Grant Thornton

APRIL 08, 2021

Risks of Another Housing Bubble:

The Post-Pandemic Housing Outlook

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A surge in demand, unleashed by plummeting mortgage rates and the abrupt shift to working from home combined with years of underbuilding have triggered the strongest home buying and building spree since the bubble of the 2000s. Home prices in suburban and resort areas soared even as apartment rents and condo prices plummeted in what had been some of the hottest urban centers. Properties moved online as fears of contagion escalated. Bidding wars broke out for properties that were never seen, resulting in some buyers' remorse.

Most of the trends we see emerging were already in place and accelerated by the pandemic. Older millennials, who had delayed first-home purchases, finally bought more expensive properties. Many baby boomers and the silent generation decided to age in place instead of downsizing to condos, exacerbating the shortage of homes for sale.

Other trends are new. Institutional investors, who once helped clear the overhang of less expensive, speculative properties in the wake of the housing bubble, returned. They scooped up the cheapest properties to rent instead of sell, reducing the supply of homes available to less affluent, first-time buyers. Bottlenecks triggered by the pandemic, fires and the widespread destruction of timberlands in the Northwest increased the cost of new construction. Immigration, which had been falling since the housing bust, came to a standstill.

This special edition of ***Economic Currents*** focuses on the 2021 housing outlook. Special attention will be paid to the risk that conditions could be stoking another housing price bubble. The return of speculative investors ups the risk that home values could overshoot.

Optimism Tempered by Humility

Overall economic growth is expected to average 6.6% in 2021, the fastest pace since 1984. That follows a 3.5% drop in 2020, the largest contraction since 1946. Rapidly ramping up vaccinations and the one-two punch of easy fiscal and monetary policy are to thank for the optimism. Overall economic activity will easily cross the peak touched in the fourth quarter of 2019 in the second quarter of 2021; that is terrific, but we will still have lost at least a year and half to the crisis.

The words "at least" are important. Employment lags overall economic activity. It will take until 2022 to hit the peak in employment we saw in February 2020; that does not include what might have been. We were generating more than two million jobs a year prior to the crisis, which means we are still down nearly 11 million jobs since the pandemic took hold.

The U.S. is an outlier among its peers and still not out of the woods. Pandemics are by definition global; we haven't even reached herd immunity here. The challenge is harder given the ongoing reticence on vaccines by adults, the lag in safe vaccines for children and the emergence of more dangerous variants. Humility has proven to be more useful than hubris when forecasting the end of the pandemic.

The good news is that homeowners have more equity in their homes than they did during the last housing bubble; this should help cushion them against any future correction in prices. The bad news is that higher prices are crowding out many first-time buyers. This is undermining their ability to build wealth and contributing to overall inequality.

The surge in home prices has added to questions about the Federal Reserve's resolve to allow a full recovery in employment with a modest overshoot in inflation before raising rates. Shelter is the largest single component in determining inflation and plays an outsize role in determining living standards. We are confident that the Fed will wait because the correlation between shelter costs and overall inflation has broken down since the peak of the last housing bubble. Inflation does warrant watching, however, given the infrastructure spending the administration is talking about implementing.

Underlying Fundamentals

The table provides a summary of our outlook for housing. Home buying and building are expected to top 2020 levels this year but remain well below the peak hit during the height of the housing bubble in 2005. Other trends:

Table 1

Housing Outlook

	2019	2020	2021
Home Sales†			
Total (Thousands)	6012	6481	6870
Existing	5327	5658	6000
New	685	823	870
Housing Starts			
Total (Thousands)	1295	1395	1559
Single	893	1000	1168
Multifamily	403	396	391
Prices (% Change, Year End)			
Median Existing Single	8.0	13.2	8.3
S&P Core Logic Case Shiller	3.7	10.4	5.6
FHFA	5.8	11.4	7.5

†Includes condos, co-ops, and single-family homes.

