ACG Insights: Housing Crash Redux?

Executive Summary

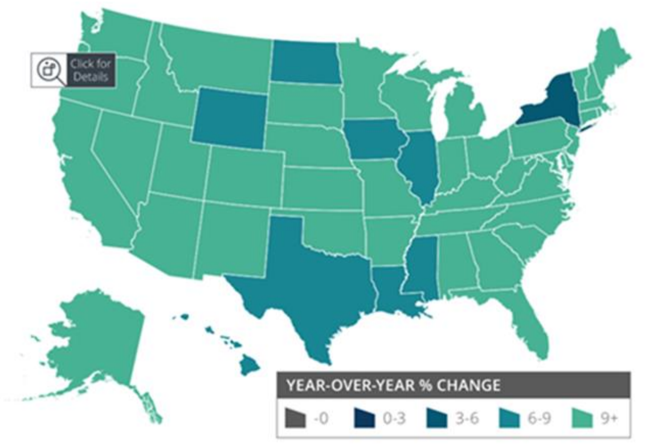
- **Americans with excellent credit have decided to take advantage of the historically low-interest-rate environment and buy homes further away from America's largest metropolitan areas.**
- **Institutions, like pension funds, have seen residential real estate as an attractive place to invest thanks to the low return environment.**
- **Builders have struggled to keep with this new demand after underbuilding in the prior decade as COVID-19 supply shortages have caused prices of labor and building materials to increase.**
- **Supply and demand fundamentals are likely to remain in place for the near-term supporting housing prices.**

Background

For decades, buying a home has been a part of the American Dream. It has been a reliable way to build wealth for many average Americans, and in turn, has become a key pillar of support for the U.S. economy. Up until the 2008 financial crisis, there were few recorded instances of housing prices falling nationally. In the run up to the 2008 financial crisis, Americans demanded houses at a rapid pace fueling a surge in prices. It was not until borrowers with the lowest credit profile, sub-prime, began defaulting on their mortgages that the music stopped for housing, and ultimately the global economy. Fast forward to 2021, and many are experiencing Deja-vu. In most states, housing prices rose more than 9% year-over-year in 2021[1], with the national average posting double-digit returns. The strong price action has made people anxious to know if we are headed for another 2008 style meltdown. Although we do not like this phrase, it accurately describes our view. "This time may be different".

[1] Source: CoreLogic

Exhibit 1: States YoY Change in Housing Prices[1]



Americans Scramble for Housing

When the United States entered lockdown in March 2020, millions of Americans found themselves confined to small living spaces in COVID hotspot cities. With many Americans working from home, the need for more space became imminent as people were "trapped" at home with children or significant others. Coupled with interest rates dropping, and projected to remain historically low for some time, Americans, took advantage and bought homes with more space in the lower cost cities near America's largest and priciest metropolitan areas. A study conducted by the Cleveland Federal Reserve titled *Migrants from High-Cost, Large Metro Areas during the COVID-19 Pandemic, Their Destinations and How Many Could Follow* explains this point. In the study, the authors examined migration patterns pre-pandemic and during the pandemic. What they found was that the "bigger 'winners' from the changes in net migration during the pandemic are smaller metro areas near high-cost large metro areas"[2].

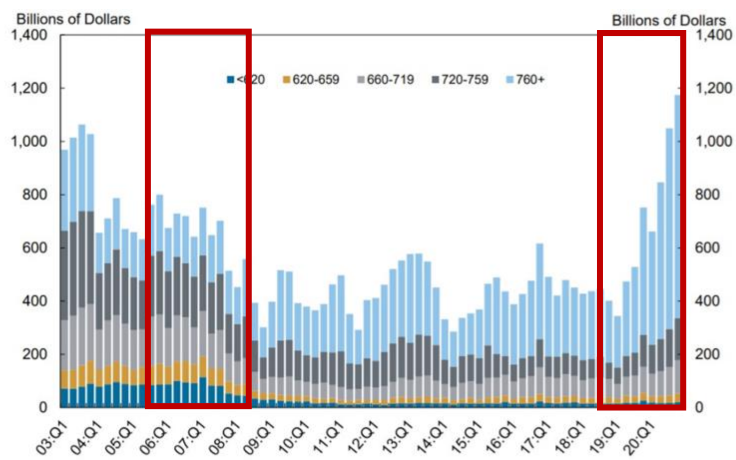
Today's buyers, however, are different from that of 2008. In Exhibit 2, we see how the quality of borrowers has changed over time. In 2008, sub-prime borrowers, people with credit scores less than 620, were a noticeable share of new mortgages. These borrowers typically had low assets to put down on a home, and higher debt to income. When the housing market collapsed these borrowers were among the first to default on their mortgage loans. By 2020, sub-prime borrowers were almost non-existent with the bulk of home borrowers having excellent credit, credit scores north of 760. These high-quality borrowers tended to have COVID resilient jobs, ability to work from home, and higher levels of assets to afford home purchases.

