ClearBridge Investments

AOR Update: Headwind, Not a Hurricane

1 February 2023

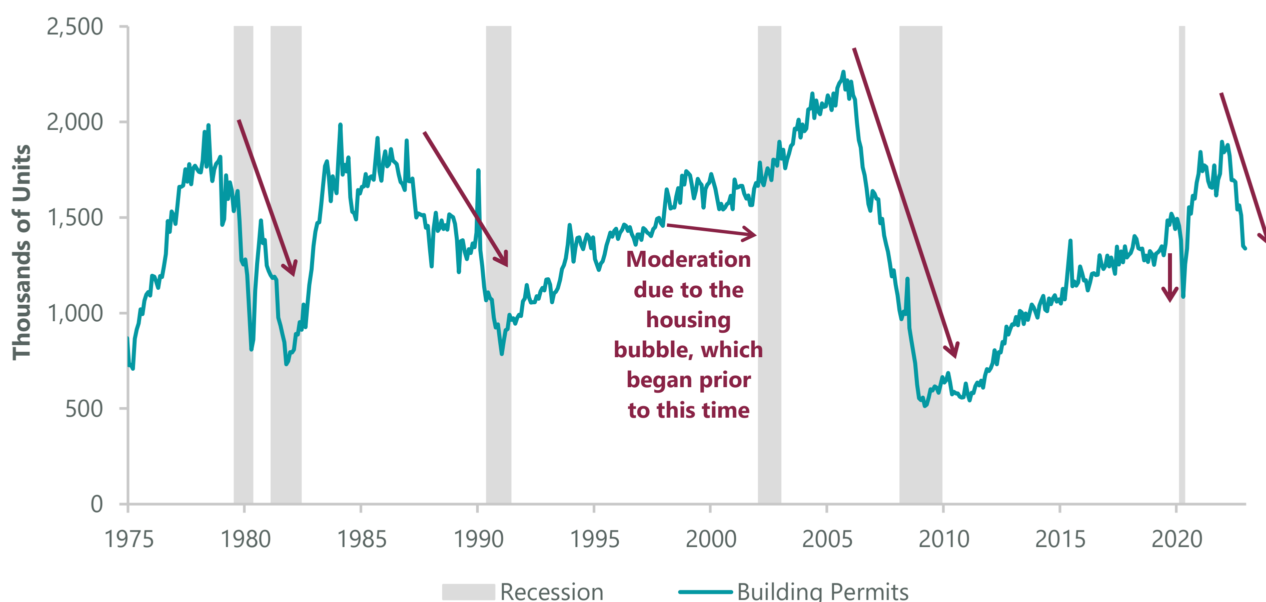
Key Takeaways

- A precipitous drop in Housing Permits over the last three quarters led to a signal change from yellow to red this past month, driving the overall signal of the ClearBridge Recession Risk Dashboard deeper into red or recessionary territory.
- While the housing market has been on the leading edge of the current downturn, the threat of higher interest rates will likely be somewhat muted relative to history as borrowers have largely shifted away from adjustable-rate mortgages.
- Both the economy and housing market are in a very different place compared to the outset of the Global Financial Crisis, which should limit the damage from a housing slump.

Residential Construction Plans Wane as Housing Slowdown Worsens

The housing market has experienced a wild ride over the past several pandemic-influenced years, with home prices rising by double-digit percentages in both 2020 and 2021 before rolling over in the middle of last year. The ClearBridge Recession Risk Dashboard focuses on Housing Permits — authorisations to build a new home — as a leading economic indicator. Permits typically move ahead of actual "shovels in the ground" metrics such as Housing Starts by several months and often fall well ahead of recessions. Permits are down nearly 30% from their peak one year ago and have dropped precipitously over the past three quarters, leading to a signal change from yellow to red.

Exhibit 1: Building Permits for New Private Housing



Data as at 31 December 2022, latest available as of 31 January 2023. Source: U.S. Census Bureau, retrieved from FRED. Compiled: econpi.com.

