Investment Management

Metro Housing Outlook

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Author:

Mike Tubbs

Quantitative Portfolio Analyst

Introduction

As mortgage rates have risen rapidly in the second half of 2022, Unison expects the national housing market to transition over the next 12 months. Certain regions will be hit harder by tightening; monetary and MSA separation will begin to show. We expect HPA to resume its normal historical rate within three years.

- The **American Southwest**, **Florida**, and parts of the **West Coast** will be hit most by slowing demand.
- The **Midwest**, along with the **East Coast**, will be most insulated from these shocks. as prices are more aligned with fundamentals.
- The **West Coast** is expected to have a more rapid recovery than the other MSAs, which aligns with its previous history.
- Much of what happens over the next 12-36 months depends on how severely the Fed continues its tightening, but a soft landing remains the most likely scenario.

Our Current Landscape

It's no secret that the U.S. housing market has experienced unprecedented price growth since the economic recovery from the 2020 COVID-19 recession. There were a variety of factors that drove that growth. Monetary policy drastically cut interest rates to spur economic activity, making mortgages highly affordable. Remote work became the norm for many industries in the U.S., which shifted the landscape on where homes became more affordable. As illustrated by Mondragon and Wieland (2022), this allowed certain markets to flourish.[1] Student loan relief and other fiscal stimulus eased debt service burdens to stimulate housing demand. Beyond that, a historically tight housing supply in combination with rising wages was a recipe to generate rapid price growth.

That picture changed quite drastically in the second half of 2022; the Fed began to set its eyes on runaway inflation. Some of the most rapid rate hikes in the history of modern monetary policy have sent mortgage rates rising at an even quicker pace. While reliable house prices lag other available economic data on a three-month basis, house prices have declined on a month-over-month basis in several MSAs, and annual growth rates have slowed from their red-hot pace.

The current pace of rate hikes will not affect all markets within the U.S. evenly, and we expect pretty severe separation depending on the geographic region, both within and outside the model. While the increase in house prices was universal, its extent was not quite the same, and some MSAs have expanded beyond their fundamentals.

[1] Mondragon, John, and Johannes Wieland. 2022. "Housing Demand and Remote Work." Working Paper 2022-11, Federal Reserve Bank of San Francisco. https://doi.org/10.24148/wp2022-11

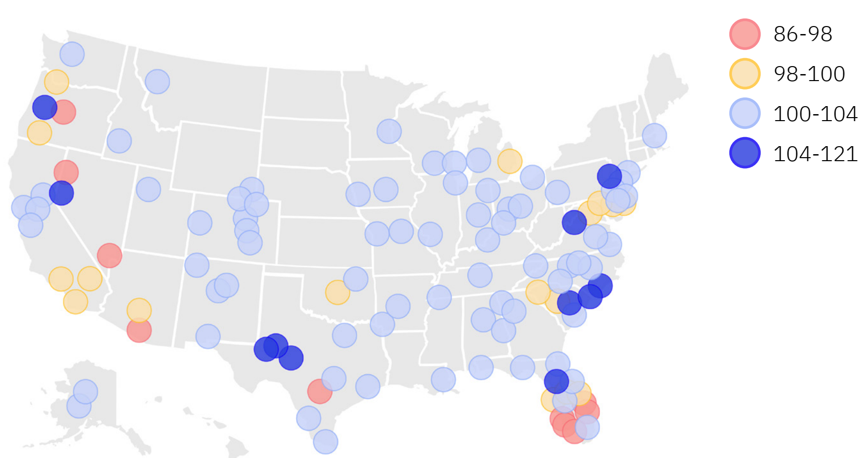
The Short Run

There is a **strong regional similarity** between MSA forecasts.

Unison's Forecasting Model is a Macro-Econometric model that takes signals from economic data at both the MSA and national levels. It's Unison's view that house prices are driven by the local supply and demand dynamics in combination with the current economic landscape. The model forecasts the Case-Shiller house price indices at an MSA level, which is the most reliable housing data aggregated to this level, but it lags behind the current housing market by two to three months.

