Investment Management

Housing Market Commentary

Q3 2023 Economic Landscape

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Market Commentary

Overview:

1. **House prices reached an all-time high.**

   House prices have surpassed their previous peak back in June 2022. The normalization of home price appreciation has continued to outperform many market and expert expectations.

2. **Housing market indicators pointing toward fundamental growth.**

   Real wage growth has shown a sharp uptick as a result of the Fed moving closer to its target. We can see that demand remains very strong for housing as vacancy rates remain extremely low.

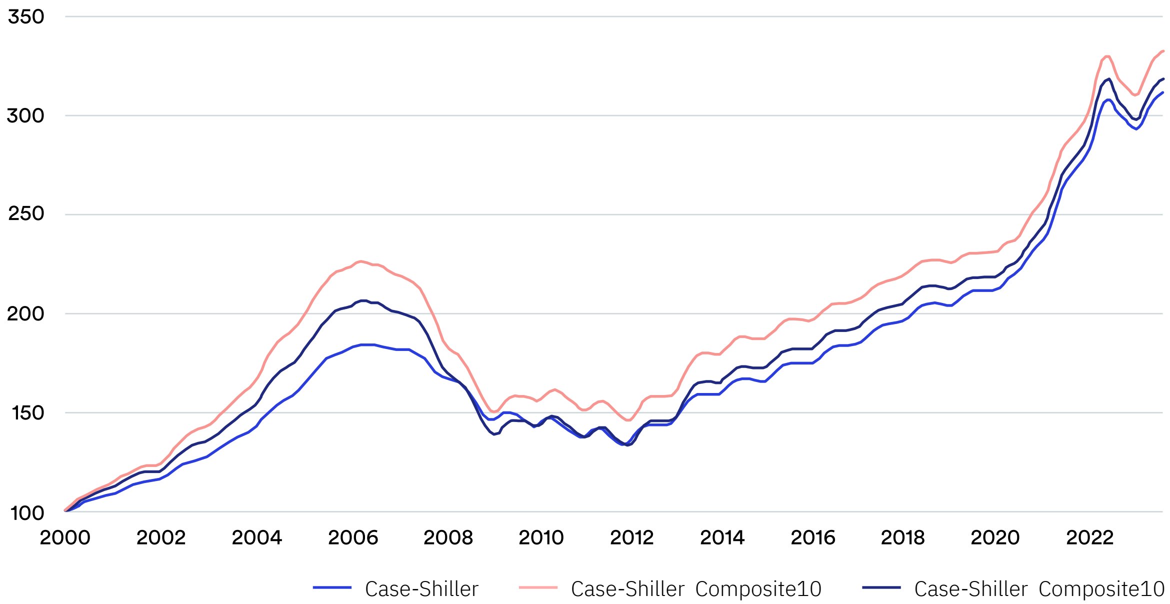
3. **Rising mortgage rates continue to constrict housing supply.**

   The current supply deficit is continually increasing, and it appears that the impact of higher rate hikes has deterred supply more than demand. Higher financing rates are reducing listings, which enables prices to appreciate despite aggressive monetary policy tightening.

Housing Prices Surpass June 2022 All-Time High

Home prices indicated by the Case-Shiller Index reached an all-time high in July 2023[1] with the index ticking just above 310, the previous peak being a little over a year ago in June 2022. Growth rates were fairly consistent, but there is a little concentration in the largest ten American metros as the ten city index[2] grew at 0.61% for the month, while the composite-20[3] (0.6%) and the national index (0.59%) slightly trailed. All three indices are back in the positive for the year at just under 1%, making up for the slight correction in prices during the second half of 2022. The fastest growing of the top 20 metros for the month were Las Vegas[4] (1.1%), and Phoenix (0.9%), which had had some of the largest declines over the last year, -7.2% and -6.6% respectively. Portland (-0.2%) and Boston (0.1%) were the two most sluggish cities for the month. The most robust growth for the year is still coming from midwestern cities; Chicago and Cleveland have seen some of the fastest growth (4.4% and 4.0% respectively). One of the ways we can account for this fact is to consider house price-to-wage ratios, which were more aligned with fundamentals in those midwestern cities a year ago, while house prices were drastically outpacing wages in cities like Phoenix and Las Vegas (as projected in our metro housing outlook[5] earlier this year).

