Real Estate and Housing Commentary — March 1, 2021

What Rising Mortgage Rates Mean for Home Sales & Home Prices

Interest Rates Spike as the Economy Heats Up Ahead of Another Wave of Stimulus

Summary

Will Rising Mortgage Rates Upend the Housing Recovery?

The yield on the 10-year Treasury note has spiked to 1.50%, which means mortgage rates will likely rise to around 3.25%. While this is still a historically low mortgage rate, it is more than half a percentage point higher than where it began the year. Higher mortgage rates will sap some strength from the housing market and slow the recent surge in home prices.

Economist(s)

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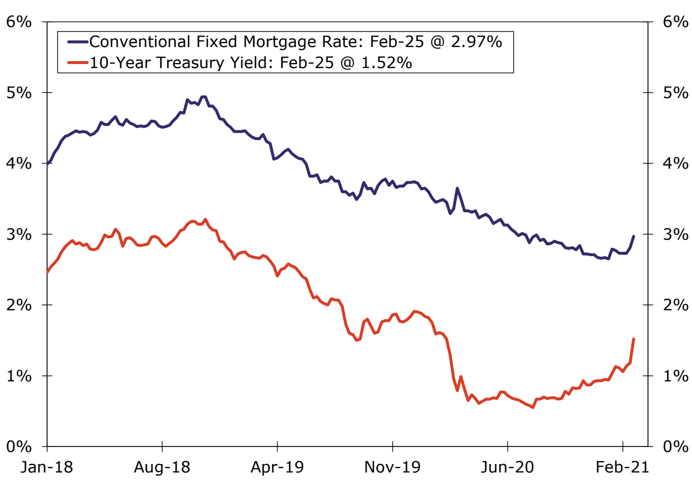
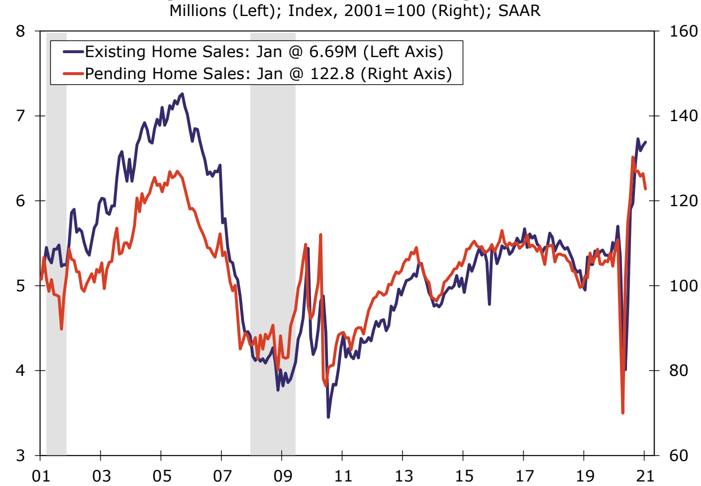
Rising Mortgage Rates May Cool Off the Housing Market, a Touch

- The yield on the Treasury's 10-year note has risen 60 bps over the past two months and broke through the psychologically important 1.50% level, following better-than-expected economic news and word that the House of Representatives is set to pass the president's $1.9 billion stimulus package.
- The spread between the 30-year conventional mortgage rate and the 10-year Treasury narrowed throughout most of last year, but mortgage rates have risen largely in step with Treasury yields, as the rise in rates accelerated this past month. The spread between the two remains relatively tight.
- Our forecast called for interest rates to increase gradually, as the country recovers from the pandemic and economic growth ramps up in response to pent-up demand and the need to rebuild inventories. Mortgage rates are expected to end this year around 3.10% and 2022 at 3.50%.
- Estimates for economic growth have ratcheted up much more than expectations for inflation and interest rates, suggesting there are still upside risks to consensus estimates for inflation and interest rates. The Fed's forecast for economic growth looks low relative to private forecasters, implying the timetable for unwinding the Fed's extraordinary pandemic stimulus may be shorter.
- Rising mortgage rates will chip away at the recent strength in home sales but will not upend the housing recovery unless they disrupt the broader economic recovery. Some cooling off in home buying was evident before the latest rise in rates. Pending homes and mortgage applications have been declining for some time.
- With demand cooling off, home price appreciation will likely moderate. We do not expect home prices to decline, however, as inventories remain near modern-era lows. Demand for housing should also improve as job growth strengthens and credit eases up. After rising 9.3% last year, we expect the median price of existing single-family homes to rise 6.1% this year and 6.4% in 2022.
- Demographics remain strongly supportive for housing, with a growing number of Millennials reaching a point in their lives where they are marrying, having children and buying homes. The affordability migration away from large, high-cost, globally-connected cities to rapidly growing "secondary" metro areas, where homeownership tends to be higher, should also continue to bolster demand.



