ANALYZE THIS: HOUSING

BLUEPRINT FOR RED-HOT SECTOR: LOW INTEREST RATES, LOW SUPPLY

We asked Tommy Zhang, CFA, Senior Analyst at Pacific Asset Management, sub-advisor to Pacific Funds fixed-income funds, to analyze the housing sector amid the economic rebound.

When the pandemic first hit, home construction ground to a halt, as homebuilders reasoned that rising unemployment and plummeting consumer confidence would weigh heavily on demand. But surprisingly, the market began to warm up by May, and activity returned to normal by summer. All told, housing experienced a full V-shaped recovery in the span of just three to four months.

So why did it fare so well?

First, interest rates saw a sharp dip in the months immediately following the pandemic—with the average 30-year fixed-rate dropping to 2.9% by the end of 2020, approximately 100 basis points lower than where it started the year. Given every 50-basis-point decrease in rates translates into about a 6% reduction in monthly mortgage payments (for a 30-year fixed-rate loan with a 20% down payment), lower rates were a material tailwind for affordability.

Second, while unemployment spiked as a result of COVID, there was a disparate impact across income levels. Notably, lower-income households suffered more, whereas higher income households escaped relatively unscathed. This bifurcation is important to highlight, as homebuyers tend to come from higher income households (in 2019, the median household income of U.S. homebuyers was $93,000, compared to the median of $69,000, according to the National Association of Realtors). So, while the pandemic was devastating to lower-income households, these households weren't the primary demographic driving home sales.

Finally, low inventory levels that were exacerbated by builders pausing construction resulted in a supply-and-demand mismatch. As of April 2021, there were 1.16 million existing homes for sale, representing just 2.4 months of housing inventory. That is far below the historically healthy level of four to six months of inventory. Given this supply shortage, prices have shot upward in search of a new equilibrium.

So, with the market on fire, where do we go from here? Barring a sudden and drastic spike in interest rates, our view is that the housing market will continue to perform well, especially as economic conditions improve. While we often hear concerns surrounding the number of delinquent mortgages that are currently benefitting from forbearance, we do not believe this threat is enough to crash the market. According to Black Knight's Mortgage Monitor, as of April 2021, there were 2.5 million mortgages that were 30 days or more past due but not yet in foreclosure. If we assume 60% of these mortgages instantly went into foreclosure today, that would add about 3.1 months of housing supply. That would bring existing home inventory up to 5.5 months of supply, still within what is viewed as a healthy level.

Keep in mind, our scenario of 60% of all delinquent mortgages going into foreclosure is an extreme downside case, especially when considering the number of delinquent mortgages has been steadily declining since COVID. However, even under these worst-case assumptions, we still arrive at a fairly balanced market. Thus, while we believe the current pace of rapid home price appreciation may cool off given affordability constraints, we don't believe that there is an imminent crash approaching.

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Mailing address:
P.O. Box 9768, Providence, RI 02940-9768
(800) 722-2333 • www.PacificFunds.com

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