Conference Title: Barclays BARC004 | FlipSide #57 Transcript

Date: Wednesday, 27th September 2023

Video: Two Barclays analysts, one hot topic, all sides explored. This is The Flip Side. The Flip Side is a podcast series featuring lively debate between two Barclays research analysts taking opposing viewpoints on timely topics of importance to economies and businesses around the globe.

Jeffrey Meli: Welcome to The Flip Side. I'm Jeff Meli, the head of research at Barclays, and I'm joined today by Ajay Rajadhyaksha, our chairman of Macro Research. Thanks for joining me, Ajay.

Ajay Rajadhyaksha: Thank you for having me, Jeff.

Jeffrey Meli: Today we're going to talk about the US housing market. Housing in the US has been a hot topic since the onset of COVID when there was a massive surge in home buying, and along with that, a virtual explosion in home prices. But prices for housing have been surprisingly resilient even after a big increase in mortgage rates. Now, normally this is a splash of cold water on a hot market.

Ajay Rajadhyaksha: Well, Jeff, I think the housing market is set for a major correction, even if, like you said, it's taken longer than expected with much of the economy, the aftershocks of COVID have had surprisingly long-lasting effects. But high prices and high mortgage rates are a bad combination. They have reduced affordability, right as we expect consumers to exhaust their savings. I'm telling you, home prices are due for a rude awakening.

Jeffrey Meli: Well, I disagree, Ajay. I think the structural issues affecting housing right now in the US are far more important than all of these cyclical considerations around the level of interest rates. Like with the economy writ large, I think the Federal Reserve has a lot less control over the housing market than people usually believe.

Ajay Rajadhyaksha: Before we jump into this debate, let's review what's happened in the housing market over the past several years, and look, it has been a wild ride.

Jeffrey Meli: Yeah, it has. Now, first, during COVID, as I said, there was a mad rush for housing. It was everywhere across the country. I mean, we had suburbs of major cities that had had little to no house appreciation for years inventory sitting on the market, and all of that changed almost overnight, home buying surged and prices did too.

Ajay Rajadhyaksha: Yeah. From the start of COVID in early 2020 to the middle of 2022, home prices nationwide increased by over 40%. That is a shocking rise over such a short period. And the thing is, the increases were very broad based, like you noted. Basically, every part of the country saw price rises.

Jeffrey Meli: Now, an important inflection point happened in the beginning of 2022. Recall that the Federal Reserve by then had started hiking interest rates, and that has an immediate effect on mortgage rates. They rose, they were very low before the Fed started hiking just over 2.5% in 2021, but by the middle of 2022, they had risen to over 7%.

Ajay Rajadhyaksha: And I would say that higher mortgage rates initially did have the natural and expected effect. Home prices did start to fall. They fell by 5% from the middle of 2022 to early 2023. But as they fell, so did mortgage rates as many investors expected the economy to slow in response to higher rates.

Jeffrey Meli: Yeah. Now, of course that didn't happen. We discussed that on episode 55 of The Flip Side. The economy kept growing even though rates were going up, and as a result, mortgage rates started to creep higher again. Now they're back above 7%, but something strange to happen this time as mortgage rates started increasing, home prices stopped falling, and they actually started to rise again. At this point, house prices have been increasing for six months. They're back at their all-time highs and there's no sign of slowing.

Ajay Rajadhyaksha: That is actually a good segue for my view. I agree with everything you said up until the part about no sign of the rise slowing. I think a deeper look at the data does suggest that the shine is coming off housing. First, let's start with the mix of reported home prices. Look, that is extremely important. The price of housing, unlike with stocks or bonds, there isn't one series you can point to.

Jeffrey Meli: Yeah, it's interesting because we're used to looking at prices of very specific assets. You look at the price of a 10-year treasury bond or you look at the price of the S&P 500 index or Apple stock, those are very specific assets they trade regularly. And so, the concept of a price is really easy to understand. You just look it up, see where is Apple stock trading today? And you see a price right there on your screen, but we don't see the price of every house every day. We only see the prices of houses that actually sell.

Ajay Rajadhyaksha: Exactly. And if the mix of the type of houses changes, then the meaning of the reported prices also changes. And there has been a shift like this in housing. More and more of the homes that are selling now are new houses. Fewer are existing homes, but new homes always cost more than similar existing homes. So some of the recent rise in home prices, Jeff, is due to this mixed shift. The change in value for a specific home is actually much less.

Jeffrey Meli: Now, Ajay, you get what you pay for. A new house is more expensive, sure, but it's more expensive for a reason. This sounds like people are buying up, so to speak, and that doesn't necessarily take away from the strength of the market.

Ajay Rajadhyaksha: Maybe not if it was a conscious choice, but in this case, the rising importance of new homes is just because existing homes, there's not a lot of them for sale anymore.

