unison
Investment Management

Housing Market Commentary

2023 Economic Landscape

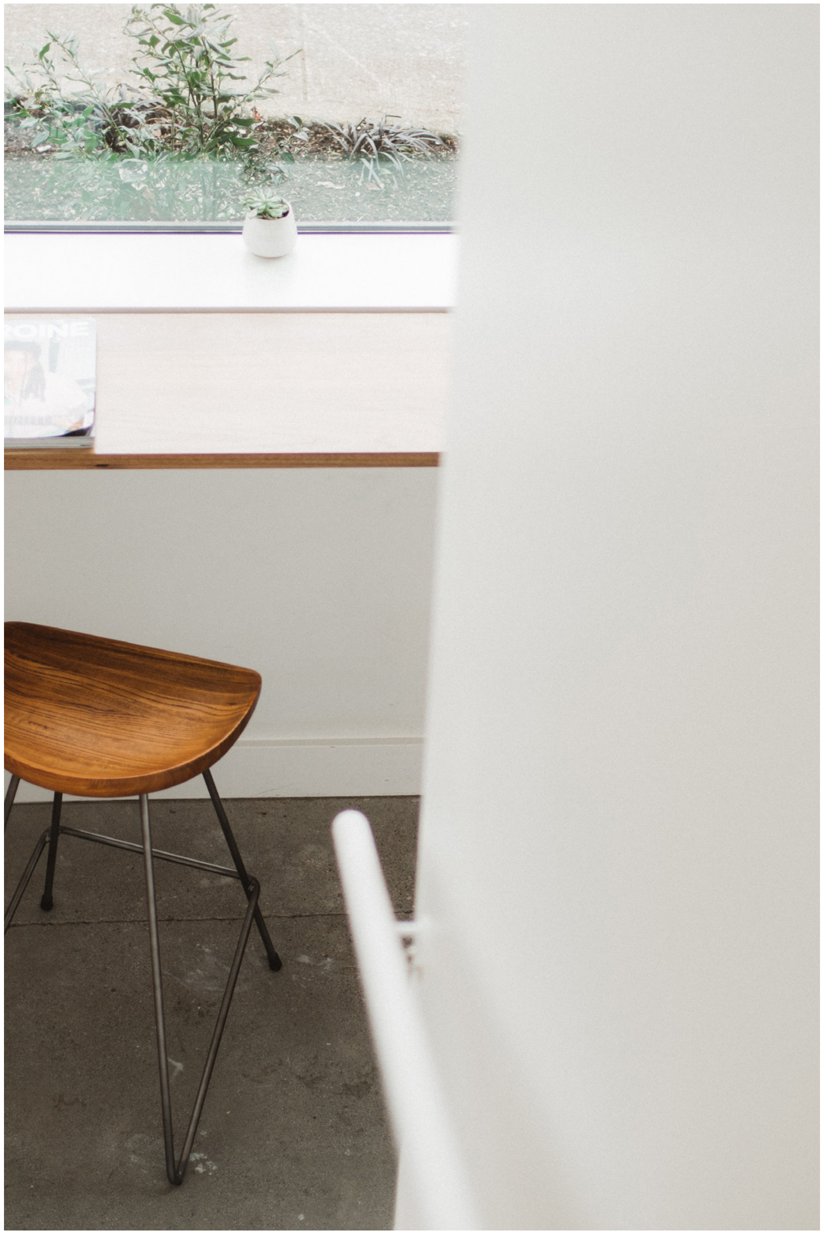


Table of Contents

Overview

1. **The housing market is returning to historical growth.**

   House prices as indicated by indices such as the FHFA and Case-Shiller are beginning to slow down due to high pressure from rising mortgage rates as Fed hikes continue, and are returning to their historical norms.

2. **Housing supply remains tight by multiple metrics.**

   One of the two most significant factors that have been a backstop in house prices compared to 2008, is the tight housing supply.

