2023 REAL ESTATE UPDATE PART II: RISING CONVERGENCES AND THE UNAFFORDABILITY OBSTRUCTION

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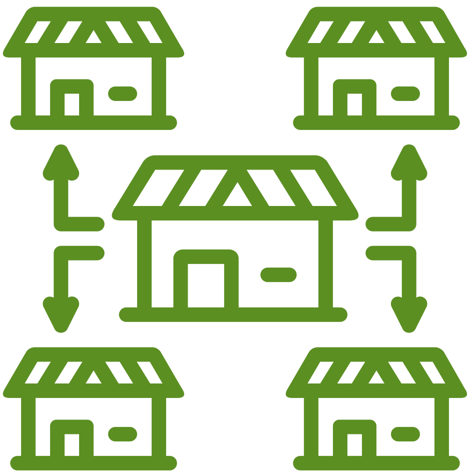
Utilizing absolutes can be extremely dangerous when making prognostications. After three years of "unprecedented" pandemic related occurrences, many analysts incorporating definitive verbiage into their forecasts have been proven misguid*ing*. Few practices, outside of the maths, physics, or perhaps to some extent symbolic logic, can safely characterize terms in rigid, settled, irrevocable language. Thus, while it is very easy to say the housing market *will* come down, we must cage this in nuance, opacity. In the first part of this three-piece series on real estate we clearly laid out the availability quandary: the US is not building enough and has not since the housing crisis of the mid-2000s.



For folks loosely tied to the news or that have looked to buy or rent a home since the beginning of 2020, it might be common knowledge, at least anecdotally that costs are up. Some could have noticed this at the grocery store, their favorite watering hole, or even Sunday dinner spot. If homes and rents are at record highs then, might it be intuitive that they should go down? Flannery O'Connor took a risk when she wrote "*Everything* that Rises Must Converge" [my emphasis] but her title stemmed from French philosophy, all those who ascend to the peak meet, maybe in ag terms we could say the cream rises to the top. Water and oil separate, but these are scientific concepts to be sure. Like Newton's Third Law: for every action in nature there is an equal and opposite reaction. But the housing market is a dynamic multi-dimensional system, so before we guarantee a gravitational pull, let's explore the situation.

In O'Connor's prize-winning prose we are confronted by Widow Chestny's refusal to accept the present and forsake the past, and Julian's resentment of her opposing differences, pushing overzealously to change his mother. The story is prescient in that we have major generational divides in the US when it comes to wealth, and especially housing. As we discussed in our first article – earlier generations, spooked by the housing crisis, underbuilt for over 15 years. A SeekingAlpha piece from 2008 highlighted many of the consumptive issues that led to the mid-2000s real estate collapse but its criticisms ring as true today, just with inflated dollar totals. Since 2008 the USA has tripled the national debt, the 156,000 bridges in need of repair then are now up to 231,000 bridges. The Great Financial Crisis has been explored in detail, but much of it stemmed from people spending too much on homes, cars, and credit cards with ease due to extremely accessible (unhedged) loans. At the same time, Millennials, in a cultural clash were popularly stereotyped and critiqued as lazy regularly even in 2007, with the famous Time Magazine "Me Me Me Generation" article in 2013. This is when your resident economist finished undergraduate studies at the University of South Carolina and there were not jobs to be had: the Millennial unemployment rate then was a whopping 12.9%, and the average hourly wage for new college graduates was $16.60/hr ($34,500 annually). These facts are not blame shifting or casting, but rather foundational to the direction this post must take in explaining the overarching conundrum.

Not to leave anyone ignored, the Gen X-ers, mid-career when the crisis hit, currently hold about $631 billion in student loan debt (Millennials at $489 billion). Suffice to say, there was a lot of debt, a lot of wealth and equity was erased in the Global Financial Crisis (GFC), jobs and opportunity disappeared followed by a decade long recovery just to return to 2004/5 economic levels. And during that entire period, we did not build at pace with population increases.

