FRIDAY, JANUARY 20, 2023

Hello and welcome to the Dividend Cafe. I am going to talk to you today about the housing market. A topic that in a lot of ways, if you think about it, is more practical and day-to-day for a lot of people than even the stock market bond market, various elements of macroeconomics we talk about a lot and so forth. I wrote a piece in May of last year that really tried to pour out some of my feelings about the housing market and particularly what a primary residence means to the balance sheet of an investor, what it doesn't mean and how I sort of think philosophically about housing. This talk today is a bit more ad hoc to the current situation. I'm going to conclude with some practical takeaways for you, but I just think it would benefit people to kind of understand a deeper level of what's going on. And to do so, we're going to incorporate charts that those you watch in the video will see up on the screen and those listening to the podcast can receive the package of the actual charts. So how almost every week say you got to read dividendcafe.com because there's some charts that'll be great. This is a very chart centric conversation, and so we're incorporating that in the video for you.

First and foremost, I just want to out of the way, get out of the way the fact that I don't really believe that one's consideration of housing ought to be something that creates a lot of distress or that creates a lot of headache. If one is trying to make a decision about making a purchase, there's some financial practicality involved there. One's looking at refinancing a mortgage if one is looking at investment property there. There's plenty of angles here, but the least relevant consideration when we talk about what's happening in the housing market and prices and transactions and things like that is someone who owns a home, let's say they've been in it for a certain period of time, value's gone up, maybe now, value's going down, all those things, and they have no intention of selling, no desire to sell, no need to sell. I don't believe this is a particularly practical subject in that context, and yet I do think that's where a lot of anxiety gets pent up is people wondering what to tell themselves their house is worth. And I don't think it's super helpful, but let's talk about the state of affairs and regardless of what lane you're in, a holder of real estate, a potential purchaser, someone who may be facing a sale, there's all sorts of situations people have at a varying degree of practicality, and I hope you'll get something out of these talks.

So the chart up on the screen right now deals with the amount of sales, the volume of transactions. It is not pertinent to the price of what various homes are selling for. And by necessity and for simplicity, we're dealing with median prices at the national average. And there's a caveat about that that should be self-explanatory. Different marketplaces are different. Different Geographies can be different, but we want to be able to have a constructive yet and holistic conversation. So we're using national averages. And you can see that the volume of transactions nationally really in the last six months collapsed and that there had been a big spike higher particularly in existing home sales, and that has substantially reduced and not just reduced to kind of the average level, it had been from let's say 2010 to 2020, but gone lower than that level. So you had a spike up in activity even from the trend line, and that has come way down.

But I want you to look to the next slide where this is more, I would say in this case than just a simple, okay people are trying to figure out what's going on with the Fed because we look at this chart here, and I didn't count 'em up, I believe this is seven different incidents of rate hikes. And you look at what happened subsequent to those rate hikes beginning in sales volume, in the quantity of transactions, and this is unprecedented, this is a much quicker and more severe drop in activity. And I would argue some of that is simply the inverse of the violence we saw. To the upside previously there was such a boost of transactions that now it's led to a more pronounced cessation of transactions. But I got to say a lot of it has to do with that rate ...the Fed raising rates from 4% to 5% is very different than raising 'em from 0% to 2, 3, 4, et cetera. So how low rates were is exacerbating, I think the suddenness of this decline of activity. But again, those first two charts are both referring to a pretty severe magnitude in drop of activity, however, doesn't yet deal with prices.

The third chart I want you to look at is a pretty important indicator of volumes of transactions because you could say, look, the market's slowing down, housing prices are dropping, and you need activity to substantiate that. If there's a house that's sold for a million and then a month later the house next door sells for 900,000 and it's a comparable home, you might say, oh wow, look, prices are dropping. And right now people are saying, no, no, no, prices aren't dropping. And I'm saying that's because things aren't selling, there aren't prices. And this third chart shows you a pretty good indicator of what's going on. It's very hard to have a transaction when people aren't even looking at homes. The perspective buyer's traffic is totally gone away. Why is that? It's going to play right into a thesis. I'm going to share in a bit about affordability, but there is a huge drop in prospective buyers, and that is leading to the obvious conclusion that people are not transacting.

Now, let's turn to the conversation about prices themselves. And in this particular case, you see that since we kind of know what happened from 2000 2006, prices were going up, I think they went up in an insane manner and were largely selling to a significant amount of people that shouldn't have been buying. And then you had this massive crash from the housing bubble burst, and then you had a kind of trend line of price appreciation year by year that sort of started in about 2011 or so really nationally, more into 2012, '13. And that's because there were some pockets in 2010, '11, '12 that were healing and others that were really beat up and oversupplied took a little longer to clear, and that was Las Vegas, Phoenix, Florida, areas like that. But once it began going higher, you saw a certain trend line that became very consistent from, let's call it 2013 to 2020. And then you see what we call in charting the hockey stick phenomena where it just went parabolic to the upside. And that is what I think has to now reverse. And you can see in existing homes, prices are starting to come lower. Hasn't been very dramatic yet, largely because of the aforementioned slowdown of volume.

