A tale of two US property markets

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Summary

As the Fed begins an easing cycle, an important element in the easing is the transmission mechanism of interest rate cuts, notably via real estate, in the post-Covid economy. But divergence between commercial real estate (CRE) and house prices creates complexity for the economy and monetary policy. The impact of lower rates on housing and CRE may be less predictable than in previous cycles. This is both because of structural shifts in demand since Covid, between housing and CRE, and because the dynamics of the two property markets may evolve differently.

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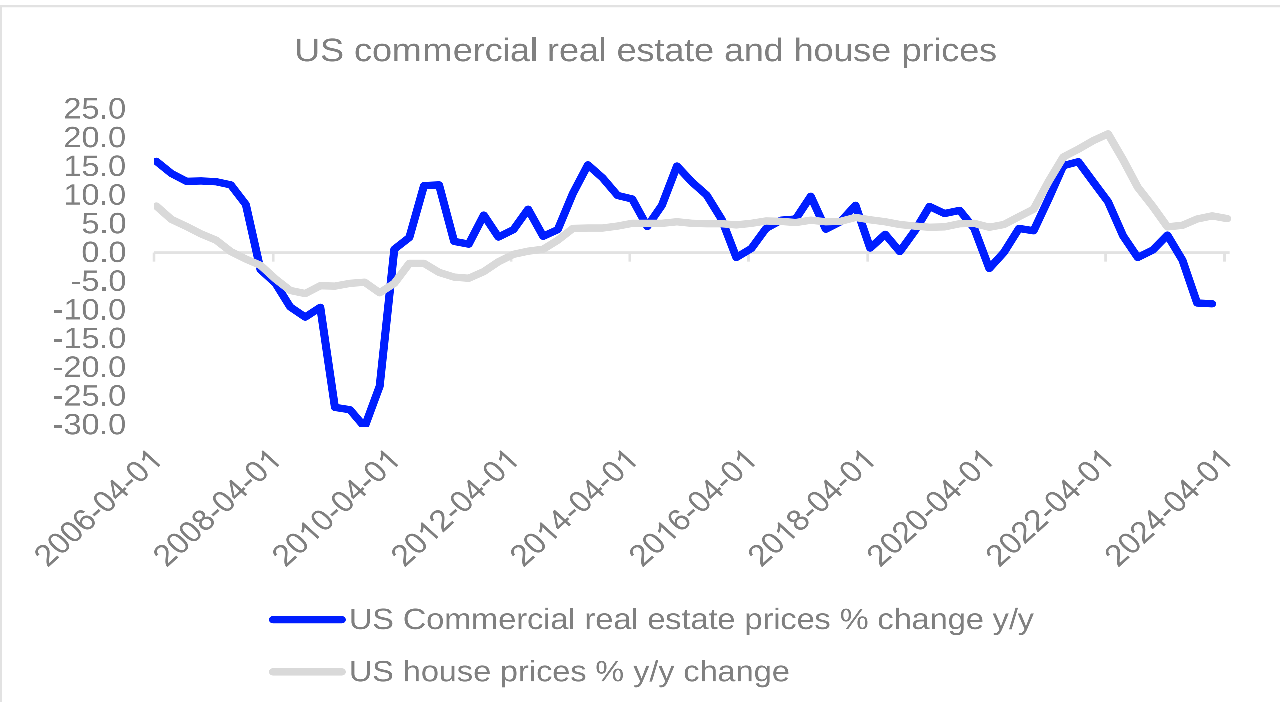
As the Fed begins an easing cycle, an important element in the easing is the transmission mechanism of interest rate cuts, notably via real estate, in the post-Covid economy. But divergence between commercial real estate (CRE) and house prices creates complexity for the economy and monetary policy. It is well known the CRE sector has suffered severe weakness since Covid, particularly in the office sector, which has been hit hard by the increase in working from home (WFH) and the decline in occupancy rates.[1]

CRE a major casualty in the GFC, as well as housing

But also note that despite the common narrative that the GFC was caused by a sub-prime mortgage crash, CRE prices actually fell more than residential housing prices during the GFC, as a dysfunctional financial system effectively shut down financing for CRE loans and the deep recession crushed demand. This created the worst CRE downturn since the S&L crisis in the early-1990s, as Exhibit 1 shows.