A few brief numbers for comparison: things have not always been bad. When the first group of Boomers reached their mid-20s, the ratio of American population to new single-family housing permits was 174:1, at the peak of the housing boom in September 2005 this number was 165:1 (slightly better). But what does this mean? Let's flash forward and let a juxtaposition enunciate the story: in May 2013, my college graduation, construction business had collapsed and the ratio became 508:1, more than triple eight years prior. For January of 2023 we were at 463 individuals in the nation per new single family permit. Where's the beef, eh?

Before we get to national housing prices, let's look at affordability according to relative income and mortgage payments. We should be clear: Boomers are an extremely resilient, efficient, and effective generation, and they had to fight through both the recession of the 1980s and the GFC, not folks to be trifled with. Economic conditions, however, have differed as each group has come of age – rendering the comparable reachability of the American dream varied.

When the first Baby Boomers started turning 30 years old in 1976 a very different America existed: Steve Jobs founded Apple Computer Co., The Eagles put out a record hits album, the documentary *Harlan County, USA* revealed many coal miners then still did not have access to running water, the federal debt was $653 billion, a Southern peach farmer was elected President, and the median home down payment was about 66% of what middle Americans earned annually. Monthly payments, pre-taxes/insurance were about 22% of gross pay for the median family. Interest rates were high, the highest for any generation entering the home search, and would get worse under FOMC Chair Paul Volcker, with the 30-yr fixed hitting almost 19% in 1981. Home prices over that period remained relatively flat and did retrace slightly as rates peaked. Thus, those who could manage a payment with sky-high interest, were able to refinance at 9% by 1987, cutting their annual rate by 50%.

1976 Affordability			
Median New Home Price		$45,500	
Median Family Income (Current $)			$14,958
Interest Rates	8.78%	Fees/Points	1.80%
Down Payment (20%+fees/points)			$9,919
Down Payment / Income Ratio			0.663
Payment Before Taxes/Insurance			$280
Payment / Monthly Income Ratio			0.224

By the time Gen-Xers began to turn 30, mortgage rates were experiencing significant volatility, dropping from over 9% in January 1995 to around 7% at the end of December. Though home completions had been dropping since the soft recession at the end of the Reagan administration, in 1991 an upward trend in home building began that reached its apex in March 2006. Thus, using end-of-year numbers, we see that in 20 years new home prices tripled, but wages almost kept up. Down payments were slightly higher on a relative basis, but monthly payments were a smaller portion of gross income. Basically: save a little more for the initial cost, but spend less on mortgage.

1995 Affordability			
Median New Home Price		$138,000	
Median Family Income (Current $)			$40,611
Interest Rates	7.11%	Fees/Points	1.70%
Down Payment (20%+fees/points)			$29,946
Down Payment / Income Ratio			0.737
Payment Before Taxes/Insurance			$726
Payment / Monthly Income Ratio			0.215

Of all people, the Millennials sort of lucked out at the onset: the lowest interest rates in decades for first-time home buyers, on the recovery side of a housing bubble being blown, oversupply in (what were and what would become) hot markets – but incomes continued to lag in growth. The main problem, however, for Millennials is that they were underemployed, unemployed, and relatively underpaid compared with the other eras, and more than that, saddled with heavier loads of student loan debt. Home ownership rates for folks under 35 years old dropped 12% from the beginning of the Great Recession through 2011. As Boomers snapped up cheap houses, Millennials grasped the chance to rent affordably in hopes of eventually saving enough for a down payment. Periodicals from The Guardian to The Atlantic to CNBC to Forbes and many in-between blamed cheap Millennials for moving in with parents, working as baristas, cohabitating, and not buying new cars - but how much of that was caused by the predicament of their situation, thusly correlated, with improper aspersions? Regardless, down-payments in 2010 ate up more of an annual income than in prior history, intuitively encouraging waiting longer to buy, and mortgage payments due to softer interest were at decade lows (in relative terms).

