Let's Get Real. Real Estate, that is.

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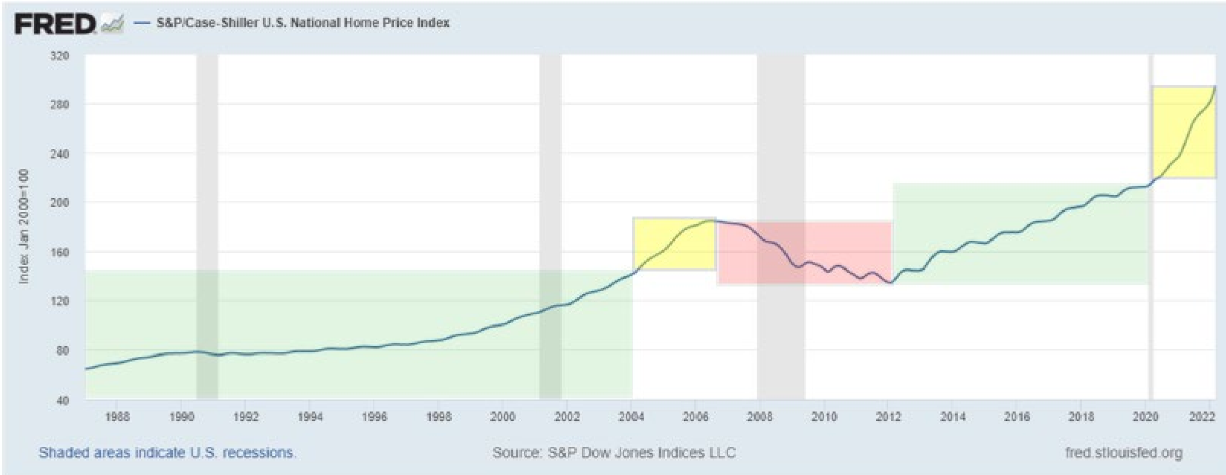
July 4th is around the corner, the weather is warm, and if you're lucky, you'll attend a few barbeques this summer. At some of these, the conversation will surely turn to the stock market. But it's also likely that people will talk about Real Estate and home prices. With that in mind, we think now is a good time to do a deeper dive into this subject.

Before we address the subject of home prices, we want to step back and **consider Real Estate investing in general**. While most individuals associate the subject of "Real Estate" with the price of their home, as investors, when we allocate to "Real Estate", the funds that we use have a much larger and more diverse opportunity set than single family homes. This table shows seven major sectors of Real Estate, the economic drivers of each, key tenants, and importantly – lease duration.

Sector	Economic Drivers	Key Tenants	Lease Duration
Office	Corporate profits, GDP	Corporations, Professionals	5-10 yrs
Industrial	Consumer spending, retail	Logistics, Manufacturing, Retail	3-5 yrs
Regional Malls	Consumer income, sentiment	Soft good retailers	7-10 yrs
Retail	Consumer spending, population	Grocery, Drug, Restaurants	5 yrs
Multi-Family (Apartments)	Demographics, Housing trends	21-35 and 65+ year olds	1 yr
Storage	Population growth	Adults	Monthly
Lodging (Hotels)	Business and Consumer Spending	Business and Leisure travel	1 day

When considering these sectors, the two most prominent differentiators are **Tenant and Lease Duration**. This boils down to Business vs Consumer and Short vs Long. For example - Hotels rent to both individuals and businesses, with essentially one day leases, and can change their prices daily. Office buildings lease only to businesses, and for extended, multi-year periods, typically 5-7-10 years. They can't adjust rents frequently. Apartment owners, a.k.a. landlords, rent housing to individuals for typically one-year periods. Of these, our favorite sector is Apartments – people must live somewhere, and you can raise rents each year to keep up with inflation. Overall, we think Real Estate is an important component of nearly every investment portfolio and to us, the best way to invest in Real Estate is in **the private markets** with well-resourced management teams that have an abundance of experience and expertise.

Now, let's turn our attention to home prices, which are more likely to be the subject of a friendly conversation, or debate this summer. Let's start with the big picture - this graph where the blue line shows the price index of homes in the U.S. since the mid '80's.