Home Prices Have Rebounded



House prices have surpassed their all time highs.

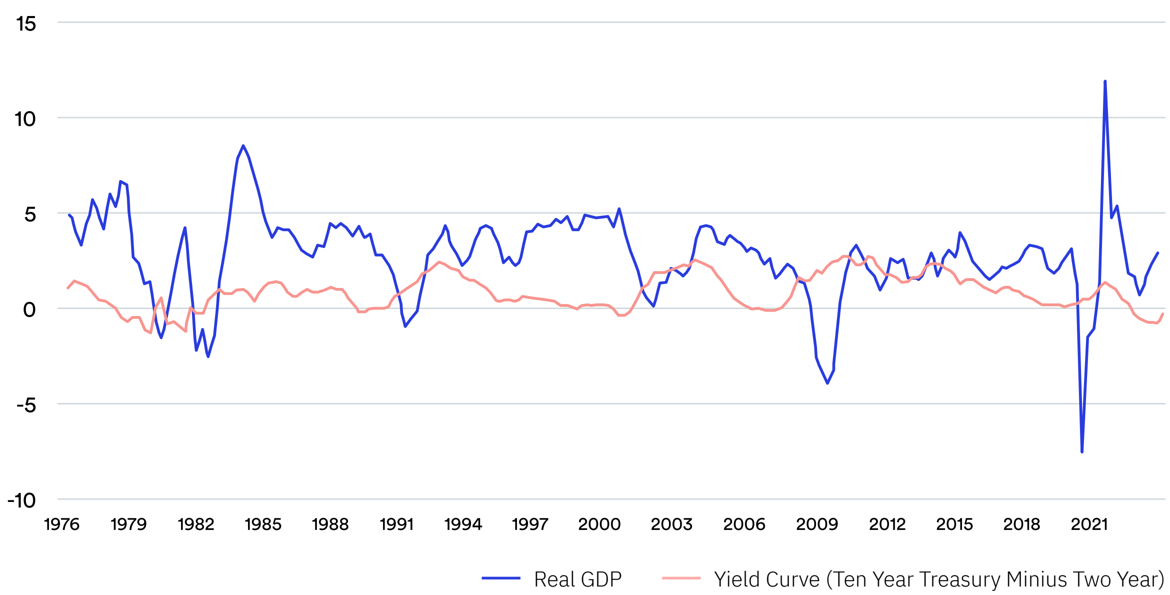
1. S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CSUSHPINSA, Oct 30, 2023.
2. S&P Dow Jones Indices LLC, S&P/Case-Shiller 10-City Composite Home Price Index [SPCS10RSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SPCS10RSA, Oct 30, 2023.
3. S&P Dow Jones Indices LLC, S&P/Case-Shiller 20-City Composite Home Price Index [SPCS20RSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SPCS20RSA, Oct 30, 2023.
4. https://www.spglobal.com/spdji/en/documents/indexnews/announcements/20230926-1466568/1466568_cshomeprice-release-0926.pdf
5. Metro Housing Outlook by Unison.

Higher Interest Rates Aren't Detering Demand

We tend to touch a lot on the actions of the Fed in these newsletters, but the picture has altered very little. The market is still pricing about a 25%[6] chance of a rate hike through the end of the year, while the most recent Fed dots indicate there is still one more hike to come. At the same time, inflation was initially trending toward the Fed's target at a fairly aggressive rate that has, however, flattened a bit; this shift reintroduces more uncertainty into the frame. As a result, credit spreads remain quite elevated by most and various metrics, and the spread between mortgages and treasuries is still well above historical norms at around 290[7] basis points.

