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HARD LANDING FOR HOUSING ACTIVITY, SOFT LANDING FOR HOME PRICES?

HIGHLIGHTS

- Aggressive monetary tightening by the US Federal Reserve (Fed) has triggered a steep rise in mortgage rates, a collapse in home affordability, and a sharp slowdown in the housing sector.
- Recent Fed rhetoric indicating that interest rates will remain "higher for longer" points to further declines in housing-sector activity, including sales, new home starts, and construction.
- But the large number of homeowners "locked-in" at low mortgage rates should help support home prices, preventing them from falling as much as sales and starts.

MORTGAGE RATES HAVE SOARED DUE TO FED TIGHTENING

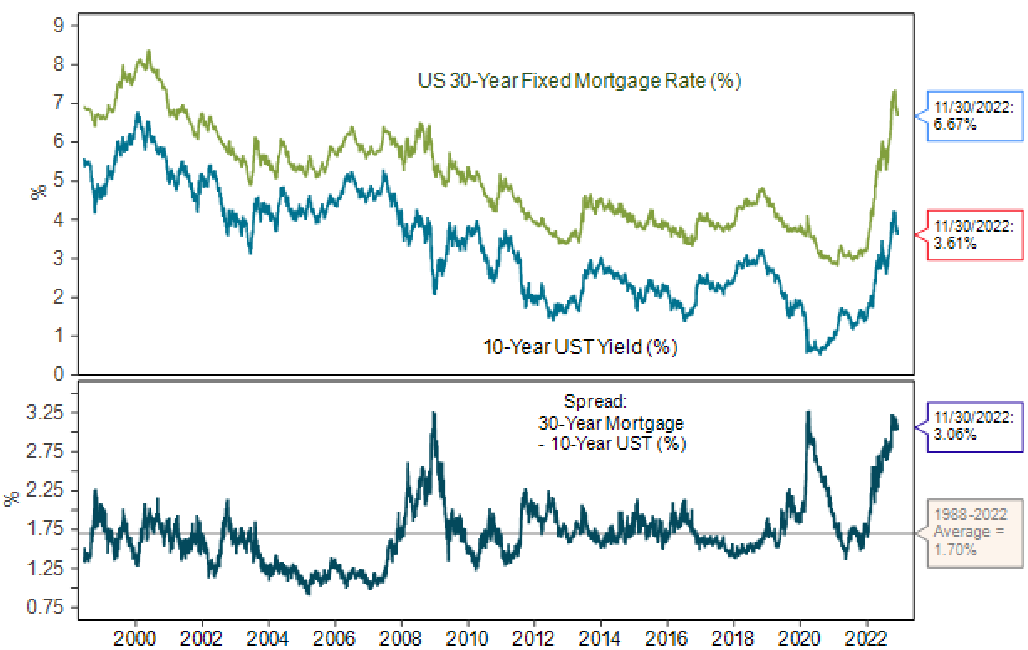
The Fed's embrace of aggressive monetary tightening this year has hit the housing market hard. This is largely by design, reflecting Fed Chair Jerome Powell's comments in June that the US housing market needed to be "reset."[1]

Fed officials understand that tight monetary policy fights inflation through housing market downturns. And even though residential investment currently represents only 4.6% of GDP, it punches above its weight as a driver of the overall business cycle. This is because the housing sector is extremely interest-rate sensitive and affects broad-based consumer spending trends and household net worth. The link between housing and the broader economy is so strong that economist Ed Leamer wrote a 2007 paper titled "Housing Is the Business Cycle." Leamer found that 80% of Post-World War II recessions came after a "substantial" housing slowdown.

In the current cycle, the Fed has hiked the federal funds rate by 3.75 percentage points in nine months, the fastest pace since the early 1980s. Mortgage rates anticipated Fed rate hikes and started rising in early 2021, 15 months before the Fed's first hike. According to Bankrate.com, the average 30-year fixed mortgage rate is currently about 6.67%, or more than double the 3.27% rate at the end of last year **(Figure 1)**. The current rate is down sharply from a peak of 7.35% in early November, but its year-to-date move still represents the largest move in mortgage rates since 1981.

FIGURE 1

US 30-Year Fixed Mortgage Rates Have Moved Up Much More Rapidly Than 1-Year Treasury Yields in 2022



Sources: GW&K Investment Management, Bankrate.com, Bloomberg, and Macrobond

Mortgage rates are up more than double what they were at the end of 2022 — the largest move in mortgage rates since 1981.

