The Hexagon Briefing: A Global Perspective from HSBC

Episode 6: Real Estate Opportunities
June 16, 2021

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Jose Rasco: Thank you for joining us today. Before we begin, you should be aware that relevant information relating to this podcast and the products and services we are about to discuss are available at the end of this recording and on our website at www.us.hsbc.com.

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I'm your host, Jose Rasco, and thanks for joining us today.

Today, we're going to cover the topic of real estate opportunities. Mitch Palminteri, HSBC's Head of Credit Advisory in the US, is here to help me unpack that.

This podcast was recorded on Wednesday, June 16, 2021.

Thanks for joining me. And let's get going.

In terms of real estate, there is a lot to talk about, so I'm lucky to be joined by Mitch Palminteri, HSBC's US Head of Credit Advisory. Mitch, thanks for coming on the Hexagon Briefing. People thought that real estate was going to get hurt in the covid lockdown, as it would during any other recession, because people are losing their jobs. And in fact, it was sort of this perverse thing that happened that people tried to move out of cities due to social unrest, due to covid. And we saw this real movement, or heavy duty movement of people and bodies, pushing demand up for housing in the middle of a recession, in particular in second and third tier cities and in suburban areas. So that has obviously persisted.

And so just to set the framework for you guys before we get to Mitch, you know, keep in mind the concept of inflation is, you know, this more money chasing the same number of goods. And what we've seen is even more dramatic than that. We've seen a lot more money where we've seen M2 rising, 25%. We've seen federal budget deficit expand exponentially. We've seen the Fed balance sheet expand. We've seen fiscal programs that are actually in excess of what FDR spent during the New Deal. Those have been, that have been proposed by the Biden administration. So we've seen a lot of liquidity added to the system. So that means there's more money to spend. And guess what? The housing market is suffering from a lack of inventory. So therefore, it's more money chasing fewer goods. It's even more inflationary. Now, the movement's, Mitch, correct me if I'm wrong, but the movements continue as people continue to move to the second and third tier cities. The work from home movement has changed the housing market. And more importantly, we're seeing the potential for higher, not just higher interest rates no, but the potential for higher income taxes is causing people to look at states now that have lower or no state income tax. And therefore, housing is booming in cities that we didn't think we were going to see at the beginning of this whole thing. So given that backdrop, what do you see?

Mitch Palminteri It is, it is amazing Jose, you hit it right on the head. You're absolutely right. So, yeah, we've seen movement from the more urban to suburban people moving out only because of this work from home concept. You know, who would have guessed, two years ago that the whole world would be working from home, basically. And what it proved was that even for us, HSBC, that we were able to run a bank from home. So with that, yeah, we saw people moving out to more suburban areas, getting more space and more room out in suburban areas like here in New York, moving out to Long Island, for example, Connecticut or further out in Jersey. So yeah, this is definitely happening and probably will continue to happen as the culture of work from home becomes more mainstream.

So, that on top of the fact that interest rates have been low has really increased that purchase market. We here at HSBC are viewing the real estate market as a purchase market because we feel that refinances, although it's still going on and we still have a fair amount of them, is moving to a more of a purchase market.

Jose Rasco So we've seen the re-fi boom and pretty much people have locked in, right, to your point and the same on the corporate side. We saw corporate debt issuance last year with low interest rates reached historic levels in 6 months. So we don't expect a lot more corporate debt issuance this year relative to that. But yeah, there's still, like you said, with the re-fi, there's still some of it going on. That purchase market is, looks hot, and some people are using the phrase overheating. One of the issues we've got, Mitch, is lumber prices are at an all-time high. And commodity prices have reached fever pitch because these places were shut down for six to nine months. They need to replenish inventories. Do you see this market remaining strong in terms of just demand? Is consumer demand, from your perspective still strong for residential construction?

Mitch Palminteri Yes, absolutely. It definitely is, I think again, going back to work from home concept as people realize that they can do their office work from their home office, you'll continue to see, I believe, an increase in real estate prices because people are moving out of the cities, most cases. But let's be fair here, it doesn't mean that the real estate market in Manhattan, for example, is going away, far from it. I think that that's still a hot, it's going to still continue to be a hot market for us. And it will continue to be, for some people, just as still a great place to live and a great place to work.

Jose Rasco But you bring up a great point, which is everybody focuses on real estate now and they're focusing on the suburban market, that house with the white picket fence, the 1.2 children and the dog. Right? But what about residential real estate in these large cities? A lot of these apartments, a lot of these condos, a lot of these homes that are for sale in large cities that have been vacated due to the political and social unrest as well as covid. A lot of those homes are a lot cheaper than they were or there didn't go up as much as prices in some of these second and third tier cities. So is there an opportunity in the big cities, the mega cities of New York, L.A., Chicago, Miami, etc.? Is that still viable? It sounds like you're saying it is.