Source: IHS Markit and Wells Fargo Securities



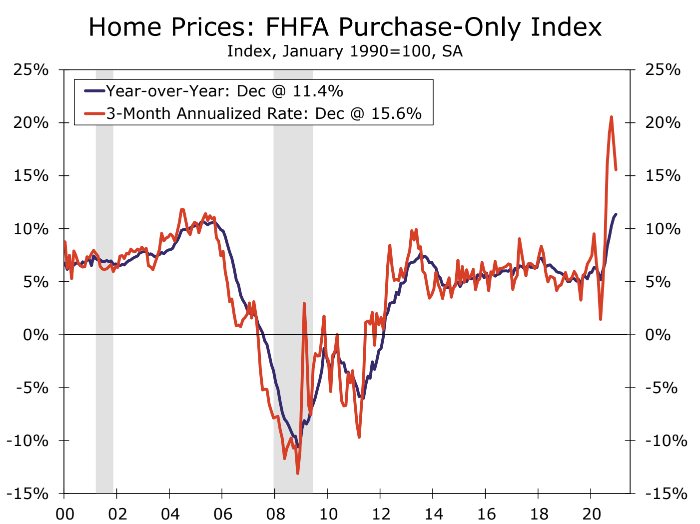
Source: National Association of Realtors and Wells Fargo Securities

Will Higher Rates Bring a Needed Respite or Hard Landing for Housing?

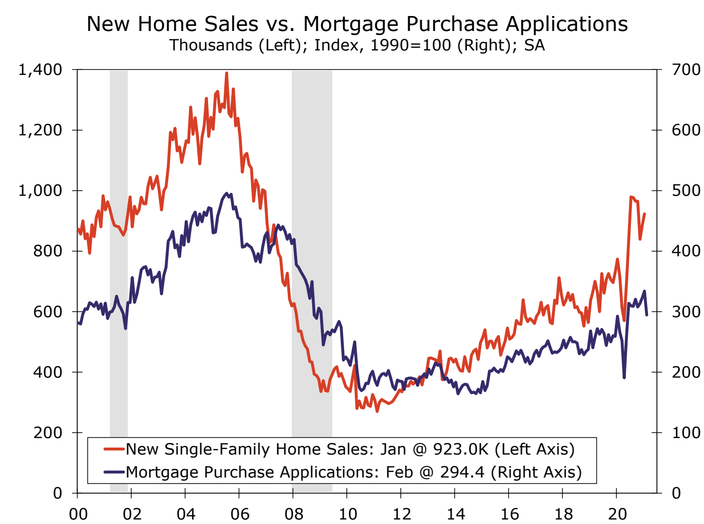
The sudden spike in long-term interest rates has set off alarm bells for the housing market, which has been one of the economy's strongest sectors this past year. New home sales have averaged an 882,000-unit pace over the past three months and totaled 815,000 homes in 2021, marking the best year since 2006. Sales of existing homes have averaged a 6.64 million-unit pace over the past three months and totaled 5.64 million units in 2020, which was the best year since 2006. The strength of home sales has pulled the inventory of existing homes down to its lowest level in decades, which means competition for homes has been incredibly intense, with more than 70% of all existing homes selling in less than a month and a growing proportion of new home sales coming from homes where construction has not yet started.

