THE ADVISORY

IMPACT OF THE NEXT RECESSION
On Residential Real Estate Markets

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RCLCO
REAL ESTATE ADVISORS

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May 2, 2019 | Gregg Logan, Managing Director, and Sean Thompson, Associate

In this issue of the Advisory we address the vulnerability of for-sale housing markets to the next recession in terms of the likely impacts on pricing and volume, as well as on development and investment strategies generally. **Without minimizing the real need to adapt to changing economic circumstances, it's important to remember that while the last recession had a paralyzing impact on housing, we can't let that overshadow the fact that other recessions have had much more modest impacts.** Given the many differences between the housing market of 2008 and today, few analysts expect the next recession to have similarly devastating impacts. Nonetheless, it's important to consider how severe the next recession is likely to be, and to prepare for the most likely impacts.

THE NEXT RECESSION

The technical definition of a recession is two consecutive quarters of negative economic growth as measured by GDP, although the National Bureau of Economic Research (NBER) takes other factors into account in calling recessions. As the Danish philosopher Soren Kierkegaard observed, "Life can only be understood backwards, but it must be lived forwards." The same is true of recessions.

The precise timing of the next recession is unknown, but given the length of the current economic expansion, we know we're closer to it now than we were a year ago. RCLCO's latest biannual Sentiment Survey published in January, and more recently the *Wall Street Journal's* Economic Forecasting Survey of more than 60 economists both suggest the risk of a recession in the near term is moderate, but many economists are still predicting a recession by 2021. Recession fears were higher at the end of 2018 due to concerns about the potential of trade disputes negatively affecting the economy and the Federal Reserve's intention to continue raising rates. Beginning in Q2 of 2015 the Federal Reserve began increasing the federal funds rate in modest intervals and raised the rate four times in 2018 to 2.50%. Financial markets priced in future interest rate increased until recently when the Federal Reserve changed their messaging, indicating they would pause their rate hiking due to some possible economic softness. This has led some pundits to suggest that while the economy may have been headed into recession, that has now been avoided. Given the history of economic cycles that seems unlikely, though the timing may have been altered.

SUMMARY

The risk of a recession in the near term is moderate, but many economists are still predicting a recession by 2021.

New home sales volume, and single-family and multifamily permits, all fell in the last six recessions. On average, new home sales declined by 9.6%, though the range across recessions is broad, from 3.5% to over 13% prior to 2008, and a whopping 66.2% in the Great Recession.

We believe the next recession will have moderate impacts on for-sale residential real estate, because:

» Current months of supply is just six months, compared with 12.2 months of supply in January 2009. Sales of new single-family houses rose in March 2019 to a seasonally adjusted annual rate of 692,000.

» The economy is strong, unemployment is low, and though real incomes for most households have been flat for too long, we are currently seeing wage growth.

» The signs of slowing that we have seen in the housing market on and off over the last year appear to be more a function of high prices than of low demand.