- Lenders have begun to ease credit standards to offset the blow to refinancing activity with more purchase applications in the face of higher mortgage rates.
- Incomes are expected to remain steady as demand for all workers picks up and emergency aid/stimulus checks are replaced by actual paychecks.
- Consumer sentiment is expected to improve as vaccines become ubiquitous, workers can more safely return to work and prospects for the future brighten.
- Inventories are expected to loosen a bit from the record lows we saw at the start of the year, as more existing properties are listed and construction in the pipeline is completed.
- Institutional investors are expected to remain in the market, which will make homes even less affordable for middle-income households in the near term.

Home Sales

Home sales are expected to reach 6.87 million in 2021 with the momentum from 2020 carrying over. Both existing and new home sales will increase as more supply comes on line from sellers and builders. Inventories will continue to be tight but up from the historic lows at the start of this year.

New Homes

New home sales are expected to top 870,000 in 2021, 6% above the pace of 2020 and the highest level since 2006. Supply of new homes remains thin following a decade of underbuilding in the wake of the housing market bubble in the early 2000s.

New homes tend to be priced at the higher end of the market, with the National Association of Home Builders (NAHB) estimating that about 60% of middle-income households are unable to afford the median price for a new home: $349,400. Widespread industry consolidation combined with a shortage of materials (mostly lumber) and a dearth of immigrant labor have pushed prices up.

NAHB estimates that first-time buyers now acccount for 43% of new home sales. That is a huge jump from their last estimate of 32% in 2018.

Affluent older millennials are dominating the first-time home buyer market. Years of stock market gains and falling mortgage rates have separated older millennials, who were able to repair their balances in the wake of the 2008-09 financial crisis, from younger millennials and generation Z. The latter are still lagging in their earnings and wealth generation relative to previous generations.

In February, the backlog of homes sold pre-construction surged 67% from a year earlier, while the inventory of move-in ready homes plummeted. Rising mortgage rates prompted buyers to lock in low rates and wait for their homes to be completed.

Speculative investors are snapping up the least expensive properties to rent instead of sell. Houston, which is one of the most popular markets, has a whole industry devoted to flipping homes to rent. Those investors boost margins for builders but limit opportunities for middle-income buyers.

Existing Homes

Existing home sales are forecast to reach six million in 2021, 6% higher than 2020 and the highest level since 2006. The supply of homes for sale dropped to a record low at the start of 2021. There were a little more than one million homes listed; that's nearly 30% below the level before the pandemic. It was only the second time in more than 100 years that the number of licensed realtors outnumbered property listings.

Supply in the market will expand when more people are vaccinated; that will help older sellers feel comfortable with potential buyers entering their homes.

Lockdowns and the widespread adoption of work-from-home sent buyers flocking to suburban and rural areas. The supply of homes for sale in rural areas has plummeted 44%. Many of those homes were bought by investors to rent as vacation homes to wealthy urbanites.

The average age of homes on the market has increased. The youngest millennials are buying the oldest homes and shouldering the burden of repairs and upgrades.

Housing Construction

Housing starts are expected to hit 1.56 million in 2021, 12% above the 1.4 million pace of 2020. These gains will not be enough to make up for the shortfall in inventories. Starts have been trailing household formation for the better part of a decade, which has left the market grossly undersupplied.

Home builders faced a perfect storm. Consolidation in the materials market constrained capacity, notably in lumber mills. Bottlenecks triggered by the pandemic contributed to delays. Producers idled by lockdowns and surprised by the surge in demand for goods are still playing catch-up.

Labor shortages are chronic. Border closures during the pandemic left builders without the cheap labor they relied upon to build homes. Many of the workers displaced by the pandemic lack the skills to pivot from restaurants to building sites. One estimate suggests that builders need to hire nearly a half million workers, nearly double the pace of prepandemic hiring.

Single-Family

Single-family starts are forecast to rise to 1.17 million in 2021, a 17% increase from 2020. Suburban markets and second-tier cities are expected to see the strongest gains as the push from first-time buyers supplants the demand for vacation homes. Downtown offices will reopen but the return to major cities is expected to slow in response to a hybrid of work-from-home.

