Cetera® Investment Management LLC

The Haunted Housing Market:

Why Homeowners are Still Haunted by Ghosts of the Past Crash

Cetera®

Haunted houses are typically portrayed in Hollywood horror films as Victorian era mansions or stately manors fitted with gothic architectural features. But don't be fooled. Nowadays, you don't need to open a creaky gate or swipe away cobwebs to enter a haunted house. The ghosts of the past housing crash haunt new developments, quiet suburban cul-de-sacs, and tree-lined streets throughout America. Housing prices have screamed higher since the start of the pandemic, and many homeowners are now wondering if the sequel to the last housing crash is lurking around the corner.

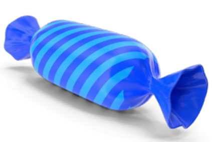
New homebuyers may be particularly frightened, questioning whether the mysterious noises heard at night are normal, or the otherworldly warnings from ghosts of the past crash. In this commentary, we will discuss why the nightmare housing market of yesteryear keeps homeowners up at night, before going six feet deep into the current state of housing. If you are easily scared, proceed with caution.

Home Sweet Home

King Size. The total value of the U.S. housing market is $52 trillion.[1] What happens in housing has an outsized impact on the economy and markets.

Fun Size. The average size of a newly constructed house is 2,532 square feet.[2] Home prices have outpaced inflation since the end of World War II. One reason is homes are getting larger. The average new build in 1950 was 983 square feet.[2]

Sour Patch. Rising mortgage rates are leaving a sour taste for homebuyers. The average 30-year mortgage rate for all of 2021 was 2.96%. Two years later, it's 7.5%. Mortgage rates are the highest in more than two decades.



Jolly Rancher. Rural county population growth was positive in 2022, reversing the prior decade's trend. There was a net migration increase of 206,000 people seeking greener pastures.[4]

Hot Tamale. The big winner of the pandemic great migration is cities with hot climates. Austin, Tampa, Orlando, Phoenix, and Las Vegas had the largest population increase from net migration in the first two years of the pandemic.[3]

Pay Day. U.S. homeowners have a whopping $31.6 trillion in housing equity. Since the post-crash low in 2012, homeowners' equity has nearly tripled.

When the Lights Went Out

Characters in horror films don't typically show fear at the start of the movie. The early 2000s housing bubble was no different. Most homeowners were oblivious to the dangers ahead as home ownership was billed as a "can't miss" investment that "doesn't go down in value." The mindset of housing having minimal risk, combined with herd mentality, easy access to credit, and creative mortgages, allowed the housing party to last until 2006. Home prices surged 85% nationally from the start of the new millennium to the 2006 bubble peak.

Eventually the lights went out on the housing market. A global financial crisis ensued as the excesses of the mania were unwound. It was a nightmare on Wall Street and on Main Street. Banks, investment firms, and individuals alike were washed out financially. Approximately 8.7 million jobs were lost during the fallout of the Great Recession and the S&P 500 fell more than 50%. From the peak of the housing bubble in July 2006, home prices declined 32 straight months, eventually falling 27% nationally when the bottom was finally reached in 2012. Declines were more severe in the most impacted cities like Miami (-51%), Phoenix (-56%), and Las Vegas (-61%). Across the U.S., 3.8 million homes were lost to foreclosure from 2007 to 2010.[5] America was paralyzed with fear.

A new economic expansion emerged from the rubble, but it was the slowest in the post-WWII era. The Federal Reserve (Fed) maintained interest rates near zero for seven years. The system healed, but it was a long and slow recovery. For those who remember the economic malaise, the events of the past crash are a horrifying reminder of what can go wrong when nobody is afraid.

Night of the Living Fed

Through the pain, the housing market healed again, rising steadily before hitting overdrive during the COVID-19 pandemic. Housing was at the epicenter of rising inflation, fueled by pandemic work-from-home dynamics, a large cohort of millennials reaching peak household formation years, and historically low mortgage rates. Home prices swelled 45% nationally from January 2020 to June 2022. The hair-raising rise in home prices seemed all too familiar for those who survived the previous housing crash.

