Market Commentary: Expensive Housing and Potential Consequences

September 2023

The average purchase of a residential dwelling in the US consists of 20% down and 80% in loans[1], typically taken through a mortgage. Given this reality, one should incorporate mortgage rates in properly calculating whether house prices are going up or down. For example, a couple with stellar credit purchasing a $1 million home with 20% down in late 2021 may have received a 3% mortgage rate. Fast forward to today and that mortgage rate is most likely above 7.5%. If our couple is on a fixed budget where they are willing to put down that initial $200K (20% of $1 million) but need to keep their monthly mortgage payment constant, they can only afford a $700K house. That is a 30% decline on a constant cost basis – yet the cost of a house has not budged! What gives?

<u>Mortgage Math</u>

House Purchase	$1,000,000	$682,500

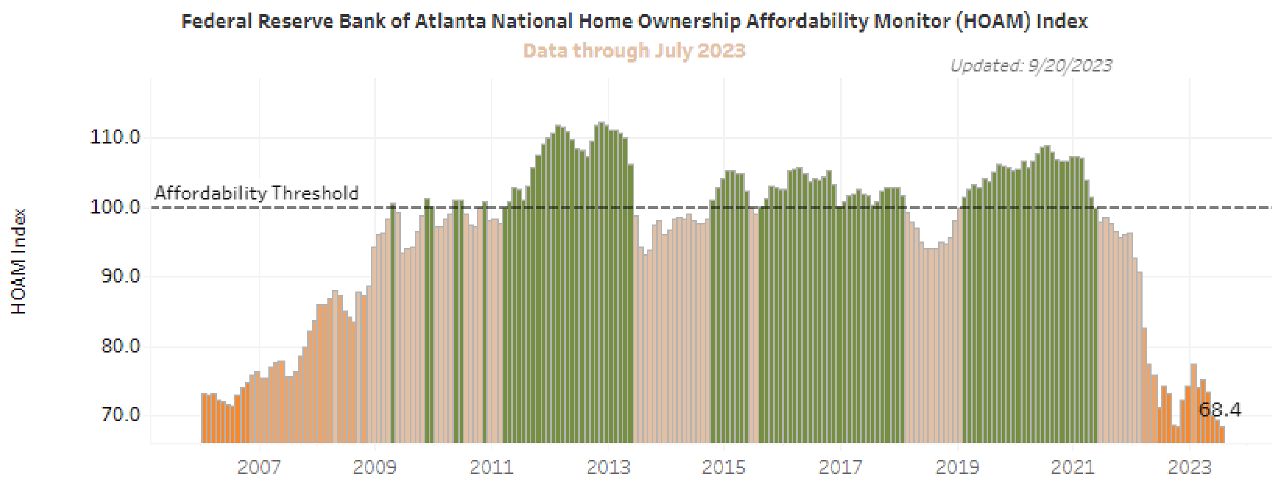
-32%

	August-21	**August-23**	**August-23**
Down Payment	$ 200,000	$ 200,000	$ 200,000
Mortgage Amount	800,000	800,000	482,500
Mortgage Rate	3.0%	7.5%	7.5%
Monthly Payment	$ 3,373	$ 5,594	$ 3,374

Despite the material increase in interest rates which translates directly to an increase in the cost of purchasing a house for the average buyer, home prices have continued to increase over the last two years, according to the well-followed S&P/Case Shiller National Home Price Index.

[1] 20% down and an 80% mortgage seems like the average based on our research, though we found the average mortgage size from the Mortgage Bankers Association of America and the average house price from the US Census Bureau so there is some chance of a data mismatch.

Typically, median mortgage payments account for roughly 30% of the median income, according to the Federal Reserve Bank of Atlanta National Home Ownership Affordability Monitor Index (HOAM). However, the recent jump in mortgage rates, combined with generally rising home prices, has increased this metric towards 45%,[2] resulting in a very low affordability reading as the chart below illustrates. A reading of 100% ("Affordability Threshold") on the following chart means that the median income is sufficient to cover the annual costs of a median-priced home which the HOAM defines as a 30% cost[3]. When the graph is below the Affordability Threshold it is less affordable and vice versa. Given the low level of affordability, a segment of the consumer market is priced out of the market and/or potentially stressing their personal finances to purchase a home.



