GW&K INVESTMENT MANAGEMENT

GLOBAL PERSPECTIVES

Gimme Shelter: Homes as a Hedge

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Highlights

- America's home prices have surged during the "everything rally" associated with the Fed's aggressive monetary easing, albeit with great geographic divergences.
- On a nationwide basis, home prices still seem affordable after adjusting for low mortgage rates. Moreover, home prices have never been cheaper relative to U.S. stock prices.
- Historically, home prices have provided a good hedge against rising inflation and weak stock markets. But households' real estate holdings are near record lows as a share of net worth.

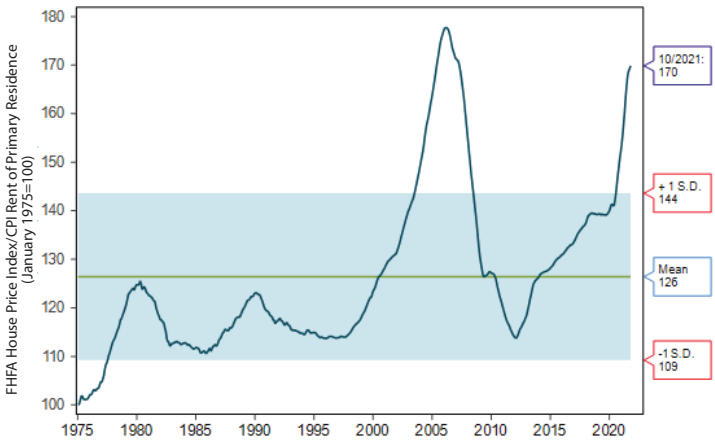
U.S. Home Prices Have Surged in the "Everything Rally"

There is little doubt that U.S. home prices have participated in the "everything rally" that has been associated with the Fed's aggressive monetary easing in response to the pandemic. The basic story has been that robust housing demand has collided with constrained supply, pushing up both home prices and rents.

For example, the Case-Shiller National Home Price Index was up 19.8% in the year through August. That's the highest annual increase since 1948, and has been matched by record increases in similar home price indexes put out by Freddie Mac or the Federal Home Finance Agency (FHFA).

It should also be noted that home prices are extremely high relative to rents, with one index of home prices to rents approaching its high level from January 2006 **(Chart 1)**. Not surprisingly, rents have also been surging as would-be homebuyers turn to rental markets, with Zillow's Observed Rent Index up 11.2% from a year earlier in October.

Chart 1: The U.S. House Price to Rent Ratio is Approaching its All-time High of January 2006



The FHFA's Home Price Index has surged compared to rents and is approaching its all-time high set in January 2006 during the U.S. housing bubble.

Source: GW&K Investment Management, Macrobond

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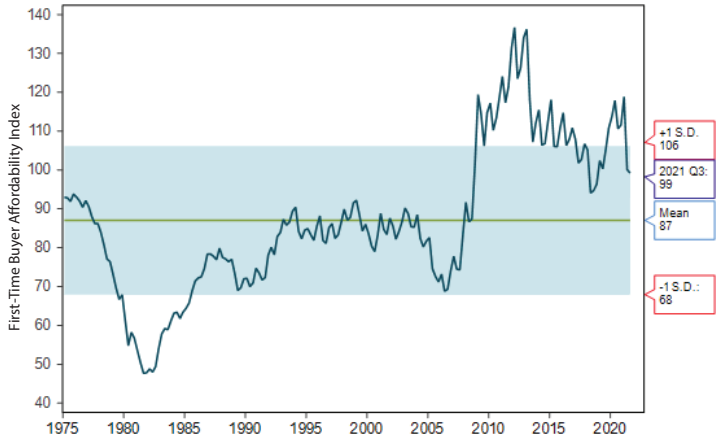
Rent inflation is an issue the Fed is watching carefully, since the Shelter component of the Consumer Price Index (CPI) accounts for nearly 40% of core inflation and tends to be a "sticky" component of inflation.

But Homes Remain Affordable on Some Measures

Despite the surge in prices, overall homes remain affordable on some key measures. For example, thanks to low mortgage rates, the National Association of Realtors' (NAR) First-Time Buyer Affordability Index remained well above its long-term average through the third quarter of 2021 **(Chart 2)**. This measure of affordability is based on monthly mortgage payments relative to monthly incomes.