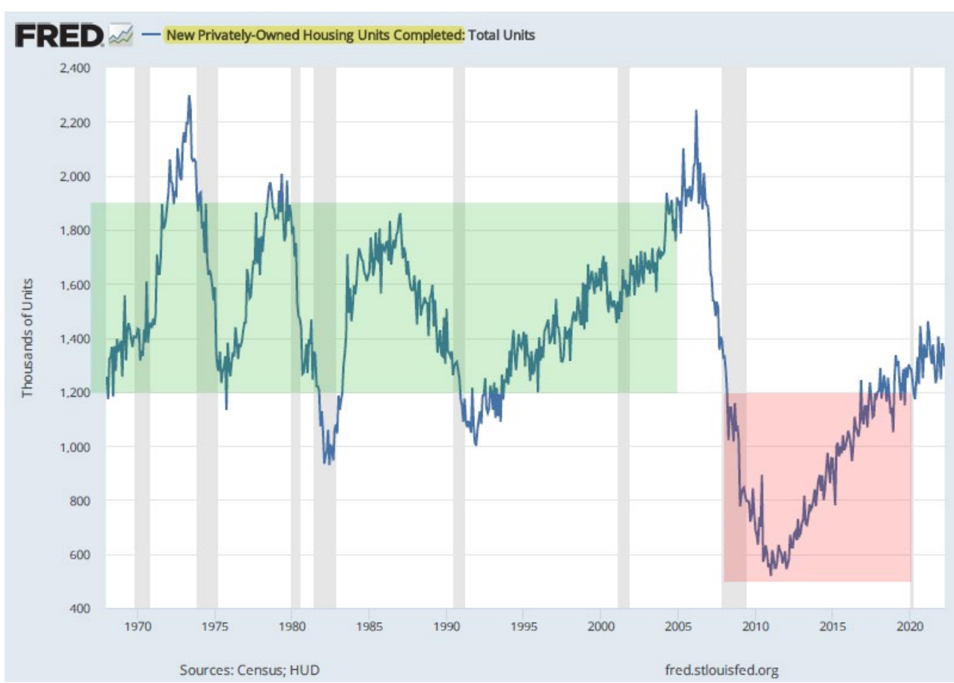
Three things jump out:

a. **Home prices generally go up over time** at a steady pace (the green shaded areas).

b. Other than the 5 years from 2007-2012 (shaded in red), you'd be hard pressed to find the only other annual decline in home prices. (It was 1991-2, when they declined ~3%.)

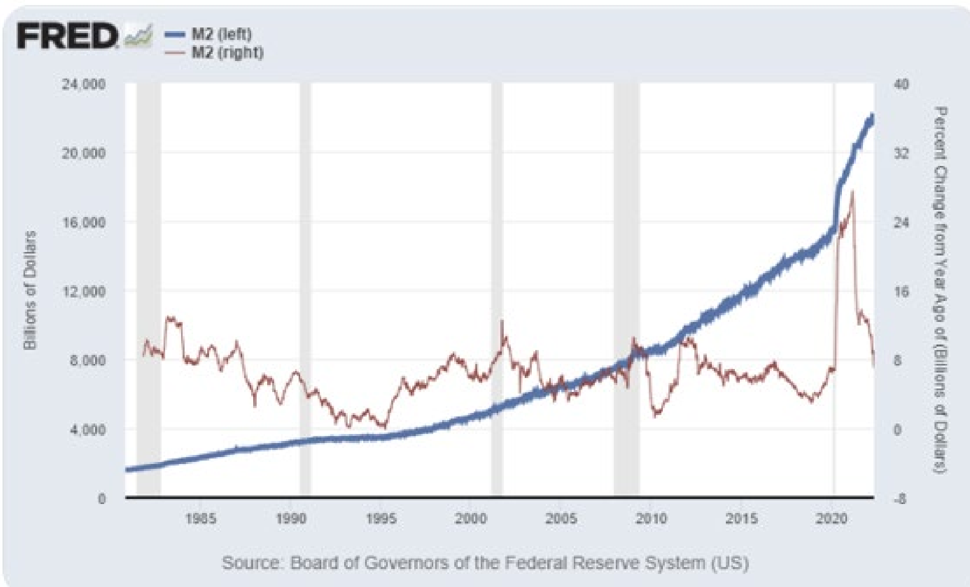
c. The most recent two years is the second episode in the last 35 years with extreme home price appreciation. (both highlighted in yellow.)

