The Great Housing Diaspora of COVID-19

Disruptive Forces in Investing **July 20, 2021**

Anu Rajakumar: The COVID-19 pandemic disrupted life in many ways, including forcing people to slow down and assess what really matters to them, particularly in terms of how they live and where they live. Globally there has been a mass exodus from dense urban areas to more spacious suburbs, and as a result the residential housing market has been steadily climbing since early 2020. In the U.S., pricing has seen an overall increase of around 15 percent, and demand has never been hotter. But can the demand for homes meet the current supply? My name is Anu Rajakumar, and with me today is Dmitry Gasinsky, head of residential loans at Neuberger Berman, to share more about today's housing market and more. Dmitry, thank you for joining me here today.

Dmitry Gasinsky: Thanks for having me.

Anu: So now Dmitry, you know, I'm based in the New York City area, and certainly from my own personal experience I've seen that it really seems like a seller's market for the last 12 months or so, particularly in the suburbs with close proximity to major cities. But could you share a bit with us about what's been happening in the residential loan space, and also what's changing the landscape over the course of the pandemic?

Dmitry: Well, I think you're exactly right, Anu. Residential housing--and as a consequence residential housing credit which is our focus--has been exceptionally strong for quite some time now. So strong in fact to your point, and I'm sure we're all seeing the headlines that in some geographies, buyers have been frustrated by how difficult it is to buy a home with rising prices and rising competition. In our view this is nothing new of course. Powerful long-term dynamics have been contributing to this and can be traced back I would say at least a decade. I'm certainly happy to expand on the history but even before COVID, national home prices had been up over 62 percent over the prior decade. More than $12 trillion of net additional home equity had been created. Having said that, to your point, COVID certainly played a role in the more recent acceleration of home prices. Nationally you know, as you mentioned housing prices are up nearly 15 percent over the past 12 months. And this is largely consistent across all major geographic regions. One post-pandemic dynamic contributing to this is lower mortgage rates. We're about 75 basis points lower today compared to pre-COVID. And of course what that means is that, at the same price point, this would translate into an eight to ten percent lower monthly payment for homeowners.

So clearly lower rates [are] a positive for home prices. Another interesting, pandemic-related development has been the rise of work from home, and also de-urbanization, mobility, and relocation trends. People are certainly investing more in their homes today. In and of itself, this is a positive for home prices and housing fundamentals. From the investment opportunity standpoint we've seen increased demand for home development and renovation finance, which we see as a very attractive higher yielding, high-credit quality lending segment. Additionally, and I'm sure and no one is surprised by this, at the height of the pandemic, with all the lockdowns, the usual appeal of urban living was waning.

And peoples' housing preferences shifted somewhat toward less densely populated suburban areas. And this has been showing up in the numbers as well. The differential in price growth between more densely populated urban areas and less densely populated suburban areas have been about ten points, so downtown areas are up in price by ten percent less. And not surprisingly, it's the cities with higher population density and higher income levels that ended up losing more people. So essentially if you could afford to move, you were more likely to move. New York, Los Angeles, San Francisco, San Jose are some examples. On the flip side, other areas seem to have been benefitting from this trend, Jacksonville, Albuquerque, Memphis. So the bottom-line is that virtually all housing segments are doing well, fundamentally. But the suburbs are doing better, single family housing is doing better, smaller metros are doing better. Back to your original point Anu, residential housing remains exceptionally attractive. Private lending environment in residential space is exceptionally attractive. And the pandemic did not cause but certainly accelerated some of these positive fundamental trends.

Anu: Yeah, thank you. That's a good overview. And important to know that this wasn't just initiated by the pandemic but something that was sort of happening, you know, pre-COVID as well. Going back to what I mentioned in the opening, we talked a little. I mentioned supply-demand. Tell us about how that pictures looks today, and what are some of the associated factors that are shifting how the housing market is looking?