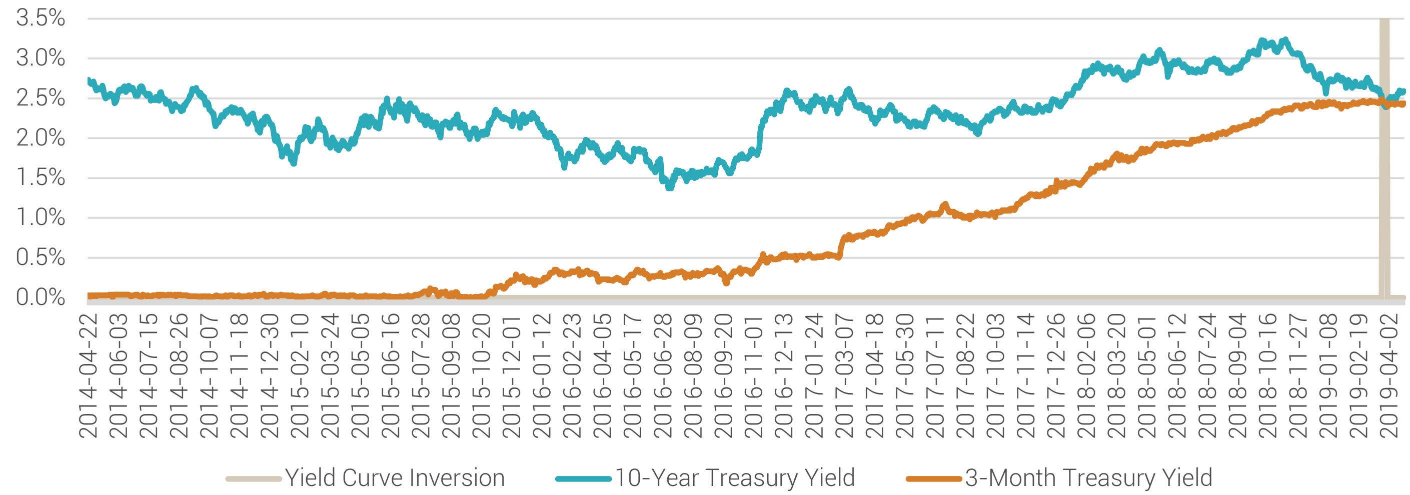
» The homebuilding industry appears to be making adjustments, albeit late in the cycle, to address the demand for smaller and more attainably priced housing.

» Millennials are a huge generation that have entered the for-sale housing market fairly recently and already account for 37% of all home sales (new and resale).

» Retiring boomer households remain a significant force in the housing market as they seek that last best house that suits this next phase of their lives.

Rising mortgage interest rates could slow down the market, as we saw in 2018. However, rates dropped again in March, and though increasing at a moderate pace, remain at historically low levels.