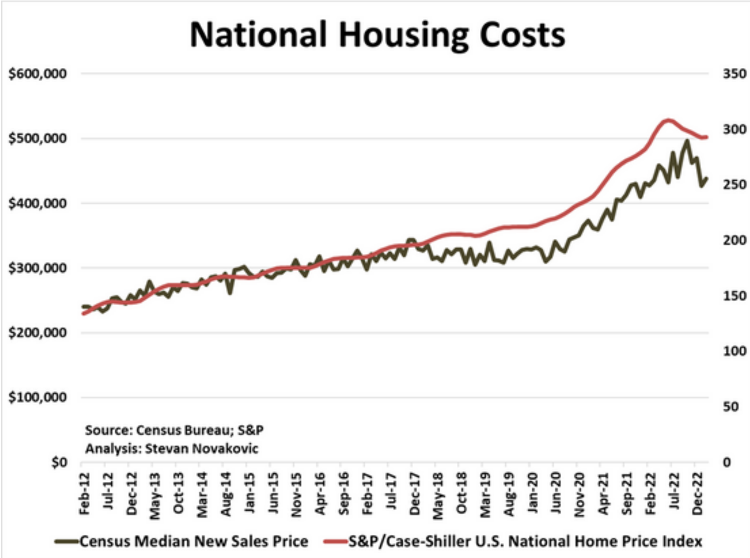
2010 Affordability			
Median New Home Price		$224,300	
Median Family Income (Current $)			$60,326
Interest Rates	4.86%	Fees/Points	0.80%
Down Payment (20%+fees/points)			$46,654
Down Payment / Income Ratio			0.773
Payment Before Taxes/Insurance			$938
Payment / Monthly Income Ratio			0.187

Prior to the pandemic, analysts were psyched for Millennials to finally utilize their spending power: their financial status may have been 7-10 years behind prior generations but it was time. They would buy cars, houses, clothes, toys, and all the accoutrements. Overnight, however, an ill-prepared world stepped into an entirely predictable situation: a global viral emergency. It was not a "black swan" as many have called it, which, by definition, is unforeseeable. Similar phenomena in literature and film are legion, such as *The Cassandra Crossing*, where a viral disease is set off on a train from a contaminated briefcase that had been in a lab – requiring the passengers to be interned at a concentration camp. But, unfortunately, the US (economically) was unprepared for the spending its analysts had forecasted to eventuate. With multiple rounds of cash stimulus and rising savings for (especially) Millennials working from home or locked down (not going out to eat, not seeing movies, etc.), they finally came to the table to spend. But it was not just them, everyone was coming to the table and with record low interest rates dropping below 2.7% in December of 2020, prices skyrocketed. Remember our introduction: the USA curtailed homebuilding. Instead of preparing for an impending need (eventually young people would buy) we underbuilt for 15