Despite one of the most aggressive hiking cycles in the post-Volker Fed era, economic activity has remained very robust. Real GDP growth has been very healthy since Q3 last year. Some of the gains this year so far are already outpacing target growth rates for the Fed at an annualized rate. Real GDP[8] grew at just over 2% in 2023Q2, and the preliminary estimate for Q3 this year is 4.8%. This is crucial for the development of house price appreciation. The most common macro environment home prices suffer relative to other asset classes is very low or negative GDP growth; otherwise, it represents one of the more consistent asset classes on a risk-adjusted basis. While we aren't quite out of the woods on the prediction range from last year's yield curve inversion[9] (frequently there is a recession 6-18 months after an inversion between 10 and 2-year treasuries), it seems more likely that the prediction we made last year will come to fruition: the inversion was more likely a function of short-term inflation premium built into pricing treasuries, and rate hikes would eventually tame it.

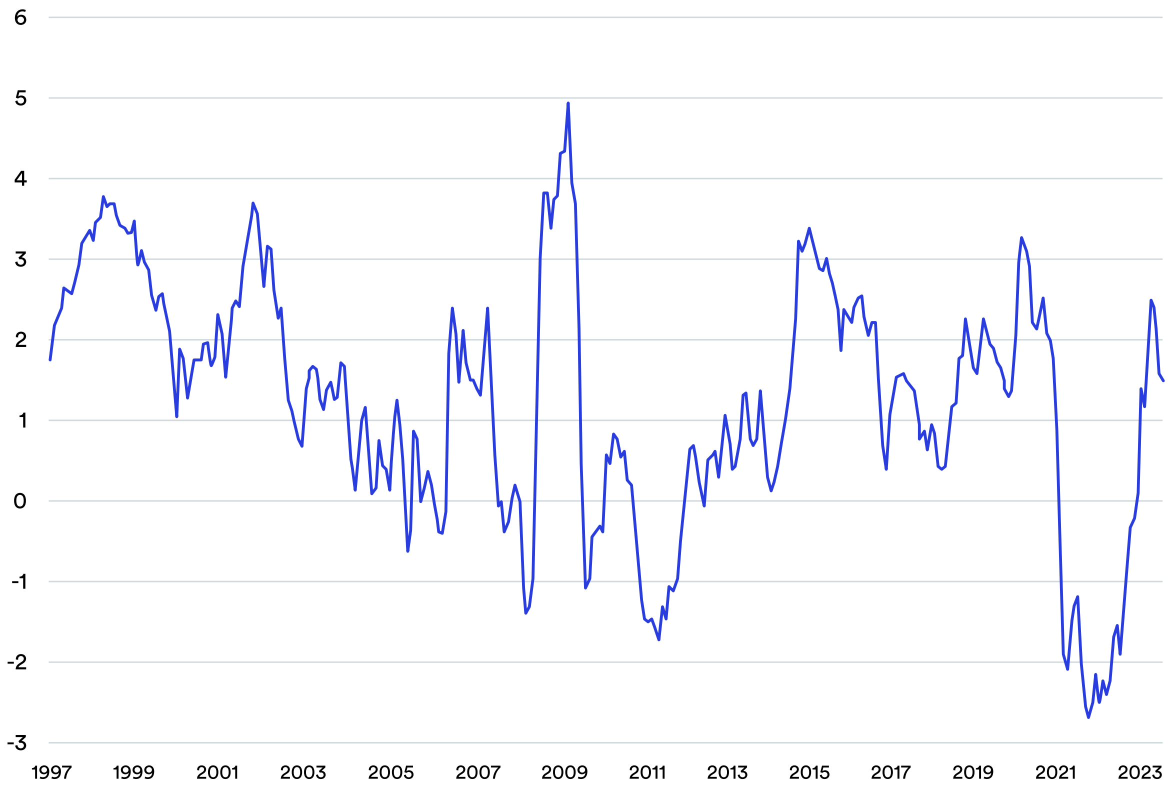
Robust Economic Growth



6. https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html
7. Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US, October 31, 2023.
8. U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDPC1, October 31, 2023.
9. Federal Reserve Bank of St. Louis, 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity [T10Y2Y], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T10Y2Y, October 30, 2023.

In a similar vein to economic growth, one of the key contributors to HPA is wage growth, and the labor market has done better than persevere with the hikes coming from the Fed. We are beginning to see real wage growth[10] resume its historical levels as inflation has come down, which is even more significant than the actual wages themselves. The real purchasing power increases are particularly important because this stream of payments makes housing more affordable and better aligns prices with fundamental increases.