Figure 1: Yield Curve; 10-Year and 3-Month Maturities

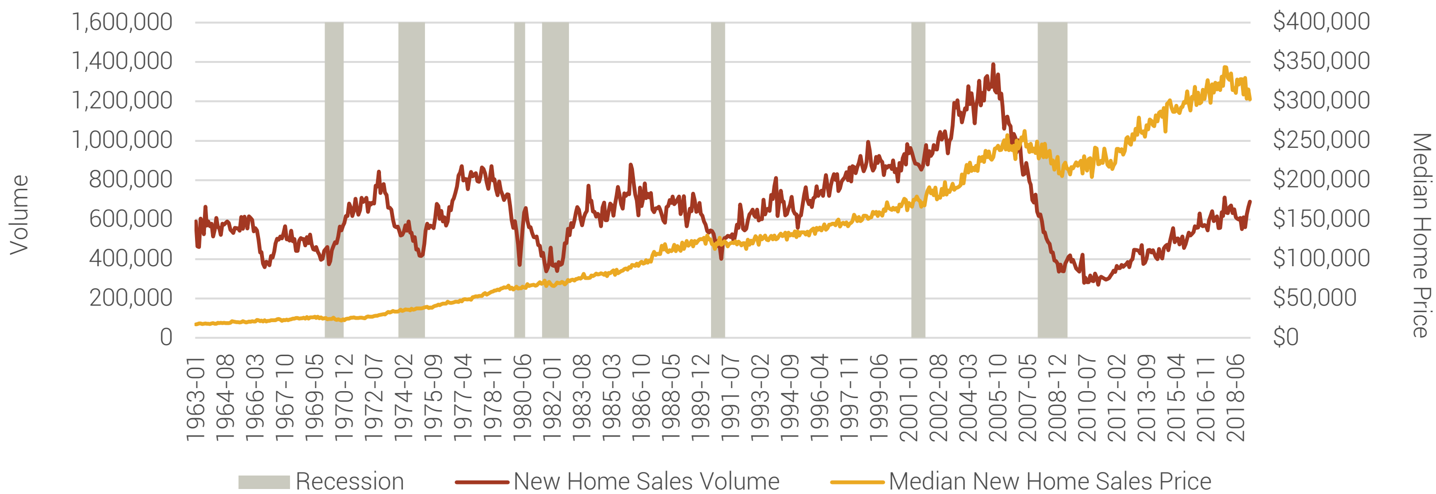


Source: Federal Reserve Bank of St. Louis

The pause in the federal rate-hiking cycle was followed in mid-March by a yield-curve inversion, as shown in Figure 1. The 10-year Treasury bond yield briefly traded below the 3-month Treasury bond yield, which has historically been a reliable predictor of a coming recession within one to two years. In the most recent *Wall Street Journal* Economic Forecasting Survey, 49% said they thought the next recession would arrive in 2020, 40.4% said 2021, and the rest said anywhere from 2022 to 2025. Respondents to RCLCO's Sentiment Survey in December 2018 said they expected the market for all real estate product types to be worse a year from now than currently, with a majority of respondents predicting resort/second home, retail, for-sale housing, and land to be in a downturn by then. Of course, that was followed by the GDP increasing at a rate of 3.2% in the first quarter of 2019 based on preliminary figures, compared with 2.2% in the same period last year.

George Santayana famously wrote that "Those who cannot remember the past are condemned to repeat it." With that in mind, it's useful to look at past recessions and their influence on new home sales pricing and volume. As shown on Figure 2 below, while other recessions had moderate impacts on pricing and more significant influences on volume, the Great Recession stands out for its more severe effects.

Figure 2: Historical Median New Home Sales Price and New Home Sales Volume



Source: Federal Reserve Bank of St. Louis

It's instructive to look back at past recessions relative to causes and severity, to understand why the next recession is likely to be mild. Figure 3 below is a brief synopsis of recessions since the 1970s. More often than not, recessionary periods were brought on by rising interest rates, or external shocks such as an oil crisis. In two of the past recessions of the recent