On March 16, 2022, the Fed kicked off its latest interest rate hike cycle by increasing rates by 0.25% from the near-zero rate they were pegged to since the onset of the pandemic in March 2020. Inflation became a nightmare, eventually rising to a spine-chilling 41-year high of 9.1% in the summer of 2022. The Fed began to rise and was now on a mission to send inflation to the graveyard by implementing the most aggressive pace of rate hikes in four decades.

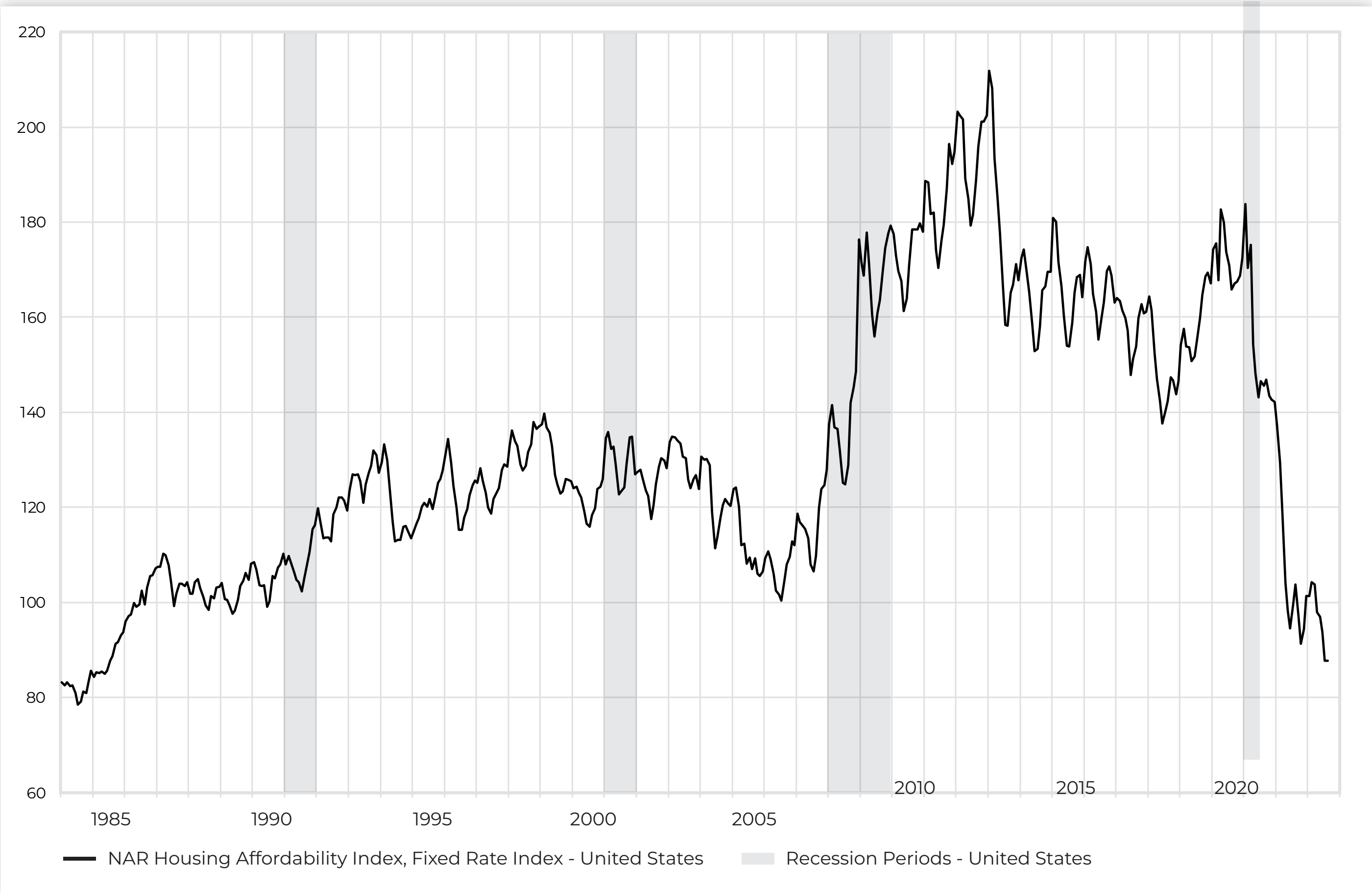
The impact was felt almost immediately. Borrowing costs hit rock bottom levels during the pandemic. The 30-year mortgage rate hit a cycle low of only 2.7% in 2021 but rallied above 4% by March 2022 ahead of the initial rate hike. Mortgage rates kept climbing, reaching 6% by September 2022 and 7% by October. Investors worried that Fed policy wasn't going to just kill inflation, but also the housing market, and eventually the entire economy. Fear took over Wall Street, sending stocks into a bear market. The S&P 500 declined 25% from the early January 2022 high to the October low. The Russell 2000 index of small cap stocks suffered losses of more than 30% from prior highs. Count Stockula drained returns from stocks and the Bond Reaper cut away bond returns. The steep rise in yields drove the Bloomberg Aggregate Bond Index to the worst year on record with a total return of -13% in 2022.

