**What Happens Next – 11.14.2021**
**Risk of Downturn in US Residential Real Estate**

My name is Larry Bernstein.

What Happens Next is a podcast where an expert is given just SIX minutes to present her argument. This is followed by a Q&A period for deeper engagement.

This week's topic is the risk of a downturn in US residential real estate.

Our speaker today is Ivy Zelman. Ivy is a leading housing analyst, and she has won the coveted top ranked home building analyst award from Institutional Investor.

In 2007, Ivy started her own investment bank called Zelman Associates which combines equity research with capital markets and investment banking advice for the housing industry.

I first met Ivy when we worked together at Salomon Brothers during the 1990s where she was known as a rising star.

Prior to the financial crisis of 2008, Ivy correctly spotted that the US was headed for a housing debacle and she laid out the reasons in her published equity research. Needless to say, her arguments upset the housing industry management teams. But she kept to her views and was proven right.

Today, Ivy will explain why she has a contrarian view on the US residential real estate market. Ivy thinks that demand will prove illusory post Covid especially if interest rates trend towards more normal levels at a time when she expects a surge in housing supply.

Ivy, please begin your Six Minute Presentation.

Ivy Zelman:

Hey, Larry. It's great to be on your show. I'm excited for you and this new platform., A sobering moment for your audience because I am the contrarian once again on the U.S. housing market. As Mark Twain has stated, "While history does not repeat itself, it sure can rhyme at times."

I'll start with the demographics as demographics are really the foundation. And what's concerning to me is over the past decade, the U.S. population has slowed to the second slowest on record this past decade at roughly 7.4%, just slightly above the 1930s population which was the slowest on record at 7.3%. And that's really a function of plummeting birth rates as well as less immigration.

Secondly, when you look at households, households over the 10-year period just completed actually grew the slowest ever on record at 8.7%. And it's not just in the blue states, it's across the country. And a lot of that has to do with the combination of women delaying marriage and family formation and pursuing higher education. And when they do have children, a lot of them are one and done.

We also have multi-generational living where you've got where the boomers are known as the sandwich generation, where they have their adult parents moving back with them, and then they have their adult children that don't leave.

And if you actually look at the number of 25 to 35-year-olds that are actually living at home, the numbers over the decade every year after initial first three years of the decade unwind from the great financial crisis has been going the wrong way, which I don't think is fully appreciated. And so, we believe normalized demand currently for the entire market should be about 1.3 million, and for single family, 900,000, and where ours starts and what's in the pipeline are already 20% above that. And for multifamily what's in the pipeline is probably 10 to 12% above that.

The second reason is the amount of capital that's chasing this asset class. It's just gone bonkers. We've got institutional capital that's raising funds. They've got to pay a return that they promised their investors, and they don't want to go to office or retail or hospitality, so everybody's going to residential. I like to say that the residential is the prettiest girl at the dance now, but even more specifically, the new asset class build for rent, it's skyrocketing.

In fact, we did a deep dive report called focused on the build for rent space, and that shows that over the last 18 to 24 months just what's been publicly announced, predominantly unlevered has been more than $60 billion of capital, but only going to predominantly the red states. So, everybody's concentrated in the same market chasing this asset class, resulting in really robust inflation.

Land prices according to our proprietary land survey are up over 30% nationwide, and where the concentration of the capital is going is up more than double.

Affordability with home prices up on a national basis approaching 20% annualized plus what we have at lease rates running up double digits in many cities in the country, affordability is hitting a wall. We're seeing buyer fatigue in the market, but the real risk to the market is going to be mobility will be arrested if mortgage rates were to go to as little as 4%. 4% mortgage rates will shut down this housing market.

And I say that because, with the exception of the millionaires and billionaires, probably some of you on the phone that can pick up and leave New York City or the Tri-State area and go to Miami, the general population is not uprooting their family. And if they are locked in, if they're one of the roughly 70% of Americans that were smart enough that actually refinanced their mortgage, think about the number of people that will be disincentivized to move.

And that will be the backlash of the Fed, is the Fed's horrible policy of keeping rates artificially low too long through purchases of MBS. And when they start tapering, you've got this perfect storm brewing, Larry, where you've got risk of rising rates, significant surge of pipeline of start activity in the face of higher prices across the board while demand, we believe is going to moderate. So, I'll stop there.

Larry Bernstein:
Okay. What about the fact that COVID has changed the actual location where people want to live? And I use Chicago as an example. So, I have an apartment downtown, which I recently put on the market, and there's very little interest in high-end Class A residential in Chicago. And what is really in demand is suburban residential, which was freely available pre-COVID, and there's bidding wars and people, women crying outside homes during open houses that they can't buy the house that they want. And then there's a lot of building going on out there. Is this just an example of the house is in the wrong place and that's requiring the new building and maybe lower rents or lower prices where people don't want to live?