So why did home prices suddenly go up so much, over 20%, in the last two years? Home prices, like any other asset, are affected by **Supply and Demand**. When Supply exceeds Demand, prices go lower. When Demand exceeds Supply, prices go up. Since our population is growing and old houses ultimately deteriorate and need to be replaced, we need more new houses each year. When new construction fails to keep pace with growing Demand, prices go up more than usual. Following the popping of the Real Estate Bubble from 2007-2012, new construction absolutely dried up. Yes, there was excess inventory that needed to be absorbed, but for many reasons, **new construction fell off a cliff and stayed low for a long time**. Few remember or realize the enormity of this change, illustrated by this chart:

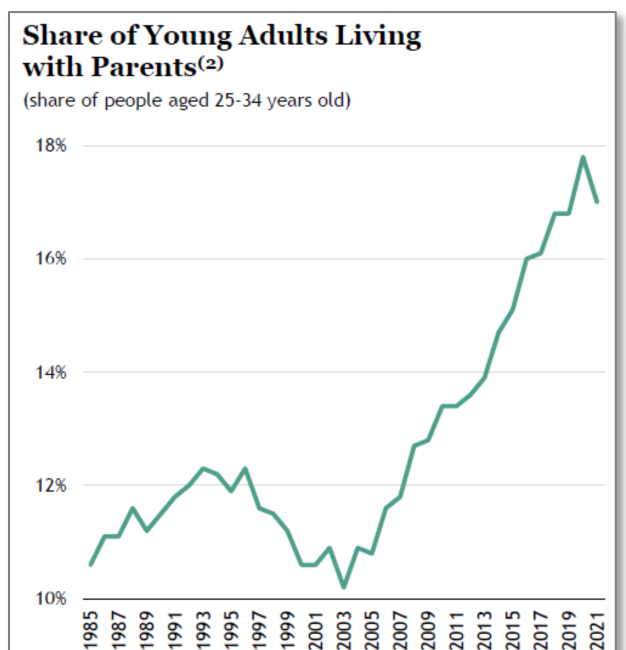


The blue line in this graph shows the # of new privately-owned housing units completed over the previous 12 months. During the 40-year period shaded in green, we typically built and delivered between 1.2 million and 1.9 million new houses each year. Then the cliff in 2009. The period from 2009-2020, highlighted in red, shows that after decades of building more than 1.2 million homes each year, we **spent much of the next 10 years building fewer than 1.2 million homes each year**. In other words, we curtailed the creation of new Supply for more than 10 years. That's a long time in any market. But does low Supply fully explain a sudden 20-40% spike in home prices? No. The lack of new Supply was only part of the equation – and it helped create a perfect storm when Demand surged following Covid.

Why did Demand surge following Covid? There are many reasons. For one, the U.S. stock market gained 18% in 2020 and another 29% in 2021, making potential homeowners feel wealthy enough to splurge on a house. Another, likely more important, financial factor that fueled the boom over the past few years was mortgage rates. Rates had been declining for a while, but 18 months ago the average 30-year mortgage was as low as 2.67%! Incomes also rose. Three different Covid-related stimulus packages totaling trillions of dollars boosted the income and savings accounts of millions of Americans. The enormity of the Covid related stimulus is worth viewing as a picture:



The Blue line shows the amount of money (M2) in circulation, and you can clearly see how it jumps vertically following Covid. The red line on this chart shows the trailing 12 month percentage change – exceeding 24% growth. The net result was **a 40% increase in U.S. Money Supply in less than two years** thanks to three different Covid related stimulus packages as well as Federal Reserve policies. This money had to go somewhere. Some of it went into stocks. Some of it went to cryptocurrency. A lot of it probably found its way into Real Estate – either for purchase (houses) or rents (apartments).