Jeffrey Meli: Yeah, I know where you're going with this. Remember what I was saying about that big change in mortgage rates? Now, when mortgage rates were really low during COVID, there was a massive amount of home buying, which meant a massive amount of mortgages that were taken out when rates were at their all-time lows. So the average mortgage rate in the country right now is still only about 4%, despite the fact that a new mortgage today would be an interest rate over 7%.

Ajay Rajadhyaksha: Yeah, and if you got a mortgage back in 2021, there is no way you sell your house now. You could have a rate below 3%, let alone four, and then you are logged in. If you sold and moved to a new house, you could double your monthly payment for a similar house. Existing home sales have fallen from about $6.5 million a year at the start of 2022 to $4 million a year because of this mortgage lock-in effect. So the proportion of new homes is rising, but because existing homes aren't for sale, not necessarily because more people want new homes.

Jeffrey Meli: Well, Ajay, my back of the envelope math suggests that this mix shift that you're talking about is real, but it's only responsible for about 10% of the recent increase in home prices. So even if the reported home prices are overstating the case somewhat, it still seems to me like prices are rising.

Ajay Rajadhyaksha: But there are other signs of trouble too. Big activity. We already talked about the fall in existing home sales. Well, housing starts are falling too. They're down 20%. So many fewer new homes are being built.

Jeffrey Meli: Yes, housing starts are off the peak. Sure. But I don't expect them to fall further from here. By the way, one look at home builder stocks suggest that investors agree with me. Home builder stocks are up 60% since the 2022 lows. Recall that they initially fell in response to higher interest rates, but land has gone up a ton in value, and builders of course always own a lot of land. They're telling us that higher rates does reduce their margins on new home sales, but the value, the price of new homes is still high enough that home builders can continue to make money. So they're going to keep building.

Ajay Rajadhyaksha: Actually, in recent quarters, a number of these home builders have noted that the demand for smaller, less expensive new homes is what has really increased. And that leads me to my next point. Affordability. The combination of higher prices and higher rates has led housing affordability to fall to its lowest level since 2006. And we were in the middle of a housing bubble then, and we know how that ended.

Jeffrey Meli: Yeah, sure, we do know how that ended. But that bubble was fueled by excess leverage by investors buying on spec by the use of mortgages like interest only loans that were almost designed to hide the true cost of the home. This current rise in home prices that we're experiencing has none of those characteristics.

Ajay Rajadhyaksha: That's true. That is a good thing. But this current rise does rely heavily on consumer balance sheets, which were greatly supported by the excess savings accumulated during COVID, both from reduced spending and from fiscal stimulus. And look, those excess savings are largely gone. That's one reason we expect a slowdown in the US next year. It will have ramifications for housing too. Any weakness in the consumer will expose vulnerabilities in housing.

Jeffrey Meli: Now, one counter argument, Ajay, is that these excess savings calculations that we run for consumers do not include the mark to market on those three and 4% mortgages that everybody took out as they bought houses during the COVID period. Consumers are locked in as you put it, because their monthly bills are so low, they borrowed at a great time. And now of course, the same borrowing would cost them much more. That's actually another source of wealth for consumers that doesn't really enter our calculation, but I think is supporting their ability to continue to spend money.

Ajay Rajadhyaksha: Yes, but by definition, I don't know that it can be used to support housing demand because if you sell your house, you lose your good rate.

Jeffrey Meli: That's a good point. But look, there's a general matter here, which is that I think the sensitivity of the economy to interest rates is far lower than we are conditioned to believe. Remember before COVID when the Federal Reserve and other central banks couldn't get inflation up despite the fact that we had record low unemployment, now they can't get inflation down. Look, they can't even get housing prices down. And that's the part of the economy that should react first to interest rates.

Maybe interest rates don't matter that much after all. And that leads to my bigger objection to your bearish take on housing. I think you're ignoring some really important structural issues that are far more important than any of the cyclical stresses that you've been talking about linked to higher rates.

Ajay Rajadhyaksha: I'm not ignoring them, Jeff. I just honestly don't see how they're more important than mortgage rates increasing by 5%.

Jeffrey Meli: Okay. Well, let's look at one structural issue that I think is actually pretty surprising. Now we all know that the US population is aging.

Ajay Rajadhyaksha: Yes. And as birth rates have fallen, the overall population is older. This has all sorts of effects, which I think you're getting at, reducing the labor force participation as boomers retire, changing the preference of safer assets as investors start spending their savings. But generally, we think of housing demand falling as people age because they don't need such large houses once kids move out, et cetera.