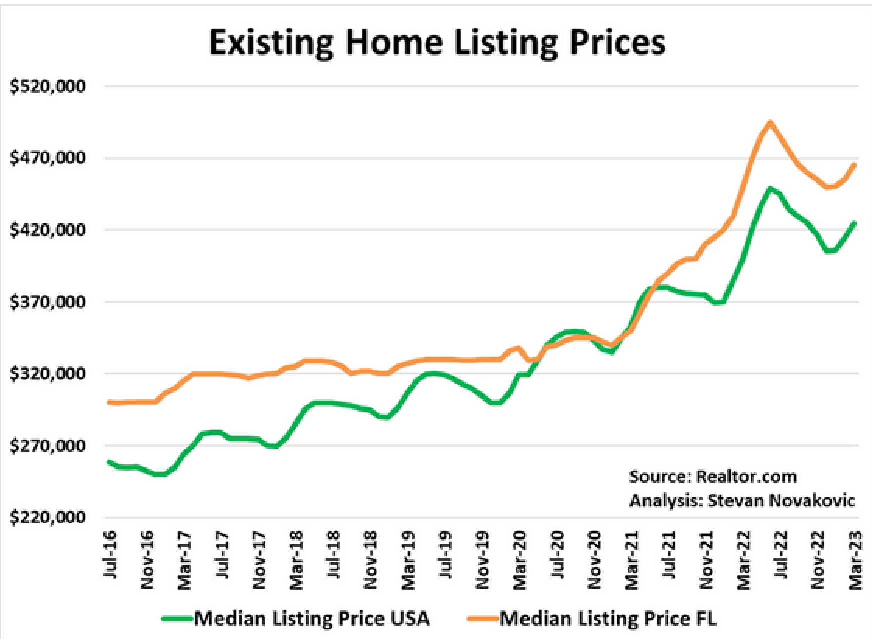
2022 Affordability			
Median New Home Price		$479,500	
Median Family Income (Current $)			$88,590
Interest Rates	6.42%	Fees/Points	0.90%
Down Payment (20%+fees/points)			$100,215
Down Payment / Income Ratio			1.131
Payment Before Taxes/Insurance			$2,377
Payment / Monthly Income Ratio			0.322

years. This misplaced forecasting bled over into the auto market as well (forecast assumptions Millennials didn't want new cars rather than could not afford them). As Shakespeare's Friar Laurence stated: "These violent delights have violent ends." Booms meet with busts meet with… a rising tide that then lifts all ships. At the end of 2022 the median down payment was 113% of a middle American household income, and payments were up to 32% of gross incomes. Not adjusted for inflation and assuming no change in income: imagine middle-class families saving 11% of their gross income annually for an entire decade and the median American home is unaffordable? That is where we have ended up.

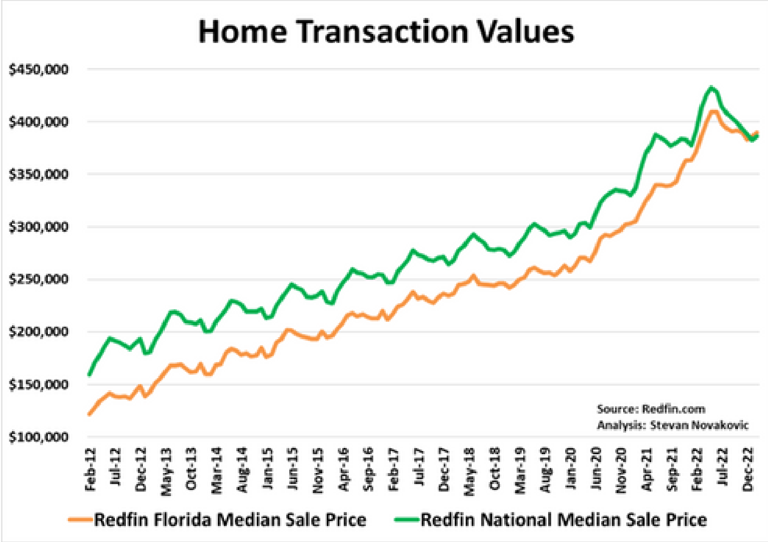
At the national, aggregate level, home prices have retreated from the peak, albeit marginally. Median new home prices may be down almost 12% from the peak set in October 2022 of $496,800, but are still 41% above April 2020 at the onset of pandemic lockdowns. The middle-of-the-road fresh house is up over 40% in fewer than three years while incomes have risen about 5% (and that is not adjusted for inflation)! Average prices for new homes skew toward the higher end, and at the peak were 57% higher than before coronavirus, currently 38% above April 2020 levels.