Real Wage Growth Accelerating



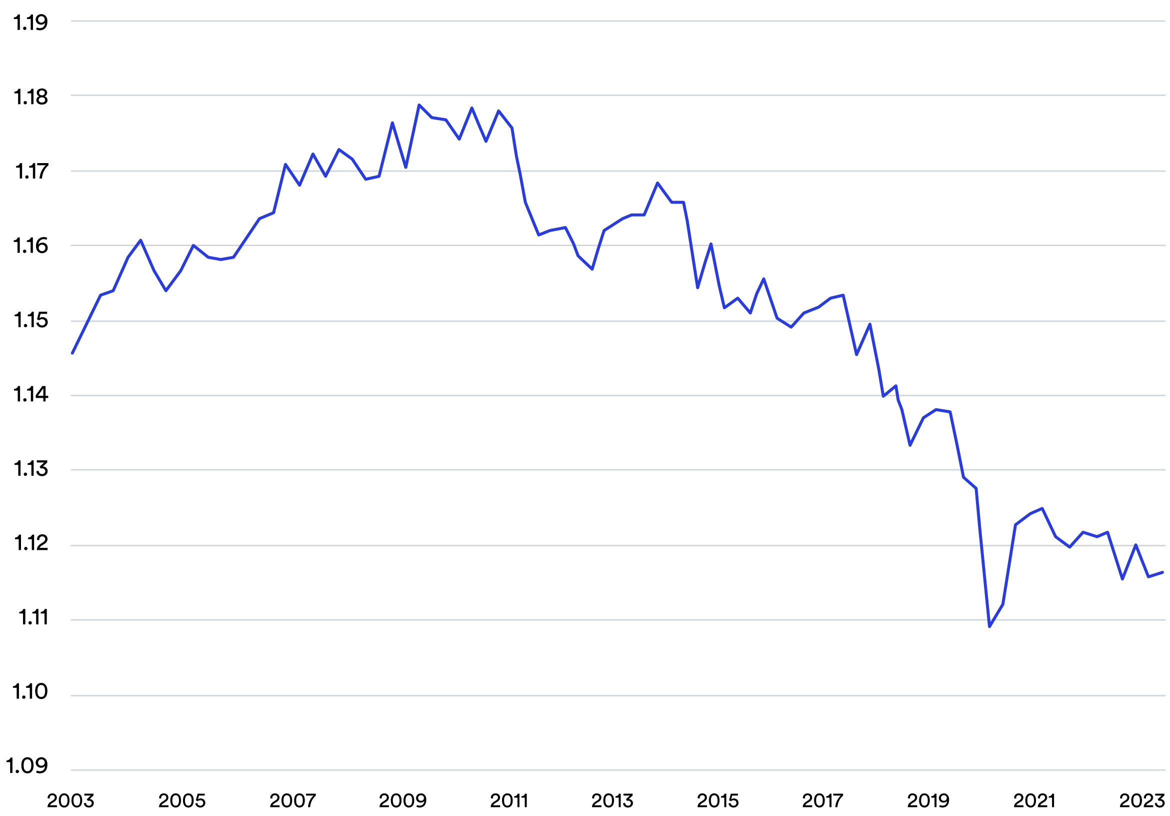
Real GDP outpacing Fed's target growth rates.

10. https://www.atlantafed.org/chcs/wage-growth-tracker and U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPIAUCSL, October 31, 2023.

Short-Run Housing Supply Is Extremely Tight

The U.S. has experienced a significant housing deficit for quite some time, but what's more alarming is the extent to, and rate at which this problem has expanded. As seen below, the inventories[11] peaked on a per-household[12] basis after the GFC, but have been on a very steady decline since. This increases the demand for the existing housing, providing a significant home price appreciation even with demand relatively weak over the last 8-12 months.