Jeffrey Meli: Our economics team did some interesting work on this topic recently, and it turns out that as people age, they might demand smaller housing units, but not fewer housing units. In fact, more people are head of household as they get older from effects like divorce, for example, and with fewer very young people and with people delaying marriage, a greater share of the population is in the range where they can be expected to head a household,

Ajay Rajadhyaksha: But actual household formation, Jeff, has consistently lagged the estimates that we created using our methodology. So in other words, it seems like at least some people are not forming their own households when they should, despite demographics suggesting otherwise. This might include new college graduates, for example, who are still living with their parents.

Jeffrey Meli: Yeah, that's a good point. But I think it actually furthers the support for house prices. The reason why household formation has lagged, it's not a cultural thing. It's because there is a chronic shortage of housing in the US.

Ajay Rajadhyaksha: Okay. That is a point. I will concede the under-building point. You're right. Between 2010 and 2020, the pace of new housing built was slower than in 1990 to 2000, let alone the decade of the housing bubble. From 1990 to 2000, we averaged 1.2 million new homes a year. From 2010 onwards until the start of COVID, we averaged less than 800,000 and for a much bigger population. So yeah, the scars of the housing crisis, the housing bust, they did run deep.

Jeffrey Meli: That's right. And so, effectively, what we've done is created a situation with a large buildup of shadow demand for housing. There's lots of sort of households waiting in the wings out there that if housing prices ever fell, they would swoop in and buy.

Ajay Rajadhyaksha: You think the kids are that desperate, Jeff, to move out on their own?

Jeffrey Meli: Not just that. I think this shadow demand can come from a lot of different sources. Just think about what's happening here in New York City right now. We have record high rents, home prices look very supported, and we have a massive shortage of affordable housing. Now, it's being exacerbated right now by an influx of migrants, but it existed even before that.

Ajay Rajadhyaksha: So normally, I would say that market forces solve supply shortages. High prices should lead to more building. But home builder comments aside, remember starts have fallen. So if there really is a backlog of demand for homes, why isn't there more building happening?

Jeffrey Meli: Well, I think part of it was what you hinted at with regards to the aftershocks of the housing crisis that we experienced in the run up to the global financial crisis. Home builders were scarred for so long by the overbuilding they did during the housing bubble that they've been very reluctant to really ramp up their building now. But also, let's not forget the other big structural issue that weighs on the supply of housing, and that's zoning laws. I'll take some suburbs for example, because we mentioned earlier how the suburbs experienced a huge boom in home prices during the onset of COVID.

In a lot of suburbs, there are laws that make it illegal to build apartments in residential areas like multifamily housing. In other areas, municipalities have minimum lot sizes. They add height requirements, all sort of in an effort to discourage home building. There's a permitting process that can be slow that also slows up the ability to supply housing into the market. Really, there's a lot of aspects of our system that are geared to protect the value of existing homes, but in the process, they make building new homes very difficult. And so we just create this structural shortage of housing.

Ajay Rajadhyaksha: Well, zoning laws came into place for a reason, Jeff. No one wants a factory next to your dream house or your school district being overrun by too many small apartments being built, and things are changing. California, Maine, Washington, all of these are states that have reformed single family zoning. The administration is now offering federal grants for towns that allow multifamily apartment building.

Jeffrey Meli: Sure, there has been some progress in certain states. I'd point out that in New York similar efforts failed during this legislative cycle, but I would also point out that it's too little and too slow to matter right now for this housing cycle. Ajay, all of this stuff that you're talking about, even if it works, would be building years in the future. Face it, new home sales in the United States have been rising for almost a year. Home builder stocks for the same period. And now home prices have started rising too. That's really hard to see that a pullback in home prices in this cycle is going to happen. Now we've weathered the interest rate storm and now these structural issues are taking the fore.

Ajay Rajadhyaksha: Hold on. I think you're declaring victory too soon, Jeff. This latest rise in mortgage rates that you mentioned, it is having an impact just not yet on home prices. Home builder's sentiment had been rising since December, but is now falling over the last couple of months. Home builder's stocks are down over 10% from their highs in recent weeks. The passage of time is working against housing as mortgage rates stay high. I think you are confusing the resilience so far with pre-acceleration.

Jeffrey Meli: Well, and I would say that people buy homes due to personal circumstances, not because mortgage rates edge a little bit higher or a little bit lower. And right now, with a chronic shortage of housing supply, under building over years accumulating and everyone employed with jobs with wages that are actually going up above inflation, why would prices ever go down? I think you're being too pessimistic, Ajay.

Ajay Rajadhyaksha: Look, I hope you're right and I'm wrong.

Jeffrey Meli: Well, at least we can both agree on that. Clients of Barclays can read our latest take on the US housing market in our Q4 global outlook, and in housing market resilience, Blame the Boomers, both available on Barclays Live.

Video: That's all for now from this Barclays podcast. Thanks for listening, and we'll catch you next time on The Flip Side. For more insights on this topic, clients can log into Barclay's Live or find out more at barclays.com/cib.