[1] Lance Lambert, "The Fed's housing market 'reset' isn't letting up anytime soon – 5 things to know heading into 2023," Fortune, November 3, 2022.

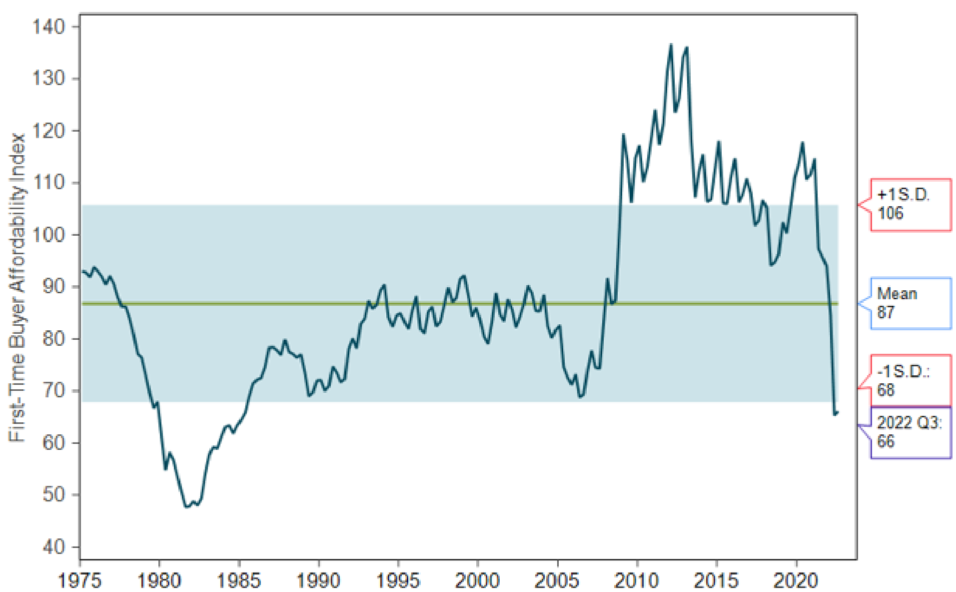
AFFORDABILITY HAS COLLAPSED, HOUSING ACTIVITY HAS PLUNGED

Rising rates rapidly curb housing activity by making homes less affordable to first-time buyers. According to Bloomberg, in December 2020 a consumer could have bought a $757,000 home, assuming a 20% down payment, an average 30-year mortgage rate, and have a monthly payment of $2,500. In contrast, with the same down payment and monthly payment today, the consumer could only afford a $477,000 home.

Reflecting this unpleasant arithmetic, the National Association of Realtors First-Time Buyer Affordability Index in the third quarter of this year had plunged by about 40% since 2020 **(Figure 2)**. The collapse in affordability reflects the double-whammy of the rapid rise in mortgage rates and high home prices, which have never increased faster than in early 2022.

FIGURE 2

First-Time Buyer Affordability Has Plunged in 2022 Due to Surging Mortgage Rates



Sources: GW&K Investment Management, National Association of Realtors, and Macrobond. "Standard deviation" is abbreviated as "S.D."

The combination of higher home prices and rapidly rising mortgage rate has resulted in a 40% collapse in affordability since 2020. Homes are now less affordable than any time since 1985.

The impact on housing sector activity and sentiment has been rapid and massive. For example:

