What would today’s market news and punditry be without calls for a market crash? As yields on U.S. Treasuries began their meteoric rise over two years ago, calls for a crash in U.S. home prices were a dime a dozen. How could one not expect a crash after a 45% increase in home prices nationwide\(^1\) topped by 500 basis points in higher mortgage rates?

Most market prognosticators follow many markets; few dive into the weeds of housing. This has led to a simplistic formulation: Higher interest rates mean lower home prices – or the corollary, lower rates mean higher prices. This naïve theory treats housing prices as analogous to fixed-coupon bond prices, which move inversely with interest rates. The housing market, however, is not quite that straightforward. Forming an outlook on housing prices requires one dig deeper than single factors such as home prices and mortgage costs into the supply and demand dynamics.

While the resilience of housing prices surprised many observers during the two-year rise in mortgage rates into October 2023, I believe prices could soften in the future if borrowing costs fall to borrower behavior-changing levels. To explain this seeming paradox, I’ll review the unusual state of supply and demand in this illiquid asset class.

**Low Housing Inventories, Rising Homebuyer Demographics**

In summer 2022, I wrote that a housing correction was more likely than a crash.\(^2\) My thesis was that historically low inventories of housing after a decade of underbuilding, along with increased demographic demand from millennials, the most populous age group in the U.S. since at least July 2019, would help cushion the hit to affordability and limit any decline in home values.\(^3\) While home prices did dip around 5% nationwide peak to trough, they’ve since recovered to new highs as that lack of supply continues to overwhelm headwinds to affordability created by high interest rates and high home prices. (*Figure 1*)

![S&P CoreLogic Case-Shiller U.S. National Home Price Index](image_url)
Entering 2022, total inventory of homes for sale (new and existing) stood at about 2.5 million units nationwide, with very few homes in foreclosure and homeowner equity at what was then all-time highs.\(^4\) By comparison, at the onset of the Global Financial Crisis (GFC), the U.S. had over 3.5 million existing inventory, 1.5 million new inventory and then over 5 million foreclosures hitting the market between 2008 and 2011. That summed to more than 10 million homes on the market during the GFC versus less than 2.5 million at the start of 2022. Mortgage rates fell during the GFC, but home prices didn’t bottom until 2012, when the supply overhang was absorbed by the marketplace. In 2010-12, homes were very affordable after their 35% decline nationwide and a 4.3% average mortgage rate, but the supply glut overwhelmed rates and affordability.

**A Rate Paradox**

In today’s market, one of the constraints on supply has been the “lock-in effect” due to widespread mortgages at 3%-4% rates, hundreds of basis points below new mortgage commitment rates, a legacy of the glory days of quantitative easing. In the wake of a dramatic run-up in rates on new mortgages, these low-interest legacy mortgages are so valuable that homeowners are very reluctant to move and put homes on the market.

Of course, a recession could add housing supply through new foreclosures, but loss-mitigation strategies developed post-GFC, such as loan modifications and mortgage forbearance, utilized extensively during the recent pandemic, are expected to curtail supply to a greater extent compared to other recessionary periods, notably the GFC. Historical precedent indicates that recessions do not inherently lead to declines in home prices; in fact, during most post-war recessions, home prices either remained stable or experienced an increase, as evidenced by the savings and loan crisis and the dot-com bust.

**A Magic Number**

Now, in a twist of irony, I believe lower mortgage rates could actually soften home prices. More affordable financing could incentivize would-be sellers who have been stubbornly locked into 3%-4% mortgages. There is a magic number for fixed mortgage rates that I think would unfreeze the housing market – in other words, a price bringing together willing buyers and sellers, a market-clearing price. By my lights, that number has a 5% handle. The supply and transaction volume unleashed by mortgage rates in the 5% zone might decrease home prices nationwide or at least flatten them. The effect on home prices also will depend on whether the lower mortgage rate unleashes more buyers or sellers. Another consideration: Pent-up demographic demand might lurk out there, overlooked, ready to extend the march to higher prices. That’s possible, but it’s not my base case. In the event of the magic number, I expect sideways price behavior.

Supply would be good for the market, good for both buyers and sellers (sellers, of course, need to find new places to live). In fact, supply would be good for the economy, as housing activity is not just about the buying and selling of homes but all the associated expenses such as home renovation, repair, and new appliance and furniture purchases. New-home construction would also likely rebound as transaction volume picked back up. But let’s return to the heart of the matter. In today’s context of frozen inventories, lower rates can potentially revive transaction activity and soften stubborn prices. May the magic number arrive. It can smooth the way for both young families and retirees making their way through America’s misunderstood housing market.

\(^1\) See also “The Lost Decade” by Morningstar Credit Research.

\(^2\) See “The Unstoppable Rise of the Homeownership Rate” by Morningstar Credit Research.

\(^3\) See “The Great Recession: A Timeline” by the Federal Reserve Bank of St. Louis.

The Misunderstood Housing Market, a Rate Paradox and a Magic Number
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Mr. Shinoda joined DoubleLine at inception in 2009. He is Chairman of the Structured Products Committee and oversees the non-Agency residential mortgage-backed securities (RMBS) team, specializing in investing in non-Agency MBS, residential whole loans and other mortgage-related opportunities. Mr. Shinoda is co-Portfolio Manager on the Total Return, Opportunistic Income, Income, Opportunistic MBS and Strategic MBS strategies. He is also lead Portfolio Manager overseeing the Mortgage Opportunities private funds. Mr. Shinoda is a permanent member of the Fixed Income Asset Allocation Committee and participates on the Global Asset Allocation Committee. In addition, he hosts DoubleLine’s “Channel 11 News” (X @DLineChannel11, dline11@doubleline.com), a webcast series that provides market insights and commentary. Prior to DoubleLine, Mr. Shinoda was Vice President at TCW, where he worked in portfolio management and trading. He holds a B.S. in Business Administration from the University of Southern California and is a CFA® charterholder.

Endnotes

1 As measured by the March 2020-September 2023 change in the S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index.

2 Ken Shinoda, “A Housing Correction Is More Likely Than Catastrophe,” Barron’s, June 30, 2022

3 See William H. Frey, “Now more than half of Americans are millennials or younger,” Brookings Institution, July 30, 2020, https://www.brookings.edu/articles/now-more-than-half-of-americans-are-millennials-or-younger/ Working with U.S. Census data, Mr. Frey calculated the percentages of population as of July 1, 2019, for the following age groups: Millennials (birth years 1981-96) 22.0%; Baby Boomers (1946-64) 21.8%; Gen Z (1997-2012); Gen X (1965-80) 19.9%; Post-Gen Z (2013+) 8.4%; Pre-Boomer (1945 and earlier) 7.6%.

4 In the event of death, divorce, job loss or other event that challenges a household’s ability to make debt service, short of forbearance programs, an owner with significant equity in his or her home will sell and pocket the equity rather than default on the mortgage.

Terms and Definitions

Basis Points (bps) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Quantitative Easing (QE) – A monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective. A central bank implements quantitative easing by buying specified amounts of financial assets from commercial banks and other private institutions, thus raising the prices of those financial assets and lowering their yield, while simultaneously increasing the monetary base.

S&P CoreLogic Case-Shiller U.S. National Home Price Index – This index tracks the value of single-family housing within the United States and is a composite of single-family price indexes for the nine Census Bureau divisions.

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