Ratio of Housing Inventory to Households Falling



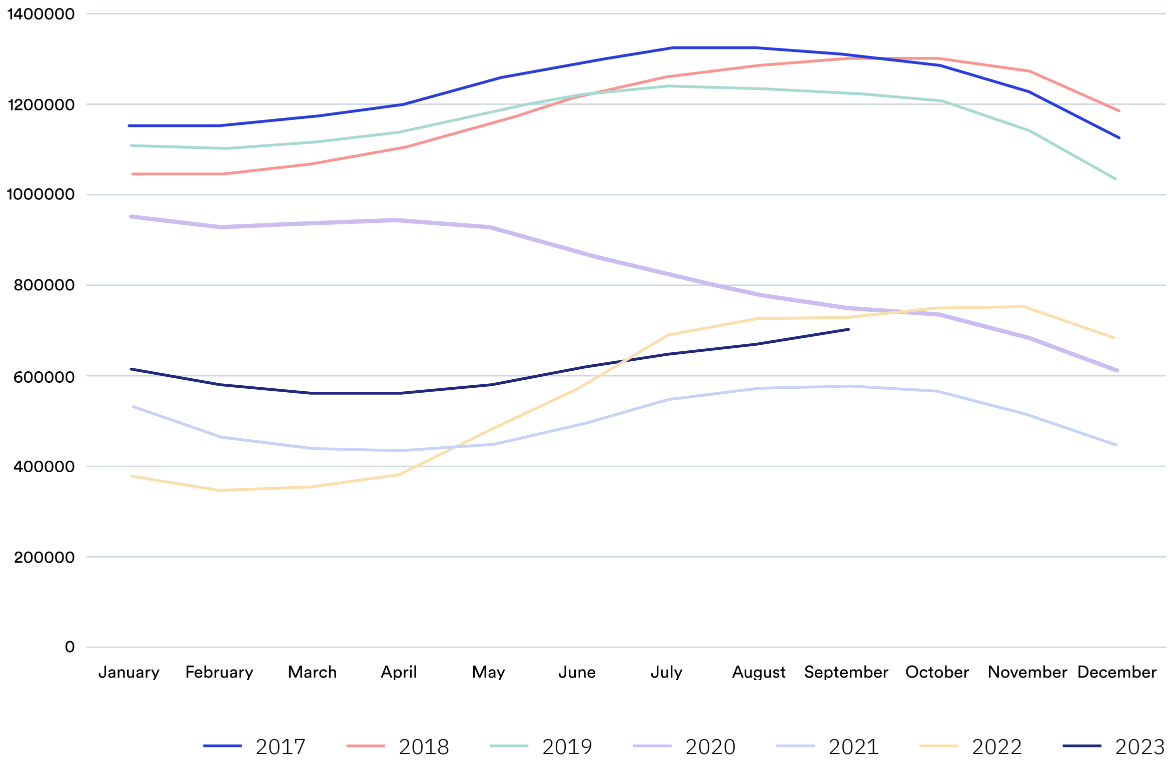
Housing supply not keeping pace with growing number of households.

11. U.S. Census Bureau, Housing Inventory Estimate: Total Housing Units in the United States [ETOTALUSQ176N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ETOTALUSQ176N, October 31, 2023.

12. U.S. Census Bureau, Household Estimates [TTLHHM156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TTLHHM156N, October 31, 2023.

This problem has also been exacerbated by the higher interest rates. While most think of interest rates as having an inverse relationship with house prices, that's not necessarily the case, as we can witness in the current environment. Many homeowners are locked into relatively cheap costs of financing, which makes moving relatively unattractive. This has severely suppressed the active listing count[13], and the figure below illustrates that the housing listings look more like they did during the incredibly high appreciation rates we saw in 2021 than anything similar to the pre-COVID high-interest rate era.