Exhibit 1: CRE and house prices



Source: US Federal Reserve Economic Data.

CRE now faces another major structural downturn

Exhibit 1 also shows that in the early stages of Covid, CRE prices fell, as economic uncertainty reduced demand and the retail and hotel sectors were effectively shut down, while in contrast, house prices barely moved. And this divergence continued in 2022-23, when the Fed began raising rates in March 2022.

US house prices have escaped largely unscathed…

Since Covid, US house prices have benefited from increased demand for WFH and low supply, as homeowners on low coupon fixed rate mortgages were effectively locked into existing mortgages, as rates rose, and refinancings collapsed. In contrast, CRE has suffered not only from refinancing difficulty due to higher interest rates, but also the structural shifts on

[1] See "More trouble in the office – can the Fed save the CMBS maturity wall?", LSEG, August 2024.

e-commerce and working-from-home. As a result, house prices rebounded quickly, despite higher rates, while CRE prices dropped significantly from 2022 to 2024.

…exposing fundamental differences between them

This also exposed fundamental differences between the two sectors, reflecting their different functions in the economy. Housing provides physical shelter and other benefits for the homeowner, so the homeowner can become deeply connected to the property. In addition, the boom in WFH, one of Covid's legacies, is another user benefit from home ownership.

Alternatively, a CRE property is an operating or investment asset, designed to be leased by tenants to generate cash flow to cover debt service, and to realize property appreciation over time. This means a CRE property owner is less likely to support a mortgage loan, when facing difficulty with debt service costs or maturity payoff.

CRE more sensitive to financing availability

While both assets may serve as inflation hedges over the long term, CRE prices can suffer from an increase in required yields when interest rates increase, while housing valuation is typically not determined by required returns. Therefore, CRE may be more sensitive to financing availability, cost and exogenous factors, while housing is mostly driven by supply and demand.

Also note that over the last 10 years, more restrictive land use regulation, tighter underwriting standards on mortgages and slower growth in housing starts, have all contributed to steady appreciation in house prices. Exhibit 2 shows that US housing starts have still not recovered to the rates reached in the early-2000s, pre-GFC, despite the growth in population since then (about 15%).

