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Renting the American Dream

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The housing market has performed exceptionally well since 2020, with strong demand across the for-sale and rental markets. However, concerns over inflation and an abrupt change in mortgage rates since the beginning of the year has shone a spotlight on the cost of housing. While the full impact of elevated inflation on consumer behaviour and spending is yet to be determined, we believe it is crucial to assess the potential future impact on the housing market as the residential sector forms a large part of the global REIT universe.

According to Google statistics over the last 10 years, interest in housing market-related search terms reached peak popularity during July 2022. The previous peak occurred right after the COVID-19 induced lockdowns in March 2020. Regionally, this tendency was more prevalent in countries with the strongest home price appreciation (i.e., Canada, Australia, New Zealand, United Kingdom, and the United States). The rest of the article will focus on key events in the US housing market over the last two and a half years.

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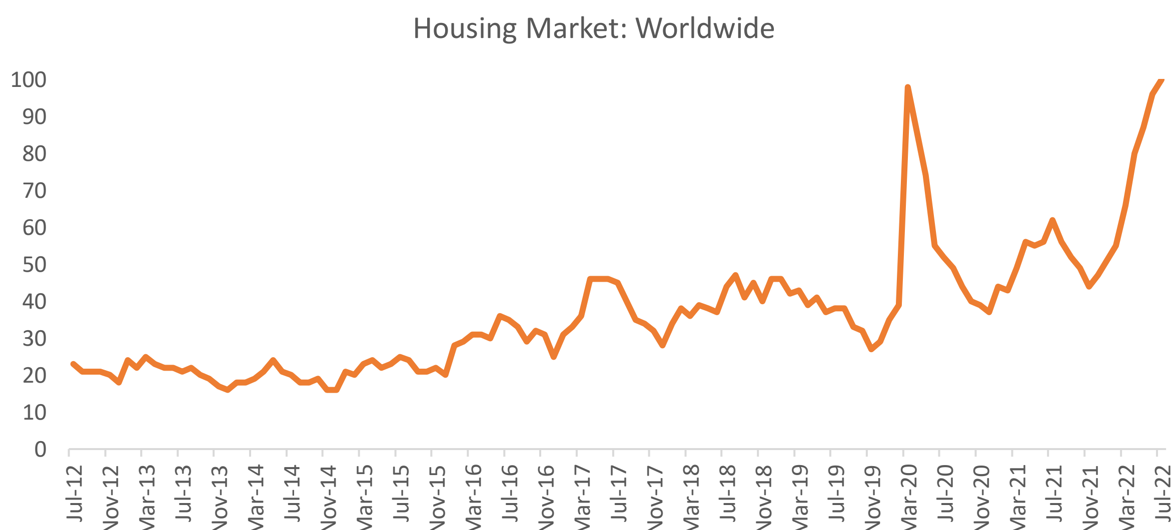
Chart 1: Google Trends – Housing market search term popularity



Source: Google trends. From 31/07/2012 – 31/07/2022. As at 02/08/22

What caused the robust home price growth?

A recent Housing and Economic Research note published by Freddie Mac posited that limited supply resulting from underbuilding, below-average distressed sales, favourable demographics, and increased migration, played key roles in US home price appreciation.

The Federal Reserve has, since March 2020, embarked on a policy of driving down mortgage interest rates which fuelled a rise in housing costs as a result of purchasing $1.3 trillion of mortgage-backed securities (MBSs) from Fannie Mae, Freddie Mac and Ginnie Mae. The artificial increase of the amount of available capital for the residential home mortgage market and the accompanying distorted interest rates further exacerbated home unaffordability. During 2020, 30-year fixed-rate mortgages in the US dropped to a record low of 2.7%. Comparable declines of this magnitude are rare and have only happened twice in the past 20 years – during 2003 and after the housing market crash in 2009.

All three occurrences resulted in noticeably higher home price growth.

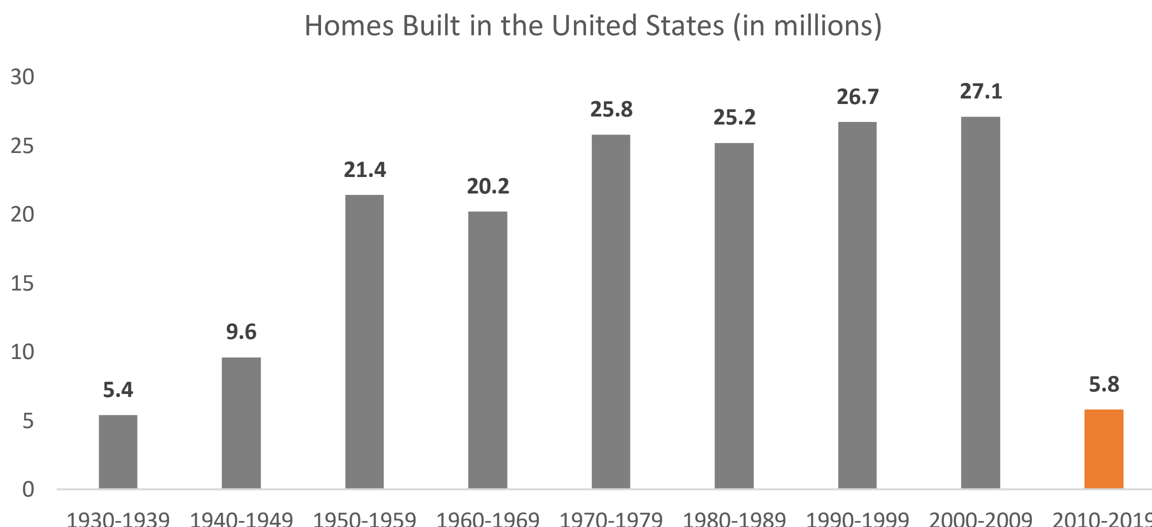
While the decline in mortgage rates benefitted households who refinanced, it added more demand to an already undersupplied market.

