Economics

Special Commentary — February 22, 2021

The Economic Outlook: What Could Possibly Go Wrong?

Part IX: Another Housing Bubble in the United States

Summary

Home prices have risen dramatically over the past year. As measured by the National Association of Realtors, the median price of an existing single-family home surged roughly 15% last year, to bring it about 50% above its value at the peak of the housing bubble in 2006. Although the recent sharp run-up in house prices may resemble the early days of the housing bubble, many of the hallmarks of that bubble—loose lending standards, lax oversight and rampant speculation—are not currently present.

The sources of the recent home price appreciation also appear to be more fundamental. The pandemic has caused many individuals to seek more living space, and record-low mortgage rates have reduced the financing costs of buying a home. Both of these factors have increased demand for housing. On the other side of the market, supply has been restrained over the past year or so. The combination of increased demand (stemming from fundamental factors) and restrained supply has pushed up home prices.

Still, a sudden correction in home prices, should one occur, would reduce home equity for the household sector, which could exert headwinds on growth in consumer spending and overall GDP. However, the fallout on the overall U.S. economy likely would be far less debilitating than it was when the housing bubble imploded over a decade ago. Households are not nearly as leveraged as they were back then and financial institutions are far better capitalized and more tightly regulated.

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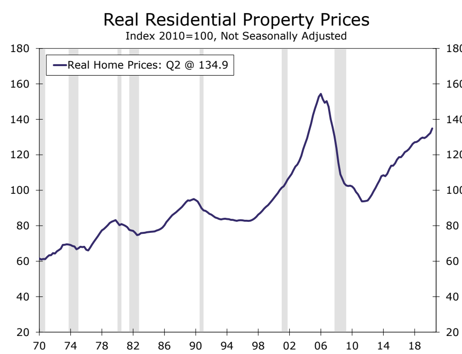
Figure 1



Source: Federal Reserve Bank of St. Louis and Wells Fargo Securities

Home Prices Have Risen Significantly Over the Past Year

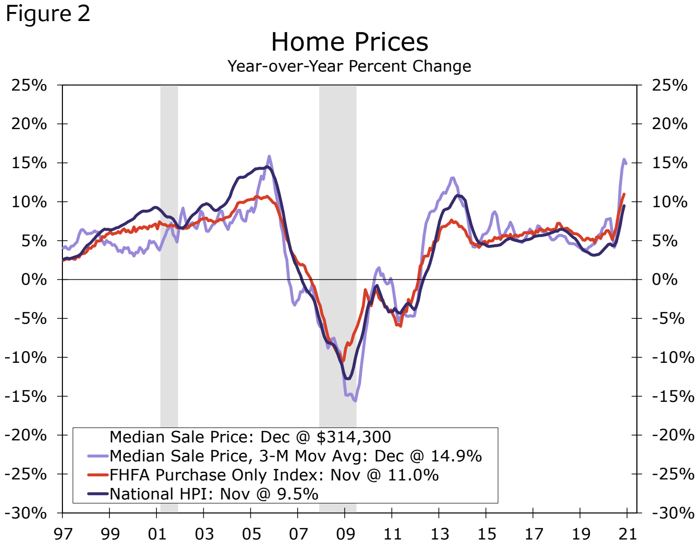
House prices rose 15% last year, the largest increase since 2005.

This past year's rapid increase in home prices has raised concerns that another housing bubble may be brewing. As measured by the National Association of Realtors, the median price of an existing single-family home surged roughly 15% from Q4-2019 to Q4-2020, the largest year-over-year increase since 2005 and easily outpacing gains in household income and rent (Figure 2). Moreover, the median house price is now about $300,000, roughly 50% higher than it was at the peak of the housing bubble in 2006. But whether the recent surge in home prices signals the onset of a bubble depends upon how much of the acceleration in home prices is being driven by the fundamentals and how much is being driven by speculation.

The pandemic has led to a marked increase in demand for housing.