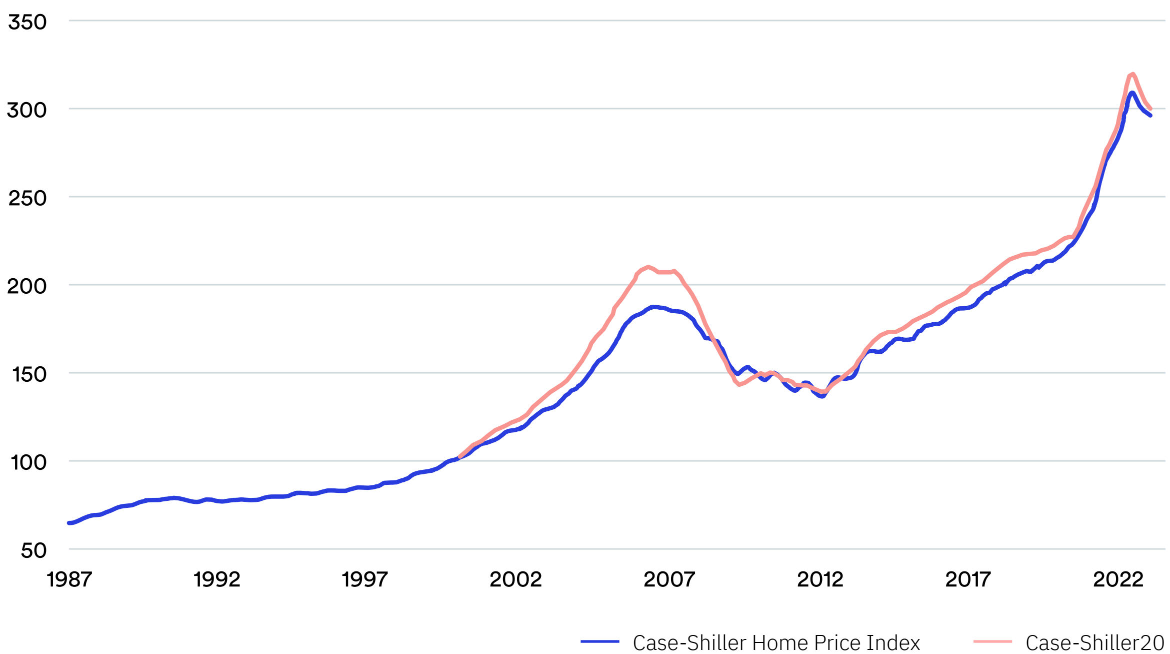
3. **Labor Market Signaling Economic Strength.**

   While rising interest rates have provided headwinds for consumers to purchase new homes, income remains elevated by any historical metric. Many markets will be more poised to rebound with more certainty regarding inflation.

The Current Housing Market

Case-Shiller[1] declined in the final month of 2022 by -0.3%; however, as a whole, 2022 was still a landmark year for home prices. Annual HPA increased at a rate of 5.7%, 100 bps more than the historical average. Most of these gains came in the first half of 2022, as uncertainty around monetary policy permeated the market in the second half. Regardless, home price returns outperformed both bonds and equities in 2022 by a significant margin. This outperformance can be attributed to the types of macroeconomic shocks facing the economy and the durability of home prices in response to them. Slowing economic growth, high inflation, and rising interest rates are putting pressure on a variety of asset classes. Recent research from Unison[2] demonstrates that HPA generally outperforms these other asset classes on a risk-adjusted return basis during these exact shocks.

Home Price Growth Returning to Normal



Annual HPA increased at a rate of 5.7%.

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, March 8, 2023.
2. M. Tubbs. 2023. "Breaking Into the 60/40 Portfolio with Residential Real Estate." Unison Investment Management White Paper. https://www.unisonim.com/white-papers

This feature has been a historical advantage of HPA in comparison to other asset classes; moving forward, it will continue to be. While monetary policy uncertainty has cooled since peaking in November 2022, it remains elevated by measures of the risk premium. With this in mind, there is still a strong possibility for mortgage rates to fall over the next six months, as history tells us this premium doesn't remain elevated for very long–even through tightening cycles.