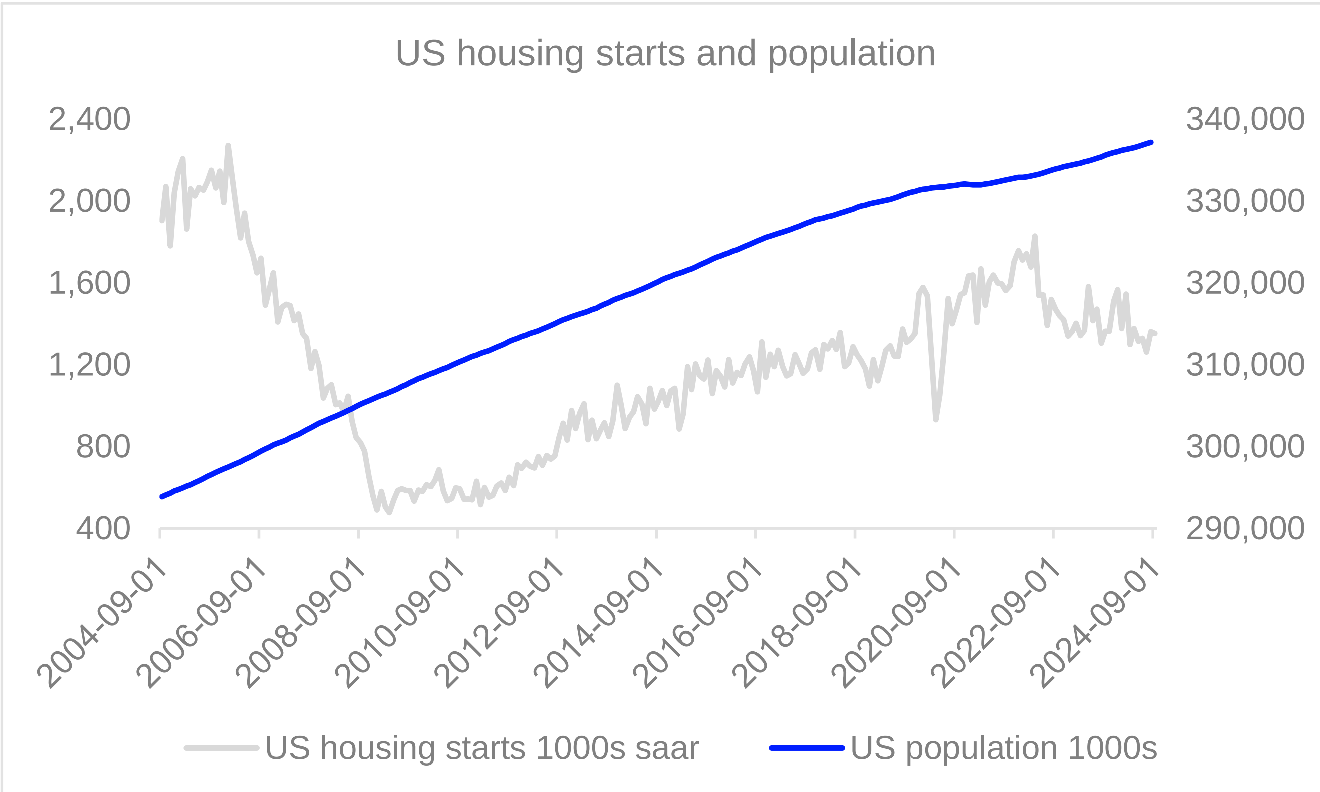
House prices boosted by lower supply and population growth

The high share of fixed rate mortgages may have also reduced the interest rate sensitivity of US house prices, since approximately 90%[2] of US mortgages are now based on the 30-yr fixed rate mortgage, compared with much lower proportions in the 1980s. So with mortgage rates climbing to above 8% at one stage in 2023, there has been absolutely no incentive for homeowners to move and get mortgages at higher rates, with 65% of existing mortgages fixed at rates below 4%[3]. With a reduced supply of existing homes coming to the market, and higher costs for homebuilders, housing starts fell in 2022-23, as the Exhibit 2 shows, reducing housing supply further, and helping to put a floor under prices.

[2] LSEG Yield Book data.

[3] LSEG Yield Book data.

Exhibit 2: US housing starts & population growth since 2004



Source: US Federal Reserve Economic Data.