Chart 2: Thanks to Low Mortgage Rates - and Despite High Prices - Homes Remain Relatively Affordable



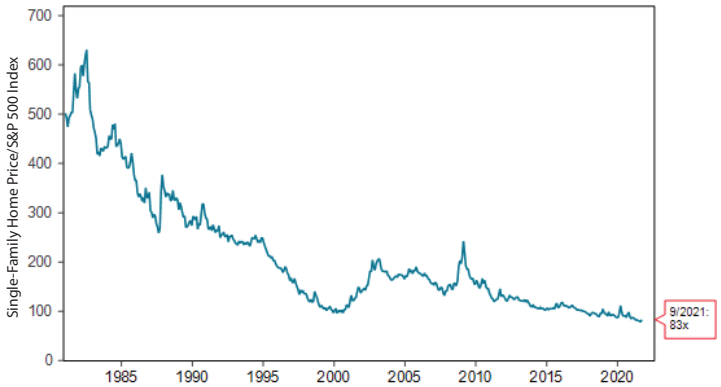
Source: GW&K Investment Management, National Association of Realtors, Macrobond

Despite the surge in home prices, homes for first-time buyers remain relatively affordable thanks to low interest rates and rising incomes.

Based on this index, homes on average are currently considerably more affordable for Millennials (born from 1981 to 1996) than they were for their Baby Boomer parents in the early 1980s. An important caveat is that home price appreciation has varied widely by location. For example, since 1990 home prices rose by 5.8 and 4.6 times respectively in tech-heavy cities like Seattle and San Francisco but up only 2.4 times in Midwest industrial cities like Cleveland and Chicago.[1]

By another measure, namely the ratio of home prices to stock prices, American home prices have never been cheaper. For example, in 1981 it took 500 units of the S&P 500 Index to buy a typical single-family home in the U.S., but by September 2021 it took only 83 units **(Chart 3)**. That's because over that period the S&P 500 Index rose by 33 times (from 129.5 to 4,307), compared to only 5.6 times for the NAR median single-family home price (from $64,500 to $359,000).

Chart 3: Home Prices are Cheap vs. Stocks: Single-Family Home Price/S&P 500 Index



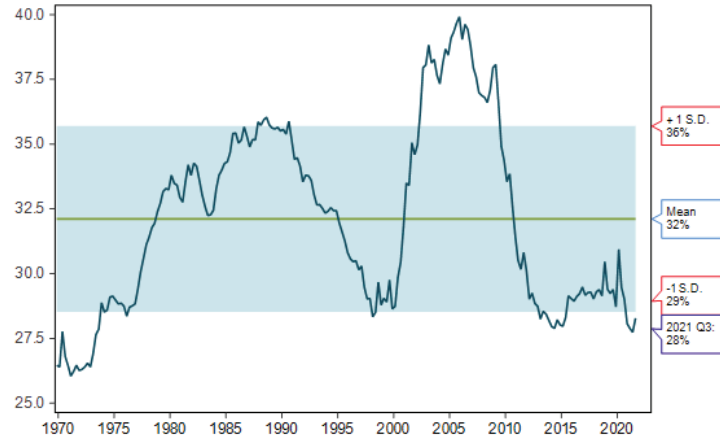
Note: Monthly data from January 1981 to September 2021 on Median Price of Single-Family Homes (seasonally adjusted by GW&K) divided by the S&P 500 Index.

Source: GW&K Investment Management, National Association of Realtors, S&P, Macrobond

U.S. homes have never been cheaper versus stocks. In 1981 it took 500 units of the S&P 500 Index to buy a typical single-family home in the U.S., but by September 2021 it took only 83 units.

This remarkable comparison prompts us to wonder whether Americans now may be underexposed to residential real estate as an asset class, despite a "trifecta of high prices" in the three major asset classes of stocks, bonds, and real estate.[2] Indeed, data from the Federal Reserve show that households' holdings of residential real estate assets represented only 28% of their net worth as of the third quarter of 2021. That remains close to its lowest level in a generation and is down from a peak of 40% in late 2005 **(Chart 4)**.

Chart 4: Households' Real Estate Holdings at Low End of Historic Range Relative to Net Worth



Source: GW&K Investment Management, Federal Reserve, Macrobond

As of mid-2021, Fed data shows that the typical American household's exposure to real estate was near generational lows as a share of household net worth.

