Why an Economic Downturn or even Mild Recession Won't Stop the Homebuilding Industry

By Tom Reiser

First, let's talk about the elephant in the room: mortgage rates. Everyone is talking about rising mortgage rates as an existential threat to the home buying industry – whether it's a resale home or a new home.

No doubt the increase of two to three points from historic mortgage rate lows is reducing home-buying power for some, but in the current climate, we view the market as increasingly bifurcated, as people, families and especially couples with dual incomes can afford the delta in monthly payments. It's the first-time entry-level home buyers will have to do what most of us did when we were younger to buy our first homes, and namely wait a little longer while using the traditional remedies of save more, spend less, borrow from family and friends if possible.

Yet the point that no one is talking about is an ongoing supply-constrained market that may actually get worse, beyond the obvious that homebuilders cannot keep up with demand.

The reason supply in the resale market may get worse in the next few years is the number of ultra-low mortgages that were refinanced at or near the bottom in late 2021. I personally have friends with 30-year fixed mortgages at 2.65, 2.75, 2.85 and even some considerable jumbo loans in the low-3s. While these folks should pinch themselves for their good fortune and excellent timing, the vast majority of them will not sell their homes anytime soon, because they can't – either intellectually or psychologically. Even if income is no issue, the intellectual exercise of paying twice as much for a comparable home is a high hurdle. Remember, in home buying it's not the cost of the home—it's the cost of the money.

While we are on the subject of mortgage rates, let's put in perspective how relatively low mortgage rates still are, and will be, even after the Fed added another 75 basis-points Federal Funds rate increase in late July, and probably another one later this year, to tame current inflation.

Mortgage rate trends over time (Source: Freddie Mac)

For some perspective on today's mortgage interest rates, here's how average 30-year rates have changed from year to year over the past five decades.

1974 to 1983 (10 years) = 11.64%

1984 to 1993 (10 years) = 10.24%

1994 to 2003 (10 years) = 7.35%

2004 to 2013 (10 years) = 5.23%

2014 to 2021 (8 years) = 3.76%

Let's face it, home borrowers have been spoiled during the last decade. Yet even when rates were higher, homes sold, they were financed and refinance, and homebuilders built and sold new residential communities.

The Fed Funds Rate and Mortgage Rates

As far as we know, there is no clearly defined delta between the Fed Funds Rate, or the target interest rate set by the Federal Open Market Committee (FOMC) that sets the rates that banks charge each other for intra-bank loans and related credit facilities, and retail mortgage rates. However, historically speaking, the difference ranges from around 2% to 4%. In 2000, for example, when the average 30-year fixed conforming mortgage was 8.05%, the Fed Funds Rate moved around from 5.61% in early January of that year to 6.53% in the fourth quarter. In 2004, when the new home sales market was as good as it has ever been and the average mortgage rates was 5.84%, the Fed Funds Rate floated around 1.00%.

Fast forward to the decade from 2010 to 2020 and before the pandemic, and as the main vehicle for restarting the economy after the Great Financial Crisis, Fed Funds Rates went from the low 2%s to 1.09% in early March, 2020, just before the pandemic was declared. During that span, retail mortgage rates bounced around below 5% and down to the low 3%s. In recent years the Fed Funds Rate has hovered near zero.

With the markets now predicting a Fed Funds at or near of 3.5% by December, based on historical data, we can expect retail mortgage rates to climb from the current mid-5%s to a range from 7% to 8%. It will certainly be enough to cool the hottest housing market we've experienced in this lifetime, but it won't kill it.

And here's why.

Millennials are surpassing baby boomers in terms of demographic dominance, and they are in their prime for family formation and home buying. They are forming families. They are and will buy homes.

Cities are losing population for the suburbs. Whether it's remote work or lifestyle choices, smaller cities and suburbs have grown since the onset of the pandemic. Price appreciation has stalled or stopped in most of the growth markets of the last two years (Boise, Tampa, etc.), but the sky isn't falling.

In California alone, new construction barely covers the 180,000 new units the state says are needed each year to close the demand/supply deficit. Phoenix is adding roughly 100,000 new residents a year. Builders can't keep up with that demand.

Moreover, it takes builders a long time to deliver a new home community. From planning to assembling the equity and debt, buying the land – and especially if the land has to be assembled by negotiating with multiple owners and sellers, to actually constructing the homes and selling them in phases. You can't turn a freighter around in a small bay.

Since the Great Recession, there is a cumulative shortage of 1.35 million single-family homes permitted in the 35 largest U.S. housing markets. That is 2.7 years' worth of permits at the rate of homebuilding at the end of 2021.

It’s true, the homebuilding industry is cyclical, yet I just don’t see a complete unraveling of the homebuilding market.

The expansion of home construction in the early 2000s was unprecedented in its duration, which started late in1996 and ran until the December 2007 bust. Even with the robust building activity since 2019, homebuilders are only close to reaching par from the previous boom-building cycle of the early 2000s.

While the housing run up in the post dot.com period from 2002 to 2007 did lead to a severe housing crash, the culprit in that recession was banks, bank regulators and the total lack of discipline in substantiating incomes in loan documents. Not to mention Wall Street’s practice of bundling the future, underperforming loans into investment vehicles called CMBS loans. This isn’t happening at this point in time, nor is rampant unemployment, and high unemployment does kill the housing industry.

It is often said “there is a first time for everything.” I am not going to argue with that. However, even with mortgage rates a couple points higher than they are now, bank lending practices as of late have been prudent and bank balance sheets are solid, demand exceeds supply and people have jobs. In my nearly four decades in selling new residential communities, I’ve never seen a housing crash when these stars were aligned.

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