation where it's challenging to pick one way or the other. I think we've talked about this a lot.

What's going to solve this problem is long-term solutions and it's not going to be just interest rate policy. There's zoning issues. There's all these things that also impact housing construction. We just need more housing to bring prices down. Otherwise, I think, again, you're kind of between a rock and a hard place.

[00:20:23] Lara Rhame: Yeah. Yeah. All right. Well, I don't…

[00:20:25] Andrew Korz: …and to be clear. One more thing. That's not to say that there can't be secular, excuse me, cyclical points of weakness in the housing market. Of course, that could happen. But thinking over one-, two-, three-year time frames, this market has some serious structural tailwinds behind it.

[00:20:42] Lara Rhame: Yeah, putting a bow on all of this discussion today because this is something I know we're going to keep talking about. We're putting out a chart book about this issue, because it is so fascinating. And I think everybody really likes to talk about it. I want to end with…sort of our three key takeaways.

The first one, trying to put a positive spin on what we just talked about because, again, it is possible to buy a home, everybody, Andrew just did it. He's a Millennial. He took the plunge.

[00:21:20] Andrew Korz: The process was not fun. I will tell you that.

[00:21:21] Lara Rhame: Yeah, no, you looked at a lot of homes, I think. It may not get easier in the near term. Don't wait until the perfect time to buy a home. That may just not really ever come. If you're going to do it, take the leap and do it.

[00:21:37] Andrew Korz: I think decades and decades of housing market history that we've looked at...data that we've looked at would tell you it's never going to feel like the perfect time to buy a home, when you can financially get it together to afford one and it's the right time for you.

I think hold your nose and jump in. It may feel like it's not the best time to buy, but I think it would tell us that this is a long-term purchase. Hold your nose and jump in the deep end.

[00:22:05] Lara Rhame: Hey, you know what? I bought my house in 2006 during another bubble and was like, it feels too expensive. I know this feels like I'm somehow not getting a good deal on this, but over time, it's worked out great. We love our house.

[00:22:22] Andrew Korz: You're doing okay, right?

[00:22:23] Lara Rhame: Yeah, exactly. All right. I think...what's the second key takeaway? I want to highlight your multifamily outlook.

[00:22:30] Andrew Korz: Look, I think again, the construction situation that has been sort of caused by the Feds, unintentionally caused by the Fed's interest rate hikes.

It's baked into the cake. The Fed could slash interest rates by 300 basis points today. And it would spur new construction activity but over the next 18 to 24, 36 months. We're going to have a shortage of apartments being completed. And we're probably going to have a pretty strong demand backdrop for apartments because of what's going on with housing affordability. So, I think the outlook for apartment fundamentals, as a CRE investor, looks really strong.

[00:23:11] Lara Rhame: Okay. Third key takeaway, I think follows that, which, for me is the inflation story. We saw rent prices come down a lot. It took a very long time for that to feed through to the CPI numbers. We have finally seen relief on that owner's equivalent rent component in CPI over the last couple of months.

But, you know, we should not get complacent. I think it's important to recognize that during the 10 years before the pandemic, owners' equivalent rent, what, trended 3% in inflation?

[00:23:46] Andrew Korz: 3, 3.5 annualized yeah.

[00:23:47] Lara Rhame: So it's always run hotter than broader inflation. I think today we're still, at 5%, maybe just under 5% now year over year.

But looking ahead, we may very well see rent inflation reignite in the beginning or second quarter of 2025. I think it just, to me, reinforces the notion that the complacency and the well-behaved inflation that we had for 20 years before the pandemic is over. And we're likely to continue to see stubborn inflation, and we're all going to have to navigate that.

The Fed, investors, all of us, households, we're all going to have to deal with that. I don't think that's going away in just a couple of months, given the multifamily and all these housing dynamics we've discussed today.

[00:24:35] Andrew Korz: Just goes to show, housing really has its tentacles in absolutely everything in the economy.

[00:24:40] Lara Rhame: Yeah. Well said. All right. Well, let's leave it there, Andrew. Thank you. I look forward to picking this up again, maybe sometime in the middle of next year after the next several rate cuts.

[00:24:49] Andrew Korz: Fingers crossed that closing goes off without a hitch.

[00:24:53] Lara Rhame: Good luck. Good luck.

[00:24:54] Andrew Korz: Thank you. Thanks, Lara. [00:25:00]