Active Listings Have Fallen Extremely Low

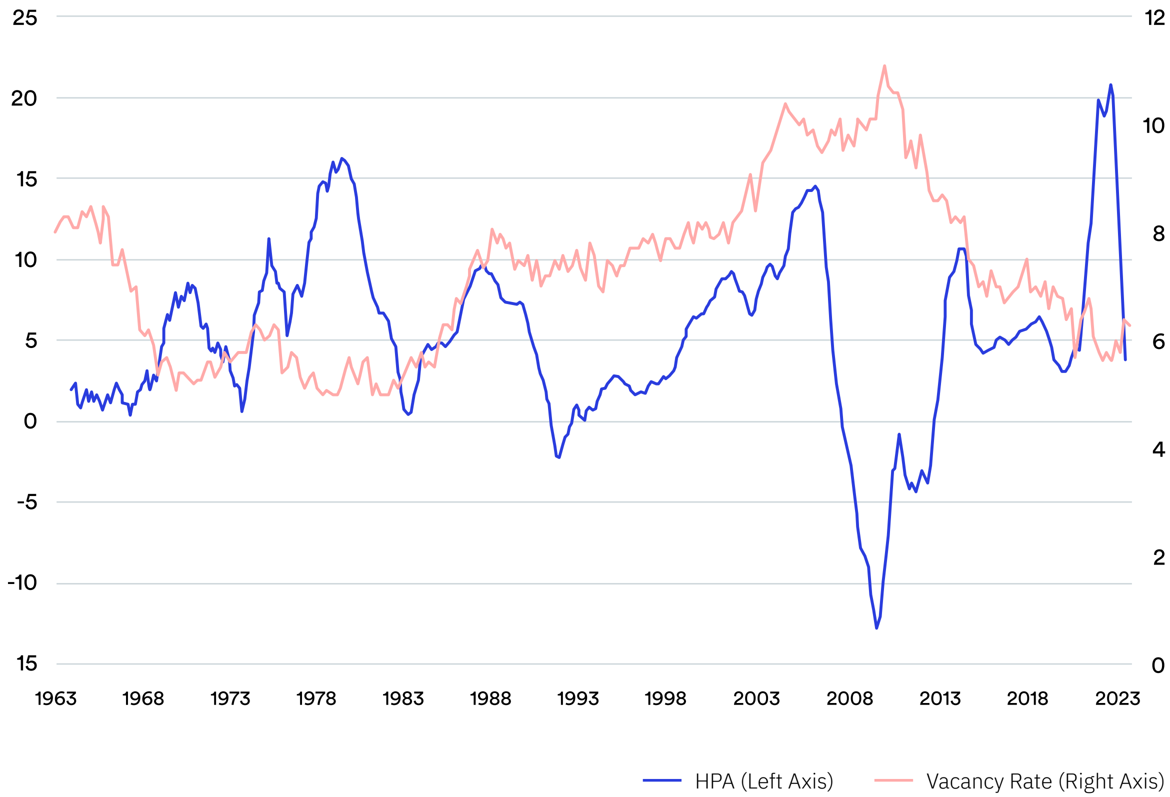


Higher interest rates are deterring sellers, keeping supply low.

13. Realtor.com, Housing Inventory: Active Listing Count in the United States [ACTLISCOUUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ACTLISCOUUS, October 31, 2023.

Finally, one of the last gauges of the tightness of the housing supply is vacancy rates. The number of vacant units reflects the limited supply. In the graph below, you can see that vacancy rates[14] were extremely low during the high appreciation period of the 1970s, and inversely, they skyrocketed during the housing bubble in 2008. It was only as vacancies began to fall that HPA recovered. While the current vacancy rate isn't as low as the 1970s, it is below its historical average and almost half what we saw from the 1990s onward.

Tight Vacancy Rates Imply Stronger Housing Demand and Supply Shortfall



The vacancy rate is almost half what we saw since the 1990s.

14. U.S. Census Bureau, Rental Vacancy Rate in the United States [RRVRUSQ156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/RRVRUSQ156N, October 31, 2023.

Summary

The housing market has made a full recovery despite pressure from the Fed. House prices surpassing their all-time highs is an indication of the robustness of the U.S. market. Plus, the growth has been fairly consistent across the largest metros in the U.S. The conditions are beginning to show strong signs of recovery on the demand side with real wages and economic growth performing incredibly well. The United States' persistent supply shortfall has only continued to grow. The shortage of homes relative to the number of households provides a floor on HPA, and vacancies signal that the U.S. market is more constrained than it has been in nearly forty years–given these facts and circumstances, home prices have sufficient support to resume their historical growth.