Another key pillar of support of housing demand today has been the rise of institutional funds. In today's low-interest rate environment there are few places to put capital to work. Institutions, like pension funds, need to generate consistent returns to meet future benefit payments. This has forced some institutions to become more creative by including single-family homes as a part of their portfolio. The pandemic only accelerated this demand as residential housing was seen as one of the few initial bright spots of the U.S. economy at that time. Now institutions are competing against average Americans for homes, which is driving prices higher. In fact, a recent Wall Street Journal article titled *If You Sell a House These Days the Buyer Might be a Pension Fund*, a real estate

[2] Source: Cleveland Federal Reserve *Migrants from High-Cost, Large Metro Areas during the COVID-19 Pandemic, Their Destinations and How Many Could Follow*

consulting firm noted "' You now have permanent capital competing with a young couple trying to buy a house. That is going to make U.S. housing permanently more expensive'"[3]. As the competition among institutional investors and average Americans heats up, this only increases housing prices.

Exhibit 2: Mortgage Originations by Credit Score[4]

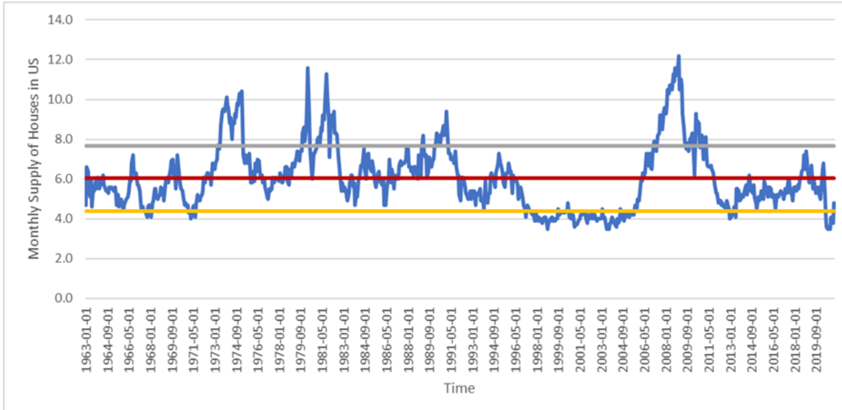


Supply in Short Order

With many American's looking to buy homes, supply has been unable to catch up. In metro markets across America inventory of homes is at the lowest levels in years. In Exhibit 3, we look at monthly supply of housing nationally going back to the 1960s. Numbers above the red line, historical average, means that there is more supply on the market with below the average saying there are housing shortages. Currently, housing inventory is at less than 5 months, below the historical average of 6 months. If we contrast with 2008, we see that monthly supply of housing was way above the historical average topping out at approximately 12 months. One explanation for the low housing inventory was seller's uncertainty due to COVID-19 pandemic. In a New York Times article titled *Where Have All the Houses Gone?* The author speaks to economists to help provide answers to this question. Professor Benjamin Keys, an economist at the Wharton Business School at the University of Pennsylvania, opined "'the supply side is really tricky. Who wants to sell a house in the middle of a pandemic? That's what I keep coming back to. Is this a time you want to open your house to people walking through it? No, of course not'"[5]. As the pandemic hit the United States, sellers pulled their houses off the market. Homeowners were fearful of contracting the virus and the idea of people walking in and out of your home was not appealing. With other uncertainties, like the economic fallout of the pandemic and what it means for their jobs, homeowners in large part decided to stay put. Resellers were not the only ones contributing to the dearth of housing supply as builders were having trouble keeping up with the increased demand.

[3] Source: Wall Street Journal *If You Sell a House these Days the Buyer Might be a Pension Fund*
[4] Sources: Bureau of Economic Analysis; Barron's calculations. As of 9.30.20
[5] Source: New York Times *Where Have All the Houses Gone?*

Exhibit 3: Monthly Supply of Houses in the United States[6]



Following the financial crisis, the construction industry pulled back on building activity as firms went out of business or were very cautious after suffering huge losses. Post financial crisis builders would only build homes if demand were confirmed. When the pandemic hit, demand surged catching the construction industry off guard. In a recent article in the Wall Street Journal Freddie Mac stated, “the U.S. housing market is 3.8 million single-family short of what is needed to meet the country’s demand…This is what you get when you under build for 10 years”[7]. Now builders are reporting shortages in skilled workers, while struggling to obtain building materials as the pandemic created supply chain issues pushing building costs higher. These supply issues could take years to sort out further supporting higher housing prices.

Summary

COVID-19 has become a key turning point for the housing market. Like other economic trends, the pandemic accelerated demand for housing, as more prime borrowers looked to take advantage of low-interest rates and increase their housing space, while institutional investors sought consistent returns in a low-interest-rate environment. While demand has been very robust, the supply response has been much more muted. Builders have struggled to meet this new demand. The lack of supply has pushed housing prices up fast enough to spread fears of a repeat of 2008. While we do not pretend to have a crystal ball, we believe that the current market fundamentals support these prices. Barring any sudden changes in these fundamentals, we do not believe fears of a housing bubble are warranted.

[6] Source: St. Louis Federal Reserve
[7] Source: Wall Street Journal *U.S. Housing Market is Nearly 4 Million Homes Short of Buyer Demand*

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