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High mortgage rates, limited inventory continue to challenge the US housing market

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Allison Nathan: High mortgage rates and a limited supply of homes have all but shut down the market for new home sales over the past year, so what's the outlook for the housing market heading into the spring selling season?

Roger Ashworth: When you think about the average mortgage being made, right now it's around $450,000. At a 3% mortgage rate, that's $1,800 bucks a month. But at a 7% mortgage rate, it's $3,000. So the affordability shock that happened certainly dried up a lot of the demand.

Allison Nathan: I'm Allison Nathan, and this is Goldman Sachs Exchanges.

For this episode, I'm speaking with my colleague Roger Ashworth, who covers the housing market for Goldman Sachs Research and is a senior strategist on the structured

credit research team. We'll be talking about his outlook for home prices and the supply-and-demand dynamics that have created one of the tightest markets in decades. Roger is joining me here in our New York studio. Roger, welcome to the program.

Roger Ashworth: Thanks, Allison.

Allison Nathan: Roger, as I just said, the market for new home sales is exceptionally tight today. If I'm not mistaken, home sales last year dropped to their lowest levels in nearly three decades. That's pretty remarkable. So walk us through how we got here.

Roger Ashworth: Thanks, Allison. Yeah, the existing home sales figures are running around 3.7 million homes per annum, and that's certainly low relative to history. And how we got here, I boil it down to three factors.

One, mortgage rates. When we look back over the history of mortgage rates over the past few years, in 2021, we had a 3% mortgage rate. And by the end of '22, we had about a 7% mortgage rate. By the end of 2023, it was about 7.8%, almost 8%. Currently, it's around seven, so that big shock

in interest rates and the impact on the mortgage payment has just forced demand out of the market.

When you think about the average mortgage being made right now, it's around $450,000. At a 3% mortgage rate, that's $1,800 bucks a month. But at a 7% mortgage rate, it's $3,000. So the affordability shock that happened certainly dried up a lot of the demand.

The second factor is the fact that during the post pandemic period we had a mad dash for housing. People wanted to change their housing situation for a whole bunch of reasons, so that pull forward of demand has to be given back at some point.

Allison Nathan: Right.

Roger Ashworth: And that's also part of it, on top of interest rates. And we had some examples that happened over the course of the past 10 years in the post financial crisis period. We instituted tax credits, first-time buyer tax credits. And again, you could measure a big spike in home sales and then a subsequent give back.

Allison Nathan: Right. It's not something you buy every year. So when you make your purchase, you're good for a while.

Roger Ashworth: Yeah. And the last impact from, again, low home sales is the lack of people moving, right? We have this thing in mortgages we like to call the lock-in effect. In other words, if I go buy a house down the street, it's going to cost significantly more at a much higher mortgage rate. Around 97% of the mortgage market right now is out of the money to refinance their loan and likely not thinking about moving anytime soon.

Allison Nathan: And if we think about that locked-in effect that you just mentioned, people are not wanting to sell their homes, so the supply of homes available has been very low. We hear a lot about the inventory of homes for sale is low because they don't want to be forced into a higher mortgage rate. So what will it take to change that? Are we just going to have to see mortgage rates coming down substantially?

Roger Ashworth: Certainly mortgage rates coming closer to the average mortgage rate in the market right now. I

think the average borrower in America, if you look at, like, agency mortgage-backed securities, which is the largest share of the market, the average mortgage rate there is about 3.8%. So in order to scare some of those people off the sidelines, we would certainly need mortgage rates to get down closer to that area. I wouldn't say we will likely see that anytime soon, but you're right. When we talk about the supply of homes on market, we tend to measure it in months supply. In other words, at existing home sales run rate, how many months will it take to burn off all the inventory in the market? That's remaining at relatively depressed levels. It's like a 3.5 to 3.7 months of supply.

At the post pandemic kind of mad dash for housing, it was around two months, so it was really tight inventory back then. The long-term average is more like five.

Allison Nathan: So I just saw a headline that questioned whether sellers could be starting to lose their leverage because of life events. Things like divorce and having kids and retiring and other factors that motivate people to move into new homes. You can only push off some of those things for a period of time before you just feel like, "You know what? I can't wait. I'm ready to move." Do you see

any type of trends or any evidence that effect is happening?