Dmitry: Yes, so I promised to elaborate a bit on history, so this may be a good opportunity. So just to give you a bit of a backdrop, for several years after the '08, '09 crisis, macroeconomic conditions remained very challenging. We were in a recession, housing credit conditions remained extraordinarily tight, both for homebuyers and homebuilders and developers. The regulatory conditions remained in flux. It was tough to get a mortgage. It was tough to buy, it was tough to build. And consequently for quite some time housing activity, of all kinds, had remained not existent then certainly very much depressed. As a result, now several years later the economy is very healthy, and we have an environment with all this pent-up demand from new families coming online, from families who delayed buying a home for a few years. And at the same time after years of underbuilding, we have a severe shortage of quality homes that people actually want to buy. Housing inventory levels are as low as they have been in over 45 years. And much of this existing inventory is old. And today's buyers want turnkey: open floor plans, modern designs, Wi-Fi availability. There is not nearly enough of this product on the market. All of this will need to be built. All of this will need to be developed and renovated. Incidentally, you know, as I mentioned earlier this is why we're so constructive on the residential development finance as a lending segment. There is not enough private capital in the space. Not enough lending expertise, and very strong demand for credit, from highly experienced well-capitalized residential developers. So a very attractive opportunity to lend on a short duration basis at attractive rates to high quality borrowers.

There is actually an additional wrinkle to this added by demographics. First, people are living longer, which of course is wonderful, but it does add additional fuel to housing demand. And second, age groups that happen to be most prone to buy homes are expected to grow at a rate faster than other age groups, going forward, which is also a demand positive. So the bottom-line is this, we've had this confluence of accelerating demand and essentially non-existent supply. And of course, as in any other market, when you have too much demand and not enough supply, prices tend to go up. COVID is playing a role, but in our view it is much bigger than COVID alone.

Anu: Yes, thank you very much for that Dmitry. Now as we know housing prices across the country are, you know, through the roof, no pun intended. How do you respond to people who are worried that this is another bubble, something like what we saw in the lead up to the Global Financial Crisis? What are the similarities or differences that you see between today's housing market, and what it looked like in 2007, 2008? What are you seeing in terms of those market trends?

Dmitry: Well I, I think this is an excellent question, and I think the differences between today's housing environment, and what was going on back in '07, '08 could not be more stark. We, as investors focus on, private residential loans, private lending. And so one of the most direct differences impacting our markets is private capital participation in residential mortgage finance. Prior to 2008, private capital played a very significant role in housing finance, being upwards of 15 to 20 percent. But since 2008, private capital essentially vanished. And it's only gradually beginning to reemerge. It's at about three to four percent of the landscape today. At the same time lending infrastructure, private lending expertise, research, management capabilities, operational infrastructure, all of those things essentially vanished after '08. So what was going on back in '07, '08 that ultimately caused the crisis?

Well there was a number of factors. First, oversupply of housing. There was a massive overbuilding fueled by loose and expensive credit and massive amounts of liquidity in the system. That led to weak credit characteristics, over-lending, including prevalence of no money down loans as some of us may recall, proliferation of fraudulent practices, unaffordable loan products, loose regulatory framework, loose regulatory oversight. And ultimately all of these things in combination resulted in a housing bubble and resulted in a 40 percent or so housing price declines. Now contrast that to where we are today. As I mentioned earlier non-agency mortgages right now, represent a fraction of what they once were before 2008. I mentioned that roughly 12 trillion of additional home equity had been created over the past decade.

At the very same time as all of this home value was being created; there was virtually no new net debt being added to the system. So, what we've seen is a massive deleveraging in housing finance, post-'08. And of course in and of itself that's a very strong fundamental trend. What we're also seeing is much better, much stronger credit characteristics in today's lending environment. Much more favorable housing fundamentals, and importantly a well-defined strong regulatory framework introduced in 2014 by the Dodd Frank Legislation. One of the most important features of that legislation was the introduction of the so called "Ability to Repay Rule." It sounds pretty self-explanatory, pretty self-evident, but essentially what that means is that every mortgage lender today is obligated to take reasonable steps to ensure that if they make a loan, the borrower has the reasonable ability to repay that loan. And that of course adds pretty meaningful credit guardrails to ensure credit quality of the system remains strong. And of course what also has been happening today particularly post-COVID is this massive and unprecedented help coming from the government and the Federal Reserve Bank to support consumers, to support the housing sector, the financial sector, mortgage servicers, and mortgage lenders. Of course all of these things in combination make as I mentioned the picture very different today, so a vastly different set of circumstances.

So in summary, I would say this: the credit environment is very different today. Credit standards are a lot stronger, housing fundamentals driven by supply and demand dynamics are a lot more favorable. And importantly the government regulatory framework is a long stronger and well-defined today.

