FRIDAY, DECEMBER 15, 2023

Well, hello and welcome to another episode of Dividend Cafe. We are down to the home stretch of 2023. It's actually our second to last episode of the year. Next Friday will be the final episode as we get ready to go into Christmas weekend. The week after that, I will be out of the country with my family and many of you will hopefully be distracted enough by the season's festivities that you're not wanting a Dividend Cafe anyways. I'm looking forward to next Friday, so I already know what that will be about. But in the meantime, what I wanted to do today is revisit the subject of housing. I wrote about it six months ago, pretty much to the exact weekend. At the time, it was a little bit more of a focus on some of the economics of what was happening in the housing market. I want to update some of those considerations, but there's kind of a new or additive angle I want to introduce today as well.

We find ourselves now six months further into this period of Fed tightening than we were in the summer. At the same time, we also find ourselves looking into the nearer future as to where Fed easing or loosening of monetary policy is expected. We got a lot of reinforcement of that this week in the bond market and financial conditions and even in Fed speak itself. But I would suggest that there's a number of things happening in the housing market that are outside of the domain of monetary policy. I do believe that more or less what has happened over the last year or so since the Fed got quite tight with interest rates and mortgage rates flew higher, coming out of the post-COVID bubble in which house prices went far above their own trend line is that we did get a pretty significant push higher in prices. A lot of that was driven by demand and a lot of it was driven by very low rates.

And then as rates have tightened, you've gone into a freeze. I've talked about this a bunch. This part is not new, but essentially the economics being that you already have high prices, then you add to that a high cost of capital and it has made it impossible for many to be able to afford a home or if they do go forward buying one, their monthly payment has moved up significantly. And the majority, not all, but the majority of Americans are still buying a monthly payment when they buy a home, not a sticker price. And so we have a chart at Dividend Cafe showing the way in which a monthly payment is moved, a median monthly payment since let's call it the middle of 2020. And the big effects there that have moved the monthly payment up so much are the combined effect of the higher sticker price and the higher cost of capital, the higher borrowing cost. Well now what you have is on the seller side, first and foremost, a ton of equity, a ton of equity. There's also a chart of that in Dividend Cafe.

And what that additional level of equity since the post crisis period has meant is that there's just not desperate sellers, not a cascading effect whereby people are needing to sell. They're upside down. There's a lot of return inventory to the market, bank foreclosures, panic selling, leading to lower prices, leading to more selling, leading to lower prices. All of that negative feedback loop is not happening. And the number one biggest factor keeping it from happening is protective equity. I view a home as a place to live. Those who believe it represents a big investment misunderstand a primary residence. And I don't just mean my own personal values based answers to why one wants to own a home. The sort of togvillian notions of community and neighborhoods, the notion of raising a family there, of creating memories, sort of sentimentalities. You can leave all that aside if you want. I hope you wouldn't. Like I hope you're a human being. But if you aren't, that's fine. Even the economics though, it just isn't fundamentally a primary investment. One can look at these cases and they go, well so and so bought a house, you know, 1989 for 250,000 and now they're selling it for 2 million. You think it's a ton of money, they're up six, seven times. And I always just point out two things, both of which are shocking to people. Number one, they didn't pay 250,000 for the home because over the 20, 30 years, whatever it is, they had year by year by year by year expenses in insurance, in homeowners association, in property taxes, in a significant amount of input costs that raise the cost basis of the home. And then when you actually do the math with or without those added input prices, that big huge dollar increase from what the price was to what the price is, whether you want to net out what you also put into the home in landscaping and maintenance and renovations and other costs and expenditures, the cost of ownership can be included or not. The fact of the matter is when you do what's called a compound annual growth rate, when you do the math of what it was then to what it is now, it's not that much. 5% a year, 6% a year, some are only 2 or 3% a year, some may be a little more, but they're single digits and that's fine. Maybe you're very happy.

But I still, apart from that economic factor and the sort of personal and underlying reality of what a home is factor, you also have this other little thing. You got to sell it. And once you sell it, you have to buy something else.

