Real Estate is Booming. Is a Bust Ahead?

Anyone looking to buy or sell a home lately has probably been hit by sticker shock. Residential real estate prices have gone through the roof, increasing at rates unseen since 2005. According to S&P Case-Shiller, home prices in March saw their highest annual rate of growth in over 15 years -- up 13.2% from a year earlier, following a 12.0% annual gain in February. Some markets -- most notably Phoenix, San Diego, and Seattle -- saw gains of 18% to 20%.[1] What's more, the median price of a new home sold in April was $372,400, up 20.1% from a year earlier, the strongest annual gain since 1988.[2]

Bidding wars are now common, and in some neighborhoods, competition is so fierce that many homes are sold before they even hit the market. According to Zillow, nearly half of the people who sold homes in April accepted an offer within a week.[3]

What's Behind the Surge

Several different factors are driving the frenzy. For one, mortgage rates remain historically low. Although they have crept up some since their all-time low in January, the rate on a 30-year conventional mortgage was just 2.93% as of June 27.[4] That means that anyone looking to spend a fixed amount per month on a mortgage can now afford much more house than they could a few years ago.

There are also demographic factors at work. Millennials, who, as a group, have long shunned buying in favor of renting, are now entering the market in force. COVID-19 and the prospect of long-term telecommuting have encouraged many to move from urban apartments to suburban homes. Many others are transitioning into larger homes to accommodate families.

Perhaps the biggest reason for the current spike in prices is supply -- or lack thereof. The inventory of new houses has been sharply constricted by a widespread lumber shortage, along with shortages of kitchen appliances and other building supplies, such as copper and PVC pipe. Transportation logjams, brought on in part by COVID lockdowns and business closures, continue to impact new home construction. This has put pressure on the overall inventory of existing homes as well, as would-be buyers of new homes opt for existing homes instead. Although existing home sales are up year-to-date, they dropped in April for the third consecutive month, according to the National Association of Realtors.[5]

Will it continue?

Although the current supply shortage shows no signs of abating, over time, the bottlenecks will likely work their way out, as the post-COVID economy kicks into gear. Price appreciation is unlikely to continue at its current heady pace, but most real estate analysts do not foresee any major price drop, as happened back in 2006 to 2012 when overbuilding and lax lending standards posed more fundamental issues. The bigger concern may be mortgage rates. Average rates remain below 3%, but that could change if inflation prompts the Federal Reserve to raise interest rates. The Fed has indicated that it intends to hold rates steady for the time being, but should inflation continue at its recently reported level of over 4%, it will likely take action. Should that happen, mortgage rates would rise and property demand would cool down.

So stay tuned, but be prepared for more of the same in the immediate future.

Notes:

[1]S&P Dow Jones Indices, *S&P Corelogic Case-Shiller Index Shows Annual Home Price Gains Climbed to 13.2% in March*, May, 25, 20121.
[2]Source: Wall Street Journal, *U.S. Home-Price Growth Surges as Demand Overwhelms Supply*, May 25, 2021, based on figures released by the Commerce Department.
[3]Source: NBC News, *It's a red-hot real estate market — so why are home sales plunging?*, May 22, 2021
[4]Source: *Freddie Mac*, as of June 17, 2021.

Footnotes/Disclaimers/Disclosures