Roger Ashworth: When we look at turnover, that's exactly right. It's death, disability, divorce. But when I think about those things, looking at our projections for employment in the country, you know, we only expect the unemployment rate to tick up just very slightly to, like, high 3%. Also, the job-worker gap we talk about in economics, that's about 2.4 million job openings in excess of unemployed people. Job market's relatively tight.

Divorce rates tend to be a little bit low. People are living longer, too, so theoretically the death rates are low. And a lot of the older folks in America, they tend to own their home outright and simply moving actually bumps up your cost of living potentially. And it seems like the migration patterns are starting to slow down where people were moving to the Southeast. But you're right, I mean, that natural level of turnover would hopefully normalize at some point.

Allison Nathan: There was one more follow-up I wanted to ask you about, which was it feels to me like coming into the year there was so much expectation for rate cuts, for

mortgage rates to come down, that it almost seems like sellers were sort of waiting for a better moment. They could probably get a higher price for their house and/or a lower rate facing themselves on the other side. But as we all know, the expectation for Fed cuts has been pushed later. Could we just see sellers giving up essentially? They've been holding on, waiting for these Fed cuts, waiting for the mortgage rates to come down. We had this little moment of seeing some reprieve in mortgage rates later last year. That's reversed. You know, at some point, can sellers just say, "You know what? I got to bite the bullet," and sell?

Roger Ashworth: It could happen. Or like you said, people could really hold out and say, "Maybe we'll wait a little bit longer." It's a tricky psychology. Home sales and home buying and selling is a very personal and highly emotional transaction. It's probably the largest transaction most people undertake financially. But you're right, it's not totally clear to me.

Allison Nathan: But what I'm hearing from you is, no, we have to see mortgage rates moving lower to really see this shift.

Roger Ashworth: A little bit. I think so. I think so.

Allison Nathan: So let's talk about the other source of supply, which is ultimately new home builds. And you would think that, with such a tight housing market today, you would see a lot more new builds coming into the market and easing some of this tightness. Are we seeing evidence of that today?

Roger Ashworth: A little bit. They are seeing a lot more order flow. So there is some positive tone in the market when it comes to new home sales. The problem is, though, that supply chain is still loosening. And some builder commentary in the earnings releases that are starting to show that we're back to pre-COVID levels. But, yeah, we think about new homes, though, in a single-family home environment. They're about 15% of home sales, which is actually around the long-term average, the mix of used homes and new homes.

I think at the post financial crisis lows, we were running around 7%. There was a significant amount of under building during that time period, which is, again, leads to

that supply constraint that we're looking at today.

Allison Nathan: So we're not seeing it bounce back. We're not seeing it going from 15% to 20% or 30% just because, again, it seems like it's a compelling environment for builders.

Roger Ashworth: It does. But like I said, those supply chain constraints, material costs, labor costs, labor shortages, that would need to loosen up a little bit.

Allison Nathan: We've talked a lot about the supply side, but when you talk about the factors behind the tight housing market, a lot of them have to do with the demand side. And this demand for housing seems to be persistent. Do you think that sort of strong demand for housing can be sustained?

Roger Ashworth: It is definitely a sustained demand for housing. The demographics in America tend to put a floor on that demand tapping out, right? Like those life events you talked about, if you look at just the census projections on the population, right? That 25- to 44-year-old part of the population, that's expected to grow until 2035. And

that's the point in life when life events happen -- marriage, kids, you start looking at school systems. The home ownership rates, according to the census, tends to about double to the national average. So think about, like, in the 30% area up to around 60% over that.

So the one offset is the affordability environment. Home prices and interest rates and affordability are certainly challenged. And we're seeing people stretch on things like their mortgage payment relative to income that we call the debt-to-income ratio is in and around 39%. It's been consistently rising over the course of the past few years and something we keep an eye on. Again, people buying a home, not just refinancing their mortgage but actually buying a house.

The other part of demand that is underlying in the housing market is that single-family rental investors, the private capital that has been raised in the market, it is a relatively small part of the overall housing stock that's owned. When you look at the largest institutional investors that own, think thousands of homes. They're only maybe as high as 5% of the overall housing stock. But you have to remember that investors have always been in the housing

market. I think a lot of the data portals that I look at, they publish estimates on how many home transactions were to investors. In the post financial crisis period, it ran around 14%. And with the lowest priced homes that are being purchased by investors now, they're up around 26%. And even on a regional basis, that's even higher.