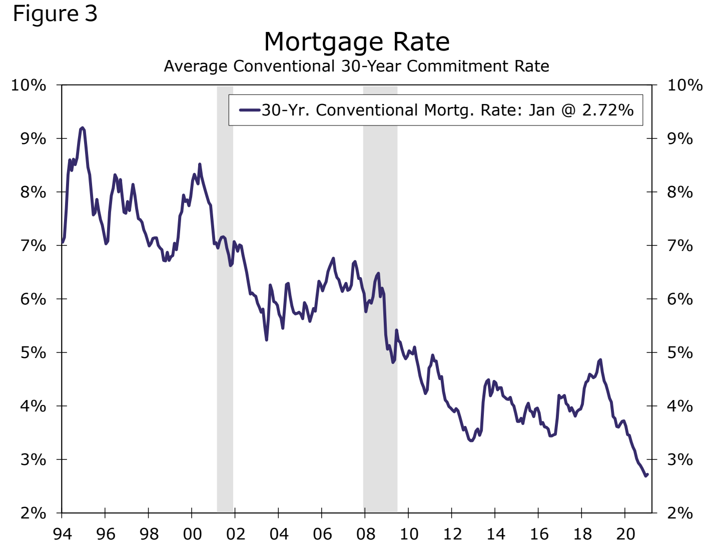
We believe that fundamentals explain the bulk of price gains this past year due to some unusual supply and demand dynamics brought on by the COVID pandemic. Specifically, home prices have been pulled higher by the sudden increased demand for housing combined with exceptionally low inventories of homes for sale. The surge in remote work, remote learning and time spent at home set off a race for more living space. More apartment renters looked to buy homes and more existing homeowners looked to enhance their current homes or buy larger homes. These shifts coincided with longer-run demographic trends, namely many Millennials reaching a point in their lives where they are settling down, getting married, having children and buying homes. Furthermore, low mortgage rates have reduced the cost of financing the purchase of a house. The rate on the 30-year fixed rate mortgage fell below 3.00% last summer, where it remains today (Figure 3).

Figure 2



Source: NAR, FHFA, S&P Case-Shiller CoreLogic and Wells Fargo Securities

Figure 3



Source: Freddie Mac and Wells Fargo Securities

Housing supply has been restrained.

While more people want to buy homes, fewer want to sell. The squeeze has been particularly apparent in the trade-up market. Many homeowners in the Baby Boomer cohort who were thinking about downsizing are now holding onto their homes because they need them to work remotely or house their adult children, who may be fleeing expensive urban apartments. Rather than selling, many homeowners are investing in upgrades, driving up the demand for remodeling and putting additional pressure on prices for building materials and home appliances. The net result has been an intense pressure for the relatively few homes available for sale, which has resulted in homes selling very quickly, often at well above the asking price.

The supply of housing is being constrained in other ways, as well. The expansion of mortgage forbearance under the CARES Act combined with foreclosure moratoriums have meant there have been fewer foreclosures and short sales. Black Knight Financial, a leading provider of mortgage analytics, shows the number of properties in foreclosure pre-sale inventory fell to just 176,000 in November from 248,000 in November 2019. Distressed sales are typically done at a discount to market prices, so the lack of foreclosures means there were fewer transactions at the lower end of the market, which exaggerates the year-over-year rise in home prices. The shift in preferences to larger homes and lack of foreclosures are two reasons that average and median home prices have increased much more than prices in repeat-sales indices, such as the S&P CoreLogic Case-Shiller and FHFA Home Price Index. Additional regulatory hurdles and upfront land development costs have also made it more expensive and difficult to develop new housing communities, constraining the supply of new homes, particularly at lower price points.

Are We Experiencing Another Bubble?

Household finances are in much better shape today than they were during the bubble years.

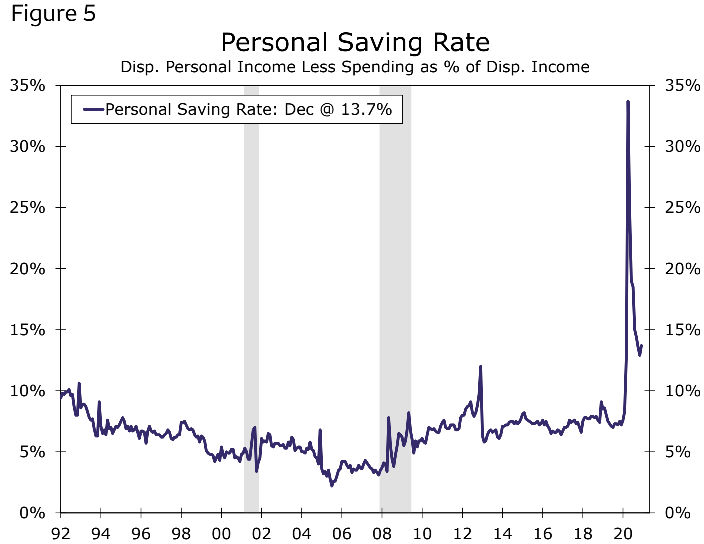
Perhaps the two greatest differences between what we are seeing in today's housing market and what was seen in the bubble years are the stronger financial position of homebuyers and greater discipline on the part of lenders. While overall employment remains well below its pre-pandemic peak, data from Opportunity Insights show employment among persons earning over $60,000 a year fell less and recovered more quickly than it did for folks earning less. Data on spending, however, show that spending by upper-income households, which tend to spend a larger share of their incomes on discretionary services (e.g., dining out, travel, salons and fitness studios), fell further and has yet to fully recover. The spending diverted from these services has largely gone to paying down debts, financing home improvements or bolstering savings for a down payment on a home. In other words, higher-income individuals are generally not using excess savings to finance speculative behavior in the housing market.