[1] For a very informative interactive website with city-by-city data on home affordability, see John Wake, "The Shocking Truth About House Prices After You Adjust for Inflation AND Interest Rates" *Real Estate Decoded*, February 2020.

[2] Robert J. Shiller, "Stocks, Bonds, and Real Estate Prices Are All Uncomfortably High," *The New York Times*, October 1, 2021.

What's more, such comparisons are even more extreme for wealthy households, with a Fed survey showing that real estate represents only about 10% of the net worth of the top 1% of households by income compared to 52% of the bottom 40% by income.[3]

Homes as a Hedge: What Does History Show?

To be sure, there is no guarantee that equity prices will always outperform home prices. They didn't in the United States for nearly 60 years from 1891 to 1950. And even since 1950 in the United States, when equities have generally outperformed home prices, there have been long periods when the reverse has been true. Moreover, history shows that equities tended to underperform home prices during periods when equity markets were weak and inflation was rising.

Consider the data in **Table 1** that lays out the 5-year annualized rates of change seen in the S&P 500 Index, the Case-Shiller National Home Price Index, and the U.S. Consumer Price Index (CPI). The final column also indicates whether inflation was rising or falling over the period, as measured by the percentage point change in 5-year trailing CPI inflation rates.

Over the entire period from 1950 through 2019, the average 5-year rate of change of equity prices, measured by the S&P 500 Index, was 8.1%. That was 3.8% per annum greater than the average 5-year rate of change of home prices of 4.3%, which reflected a tremendous long-term advantage for equities versus homes.

That said, in 4 out of the 14 periods shown, the average 5-year return to equities was less than 2%. As shown in **Table 1**, in those periods (highlighted in red), stock prices underperformed home prices by an average of 6.6% annually. That represents cumulative underperformance of stocks versus home prices of nearly 30% on average during those 5-year periods.

Likewise, in 6 out of the 14 periods shown, the 5-year rate of CPI inflation rose from the previous period (also highlighted in red in **Table 1**). In those periods, stock prices underperformed home prices by an average of 4.0% annually. That represents cumulative underperformance of stocks versus home prices of nearly 20% on average during those 5-year periods.

In short, history shows that home prices tended to act as a hedge against weak performance of equities and rising inflation. That is partly due to the simple fact that stock prices have been far more volatile than home prices. That confers a natural advantage to home prices during periods of notable stock market weakness. It also reflects the fact that stock prices tended to gain less than average during periods of rising inflation, while home prices rose more than usual during such periods. Of course, there is no guarantee that such tendencies will persist in the future.

Table 1: Stocks Have Tended to Underperform Home Prices Mostly During Periods of Weak Stock Markets and/or Accelerating Inflation

	5-Year Annualized Rate (%)					Change (ppt)
5-Year Periods	S&P 500 Index [A]	National Home Price Index* [B]	S&P 500 vs Home Price [C] = [A] - [B]	Trailing 5 years CPI Inflation [D]	Previous Trailing 5 years CPI Inflation [E]	CPI Inflation Acceleration (Deceleration) [F] = [D] - [E]
1950-1954	16.5	5.2	11.2	2.5	5.8	(3.3)
1955-1959	10.7	0.9	9.8	1.9	2.5	(0.6)
1960-1964	7.2	1.0	6.2	1.2	1.9	(0.7)
1965-1969	1.7	3.1	(1.5)	3.9	1.2	2.7
1970-1974	(5.7)	5.6	(11.3)	6.6	3.9	2.7
1975-1979	9.5	11.3	(1.8)	8.1	6.6	1.5
1980-1984	9.2	4.4	4.7	6.5	8.1	(1.6)
1985-1989	16.1	7.5	8.7	3.7	6.5	(2.9)
1990-1994	5.4	0.9	4.5	3.5	3.7	(0.2)
1995-1999	26.2	4.4	21.7	2.4	3.5	(1.1)
2000-2004	(3.8)	9.8	(13.5)	2.5	2.4	0.1
2005-2009	(1.7)	(1.6)	(0.1)	2.6	2.5	0.1
2010-2014	13.0	2.6	10.5	1.7	2.6	(0.9)
2015-2019	9.4	5.0	4.4	1.8	1.7	0.1
Average, all periods	8.1	4.3	3.8	3.5	3.8	(0.3)
Average when S&P 500 was weak [A] < 2%	-2.4	4.2	-6.6	3.9	2.5	1.4
Average when inflation accelerated [F] > 0	1.6	5.5	-4.0	4.2	3.0	1.2

