

Home Prices Plateauing, Rents Catching Up

The housing sector surged during COVID in large part due to loose money. The Federal Reserve kept short-term rates artificially low and the M2 measure of the money supply soared. Now, with rising short-term rates and slower growth in M2 sending mortgage rates higher, the housing sector has a bad case of indigestion. Sales are down, construction is down, and the most recent reports on home prices show a sudden and sharp deceleration.

This should sound familiar, because it's very similar to what happened to "real" (inflation-adjusted) retail sales. Sales soared in 2021 but have since plateaued, as growth in consumer spending has come from services, not goods. Expect something similar in the next few years with housing, with national average home prices roughly unchanged while rents continue to catch up.

Recent problems in the housing sector are widespread. Existing home sales have dropped for six straight months and, with the exception of the first few months of COVID, are the slowest since 2015. New home sales are the slowest since early 2016, even if you include those horrible first few months of COVID.

Private residential construction rose for twenty-four straight months through May and has now declined for two straight months. Meanwhile, after peaking at a 1.805 million annual rate in April, housing starts fell almost 20% to a 1.446 million rate in July. In time, fewer housing starts today will lead to less overall construction and home completions later this year.

But perhaps the most dramatic change is on prices. The national Case-Shiller index rose more than 1.0% in every month from August 2020 through May 2022. Every single month. Home prices rose a total of 8.9% in the first five months of 2022. More of the same. But then came June, when prices rose a meager 0.3%.

As a result, some are thinking we are in for a massive housing bust the kind of which hit the US after the last boom in the 2000s. But we think that's highly unlikely. Housing is going to feel some pain, but we are facing nothing like what happened in the last housing bust.

Last time, national average home prices bottomed in 2012 about 25% below where they peaked in 2007. From peak to bottom, housing starts plummeted 79.0% and new home sales fell 80.6%. These are not typos! Existing home sales dropped 52.3%. Mix all these changes with mark-to-market accounting

and no wonder we had a Financial Crisis and the Great Recession. That's not happening this time around.

So why do we think we are not in for a huge housing disaster like last time? First, because the last housing bust was preceded by several years of massive overbuilding. We simply had too many homes; too many homes available for sale, as well as too many homes available to rent. By contrast, the most recent turbulence in the housing market has not been preceded by overbuilding. If anything, we've built too few homes in the past decade, not too many.

Second, although home prices have risen substantially since 2020, relative to replacement cost, they are only up about 2% and only about 4% higher than the median in the past forty years. No big deal. Why does replacement cost matter? Because the more it costs to replace your home, the more your current home is worth. So, yes, home prices are up substantially, but if the costs of copper pipe, drywall, lumber, and labor are up, too, then it makes some sense for home prices to be up, as well.

Third, rents should continue to rise at a rapid pace, putting a sturdier floor under home values. In the last housing crisis, not only did home prices fall but housing rents decelerated sharply and then temporarily went negative, as well. Think about that: many people were leaving home-ownership but landlords couldn't squeeze them for more rent because there were simply too many homes.

Now, in the current environment, where higher mortgage rates are persuading some potential home buyers to remain renters, landlords are in a much stronger position. They can keep raising rents because the market isn't oversupplied with homes. And, in turn, higher rents should keep home prices from falling like in the prior housing bust. The more a home can generate in rent, the more valuable the home.

The bottom line is that what we are seeing right now in the housing market is a bad case of indigestion from higher interest rates. Due to overly loose monetary policy and other COVID-related policies, home prices got too high versus rents in the past couple of years and both prices and rents need to correct. We project continued gains in rents in the next few years as home prices are roughly unchanged. The maximum drop in home prices from the peak to the bottom in this cycle should be around 5%, not a 25% implosion like last time.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-6 / 9:00 am	ISM Non Mfg Index – Aug	55.3	55.6	56.9	56.7
9-7 / 7:30 am	Int'l Trade Balance – Jul	-\$70.2 Bil	-\$70.5 Bil		-\$79.6 Bil
9-8 / 7:30 am	Initial Claims – Sep 3	235K	237K		232K
2:00 pm	Consumer Credit – Jul	\$32.0 Bil	\$30.0 Bil		\$40.2 Bil