RIVERFRONT INVESTMENT GROUP

# Weekly View

*by* ROD SMYTH

THE RIVERFRONT WRITING TEAM

REBECCA FELTON
Senior Market Strategist

ADAM GROSSMAN, CFA
Global Equity CIO |
Co-Head of Investment Committee

CHRIS KONSTANTINOS, CFA
Director of Investments |
Chief Investment Strategist

KEVIN NICHOLSON, CFA
Global Fixed Income CIO |
Co-Head of Investment Committee

DOUG SANDLER, CFA
Head of Global Strategy

ROD SMYTH
Chairman of the Board of Directors

SUMMARY

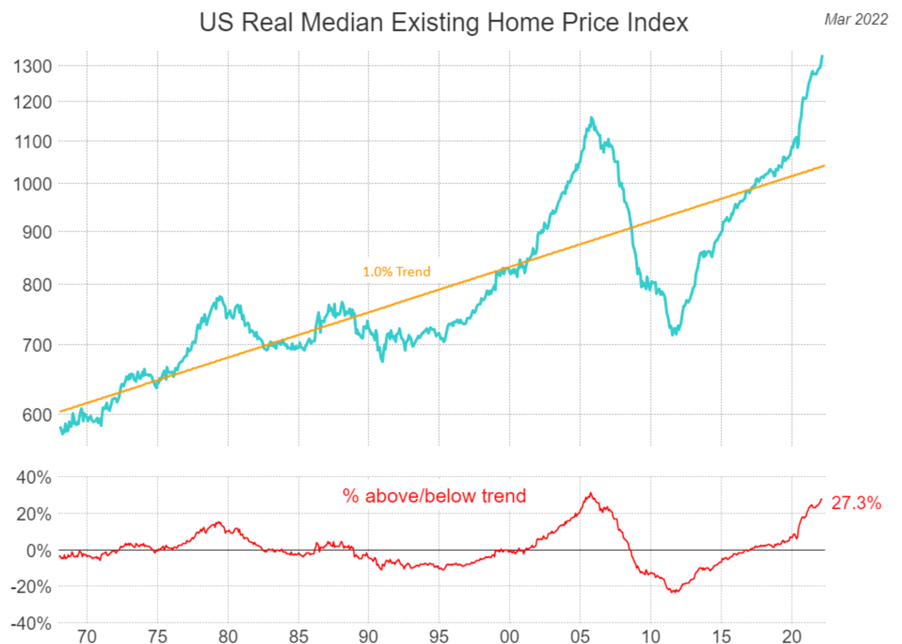

- Real median home prices are at record levels and significantly above trend, in our view.
- We believe rising mortgage rates and falling affordability suggest prices will peak soon.
- We do not expect a housing bust due to favorable supply demand conditions.


5.23.22

# Housing Needs to Cool Off...and it Probably Will

## VALUATIONS ARE HIGH, BUT DEMAND IS STRONG, AND SUPPLY IS CONSTRAINED

By any measure, the housing market is 'hot'. As of February, some 50% of sales are above the asking price, versus around 20% prior to the pandemic. Also as of February, the median home is on the market for just 14 days relative to 40-50 days pre-pandemic. As the chart below shows, by 2020 real home prices (adjusted for inflation) had recouped most of the losses incurred after the peak in 2006. Since the COVID-19 pandemic began have risen at an unusually rapid pace. They are now 27% above their long-term trend, an amount like that experienced at the peak of the last cycle.




*Source: Refinitive Datastream, RiverFront. Data monthly as of 3/31/22. Chart shown for illustrative purposes only. Past performance is no guarantee of future results.*

With all this data, it seems reasonable to ask if housing is in an unsustainable bubble, and if prices are at risk of falling. Our current thinking is that house prices are at or close to a peak, and in markets that have been overly speculative will come down somewhat. However, due to strong supply/demand conditions we believe most markets are more likely to 'rust' than 'bust'. By rust, we mean that nominal prices (not adjusted for inflation) could decline somewhat or stagnate around current levels for several years, to allow wages and inflation to make them more affordable to the average buyer. This is what happened in the 1980's and 90's when home prices traded sideways.

In writing this Weekly we would like to acknowledge the work of Mark Vitner, Managing Director and Senior Economist at Wells Fargo, whose insights on this topic were very valuable.

**Why median US house prices are likely to peak**

- **Mortgage rates are up.** Most buyers who use a mortgage care less about the price of the house and more about the cost of the monthly payment. 30-year mortgage rates have risen from 2.65% in Jan 2021 to 5.3% today according to Freddie Mac.

- **Payments have risen dramatically.** On a $240,000 fixed rate loan the monthly payment is now $1300 a month, up from around $1000 a month at the start of this year – a 30% increase! A borrower who can only afford $1000 per month can now only borrow $180,000. Thus housing, like a lot of things in this high-inflation era, has become a lot less affordable. This is especially true for a first-time buyer who has not benefitted from the rise in prices.