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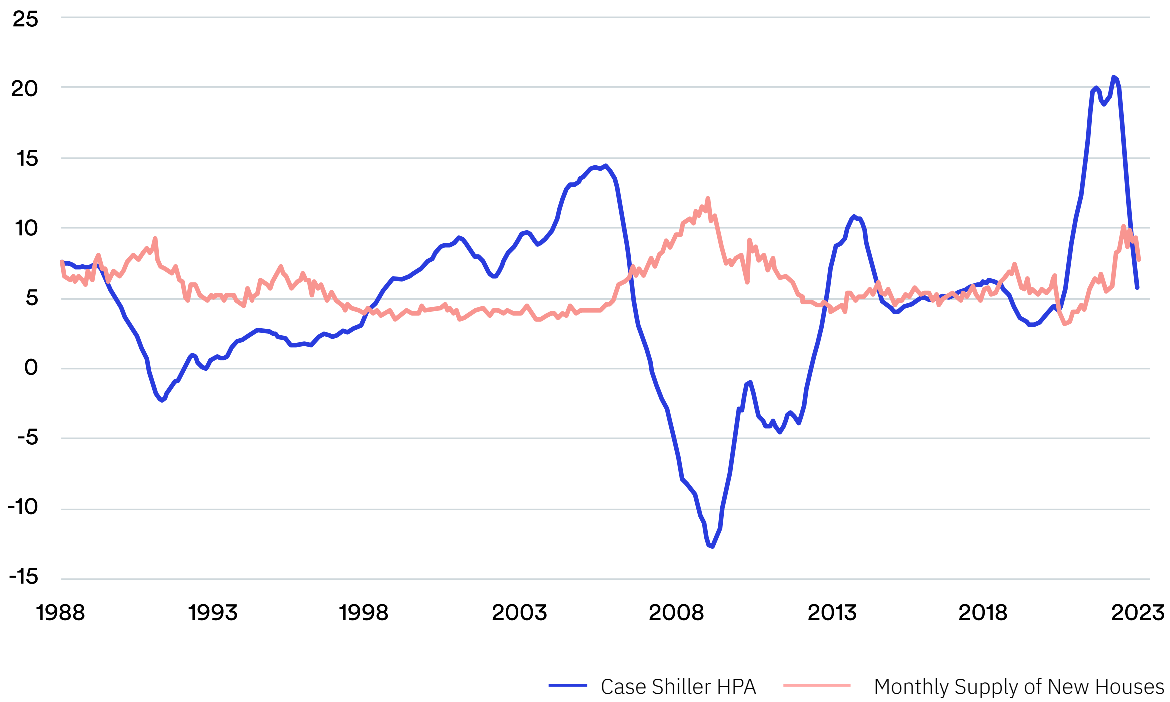
Housing Supply

The U.S. housing supply is one of the constraints that is putting a significantly lower bound on HPA in comparison to the 2008 financial crisis. In the Great Financial Crisis (GFC), the monthly supply of new homes continued to rise at a quick rate despite home prices falling precipitously. It took nearly two years before the housing supply reacted to the falling annual house prices. This delay was due to a variety of factors, but generally, the pipeline was less responsive to the changes in demand that shook the framework. Supply has been much more responsive to the changing demand in this cycle[3], and has begun to pivot before annual HPA has begun to fall.