era, in 2001 and 2008, recessions were brought on at least in part by speculation. **New home sales volume, and single-family and multifamily permits, fell in the last six recessions. On average, new home sales declined by 9.6%, though the range across recessions is broad, from 3.5% to over 13% prior to 2008, and a whopping 66.2% in the Great Recession.** Excluding the Great Recession, new home sales pricing has been less affected, with prices staying basically flat or continuing to increase. Median new home prices are more likely to moderate now due to the need to bring to market more attainably priced housing, and larger inventories at the higher end of the pricing spectrum.

Figure 3: Past Recessions and Residential Real Estate Effects[1]

RECESSION	CHANGE IN GDP	CHANGE IN NEW HOME MEDIAN SALES PRICE [1]	CHANGE IN NEW HOME SALES VOLUME [1]	SINGLE-FAMILY PERMIT ISSUANCE [1]	MULTI-FAMILY PERMIT ISSUANCE [1]	CHANGE IN MORTGAGE INTEREST RATES	SEVERITY AND CAUSES
1969-1970	-1.10%	-6.00%	-3.50%	-5.00%	-15.00%	NA	Mild; coincided with fiscal tightening and Federal Reserve raising interest rates
1973-1975	-2.50%	7.50%	-10.60%	-24.90%	-40.00%	1.10%	Deep; Significant period of economic stagnation caused by oil crisis and fall of the Bretton Woods system
1980	-2.20%	4.40%	-5.90%	-4.20%	-8.60%	-0.70%	Mild; Federal Reserve raised interest rates, seeking to thwart high inflation which had increased to 7.7%
1981-1983	-2.60%	1.30%	-13.00%	-11.00%	-7.30%	-3.80%	Deep; Iranian revolution caused a spike in oil prices; Federal Reserve tight monetary policies
1990-1991	-1.40%	-0.70%	-11.60%	-7.30%	-17.30%	-0.70%	Mild; Inflation began to grow, the Federal Reserve raised interest rates, weakening growth; high oil prices contributed
2001	-0.40%	3.00%	-13.20%	-3.50%	-5.40%	-0.80%	Brief and shallow recession following the collapse of the Dot.Com bubble and September 11 attack
2008-2009	-4.00%	-16.70%	-66.20%	-63.60%	-61.10%	-1.70%	Worst since the 1930's; Subprime lending and housing speculation