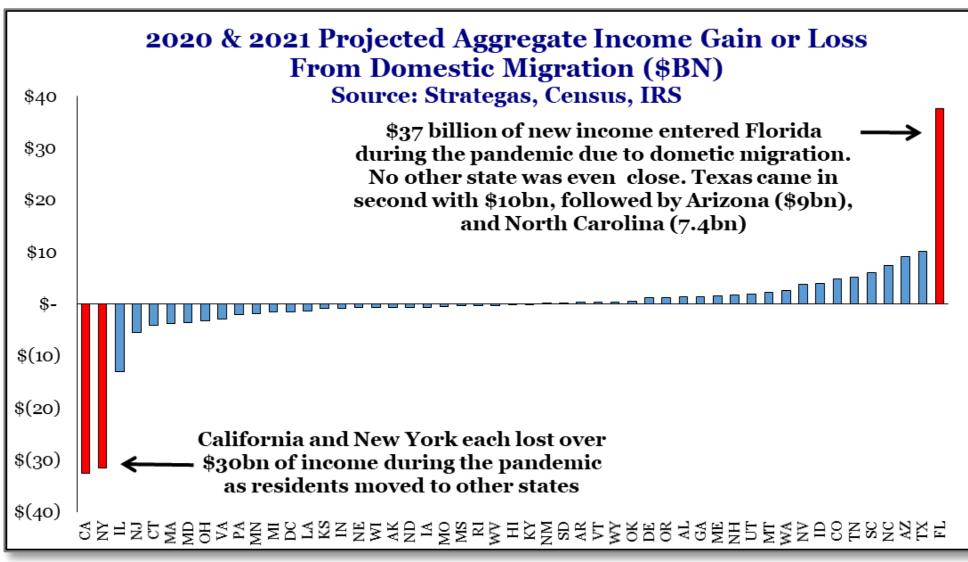


And speaking of Apartments. Perhaps you or someone you know had one or more twenty-somethings living at home over the last 10 years. This was not unusual. In fact, it was a nationwide phenomenon. This eye opening chart shows the percentage of young adults (aged 25-34) living with their parents. From 1985-2008, that level was usually between 10-12%. In 2020, it reached nearly 18%! That's **millions more young adults living at home than had been typical** for the previous two decades – creating pent up demand of millions of potential future home buyers and apartment renters. Covid was the spark to get them out of the house - After Covid forced many parents to work from home for six or more months, it seems the kids took the Government's stimulus checks and decided they wanted to finally move out!

But as we all know, Covid's impact on the Housing market wasn't simply due to financial or demographic factors. The housing market was also significantly altered by the **sudden evolution toward Work-From-Home (WFH) and Work-From-Anywhere (WFA)** policies. For this discussion, we define "WFH" as a hybrid policy whereby you work from home several days a week, but still need to be within a commutable distance to the office. Similar but different, "WFA" means you can work remote 100% of the time from anywhere in the world essentially.

The popularity of both WFH and WFA policies had a predictable impact on the value of office buildings and the attractiveness of major metropolitan cities. To wit, only two of the nation's largest cities saw population growth between July 2020 and July 2021. New York City was the biggest loser, followed by San Jose, Chicago, and Philadelphia. Only San Antonio and Phoenix saw population gains. Do they have anything in common? More on that in a bit. The short-term and long-term impact of WFH and WFA policies is hard to quantify, but three professors from New York University and Columbia released a paper this May estimating that these policies will result in a 28% reduction in the value of New York City office space – the equivalent of $500 billion of value destruction. Oof!

Conversely, the value of Real Estate in **Florida and Texas has been skyrocketing**. Those two states have been the biggest benefactors of the WFA movement. If you can work from anywhere, then it seems many people would prefer a warmer climate with no state income taxes. Shocker! Here's a dramatic chart that illustrates how much personal income has migrated out of or into each state over the last two calendar years. **New York and California have been the big losers** (each losing over $30 billion of personal income), while Florida has been the biggest winner – with over $37 billion of personal income migrating to Florida over the past two years alone. Wow.



Fun Fact - Florida was the least populated state in the South prior to the invention of Air Conditioning. Now it's the third most populous state in the country. The way we see it, the Work-From-Anywhere evolution, like the game changing advent of Air Conditioning, has sparked the next tsunami of migration to States with warmer climates and lower taxes.