There are no other changes to the dashboard this month, although both Truck Shipments and Jobless Claims deteriorated beneath the surface and are nearing yellow territory. A worsening dashboard and economic outlook in the face of a rallying market is undoubtedly frustrating, although not entirely unexpected. In November we highlighted how countertrend rallies are not uncommon during extended bear markets, and we continue to believe a durable bottom has not yet formed.

Exhibit 2: ClearBridge Recession Risk Dashboard

		Current	Rapid Summer Deterioration		
		January 31	August 31	July 31	June 30
Consumer	Housing Permits	✖	⬆	⬆	⬆
	Job Sentiment	●	⬆	⬆	⬆
	Jobless Claims	⬆	⬆	⬆	⬆
	Retail Sales	✖	✖	✖	●
	Wage Growth	✖	✖	✖	✖
Business Activity	Commodities	✖	✖	✖	●
	ISM New Orders	✖	●	●	●
	Profit Margins	✖	⬆	⬆	⬆
	Truck Shipments	⬆	⬆	⬆	⬆
Financial	Credit Spreads	✖	✖	✖	✖
	Money Supply	✖	✖	●	●
	Yield Curve	✖	●	●	⬆
	Overall Signal	✖	✖	●	⬆

⬆ Expansion ● Caution ✖ Recession

Source: ClearBridge Investments.

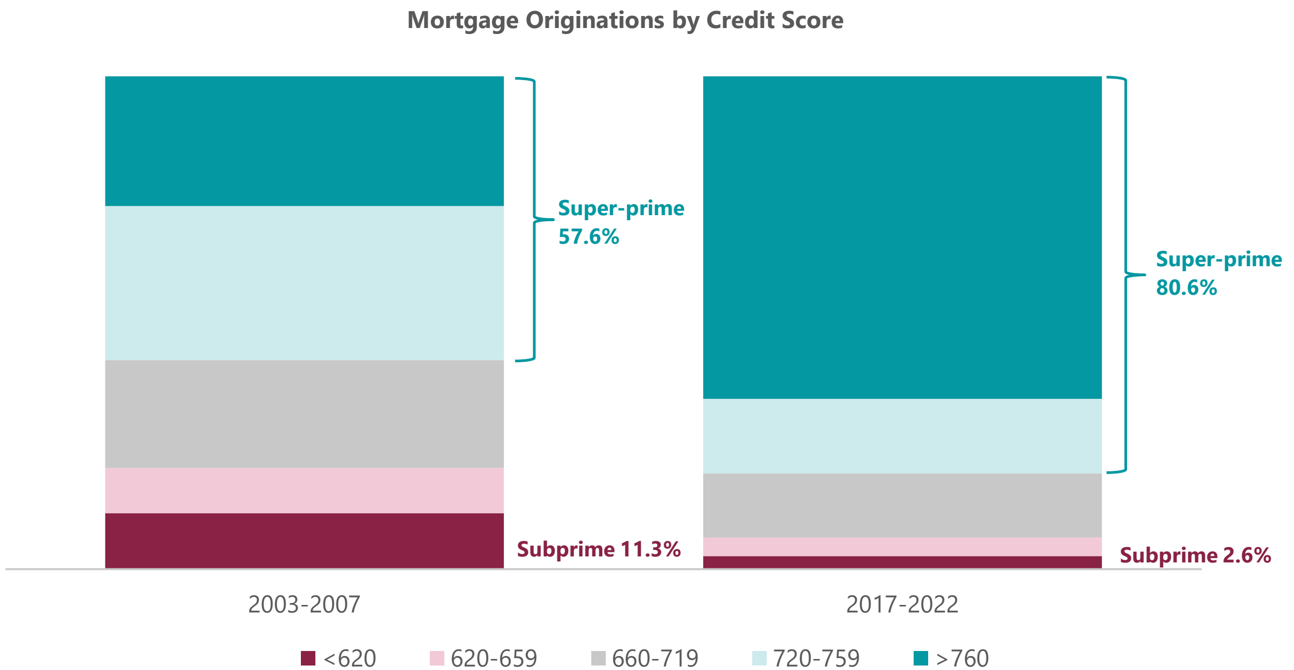
While the Housing Permits indicator has held up until now, the broader housing market has been at the leading edge of the current economic slowdown. This is unsurprising considering housing is typically one of the first dominoes to fall. Housing is one of the most interest-rate-sensitive areas of the economy, given most homeowners borrow to purchase homes; changes in mortgage rates have a meaningful impact on demand. Over the last 10 months through the end of January, the Fed has raised its target rate 425 basis points to cool economic growth and tame inflation, helping push mortgage rates much higher from their late 2021 trough. The rise in mortgage rates, combined with the substantial increase in home prices, has pushed affordability metrics down to multidecade lows.