Housing was the first economic domino to fall. Permits for new housing construction plummeted 29% from January 2022 to January 2023, sales activity dropped to the lowest level in more than a decade, and home prices declined seven straight months from July 2022 through January. The drop in home prices, sales activity, and new housing starts pushed the housing market into a recession. The Wicked Witch took over several western housing markets including Seattle, Boise, San Francisco, and Phoenix, where declines were more pronounced than major cities in the Midwest and the Southeast.

Is Housing Rising from the Dead?

To the surprise of many, the housing market began showing signs of life in February of this year. As of July, the national home price index has increased seven straight months and home construction activity is rebounding off the lows hit earlier in the year. We don't think housing has fully risen from the dead, but there is an arm popping up from the grave. Overall sales activity in the existing homes market remains at alarmingly low levels, but a major reason for low sales is historically low inventory. There has been enough demand relative to the low level of supply to push prices higher. Bidding wars still exist, there are just fewer bidders. This story is still playing out and risks remain in the housing market, but we don't think the ending will be terrifying like the last housing crash. It might be a different type of scary story altogether.

Figure 1: Housing Affordability



Source: Cetera Investment Management, FactSet, National Association of Realtors (NAR). Data as of 8/31/2023.

There isn't enough Halloween candy to sugar coat the elephant, or shall we say ghost, in the room. It's housing affordability. The National Association of Realtors (NAR) housing affordability index is at the lowest level since 1985.

Both home prices and borrowing costs have surged, leading to a considerable increase for the monthly payment and down payment needed to buy a home, relative to average income levels. For the median priced house purchased at the average 30-year mortgage rate (assuming a 20% down payment), the monthly payment for principal and interest is an eye popping 82% higher than it was just two years ago (Aug. 2021 to Aug. 2023).

People are still scarred from the previous housing crisis because of how fast home prices fell. The collapsing housing market took the entire economy and stock market down with it. The current crisis in housing is rooted in the fact that prices aren't falling, or at least not materially in most markets, as interest rates have risen. The so-called "American Dream" of homeownership is becoming out of reach for many. We are in a crisis marked by low inventory and affordability.