Supply Better Adapting to Demand

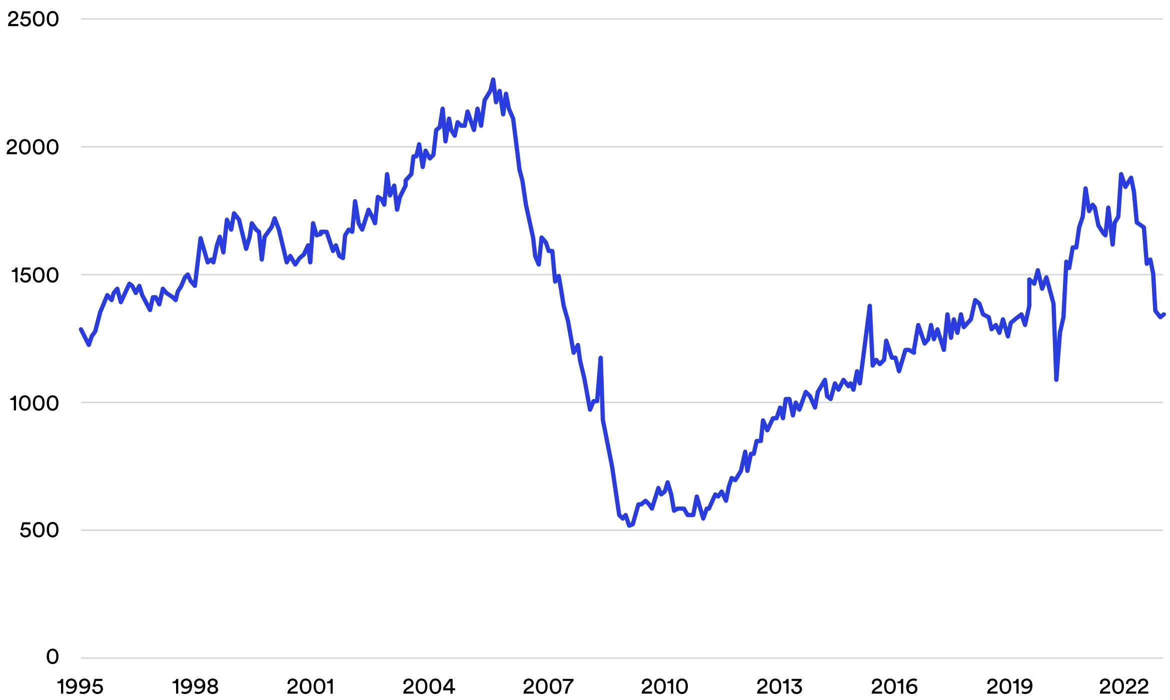


Supply has been much more responsive
to the changing demand

3. U.S. Census Bureau and U.S. Department of Housing and Urban Development, Monthly Supply of New Houses in the United States [MSACSR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MSACSR, March 9, 2023

This reaction isn't just happening at the builder and market level; supply tightness is coming from the government agencies issuing permits as well[4]. These agencies have been more conservative with permit issuance since the GFC. From 1980 until 2007, these agencies issued about 13 permits per one thousand jobs in the U.S. economy. Since the crisis, that number has fallen to eight. This shift resulted in nearly a decade and a half of constrained housing market production. Once again that number has also relatively fallen in reaction to demand as of late.