Below is a graphic of Unison's model forecast at the one-year horizon for all the MSAs with the necessary data. It's clear that there is a strong regional similarity between the various MSAs forecasts. In almost all the MSAs in the Northeast and the Midwest, we see slow to positive HPA. In stark contrast, we see that MSAs in Florida along with those in the American Southwest, and West Coast will suffer moderate HPD over the next year.

FIGURE 1
2023 MSA Growth



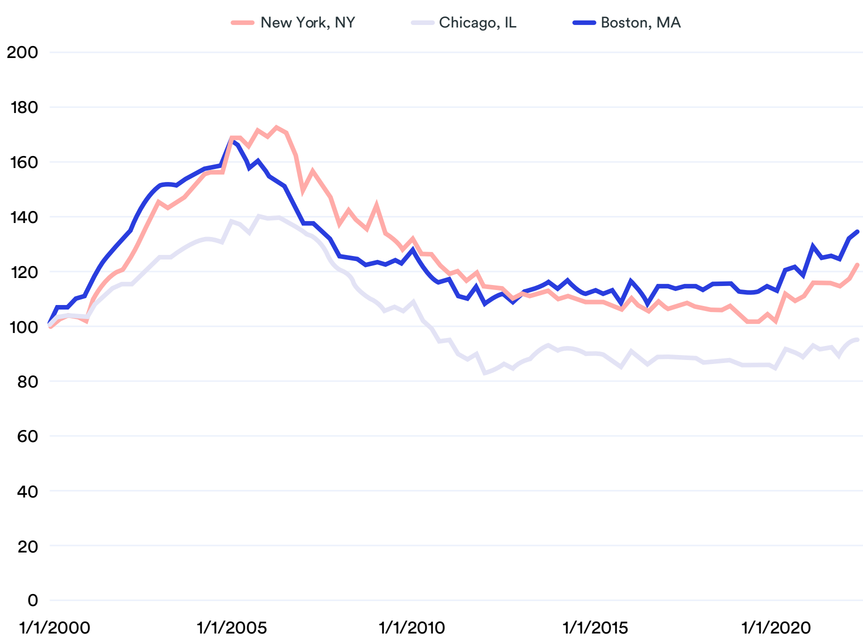
While home prices have increased throughout the pandemic in the Midwest and the Northeast, they have, by and large, kept pace with the fundamental drivers of HPA in those MSAs. The HPA throughout the post-pandemic expansion has been more moderate in that case. While the model does not capture this dimension explicitly, it's worth noting that these areas didn't see the boom in migration from remote work that other MSAs did. Therefore, much of their evolution was 'natural' in the sense that the same labor market dynamics were in place. As can be seen in one dimension of the model below, home prices have stayed relatively aligned with wages throughout the pandemic in stalwart Midwestern and Northeastern economies.

Home price-to-wage ratios were a key fundamental driver of HPA.

FIGURE 2

Home Price to Wage Ratio

(1/1/2000=100)



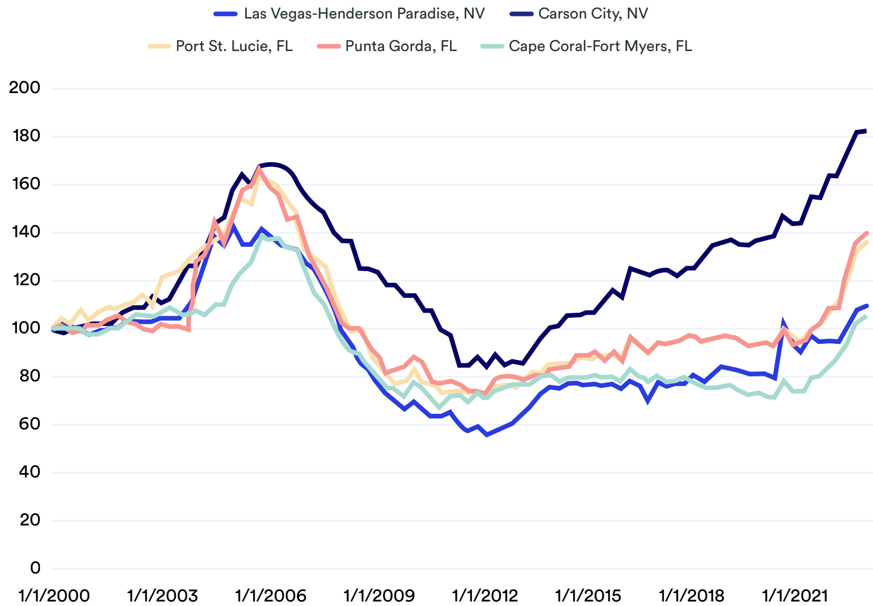
This contrasts with the MSAs we believe are more likely to experience moderate to severe HPD over the next year. Many of these MSAs were the darlings of the post-pandemic boom. These MSAs saw rapid appreciation during this timeframe at a pace that far exceeded the fundamental drivers of HPA. One dimension to see this is house price-to-wage ratios which are one dimension of the model. Below is a graphic of the ratio.

