A V-SHAPED RECOVERY IN HOUSING

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A marked shift in housing preferences is one of the multitude of ways that the coronavirus epidemic is transforming behavioral and lifestyle patterns in American society. Families are rapidly exiting large urban centers to set up residency in suburban, exurban, and rural locations across most regions of the US. There is also a massive shift underway from rental to home ownership. The evidence is irrefutable: Signed sales contracts in New York and San Francisco are collapsing, while deals for single-family homes in the suburbs are escalating.

Summary and Major Conclusions:

- In sharp contrast to the overall US economy, the housing market appears to be in a solid V-shaped recovery, propelled by favorable demographics, rock-bottom mortgage rates, a record-low inventory of homes for sale, and lifestyle preferences brought about by the US coronavirus epidemic.

- All measures of housing activity are consistent with a V-shaped recovery, with some metrics at multi-year highs. Residential construction is on a steep upward curve, while sales of new and existing homes are on a rapid growth path.

- Selling prices are increasing at a brisk pace, although there is a wide dispersion in price gains depending upon the index. The most reliable data can be found in the S&P CoreLogic Case-Shiller Index, which indicates a 4.5% rise in selling prices.

- A simple supply and demand model explains the rise in house prices. The demand for housing has accelerated in recent months at a time when the supply of homes is at an unprecedented low.

- The inventory of unsold existing homes nationwide declined by 22% in July to only 1.5 million, the lowest level on record. At the current sales rate, the supply of homes for sale is equivalent to only 3.1 months. The nationwide homeowner vacancy rate dipped below 1% in June, the lowest on record.

- Families are rapidly exiting large urban centers to set up residency in suburban, exurban, and rural locations across the US. There is also a massive shift underway from rental to home ownership, which has spiked to a multi-year high.

- The catalyst is a desire to escape densely populated cities in exchange for larger single-family homes in more spacious and remote neighborhoods, consistent with the rise in telecommuting and home schooling.

- My forecast assumes that residential construction will be the primary driver of GDP growth over the next several years. Total housing starts could rise by 10% to 1.65 million in 2021 and then to 1.75 million in 2022, led by the single-family component.

- It is much too early to declare the housing market to be in a bubble. An asset bubble is defined as a market in which the price of an asset is bid to unrealistically high levels relative to underlying supply and demand conditions.

- House prices are rising because of a large gap between strong demand and extremely tight supply. The current rise in house prices of 4.5% is actually lower than the 5.5% average increase of the past five years, while the growth rate is roughly equivalent to the normalized growth in household income.
- The primary risk to the housing market is a sustained rise in mortgage rates from current record-low levels. A further deterioration in the labor market would also undermine housing demand.
- Builders are also facing a rapid rise in the cost of building materials and labor. There are also regionalized shortages in buildable land and skilled labor. A rapid acceleration in house prices would undermine affordability.
- To summarize, the US housing market is in the early stages of a sustained cyclical recovery that could persist for the next several years, at a minimum. Residential construction should be the fastest growing segment of GDP in both 2021 and 2022.

In sharp contrast to the overall US economy — which appears to be in a U- or W-shaped recovery pattern — the housing market is in a solid V-shaped recovery, propelled by favorable demographics, record-low mortgage rates, a severe shortage of homes for sale, and lifestyle changes brought about by the coronavirus epidemic. This week's *Economic Perspective* provides an analysis of current housing market conditions, along with a forecast for home sales, prices, and construction over the next two years.

WHAT ARE THE KEY INDICATORS OF THE CURRENT HOUSING RECOVERY?

<u>The housing market is currently experiencing boom conditions</u>. <u>All measures of housing activity are consistent with a V-shaped recovery, with some metrics at multi-year highs</u>.

- Existing home sales surged in July to 5.86 million, up nearly 10% from a year ago, and the *<u>highest level in nearly 15 years</u>*. Pending home sales rose at an annual rate of 15% in July — up 75% over the past three months — to the highest level since 2005.
- New home sales surged in July to the highest level in 15 years. New home sales are increasing at a 36% annual rate (see chart 1).
- Housing starts reached 1.5 million in July, up nearly 25% from a year ago. Building permits are also rising at a 20% annual rate. Finally, most large national builders are reporting growth in bookings in excess of 25%.
- Builder sentiment is also at an all-time high. The 35-year-old monthly survey of the National Association of Home Builders (NAHB) rose to its highest level on record in July (see chart 2).