Governments Pulling Back Permit Production

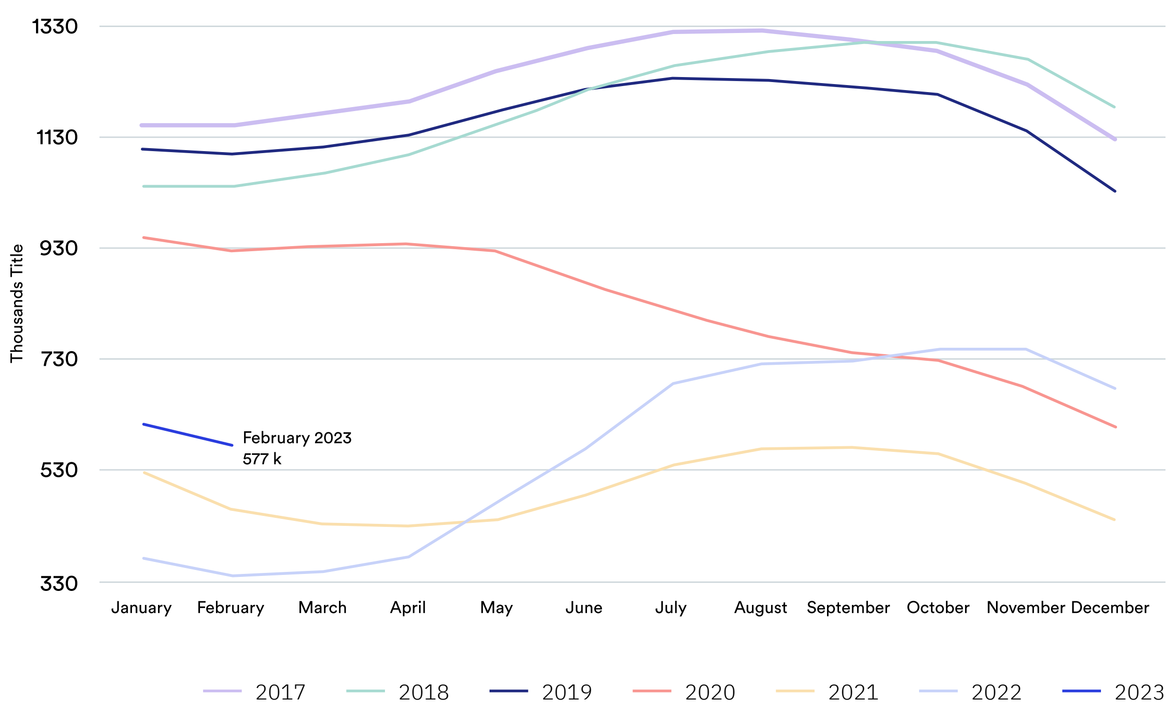


More stringent permit issuance has lead to **constrained housing supply** since the GFC.

4. U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Privately-Owned Housing Units Authorized in Permit-Issuing Places: Total Units in the South Census Region [PERMITS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PERMITS, March 13, 2023.

Finally, simplistic measures of market supply remain rather constrained. Active listings[5] have risen since their pandemic ultra lows, but are very far from the pre-pandemic measures. The active listing count bottomed out in February 2022 when the U.S. was seeing record HPA, at 344 thousand units. Since then, it has risen in the last year to 577 thousand. This is still almost half the number of active listings we saw pre-pandemic at over a million in 2017-2019.

Active Listing Count



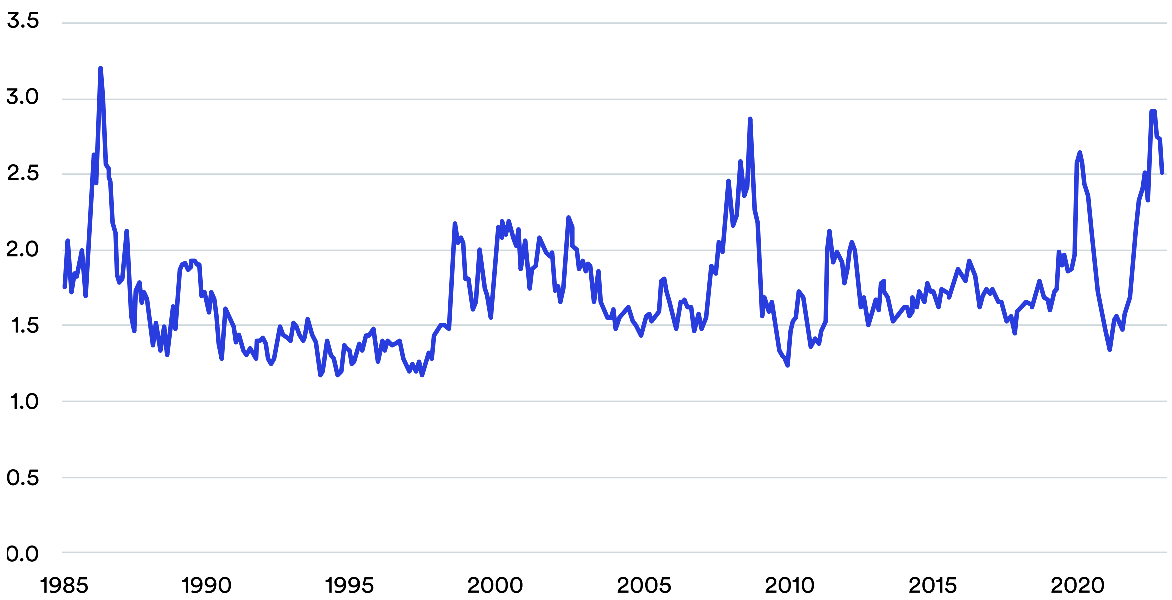
5. Realtor.com, Housing Inventory: Active Listing Count in the United States [ACTLISCOUUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ACTLISCOUUS, March 12, 2023.