That's interesting, but where do we stand today? Well, according to Ned Davis Research, we began this year with an imbalance of Supply and Demand to the tune of a shortage of 2.6 million homes. And in spite of the anticipated construction of 1.5 million homes in 2022, **we will end the year still short about 2.5 million homes** due to increased Demand this year. The vast majority of this Demand spike is the result of an anticipated "formation" of 1 million additional households in 2022. Looking at rentals, over the last 65 years, the Apartment vacancy rate has averaged 7.3%. Today it is only 5.8%. So, we still have a large imbalance in Supply and Demand due to the factors laid out above – a decade of underdevelopment, Covid-related WFH and WFA factors, and demographics.

But things have changed very quickly over the past two months, and in our opinion, are likely to continue changing. First, the stock market's decline is going to take the wind out of the sails of some buyers. But the real news is in the mortgage market, where the **recent change in mortgage rates is likely going to stop the real estate market in its tracks**, at least temporarily. Whereas 18 months ago mortgage rates were only about 2.75%, they are now…get ready for this…as high as 6.25%. Let's look at the mortgage payment of a hypothetical buyer of a house that 18 months ago was $500,000 but is now listed at $650,000, with a mortgage rate that went from 2.75% to 6.25% over that time:

	Hypothetical Mortgage Payment	
	Then	Now
Home Price	$500,000	$650,000
Same Down Payment	$130,000	$130,000
30 Year Mortgage	$370,000	$520,000
Mortgage Rate	2.75%	6.25%
Mortgage Payment	**($1,507)**	**($3,185)**
Monthly Difference		($1,678)
Annual Difference		($20,137)

That's **a monthly increase of $1,678**. An annual increase of over $20,000. Over the 30-year life of this loan, the total interest cost would be almost $460,000 more! The reality of higher rates is already hitting the mortgage market – applications for new purchases and refinancing are dropping sharply nearly every week. Real Estate industry analysts are starting to predict a correction. Moody's chief economist expects prices to be flat over the next year in many markets. He thinks that a recession would see prices nationwide drop 5%-10% with the most overvalued markets dropping 15-20%.

While a short-term price decline in most markets seems inevitable, we, and others, do not think we're heading toward a Real Estate or Housing bear market like we experienced 15 years ago. Why not? Because **today is nothing like 2008-9**. Back then, Banks were giving mortgages to everyone – a large portion of loans were "Sub-Prime" (remember that term?). There was rampant speculation in the housing market with millions of houses being "flipped" (remember that too?). Financially, this time the market has been much healthier as homebuyers have been putting more money down and on average, they have much higher credit scores. In 2008, there was excessive building and an abundance of excess supply. Today, **we remain short on Supply** – a phenomena unlikely to get fixed soon in the face of higher commodity and financing costs plus a shortage of skilled construction labor. (Already, May housing starts are down 14% and building permits are down 7%). Plus, **Demand is only going to continue to grow** due mostly to demographics and more household formation, but also due to Covid's impact on WFH and WFA policies.

We don't have a crystal ball, but over the short-term, we think higher mortgage rates will have a large impact and most of the residential real estate markets around the country will **cool significantly – but not crash**. True, recession risks are rising, which would pressure prices further, but that would also bring lower interest rates, which would be a relief for buyers. (Recession or not, we don't expect mortgage rates to stay near 6% for long and to drift back toward 4-5%.) Expect sellers to be very reluctant to sell at levels far below what their neighbor sold for only months ago. Over the next year or two, while some overheated markets could see prices contract 20%, in most areas they may only slip 5-10% from recent levels, and thus, would still be much higher than 2 years ago. The most attractive areas (Florida?) may see prices merely plateau and not give back much or any gains. Looking past any short-term declines, five years from now, prices are unlikely to be lower than today in most markets. That means housing affordability will remain a challenge for many.

Locally, thanks to Work-From-Home policies, we think towns near cities that previously enjoyed large premiums due to short commuting times will face headwinds while demand will continue to grow for larger houses with longer, but still doable commutes. Regionally, Work-From-Anywhere should continue to fuel migration to better climate and low/no tax states. With the inevitable increase in households over the next 5+ years, Demand is expected to remain strong, especially for Apartments. That axiom about the three most important things in Real Estate? Thanks to the events of the last two years and the outlook for the next five, it may have to be updated to "**Location"** (Local and Regional), "**Formation"** (of new Households) and "**Vocation"** (WFH and WFA).