With demand so strong and inventories so low, home prices have been pulled sharply higher. The National Association of Realtors reported that the median price of an existing single-family home rose 9.3% in 2020 to $300,200, while the price of the median new home rose 4.6% to $333,900. Other price measures have also perked up. The Federal Housing Finance Authority (FHFA) home price measure for home purchases shows prices rising 7.7% in 2020. Prices spiked more during the latter part of the year, however, surging at a 15.6% annual rate during the last three months of the year and ending the year up 11.4% from the end of 2019. The S&P Case-Shiller CoreLogic home price indices also ramped up during the second half of the year, with the national home price index rising 6.0% for the year as whole but surging at a 14.1% pace during the last three months. The index ended 2020 10.4% higher than it was in December 2019.

The rapid acceleration in home prices has raised fears of another bubble. We believe the bubble talk is premature. Prices have been pulled higher by a huge imbalance between supply and demand, which grew even larger amidst the pandemic. Sales surged this past year even though mortgage underwriting tightened. Most of the growth in sales this past year occurred among buyers with relatively high FICO scores and there has been relatively little speculative buying. Homeowners are also sitting on a record $20.4 trillion in home equity that has been built up over the past decade through a combination of paydowns in principle following a wave of refinancings following the Financial Crisis and home price appreciation. That pool of home equity should allow for a relatively smooth transition for homeowners that have taken advantage of the expanded use of forbearance during the pandemic. (For more details see Five Questions for Housing in 2021).



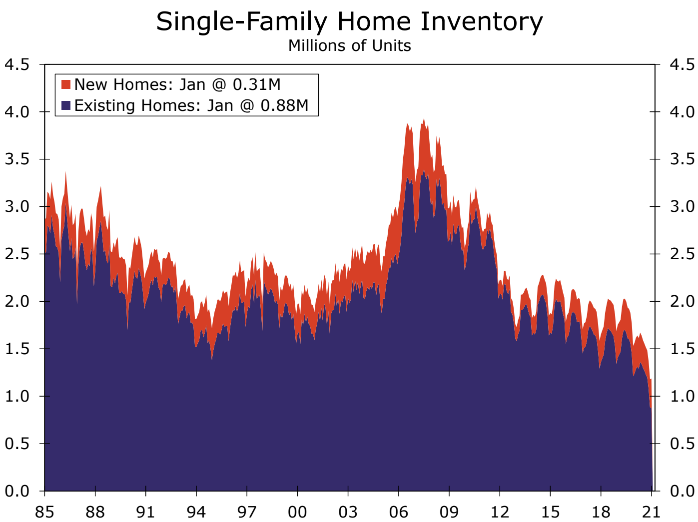
Source: Federal Housing Finance Agency and Wells Fargo Securities



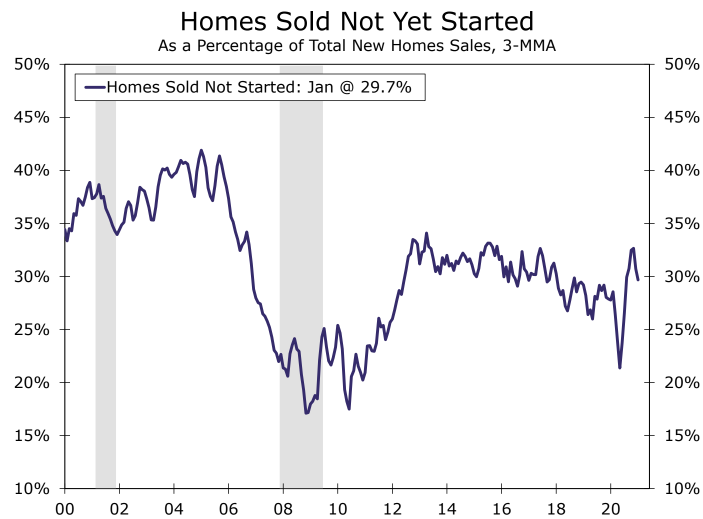
Source: U.S. Department of Commerce, MBA and Wells Fargo Securities

