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HOT TOPIC

Too Hot to Handle: What's Ahead for the U.S. Housing Market?

The U.S. housing market, already strong before the pandemic, has heated up to record levels in 2021. The Case-Shiller U.S. National Home Price Index, which measures home prices in 20 major metropolitan areas, reported a 12-month increase of 18.6% in June 2021, the largest year-over-year gain in data going back to 1987.[1]

The National Association of Realtors (NAR), which provides more current data, reported that the national median price of an existing home was $359,900 in July, down from a record $362,800 in June. Even so, this was the 113th consecutive month of year-over-year price increases. The June to July price relief was due in part to increased supply. Total inventory of new and existing homes increased 7.3% over June, but was still down 12.0% from a year ago.[2]

The July 2021 NAR data suggests that the red-hot market may be cooling slightly, but prices are still extremely high, and industry experts expect them to remain high for the foreseeable future. Here's a look at some key factors behind the current trend and prospects for future direction.

Low Supply, Surprise Demand

The housing supply has been low for more than a decade. The housing crash devastated the construction industry, and a variety of factors, including labor shortages, tariffs, limited land, and restrictive permit processes, have kept the supply of new homes below historical averages, placing more pressure on existing homes to meet demand.[3]

The pandemic exacerbated labor problems and led to supply-chain issues and high costs for raw materials that held back construction, while demand exploded despite the economic downturn. With the shift to remote work and remote education, many people with solid jobs looked for more space, and low interest rates made higher prices more affordable.[4]

At the same time, homeowners who might have seen high prices as an opportunity to sell were hesitant to do so because of economic uncertainty and the high cost of moving to another home. Refinancing at low rates offered an appealing alternative and kept homeowners in place. Government mortgage forbearance programs have helped families from losing their homes but also kept homes that might have otherwise foreclosed off the market.[5]

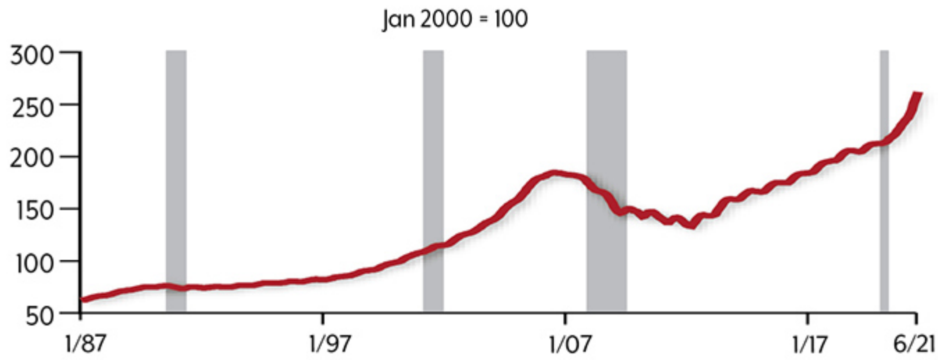
Health concerns also played a part. The pandemic made it less appealing to have strangers entering a home for an open house. And older people who might have moved into assisted living or other senior facilities were more likely to stay in their homes.[6]

Taken together, these factors produced a perfect storm of low supply and high demand that drove already high prices to dizzying levels and created desperation among buyers. All-cash sales accounted for 23% of transactions in July, up from 16% in July 2020. The average home stayed on the market for just 17 days, down from 22 days last year. Almost 90% of homes sold in less than a month.[7]

Skyrocketing Prices

Unlike during previous recessions (shaded areas), U.S. housing prices have been on a tear since the pandemic recession of early 2020.

S&P CoreLogic Case-Shiller National Home Price Index



Source: S&P Dow Jones Indices, 2021; retrieved from FRED, Federal Reserve Bank of St. Louis

Freezing Out First-Time Buyers

Recent inventory gains have been primarily in more expensive houses, and there continues to be a critical shortage of affordable homes. First-time buyers accounted for just 30% of purchases in July 2021, down from 34% the previous year.[8] A common formula for home affordability is to multiply income by three — i.e., a couple who earns $100,000 might qualify to buy a $300,000 house. A study of 50 cities found that home prices in Q2 2021 were, on average, 5.5 times the local median income of first-time buyers, putting most homes out of reach.[9]

The lack of affordable housing for first-time buyers also helps to drive rents higher. People with higher incomes who might be buying homes are willing and able to pay higher rents. Rents on newly signed leases in July were 17% higher than what the previous tenant paid, the highest jump on record. After dropping while many young people lived with parents during the pandemic, occupancy of rental units hit a record high of 96.9%.[10]

Is This a Bubble?

From 2006 to 2012, the housing market plummeted 60%, taking the broader U.S. economy with it.[11] Mortgage requirements were made much stricter after the housing crash, and homeowners today are more likely to afford their homes and to have more equity from larger down payments. The housing market has always been cyclical, so it’s likely that prices will turn downward at some point in the future, but less likely that prices will collapse the way they did during the Great Recession.[12]

What’s Next?

Prices are so high that some buyers are backing off, but demand remains strong and will outstrip housing supply for the foreseeable future. Some near-term relief might come if high prices inspire more homeowners to sell, and if the end of government programs puts more foreclosed homes on the market.

There are more single-family homes under construction than at any time since 2007, but it will take months or years for those homes to increase the housing supply.[13]

The housing market tends to be seasonal, with demand dying down in the fall and the winter. That didn't happen last year, because pent-up demand was so strong that it pushed through the seasons. With the supply/demand tension easing, the seasonal slowdown may be more significant this year.[14] The Federal Home Loan Mortgage Corporation (Freddie Mac) projects that home prices will grow by 12.1% in 2021 — lower than the current pace — and drop further to 5.3% growth in 2022.[15]

Location, Location

Although national trends reflect broad economic forces, the housing market is fundamentally local. The West is the most expensive region, with a median price of $508,300 for an existing home, followed by the Northeast ($411,200), the South ($305,200), and the Midwest ($275,300).[16] Within regions, there are dramatic price differences among states, cities, and towns. The trend to remote work, which helped drive prices upward, may help moderate prices in the long term by allowing workers to live in more affordable areas.

There are inherent risks associated with real estate investments and the real estate industry, each of which could have an adverse effect on the financial performance and value of a real estate investment. Some of these risks include: a deterioration in national, regional, and local economies; tenant defaults; local real estate conditions, such as an oversupply of, or a reduction in demand for, rental space; property mismanagement; changes in operating costs and expenses, including increasing insurance costs, energy prices, real estate taxes, and the costs of compliance with laws, regulations, and government policies. Real estate investments may not be appropriate for all investors. Projections are based on current conditions, are subject to change, and may not come to pass.

1) S&P Dow Jones Indices, August 31, 2021
2, 7–8, 16) National Association of Realtors, August 23, 2021
3–4, 6) *The New York Times*, May 14, 2021
5) NBC News, July 6, 2021
9) *The New York Times*, August 12, 2021
10) Bloomberg Businessweek, August 18, 2021
11) NPR, August 17, 2021
12) *The Wall Street Journal*, March 15, 2021
13) Bloomberg, August 19, 2021
14) CNN Business, August 23, 2021
15) Freddie Mac, July 2021