

Higher Rates Unlikely to Derail the US Housing Market Strength

Jake Siewert: This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries, and the global economy. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

Today we're going to talk about the US housing market and how it's been impacted by the change in interest rates. We're joined by Marty Young of Goldman Sachs Research who has a new report out on this topic. Marty, welcome to the program.

Marty Young: Thanks for having me, Jake.

Jake Siewert: So, obviously, housing is in one of the most rates sensitive sectors of the US economy. What have you seen over the past year in terms of how the low interest rate environment has had an impact on the housing market and the dynamics between supply and demand?

Marty Young: Yeah, absolutely, you're right. If you compare home building to other sectors of the economy like software investment or food consumption, housing demand is certainly much more geared to the interest rate cycle. And we have seen a meaningful pick up in housing construction in the second half of 2020 on the back of high demand for housing. 2020 Q4, that was the highest quarterly level of housing start since 2006. And not even just construction of new homes, but we've seen large demand for existing homes, people moving out of apartments and into single family homes. In general, demand for housing saw a sharp V-shaped recovery starting in June of last year.

Jake Siewert: So, some of these dynamics were in place before the pandemic hit. I mean, we had some demographic tailwinds. So, how much of this pandemic related versus the broader industry tailwinds that we saw even before 2020?

Marty Young: You know, that's a good question. 2020 was strong. And a decent amount of that does reflect, we think, fundamentals that were in place even before COVID. Because if you look at January and February of 2020 before the full COVID shock, we were already seeing impressive housing sector data. Housing construction in February 2020 was up very solidly versus the previous year. And we were taking note in the strong market. And we had a strong labor market then, you'll remember. And to your earlier point, mortgage rates were already pretty low by January 2020. The Fed had executed a dovish pivot in 2019. Rates

were already pretty low. And it was supporting a pretty strong housing market even before COVID.

And then again, in addition to the impact of low rates, you pointed to the demographic tailwind that we think is going to be helping the housing market for the next few years. You know? If you look at the millennial cohort, you know, specifically around the 30- to 34-year-olds, they're the largest demographic cohort today. In fact, they're the largest five-year cohort in US history demographically. And they're moving up the ramp in terms of housing demand. You know, 35-year-olds tend to demand more housing consumption than 30-year-olds. And so, as this large cohort ages, we think they're going to add a lot to aggregate demand for housing.

And maybe another fundamental in place before COVID that I could point to is the limited supply. Home building has been relatively restrained since 2008. It's picked up in 2020, but still remains relatively low by long run standards. And so, we don't have a massive oversupply of homes. More the opposite. We have an undersupply. So, all of that is to say the strong house price data we're seeing in 2020 has been partly, you know, a short-term response to the COVID event, but also reflects some fundamentals that have been in place for a while.

Jake Siewert: Yeah, a lot of people nesting. And they need room to nest.

So, rates have crept back up recently. Or not necessarily crept back up. But how are you thinking about mortgage rates for the rest of 2021? Are we going to continue to see them rise?

Marty Young: Yeah, we do think that the long run direction of travel for mortgage rates is up further. Our economist has, you know, a very strong growth forecast for 2021. They're looking at, like, 7 percent GDP growth on the back of the vaccine-led reopening of the economy. And you know, now they're maybe up to 1.9 trillion of fiscal stimulus. So, inflation also moving back up. So, all of this suggests that ten-year treasury rates of 1.5 around where they're at now is probably too low. So, treasury rates, you know, our rate strategists think, are going to be moving up this year and that will bring, we think, 30-year mortgage rates back up with them.

But having said all that, there are reasons to think that we think the move up in interest rates is going to be contained, is going to be gradual. You know, for one reason, you know,

interest rates are still negative in some places around the globe. And so, you know, it's a global interest rate market. That's going to put, maybe, a ceiling on how high US rates can move up. And also, the Fed has been pretty clear that they intend to be supportive to be dovish. We've gotten dovish language even this week. And so, this all adds up to relatively what we think of as sort of a slow drift back up in mortgage rates. But yes, I would agree that probably we expect to move up rather than down in 2021.

Jake Siewert: Well, as someone who was alive in the '70s, I mean, 1.5 percent treasury ten-year yields are still a historic anomaly. Given that interest rate backdrop, what do you expect from the broader housing market over the course of this year?

Marty Young: We've been characterizing our forecast for the 2021 housing market as taking us from hot to warm. You know? 2020 was a very hot year. House prices grew 10 percent year over year. That's unusual for an asset that you can live in and, you know, high relative to long run house price growth standards. We think 2021 we shift from hot to warm. So, instead of getting a 10 percent price growth on the year, it might look more like 4 or 5 percent. You know? In 2020 demand far exceeded supply. The inventory of homes available at sale was at multi decade lows. You know, when houses came to market they were lifted very quickly. A lot of homes sold within one week of listing. Even, you know, as recently as February it was very much of a sellers market.