These three measures of housing supply indicate a degree of market efficiency that has improved since the GFC. The combination of historical shortage over the last decade-and-a-half and the recent pullback in supply helped to reduce the impact of housing demand decline due to rising mortgage rates. In the GFC, supply continued to expand while demand was deteriorating, which put all of the pressure on prices to adjust.

Demand

The demand side of the housing market has certainly borne most of the burden in the market, which has in large part been due to the rising interest rates and market uncertainty around future hikes from the Fed. As seen in Figure Five[6], the spread between mortgage rates and the ten-year treasury[7] remains stubbornly high, above 250 bps. We remain optimistic that even if the Fed continues tightening, the risk premium will fall as the future becomes more transparent. This result would fall in line with the historical precedent, as that rate has not remained elevated above 250 bps for more than six months since 2000. When the spread between mortgage rates and treasury yield spread falls in line with the historical average, mortgage rates could come down almost a full percentage point.

Mortgage Risk Premium



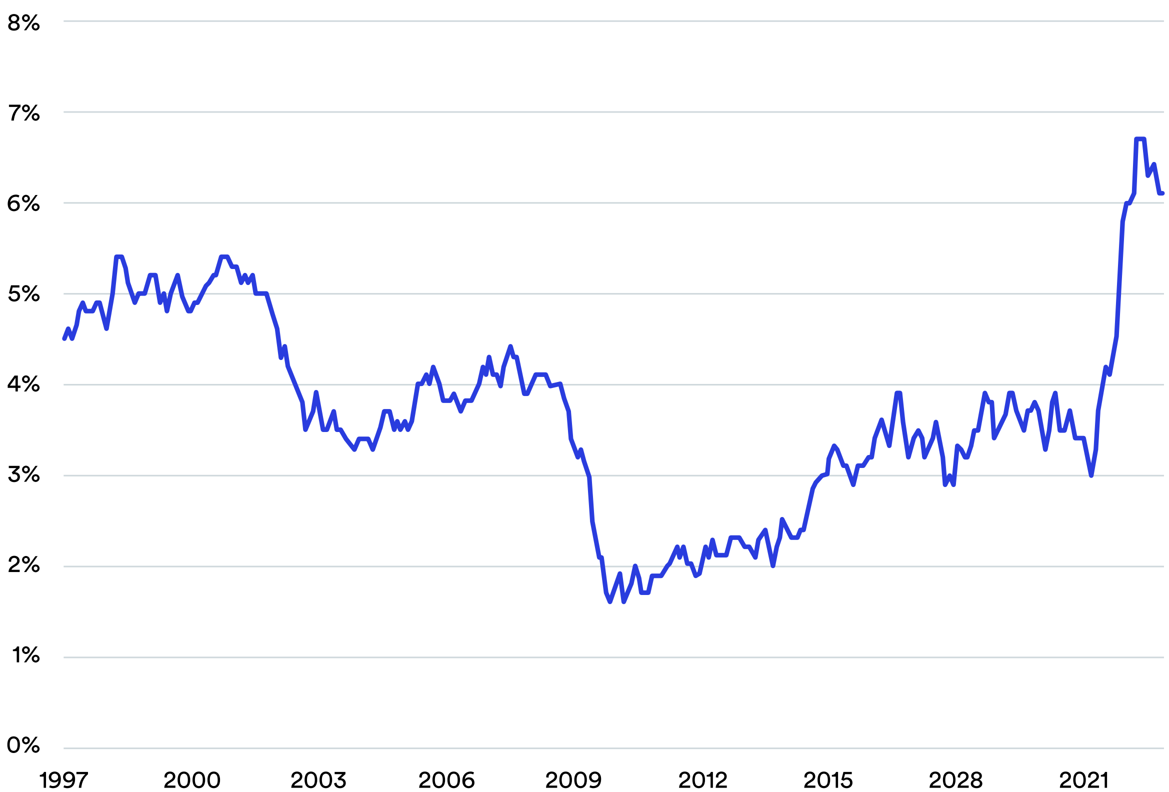
The risk premium will fall as the future becomes more transparent.