The strongest metro markets are expected to remain Austin, Seattle and Raleigh, as the technology and professional services sectors make up a large portion of the growth in employment in these cities. We also should see a nice snapback in tourist destinations such as Orlando, Las Vegas and New Orleans. San Francisco and San Jose are showing signs of coming back. Boston is expected to rebound, while larger and less tech-intensive cities such as New York and Chicago are expected to lag.

Multifamily

Multifamily construction is forecast to come in at 391,000 in 2021, close to the level of the last two years. A drop in construction in the most densely populated urban areas is being mostly offset by a pickup in suburban construction.

A recent study found that most of the loss in demand in densely populated areas was due to a shortfall in in-migration as opposed to a surge in out-migration. Foreign students who were locked out due to border closures couldn't rent or buy near their universities in urban centers. Young graduates moved in with their parents to save on rent and work from home.

Vaccinations and partial office reopenings are bringing young adults back. Rents in the hardest hit markets have bottomed. New York, which suffered the biggest blow to in-migration during the pandemic, posted the strongest month for condo sales in 14 years last month. Many properties are selling at a discount but coming back nonetheless.

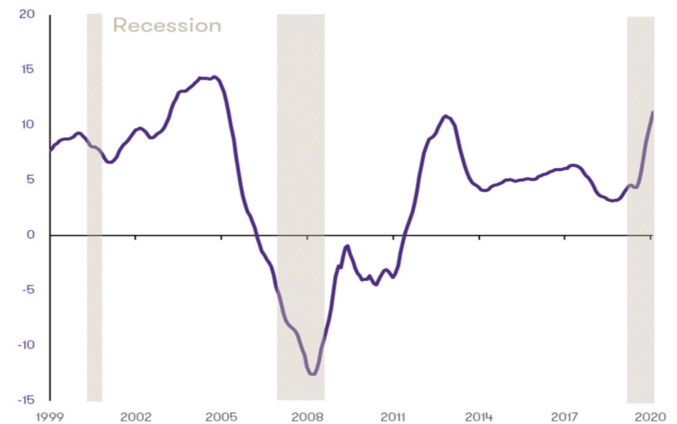
Cities with greater exposure to finance, information and professional services industries will fare better overall than cities with more manufacturing activity. The hottest construction markets are expected to be in the South. Dallas, Austin, Houston and Raleigh continue to attract tech firms and young professionals, while Charlotte, Atlanta, Orlando, Nashville and Miami are attracting finance and consulting firms.

In the West, Phoenix, Salt Lake City and Denver are leading the way. Many fled Silicon Valley early in the pandemic to take advantage of working from home in lower-cost areas. This trend will slow in 2021 but these cities will continue to see interest from younger workers looking for more space and a lower cost of living. Sacramento experienced a surge in Bay Area migrants and will continue to be a strong contender for in-migration in 2021.

In the Midwest, Minneapolis now has more apartment construction coming on line than Chicago. Cities like Columbus and Madison are expected to do better with strong anchors provided by universities and hospitals. We expect Detroit, Cleveland and Pittsburgh to remain laggards.

The latest infrastructure spending proposed by the White House will reduce land use regulations for multifamily properties. If passed, those changes could boost construction of more affordable properties in some of the most expensive markets. (Think California.) The problem is timing. That supply cannot come on line soon enough to stem the rise in rents at the lower end of the market.

Chart 1



Source: Standard & Poor's/Haver Analytics

Home Prices

Home values are forecast to rise between 5.6% and 8.3% in 2021, depending on the measure. That's a slowdown from the double-digit pace of 2020; the least expensive homes experienced the fastest appreciation, as inventories dried up. Housing appreciation has yet to match the frenzied pace of the housing bubble, but risks are to the upside. (See Chart 1.)

New home values have not risen as fast as existing, despite the upward pressure on costs. That could change as investors take a larger share of new construction to rent instead of sell; they accounted for about 20% of new homes sold at the start of the year.

