Key Private Bank

Key Questions

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Is The Current Housing Boom Heading For Another Bust?

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For anyone who has attempted to buy a house in recent months, they know how hot the US housing market is.

With historically low inventory levels across the country and many homes for sale receiving multiple offers above the asking price, some may be reminded of the housing boom, which ultimately triggered the Global Financial Crisis (GFC) in 2007. Recently, a fixer-upper in Washington, D.C., which was listed for $275,000, reportedly had 88 offers. In the end, the four-bedroom, 1,800 square-foot home sold for nearly 70% above the asking price.

A Supply Crisis That Has Been Years in the Making

The example above, while extreme, is a microcosm of what is occurring around the country. Multiple factors are driving the surge in housing prices, including low interest rates, strong pent-up demand as a result of the Covid-19 pandemic, a sizable millennial cohort with relatively strong balance sheets entering prime homebuying years, and record-low inventory following a decade of underinvestment since the GFC. On top of all that, shortages of lumber have exacerbated the problem, further driving up prices at a time when demand continues to outstrip supply by a large margin.

According to the National Association of Realtors, the median home price has increased by 16% year-over-year. Also, existing home inventory is currently at all-time lows at just 1.8 months of supply, compared with roughly six months historically.[1] The millennial population, estimated at 77 million, is moving into peak homebuying years. According to Wolfe Research, this generation is expected to drive 1.2 million household formations annually over the next decade, further underpinning a strong housing-start outlook for years to come.[2]

Is It 2007 All Over Again?

We do not see evidence that the dynamics that led to the 2007 burst of the housing bubble are now at play. For one, the housing bubble that caused the GFC was primarily fueled by weak lending discipline and low credit standards. According to the Mortgage Bankers Association (MBA), current mortgage credit availability, a measure of lenders' willingness to issue mortgages, is at its lowest level since 2014.[3] Additionally, the Federal Reserve Bank of New York states that about 70% of mortgages issued in 2020 went to borrowers with credit scores of 760 or above, up from 61% in 2019. The bottom line: Credit is getting tighter, not looser. Demand has been so strong that lenders can afford to tighten their standards, which results in less systemic risk in the market — all positives for the bull case in housing.

Rising Rates – The Elephant in the Room

Will rising rates shut down housing demand? A recent survey of homebuilders by Evercore ISI suggests that a 30-year fixed-rate mortgage of 3.8% would trigger a demand flattening.[4] That said, rates are still far below the 30-year average of 5.97% and remain attractive on an absolute basis. In a static environment (no wage/job growth), an increase of 0.50% in mortgage rates equates to a 6% average increase in monthly mortgage payments and removes 7%-8% of potential buyers for affordability reasons.

However, rate increases generally impact demand for six months. Changes in demand usually correlate positively with the changes in the economy (better or worse) as consumers digest the rate move.

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Rising prosperity can more than offset the adverse impact on housing demand of modest rate increases (more on that in the following section). And it is often the pace of rate increases rather than the magnitude that leads to the most severe demand and equity disruption.

The Bull Case for a Prolonged Housing Cycle

We believe that the current housing boom has room to run for several reasons. While we are not dismissive of concerns that a rise in interest rates usually creates a pause in demand, several factors give us confidence that higher interest rates will not derail momentum:

1. Pre-COVID housing demand was very healthy when mortgage rates were above ~3.4%; rates are lower today, suggesting there is more capacity for rate increases before an impact is felt on demand.
2. Current rates are still historically low, and the release of pent-up demand is far outstripping supply with no signs of abating despite a recent 0.50% increase off the lows.
3. The rise in household incomes is contributing to improved housing affordability. Mortgage payments have historically consumed 18% of monthly income compared with only 15.2% today.
4. The home price-to-income ratio was 7.9x at the end of 2020 versus 8.7x historically, or 9.2% below the long-term average.

The US has 430,000 millennials entering the key 31-35 age bracket; since the first-time homebuyer's median age is 33, this bodes well for housing demand.

The US has had an average homeownership rate of 65% since 1965, but millennials have lagged previous generations with a homeownership rate of just 48%. Therefore, assuming a conservative 45% homeownership rate and two adults per household still implies an incremental 95,000 new home sales in 2021. We view the expected demand for homeownership by millennials, the persistent inventory shortage, and the potential for rising wages to be favorable tailwinds for the housing market and homebuilders.

Conclusion

We expect that ten years of underinvestment following the housing bubble that led to the structural shortage of US housing needs will now drive a multi-year investment catch-up period.

While it is impossible to know when the housing market will turn, we agree with the thesis that housing is in a Goldilocks era of high demand and still-low interest rates. Overall, the backdrop for housing appears to remain favorable.

For more information, please contact your Key Private Bank Advisor.

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Sources:

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