Allison Nathan: But when you're talking about these investors, so these are institutional investors buying up homes that then they're going to try to rent out? Just to be clear what we're talking about here.

Roger Ashworth: To put it in context, I think the Harvard Joint Center for Housing Studies, they put out an annual rental report, and in 2001 they estimated the non-individual investor -- so that's like a real estate investment trust or a nonprofit, which is a little bit broader than a very specific private capital raised to buy houses -- they represented about 18% of the single-family homes of the ownership of those homes. And more recently, their estimates based on last year was around 25%. So to give you a sense of, like, the holdings across the board.

Allison Nathan: So they buy those and then they rent

them out to individuals?

Roger Ashworth: That's correct. It was a very popular development that happened in the post financial crisis period. If you looked at the yield on a home and you looked at that yield relative to underlying interest rates, pre financial crisis -- in other words, 2004 and earlier -- that spread was actually a negative relative to underlying treasury rates. In the post financial crisis during the zero-interest-rate policy regime, that spread actually popped up to around 250 to 300 basis points and it was relatively consistent, right? Rents didn't go down as much as home prices did. So institutional investors A) they started buying foreclosures and then B) ultimately started purchasing homes in the secondary market because then you just simply apply some financial leverage to a consistent spread, you have a business.

So if I go get a mortgage in America today, the vast odds are is it will end up in a bond at some point, which is guaranteed by a government agency. They collectively pool loans, collect an insurance premium from the originator of that loan, and they syndicate it in the secondary market. The demand for those securities is wide ranging. It could

be banks, it could be foreign investors, it could be money managers, hedge funds. And we tend to not just pull up the loans but then actually carve up those loans into different cash flows.

But now the supply and demand, though, is largely driven by bank purchases. Banks' demand for those bonds right now is actually relatively low. Banks faced a lot of regional banking issues and potential capital rules. So the demand has certainly dried up, and now the incremental buyer of those loans, or those bonds, are actually money managers, hedge funds, some foreign institutions. So it's kind of a development of the financial crisis is that institutional ownership.

Allison Nathan: Let me take a step back, though. As you've been alluding to, home prices are still quite high, and you actually don't see much reprieve, at least on a national basis. You've actually just recently raised your expectation for house prices this year. So walk us through why that is.

Roger Ashworth: Yes, that's right, Allison. We are actually projecting home prices to appreciate around 5%

this year. What we do with our home price model more recently is just we tend to pull forward some of this home price appreciation over the next several years into this year for a couple reasons, one of which is actually a price momentum. You know, we were running in the neighborhood of 8% annualized home price appreciation heading into year end, and that's the time of year when we tend to see a little bit lower home price appreciation; people tend to move in the spring.

The other kind of underpinning to that home price forecast is that there is a simple floor on home prices based on the low supply that's pervasive across the housing market.

Allison Nathan: Interesting. We've mostly been talking about national averages, what we're seeing nationally, but what are you observing in terms of geographic differences? Are there some places glaringly tight and others much less so?

Roger Ashworth: When I talk about geographic differences, I like to lean on our home price appreciation model. We try to project home prices on about 380 metro areas, and then roll that out to a national projection, which

is for this year, again, around 5%. But the model takes two steps. First, they try to decide what's an affordable home price in every metro area? And then we have some correction terms on the second step. There's a lot of technical factors like momentum.

But the places where we see the most home price appreciation this year would be the older cities where we didn't have as much construction activity. Let's say in the Northeast, say like a Philadelphia. And the places where the model is most pessimistic are places like out on the West Coast where housing has tended to be expensive and remains expensive. And there's fundamental trends like migration out of the state. And when we go to the Southeast, it's more of a mixed result, right? We have certainly an affordability challenge because home prices appreciated the most there, but the economies are doing pretty well. So stable growth economically, but still affordability challenged.

Allison Nathan: If the Fed does start to cut rates this year, as is still widely expected, even if expectations have moved forward in the year, how might that transfer into mortgage rates? How long does it take? Is it a one-for-one move?

Walk us through how that would translate into mortgage rates.

Roger Ashworth: It's not a direct translation. The Federal Reserve, once they start to cut rates, that will have some knock-on effects with underlying interest rate markets and Treasuries where we would see a drop in the volatility of interest rates, and that would benefit the secondary mortgage market of mortgage-backed securities where we would see an improvement of the yield and the spread of that yield underlying mortgage rates. When you make a mortgage, you actually short interest rate volatility, so a drop in rate volatility will help the secondary market recover valuation-wise. So that's one of the fundamental reasons.