Politicians are blaming institutional owners, such as American Homes 4 Rent (AMH) and Invitation Homes (INVH) for the surge in home prices, although evidence does not support this view. According to Freddie Mac, "Overall investor share of home sales stood at 27.6% in December 2021, slightly higher than the 26.7% in 2019." Large investors (10+ homes) account for only 6% of all home purchases and home sales to investors is therefore at lower levels today than in 2006.

Instead of pointing fingers to institutional owners, we believe lawmakers should focus on eliminating barriers to housing supply. Stringent zoning restrictions, lengthy approval processes, density limitations and regulatory costs, which often account for 30% of the costs of housing construction, is the more likely cause of limited supplies. Rent control further compounds the problem by deterring new construction, giving landlords fewer incentives to spend on maintenance and remodelling, further reducing the future supply of housing.

During the past decade new construction remained at lower levels than during prior decades partly due to such restrictions.

Chart 2: Homes built in the United States by decade



Source: Keeping Current Matters - Robert Frick, NFCU. Reitway Daily by Raymond Moore.

What is going on now?

During June 2022, 30-year mortgage rates crossed 6%, double the levels in December 2021. This was the fastest increase of that magnitude since the early 1980s. Markets are impacted by this rapid increase and recent industry comments from US homebuilders confirmed the greater hesitancy among potential homebuyers, resulting in a rapid decline of buyer traffic over the course of the second quarter. While these effects are uneven across various markets, almost all buyers are facing a 'sticker shock' moment without parallel.

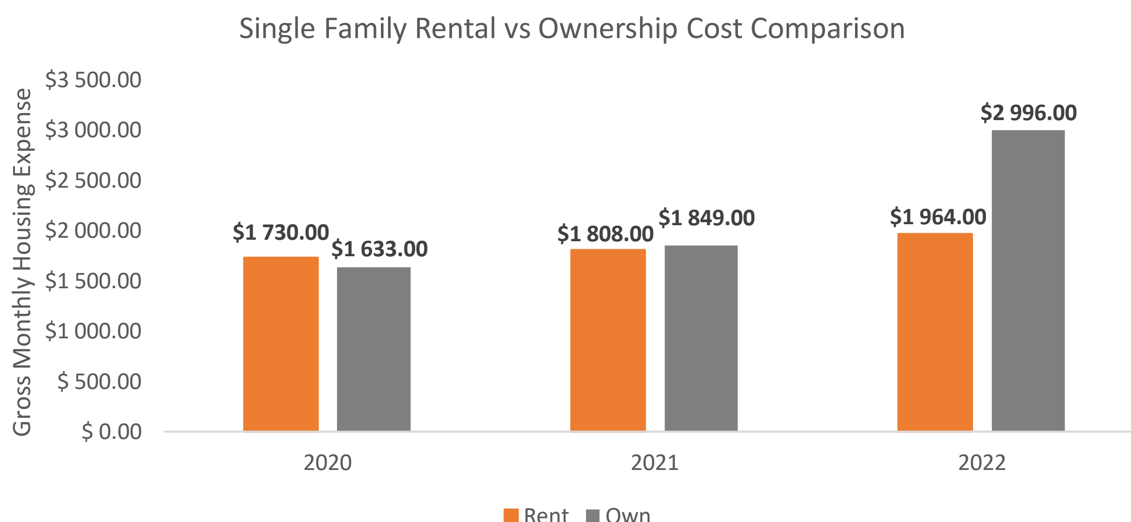
With increased borrowing costs setting a ceiling on affordability, sales of both new construction and existing homes have fallen in recent months, with many buyers taking a break from house hunting.

Improving inventory levels is a likely silver lining although it is too early to tell whether this trend will persist as some sellers, who might believe they missed the market peak, decide to remove their listings as they are not forced to sell in a slower market with higher financing costs.

Calculations done by Raymond James show the potential new monthly payment on a median-priced home, with a standard 30-year fixed rate mortgage has surged ~62% y/y through mid-June given the significant home price appreciation, leading to much higher loan balances to which higher rates are now applied.