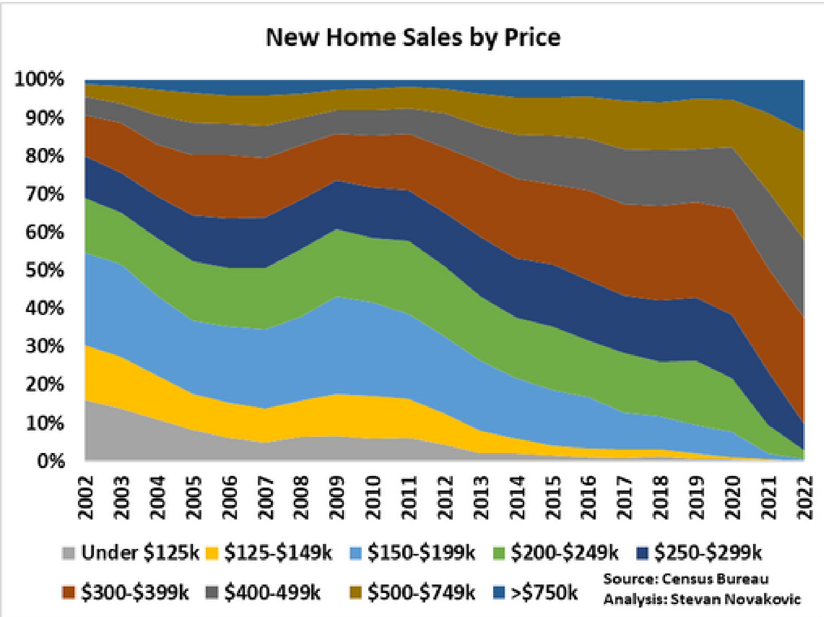
Typically, new homes sold make up about 13% of all closed transactions, meaning existing homes encompass circa 87% of the market. Older homes skew smaller, and, in aggregate, tend to be less expensive than new homes (new houses are overwhelmingly built for higher and higher pricepoints as we shall see below). Nationwide, existing home sales peaked in June 2022 at 41% above pre-pandemic levels and currently sit 33% above April 2020. Florida listing prices also peaked in June 2022 at $494,450 – 51% higher than when lockdowns occurred. While Florida's prices retreated temporarily for a few months, they have been rising again and remain 45% ahead of costs at the pandemic's onset.



When it comes to existing home closed sales, the curve similarly follows listings and new sales. According to data from Redfin.com – prices in Florida peaked about 51% above April 2020, and most recently in March 2023 remained 44% higher. For the nation, the apex was 42% greater than the pandemic's beginning, and continues to be about 27% elevated.



Before concluding, let's consider one last chart that greatly impacts the future of pricing: new homes by sales price. As fewer and fewer existing homes come onto the market, what sort of affordability trends has the country been experiencing?



In the old Census Bureau reporting format prices at the upper echelon were stratified as "$300,000-$499,000" and then "$500,000 and over" because bifurcating them further was not statistically necessary. By 2002 as the boom ramped up, a change was made splitting both of them. Twenty years ago that might have seemed unimportant, but certainly not now. In 1999 a full 67% of new home sales in the US were priced under $200,000, with the median of nearly $160,000 not much higher than our 1995 example. Even at the trough of record low builds in 2011, homes below $200,000 made up 39% of construction. But these numbers plummeted: in 2022, nationwide, fewer than 4,000 new homes were purchased under that price point, yet just ten years prior 12.5% of the market was actually below $150,000. Even if we increase the price point to below $300,000 it is discovered that 80% of new houses fell into that category in 2002, by 2022 it was less than 10%. More than 43% of new home sales in 2022 were above $500,000, inferring an estimate close to 50% above the median. In a normal year, that might be acceptable, but going back to our example early on – we were in an elevated environment. So, compared with prior years, let's apply one last simple case study.

Recycling our average payment / gross income ratio over the three periods before 2022 we get just under 21%. Using the 2010 down payment / annual income ratio plus a compound growth rate of 8% (it had been trending higher by generation) we get 83.4%. Let's back into what I'll call "Trended Affordability" with some back of the envelope algebra and see what we can conclude.

