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Time to think differently – the state of the US housing market

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"US consumer confidence measure plunges to historic low"

"Housing inventory picks up speed at a record pace"

"US new home sales tumble to a 6.5-year low"

These are a few of the headlines from reputable news agencies over recent months. News providers have an incentive to use sensationalist headlines. The democratisation of information is great, but it can be dangerous if you don't have the ability to put it into context and interpret it. It is daunting to know what information to prioritise and whom to trust. None of the headlines above is factually incorrect. The problem is that the articles do not give you the full context of the state of the US housing market.

The 30-year mortgage rates have climbed from below 3% to above 7% in 12 months, levels we last saw in 1999-2000. It is true that the spike in mortgage rates has created affordability issues for new home buyers, which will reduce demand. It is worth noting that new home sales are still double the 2008-2010 period, as depicted in Figure 1 below, and this is in line with pre-COVID levels.

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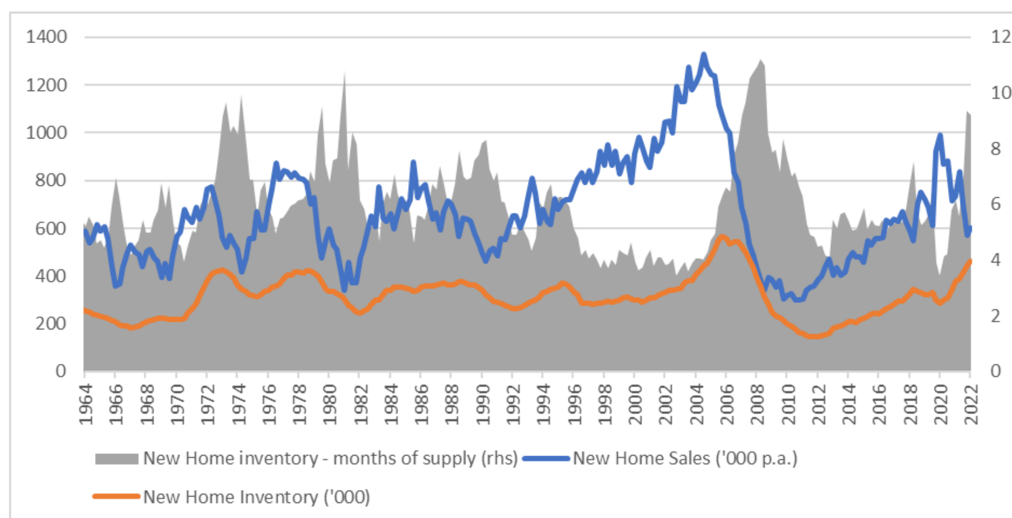
Figure 1: US new home statistics

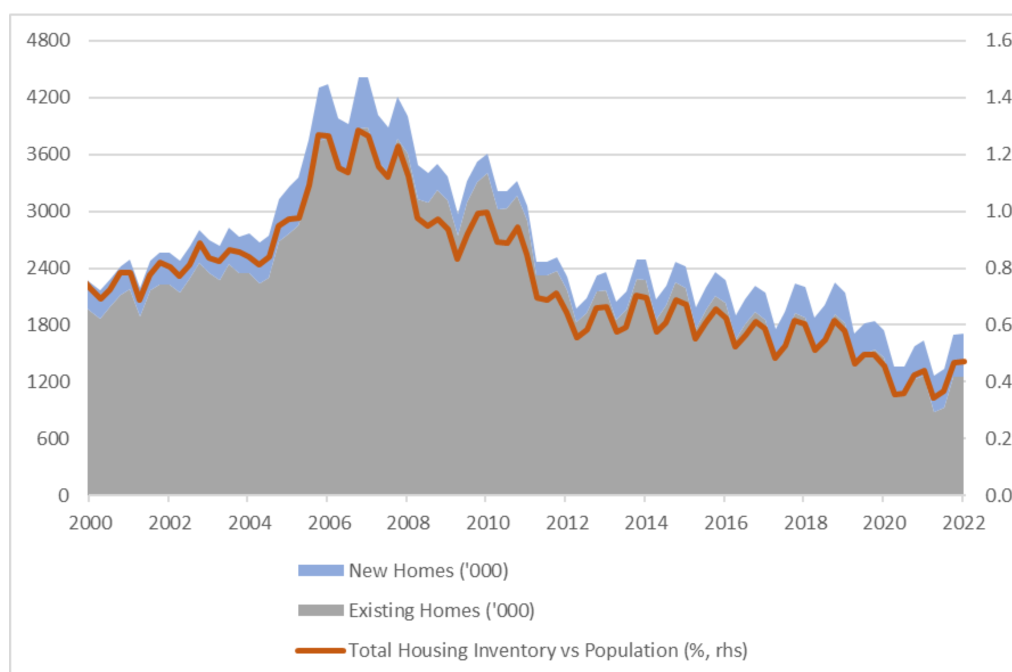


Source: Bloomberg, Fairtree

Analysis of the US housing market also fails to mention that new home sales and inventory are a small part of the market, which have averaged 13% of existing home sales over the last two decades.

Therefore, if we look at the market holistically, the total US housing inventory has been declining consistently since the Global Financial Crisis (GFC). New homes are simply not being built fast enough to match US household formation. Inventory levels have been depleted to very low levels (see Figure 2 below), placing sellers in a strong position. Homeowner vacancy rates are at the lowest level in five decades, and as a result, house prices have responded by moving higher.