With annual costs of home ownership up considerably since 2020 and median rents up only ~13%, relative affordability ratios have improved in favour of the rental sector. The cost differential between renting and owning comparable homes has ballooned to the widest spread on record. In the data of the second quarter of 2022, the payment differential between fully loaded ownership costs versus rental cost of an institutionally managed single-family home is roughly $1,000 per month.

Chart 3: Cost comparison



Source: US Census Bureau, US Bureau of Economic Analysis, National Association of Realtors, Factset, Raymond James Research.

**Equivalent Ownership costs incorporates a 30-Yr Fixed Rate Mortgage of 6.04%. Median Price of $423,300, Taxes, Maintenance & Repairs, FHA Mortgage Insurance and Property Insurance.*

Mortgage rates remain volatile due to increasing economic concerns and we believe the high uncertainty surrounding inflation will likely cause rates to remain erratic. While rates have dropped since their mid-June high, ending just above 5.2% for the week ending August 12th, we do not expect a massive surge in home buying activity given a growing number of signals that point to a pullback in spending, including lower mortgage applications (lowest levels since early 2000's) and a decline in purchasing intentions for large durable goods.

Rental market implications

Many forces have combined to create a rental market that is setting records.

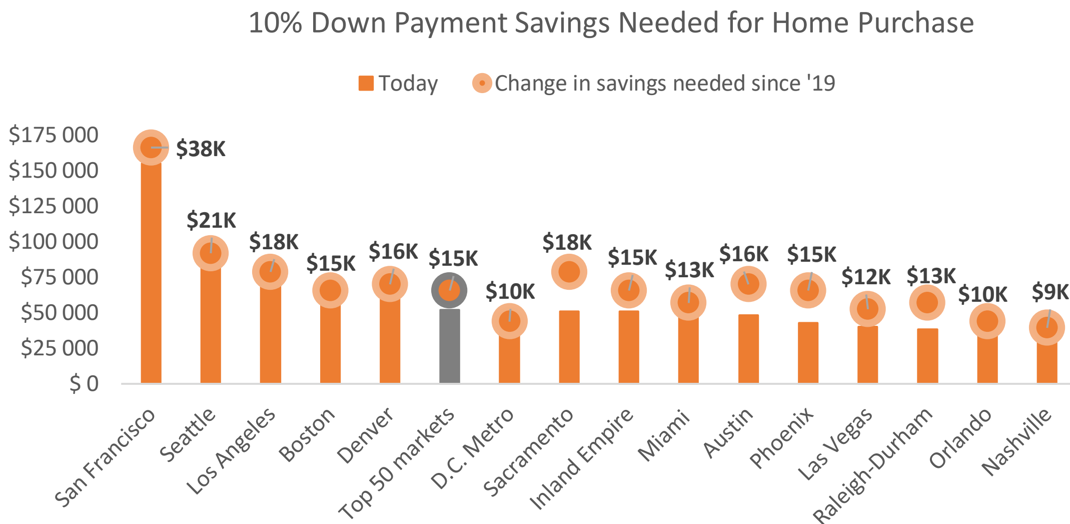
Benefiting from the affordability issues plaguing the ownership market, both Sunbelt and coastal-focused REITs reported robust rent growth, historically high occupancy rates, and record-low turnover.

While the era of double-digit rent increases may be coming to an end, there's plenty of "embedded" growth remaining given the historically wide gap between new lease rates and in-place rents.

Despite strong second-quarter earnings results, in which most residential REITs raised their full-year guidance, the sector continues to trade at historically cheap valuations.

Though we continue to monitor rent-to-own ratios, it's important to remember that they do not tell the full story as they presume individuals have sufficient savings for a down-payment. Based on Green Street analysis, the required savings for a 10% down-payment is up ~$15,000 since the start of the pandemic, making it increasingly out of reach for a large segment of the population. This will result in a more captive audience of renters coming through the pipeline as tenants are forced to rent longer.

Chart 4: Down-payment savings needed for home purchase



Source: Green Street and National Association of Realtors.

Our view

While rental fundamentals won't be immune, as rising food, fuel and other living expenses begin to alter consumer spending, we believe negative effects will likely hit more discretionary areas of the economy (i.e., travel, restaurants, and retail) sooner and harder than rental housing.

At Reitway, we believe the stage is set for residential REITs to outperform the overall market over the coming years due to the positive demand-supply balance; a shortage of housing; and an attractive rent versus buy consideration.

Though we are overweight in all sub-sectors within the residential sphere, we will remain nimble and adjust our exposures to the companies with the best risk-reward prospects based on their location, asset quality and product type.

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

Martin Botha

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Martin joined Reitway Global in 2013 and is responsible for REIT research and analysis, portfolio construction and performance attribution. Martin graduated with a Bachelor of Commerce degree in Investment Management from the University of Stellenbosch in 2010, followed by an Honours degree in Financial Management from UNISA in 2013. Martin is a CFA® charter holder and holds the CIPM qualification.