Chart 1: New Home Sales Spike to a 15-Year High
Sales of Newly Built Homes (Hundreds)
Source: US Census Bureau

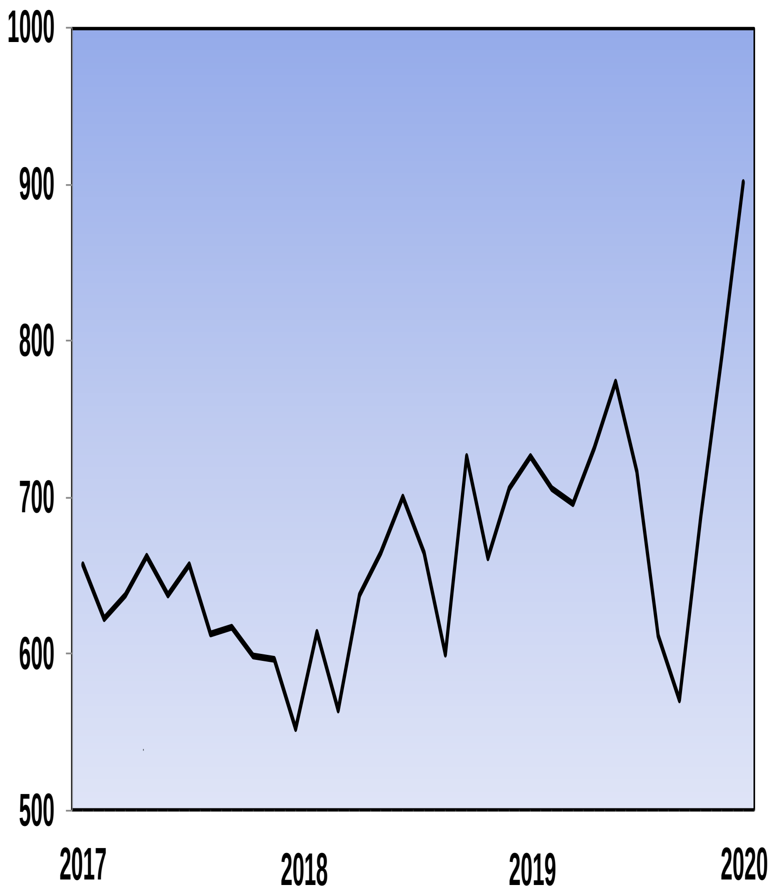
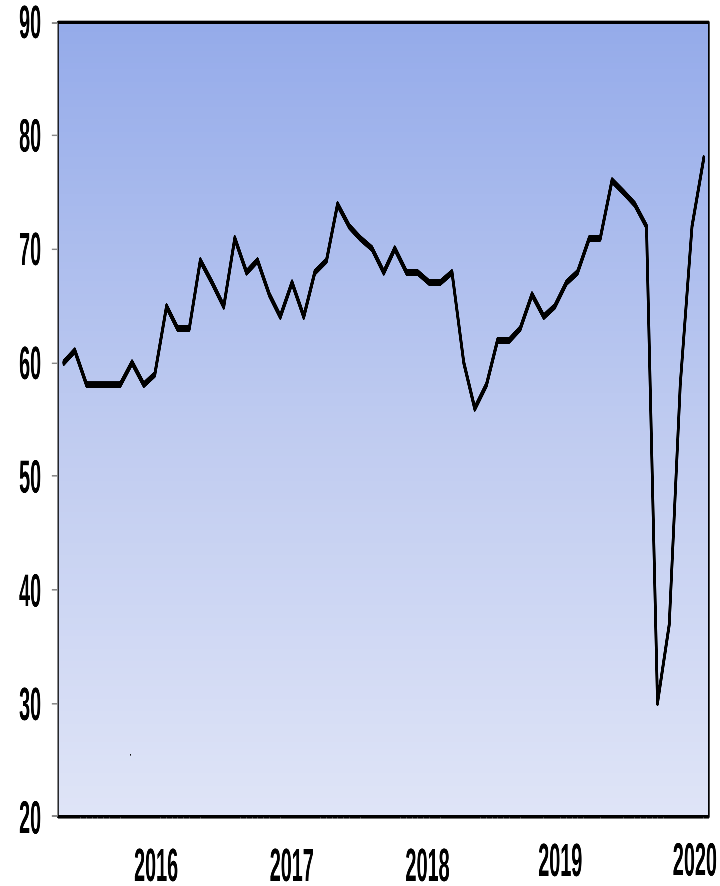


Chart 2: Homebuilder Confidence at an All-Time High
Index of Homebuilder Confidence
Source: National Association of Home Builders (NAHB)



- Bidding wars are becoming commonplace. According to the National Association of Realtors (NAR), homes listed for sale remained on the market in July for an average of only 22 days, the shortest timespan on record.

