SHOULD INVESTORS FEEL AT HOME WITH HOUSING?

Despite several headwinds, other signs indicate the housing sector may remain strong.

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Key Takeaways

- Today's housing sector has been buffeted by headwinds and tailwinds.
- Recession fears and rising interest rates have investors concerned.
- But the U.S. also has strong labor market and rising household net worth, making mortgage defaults potentially less likely.
- A low percentage of current mortgages are ARMs compared to those in the mid-2000s, when the housing bubble burst, in part because of rising interest rates.
- The housing market is vastly healthier than it was prior to the Great Financial Crisis of 2007–2008.

Few sectors of the U.S. economy attract more attention from investors—including homeowners, prospective buyers, and speculators—than housing. In recent years, home prices have soared as inventory has plummeted, but fears of a recession and rising interest rates have investors wondering, "What's next for the housing sector?

Before we dive into housing specifics, it's important to look at the U.S. economy in general. Despite this year's stock-market volatility, fundamentally, the economy is relatively healthy with a strong job market. However, an unexpected inflation shock has the Federal Reserve (Fed) scrambling to tamp down rising prices with a series of interest-rate hikes, essentially inverting the yield curve. Many studies have shown how inverted yield curves have historically presaged recessions. However, yield curves can send false signals of imminent recessions, so it would be prudent to observe other indicators as well.

The stock market itself may also predict recessions. Although the stock market tends to be a leading indicator of the overall economy, changes in net wealth may be a better signal for recessions to come. Recessions tend to follow periods when annual percentage changes in net wealth are roughly flat to negative, while negative returns in the stock market can also send false signals of recession.

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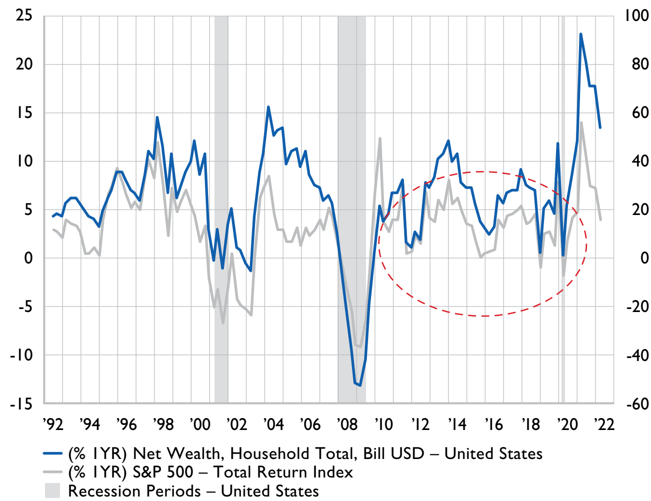
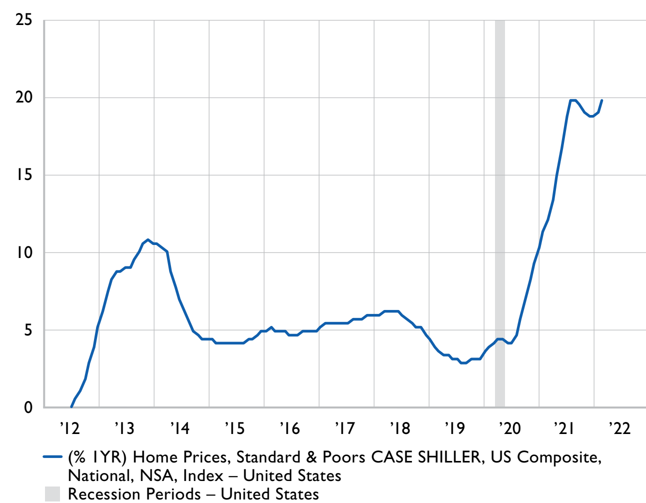
Net Wealth of U.S. Households vs. S&P 500 Total Return



One's net wealth extends beyond just the stock and bond markets, and that's where housing comes in. According to the Fed, housing wealth equates on average to about one-half of household net worth. Consumption patterns tend to align with changes in household net wealth, which is important since consumption makes up roughly two-thirds of the U.S. gross domestic product (GDP).

Housing wealth is obtained primarily by price appreciation gains, and the U.S. housing market has seen prices accelerate at a rapid rate during the last decade, particularly during the past two years.