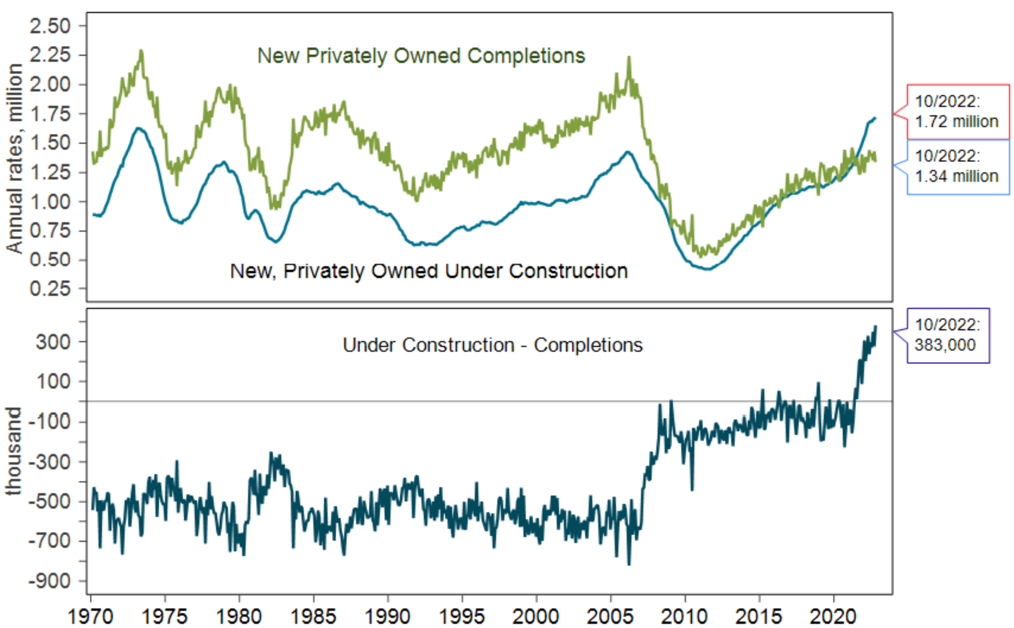
- In national accounts, residential investment declined respectively at annual rates of 18% and 26% in the second and third quarters of this year.

- Through October, US existing home sales fell for nine consecutive months and were down 28% from a year earlier. That is the largest annual decline since 2008.
- US housing starts through October are down by 21% since peaking in April of this year. Housing permits, a key leading indicator of construction activity, are down 19% from their March peak.
- Mortgage purchase applications are down 51% from the peak in January 2021 and are off a record 40% on a year-on-year basis.
- The National Association of Homebuilders (NAHB) index of homebuilder sentiment fell to 33 in November, the lowest level for the index since it plunged at the start of the pandemic.
- According to a University of Michigan survey, consumer attitudes toward buying homes is at an all-time low going back to 1978.

Although these data points make it clear that the housing sector has entered into a sharp downturn, there is one outlier statistic worth noting: the number of privately owned new housing units under construction remained at an all-time high of 1.72 million units in October **(Figure 3)**. That is up 17.5% from a year earlier and 12.9% for the year to date. In contrast, completions of new housing units are running at an annual rate of only 1.34 million units and have risen only 1% for the year to date.

FIGURE 3

US Homes Under Construction Posted an All-Time High in October, Exceeding Completions by a Record Amount



Sources: GW&K Investment Management, US Census Bureau, and Macrobond

A record 1.72 million privately owned new homes were under construction in October, up 12.9% for the year to date. But completions have lagged badly, reflecting supply chain issues and labor shortages.

As a result, there is now a record gap of 383,000 units between housing under construction and completions, even though the two items have historically moved in tandem. The unprecedented gap reflects supply chain issues and labor shortages that have slowed the building process. Another factor is builder reluctance to move ahead with contracts that may get canceled as buyers face the stress of higher mortgage rates.

In short, the construction backlog is so large that builders and contractors remain busy for now. That has almost certainly slowed down the surge in construction job cuts that normally come in the wake of a Fed-induced economic slowdown. That said, construction job cuts and lower building volumes seem likely in 2023 as builders work through the backlog while facing declining sales.

MORE HOUSING DISTRESS IS LIKELY UNTIL THE FED EASES

With the Fed having engineered the current housing downturn through aggressive rate hikes, it stands to reason that more housing distress is likely until the Fed reverses course and begins cutting rates.

Federal Reserve Chair Jerome Powell made it clear at the Fed's early November meeting that more rate hikes are likely through the early part of next year. His recent message, along with many of his Fed colleagues, has been consistently hawkish: Failing to tackle inflation, and allowing it to become entrenched, is far riskier than tightening excessively.

Consider what Powell told reporters after announcing the Fed's fourth consecutive three-quarter point hike in the federal funds rate: "We have a ways to go, we have ground to cover with interest rates before we get to that level of interest rates that is sufficiently restrictive…we will stay the course until the job is done."[2]

Based on such guidance, investors are currently pricing in a peak in the federal funds rate of 5.0% – 5.25% by mid-2023, up substantially from the current target range of 3.75% – 4.0%. No significant monetary easing is projected until the fourth quarter of 2023, with futures markets pricing in a federal funds rate of about 4.5% by early 2024 and further easing to a range of 3.25% – 3.50% over the course of 2024.