Ultimately this is a classic economic 101 analysis with supply vs demand and elastic vs inelastic costs (replacement) figuring prominently.

Currently, the number of homes for sale is well below average as can be seen on the following chart. If demand stayed at average, which one can assume, yet supply declined, the result will be upward pressure on prices. The demand-supply equilibrium may have been further exacerbated by certain asset managers purchasing single homes as an investment and renting them out, as recently highlighted by a *New York Times* exposé on the topic[4]. This may have contributed to the increase in average home prices, though, more recently, the *Wall Street Journal* published an article stating that these asset managers have effectively stopped purchasing homes as they have become too expensive[5].

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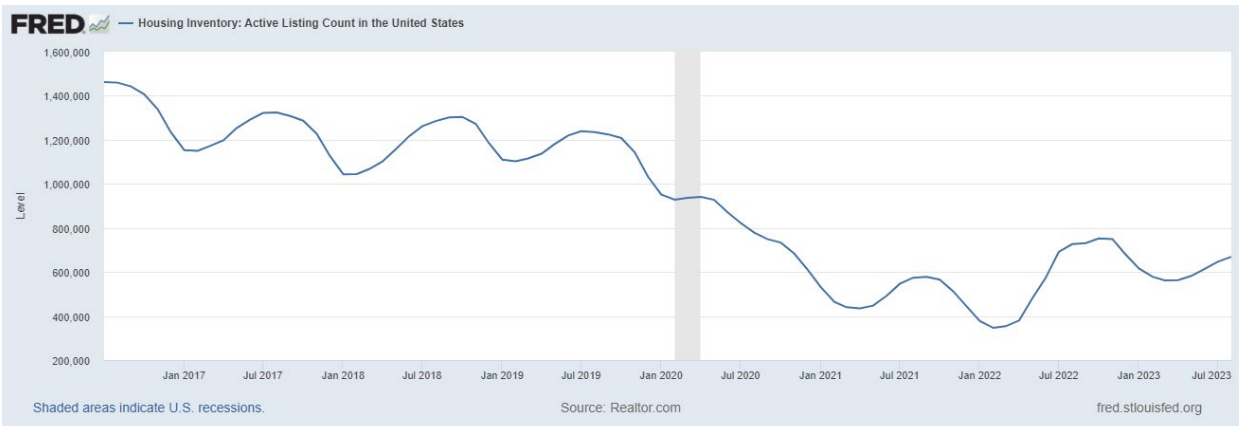
[2] A third component that plays a role here is wage inflation. However, as can be seen from the chart and data shared, wages have not kept up with costs.

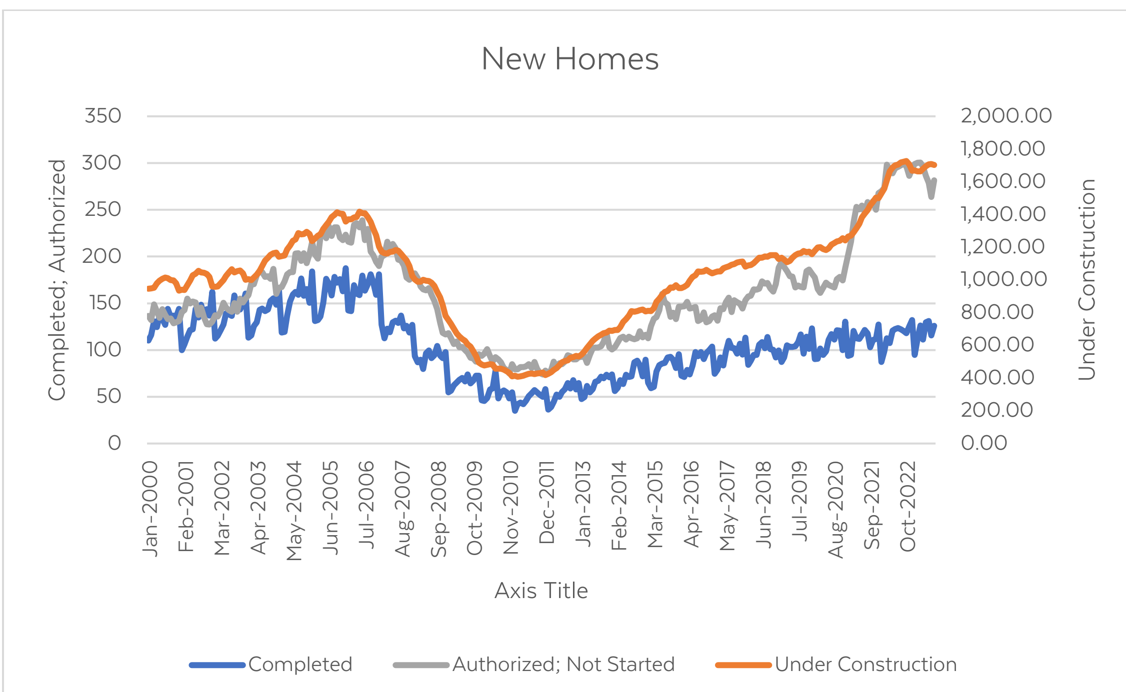
[3] Index methodology: [Home Ownership Affordability Monitor - Federal Reserve Bank of Atlanta (atlantafed.org)]