While our forecast had assumed a relatively smooth return to the new normal for the housing market and the broader economy, we have always been aware that the financial markets often get ahead of themselves from time to time and that, despite the Fed's determination, a repeat of the Taper Tantrum experienced back in 2013 remains a possibility. The Taper Tantrum upended the housing recovery and led to slew of contract cancelations that set the housing recovery back by nearly two years. The current environment does not look nearly as ominous. While long-term rates have risen 60 bps since the start of the year, they remain historically low. The increase may cause some potential buyers to hold off for a few months to see if interest rates pull back a bit. Buyers may also adjust their search to smaller and less expensive homes. Moreover, the broader economy is expected to strengthen, as the declining number of COVID infections and rising number of vaccinations allow more businesses to reopen and lead to increased economic engagement. Another round of stimulus is set to hit the economy this spring, which should ratchet up the pace of economic growth even further.

Most of the leading indicators of home sales suggest that this past year's surge in home buying was set to cool off a bit, even before the recent interest rate spike. That cool down now looks more certain, but we believe it will be more of a pause that refreshes variety rather than the hard landing experienced back in 2013. Pending home sales, which are purchase contracts for existing homes and lead closed transactions by about two months, fell 2.8% in January and have fallen in three of the past five months. Collectively, pending home sales are down 5.8% over this period. Mortgage purchase applications plunged 11.6% in mid-February and have fallen in four of the past five weeks. Purchase applications are down 23.9% from their mid-January level. Even with the drop, mortgage purchase applications remain 7% above their year-ago level. The latest drop may include some impact of the recent harsh winter weather in Texas, which accounted for a nation's best 16% of single-family permits in 2020. That harsh weather will likely weigh on home sales and housing starts during the next couple of months.



Source: U.S. Department of Commerce, NAR and Wells Fargo Securities



Source: U.S. Department of Commerce and Wells Fargo Securities

The Pause that Refreshes

The housing market could likely use a breather. Like other parts of the awakening economy, the housing market is dealing with extreme supply chain disruptions. Inventories of existing homes remain near modern era lows, as fewer homeowners have been willing to put their homes on the market and open them up for showings where large numbers of people would be going into their home. Many homeowners have also reassessed their housing needs during the pandemic. Homeowners that might otherwise have downsized suddenly found they needed more space to accommodate working from home and remote schooling, as well as the return of adult children from universities and the workplace. Foreclosure moratoriums and mortgage forbearance have also deprived the market of lower-priced distressed sales. New construction also took time to ramp up. Higher lumber prices and shortages of some building products have weighed on the rebound. Inventories of completed new homes have fallen to modern era lows, which has meant that a growing share of new home sales have been for homes where construction has not yet started.

When you factor in the more positive demographic trends, most notably the growing number of Millennials marrying, having children and buying their first homes, and the migration away from renter-dominated urban markets like New York, San Francisco and Los Angeles to homeowner-driven markets like Dallas-Fort Worth, Phoenix and Atlanta, it is hard to get too worried about the housing market this year. After some cooling over the next couple of months, we expect home sales to ramp back up this spring and summer. Single-family home building should be even less disrupted. Some slowing may even be beneficial, as it will allow saw mills to ramp production and help curb the spike in lumber prices. A key stumbling block has been a shortage of workers, and that may ease as the threat from COVID cases continues to decline, allowing more workers to return to their jobs.

Some slowing in home sales should also help moderate the heated pace of home price appreciation. Part of this past year's surge in home prices has come from a shift in demand for larger and more expensive homes. As noted earlier, fewer homeowners in this price segment have been willing to sell. The squeeze in the trade-up market has led to intense competition for what few listings were available. With schools re-opening and more people returning to work, this squeeze should abate somewhat this year. We also expect more homes to come onto the market, as more homeowners rush to take advantage of today's strong market conditions. We expect home price appreciation to moderate somewhat this year. The surge in home prices late last year, however, means the prices for 2021, as a whole, will rise by about the same amount that it did in 2020, even if prices cool off significantly over the next few months. A significant moderation in home prices does not seem likely. While prices might fall slightly in some extremely high-priced markets, like San Francisco and New York, prices will remain under upward pressure in the suburbs surrounding these areas, as well as neighboring metro areas and secondary markets in the South, Southwest and Mountain states.