However, the threat from higher interest rates will likely be muted relative to history. In the wake of the Global Financial Crisis (GFC), borrowers shifted away from adjustable-rate mortgages (ARMs) and have largely stayed away from them since. The share of ARMs as a percentage of all mortgages (by dollar volume) has fallen back to 13.5% after peaking slightly below 25% last fall, a stark contrast to the run-up to the GFC when around 50% of homebuyers were using this variable type of financing. Even though higher rates may dissuade new buyers, the impact on mortgage payments for existing owners is blunted by this dynamic relative to the 2004–2006 hiking cycle.

The mortgage market also looks different than during the GFC from a quality perspective. While so-called "liar loans" — mortgages where borrowers falsified their incomes or provided no income documentation to qualify for mortgages they couldn't afford — were common in the mid-2000s, the creditworthiness of borrowers today appears far healthier. Consumer balance sheets are still in great shape after a tough year for markets, with robust wage increases, rising home prices and accumulated savings supporting household net worth. In fact, just over 80% of mortgages originated over the past five years went to super-prime borrowers (>720

credit score), and the share of subprime borrowers (<620 credit score) was in the low single digits, a stark contrast from what the early days of the GFC when super-prime was less than 60% and subprime was over 10%.

Exhibit 3: Mortgage Origination Quality Improving



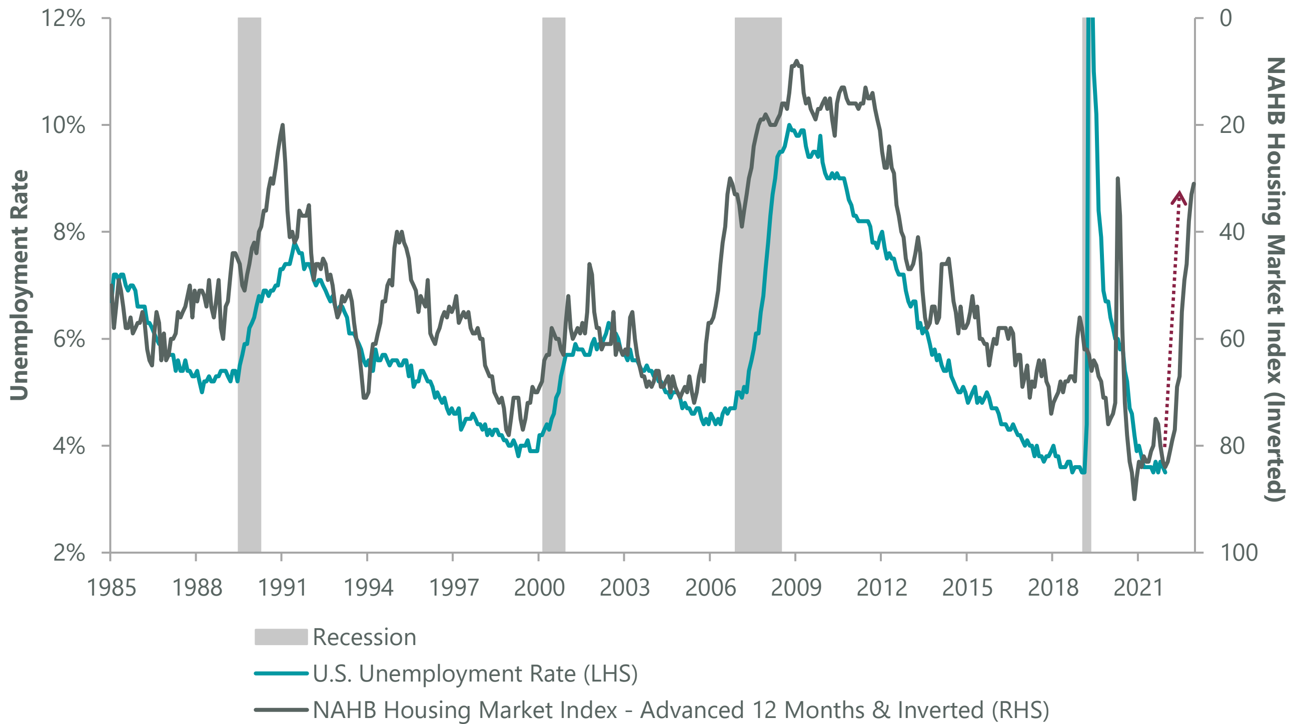
Data as at 30 September 2022, latest available as of 31 January 2023. Source: Federal Reserve Bank of New York Consumer Credit Panel/Equifax, Bloomberg.