Figure 2: US housing inventory

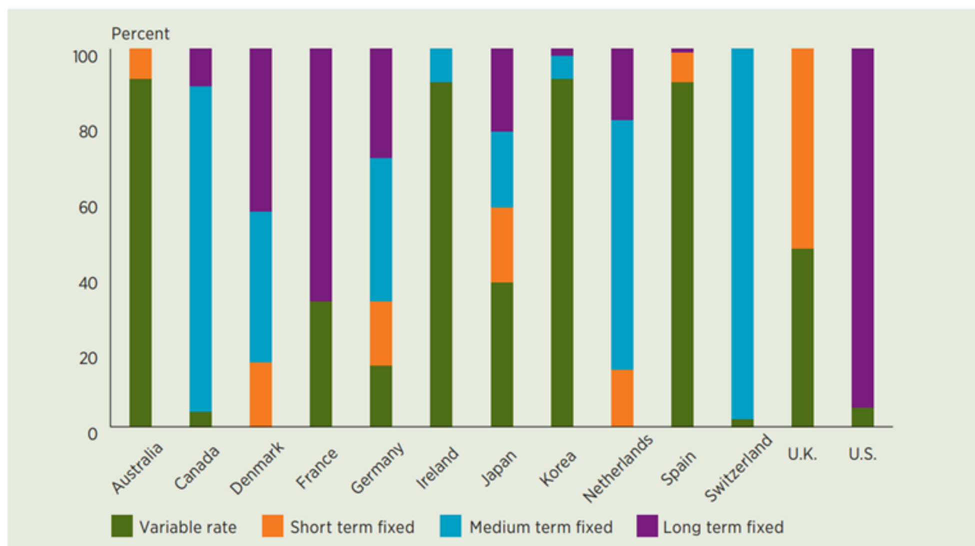


Source: Bloomberg, Fairtree

The other consequence of higher mortgage rates is that existing homeowners will be in no rush to sell their homes. The reason for this is that 96% of US mortgages are at a fixed rate (see Figure 3 below), with 30-year mortgages being the norm. All the current homeowners are sitting with mortgage rates that are much lower than the prevailing

rate. Consequently, this means the supply of existing homes (typically 85% of the supply) will be very low. How these opposing tensions play out in terms of US housing prices and new home sales is difficult to predict, but it is important to understand the context.

Figure 3: Mortgage product interest variability

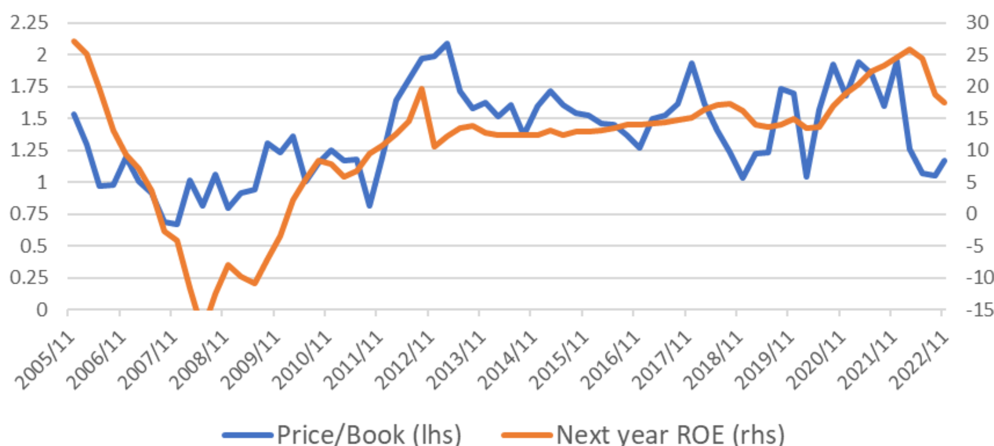


Source: RBA, CHMC, KHFC, EMF, GPG, MBA and S&P

"Prediction is very difficult, especially if it's about the future."
- *Niels Bohr*

While it is impossible to predict with certainty what the future holds, it is possible to determine what other market participants are pricing in. If we look at the US homebuilder subsector, the earnings estimates are expecting return on equity to normalise at 17%, as set out in Figure 4 below. This is still a healthy return above the cost of equity. However, investors are only willing to pay 1.2 times the book value for this sector, which is close to COVID and GFC lows. The market is therefore expecting a dire outcome for this sector.

Figure 4: US homebuilders return vs valuations



Source: Bloomberg, Fairtree

The GFC has scarred all stakeholders in the US housing market, which means industry behaviour has changed dramatically:

- Homebuilders have more conservative balance sheets, larger order books and showcase effective capital allocation through share buybacks and utilisation of land options.
- Banks have tightened credit standards after the GFC, resulting in increased regulatory oversight and more stringent capital requirements.
- Homeowners have reduced the number of investment properties they own, and they have refinanced to low, fixed-rate mortgages.
- Investors are pricing in a worst-case scenario and possibly preparing for another GFC crisis.

The factors and statistics discussed above give us confidence that the scenario, which the market is pricing in, is too pessimistic. You can only outperform if you have a diverse view to the general consensus and have the temperament to stomach a different positioning from the herd.

There are many moving parts, so expect more volatility. Housing prices will continue to come down, which will be negative for earnings and sentiment. Cyclical parts of the market struggle to outperform, while recession fears dominate headlines. It is important to see the forest and not just the trees. If the US falls into recession, it will likely be a mild one. We can't see many excesses that need to unwind. Borrowings at household and corporate levels are low: there are 1.9 times job openings for every unemployed person and high levels of pent-up savings.

Most people view volatility negatively, but active managers should embrace it. Volatility creates a fertile environment for nimble managers to create value. A volatile market offers opportunities to buy at discounts and take profits on stocks that have run hard.

"Successful investing is about managing risk, not avoiding it."

- *Benjamin Graham*

Glacier Research would like to thank Cornelius Zeeman for his contribution to this week's *Funds on Friday*

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