Now, what about supply? This is an argument I have made that one of the things pushing prices higher in 2020, '21 was that demand was high and cost of capital is low and there wasn't a whole lot of inventory. And from basic economics, the understanding of supply of demand that tends to push prices higher. And right now, why would I believe prices are going lower when the same supply demand fundamentals are in play? And I think that the answer is that supply has started to pick up to some degree, but it's still far lower than its historical average. However virtually no inventory is where we were a year ago is different than now in a pickup of inventory. And I'm still going to argue that the price forecast we have is not primarily related to supply.

One of the things I think if you go to the next chart about construction on the rise is that this low inventory is also being somewhat remedied. I mean, there's a lot of headwinds because you're dealing with kind of some various crazy regulations, some environmental issues, a lot of zoning restrictions. There's a lot of impediments in certain parts of the country to production of new homes. And yet you do see construction on the rise, particularly for privately owned single family housing. Let's move to the general for what's the word I want to use here? The kind of landscape we're in right now. We're talking about supply is still low, but it's picking up prices are still high, but they're coming down.

Where are we? Why would I have this view that prices are imminently correcting? I don't know that you could see something more clear than the confidence level at play in the home builder sentiment. Home builder sentiment did not just drop in the last six months. It absolutely fell through the floor a complete collapse in sentiment, which has a lot to do with a large ticket purchase like a new home. Home Builders are not only themselves less competent, but they are reflecting and expressing that there's a lot less confidence from would be home buyers. So you see a violent plummeting in home builder, confidence and sentiment, which I think speaks to the idea of more corrective behavior to come.

The thesis that I want to be able to make clear is that the affordability of housing is really what we're talking about. And affordability for a typical US home buyer, maybe not a lot clients of our firm, maybe not in some of the more ultra high net worth pockets of the country, where by the way, there's still price sensitivities whether one's paying in full or they are financing. But for the most part, Americans buy a monthly payment. And when you look at this chart of the affordability of monthly principle and interest payment, you really see as clear as could be what went wrong back before the financial crisis the payment levels because of how insanely high-priced things were, got very, very high. That collapsed, and that was a self-correcting mechanism. There ended up being a lot of other issues that had to get worked through foreclosures, excess inventory. And then we went a fair period of time where things were more affordable. There was a good time to be buying in 2011, '12, '13, it modestly started picking back up. And then it not only got up to its pre-financial crisis level in terms of that afford that level of the monthly interest payment, but it just flew higher. The expression hockey stick growth doesn't even apply here when you look at that chart. And so I think that this now brings us to the state of affairs we're in.

The next chart looks at mortgage credit availability. And this is very connected to the things I've been talking about. You have these supply issues, you have affordability problems, and the home builder sentiment being so low that many people right now with higher interest rates now have worse looking ratios and become less credit worthy borrowers. So you get a kind of negative feedback loop where things go poorly. So it causes other things to go poorly that makes things go more poorly. And right now, that real collapse of mortgage credit availability speaks to less credit worthy borrowers, not just by the way about credit themselves itself, like your credit rating, your FICO score, but more specifically equity down payment, qualified verifiable income, and just banks underwriting standards, they tighten up when they sense a higher risk of loss in the marketplace. So it kind of piles on to some degree.

I've talked about the supply and the cost of capital and sentiment, but haven't talked about the demand side where you know could sometimes argue, oh, there's a drop in prices because demand is coming lower. And yet as you look at this chart here, which is really about demographics in our country of every age from zero to a hundred across our whole population, we have more 31 year olds than anything else. And we have a very high amount of 29, 30, 32 year olds. And these things obviously are, first of all, I think it's fascinating data. You look at that chart there, they're byproduct of what the birth rates were in various years, 30 years ago, 50 years ago, and so forth. And then as you get into later years, you also are dealing with where excess death rates, mortality becomes a factor. But a lot of people aren't buying their first home, and a lot of people aren't buying another home when they're 60, 65. There's generally less home buying going on. Sometimes people sell a home and relocate by a new home. Sometimes people downsides in retirement, whatever. But for the most part, the demographic suggests that the demand side is not a problem that we are really dealing primarily with the right demographics. So this really does bring me to the conclusion I want to make before I provide a number of practical takeaways.