*S&P/Case-Shiller National Home Price Index
Note: Red shading highlights periods when (1) S&P 500 returns were less than 2% annualized, (2) 5-year CPI inflation rose from the previous 5-year rate, or (3) S&P 500 returns were lower than Home Price Index returns.
Source: GW&K Investment Management, S&P, Macrobond

The S&P 500 Index has generally outperformed the Case-Shiller National Home Price Index since 1950. But stocks tended to underperform homes during periods of weak equity markets or rising inflation.

Will Investors Rebalance Their Wealth Toward Real Estate?

For investors who are concerned about (1) potential equity market weakness, (2) higher long-term inflation, or (3) both, history suggests that increased exposure to real estate makes sense. However, according to the Fed's data reviewed above, it would appear that few investors are positioned that way as real-estate holdings remain near record lows as a share of net worth.

To be sure, we expect few investors to deliberately rebalance their allocation to residential real estate based on misgivings about the stock market or inflation concerns. Nor would we advise them to do so, since we are cautious about putting too much faith in market forecasts. Moreover, selling stocks to buy a bigger home or a second home could come with high real-estate transactions costs and unwelcome tax bills.

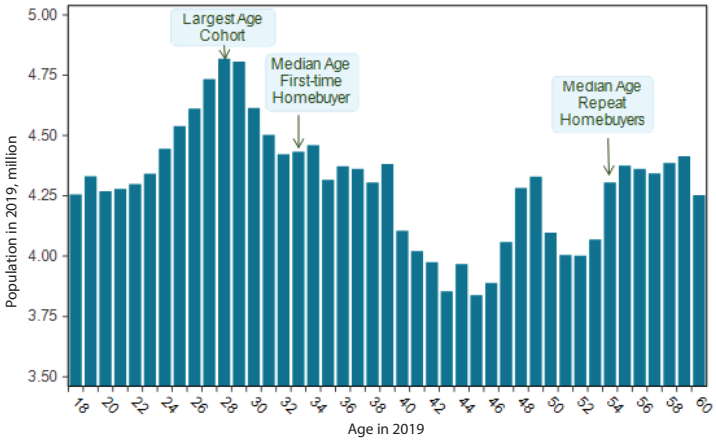
That said, conditions seem ripe for households to continue to add incrementally to their overall real estate exposure, particularly the high net-worth households with relatively modest exposure. This could include purchases of second homes or vacation homes, intra-family loans at low rates to adult children to purchase

[3] Board of Governors of the Federal Reserve System, "Survey of Consumer Finances and Financial Accounts of the United States," October 1, 2021.

real estate (which keeps real-estate appreciation outside of the parents' estates), or participation in private equity funds focused on investing in residential real estate.[4]

Financial flows toward real estate could also gain support from favorable fundamental factors such as demographics and limited housing supply due to regulation. Regarding demographics, there are 28 million Millennials in the 27 to 32 year age range who are approaching the median age of first-time homebuyers, which is 33 years old **(Chart 5)**[5]. On the supply side, in recent decades there has been a steady rise of local land-use regulations that have limited the supply of new homes and driven up home prices and rents. Despite some local government efforts to reverse that trend, a nationwide solution remains elusive.[6]

Chart 5: Large Demographic Tailwind Amind Low Inventory of Homes for Sale



Source: GW&K Investment Management, U.S. Census Bureau, Macrobond

The U.S. housing market faces a very favorable demographic tailwind as 28 million 27-to-32 year old Millennials are approaching the median age of first-time homebuyers (33 years old).

Home may well be where the heart is. But in the current "trifecta of high prices" home may also be where the hedge is.

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[4] See "Barbarians at the garden gate: hostility towards private equity's push into property is misguided," *The Economist*, November 27, 2021.
[5] See Nicole Friedman, "Millennials are Supercharging the Housing Market," *Wall Street Journal*, December 14, 2021.
[6] Ronnie Walker, "The Housing Shortage: Prices, Rents, and Deregulation," *Goldman Sachs Economic Research*, October 11, 2021.

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