As shown in Figure 4, the ratio of household debt-to-disposable income rose sharply during the bubble years of the early 21st Century. However, American households have deleveraged considerably over the past decade, and the ratio has fallen to less than 85%, where it stood before the bubble started to inflate. The household saving rate has been pushed higher by the income-boosting effects of the fiscal support packages (Figure 5). Nevertheless, the savings rate averaged 7.4% in the five years preceding the onset of the pandemic, three percentage points higher than the average rate during 2003-2007.

Figure 4

Source: Federal Reserve Bank of New York and Wells Fargo Securities

Figure 5

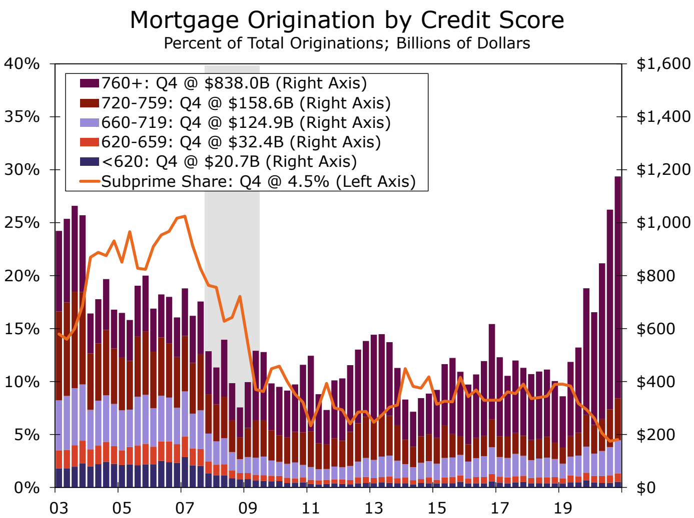


Source: U.S. Department of Commerce and Wells Fargo Securities

Mortgage underwriting is fairly tight today.

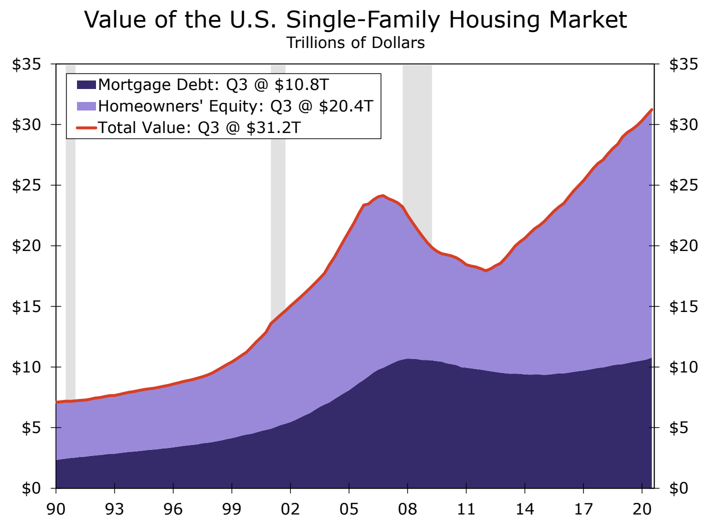
Mortgage underwriting tightened at the onset of the pandemic and remains fairly tight today. Borrowers with fairly high FICO scores account for most of the growth in conventional mortgages for the purchase (Figure 6). Specifically, borrowers with FICO scores of 750 or more currently account for 53% of mortgages for purchase, up from 49.6% a year ago. Just 6.2% of mortgages were originated by buyers with FICO scores below 650, down from 9.1% one year ago. For refis, the average FICO score was 765 and cash-out refinancings are nowhere near as prevalent as they were in the bubble years. Homeowners also have substantially more equity in the homes today. Federal Reserve data show single-family home equity at a record $20.4 trillion, or nearly two-thirds of single-family housing values (Figure 7). Moreover, many homeowners have been able to refinance their mortgages at lower rates, reducing their monthly payments and enhancing their creditworthiness. In that regard, the household debt service ratio, which measures the amount of disposable income that households need to devote to amortization and interest payments on their debt obligations, has fallen to only 9%, well below the 13% ratio during the height of the bubble years.