6. 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, March 13, 2023.

7. Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, March 12, 2023.

While the costs of owning a home have risen, the stream of payments that individuals use to purchase remains as robust as ever. Annual wage growth was 6.1% for January 2023, according to the Atlanta Fed. This is almost 2% higher than typical wage growth historically. We believe current and future homeowners are in a prime position to take advantage of even a very small adjustment to mortgage rates.

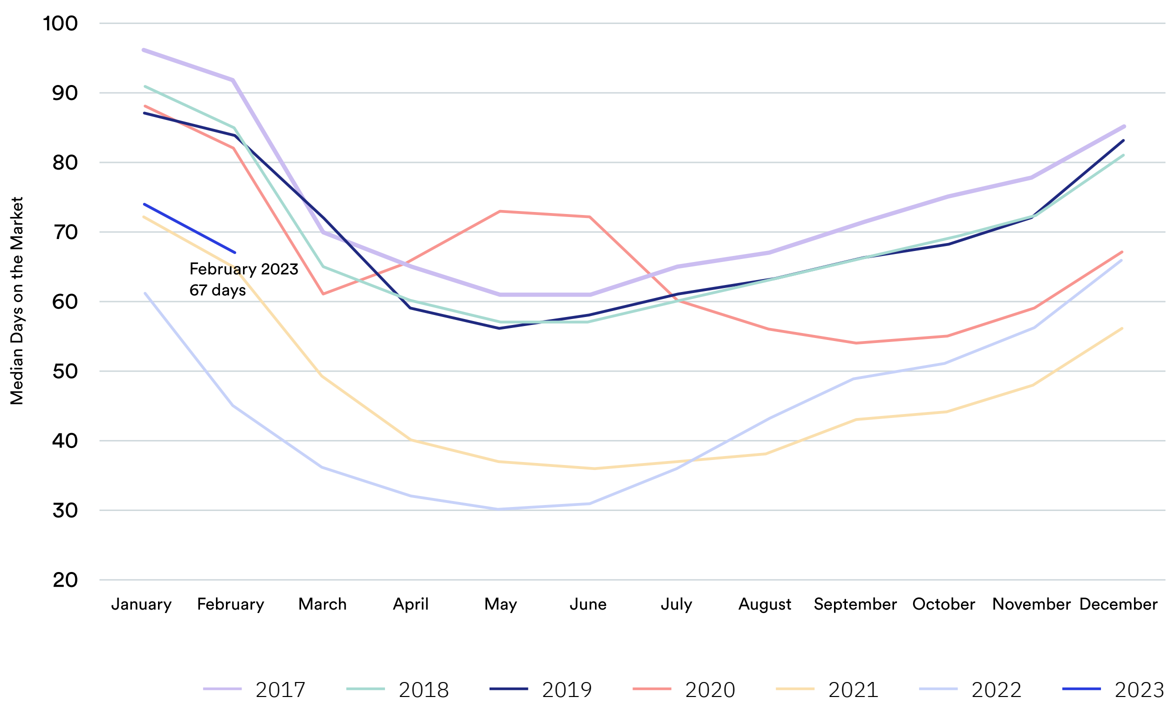
Atlanta Wage Growth Tracker



Annual wage growth was 6.1%

Even in the current environment, demand remains robust (despite what news headlines would lead you to believe). One of the best gauges for current housing demand is the number of days that a home stays on the market. While that rate was at an all-time low (since Realtor.com began to keep track in 2017) in 2022, the current average time on the market is 67[8] days. This is significantly below the pre-pandemic period, which was 80+ days during the winter months. So while home prices have slightly weakened and turnover has slowed a little, the demand is still stronger than the pre-pandemic booms, and it looks like the market is drifting back to its historical pace.