Naturally, the interest rate outlook is subject to change based on incoming economic data on key items like inflation and unemployment. Taking current Fed interest rate guidance at face value implies further substantial pressure on the housing market through much of 2023. Powell admitted as much when he told reporters in November that "Housing is significantly affected by these higher rates."

Reflecting the Fed's "higher for longer" guidance in interest rates, the Bloomberg consensus economic forecast calls for new home sales to fall another 13% in 2023 following an estimated 18% decline in 2022. Existing home sales are projected to follow a similar trajectory. Home sales are not predicted to bottom out until late 2023 when the Fed is widely presumed to start cutting rates in response to economic weakness and moderating inflation.

CAN MORTGAGE RATES DECOUPLE FROM OTHER INTEREST RATES?

Whether mortgage rates can decouple from the federal funds rate will also be of importance to the housing sector. GW&K Securitized Analyst and Government Bond Portfolio Manager Brendan Doucette has noted that there could be a scenario where mortgage rates fall even in the absence of a broader decline in rates, because mortgage rates have risen much more than US Treasury rates this year. This has resulted in an unusually wide current spread of about 306 basis points between the 30-year mortgage rate (6.67%) and the 10-year US Treasury yield (3.61%). Using data back to mid-1998, that spread is a 99th percentile reading.

The typical spread between the 30-year mortgage rate and the 10-year Treasury yield is 170 basis points **(Figure 1)**. The current spread has become extremely elevated as a function of the abnormally high level of volatility in US Treasury yields and the Fed's balance sheet reduction. If

[2] Federal Reserve Board, "Transcript of Chair Powell's Press Conference," November 2, 2022.

rate volatility subsides in 2023 as the Fed slows the pace of its tightening cycle, the spread might well revert some distance toward its average level, suggesting the potential for mortgage rates to fall by as much as 70 basis points even if US Treasury yields remain around current levels.

This reversion-to-the mean scenario for mortgage spreads is also reinforced by near-term prospects for a low rate of mortgage refinance activity. That is, since almost no households currently carry mortgages with rates above current levels, there is little risk of an increased supply of mortgage-backed securities (MBS) associated with refinancing activity.

That said, a full reversion-to-the mean scenario for mortgage spreads is likely to be stymied by the Fed's ongoing balance sheet reduction plans. Although the Fed is unlikely to sell outright any of its $2.7 trillion in MBS holdings, it is widely expected to let its holdings run off at a $200 billion annual rate, between scheduled and unscheduled principal. That seems likely to keep mortgage spreads wider than would otherwise be the case.

Of course, the most optimistic scenario for mortgage rates would be for a decline in mortgage spreads to coincide with a decline in US Treasury yields. For example, a Bloomberg consensus economics survey projects the 10-year US Treasury yield will return to an average yield of about 3.5% by the fourth quarter of next year. If that were to occur while the comparable mortgage-rate/Treasury yield spread compresses by 70 basis points, it would imply the 30-year mortgage rate could fall back to 5.9% over the next year.

WHY HOME PRICE DECLINES MAY BE MUTED

While the collapse in housing affordability is sharply curbing home sales and housing starts, the impact on home prices may be more muted for several reasons. First, housing affordability has collapsed for first-time homebuyers or prospective buyers, but not for existing homeowners. That is because most existing homeowners have locked in very low 30-year fixed rate mortgages.

When mortgage rates fell to their lowest level in 50 years during the pandemic, millions of borrowers were able to refinance and obtain lower mortgage rates. According to data from CoreLogic, this has moved the median rate for outstanding mortgages from 4.0% in August 2019 to 3.1% in August 2022.