In combination, these trends are unambiguous evidence of a boom in the housing market, and one that appears to be in the early stages.

HOW HAS THE REAL ESTATE BOOM AFFECTED PROPERTY PRICES?

Selling prices are increasing at a brisk pace, although there is a wide dispersion in price gains depending upon the index. According to the NAR, prices are rising at an 8% annual rate. According to the Federal Housing Finance Agency (FHFA), prices are rising at a 6% annual rate. The most reliable data can be found in the S&P CoreLogic Case-Shiller Index, which indicates a 4.5% rise in selling prices. Irrespective of the specific index, it is clear that house prices are rising at a rapid pace, well above the 3.5% rate of increase in 2019.

Chart 3: Inventory of Unsold Homes at an All-Time Low
Existing Home Inventories (Millions of Homes)
Source: National Association of Home Builders (NAHB)

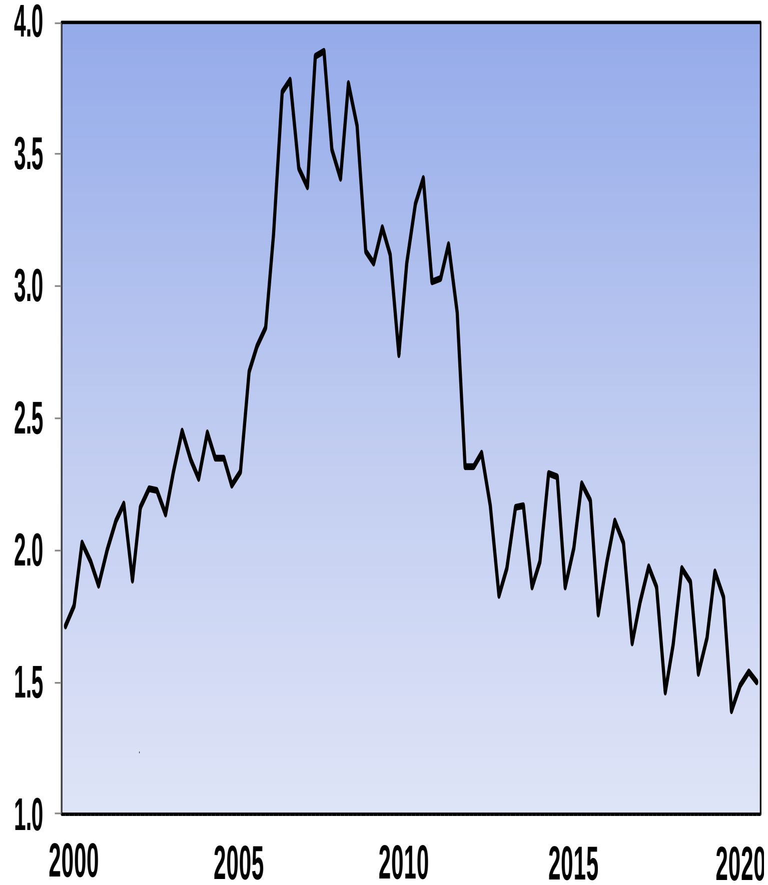
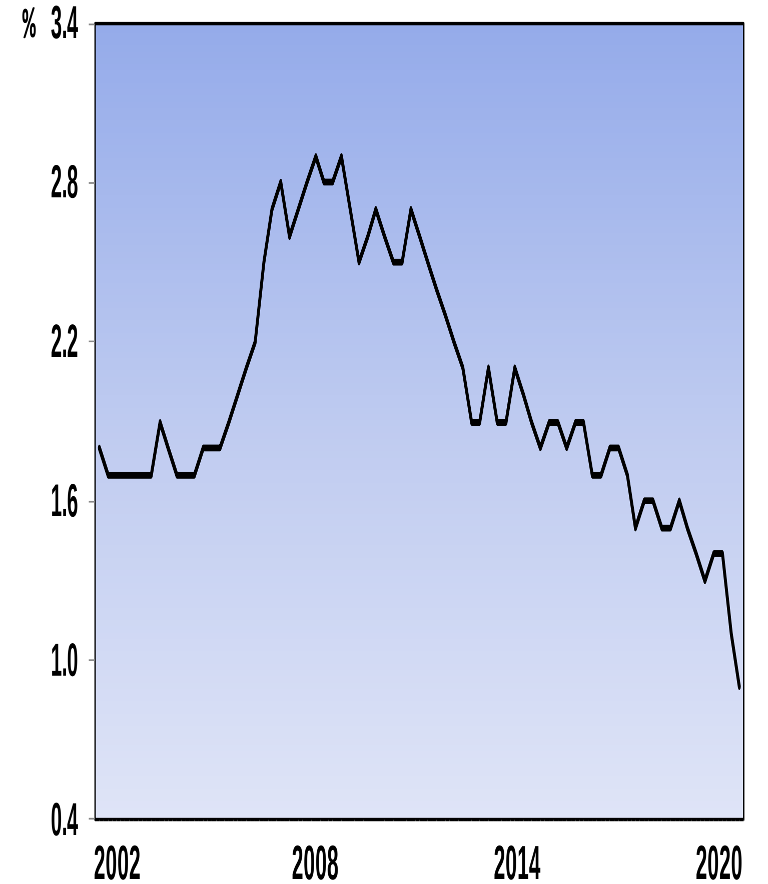