So unless you're doing that famous Newport Beach to Little Rock, Arkansas trade, you're very likely selling high and buying high at the same time. So all that to say, there's economic and multiple reasons why. This is not a story when we talk about house affordability. It's not a story about investment, whether or not prices come lower to recreate affordability or whether or not prices don't come lower and then interest rates come down. The primary economic consideration of the current state of housing is affordability around people being able to formulate first time home purchases, second home purchases. Those are in good homes. They want to upgrade to better homes. Their station in life has moved a little bit. Interest rates have frozen them. Sellers do not want to sell a house they're paying 3% on to buy a house at 7% on. And so both, and then especially sellers that are not desperate to sell and buyers that are already facing affordability pinch were frozen.

And the thing that can break it all is supply. The thing that brings optionality back to the markets that lowers seller leverage and increases buyer optionality is supply. We just don't have it. So what I did in Dividend Cafe this week is suggest four primary reasons why supply is so constrained. One being capital markets themselves. Banks are not in a position to lend. The regulatory environment, the risk appetite, home builders getting access to capital, it exists but it's constrained. And sometimes where it does exist, it's in private equity, people get all mad about that too. Capital markets, the capital to go, that risk takers have debt and equity to go forward, it's limited. Number two, nimbyism. This is the biggest, by the way, of the four.

The mentality that exists in many neighborhoods, communities, municipalities of we don't want new growth, we don't want new construction, we don't want new development, we don't want high density. No. It could be red state, blue state, conservative, liberal. Nimbyism is one of the true bipartisan maladies of our country. And where there's been less nimbyism, there's been more construction, certain parts of the southeast, certain parts of the Sun Belt.

So that overall dynamic puts a huge impediment up to being able to get new product built in the housing market. Number three is the general red tape of what goes into this space. The environmental impact reports, the zoning laws, the period of time, not to mention the very low assurance of success, and the fact that home builders need cash flow to make a living. You can write that down. It's a real unique aspect of their business. And there's no cash flow running through paperwork, waiting for approvals, going through permitting, getting denied. All of that step is a huge impediment in the red tape. And then number four, public policy. There are just certain elements of policy. It might have been well intentioned, but they serve as an impediment to getting new construction approved, to creating new options. It results a lot of times in higher costs.

And so this could get a little bit more political, and I'm happy to move on in the sake of time. But I think capital markets, nimbyism, red tape, and public policy all represent impediments to new housing supply. And new housing supply is the only thing that will break this stalemate. If interest rates come down, and I'm very happy to say it's not if, it's when. When interest rates come down, I don't know that you're able to get things to move much because you say, well, now sellers are going to have even more leverage. Buyers can't pay more. The affordability index is low as it gets. It's as low as it was pre-financial crisis. There isn't the pricing power to move prices higher. And then in terms of the seller's positioning, they may be more willing to sell something, to buy something else because the rate issue has gone away. But there still exists the problem of low inventory. Low inventory is what brings back optionality, changes the dynamics, buyers and sellers alike. That's the state of housing. That's where we are. I don't believe that the percentage of construction, that construction represents as a percentage of total GDP, rather. I don't think it's significant enough to be having a major macroeconomic impact.

We are down in construction, but there hasn't been a ton of lost jobs. And there's been a lot of construction in the commercial side and other elements. But look, we, residential, new home building, we're not getting the houses built we need.

And that is not now causing cascading prices or growing prices. It's causing no activity.

And in the meantime, we continue to have an affordability issue for people that are now at an age and stage where they may be wanting to start a family. They may be ready to practice household formation, new careers, growing careers, community development, all these things that are somewhat integral in the American life. And we're kind of in a stalemate. New housing supply is the major story, not what house prices are, not what interest rates are.

That is my take on housing this week. I do hope you've gotten some out of this. I welcome your questions. Hope you have a wonderful weekend. I look forward to coming back to you next week, the very last Dividend Cafe of 2023. Thanks for listening. Thanks for watching. And thank you for reading the Dividend Cafe.