Housing Forecast

National Housing Outlook	Actual								Forecast	
	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Real GDP, Percent Change	1.8	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	6.2	5.1
Residential Investment, Percent Change	12.4	3.8	10.2	6.6	4.0	-0.6	-1.7	6.0	16.1	9.2
Nonfarm Payroll Change (Avg. Monthly)	191.8	250.3	226.7	193.2	181.3	193.2	167.6	-778.1	481.0	282.0
Unemployment Rate	7.4	6.2	5.3	4.9	4.4	3.9	3.7	8.1	6.0	4.9
Home Construction										
Total Housing Starts, in Thousands	928.2	1,000.3	1,106.8	1,176.6	1,207.4	1,248.3	1,295.3	1,395.8	1,480.0	1,510.0
Single-Family Starts, in Thousands	619.2	646.3	712.3	784.8	851.3	872.2	892.6	999.6	1,105.0	1,130.0
Multifamily Starts, in Thousands	309.0	354.0	394.5	391.8	356.1	376.1	402.7	396.3	375.0	380.0
Home Sales										
New & Existing Home Sales, in Thousands	5,517	5,375	5,757	6,014	6,127	5,957	6,029	6,462	7,100	7,305
New Home Sales, Single-Family, in Thousands	430	440	503	562	616	614	685	818	900	955
Total Existing Home Sales, in Thousands	5,087	4,935	5,254	5,452	5,511	5,343	5,344	5,644	6,200	6,350
Existing Single-Family Home Sales, in Thousands	4,484	4,344	4,646	4,838	4,892	4,742	4,765	5,066	5,570	5,730
Existing Condominium & Co-op, in Thousands	603	591	608	614	619	601	579	578	630	620
Manufactured Homes										
Total Shipments, in Thousands	60.2	64.3	70.5	81.1	92.9	96.6	94.6	94.4	96.3	98.6
Percent Change	9.7	6.8	9.7	15.0	14.5	3.9	-2.0	-0.2	2.0	2.4
Home Prices										
Median New Home, $ Thousands	265.1	283.2	293.7	306.5	321.6	323.1	319.3	333.9	342.0	351.5
Percent Change	9.5	6.8	3.7	4.3	4.9	0.5	-1.2	4.6	2.4	2.8
Median Existing Single-Family Home, $ Thousands	197.4	208.9	223.9	235.5	248.8	261.6	274.6	300.2	318.5	338.7
Percent Change	11.4	5.8	7.2	5.2	5.6	5.1	5.0	9.3	6.1	6.4
FHFA Purchase Only Index, Percent Change	7.0	5.0	5.2	5.7	6.3	6.3	5.2	7.7	7.4	6.2
S&P Case-Shiller National Home Price Index, Percent Change	9.6	6.6	4.6	5.1	5.8	5.8	3.5	6.0	6.5	6.2
S&P Case-Shiller C-20 Home Price Index, Percent Change	12.0	7.9	5.0	5.2	5.9	5.7	2.4	5.4	6.0	5.7
Interest Rates - Annual Averages										
Federal Funds Target Rate	0.25	0.25	0.27	0.52	1.13	1.96	2.25	0.50	0.25	0.25
Prime Rate	3.25	3.25	3.26	3.51	4.10	4.90	5.28	3.54	3.25	3.25
10-Year Treasury Note	2.35	2.54	2.14	1.84	2.33	2.91	2.14	0.89	1.41	1.81
Conventional 30-Year Fixed Rate, Commitment Rate	3.98	4.17	3.85	3.65	3.99	4.54	3.94	3.12	3.11	3.51

Forecast as of: February 26, 2021

Source: U.S. Departments of Commerce and Labor, FRB, FHFA, FHLMC, National Association of Realtors, S&P and Wells Fargo Securities

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