Chart 4: Vacancies in Single-Family Homes at an All-Time Low
The Homeowner Vacancy Rate (%)
Source: US Census Bureau



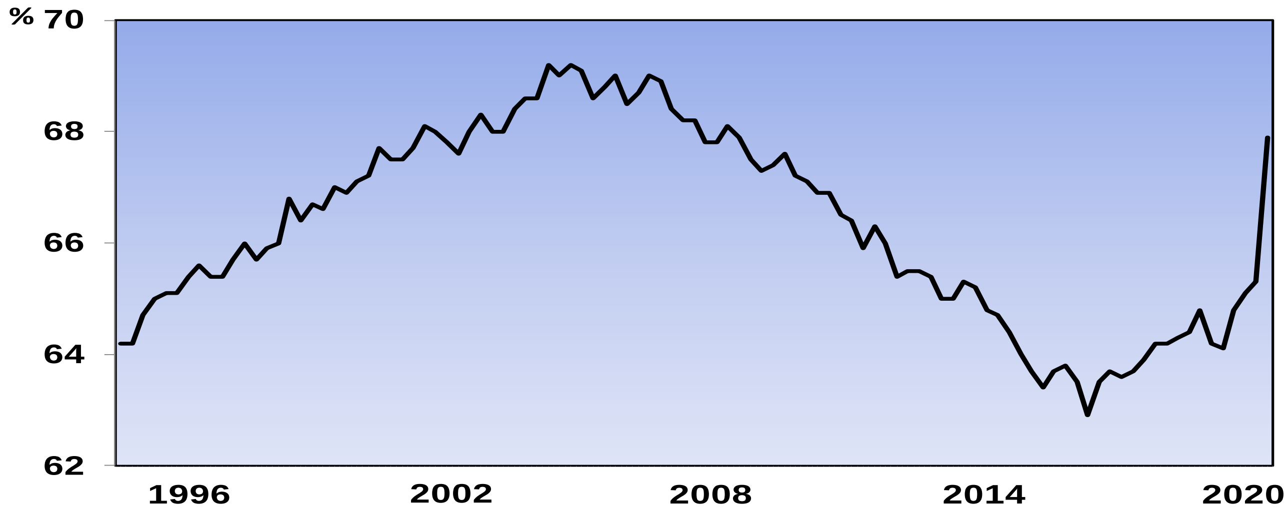
WHAT ACCOUNTS FOR THE STRENGTH IN SELLING PRICES?

Supply and Demand: The demand for housing has accelerated in recent months at a time when the supply of unsold homes is at an unprecedented low. The inventory of unsold existing homes nationwide declined by 22% in July to only 1.5 million, the lowest level on record (see chart 3). At the current sales rate, the inventory of homes for sale is equivalent to only 3.1 months. Anything below five months is a tight market. The nationwide homeowner vacancy rate dipped below 1% in June, the lowest on record (see chart 4).

IS THIS RATE OF GROWTH IN HOME PRICES SUSTAINABLE?

Probably not. It appears that the housing market is experiencing a temporary spike in demand at a time when supply has been depleted. An expected acceleration in new construction over the next six to 12 months — along with some moderation in demand —should result in a slowing in the rate of price increases.