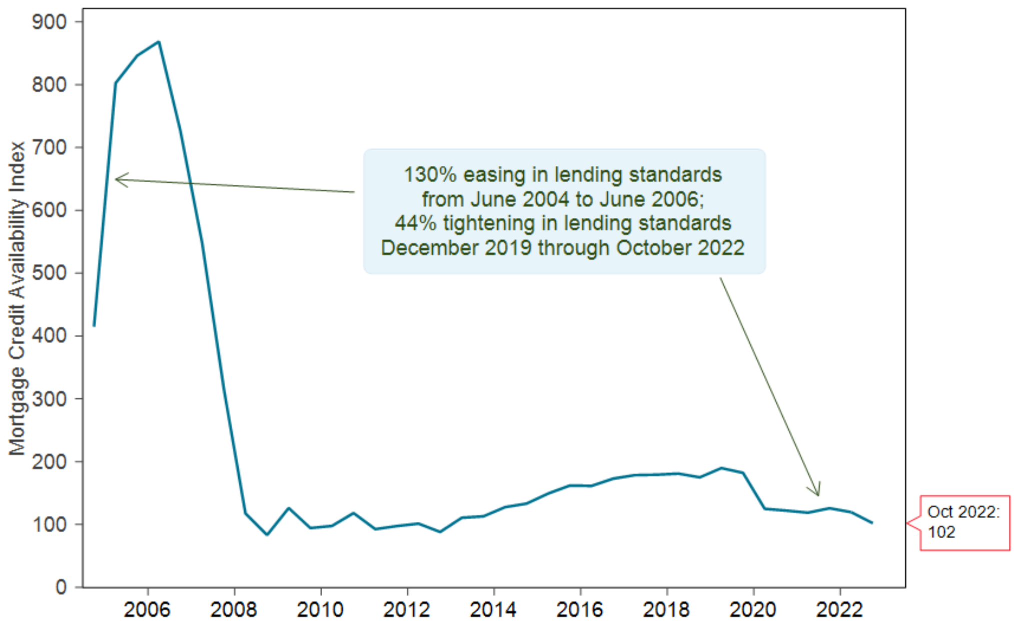
This so-called "lock-in effect" creates strong incentives for homeowners to keep their homes off the market. Homeowners who currently hold low-interest-rate mortgages are naturally reluctant to sell in a higher-rate environment since they would need to relinquish the low mortgage rate on a current property and take out a much higher-rate mortgage on a new purchase.

The lock-in effect helps drive home sales lower. At the same time, by keeping housing supply off the market it helps keep prices from falling as fast as in previous cycles. While lower homebuyer demand has caused a drop in home sales and an increase in inventory, the inventory of available homes for sale remains slim. Even though unsold inventory was up 12% in September 2022 from its low in February, it remained nearly 30% below the average of the last five years and nearly 75% below its average level during the global financial crisis (GFC) recession from 2007 – 2009.

A second key reason that home price declines are likely to be more muted in this cycle is that bank lending standards were tightened substantially following the GFC after having been loosened substantially between 2004 – 2006 **(Figure 4)**.

FIGURE 4

Lending Standards Have Tightened Since 2019: Mortgage Credit Availability Index



Sources: GW&K Investment Management, Morgan Stanley, MBA, and Macrobond

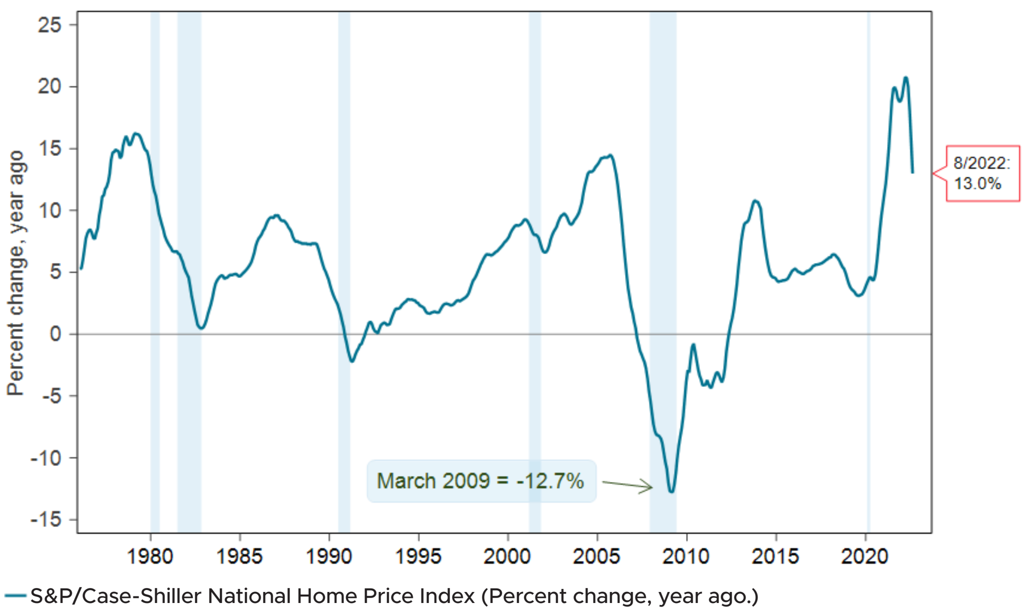
Banks have tightened mortgage lending standards since late 2019, suggesting low potential for large-scale distress sales and foreclosures. In contrast, standards had eased notably in the 2004 – 2006 period.