Housing affordability actually improved at the start of the year, but those figures are misleading. (See Chart 2.) The market is driven by more affluent buyers who have the income needed to qualify easily for mortgages. Middle-income households, who once dominated the first-time buyer market, are being pushed out. This is even as lenders are easing credit standards a bit. In response, rents on more affordable apartments and homes are accelerating, making it even harder for those at the bottom of the income strata to make ends meet.

Last, but by no means least, owners have much more equity in their homes than they did during the height of the subprime lending boom. FICO scores were much higher in 2020. That protects banks against losses, should prices turn south.

Chart 2

“Resolute Patience” at the Fed

Federal Reserve Chair Jay Powell and his colleagues have laid out how they will be patient:

- They will hold the line on rates and look through a temporary flare in inflation triggered by bottlenecks.
- They will wait for employment to fully recover what was lost to the pandemic and then some.
- They would welcome a modest, persistent overshoot in inflation to achieve a broader recovery in employment.

Most participants at the March Federal Open Market Committee (FOMC) meeting expect to hold off on rate hikes until at least 2024. That has provided little solace for the bond market, which expects rate hikes to begin in 2022. This wouldn’t be the first time the bond market has forecast rate hikes that never materialized.

The relationship between rising home values and inflation has broken down over the last three decades. Lower mortgage rates, easier lending standards and refinancing activity have dampened the effect that higher prices have on monthly expenses.

The larger issue for the Fed is how long it takes for wages to accelerate. It took nearly a decade, a drop in the unemployment rate to 3.5% and a slow increase in labor force participation to get there during the last expansion.

Why do we care about wage gains? Because accelerating inflation doesn’t stick unless those gains are backed up by wages. The loss of worker bargaining power has made that difficult. Even wage gains tied to productivity growth have proven elusive in recent years. Much of the acceleration in wages tied to new technologies has been limited to the firms that produced them; they never made it into overall wage gains.

We now expect the first hike in rates to occur in late 2023 instead of early 2024, a little sooner than the Fed. Our forecast does not include any additional stimulus tied to the administration’s new infrastructure proposal; if passed that could move the timing of the first rate hike up to Spring of 2023.

Bottom Line

The housing market has come to embody the best and worst of the COVID recovery. Those who were able to work from home experienced a stronger recovery in employment. They saw their stock portfolios soar and, when mortgage rates dropped, they seized the opportunity. They upgraded what they had, bought first homes, vacation retreats and everything they could to fill them.

First-time buyers returned, inventories plummeted and home prices accelerated. The market remains affordable for the well-to-do, while low- and middle-income households struggle.

Affluent first-time buyers and speculators will be driving market gains in 2021. Those gains will provide younger, less affluent buyers with homes to rent, but not own.

Housing prices will continue to rise, but the wealth tied to the ownership of those homes will not be shared as much as it once was. What we are seeing is not a typical bubble, but still troubling; it is preventing many young buyers from climbing the ladder of wealth accumulation built by home ownership. Wealth inequalities will worsen.