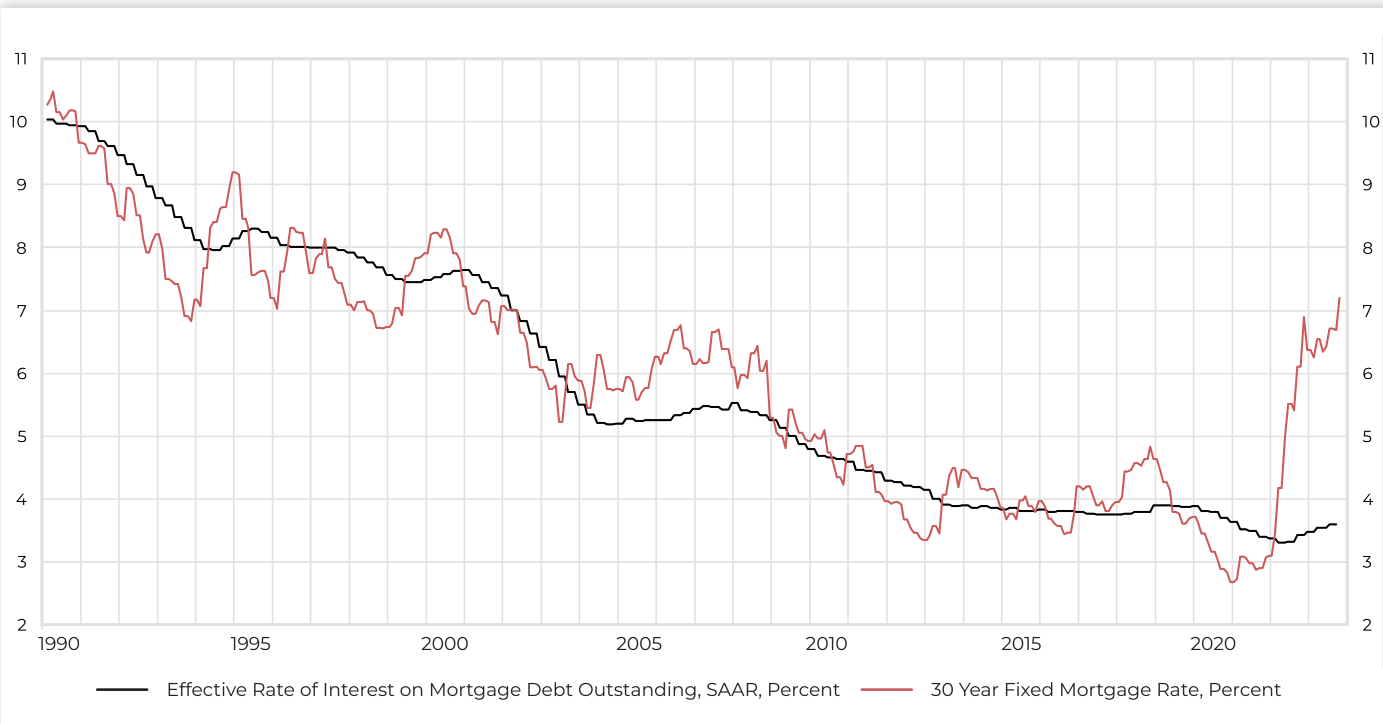
Homebuyers are terrorized by this two-headed monster. Housing's narrative could change if the supply-and-demand imbalance drifts toward healthier levels again. This crisis is still terrifying, but we don't think today's housing market is a sequel to the last housing crash.

Good Bones

For the ghosts of the past to return for a sequel, the housing market will need to crumble under mass foreclosures and the construction industry will need to collapse into a multi-year tailspin. However, there is a stronger foundation in this housing market, and we'll explain why.

Lower Risk of Mass Foreclosures. Overall, consumers have low debt-to-income levels, with most homeowners locked into fixed mortgages at low rates. At the peak of the last housing mania, the percentage of homeowners taking on adjustable-rate mortgages (ARMs) was over 30%. The average percentage of ARMs since 2009 is only 5.7%. Interest rates have increased substantially, but most homeowners are shielded from rising interest rates. The effective mortgage rate for current homeowners is only 3.6% (weighted average of all active mortgages), compared to the average rate of 7.5% for a new 30-year mortgage (as of September).