Indeed, homeowners have never had more equity than they have today. Thus, there are likely to be far fewer distress sales and foreclosure sales during this housing-sector correction.

In the wake of the GFC nationwide home prices had a peak-to-trough decline of about 30% spread out over a five-year period. The maximum year-on-year decline was -12.7% reached in March 2009 **(Figure 5)**. Considering the lock-in effect and the likelihood of fewer distress sales and foreclosures, it is difficult to see where enough supply will come from to push prices down as much as sales or starts — or at a pace anything like that seen after the GFC.

FIGURE 5

Record US Home Price Appreciation in Early 2022
Followed by Sharp Deceleration Since March



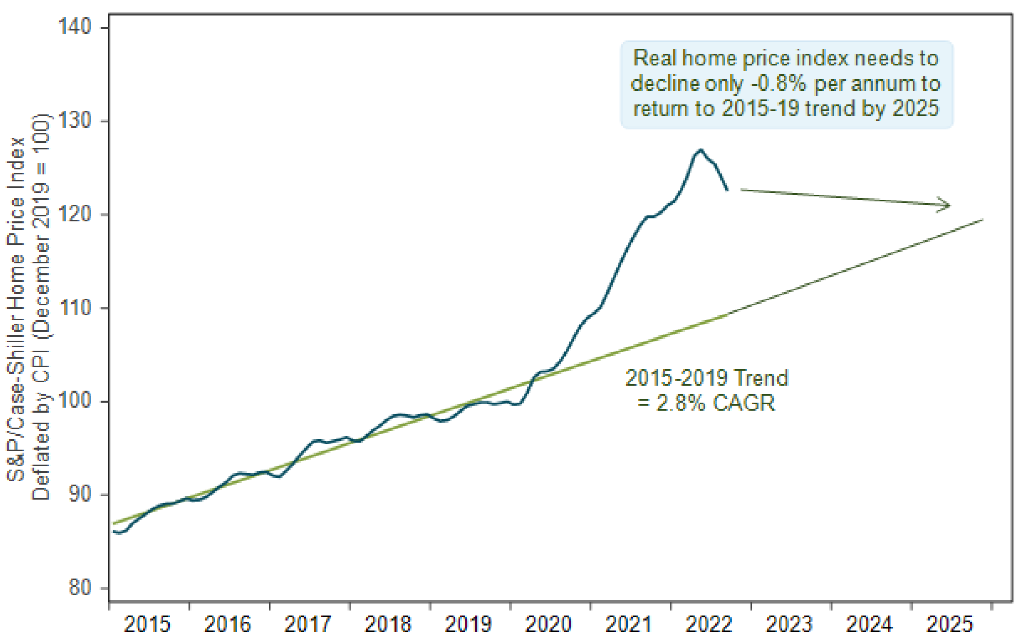
Note: Shaded areas denote NBER recession periods
Sources: GW&K Investment Management, S&P, and Macrobond.

US home price appreciation reached a record rate of 20.8% year-on-year in March, but has decelerated rapidly since then. The record year-on-year decline was -12.7% in March 2009.

Consider also that the Case-Shiller Nationwide Home Price Index, when adjusted for inflation, was 12% above its 2015 – 2019 pre-pandemic trend **(Figure 6)**. This means that it would only take a real decline of -0.8% per annum for that index to return to its pre-pandemic trend by the end of 2025. That could easily be achieved with stagnant home prices against a backdrop of 2.5% inflation that is predicted for the next three years by breakeven inflation rates based on Treasury Inflation Protected Securities (TIPS).