Mitch Palminteri Yeah. Look, let's let's face it, Manhattan and those other large city types of areas like L.A., Chicago, they're not going away. People will always want to live in those urban type of areas. Of course they will. And, you know, when I hear some people say, God, you've heard it, Manhattan is dead. It's not dead. There's no way! That's going to come back and rebuild and it's going to be a viable market. Of course it will be once again.

Jose Rasco All right, so demand is there now. Well we touched on interest rates and you mentioned them earlier. And let me pause at a theory with you here, a lot of people are saying inflation is stronger than people think and they point to housing one for one reason why lack of commodities and all that. And so our view at HSBC has been that it is transitory. We agree with the Fed. And that even though transitory may last longer than we're comfortable with, it's still transitory, it's not long lasting, it's not permanent. And when supply catches up with demand, you'll see the price gains will normalize. They won't be growing at 6, 8% in some areas. They'll be growing at more normal or historical levels. So that's one thing.

The second thing is as the Fed begins to normalize their monetary policy, what effect does that have on residential real estate, right? In other words, not just Fed funds and raising the short term interest rates, but as they lower that quantitative easing program, they begin to taper, which is something it's probably going to happen in the next 2 to 3 quarters as they begin to do that. Here's the theory that we've got. If they do that, you will see that there is no buyer of last resort for treasuries. So it goes to the open market. And as rates begin to rise and the curve begins to steepen a little bit, what happens? Oh, people will say, well, that's the end of housing, because look at that. The you know, the 30 year mortgage is climbing 25 basis points. But what's going to happen in the market for treasuries is that you will see that as those rates climb, foreign buyers of treasuries will be attracted to that relative yield because all of a sudden, US Treasuries, which is the largest and deepest market in the financial market system globally, all of a sudden they yield a better year. They have a better yield, they're more attractive. So they will buy them, which again brings that yield down.

So my point is and my question to you is, do you agree with that view that there is sort of an upper bound limit or constraint to long term interest rates in the US, given that such a large percentage of other sovereign bonds are in negative yield areas or in very low yields? So what's your view there and its effect on mortgage rates?

Mitch Palminteri So as the Fed starts to inch up interest rates, and I agree with you, it'll happen. As the Fed starts to increase interest rates, what you'll see is then obviously the debt service for borrowers will increase right? They'll have to pay a higher mortgage payment. That's obvious. So what that means is, the buyer, in order to maintain a level of payment that they can afford, and it's all a regulated product, the mortgages in the US, then they'll have to pay down or put down a higher down payment in order to get to a level where they could service that debt. If it gets out of reach for some buyers out, then you're going to shift from higher priced homes to something that they could afford, maybe lower priced homes. But that has always been the struggle for the consumer is just affordability. And interest rates obviously have a big part in that.

Jose Rasco So, yeah, I think and to me, the perverse thing here is as the Fed begins to taper and other buyers of treasuries look to buy treasuries, it means rates will probably stay a little lower than people think they would go to and therefore extends the duration of this thing and that demand for housing can be met. But it's just going to take a little longer than people like.

Now, in terms of one of the, another issue we've got in residential real estate is inventories, Mitch. And we're seeing that a lot of companies are saying, well, we can't get the lumber for 2 to 3 months or the prices are going up. And but the key is inventory of unsold homes remains very low as a lot of people are moving. But the demand is just far outstripping supply.

So do you see as the cycle continues to expand and and broaden out, growth rates will slow, obviously. We're not going to grow at 6, 8, 10% forever. But as we normalize the economy and the consumer gets back to work and that unemployment rate goes down substantially, you know. Do you think that that inventory problem will begin to resolve itself as builders continue to to expand on their supply issues?

Mitch Palminteri It will, of course. Yeah, of course it will. Because once the supply catches up with the demand, then I think you will see just kind of a leveling off of the pricing. But that's just a normal reaction of of the market when it comes to real estate.

Jose Rasco Right. And so the one thing that a lot of people have asked and a huge source of demand over the last decade, 15, 20 years in fact, has been foreign demand for homes. Now, you know, I talked to a lot of our clients who are who are foreign based, you know, live in other countries. So a lot of our clients are asking about investing in real estate in the US. And I guess the question I would have for you is, do you see continued interest from foreign buyers? Because we know that we're seeing a lot of inflows from Asia, broadly speaking, from Europe as well as Latin America, where we're seeing and as other emerging market countries as well who want to buy quality assets. And when they saw that the price of real estate or the demand for real estate was strong in this country, a lot of money has has come into the US. Do you think that's something that's sustainable? And can you give us some color around that?