Home Prices Have Soared Since 2020

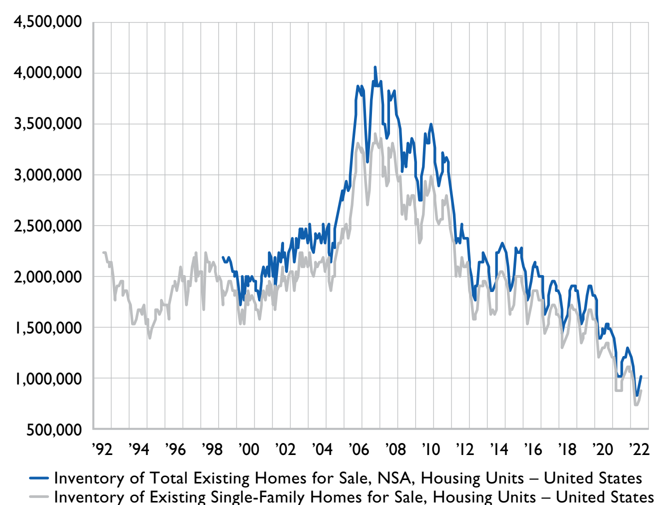


According to a study by the National Association of Realtors, U.S. households amassed $8.2 trillion in housing wealth from 2010 through 2020. The study also found that among middle-income homeowners, total housing wealth jumped by $2.1 trillion. It should be noted that those figures exclude the staggering 20% home price appreciation seen during 2021. This rise in housing wealth means more potential spending power for consumers who choose to use that wealth through home equity.

On the supply side of housing, high input costs and a record low lack of supply have contributed to rising housing prices. A sharp rise in lumber prices last year also contributed to the recent surge in housing prices.

Lumber Prices Reached Record Highs in 2021

Housing Inventory Is at a Record Low



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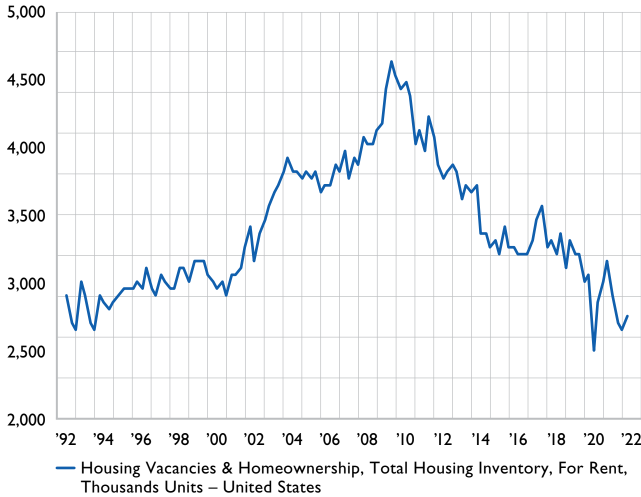
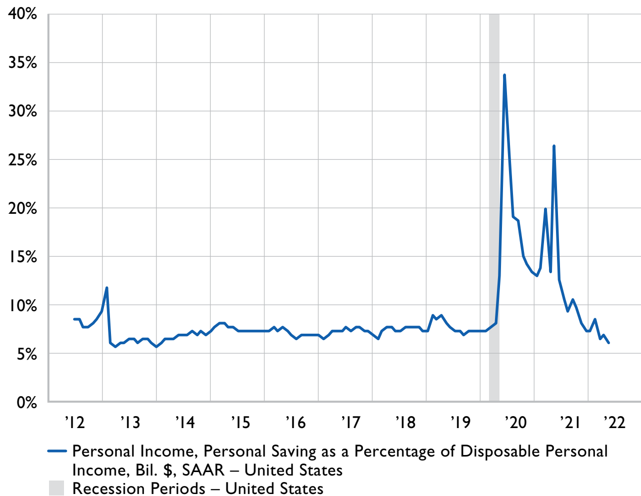
Total Housing Inventory, Including Rentals, Remains Low



On the demand side, low interest rates and new opportunities from the lack of available housing have attracted both traditional buyers and investors. According to Redfin, investors bought nearly one in seven homes sold in the top U.S. metropolitan areas in 2021. In certain areas, majority of the rental units are owned by companies such as private equity firms.

Above all, people simply had more money to spend, with some of that coming from government stimulus checks during the pandemic.

Personal Savings Spiked in 2020



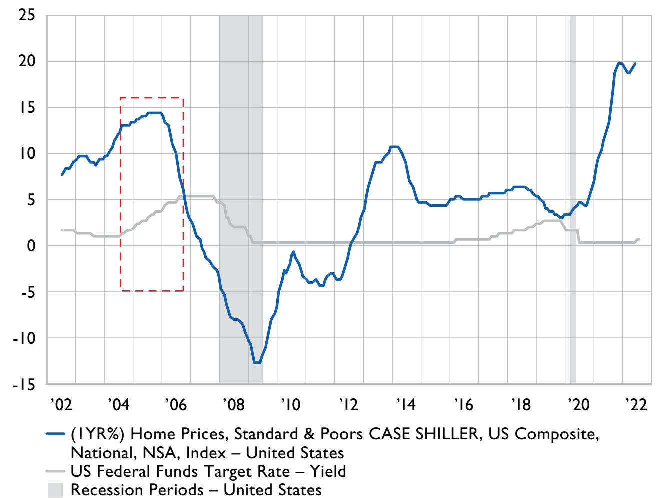
The excess savings rate allowed more people to become homeowners, as bidding wars likely drove home prices higher.