FIGURE 6

Soft Landing for US Home Prices?
Real Home Price Index vs. Trend



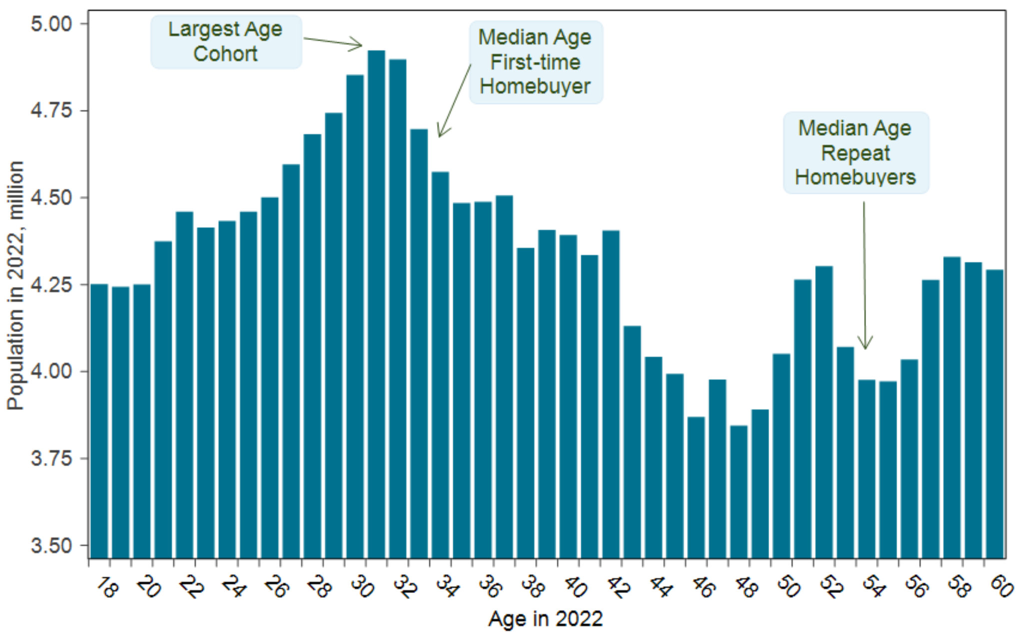
Sources: GW&K Investment Management, S&P, and Macrobond

The S&P/Case-Shiller National Home Price Index, adjusted for inflation, was 12% above its 2015 – 2019 trend in September. A decline of -0.8% per annum would return the index to its trend by the end of 2025.

Finally, favorable demographic trends and limited housing supply due to regulation should support home prices as soon as there is any relief on mortgage rates. Regarding demographics, there are 28 million Millennials in the 27 – 32-year age range who are approaching the median age of first-time homebuyers, which is 33 years old **(Figure 7)**.[3]

FIGURE 7

Large Demographic Tailwind Amid Low Inventory of Homes for Sale



Sources: GW&K Investment Management, US Census Bureau, and Macrobond

The US housing market faces a very favorable demographic tailwind as 29 million 27 – 32-year-old Millennials are approaching the median age of first-time homebuyers (33 years old).

Unfortunately for buyers, there has been a steady rise of local land-use regulations in recent decades that have limited the supply of new homes and driven up home prices and rents. Despite some local government efforts to reverse that trend, a nationwide solution remains elusive.[4]

[3] See Nicole Friedman, "Millennials are Supercharging the Housing Market," *Wall Street Journal*, December 14, 2021.
[4] Ronnie Walker, "The Housing Shortage: Prices, Rents, and Deregulation," *Goldman Sachs Economic Research*, October 11, 2021.

CONCLUSION: "THIS TIME IS DIFFERENT"

Taking all these factors into account, we anticipate a modest peak-to-trough decline in the nationwide home price index of about 5% – 10% over the next year, well below double-digit declines that seem likely for sales and starts. To be sure, nationwide home price indexes smooth out much of the variation that is seen in local and regional markets. And local markets that were significantly frothy due to pandemic-related work-from-home surges in demand are at risk of greater corrections than the nationwide indexes suggest.

If we are correct, that would constitute a soft landing for home prices despite a hard landing for housing activity. That may sound like a Pollyannish, "this time is different" view after the fastest runup in home prices since the 1970s. It also contrasts with the searing memories investors have of home price declines following the global financial crisis.

But the differences between now and then are notable. Affordability has collapsed for first-time homebuyers, not for existing homeowners. The "lock-in effect" is real. There is no subprime lending problem. Homeowners have never had more equity. Mortgage rates may have already peaked. And demographics are a likely tailwind for home prices, not a headwind.

Home price appreciation has already decelerated rapidly and will likely be negative next year. But, yes, this time is very different from the GFC.

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