Jennison Associates
Consumer Engine Stalls
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Audio Starts

Alex: [00:00:00] Hey everyone, welcome back to Clipping Coupons with Jennison. My name is Alex Chansky, and I'll be your host for the show!

Today I have with me Dmitri Rabin, who is one of the portfolio managers helping run Structured products here at Jennison and Dmitri has been a guest on the show a couple of times before.

So today we're going to be talking a lot about home prices and effects on the market. First question I have for you today: Why do investors care about home prices?

Dmitri: Investors care about home prices because it is a very large and very important asset class that's been at the heart of some of the biggest movements in financial conditions over the last 10, 20, 30 years.

The great financial crisis was in large part caused by some of the conditions in the US housing market and then caused contagion from there, but we've seen it be continuously important. Investors also care about house prices because the Fed and policymakers really care about house prices. Housing is the most widely owned asset class, so it is politically very sensitive for the US consumer and for the US electorate.

But in his very first press conference, Kevin Warsh, Chairman Warsh, was asked about conditions. Are financial conditions restrictive? And the first thing that he talked about was housing and mentioned that when it comes to housing, and I'm paraphrasing here, conditions are actually restrictive.

The actual language was more nebulous than that. But the upshot was Chairman Warsh was quite clear that he follows very closely housing activity, house prices, transaction volume, and so on, and viewed the housing market as being in a restrictive, somewhat negative place vis-a-vis interest rates.

So housing has been on a bit of a roller coaster if one goes back all the way to 2000.

If you think about [00:02:00] 2001 through 2006 period, that was a period now famously known as the housing bubble, and house prices rose about 75% and everything for now will be in nominal terms. They then fell by more than 30%, wiping out enormous amount of consumer wealth, banking balance sheet stress, and caused a number of problems, and brought with them the deepest US recession since the Great Depression.

So that is again, one of the reasons we care. And then from the bottom of 2012, housing has increased by 2.5X, which is quite, quite an extraordinary turn of events. And the biggest rise came in the 2020, 2022 period during COVID, when house prices nationally rose by more than 50%, really boosting consumers coming out of that.

A big part of that was the Sharp decline in rates that resulted in the quantitative easing program, extraordinary quantitative easing conditions that the Federal Reserve put in place

Alex: So then during COVID, we saw significant migration towards the southeast and some other lower cost markets. Has there been some reversal or normalizing of these patterns? And what does that normalizing look like today?

Dmitri: The last three years have been particularly uncertain and unusual for housing. We saw sharply higher interest rates.

They went from about two and a half percent to above seven percent for the type of interest rates that most consumers have been facing. They're around six point 6.7% today. This has been hugely political, um, consequential. What it means for most people is that buyers who wanted to buy can, could sort of stay in their existing home, but they could not sell their home and afford to buy another house.

So you've had what economists and sort of people who model housing talk as those lock-in effects, um, which have been as large as we've really ever seen. So [00:04:00] that's the first one. Now, underneath that three years of roughly flat house prices that we've seen since 2022, 2023 has been a lot of regional differences.

The Northeast and the Midwest have actually seen house prices appreciating at about 4 to 5 percent per year the last few years. And the markets which have been the most active have been markets like Indianapolis and Buffalo, where home price have gone up the most. That's sort of pretty unusual. One does not typically associate Indianapolis and Buffalo with bubble type house prices.

And what's been happening is consumers coming back from sort of stay-at-home, work-from-home environments and needing to move closer to where the jobs were, and very little, if any, construction. The reverse of that has been in the Sun Belt, where Florida in particular has seen fairly significant home price declines.

10 or above percent in nominal terms, up to 20% in real terms. Texas, Georgia, the Carolinas, all of these regions have seen house prices which are weaker, sort of flat or negative in real terms. So we've seen this divergence, which is a little bit of a payback from the increase that we saw during COVID.

Alex: Thank you. So then adding on to that, what evidence are you seeing that housing conditions are starting to improve, and how sustainable do you think that improvement is?

Dmitri: So we track housing across a number of different indices, which have a mix of kind of accuracy, detail, speed in terms of you get the data and so on. And we also look at other leading indicators like months of unsold inventory on housing.

And across these, we're seeing a change. In the Sun Belt, it's no longer declining in the last two to three months, so this is quite recent. The Northeast and the Midwest is still going up, but maybe at 3% rate, kind of inflation-type rates instead of 4% to 5%. And so this is a more normal housing market, which has implications for the [00:06:00] US economy as particularly the Sun

Belt region, the Southeast and California begin to heal and see positive house price increases with less of a lock-in effect.

There's a couple of implications from this, right? It should improve the Fed's view of the economy. The Fed looks at this, as we talked about, and on a forward-looking basis, should make them a little bit more hawkish, all else equal. And it could sort of provide consumers with a little bit of confidence to spend.

In 2006, we had a lot of borrowing compared to the size of our housing market. The housing market has since doubled to about $50 trillion in value, but the debt has only gone from 10 to 14. What that means is there's about $35 trillion of home equity that consumers have left untapped, and that equity has sort of been difficult to tap, in part because banking regulations post-2008 have been very tight.