The Homeownership Rate Also Spiked in 2020

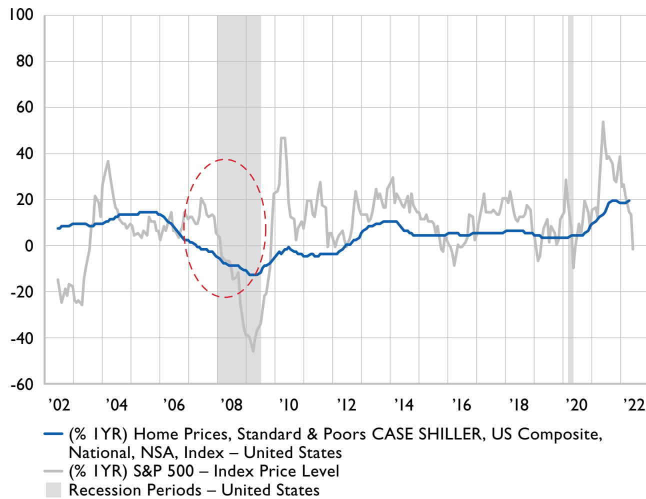
The Fed

Currently, we are dealing with a more hawkish Fed that is set on hiking rates to quell inflation. The last time the Fed rose rates to fight inflation was during the prior housing boom in the mid-2000s. During 2004 and 2006, the Fed steadily rose the fed funds rate from 1% to 5.25%. This ultimately was followed by a significant correction in the U.S. housing market.

Home Prices vs. Rising Interest Rates

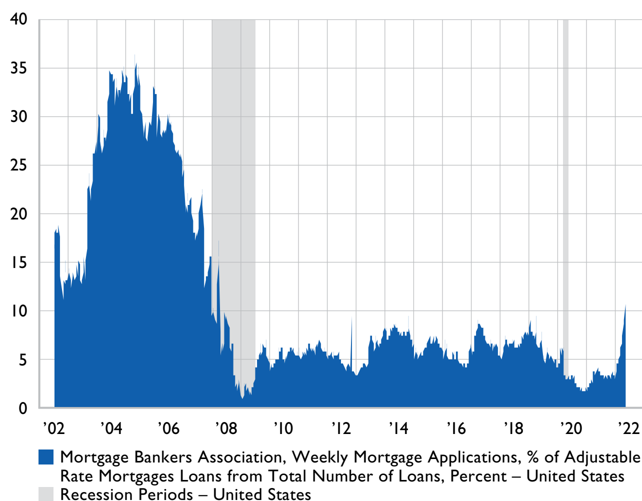


Declining Housing Prices in 2007–08 Preceded a Recession



As risk assets have come under pressure thus far in 2022, many investors wonder what is ahead for the economy, especially as the Fed prepares for further rate hikes. The key difference between the 2004–2006 rate-hike regime and the current one stems from the type of mortgages that were taken out. Between 2004 and 2006, roughly 30–35% of the loans were adjustable-rate mortgages (ARM), making them vulnerable to rising interest rates. But in the current cycle, ARMs represent a much smaller percentage of total mortgage loans.

ARMs Have Declined Since Last Housing Boom



This would suggest that the housing side of the economy may be less sensitive to rate hikes than it had been in past cycles. Not only are the loans less sensitive to rate changes, but most of the loans made during this cycle were of high quality rather than subprime ones.

Although rising rates may have a limited impact on existing mortgage holders, the housing market is expected to slow down as higher mortgage rates will drive away some potential buyers. In fact, home purchases have begun to slow down. Despite the cooling housing market, solid fundamentals should keep it robust.

Conclusion

The housing market has had a healthy runup during the past decade, which has allowed net wealth to grow along with other investments such as stocks and bonds. Despite the recent stock market volatility, net wealth remains relatively robust as the U.S. housing market continues to remain relatively strong. If employment conditions remain robust, mortgage defaults should not become an issue. Furthermore, since ARM loans represent a very small percentage of the market, future interest-rate hikes should only have a limited impact on existing borrowers. The housing market is in a vastly different and healthier condition than it was prior to the Great Financial Crisis, which should help absorb the downside effects of a stock market correction and avoid a recession in the near-term.

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