IS THE RUN-UP IN HOUSING PRICES SUSTAINABLE OR IS THIS A BUBBLE READY TO BURST?

By: Scott Colbert, CFA®

By now we've all heard anecdotal stories about multiple contracts with escalator clauses to purchase a home for sale and prospective home buyers being so desperate to make a single-home purchase they are willing to forego a home inspection as part of the sales contract.

The S&P/Case Shiller Home Price Indices, the leading measures of U.S. residential real estate prices, recently rose more than 14% on a year-over-year basis—the largest annual price increase since December 2005. Quite obviously demand for residential housing is directly fueled by low interest rates and remains robust even in the wake of the moderating COVID-19 pandemic.

While ongoing demand remains high, home supply inventories are constrained. Lack of supply exacerbates the problem for entry level first-time home buyers or those wishing to upgrade. No wonder recent housing statistics show used homes were on the market an average of just 17 days (the fewest on record) and 90% were sold in less than a month.

However, subtly pushing back behind the scenes on this demand is the near-term issue of managing a significant number of delinquent homeowners who have been helped via government forbearance programs that just ended in July.

What will the impact be? Perhaps as many as 9 million households in total (renters and mortgage payers) hit the pause button on making monthly payments via the provisions of Coronavirus Aid, Relief and Economic Security Act (CAREs), entering into "forbearance."[1] Presumably many homeowners will now have to revisit terms with their mortgage lenders. And of course, added into the mix is the fact that rapidly rising home prices have begun to dent affordability.

Tangentially, it is estimated that more than 15 million people in 6.5 million U.S. households are currently behind on rental payments according to a study by the Aspen Institute and the COVID-19 Eviction Defense Project, collectively owing more than $20 billion to landlords.[2]

Could all these market forces create a tipping point? We don't believe so, but here is a list of factors driving the housing market we should all watch going forward…

1) **INTEREST RATES** – Surprisingly low fixed-rate mortgages are still working their magic. Interest rates peaked this year at the end of March and gradually declined over the last four months. And as mortgage lenders have worked their way through the initial surge of refinance activity last year, they are now taking less spread – read "less cost to you" – to originate your loan. The average 30-year fixed rate mortgage continues to hover around 3.0%. Obviously, the mortgage rate is the key driver to affordability and to the extent mortgage rates rise, demand will begin to fall.

2) CORONAVIRUS FLARE-UPS – With growing apprehension about the delta variant, people are still looking to add or buy more space in their living arrangements that they might not have needed or sought before the outset of the pandemic. Delayed household formation has added to pent-up demand, keeping the housing demand rate consistently high as reopening the economy continues on its relatively steady path.

3) NEW HOME STARTS – There was a sharp drop in new home construction after the subprime crisis and a sizable new generation of home shoppers is entering the market while older generations are choosing to hang on to their homes. Optimally, the rate of new home construction needs to keep up with new household formation. But cautious homebuilders and bankers who clearly remember the financial crisis have reacted warily to this sudden surge in demand, while supply chain disruptions regarding lumber, other housing materials and even labor have limited the new home construction response. While housing starts are up 29% from depressed year earlier levels, it takes a long time to source, permit, develop and build a subdivision and new supply has yet to catch up with demand.

4) THE MILLENNIAL GENERATION IS PLAYING CATCH-UP – The 22- to 35-year-old crowd has delayed family/household formation and this in turn delayed housing demand. Now they are having children, and that apartment in an urban area next to a coffee shop isn't as appealing now as a house with some space for the kids and a good school district.

5) AFFORDABILITY – The affordability index remains surprisingly near all-time highs mostly because low interest rates give buyers more purchasing power and is still nowhere near the lows reached just prior to the subprime crisis in 2007-2008.

6) LACK OF OWNERSHIP AND RISING RENTS – Forty-four million or 36% of U.S. households rent their homes today[3], up from 31% prior to the subprime crisis. Those folks who lost their house during the housing-induced recession have restored their credit scores and would like their homes back. In addition, more than a third of current renters are under the age of 35. With residential rents increasing at a 6% pace, there is ample demographic and financial incentive to lock in a permanent residence.

7) INVESTOR DEMAND FOR "THE SINGLE-FAMILY ASSETS CLASS" – Historically single-family rentals have been a mom and pop operation of limited scale. But as millions of houses were dumped on the market after the subprime crisis, hedge funds, driven by falling prices and investor demand, stepped in and accumulated large tracts of single-family housing, reducing available supply while demand has picked up. It is possible these large-scale investors could eventually become sellers, but for now they are steady holders and have taken marginal supply off the market.

8) UNDERWRITING – New stricter mortgage underwriting standards are now in place and the days of "no money down, no job, no income and no doc" mortgages are well behind us. Buyers have their down payments and their incomes are now fully documented. Underwriting tends to weaken late in the cycle but today it remains closely regulated and fully buttoned down.

While it's clear that we will always have the push and pull of supply and demand and offsetting market behaviors for quite some time, the combination of today's low rates, pent-up demand, lack of new supply and a re-opening economy will more than likely offset any nearer term increase in supply and the less affordable prices buyers are confronted with. At the margin the rapid price increases we've seen so far are certainly going to cool, but the underlying robust demand will provide a rather persistent and solid floor to home prices on a going forward basis.

[1] https://m.investing.com/news/coronavirus/us-covid19-residential-eviction-ban-set-to-expire-at-midnight

[2] https://www.cnet.com/personal-finance

[3] https://ipropertymanagement.com/research/renting-statistics

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