Research @ Citi Podcast, Episode 3: Is the U.S. Housing Market Broken?

Host: Rob Rowe, U.S. Regional Director of Research and Head of Global Strategy and Macro Group, Citi

Guest: Anthony Pettinari, Homebuilding and Building Products Analyst, Citi

Transcript:

Lucy Baldwin (00:00)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Rob Rowe (00:22)

My name is Rob Rowe, I am the U.S. Regional Director of Research at Citi, and my guest today is Anthony Pettinari, who is our senior equity analyst covering homebuilding and building products. And our topic today is an important one, both for the U.S. economy and in general for most people out there, and that's housing.

Anthony, a lot of people over time now have been looking at the housing market, which both seems robust, seems to be doing well, but at the same time, seems to be stuck in a way, right? We've seen inventory shortages, and we're also facing a moment now or a critical moment or transitional moment for the U.S. economy in terms of whether we continue to see the kind of strong growth we've seen in the economy over the last couple of years or whether we're heading more into a slowdown. And so it's important, I think, both for our investors as well as retail homebuyers to know what the condition of the housing market. Is it stuck? Is it broken? I mean, how would you articulate the current state of the housing market?

Anthony Pettinari (01:31)

Yeah. Thanks, Rob. I mean, I think the housing market remains very challenging from a buyer perspective. So affordability is near all-time lows. Our team created an index that looks back on the ability of prospective home buyers to afford a new home. And looking back over almost 50 years, we're in the seventh percentile of affordability. So, you know, first percentile means least affordable. 99th percentile would mean the most affordable. And so we're really in the lowest decile historically in terms of the ability of an average American to buy a new home.

There's a lack of supply on the market. U.S. housing stock is underbuilt really in the first place. But in addition to that, many homeowners are locked in at rates well below current mortgage rates. And, you know, typically there are around two and a half million single family homes on the market. We're closer to one and a half million homes today, so we're missing about a million homes. And as a result, we've seen lower number of total housing sales, lower amount of activity. We did just over 4 million sales last year. You know, that's well below recent historical average of 5 million. Unemployment and GDP growth are good by historical standards, and the economy seems pretty strong on paper. Americans don't really have access to the homes they would like to buy in the areas they want to live in, you know, especially compared to previous periods of good economic growth. And ultimately, you know, that's why the market feels very frustrating to so many Americans. The market definitely feels stuck. And I think for a lot of Americans, it doesn't feel stuck, it does really feel broken.

Rob Rowe (03:16)

And Anthony, what are the factors that have led to this lack of supply of housing?

Anthony Pettinari (03:23)

You know, we're still feeling the echo of the global financial crisis. You know, 2008, we called it the Great Recession. But for the U.S. housing market, it was really a depression, and it took years to work through excess inventory of homes. And a lot of builders and lenders really exited the market after 2008 or significantly dialed back activity. On the building side, we probably overcorrected to some extent. You know, over the course of the past decade, we've averaged close to 1 million housing starts. Pre–Global Financial Crisis, the average was 1.5 million housing starts. I mean, that was the U.S. average for, you know, 30, 40 years, even at a time, you know, when the country had a much smaller population.

So, you know, there's different measures you can use, but we estimate the U.S. could be short 3 million homes, and the market does not really have a path to close that housing deficit in the near term. 2020 kind of ironically was going to be the first year that we might get back to that kind of normal building pace, close to 1.5 million homes. And then, obviously, the pandemic hit, you know, the pandemic stimulated a lot of demand. You had a lot of Americans prioritizing home purchases because we were all working from home and schooling from home, and a lot of people were moving to different parts of the country. But the supply chain issues basically ground a lot of construction to a halt. You couldn't get building products, you couldn't get labor. And so the average time it took for a large builder to build a home, you know, went from something like six months to 12 months. For many smaller private builders that still make up the majority of the market, it was much worse than that. So those are some of the issues from a supply perspective.

Rob Rowe (05:14)

And interest rates, Anthony, have also played a role here, no?

Anthony Pettinari (05:18)

Yeah, absolutely. I mean, from a lock-in effect, I mean, the majority of U.S. mortgage holders have mortgages that were originated at rates below 4%. So something with a three handle. Current benchmark mortgage rates are a touch over 7%, which creates a really powerful disincentive to sell your home and lose that privileged rate. So, you know, we've estimated that it would take a pretty significant decline in benchmark mortgage rates to drive supply up to pre-pandemic levels. So, you know, by our estimates, I mean, rates might have to reach closer to 5% to get us back to that pre-pandemic level of supply, you know, from 7% currently, you know — that's not Citi’s interest rate forecast. I think it's not where most consensus forecasts are either. So I think the unlocking of supply by lower rates will happen, but I don't think we're going to see a tidal wave of supply driving prices sharply lower and sort of fixing this housing market. And it's important to remember that, you know, the unlocking of supply by lower rates will also presumably be accompanied by some increase in demand, as the majority of these sellers are going to be looking for a home to purchase.