And then ultimately we'll see a steepening of the yield curve, and then that should overall benefit rate products broadly. But within mortgages, it will certainly help that secondary mortgage market recovery and valuation. And then the technical aspect of Federal Reserve tightening is bank securities demand. Now that we've seen deposit outflows tend to stabilize and the path forward on interest rates is relatively known, we should see more bank

purchase.

Again, the two big buyers of mortgage-backed securities were the Federal Reserve -- and they're not buying anymore -- and banks, who have definitely pulled back because of all those regional banking issues. So bank demand is definitely a critical part, which would help mortgage rates ultimately fall. And based on a lot of these rates forecasts that we have here, we're still expecting around a 6.3% mortgage rate by year end and maybe a 6% by the end of next year. So some recovery from the 7% we see today.

Allison Nathan: So we see a moderate decline --

Roger Ashworth: Moderate decline.

Allison Nathan: -- in mortgage rates even though we see home prices remaining relatively elevated. Mortgage rates come down as interest rates. And just to clarify, like, our Fed call is 25 basis point cuts four times this year --

Roger Ashworth: Correct.

Allison Nathan: -- by end of the year. And that's what's

flowing through your mortgage rate forecast.

Roger Ashworth: That's correct.

Allison Nathan: Understood. If you look at the risks facing the housing market, the mortgage market, what are the risks you're most focused on right now?

Roger Ashworth: Some of the big risks that we're really paying attention to are the underlying macroeconomic trends. I think everyone is tending to be focused on it. If we do see inflation remain high for a period of time, that will keep the Federal Reserve from cutting rates and starting that beneficial chain of events which would help lower mortgage rates and spur some more demand. Rates staying restrictive is certainly a big problem. And then there's the out-of-our base forecast outcomes is that, if we do see an economic shock that leads to job loss, right? If there's an income blip away from our two and three quarters percent real income growth over the course of the year, that could create a vacuum of demand potentially. And that would lead to lower home sales, lower home prices. And that's certainly a risk factor that we look at.

Regionally, there is a lot of multifamily construction, apartment buildings. There's an oversupply happening there where we are seeing rent growth actually slow down, and it could get to a point where rents look a little bit more attractive than buying and you might put off that life event even though you're looking forward to do it and you think you need to do it but maybe that economic calculation falls into play where you just say, "You know what? I'm going to stay renting for a little bit longer."

And then other regional issues, we certainly see that wealth effect is actually a pretty big driver of home prices. If we do see some weakness regionally, whether, like I said, in California, maybe that could impact home prices there as well.

Allison Nathan: But just to be clear, because if I think about the risks to the macro view, a lot of people are focusing on the consumer right now, thinking is the consumer going to hold up? But at this point, you're not seeing much evidence, at least in the housing market, of consumer weakness. It's really more a risk.

Roger Ashworth: Yes, that's correct. Now, when we look

at delinquency rates across a range of types of mortgages that go to people, whether they're self-employed or a regular-way mortgage through Fannie Mae or Freddie Mac, there are some normalization of delinquency rates. But I think the one underpinning fact that we have to remember is that there's around 70% equity in the housing market. So we have about $14 trillion of mortgages, but the equity held by the market is around 70%. And that's certainly, there's a distribution there and a whole bunch of people own their home outright. But when you talk about credit performance, that's a lot of money to walk away from. As a result, we tend to see relatively low delinquency rates. The tight job market certainly helps.

The level of foreclosures that we see in the market, too, are certainly very low, considering you're looking across even far longer history. Foreclosures are very low, so we don't see much distress in the market. Where we do see some stress, again when you talk about the consumer, the credit card delinquencies have certainly ticked up and it's made the news. And in other places, the subprime borrower who goes and takes out an auto loan. And the way I look at it is they tend to be the people most exposed to high interest rates.

Again, credit cards, interest rates are floating; they're certainly quite higher right now. The subprime borrower is probably more levered than the average consumer, let's put it that way. These are the people who, unfortunately, where an inflation era really pinches them the most. And that's where we see some pickup in delinquency rates, but our economics team, they tend to think the bulk of high interest rates, the impact there is certainly behind us. And we would expect things to start to normalize the second half of this year.

Allison Nathan: Thanks very much, Roger.

Roger Ashworth: Thanks, Allison.

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