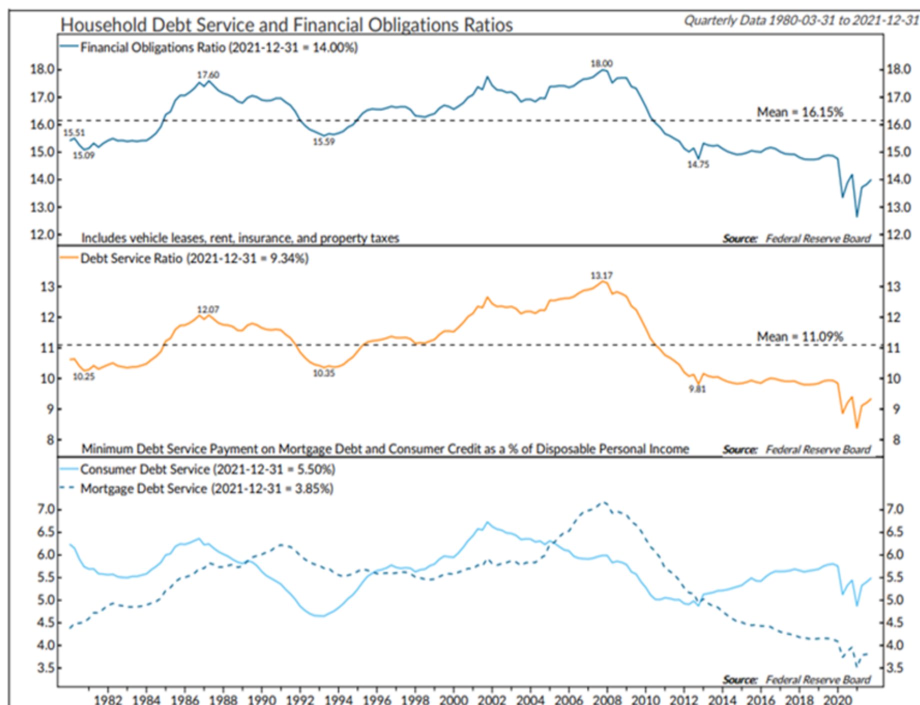
- **High end buyers have seen a drop in their wealth.** The S&P 500 is down 18.1% through last Friday. This is likely to reduce the price they will pay for homes, in our view, and their immediate appetite to transact.

**Why house prices are unlikely to repeat the 2007-2009 crash experience**. There are some important differences between now and 15 years ago.

**Why median US house prices are unlikely to 'bust':**

- **The inventory of homes is at record lows…**whereas there had been record building between the 2002 to 2007 period. In 2007 the inventory of new homes represented 11 months of sales; today it is six months. Existing home inventory in 2007 represented 11 months of supply; today it is just two months! In other words, housing is in short supply.

- **Consumers are in better shape.** The chart below shows the financial obligations ratio. This is a statistic produced by the Federal Reserve which represents the ratio of household debt payments to total disposable income in the United States. It measures how much household income is being spent on repaying debts and other financial obligations. The situation today could not be more different than 2008. The ratio was at a 40-year high in 2008 and interest rates were averaging two percentage points higher, whereas the figures from the end of 2021 are close to 40-year lows. The ratio will rise with interest rates in 2022 but not to a threatening level, in our opinion.




*Copyright 2022 NDR, Inc. Further distribution prohibited without prior permission. See NDR Disclaimer at [www.ndr.com/copyright.html](www.ndr.com/copyright.html). Chart shown for illustrative purposes only. Past performance is no guarantee of future results.*

**Lenders are being more prudent in our view.** Between 2004 to 2008 mortgage lenders and brokers were lenient in their lending, collecting little information and often not verifying it. The term 'no-doc loans' was used to describe this phenomenon. Several large mortgage lenders went bankrupt in 2008-09 due to their aggressive lending. Today bank lending practices are much more closely scrutinized by the Federal Reserve. While banks have been keen to lend, we see fewer signs of excess.

**Less speculation.** While we don't have specific data on this, we believe many of today's buyers are looking for somewhere to

live, not speculating on price rises by 'flipping' houses. The significant price declines of 2008-09 were largely due to over-levered speculators becoming forced sellers. We do not see that kind of speculation and leverage today.

**Millennials are entering their peak years for household formation and spending.** The oldest millennials are turning 40 and the youngest are turning 26. According to the US census bureau there are approximately 71 million millennials, and they make up 22% of the US population and 35% of the workforce. With baby boomers retiring at a rapid rate, it is estimated they will make up as much as 75% of the US workforce by 2025.[1] In 1975, 45% of 25–34-year-olds had attained 4 common milestones: 1. Lived away from parents 2. In the labor force 3. Married and 4. Had a child. In 2016 the figure was 24%.[2] Millennials have delayed these things, but now household formation is picking up, providing a source of structural demand. In addition, buyers are likely to spend more on homes and less on other things in our view due to the pandemic's shift to flexible schedules and the need for more space. This will also push a move to the suburbs.