Home prices are expected to make **a quick rebound,** unlike during the GFC.

FIGURE 3

Home Price to Wage Ratio

(1/1/2000=100)



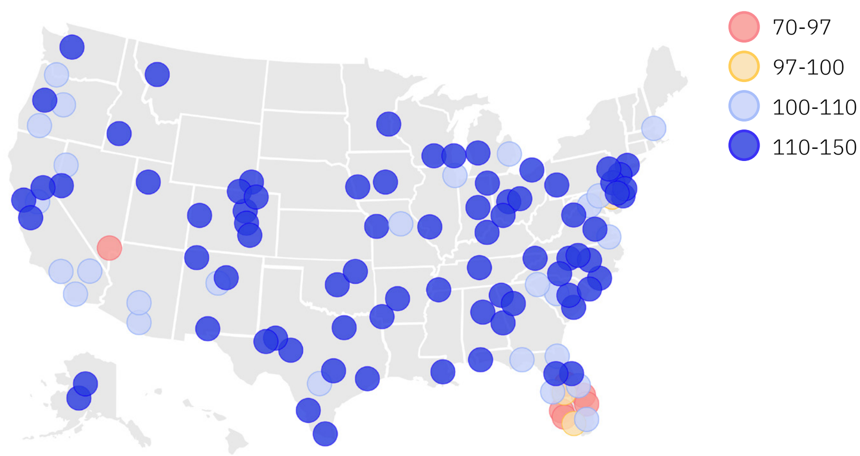
Wages are the stream of payments households use to make financial decisions, and thus if prices are moving quickly beyond that stream, they may be pushing beyond fundamentals. During the housing bubble of 2008, home prices rapidly outpaced wages, but have been stable in many MSAs since then. However, as you can see in this selection of MSAs set to decline, home prices have quite rapidly accelerated– not quite to the 2008 level, but still faster than their pace over the previous decade. Additionally, many of these MSAs experienced a lot of remote work growth, which will be expected to slow, if not turn around entirely, in the upcoming year. Many of these MSAs have historically shown much more sensitivity to interest rate hikes than MSAs that have been more insulated from them.

The Medium and Long Run

One of the things we saw during the GFC was that home prices took a long time to recover. For example, Phoenix, AZ took nearly 15 years to reach the 2008 levels again. The current forecasts don't expect that same dynamic to continue. While the MSAs in the Southwest and Florida are expected to bottom out over the next three years, the West Coast is already showing signs of life by this same period. The primary reason for this contrast is that many factors we saw in 2008 are just not present, and while these MSAs have pushed beyond fundamentals they aren't far beyond that point. We expect almost all of the country to resume historical HPA norms of 4.5-5% by this time frame.