A final key difference relative to the GFC that could help limit downside in the housing market is demographics. The bulk of the millennial generation is now hitting its peak earning and child-bearing years, helping support longer-term housing demand. Many millennials have lived at home and delayed forming households longer than previous generations, although this appears to be shifting. Further, the trend toward "aging in place" means fewer retirees are moving into retirement homes, limiting housing supply in a period of increased demand. As a result, demographic trends will likely support the housing market in the coming years, which should limit how far activity and prices fall in a downturn.

While housing prices have rolled over and transaction activity has stalled, construction activity has held up. Housing completions in the fall of 2022 were at their highest level since 2007 and 2023 is likely to see the highest number of new multifamily units come to market in several decades. This activity is supporting strong gains in construction jobs, which steadily marched higher in the second half of 2022 despite a softening backdrop for home prices. However, as the backlog of building projects clears out this spring, the typical layoff cycle in construction is likely to commence. Although the economic pain in housing has yet to be felt, leading indicators including permits and starts to suggest it will become an economic headwind in the coming quarters.

Against this challenging backdrop, there are reasons for optimism with the recent bounce in the National Association of Home Builders (NAHB) survey and weekly mortgage applications. While it's not surprising to see homebuyers take advantage of declining interest rates, a small bounce in housing data isn't uncommon as the Fed wraps up a tightening cycle. More concerning, however, is how the NAHB survey has historically led changes in the unemployment rate by 12 months. This survey's massive drop in 2022 suggests more pervasive layoffs are likely in 2023.

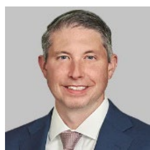
Exhibit 4: Home Builder Sentiment vs. Unemployment



Data as at 31 August 2022, latest available as of 30 September 2022. Source: FactSet, US Department of Labor, NAHB, NBER.

Although the economy's trajectory is relatively clear, the timeframe and severity of a potential downturn are anything but, as we discussed in the most recent Long View. The good news is both the economy and housing market are structurally in a very different place compared to the outset of the GFC. This should limit the damage from a housing slump, creating more of a headwind than a hurricane. With the U.S. economy slow dancing toward a potential recession, we continue to believe the first half of 2023 will prove choppy for equity markets as incoming data fails to reveal a clear trend for growth and earnings.

About the Authors



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