Rob Rowe (06:31)

And before we talk about potential solutions, is demographics also playing a role here?

Anthony Pettinari (06:38)

Yeah, you know, we talked about the supply side. I think from a demand perspective, we have a demographic cohort that is really demanding a lot of housing. Millennials are now the largest generation in the U.S. workforce. Millennials are a larger generation than Gen X. And the single-family home purchase is really typically triggered by household formation, which is getting married and having a kid. So we have a lot of, you know, what you would call older millennials, late 20s, early 30s, that are really in that prime household formation cohort. So that is definitely an important demand driver, you know, really over the next three to five years.

Rob Rowe (07:22)

And what about aging, you know, about the elderly? Is that more stable, or how does that work?

Anthony Pettinari (07:28)

Yeah, you have, so when we talk about supply constraints, there really is a focus on the lock-in effect, and that is, I think, the primary driver with most mortgage holders with something like a 3% handle on their mortgage. But aging in place is also an important contributor to lack of supply, and one that's a little bit harder to quantify — I mean, order magnitude, that could be, sort of 20 to 30% of the issue. We have this kind of demographic pinch point where you still have a lot of baby boomers aging in place — often in much larger homes than, you know, frankly, they need, while at the same time, you have this, you know, millennial cohort coming up that in many cases, need those homes.

Rob Rowe (08:12)

And, Anthony, maybe you can comment a little bit on home pricing, too. Is that, I mean, I know that inflation is still, has still in many areas remained sticky. Has that been an issue? And maybe we can also after that touch on geographics a little bit.

Anthony Pettinari (08:28)

Sure. You know, you can, you know, in terms of home pricing, you can really slice and dice home prices in a lot of different ways. You can look at median average, mean average. You can look at the MSA level, resale versus new homes. You can adjust for mix. And I think in the media and maybe sometimes amplified by realtors, you tend to see a lot of splashy headlines around big price moves in some communities. We really focus on the median price for new home sales. And generally on kind of an apples-to-apples basis, we see those prices flattish to maybe down low-single-digit percentage year over year in 2024. So, you know, there's some local markets that are seeing a little bit more resale inventories come to market, and that creates maybe a bit more price pressure.

But it's important, and regionally, there has been recent focus in Southern Florida, I think Austin in Texas has gotten a lot of attention. But I think it's important to remember, a lot of these markets saw 60, 70% price appreciation over the past few years. So I think it's kind of important to contextualize, a 5 to 10% price drop when the price of the home is maybe you know, close to doubled over a relatively short period of time. So I think pricing broadly stable, some areas of higher incentives, some areas where price cuts are cropping up more. And so I think it may be a little bit more of a buyer's market than certainly it was during the pandemic, but I wouldn't sort of overstate it.

Rob Rowe (10:06)

Right. So it's more of a buyer's market from a price point, but maybe not from a funding point in the sense that mortgage rates remain elevated.

Anthony Pettinari (10:14)

Right, and an availability of supply, you know, so you do see a little bit of pressure on prices in some of these markets that were hotter during the pandemic, but your funding costs are high, and the, you know, the total level of supply is not great.

Rob Rowe (10:29)

And you had mentioned certain local markets. So is there a geographic, kind of geographic challenge here? I know that there was previously and maybe, you know, during the pandemic or post pandemic, there was a large migration to the sun belt. You know, are there areas where there's a particular lack of supply versus some others?

Anthony Pettinari (10:50)

Yeah, Florida and the Southeast. So, you know, Carolinas, Georgia. Those remain really underbuilt. Some of the hotter markets like in the Inland West. I mean, you remember Boise was talked about a lot during the pandemic, you know, Austin benefited from a lot of tech migration. Those markets have cooled. But if you think about that kind of core Southeast — Carolinas, Georgia, Florida — you're still seeing great job growth, white-collar employment, wage growth. And so there is really a lack of housing in those states. You know, the coasts — you think about the Northeast, you think about California — that were hit pretty hard during the pandemic, or where price appreciation really lagged, the sun belt, those have kind of caught up. And actually, some of the hottest markets from a year-over-year perspective now are in California, and you're definitely seeing what looks like, you know, the impact of the AI boom in the real estate market in Northern California. So some of those trends that we saw during the pandemic had evened out, you know, a fair amount. You see strength in some parts of the upper Midwest, Ohio, around Columbus, you know, those are pretty good housing markets. But in terms of being underbuilt and where we still need, you know, structurally more capacity, Southeast, Florida remain kind of key points.

Rob Rowe (12:10)

And I want to go back to something else you had said, which is: post-GFC, you had said that a lot of homebuilding had gone offline, essentially, and it's been a long, sounds like a long march towards getting that capacity back up, so specifically about the homebuilders. But also, do you think that there's anything on a policy standpoint or the private sector can do right now to sort of relieve the paucity of supply in the housing market?