Mitch Palminteri Yeah, absolutely. I do. I do think it's sustainable. It's been going on for years here in the US. And we as an international bank, we do a lot of business. We do a lot of financing for international buyers. It's something that we do very well. There are other lenders here in the US that want to do what we can do, but because they're not international banks, we at HSBC have really honed in a skill of lending to an international borrower. We know how to do it. We do it seamlessly. So, yes, I see that continuing because foreign nationals do want to buy real estate in the US. It's a destination for them.

That also includes which we sometimes forget about, is the children of these international clients. So you may have a client in Hong Kong, for example, that's sending their child to the to the United States for University. Well, the one thing that they'll do is they'll buy a property here for that for their child to live in. So that will that will continue. We at HSBC are the perfect bank for that type of financing because we are an international bank. We understand the international client. We in most cases have a relationship in all the other regions that we do business with. And that business is a referral here to us in the United States. So we know the client, we understand the client, and we have a good relationship with them, not only in the US, but also internationally.

Jose Rasco So those global flows get facilitated. But you see that being something that continues. And then keep in mind, the other thing to keep in mind, I think as we talk about US residential real estate or demand for it, is that foreign buyer is a big part of the market. It used to be much bigger, but it's still very strong. And as we see in especially in Asia, where growth rates over the next 5 to 10 years are pretty explosive. Right? And that creation of the middle class in Asia continues to to just grow. And this is something that's going to be very powerful. And especially if you look, I believe the stat. I'm sure it's way out of date. But there was a point at which, you know, Chinese consumers, for example, only 4% of them had passports and could travel abroad. And I think, as you see, the Asian consumer continue to grow, technology continues to diffuse. This creates wealth and that wealth is looking for a home. And one of those homes is is buying residential real estate in the US. So we remain positive on that market for that reason as well.

All right, great. Now, Mitch, what about the mortgage market? Are there any things going on in the mortgage market that you think bare mentioning?

Mitch Palminteri Interest rates in the U.S. are still obviously very low, so that continues to to fuel the the purchase and the refinance market. So as rates stay at this level, you'll continue to see that type of mortgage activity.

Jose Rasco One of the other questions I've got, one of the final questions I've got for you here is you talked about affordability and as homes get more, of less affordable, as prices go up and let's say I get a job in Phoenix and my wife and I go out there and say, wow, we really can't afford to buy in the neighborhood we want to live in. Right? Whether it's kids in school districts or whatever. Or if, you know, for that foreign buyer, if you want to be in in New York, because your kids going to go to NYU or whatever? Right? There are markets you're looking for and you may say it's not affordable. So and historically, this is what we see as prices go up. Then people look at the rental market. Right? Consumers switch. Consumer behavior is very dynamic. So as consumers switch toward the rental market, that is something we have to watch because then something called the owners equivalent rent in the CPI, which is 24% of the CPI, could begin to push the CPI a little higher.

But more importantly, what does it mean for demand for multifamily housing? So multifamily housing has been a very strong component of what's going on. Do you have any insights in terms of multifamily construction and a lot of our clients are developers or looking to develop these properties? Is that something you can give us some color on?

Mitch Palminteri Look, commercial real estate financing is something that we also do in the Private Bank. We also have a very large group in our Commercial Markets group that also does very large commercial real estate property. Multifamily is the one hot spot or at least one place that we have an interest in. And the reason for that is because of the shift from, as keep layering in this conversation, the work from home, you know, we're more interested in the mulitfamily than we are at least in the Private Bank on office type of financing. So yeah multifamily will continue to grow. You're right Jose, if prices get out of range from some buyers, maybe not our Private Bank type clients, but if they get out of range for some of our clients, then yeah it would open up the rental market, which then of course opens up the market for family finances as well.

Jose Rasco Mitch, thanks for joining us today.

Mitch Palminteri My pleasure.

Jose Rasco The conversation with Mitch was fascinating and here's what I'm taking away from it. As we've talked about, the economy is expanding and it's going to slow because we're going to see the explosive growth rates of reopening the economy are going to normalize back to that 2 to 3% range, which is where we want to be. And as the unemployment rate continues to drift lower and people get rehired, especially in the services sector, expect demand for housing to remain strong. More importantly, that lower unemployment rate means people will have purchasing power. And with interest rates staying more or less lower than historically normal demand for housing should say stronger for much longer than people think. Last but not least, we have these major changes in technology coming, and those will all empower that work from home movement. Not only that, the creation of new businesses, which may or may not have to be centered in major metropolitan areas. So again, demand for housing should remain strong. So we are looking for residential activity. Construction, you have to keep building because the demand is strong. So we expect residential construction and we expect demand for homes to remain strong, which means it's still an area that we would like to explore as investors going forward.

Thanks for listening to the Hexagon Briefing, I'm Jose Rasco. See you next time.

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