Economic forecast — April 2021

	2020	2021	2022	2020:4 (A)	2021:1 (A)	2021:2	2021:3	2021:4	2022:1	2022:2	2022:3	2022:4
National Outlook												
Chain-Weight GDP[1]	-3.5	6.6	4.3	4.3	5.6	9.5	8.5	5.1	3.8	2.0	1.9	1.9
Personal Consumption	-3.9	7.5	5.0	2.3	9.6	8.8	6.9	6.0	4.8	3.7	3.2	3.2
Business Fixed Investment	-4.0	8.0	6.6	13.1	6.9	6.6	12.2	8.4	6.7	4.3	3.7	4.2
Residential Investment	6.1	12.0	-5.8	36.6	9.5	3.8	-2.1	-5.1	-8.0	-8.1	-7.0	-6.6
Inventory Investment	-77	88	179	62.1	-69.6	28.2	173.6	220.6	220.2	199.5	164.2	130.3
Net Exports (bil $ '12)	-926	-1260	-1323	-1122.0	-1189.0	-1245.8	-1283.4	-1320.2	-1327.8	-1328.1	-1322.2	-1315.4
Exports	-12.9	6.3	7.5	22.3	0.7	9.3	7.8	8.5	7.6	6.8	6.3	5.7
Imports	-9.3	15.0	6.6	29.9	8.6	13.1	9.5	9.7	5.7	4.4	3.5	3.0
Government Expenditures	1.1	2.8	0.0	-0.8	8.5	7.7	0.0	-0.6	0.7	-2.2	-0.1	-0.6
Federal	4.3	2.7	-2.1	-0.9	22.3	-9.3	-3.4	-1.7	-1.4	-1.0	-0.4	-1.6
State and Local	-0.8	2.9	1.4	-0.8	0.3	20.4	2.2	0.0	2.0	-3.0	0.1	0.0
Final Sales	-2.9	5.8	3.8	2.9	8.2	7.5	5.6	4.3	3.9	2.4	2.5	2.5
Inflation												
GDP Deflator	1.1	2.3	2.1	2.0	3.7	1.7	2.0	2.3	2.0	2.0	2.3	2.3
CPI	1.3	2.4	1.6	2.5	3.4	1.8	1.8	1.7	1.4	1.4	1.6	2.1
Core CPI	1.7	1.7	2.0	1.8	0.9	1.6	1.9	2.2	1.9	2.2	2.0	2.3
Special Indicators												
Corporate Profits[2]	-0.7	11.0	1.8	-0.7	18.8	41.8	12.3	11.0	7.2	0.1	-0.7	1.8
Disposable Personal Income	5.8	3.5	-1.4	-10.1	64.2	-27.8	-5.7	-3.5	4.3	3.1	2.8	1.8
Housing Starts (mil.)	1.39	1.56	1.39	1.58	1.54	1.61	1.57	1.52	1.46	1.41	1.36	1.32
Civilian Unemployment Rate	8.1	5.1	3.6	6.7	6.2	5.4	4.6	4.1	3.8	3.6	3.5	3.5
Total Nonfarm Payrolls (thous.)[3]	-7293	6397	596	1897	902	2673	1758	1064	769	668	529	418
Vehicle Sales												
Automobile Sales (mil.)	3.5	3.8	3.8	3.9	3.9	3.8	3.7	3.7	3.7	3.7	3.8	3.8
Domestic	2.5	2.6	2.5	2.8	2.6	2.6	2.5	2.5	2.5	2.5	2.5	2.5
Imports	1.0	1.2	1.3	1.1	1.3	1.2	1.2	1.2	1.2	1.2	1.3	1.3
Lt. Trucks (mil.)	10.5	12.9	12.9	12.3	13.1	13.0	12.8	12.8	12.9	12.9	12.9	12.8
Domestic	8.6	10.1	10.0	9.6	10.3	10.2	10.0	10.0	10.1	10.0	10.0	9.9
Imports	2.4	2.8	2.9	2.7	2.8	2.8	2.8	2.8	2.8	2.9	2.9	2.9
Combined Auto/Lt.Truck	14.0	16.7	16.6	16.2	17.0	16.8	16.5	16.5	16.6	16.6	16.7	16.6
Heavy Truck Sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.5
Total Vehicles (mil.)	14.4	17.2	17.1	16.7	17.5	17.3	17.0	17.0	17.0	17.0	17.1	17.1
Interest Rate/Yields												
Federal Funds	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note	0.9	1.7	2.1	0.9	1.3	1.7	1.9	2.0	2.0	2.1	2.1	2.1
Corporate Bond BAA	3.7	3.9	4.2	3.4	3.5	3.8	4.0	4.1	4.2	4.2	4.3	4.3
Exchange Rates												
Dollar/Euro	1.13	1.18	1.19	1.19	1.21	1.20	1.21	1.22	1.22	1.23	1.23	1.24
Yen/Dollar	106.8	111.5	112.5	104.5	106.2	111.0	114.0	115.0	114.0	113.0	112.0	111.0

1. in 2020, GDP was $18.4 trillion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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