Figure 2: Effective Rate on Outstanding Mortgage Debt vs. 30-Year Fixed Mortgage Rate

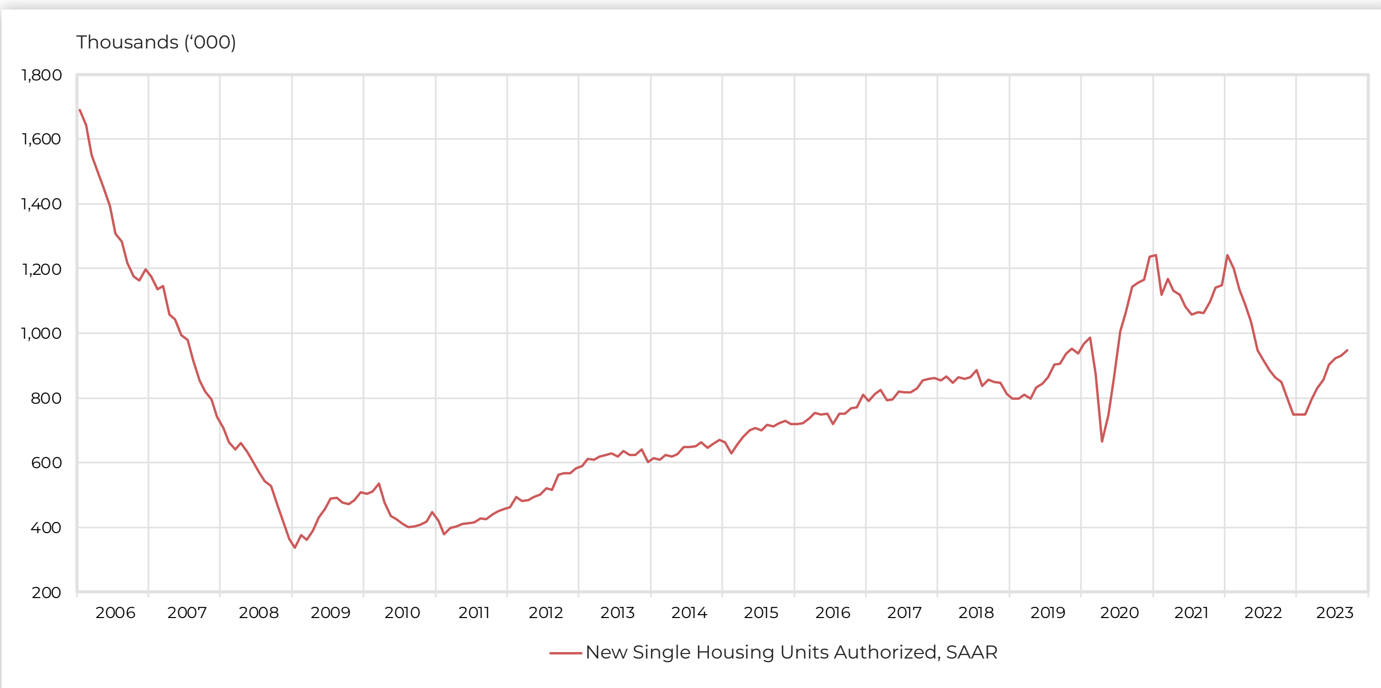


Source: Cetera Investment Management, FactSet, U.S. Bureau of Economic Analysis, Freddie Mac. Data as of 9/30/2023.

Furthermore, 39% of owner-occupied homes today are owned outright without any mortgage debt, and homeowners' equity is 71% of the total value of household real estate. The last time this figure was as high as recent levels was 1960. High housing equity reduces the risk of forced selling in the event of housing market turbulence. What this is telling us is that the risk of mass foreclosure is low. Homeowners today are better qualified, most are locked into low fixed-rate mortgages, and consumers aren't as debt burdened as they were during the previous housing boom. On top of that, the labor market is still growing at a healthy pace.