That has been getting relaxed, and that could be sort of really accelerate consumers' ability to spend in certain pockets. I should say that everything that we're talking about here applies to 60%, 65% of US consumers who own their homes. The lower income consumers, people who rent, subprime borrowers – we're seeing a very, very challenging consumer outlook for those borrowers.

But if we look at folks who own, they have all this equity that potentially they would be able to tap, particularly if house prices stabilize in some of these regions and start to go up.

Alex: Understood, thank you. One other thing I want to touch on today is that we've seen some Ginnie Mae borrowers taking out some really high LTV loans, including mortgages paired with rate buydowns.

Can you tell us a little bit about what risks are new here, and maybe how should we think about those risks?

Dmitri: The first implication is that what used to be the subprime mortgage market today is entirely the Ginnie [00:08:00] Mae market.

The high LTV (up to 97 or 100 LTV) and low FICO (600 FICO or lower) borrower is borrowing almost exclusively through the Ginnie market. There isn't much of a private market for that. That from a macroeconomic perspective creates some stability because what that means is that the US government is likely to continue to lend to these borrowers regardless of conditions.

Versus if you think about what happened in 2008 when that market went away, the ability of the weaker consumer to fund themselves and their in-house purchases went away with it, and you had a huge destruction of demand. So that's the first thing to think about. If as a taxpayer, you might not feel quite as good about the fact that a lot of these types of risks are going on the US government balance sheet via Ginnie.

And the buydowns in particular are a problem because what's happening in the Southeast – we talked about the weakness there – is borrowers are sort of unable to afford a house, right? They don't have money for down payment. Even the 3% might be challenging or they may not be able to kind of afford the monthly payment.

And home builders have a house that's priced at a price that they can't sell it at. Well, what the home builder can do is say, "Look, rather than lowering the price, and then you still have to get 97% or 95% loan, so you still have to come up with that money, I'm going to keep the price high, but I'm going to subsidize your mortgage by taking your mortgage rate from, let's say, 7% to 5% or from 6% to 4%."

If I do that, the consumer essentially gets a lower mortgage, it makes the house more affordable. From a Ginnie Mae sort of balance sheet perspective, that's not a great loan because that loan started out at a 97% LTV, and the reality is the home builder couldn't sell it at that level. So they subsidized it by somewhere around 5% to 10% of the price by giving the consumer this mortgage, which means really the US [00:10:00] government funded that consumer at somewhere near 110% of the real price of the house.

That's a problem from a default perspective. It's also a problem that if that consumer later wants to refinance or do anything with their house, or if they want to move, they are sort of even more locked in because they would have to come up with a significant amount of cash – way more than they did to buy the house, in order to pay off the loan and be able to move.

So we do think there are some challenges there. Again, the US government is pursuing a social policy where it wants to support housing in a certain way, and this is sort of the most aggressive part of that approach.

Alex: Pulling everything together, I personally think these housing trends are really interesting to talk about, and I'm sure a lot of other people do too. So can you tell us a little bit about maybe what are some implications for our portfolios? What are some of the developments here that matter to us specifically?

Dmitri: So there's a couple of things that matter.

The first one is housing is a really important macroeconomic indicator. To the degree to which it stabilizes, starts to improve, um, that should make the Fed on the margin a little bit more hawkish, a little bit more comfortable. There's a lot of other things that the Fed is thinking about, but it does help.

At the same time, it will sort of feed into CPI – but the feedback of house prices into CPI and PCE and various inflation indicators the Fed looks at is very lagged and almost immaterial. So it's really kind of how the Fed thinks about financial conditions, consumer balance sheet, and consumer spending that this is going to matter. So that's the first.

The second is that more consumer wealth that, that is achievable and a little bit more confidence that house prices are not going down, particularly in some of these regions of the Sun Belt means that we might see consumers being willing to spend more. Doesn't look like they have a lot of savings, but in fact, in housing, if they can tap that, the [00:12:00] prime homeowning consumer does have fairly significant spending capacity. So that's the second.

And so what this should mean is that the prime consumer, in terms of whether it's autos or various consumer-related brands that we look at in the corporate world – all of those should be in reasonable shape. All of those should feel pretty comfortable. The subprime consumer I think has a much more difficult story and those consumers just don't have that wealth, right? Or that spending capacity, and it's very, very difficult for them.

And then if we think about mortgages specifically, this is a positive from a credit perspective and to the degree to which we own the non-agency mortgages. Any concerns about future defaults should be lower than they were before. But it is a negative from a prepayment perspective because as consumers' equity becomes better, their ability to refinance, to prepay the mortgages gets a little bit better as well.

The Southeast, where places like Florida has seen pretty good prepayment protection, in part because of these house price declines – that's likely to be less true in the future as we think about it. And so we're trying to sort of feed all of these indicators even before we see actual data, even before we see full direction.

The direction of travel is really important to us, and so we're trying to adjust portfolios in real time to reflect that!

Alex: Great, thank you so much, Dmitri! I really appreciate your time today

Audio Ends

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