Chart 5: The Most Rapid Shift From Rental to Homeownership on Record
The Rate of Homeownership (%)
Owner-Occupied Homes as a Percent of Total Households
Source: US Censor Bureau



At the same time, it should be emphasized that housing demand should remain firm over the next several years — with expected annual growth rates in excess of 10% — while the return to normal supply conditions will require another several years of strong construction activity. Consequently, house prices should remain in an uptrend, but rise at a slower pace.

WHAT ARE THE FORCES SUPPORTING HOUSING DEMAND?

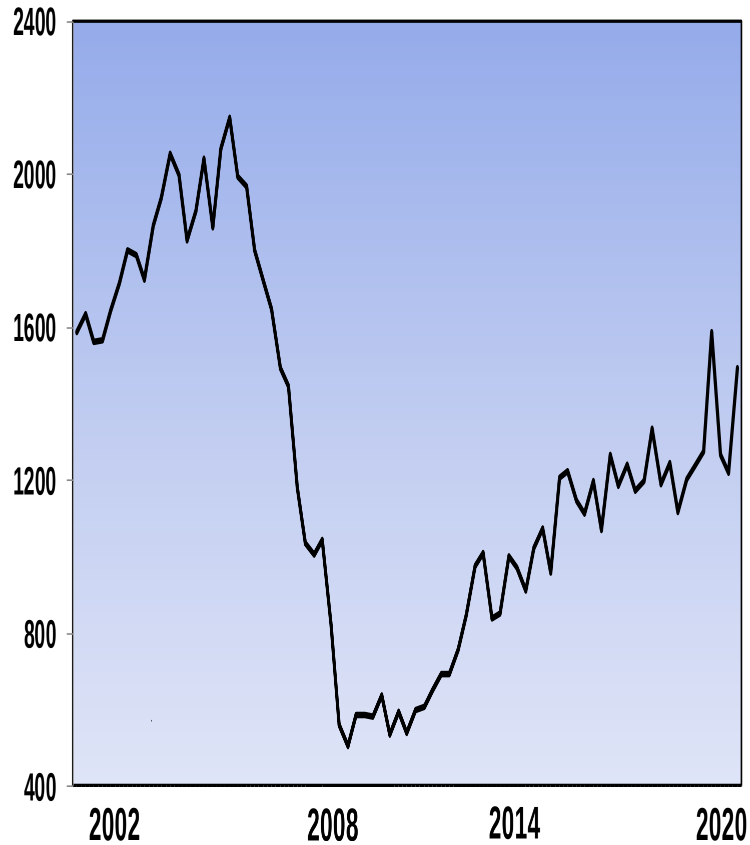
There are numerous factors that I have discussed during the past several years, pertaining to financing, demographics, and pent-up demand. There is also a massive shift from rental to homeownership, partially driven by demographics and partially driven by the COVID-19 epidemic.

Demographic factors are extremely favorable, in two respects. First, the young adults born between 1980 and 2000 — numbering 72 million — are in their prime homebuying years and are the fastest-growing segment of the population. A significant portion of this age group has postponed family formation since the financial crisis but are now in the process of shifting from renting in cities to owning homes in the suburbs.

The second demographic factor pertains to the aging baby boomer generation, who are opting to remain in their homes for far longer than those in this age group in previous decades. *The result has been a surge in the homeownership rate to 68.2% in the second quarter, the most rapid quarter-to-quarter increase on record*. Owner-occupied housing units ***rose*** by seven million to 86 million last quarter, while renter-occupied houses ***fell*** by more than three million to 41 million. *This shift from renting to owning could persist for many years* (see chart 5).

Chart 6: Residential Mortgage Rates at an All-Time Low
Contract Rate on Conventional 30-Year Fixed-Rate Mortgage
Source: Freddie Mac

Chart 7: Still Large Pent-Up Demand for New Home Construction
Housing Starts, Hundreds of Units
Source: US Census Bureau



Financial conditions have also been supportive of the housing market. The contract rate on 30-year fixed-rate mortgages is currently less than 3%, the lowest on record. The federal government has been supporting mortgage availability: Nearly three-quarters of all new mortgages are guaranteed by Fannie Mae, Freddie Mac, and the Federal Housing Administration. In addition, the Federal Reserve has purchased a record one trillion dollars of mortgage-backed bonds this year in an effort to suppress mortgage rates even further (see chart 6).

IS IT POSSIBLE TO QUANTIFY THE AMOUNT OF PENT-UP DEMAND FOR HOUSING?