**Wild Card: The Institutional Buyer**

In the last 14 years a new buyer of homes has emerged. Institutional investors have sprung up as a new buyer of rental properties. It is hard to gauge how they might react to prices rolling over. Our best guess is that they are stable owners, especially in our 'rust' scenario as rents will likely continue to rise. In a bust scenario they might also be a source of stability and new buying as rental yields rise, but they might also cause instability if they decide to exit their holdings and take profits. Since they have been investing for years, the strategy has been successful, but in recent years there has been an increase in the number of investors and as a result, they have been going to smaller markets where they have become a larger percent of the market. These investments may be more unstable.

**Location, location, location: All Housing is local**

It is important to stress that national statistics are the result of very different local markets and location is always a key factor. Looking regionally, there are some interesting dynamics occurring as a result of the pandemic. Remote work is allowing buyers to relocate from the most expensive urban markets to cheaper ones. For these buyers, interest rates are likely to have less effect since the housing markets they are moving to are cheaper. The biggest beneficiary has been the South.

According to Mark Vitner at Wells Fargo *"prices are up mostly in the South, where they have risen 18.1% over the past year. By contrast, prices are up a more modest 7.6% in the Midwest and are up just 7.2% and 6.1% in the Northeast and West, respectively."* He also says, "*The South, where the median price of an existing single-family home was $326,900 in February, or 10% below the national average, has been the greatest beneficiary of these inflows."*

**Housing and the economy**

We believe housing is important for the economy and for investors watching for signs of recession. House values have a significant impact on household wealth, as real estate comprises approximately 25% on average of total US consumer net worth (Ned Davis Research). We believe that house price movement can have a meaningful psychological 'wealth effect' on consumer confidence and consumer spending. We also believe housing-related industries, such as lending, construction, real estate brokerage, and home improvement, are important segments of the economy. Our 'rust' versus 'bust' scenario for house prices helps give us confidence that we are not forecasting a recession in the next year, though we are monitoring housing data closely for signs of further deterioration.

**Some final advice**

Buying a home is more than a pure financial decision. Unlike a stock portfolio which is purely an investment, you get to live in your house and there are all kinds of intangible emotional factors involved in buying a home. Since we all need somewhere to live, the choice is buying or renting and owning a home just feels different. It also allows you to add value to your home by improving it. The advantage of renting is flexibility, but rents are also rising rapidly. Generally, the longer you plan to live in a home, the more advantageous it is to buy. Given our views on home prices, we suggest the decision be based on personal

[1] Millennials in the Workplace Statistics 2022: Latest Trends | TeamStage
[2] Young Adulthood From 1975 to 2016 (census.gov)

preferences, not on the expectation of further significant price increases in the next few years. We also suggest buyers avoid getting caught up in the current frenzy, as we expect it to die down, and take the time to make a prudent decision.

***Important Disclosure Information***

*The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.*

*Chartered Financial Analyst is a professional designation given by the CFA Institute (formerly AIMR) that measures the competence and integrity of financial analysts. Candidates are required to pass three levels of exams covering areas such as accounting, economics, ethics, money management and security analysis. Four years of investment/financial career experience are required before one can become a CFA charterholder. Enrollees in the program must hold a bachelor's degree.*

*Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed.*

*This report does not provide recipients with information or advice that is sufficient on which to base an investment decision. This report does not take into account the specific investment objectives, financial situation or need of any particular client and may not be suitable for all types of investors. Recipients should consider the contents of this report as a single factor in making an investment decision. Additional fundamental and other analyses would be required to make an investment decision about any individual security identified in this report.*

*Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.*

*Technical analysis is based on the study of historical price movements and past trend patterns.  There are no assurances that movements or trends can or will be duplicated in the future.*

*In a rising interest rate environment, the value of fixed-income securities generally declines.*

*Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.*

*RiverFront Investment Group, LLC ("RiverFront"), is a registered investment adviser with the Securities and Exchange Commission. Registration as an investment adviser does not imply any level of skill or expertise. Any discussion of specific securities is provided for informational purposes only and should not be deemed as investment advice or a recommendation to buy or sell any individual security mentioned. RiverFront is affiliated with Robert W. Baird & Co. Incorporated ("Baird"), member FINRA/SIPC, from its minority ownership interest in RiverFront. RiverFront is owned primarily by its employees through RiverFront Investment Holding Group, LLC, the holding company for RiverFront. Baird Financial Corporation (BFC) is a minority owner of RiverFront Investment Holding Group, LLC and therefore an indirect owner of RiverFront. BFC is the parent company of Robert W. Baird & Co. Incorporated, a registered broker/dealer and investment adviser.*

*To review other risks and more information about RiverFront, please visit the website at www.riverfrontig.com and the Form ADV, Part 2A. Copyright ©2022 RiverFront Investment Group. All Rights Reserved. ID 2213944*