Source: RCLCO

In each case, the timing and impact of the recession on residential real estate depended on the economic and political circumstances of the particular time period. Excluding the last recession (2008), previous recessions were often brought on by the Federal Reserve raising interest rates in order to combat inflation, which limits liquidity and reduces spending. There have also been unique events and circumstances, such as the bursting of the Dot.Com bubble, that led us into economic declines.

Housing market conditions are quite different today than they were preceding the last recession. In the years leading up to the Great Recession, Wall Street expanded into mortgage lending, a large portion of which was the packaging of subprime loans. This, along with investors believing that residential real estate would never decline in value, led to considerable housing oversupply and rapid home price increases. When home prices started declining, many subprime borrowers defaulted, leading to problems with mortgage backed securities that in turn fed a broader crisis across financial markets. Today, although rising prices and mortgage rates have contributed to the long-term trend of declining housing affordability, the housing market is not only not oversupplied, but in many areas, such as

1 Change in New Home Sales Pricing, New Home Sales Volume, and Single-Family and Multi-Family Permit issuance shows the change in demand in the initial year of the associated recession.

California, it is undersupplied. It's highly unlikely that the next recession will be led by the housing market. Nonetheless, it's important to consider the potential for short-term declines in permitting and new home sales.

What will lead to a recession this time is of course unpredictable, but there are areas of concern despite the apparently strong job market. These include uncertainty associated with U.S. trade policy, which could lead to higher prices and resultant reduced employment; high levels of income inequality that could diminish spending by the broader population; the volatile and highly partisan political environment; government policies domestically and abroad; and an unforeseen or overlooked event or structural weakness. We don't know when the next recession will arrive or what will cause it, but only that we're nearer to one now than last year, and that many economists expect a recession will begin in the next few years.

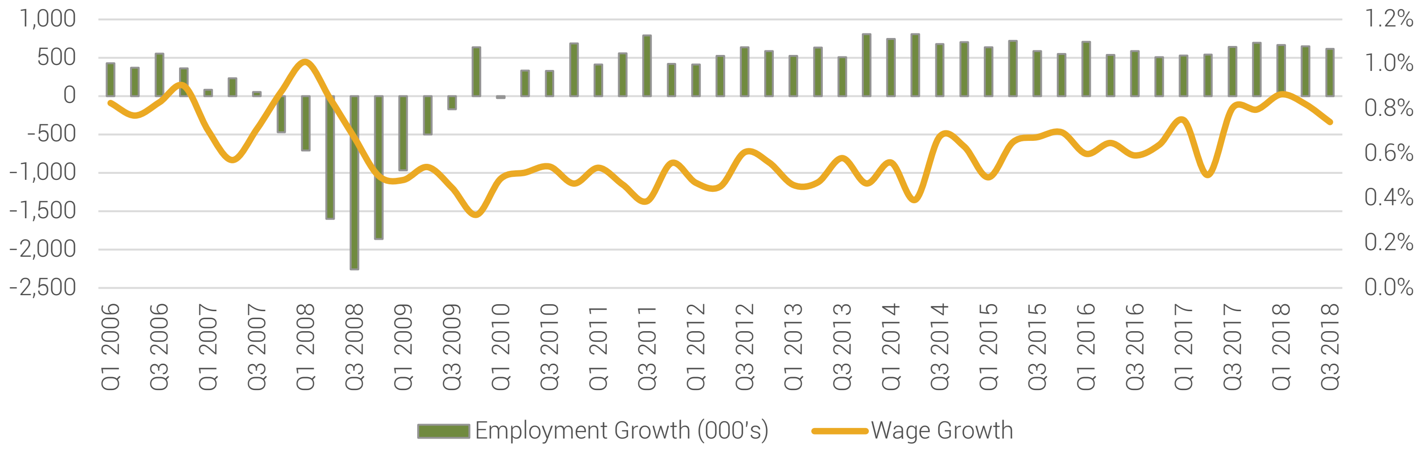
Before we opine on the likely impacts of the next recession, it's important to take stock of where we are now—the context for the next recession. **We are currently experiencing trends typical of late real estate cycle behavior, such as high material and labor costs, rising prices, and, until recently, rising interest rates. It's important to note that although the Fed had been raising rates, overall the Federal Funds rate remains at historically low levels. Mortgage rates had been similarly rising, peaking at 4.62% in early March, and then falling to 4.17% by late March. Now they are inching up again, but they also remain at relatively low historical levels.**