I have been discussing pent-up demand as a major condition in the single-family home market for several years. The number of single-family homes built during the ten years ending in 2019 fell massively short of the underlying demand, as defined by new household formations. Specifically, compared with an underlying demand of 1.1 million new single-family homes per year, the average number of homes built annually during the 2009 to 2019 period numbered only 650,000, a shortfall of roughly 450,000 homes per year (see chart 7).

The correction or catch-up of this cumulative shortfall of approximately 4.5 million single-family homes should occur over the next five to ten years. This implies an increment of 450,000 in new single-family construction superimposed upon the normal demand of 1.1 million annually through 2030, or an accumulative annual rate of 1.55 million single-family homes. *When multi-family construction is included, the normalized rate of housing starts over the next five to ten years could average 1.75 million*.

HOW IS THE CORONAVIRUS EPIDEMIC SUPPORTING THE HOUSING MARKET?

A marked shift in housing preferences is one of the multitude of ways that the coronavirus is transforming behavioral and lifestyle patterns in American society. *Families are rapidly exiting large urban centers to set up residency in suburban, exurban, and rural locations across most regions of the US*. There is also a massive shift underway from rental to home ownership. The evidence is irrefutable: Signed sales contracts in New York and San Francisco are collapsing, while deals for single-family homes in the suburbs are escalating.

The catalyst for this mega-trend is a desire to escape densely populated cities in exchange for larger single-family homes in more spacious and remote neighborhoods, consistent with the rise in telecommuting and home schooling. Demand for second homes in the country and in coastal towns is also increasing. Current forces in support of the housing market are undeniable; the only unanswered question is whether these migration patterns are permanent, semi-permanent, or temporary.

IS THE HOUSING MARKET IN A BUBBLE?

It is much too early to label the current housing market as a bubble. As a generalization, an asset bubble is defined as a situation in which the price of an asset is bid to unrealistically high and speculative levels, relative to underlying supply and demand conditions. The housing market does not currently fit that description, for several fundamental reasons:

- The current 4.5% rise in house prices of is actually lower than the 5.5% rate of the past five years and is comparable to the 4.3% average of the past ten years.
- House prices are rising because of a legitimate divergence between very strong fundamental demand and extremely tight supply.
- The trendline rise in house prices is roughly equivalent to the percentage rise in household incomes.

- Based upon my analysis, a return to some semblance of balance between supply and demand may not occur for another several years.

- The more relevant metric of house price reality is the ***affordability index***, which measures the ability of the average household to afford the median-priced house nationwide. This ratio of 168.5 is almost exactly equal to the average of the previous seven years, arguing against an asset bubble in housing.

To summarize, *it is inappropriate to characterize the housing market as a bubble simply because house prices are consistent with the very favorable underlying fundamentals of the market*. It is conceivable that a genuine bubble could develop, but I would not expect that event to happen for at least several years into the future.

COULD YOU SUMMARIZE YOUR FORECAST FOR HOUSING CONSTRUCTION?

My forecast assumes that residential construction will be the primary driver of GDP growth over the next several years. Currently at an annual rate of 1.5 million, total housing starts could rise by 10% to 1.65 million in 2021 and then to 1.75 million in 2022. Construction of single-family homes could increase at an even faster pace as the share of multi-family starts steadily declines over the next two years.

WHAT ARE THE PRIMARY RISKS TO THE OUTLOOK?

In principle, the primary risk for the housing sector at any point in time is the level and direction of mortgage rates. However, market interest rates are likely to remain at historically depressed levels for at least the next several years. Nonetheless, there are other legitimate risks to the outlook:

- **Employment**: Weakness in employment could undermine the demand for housing.

- **Construction Costs**: Costs of labor and materials — most notably lumber — are rising at a rapid rate.

- **Foreclosures**: There are currently millions of homeowners who are delinquent on their mortgages but are not currently at risk because of the federal government’s loan forbearance program. However, many of these homes are at risk to foreclosure in the event of a double-dip recession and/or when the government forbearance program ends.

- **Affordability**: An unexpected surge in house prices would reduce demand by making homes less affordable.

- **Coronavirus Epidemic**: A worsening of public health conditions — and an increase in lockdowns and other restrictions to social contact — could temporarily disrupt the housing market until treatments for COVID-19 are available.

To summarize, the US housing market is in the early stages of a sustained cyclical recovery that could persist for the next several years, at a minimum. Residential construction should be at the leading edge of US economic growth in both 2021 and 2022, accounting for nearly one-quarter of the growth in GDP each year.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.