We think it shifts incrementally. But very much to your point, by long run standards, you know, mortgage rates moving up to 3, even 3.5 percent, these are still pretty affordable by long run standards. And so, we don't think that takes air out of the housing market yet.

Jake Siewert: Well, there's one scenario that's gotten a lot of attention recently that might have an impact. And there has been a lot of chatter about a scenario where rates went up pretty dramatically. And we saw a sharp [UNINTEL] environment. Your team put together a little [UNINTEL] analysis. And what do you think that would do in the instance of an interest rate shock scenario?

Marty Young: Right, yeah, the point of the model was to try to stress test and say what happens if mortgage rates move up even farther or faster than we expect. And so, we ran, you know, our baseline scenario. Which again leads to still a pretty warm

housing market. And then we say, what if we push rates up a further 1 percent or 100 basis points even above that baseline? And we found that in that scenario house price growth still remained positive. You know? So, we do think that we can withstand even a further push up in mortgage rates than our baseline forecast.

You know, and maybe as a reality check, I mean, if we go back to 2018 when the Fed was in a hiking cycle and mortgage rates got up to 5 percent, close to 5 percent, house price growth did noticeably slow down. But it did remain positive. And same with the 2013 taper tantrum event. Mortgage rates moved up and house prices growth, again, moved from hot to warm in that scenario. So, we do think that, in general, house price growth stays positive under our baseline scenario, and even in-- interest rate paths worse than our baseline scenario.

But having said all that, I would say that if we look at the most expensive markets, you know, places like San Jose and Seattle where affordability is pretty challenging, those are some of the markets that came under pressure in 2018 when rates were moving up last time. And so, I think that if we did see a move up in rates, we still think that across the US house price growth remains positive. But we should probably expect in some of these most expensive markets that seem pretty levered to low interest rates, that those markets might feel some pressure.

Jake Siewert: So, Marty, given the dynamics you've described with, you know, sort of pent-up demand and low interest rates historically, why is supply not coming on stronger? Why are home builders being a little reticent about ramping up as much? And are there constraints on supply right now?

Marty Young: Yeah, that's a good question. When you see the strength in the housing market you could ask why aren't home builders really stepping up their construction volumes. And it's been the case since 2008, since the last recession that home building has been quite moderate relative to the historical norms. And I think partly that reflects the fact that, you know, the home builders got burned in the last cycle. And so, they've been reluctant to take on large land inventories. They know that housing cycles can turn. But in addition, other, you know, constraints, whether it's regulatory or on supplies or labor. But as a result, we think home building is picking up. It's going to be another strong year, we think, in 2021. But still by historical standards we're not getting the kinds of oversupply that we've seen in previous boom and bust cycles. And that's

another reason that we think home price growth is going to stay fairly moderate is that we've had relatively muted supply response in this boom cycle.

Jake Siewert: So Marty, you're talking to a lot of clients every day about what's going on in the housing market. What's the conversation that you're having with clients today that we haven't talked about yet today?

Marty Young: We've been talking about the household sector broadly in terms of mortgages and then just consumer credit. And we see that the household sector came into 2020 in better shape, for example, than the non-financial corporate sector. You know? The non-financial corporate sector was leveraging, you know, since the 2008 recession, was adding to the debt. Whereas the household, the consumer sector was delevering, was taking down the levels of debt. The mortgage rates that borrowers are paying are a lot lower. There's been less credit card utilization. There is, obviously, no more subprime or no doc mortgages like there were prior to the last cycle. So, we felt that the household sector was coming into this event in pretty decent shape. And then you add to it the fiscal stimulus which has been helpful for the household sector. And as a result, consumers have survived the COVID shock relatively well.

So, if you look at auto loan delinquency rates, credit card delinquency rates, they're actually down year over year, which is not what you would usually see in a recession. And we think that fiscal stimulus is going to be coming again to, you know, give an additional boost to the household sector in 2021.

So, across, you know, the different kinds of risks that investors can take, you know, interest rate risk, corporate credit risk, consumer credit risk, you as you pointed out, we're still in a pretty low yield environment and investors are struggling where they can take risks and earn some amount of yield. And we've been saying that it is reasonable to consider an overweight in consumer, you know, household credit given sort of the strength we've seen and the boost that they're going to be getting from fiscal stimulus this year according to our economists.

Jake Siewert: All right, Marty. Well, thanks so much for that. We'll check back in later this year to see how your scenarios are playing out.

Marty Young: Thank you very much, Jake.

Jake Siewert: That concludes this episode of Exchanges at Goldman Sachs. Thank you very much for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating or a comment.

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