Labor slack in the economy overall is likely nearing its end, with the economy near full employment, causing wage growth to begin picking up. Inflation has begun to reach the Federal Reserve's inflation target, averaging about 2% in 2018.

Recessions typically contribute to falling demand, which leads to at least temporarily lower transaction volumes and sometimes lower home prices. The major drivers of strong housing demand are new household formations, growth in employment, and wage growth. **Although the climb out of the Great Recession was gradual, the economy has produced over 21 million jobs since the beginning of the recovery in 2010, and the unemployment rate remains at historical lows.** As shown on Figure 4, average nonfarm payrolls increased approximately 215,000 jobs per month between 2014 and 2018, and this trend has continued into 2019, though there are some recent signs of slowing in some sectors such as manufacturing, particularly among industries hit by tariffs imposed by other countries in response to those implemented by the U.S. Job growth in professional and business services, and health care, remain strong.

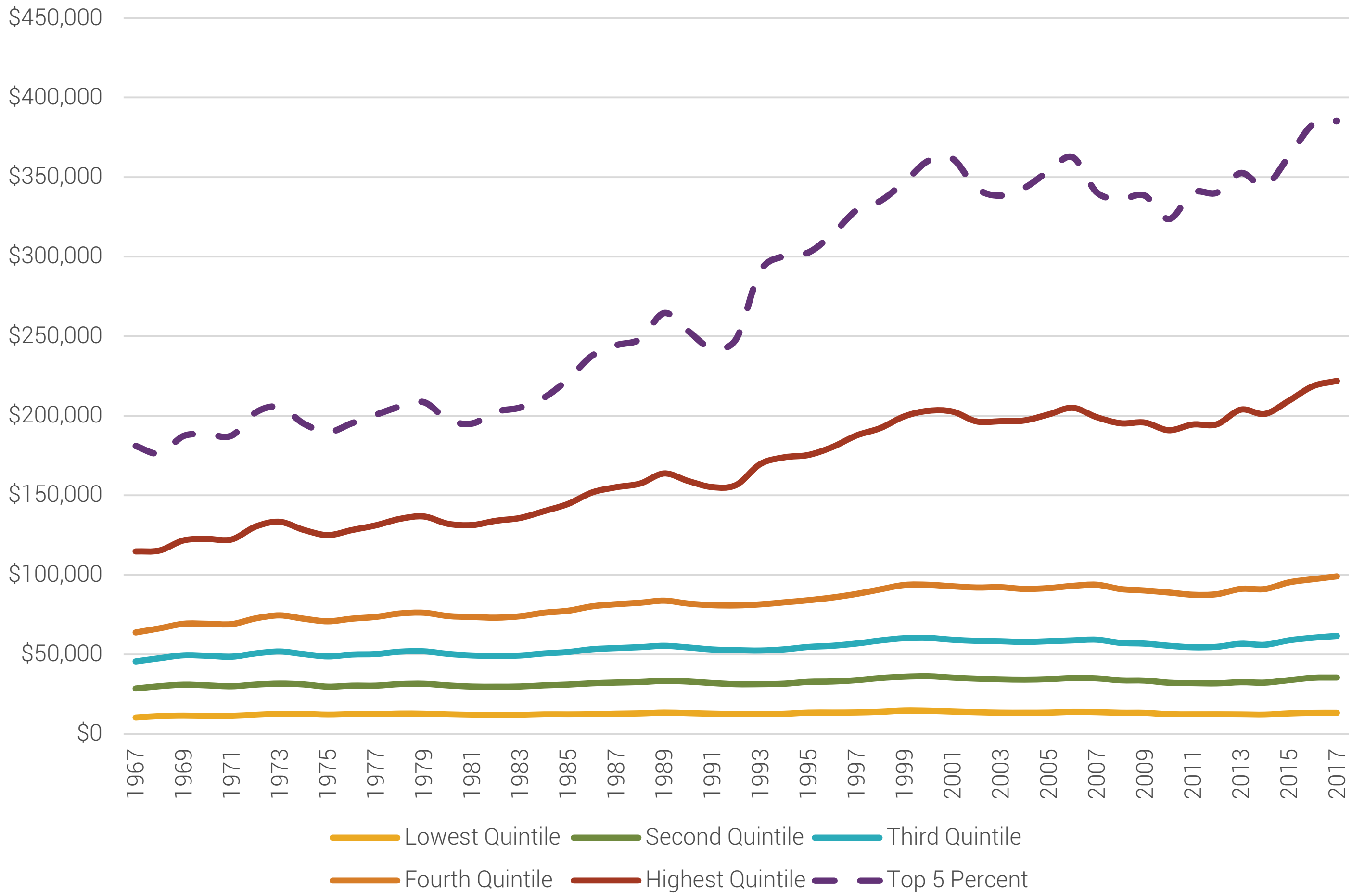
Wage growth is similarly important in a consumer economy like ours, and with low unemployment and increasing labor force participation rates, wages have posted stronger gains. However, as shown on Figure 5, longer-term structural issues remain. The growing gap in earnings between the country's most affluent households and the rest of the country persists and will continue to influence consumer spending on all products, including housing.