It's about affordability, and the next chart to me shows you exactly what has transpired and what has to happen going forward. Because we're really not dealing with a demand thing or a supply thing fundamentally, we are dealing with affordability that, as you see in this final chart, was unbelievably low because of insanely high prices back at the financial crisis onset late '06, early '07. And then affordability got much better because prices came way down. It's just math. So the more expensive something is, the less affordable it is. And then as things got less expensive through price depreciation out of the financial crisis, affordability went higher. And now you see that affordability number crashed. The affordability index tanked in 2021. And this is the thing I have to point out why it's really piled on here into '23. In '21, interest rates in the mortgage market were the lowest in history. How in the world do you have a collapse of affordability when the cost of capital is the cheapest it's ever been? Well, obviously it's math. There's only one answer. Prices were too high. So low cost of capital, but with brutally high prices led to that kind of limited affordability. Now you have the price problem contributing to lack of affordability combined with a very high cost of capital, which just simply makes things even more unaffordable. So a combination of things will have to be at play to a remedy, affordability, declining mortgage rates and declining prices. And is it going to be 50-50 that get us to a place of equilibrium? Is it going to be pretty much all about price correction and not so much on the rate side? Is it a combination of both? It gets weighted in different ways that who knows. But what I do know is that prices don't kind of clear and normalize until affordability comes higher. And the things that bring affordability higher are lower prices and a lower cost to capital.

So on a macro basis let me just say that I don't think this is a major macroeconomic story. There are knock on effects. You certainly see people buying less appliances and less landscaping and less home furnishings when there's less activity going on in the housing market. There is a fair amount of people that are employed in the ecosystem of home ownership, whether it be title, mortgage, brokerage, and some of those sort of adjacent industries could definitely suffer. But I don't think this last long, it lasts long enough to get back to a point of reasonable affordability. And I don't know if that's a year, two years but I don't think it's a major macro event. And of course, to the extent that we normalize prices to a level that allows people who are gainfully employed and credit worthy to be able to purchase, I would argue it could be a very good thing. And that those who believe a permanent state of bubbled prices is healthy economically or simply wrong. And I hope that history has been clear enough about that point.

I mentioned earlier, it's a national set of data. We use national charts. There is a very different supply and demand reality right now in states like Florida, Arizona, Texas, and there are real significant headwinds in certain major US cities, San Francisco, Portland, Seattle, Chicago. Certain states are not in the same situation as others for a number of different reasons. Some of it could be tax and regulatory. Some of it could be the supply levels of housing and where new, there's a lot of new job creation or universities or what have you. But regardless of what one believes, the social, political, sociological educational appeals are various cities that play into supply demand reality. I still believe the national narrative is useful for our purposes and that on a national basis, if one can wrap their arms around the idea that a 10 to 20% adjustment and prices comes that we probably help restore some affordability that doesn't look anything like 2008s', 40 to 50% drop with the sea of foreclosures. As I wrote about a lot in the white paper we just did a few weeks ago. The key difference there why does a 10 to 20% drop now not necessarily lead to that many more foreclosures because there is pretty much that much protective equity. And people do not generally walk away when they have equity in a home. They can lose their job and decide they need to sell, but usually they sell not for clothes when that equity's there. That was not the story in 2008.

So the macro side, I believe has just totally, depending on your vantage point, the seat you're sitting in, a combination of good news and bad news. If one needs to go sell their home next month, I would say it's going to be harder to sell than it was a year, year and a half ago, and the price is going to be lower than it was a year and year and a half ago. But apart from forced selling or eager selling I consider most of it on a personal level pretty immaterial.

And the two things that I'm going to conclude with, it's a way I concluded the written Dividend Cafe. I believe that someone wondering if they should wait to buy a home, should you know that should they do it in three months, six months, that there isn't the right answer to it. As a general rule of thumb, obviously I've kind of made the case. I expect prices to be a bit lower in six to 12 months. So why wouldn't one wait? Well, maybe one is just anxious to start decorating. Maybe one doesn't care if it goes down a bit after they or they buy because they plan on living in it happily ever after. Maybe there's a new job and they don't want to have to rent for a few months and they got to get settled somewhere. There's all kinds of reasons to not let price consideration dictate timing consideration.

But fundamentally, here is what I will tell you as a takeaway. Two takeaways to my feeling about this subject. Number one, the more equity in one's owned home, the less one needs to care about this conversation.

FRIDAY, JANUARY 20, 2023

Protective equity always in forever insulates from one's thoughts being in an unfortunate position where they have to be a forced seller. The financial security aspect, protective equity solves a lot of instabilities around housing. Number two, the more one views their house as a home and not a financial asset, the happier of a person they will be. Thank you for listening to the Dividend Cafe. Thank you for bearing through our charts. I hope it's been helpful. I certainly welcome your comments, questions, feedback. To the extent this has been helpful for you, I'd love for you to share with others. Rate us, star, subscribe, thumbs up, all the good things. Thanks for listening to watching Dividend Cafe.