Housing Demand Remains Strong



Current average time on the market is 67 days.

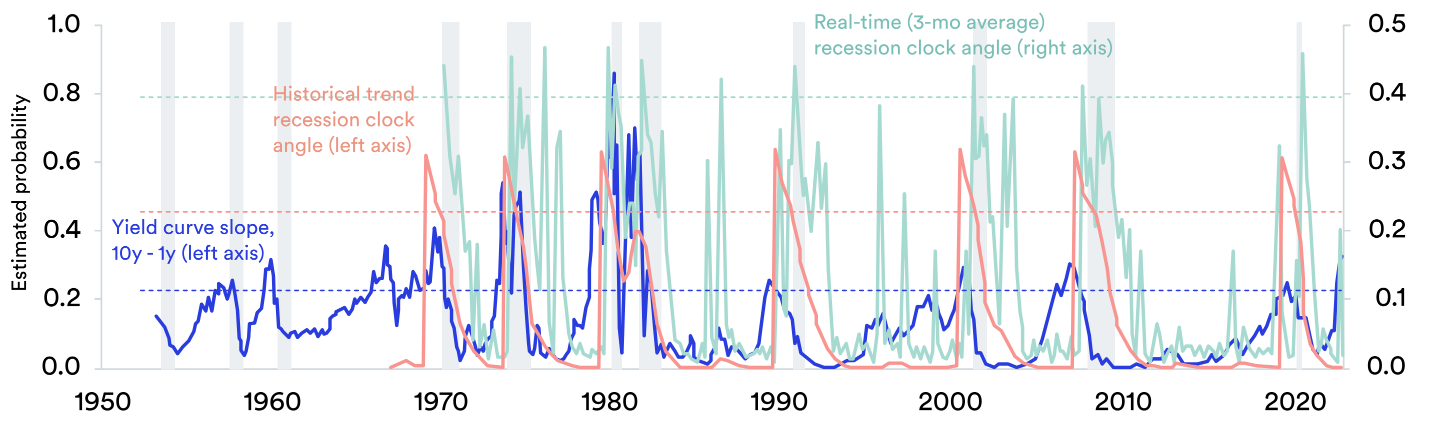
8. Realtor.com, Housing Inventory: Median Days on Market in the United States [MEDDAYONMARUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MEDDAYONMARUS, March 12, 2023.

Market Forecast

The recent yield curve inversion has many investors concerned about a looming recession, but there is a fundamental difference between this inversion and those of recent history: inflation. In a traditional inversion, we believe investors are flocking to longer-run securities because they are concerned about the short-run growth in the economy. While an inversion has preceded most all recessions in U.S. history about one year in advance, we believe that excess inflation risk is the primary cause of the current inversion. Investors are more likely to believe that there is less inflation risk in long-term bonds because they believe in the Fed's ability to tame inflation over a longer-run horizon. There is substantial inflation risk in the two-year treasury as market makers are less convinced the Fed will subdue inflation over time.

With so much inflation premium built into shorter-term interest rates, there are more useful predictors of recessions. Research by Thomas Mertens[9] from the San Francisco Fed uses labor market indicators to predict recessions. The Economic Recession Clock looks at changes in the jobless unemployment rate and the rate of change therein to predict future recessions with more accuracy at the six-month horizon than yield curve inversions. The most recent data from the Recession Clock indicates that there is a low probability of recession in the upcoming six months, and that the yield curve is not the reliable indicator in the current period.

Estimated probabilities at 6-month horizon



9. Mertens, Thomas M. 2023. "Recession Prediction on the Clock." FRBSF Economic Letter 2022 (December 27).

Conclusion

Home prices have slowed from their pandemic highs, and are returning to alignment with their long-run moving average. While the Fed's rate hikes have certainly put pressure on HPA, it is not unique to this asset class, and HPA remains resilient to the type of shocks facing the economy. Moreover, the extremely tight housing supply will act as a constraint on HPA moving forward. Demand is moving towards the pre-pandemic trajectory and remains ready to react when the risk premium falls.