Anu: Yeah, perfect. Thank you for answering that very comprehensively. I think that's very important to compare and contrast those, those two very different and important time periods. I just want to touch upon something that you spoke about at the end of your comments there about policy. There's been huge amounts of stimulus around the globe and would like for you to just dig in a little bit deeper about the current credit landscape that you're seeing here in the U.S. and how that affects the overall housing market. You know, we talked a little bit about mortgage rates going down. I know lots of people have refinanced in the last year as well. Could you just expand upon that a bit?

Dmitry: Well, clearly, government policy has always played an important role in residential mortgage finance. A large portion of the consumer mortgage market is ultimately guaranteed by the government, prior to being sold to investors. So naturally, what the government decides to guarantee in what fashion, very much impacts where and how in turn private capital can participate and find value. This is something that we as private investors pay very close attention to, and it certainly impacts our opportunity set. A good recent example of that is a decision by the government agencies to limit the amount of non-owner occupied or investor property loans they guarantee, which is likely to increase non-government capital participation in that segment of the market in particular.

And though there are other direct and indirect ways that government policy plays a role, certainly this was particularly evident last year. To your point at the height of the COVID disruption when the government injected, unprecedented, really unprecedented amounts of fiscal and monetary stimulus to prop up consumers and businesses. This was extremely effective, and essentially helped ensure that COVID ended up being a non-event from the credit standpoint. And of course we also ended up with much lower mortgage rates, due to substantial monetary stimulus coming from the Fed. And of course all this liquidity coming into the system is likely to create some inflationary pressures in our view, and boost demand, including consumer demand for housing, which we think is a net positive for the housing market.

Anu: Terrific, thank you. You know, as we wrap up here, Dmitry, I would just like to get your thoughts on where do we go from here? You know, personally I'm team New York's coming back. I don't know what your view is on cities, do you see de-urbanization as an ongoing trend. Do you think the landscape is going to change and moderate? Would love to get your thoughts on that.

Dmitry: Yeah, well look, I think the jury is still out to be perfectly honest. To be fair, it remains to be seen how much of this post-COVID landscape will become permanent, versus ultimately being transient in nature. My personal view and I agree with you entirely, the city is not going anywhere. It's been a part of human social evolution for thousands of years, and it's unlikely that a one-year pandemic will somehow irreparably tarnish it. So you can probably tell, I'm also a fan. Having said that, we're also likely to see a continuation of robust demand for single-family living. Whether in urban or suburban areas, price appreciation trends are more likely to moderate, and the gap between, more and less densely populated areas that has been growing more recently is likely to close over time.

But more broadly the punch line, if you will, is this: residential credit and private lending environment today is as attractive as it's been in decades. I hardly recall an environment as fundamentally favorable as it is today. We expect very robust housing activity in the coming months. Home purchase activity is certainly picking up, single-family rental demand is growing.
Building and development activities of all kinds are picking up, and all of our key lending segments in virtually all relevant geographies are growing. Housing fundamentals are as strong as they've been in decades. So we're very constructive on our markets in 2022 and beyond.

Anu: Excellent, thank you very much Dmitry. Now for the bonus question in today's episode I would like for you to please describe your dream house. If you could live in any other home, anywhere in the world, describe that property and where it would be located?

Dmitry: [Laughs] Um, oh boy, that is a tough question. Well, you know, as I mentioned, I have been a, a city dweller for pretty much my entire life. So, that's where my heart is. I like living in, you know, densely populated downtown areas. So I suspect that my dream house is not a house, it's more like an apartment somewhere on the, you know, 87th floor of some tower, overlooking some, body of water somewhere in the world. But I do like to travel. I like to see other places, meet other people. So the extent possible if I'm ever in a position to own multiple homes, I think that's something that I would very much enjoy as well just to, to, to have an ability to spend time in other places around the world.

Anu: That is very fair. I was going to say, you know, just south of Central Park there are some beautiful new huge buildings that have a great view of the reservoir right in the middle of Manhattan. So, something to consider.

Dmitry: [Laughs] Well, there you go [Laughs].

Anu: All right, well thank you Dmitry so much. That's going to do it for this episode. Really appreciate the insights on an area of the investment world that is so important and close to home to many. Very intrigued to see what's ahead for the housing market, but again Dmitry thank you very much for joining us today.

Dmitry: Thanks very much Anu as well. It's been a pleasure being here.

Anu: And to our listeners if you like what you've heard today you can subscribe to the show via Apple podcast, Google podcast, or Spotify, or you can visit our website, www.nb.com/disruptiveforces for more information about our firm and offerings.