Figure 4: Nonfarm Payroll Employment Growth and Wage Growth



Source: Federal Reserve Bank of St. Louis

Figure 5: Real Incomes by Quintile

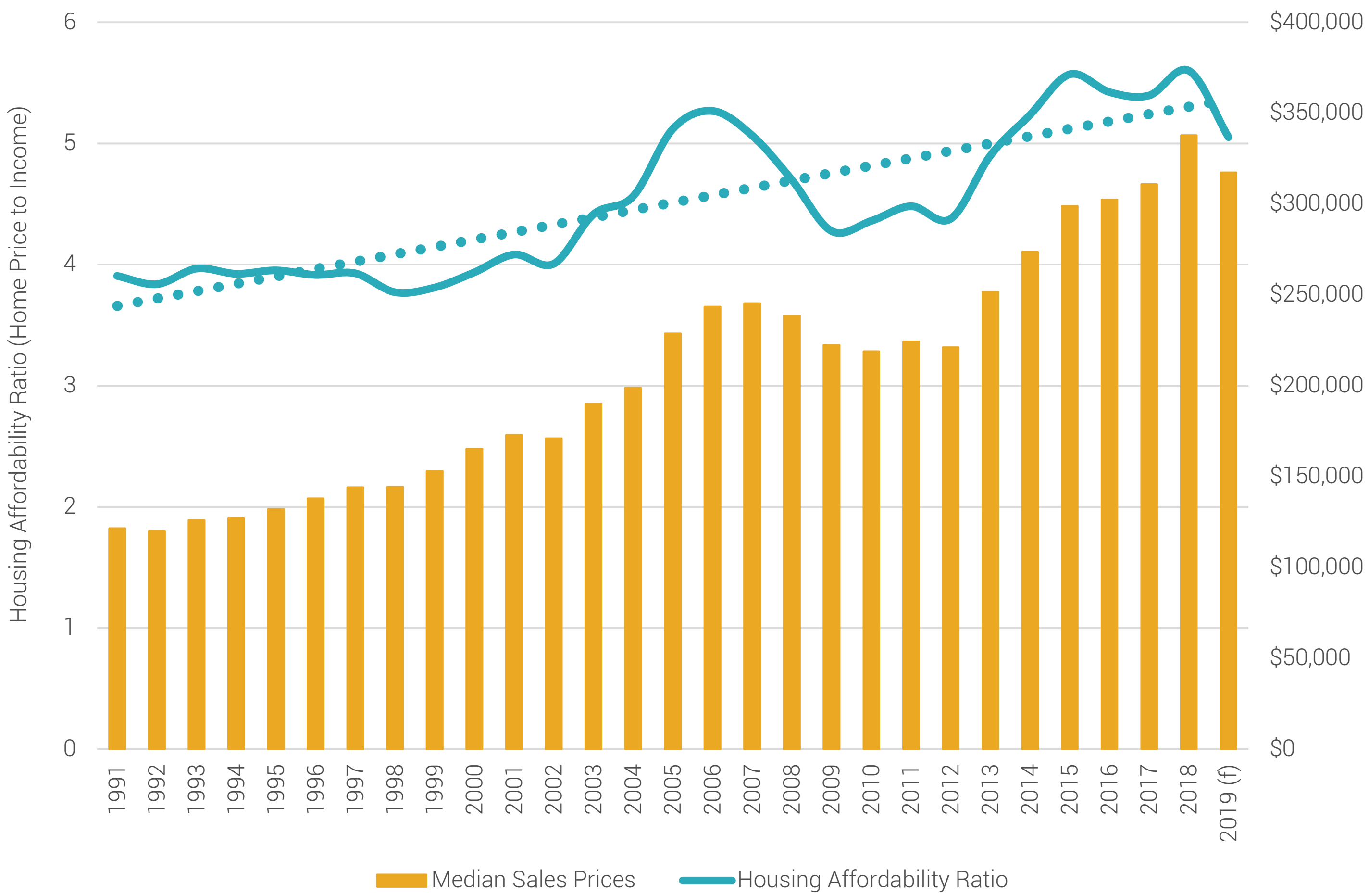


Source: U.S. Census Bureau

NEXT RECESSION'S LIKELY IMPACTS

The pace of new home sales as of March 2019, an annualized sales pace of 692,000, represents a 16-month high. Median sales prices increased consistently between 2011 and 2018, but actually decreased 9.7% from March 2018 to March 2019, suggesting that builders may be attempting to adjust their mix to include more attainably priced options (Figure 6). This could indicate an improvement in the affordability ratio for new homes—the median new home price divided by the median income. New home prices have been rising faster than incomes for years, and housing affordability is one of the most challenging issues affecting the housing industry and new home consumers. This short-term but important change in the affordability ratio, if it can be sustained, is positive context for the new home market and could help to mitigate the severity of the impact of the next recession on housing. **In the run-up to the 2008 recession, median new home prices increased 43%; median new home prices in March 2019 were up 35% from March 2010, although median new home prices were higher in March 2017 and March 2018.**

Figure 6: Housing Affordability Ratio



Source: Federal Reserve Bank of St. Louis

We believe the following factors will contribute to a moderate impact of the next recession on for-sale housing:

1. Prices are high relative to incomes, but there is no oversupply except perhaps at the very high end in some market areas. The years preceding the last recession were characterized by an overheated housing market, and that contributed to the severity of the recession's impact on the economy overall and housing in particular. Housing volume has not recovered to the same levels of production as in the years preceding the last recession, particularly for more attainably priced housing (e.g., homes priced below $300,000 accounted for 61% of home sales just five years ago but only 44% in 2018). Recently, builders do seem to be attempting to shift more of their mix towards the more moderate end of the price spectrum. **Meanwhile, current supply is just six months, hardly representative of substantial oversupply, when compared with 11.6 months of supply heading into the 1980 recession or the 12.2 months of supply in January 2009.** Sales of new single-family houses in March 2019 were at a seasonally adjusted annual rate of 692,000, according to estimates released by the U.S. Census Bureau and the Department of Housing and Urban Development. This is 4.5% stronger than the annual rate a month earlier, in February.