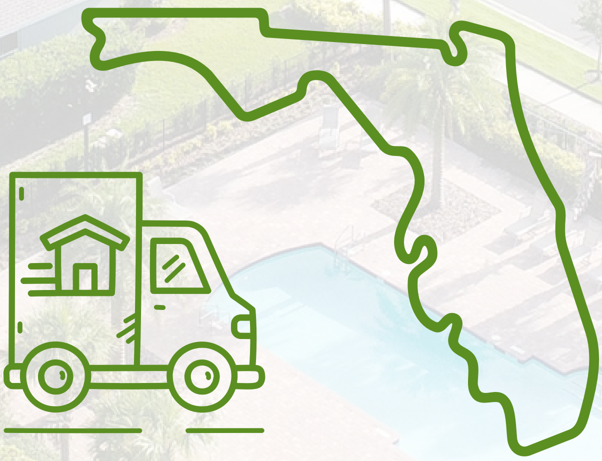
2022 Trended Affordability			
Median New Home Price		$353,572	
Median Family Income (Current $)			$88,590
Interest Rates	6.42%	Fees/Points	0.90%
Down Payment (20%+fees/points)			$73,884
Down Payment / Income Ratio			0.834
Payment Before Taxes/Insurance			$1,752
Payment / Monthly Income Ratio			0.210

What a difference! Even with homes getting more expensive and higher interest rates than 2010, a linear forecast would have new home costs 26% below where they were at the end of 2022. With fewer than 10% of new homes sold below $300,000, and splitting the difference on homes from $300,000-$399,000, the total share of the actual market is still only 23%. Even if we stretch (for hypothesis sake) to say all of the homes under $399,000 were actually below $353,000 that would still account for just over 37%: hardly a median new home price. At minimum, more than 63% of new homes fall outside of our affordability calculation, and likely over 70%. With those numbers, how low can prices really fall?

CONCLUSION

For the sake of brevity we won't delve too much here into Florida, but suffice to say (as we have for multiple years now): everyone, and their grandmother, and their uncle, wants to move to the Sunshine State. Our next piece will focus on future accessibility, and I can tell you as a preview: it is not looking good. The US remains in a supply side crisis, *especially* in the most sought after markets. The future of pricing is location specific. Seek beach access within an hour? Pay up. Good schools? There is a premium. No state income tax? That has to be worth at least 3-4%. Intuitively, we know this has always been the case but never exacerbated to the extent we experience currently. Hyperinflated markets such as Boise, ID have fallen noticeably, but down from unrealistic peaks. San Francisco is another example of price correction, but this is also strongly linked with major upticks in crime, the business district turning into a ghost town, and grocery stores (like the flagship Whole Foods) leaving – resulting in fewer amenities.

The point is, as stated in the last article, less (or even un-) desirable markets will suffer and soften in price, along with the tax base and public services, contributing to further spirals downward for some communities, this will only increase the premium necessary to afford living in the most attractive locations. All, however, is not lost. Hearkening back to our literary example, we should not come to the same conclusion with which Julian tortured his mother: "From now on you've got to live in a new world and face a few realities for a change. Buck up, it won't kill you." There is no way to buck up if you can't find a roof to put over your head – but if this situation is managed properly opportunities will rise. Young people (and maybe those who are older) will have to make choices: can they live in Iowa instead of Florida? Or Kansas instead of Arizona? Maybe even Arkansas over California? New migrations in the US must occur, from "Go, West, young man!" to the poor yokels of yesteryear we often reference. Small towns have a chance to revitalize by attracting folks working remote – if they can improve internet availability. Aging, struggling, often remote communities that prioritize rule of law and maintain safe, high-performing public schools can make the pitch as decent places to live. Developing neighborhoods in less desirable geographical regions with marketable perks is imperative, not just new builds in the I-4 corridor. While all roads may lead to Rome, the United States has a finite geography – not everyone gets to live in Orlando.



ABOUT OUR ECONOMIST

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