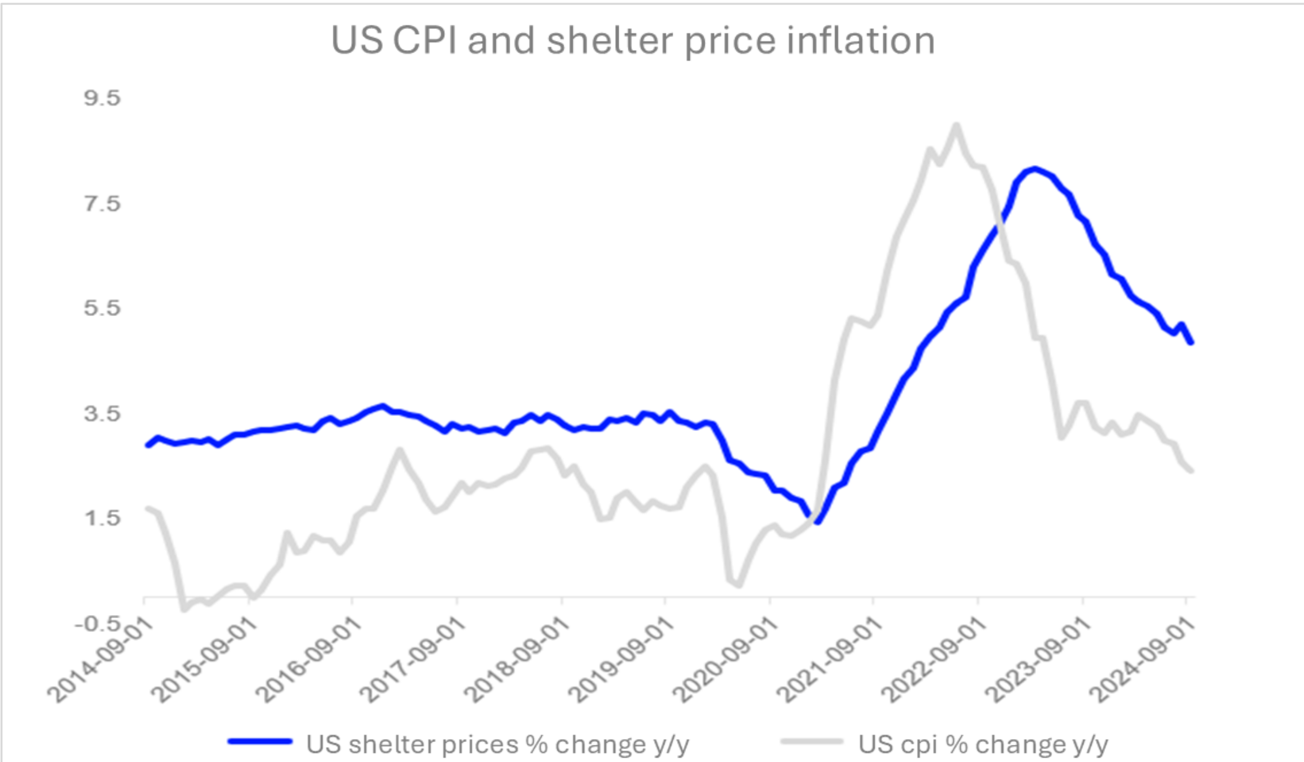
Policy rates may have less predictable consequences?

With the Fed now reducing rates, the impact on house prices will depend on whether rates would fall fast and far enough to (a) increase affordability for new buyers, including those currently in rented accommodation, and (b) to break lock-in for existing homeowners. But the dynamics here are unpredictable. If the Fed adopts a “higher for longer“ gradualist easing cycle, because the economy remains robust, potential new buyers may jump into the housing market, on the view mortgage rates will not return to post-Covid lows, while there is no pickup in house selling. So Fed rate cuts will not solve the supply issue but may boost some demand, making the imbalance even worse – an unintended consequence. This could also in turn reduce demand for rental properties, hurting multifamily fundamentals. So policy rates may have unpredictable ramifications.

Different dynamics and adverse feedback loop for CRE?

In addition, because US inflation gauges, like the CPI, have large shelter components (36% of the overall index, BLS data), a spike in house prices and multifamily rental rates can push up inflation sharply, as it did in 2021-22. Indeed, shelter inflation is still at 4.85% y/y, as Exhibit 3 shows. This helped drive the substantial monetary tightening from the Fed in 2022-23, and made CRE financing more difficult. In theory, it also means that a cooling housing market with lower shelter cost would help CRE to recover. But if a housing correction happens because the US economy enters a recession, and unemployment spikes, this would be unlikely to help CRE properties, since their operating income would fall. So the high weighting of shelter in US inflation indices can create an unfavourable feedback loop for CRE, even if residential house prices are protected by reduced supply.

Exhibit 3: US CPI and shelter price inflation



Source: US Federal Reserve Economic Data.

Reduced, and uncertain interest rate sensitivity of the economy?

In conclusion, these considerations suggest the impact of lower rates on housing and CRE may be less predictable than in previous cycles. This is both because of structural shifts in demand since Covid, between housing and CRE, and because the dynamics of the two property markets may evolve differently. It may also mean the relationship between US interest rates, and the economy is less reliable, with uncertain lags. Evidence of that has emerged in 2022-24, when despite the Fed raising rates by over 500bp, house prices have barely fallen, but CRE prices fell sharply.

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