2. **The economy is strong, unemployment is low, and though real incomes for most households have been flat for too long, we are currently seeing positive wage growth.** The signs of slowing that we have seen in the housing market appear to be more a function of high prices than low demand. Housing is a basic need, and, as in past recessions, consumers will continue to buy, although they will likely seek more moderately priced housing. The homebuilding industry appears to be making adjustments, albeit late in the cycle, to address the demand for smaller and more attainably priced housing. A big increase in the unemployment rate could negatively impact demand, but the current low unemployment levels suggest that's not likely.

3. Millennials are a huge generation that have entered the for-sale housing market fairly recently and already account for 37% of all home sales (new and resale). **The demographics of households aging into their mid-30s and 40s is strong and will create strong underlying demand for homes for the next several decades.** While millennials will maintain strong housing demand, their lower ability to afford expensive homes, particularly among minority households, will put downward pressure on prices. In some past recessions, particularly the Great Recession, prices have been substantially impacted. But that's not true of most recessions, as shown above.

4. **Retiring boomer households remain a significant force in the housing market as they seek that last best house that suits this next phase of their lives.** We're early in the boomer retirement wave, and that will continue to create strong demand for new housing, provided they can continue to convince millennials coming into the market to buy their older existing homes. So far, despite warnings to the contrary, this does not appear to be a significant issue, but it is something to keep track of. Boomers are net sellers, while millennials are net buyers. Some have speculated that millennials won't want the big boomer homes in the suburbs. But many millennials are behaving more like boomers once they settle down and get married and contemplate having children. In the meantime, affluent boomers, with their substantial home equity, will continue to drive a share of new home demand. They are currently 32% of the buyers for all homes (new and resale).

5. Rising interest rates could slow down the market, as we saw in 2018. **However, the Fed has recently signaled that it is putting rate hikes on hold, so that is not a likely scenario for leading housing into a downturn anytime soon.** When a recession hits, the Fed's response will most likely be to lower rates.

For these reasons and others, we believe the current for-sale housing market appears strong enough to get through the next recession with only moderate impacts on new home sales volume, and pricing will be more affected by the already present need for greater price and product diversity to address affordability than it will be by the recession itself. Of course, there are some wild cards to consider that could influence the depth and duration of the recession. The predicted timing of the next recession coincides with the next presidential election. How will politics play into the policy decision-making on either side of the aisle? Another wild card is the degree of intervention that the Fed, president, or Congress will have to mitigate the next recession, given that rate cuts and stimulus packages are the typical tools. Rates are already low, so the Fed doesn't have as much to work with in terms of lowering the federal funds rate. And Congress may be reluctant or unable to pass a stimulus package, given the current political climate in Washington.

REAL ESTATE COMPANY STRATEGIES FOR THE NEXT RECESSION

With the expectation that a recession is still on the horizon, and will likely have modest impacts on for-sale residential real estate, how should real estate operators and investors prepare? RCLCO thinks about real estate cycle strategies in terms of "defensive" and/or "offensive" tactics. Defensive cycle strategies are actions taken to improve the odds of surviving the recession, such as shedding under-performing assets, recapitalizing or "right sizing" in advance of the downturn. Offensive strategies focus on positioning the company for the next upturn by maintaining "dry powder" to be ready to take advantage of acquisition opportunities, hiring key personnel, etc. With a strong balance sheet, it's much easier to be the consolidator, rather than the consolidated. **The strategy that is best for your firm depends on the shape you're in heading into the next recession, the steps you take now to prepare, and the resources you have available for taking advantage of this pivotal point in the economic cycle.**

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-- Jimmie Jenkins, Vice President, Toll Brothers, Inc.

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