FIGURE 4

2025 MSA Growth

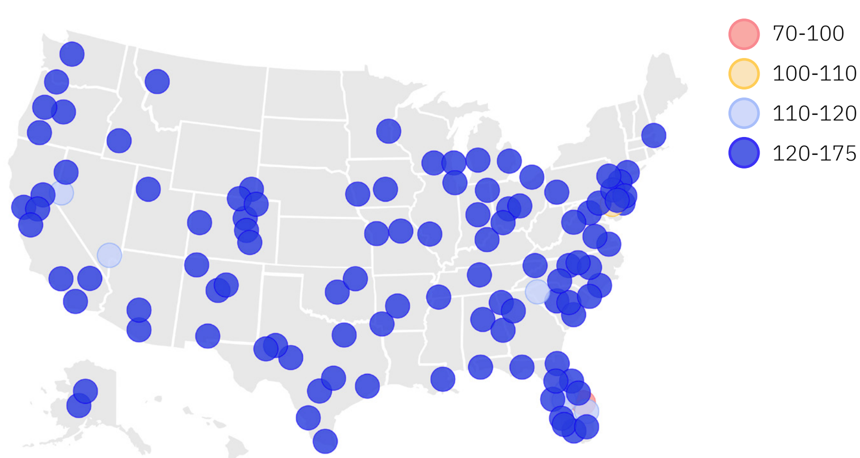


Homeowners are not over-levered toward their homes.

Household debt held in real estate is not in the same place it was during this period, meaning homeowners are not over-levered toward their homes, which is drastically different than 2008. Also, most of the mortgage debt held is by prime or superprime, as opposed to 2008, where subprime held most of the debt. Finally, supply has been quicker to contract and respond to weakening demand. Housing Inventory is still relatively low by historical standards. This has provided a lower bound on the house price contraction that wasn't there in 2008. Regardless, those MSAs in which housing supply can fluctuate due to construction more easily–like Phoenix or Las Vegas–will rebound slower than those constrained markets, either geographically or politically, such as San Francisco and Los Angeles.

FIGURE 5

2028 MSA Growth



A Shifting Horizon

These forecasts depend on the evolution of the economy and the Fed's response over the next year and could shift dramatically if monetary policy begins to slow down its tightening schedule. There are many signals that could bear positive information moving forward in the housing market. One prime example is that the pace of rate hikes the Fed is projecting appears to be more of an upper bound than the expected path, and that we are closer to the terminal rate for monetary policy. The Fed is committed to fighting inflation, but shelter costs have been a primary driving factor in rampant inflation. However, due to how the shelter is calculated, it is quite backward-looking and lags anywhere from 6-12 months of real shelter prices. Rental rates as indicated by Zillow (ZORI)[2] have decreased drastically, and these lower rents will begin to be integrated into inflation data over the next six months. Combine this fact with falling core headline inflation and the Fed won't have to raise rates to tame inflation.

A substantial portion of the run-up in mortgages is due to the risk premium. Uncertainty over the future is pushing mortgage rates beyond their historically-sustained levels. For example, the spread between the ten-year Treasury Rate and the 30-year mortgage rate is typically 150-200 bps. During this current tightening cycle, that rate has ballooned to 325 bps. This immense increase was driven by the uncertainty of the peak of monetary policy tightening, and the fact that there was no sign of inflation ending in sight as those fears relax, however, this spread comes down rather quickly. Plus, less uncertainty, even with continued tightening, will bring lower mortgage rates. This is already happening as mortgage rates are over 90bps off their November highs, and applications for new mortgages are already beginning to pick up.

The most likely scenario is that the Fed eases the severe tightening of the short-run rate and, with an extremely healthy labor market, both the economy and the national housing market experience a soft landing to normal HPA.

[2] Clark, Joshua. "Methodology: Zillow Observed Rent Index (Zori)." Zillow, September 17, 2022. https://www.zillow.com/research/methodology-zori-repeat-rent-27092/.

About Unison

Unison is a San Francisco and Omaha-based company that is pioneering a smarter, better way to own homes. Until now, the only way to finance a home was by taking on debt. Through equity sharing agreements, we help homeowners access their equity flexibly with no monthly payments or interest. We enhance home affordability, reduce debt, and deliver a less risky way for homeowners, investors, and society to think about their most important asset — the home.

unisonim.com

For questions about this report:

michael.tubbs@unison.com

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