Anthony Pettinari (12:37)

Yeah, you know, from a policy perspective, I think the fundamental issue is, you know, we have a political system where voters really have the ability to veto new housing construction at a local level. And they really do so, you know, pretty frequently and consistently. So, you know, people, everyone likes the idea of new housing and housing supply. But when it's time to build something, you know, next to your subdivision or your home or your apartment building, you know, it's going to create traffic, it's going to block your view. It's going to change the character of the neighborhood, and maybe the units are too high priced or they're not high priced enough, you know, there's always a lot of reasons that local residents and voters discourage construction at a local level, and they kind of have been empowered to do so by policymakers over the years. I think in New York and California, pretty notably, there have been recent efforts by the governors there to increase housing construction and density. But, you know, those have faced a lot of pushback, and it's not really a Democrat or Republican issue. It's really something that we see everywhere. So that's kind of a big policy challenge that is multi-year and probably somewhat thorny to tackle. You know, in the near term, you know, just practically, builders have focused on smaller homes, easier to build formats, things like townhouses have gained a lot of popularity in recent years. But I think practically the real lever to sort of add supply to the market is interest rates kind of moving lower to kind of offset this lock-in effect and making affordability a little less challenging.

Rob Rowe (14:25)

And so when I think about that, I mean, obviously, if rates are coming down, that means the economy is slowing down. And it could be that you could achieve this, and I think what I'm asking here, Anthony, in this roundabout way, is scenarios here. You know, there's a scenario where rates stay relatively elevated due to sticky inflation, there's a scenario where we have a soft landing, which would implicate that, you know, growth slows, but it doesn't necessarily go into recession, and then there's kind of a recessionary scenario or a more deeper slowdown scenario. I think in two of those, you might see rates come down. What's ideal and what happens in a situation if it's more recessionary or suggests that?

Anthony Pettinari (15:07)

Yeah, I think the ideal scenario is modestly lower rates, a growing but not overheating economy. Ideally, maybe some policy initiatives to make adding supply a little bit easier. That would be sort of the ideal scenario. In recessions, uniformly, you're going to see housing construction go down. You know, homebuilders are cyclical. They often sort of lead the cycle. So if we're into a recession, you'll see construction go down, you'll see pricing go down. And so I think those are kind of the scenarios that we consider over the next 12 months.

Rob Rowe (15:47)

Okay. And lastly, what are the things that we should be keeping an eye on in terms of the potential impact to the market — or, I would say, potential impact to your market as well in terms of homebuilders?

Anthony Pettinari (16:00)

Yeah. I think there's a few interesting developments, maybe both positive and negative, that we look at. I mean, obviously, we look at the big things like rates and employment growth and wage growth and consumer confidence. You know, those are obviously really the keys to the market. But there's some things we're keeping an eye on. You know, there's the recent settlement with the National Association of Realtors, which has gotten a lot of attention. Historically, U.S. Realtor commissions have been, 6% paid by the seller and split equally between the buyer and seller broker. 6% is high compared to other developed economies. You know, often, you see kind of 2% to 3% commissions in other countries. So after this settlement, the buyer and seller commission is essentially going to be kind of unbundled, and you should see some compression in overall commissions. And that has the potential to take some cost out of the home buying process, which could be a positive for sort of activity and maybe affordability. It's not completely straightforward, because buyers are going to have to presumably start paying some commission. So in terms of how this actually plays out in the market, I think it'll take a little bit of time to see what this ultimately will look like, but I think it is something that has the potential to reshape the market a little bit.

On the negative side, I mean, we see kind of tail risks around insurance rates and really climate change. We've seen a number of home insurers exit big important markets, notably, you know, Florida and California on risks around storms and fires, respectively. You know, Florida home insurance costs have doubled over the last three years. They're the highest in the U.S., by some measures, they're quadruple the US average. California insurance rates are more in line with the U.S. average. But, you know, I think part of that is just laws in California are more aggressive about limiting rate increases, but kind of as a result of that, it's maybe harder to get insured because a lot of the major insurers have left. So, you know, insurance costs, homeowner insurance costs are not the largest component of home buyer costs historically. But with kind of the rapid increase that we've seen in some of these states over the last three to four years, it's something to definitely watch over time. So, I think those are a couple kind of interesting trends worth watching. But again, I think that kind of the take-home message for '24 is the best case would be modestly lower rates, a still-growing economy, and maybe a little bit of a loosening of supply.

Rob Rowe (18:35)

Anthony, I really look forward to that. *[Laughs]*

Anthony Pettinari (18:40)

You and me both. You and me both, Rob. *[Laughs]*

Rob Rowe (18:42)

Fantastic. Well, Anthony, thanks so much for being on our podcast today.

Lucy Baldwin (18:47)

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