[4] [What Happens When Wall Street Buys Most of the Homes on Your Block? - The New York Times (nytimes.com)]

[5] [Wall Street Thinks America's Homes Are Overvalued – WSJ Oct 3, 2023]



An increase in home prices should attract builders to the space which would in turn increase supply. There is a lag effect here as it takes time to get the necessary permits and build a house. This lag effect has been exacerbated by some of the supply chain issues that the world has been dealing with in the aftermath of COVID-19. As can be seen on the following chart[6], while completed housing has been trending up slowly, those in construction and authorized but not started are at decade highs. This new housing supply should hit the market over the next couple of quarters.



[6] Data from the US Census Bureau: Census.gov

Why it Matters

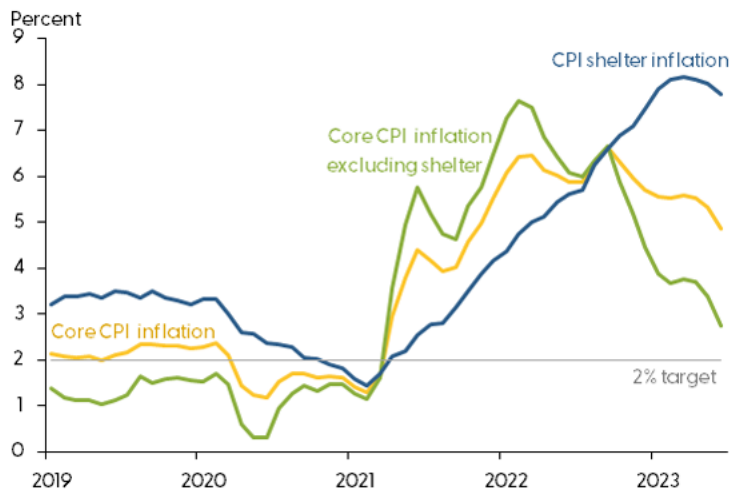
Housing makes up 15% - 18% of the economy[7] and comprises roughly 35% of aggregate household wealth in the US when including both home equity, rental properties, and other real estate[8]. A large decline in value may result in a contracting economy and less wealth among Americans.

Housing ("shelter") makes up 30% of the Consumer Price Index (CPI) consumption basket, one of the main measurements of inflation. One of the reasons the CPI has been so "sticky" has been housing, which has been on a relentless march up in value despite the referenced materially increased costs. Most pundits expect this component of CPI to decline materially over the next 6 – 12 months, resulting in a further decline in the overall CPI[9]. As can be seen from the chart below, CPI excluding Shelter has been closing in on its 2% target.

Without a material jump in wage inflation and assuming yields remain elevated, it is hard to see how shelter even remains flat over the next six to twelve months. Headwinds include low affordability, an expected jump in completed new homes, and a general increase in natural supply. If housing costs decline, it will put pressure on the US economy but also may allow the Fed to step off the pedal. Given the dependent nature of all these variables, lower rates given declining inflation and a contracting economy (meaning a supposed "easing" environment for rates) would result in lower mortgages, making homes cheap(er). Again.

Figure 1

The role of shelter inflation in overall inflation



Source: Bureau of Labor Statistics via Haver Analytics.

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[7] Housing's Contribution to Gross Domestic Product - NAHB

[8] The Wealth of Households: 2021 (census.gov)

[9] Where Is Shelter Inflation Headed? | San Francisco Fed (frbsf.org)