Building Recovery. Many homeowners don't want to sell because of "golden handcuffs." They are paying a low mortgage rate on a house that was purchased at much lower prices, locking them in place. The cost to move right now is financially frightening, so most are staying put. This is why housing inventory is so low. It's bad news for homebuyers looking for a boost in inventory, but it's a benefit for homebuilders. Tight supply of existing homes for sale is firing up demand for new homes. Before the pandemic, housing supply issues were starting to emerge after more than a decade of underbuilding following the financial crisis. Homebuilders were spooked by the last crash. That changed during the pandemic when another building boom emerged. New construction slowed in the second half of last year, but there is a recovery this year as prospective homebuyers are finding value in new homes in the current housing landscape. Builders are enticing buyers with rate buydowns, reduced pricing, and a move-in-ready house that doesn't need costly repairs and updates. From the January low, new single-family home construction permits are up 27% as of August.

Figure 3: Single-Family Housing Permits



Source: Cetera Investment Management, FactSet, U.S. Census Bureau. Data as of 8/31/2023

New home sales are up 24% from the 2022 low. Over the last three months, new home sales averaged 699,000 (seasonally adjusted and annualized). For perspective, the 2018-19 pre-pandemic monthly average was 650,000. This dynamic is also boosting construction employment, which is at a record high level. Many thought home construction was left for dead at the start of the year, but the industry dug out of a deep hole.

Looking Through the Fog

We aren't going to make predictions on the future of home prices. Mortgage rates at current levels could severely limit the upside for price growth in most housing markets. There is a real possibility that the national home price index falls again because mortgage rates are so high. Local markets where affordability is the weakest could see material downward pressure on prices, whereas the most affordable markets could see a boost in demand from individuals relocating from pricier cities. If a structural shortage of housing inventory remains long-term, the floor on prices will remain higher than prospective homebuyers will like. There are risks in the housing market and it does feel haunted by ghosts of the past crash when looking at listing prices. A balanced housing market is good for the housing industry, and we need a lot more inventory for that to happen. The good news is more inventory is coming from new construction, a trend that can be a longer-term tailwind for economic growth. The deterioration in affordability could weigh on buyer sentiment and reverse the downward trend in inventory, providing a path toward better balance next year.

The stakes are high for markets and the economy. High rates could threaten the economic expansion and another leg down in housing could increase the risk of a recession. That would be bad news for the stock market. Positively, the overall housing market has good bones. Most homeowners are in much better shape financially compared to the last housing cycle, the labor market and wages are still growing at a healthy pace, and builders are getting a demand boost from the housing shortage.

You *Likely* Don't Need to Sleep with the Light On

Fall festivities are kicking into high gear as we approach Halloween. For many, a fall weekend trip to the pumpkin patch will do the trick. For others, watching a scary movie or visiting a haunted attraction is a real treat. No matter where you fall on that spectrum, there is something about a haunted house that can let your imagination run wild. Home prices did reach nosebleed levels again, but the current housing market has key differences when compared with the early 2000s housing mania. Moreover, an outright national home price crash is rare. Not all real estate slowdowns should keep homeowners up at night. If you are a prospective homebuyer, it is advisable to speak with your financial professional to make sure a home purchase makes financial sense. The financial graveyard is filled with unprepared homebuyers. But don't be frightened, a good plan and finding the right house can help you avoid a housing nightmare.

You *likely* don't need to sleep with the lights on. But make sure to turn the front light on for trick or treaters on Halloween night. We hope you have a Happy Halloween!

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[1] https://finance.yahoo.com/news/real-estate-values-49-5-210012925.html

[2] https://www.investopedia.com/articles/pf/07/mcmansion.asp

[3] https://business.bofa.com/content/dam/flagship/bank-of-america-institute/economic-insights/housing-morsel-great-migration-continues.pdf

[4] https://dailyyonder.com/rural-population-increases-slightly-remote-counties-lose-residents-new-census-data-shows/2023/03/30/

[5] https://www.chicagofed.org/publications/chicago-fed-letter/2016/370

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A diversified portfolio does not assure a profit or protect against loss in a declining market

Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measure the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

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