Figure 6



Source: Federal Reserve Bank of New York and Wells Fargo Securities

Figure 7



Source: Federal Reserve Board and Wells Fargo Securities

So What Could Go Wrong?

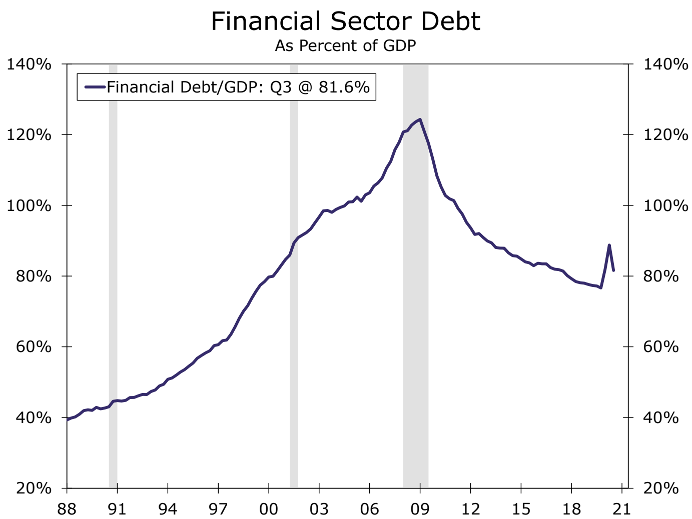
Risks to the broader economy from a decline in home prices are fairly minimal today, but risks likely will rise over time.

In sum, we do not believe that a major correction in home prices, at least not on the order of 2006-2012, is in the offing anytime soon. But what if we're wrong? There are certainly some questions about how sustainable the recent strength in home sales and residential construction will be, particularly given the large number of homeowners currently in forbearance. Higher interest rates would also present a challenge to asset prices in general. Clearly, individual homeowners would realize paper losses due to the decline in the value of their home, and paper losses could turn into realized losses if these homeowners needed to sell their homes at lower prices than at which they purchased them. Reduced perceptions of wealth might also weigh on consumer spending, which would lead to slower real GDP growth.

But given the record levels of home equity, high saving rate and low debt-to-income ratios, the risks to the economy from a drop in home prices are fairly minimal today. Not only is the household sector less levered today than it was during the bubble years, but the debt-to-income ratio in the financial sector has also receded significantly over the past decade (Figure 8). In short, a decline in home prices likely would not have the same debilitating effect on the U.S. financial system as it did when the housing bubble imploded nearly 15 years ago.

That said, overall macro risks likely will rise over time. There has been an enormous shift of wallet-share for higher income households away from travel and leisure spending toward housing. Residential investment has increased as homeowners have updated and expanded their homes to accommodate the needs of working remotely, remote education and entertainment. The savings from reductions in dining out and discretionary leisure travel have also helped finance home purchases. Some reversal of this shift would be expected as the economy opens back up and spending begins to revert to its previous norms. Stronger economic growth would also bring with it higher interest rates, which would reduce housing affordability and the implied returns on homeownership relative to renting. Both of these issues, however, would more likely slow house price appreciation rather than reverse it.

Figure 8



Source: Federal Reserve Board and Wells Fargo Securities

Conclusion

House prices in the United States have risen significantly again, especially since the onset of the pandemic last spring. In our view, this run-up in house prices largely reflect fundamental factors. First, the pandemic has increased demand for more living space due to the necessity for many households to work from home and to educate from home, and record-low mortgage rates have reduced the cost of financing home purchases. These pandemic-induced factors have interacted with longer-run demographic trends—many Millennials are reaching their prime home-buying years—to push up the demand for housing. On the other side of the market, supply has been restrained by the unwillingness of many potential sellers to list their homes and by the moratorium on foreclosures. The combination of increased demand and restrained supply has pushed up home prices.

A drop in house prices in the near term, should one occur, likely would not have the same devastating effects on the economy as the bursting of the housing bubble did nearly 15 years ago. Underwriting standards have been much tighter in recent years than they were at that time, and the financial position of the household sector is much stronger today than it was during the bubble years. The debt-to-income ratio for the overall household sector has receded significantly over the past decade, and the ability of many households to service debt is much higher today. Furthermore, the financial system in not as leveraged as it was prior to the financial crisis.

In sum, the rise in house prices has been driven, in large part, by the effects brought on by the pandemic. Not only has the pandemic had implications for the residential real estate market, but there also has been fallout on the commercial real estate (CRE) market. We will address these effects on the CRE market, and their potential implications for the overall U.S. economy, in our penultimate installment in this series, which we plan to publish shortly.

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