Ivy Zelman:
Well, I think we all have to take a step back and recognize that COVID was an unfortunate event in the U.S. history that changed how people thought about where they were living and a lot of that going from sort of dense urban markets fleeing for more space and safety, especially as we started seeing crime rate surging and looting happening. We pulled forward a lot of demand.

And I also believe that, because of the remote work phenomena, that many people have dual properties right now. Now you just listed the unit that you want to sell. What you have is, like today, artificially higher demand because people have a place in the city and now, they have a place in the suburbs. And they don't even know what they're going to do because they have the employer hasn't said whether they can work 100% from home yet. So, they're in sort of this hybrid moment.

I think we've actually now started to see a return to the city especially by young people. And we're seeing rent surging in cities. Now in terms of condo sales and what's happening at the high-end luxury, which is a relative negligible part of the overall housing market, I do agree that there's still pressure, especially in New York and San Francisco on multi-million dollar plus condos, but the for-sale market in cities like New York, below two million, you can't find anything and prices are surging again.

Larry Bernstein:
Okay. You mentioned clarifying the difference between the Midwest where the market isn't so strong in some of the red states. I'm currently renting in Miami Beach, and the Miami market is on fire. I also hear that Austin is doing terrific. Are we just going to see just a real difference amongst certain cities that are growing quite quickly, and is it COVID related as well that, if you can live anywhere, why not live in Miami versus in Minneapolis?

Ivy Zelman:
Well, I think obviously you got favorable tax-based states. Both Florida and Texas are both no income tax states. So, you do see more inbound migration and more people thinking about where they want to live longer term and whether it's Xers or boomers that are setting themselves up in these other cities. But it also comes down to how much supply. In Austin where home prices are up more than 30%, you've had a tremendous number of new jobs, new headquartered organizations that are coming there like Tesla and others that is driving more people to relocate there, but I wouldn't want to be buying in Austin right now with home prices where they are with the amount of supply coming in Austin. Miami is more constraint. So, there's not as much development, especially single-family development. But I do think that prices are not inelastic.

But I think we're starting to see fatigue in the market, and we're going to start to see a normalization in demand and that's going to come right at a time when supply is ramping. And supply right now is bottle necked because of supply chain issues, and ocean freight sitting backed up at ports and people can't get homes closed, but assumingly, those things will become at some point less problematic, there is a massive pipeline that's coming.

Larry Bernstein:
We had Steve Alloy on What Happens Next, twice before, in in the spring of 2020, and the summer 2020, what Steve was telling us was even though there's a COVID crisis, he's selling out all of his new homes, and taking orders like crazy. And he was very worried about, could he get the labor? Could he get the materials to build the new homes? But he said, "Margins are great. Opportunity is great."

Ivy Zelman:
Well, I think demand right now is peaking and I believe demand will moderate, but you know what you're also seeing is Steve Alloy, who's a good friend, would admit that he's selling homes to private investors that are trying to diversify risk by not just being exposed to the stock market. We're seeing institutional capital that have created liquidity in the market, called instant buyers, where you've got Zillow Offer, RedfinNow, Opendoor, OfferPad where you can sell your house in three days, they buy it from you, charge you a fee, tell you they're going to put some lipstick on the pig, and you're going to pay those fees and then they'll turn around and sell it.

Well, what happens when you go from a seller's market where you can buy that house and fix it up and flip it, to a buyer's market where it's hard to sell that, or you might lose money on that house? Those aren't primary buyers; they're going to sell. So, in the zip codes where you've got private investors like Austin, Phoenix, you've got instant buyers, we call Ibuyers, you've got build-for-rent operators that are bringing a ton of product. You have to appreciate that a level of primary demand is being clouded by fix it and flip investors.

So from my perspective, investors gone wild, but maybe not with the leverage that we had last cycle. We have a lot of investors that are clouding it, and Steve Alloy and everyone else is benefiting from strong demand. I do not believe it's going to be sustained, and we'll see that demand moderate as it's petering out. "Let's step on the gas. Let's bring more production. Let's raise prices, let continue to buy inflated land. Every builder on these conference calls earnings right now is like, "Oh, we're going to grow 15%, 40%," they're all doing it at once. And they're just like, "Let the party keep going." You know? And Jay Powell's the bartender, and he just keeps serving an overserved crowd, and eventually Larry, the drunk passes out. And right now, everybody's high on free money. Why not? Buy a second home, go buy a third home.

Larry Bernstein:
Yeah. How do you compare this versus 2007? What's different?

Ivy Zelman:
Well, I mean, the housing market really turned in '05, well before the economy started feeling the effects, at least on the new home side. I'd say that the difference is leverage. We had liar loans, 100% LTV no documentation, thanks to Dodd Frank, the mortgage market is pretty sound right now. I think there's incremental buyers that are probably too levered, but for the most part, the leverage or lack of consumer leverage is probably the biggest difference from last cycle.

But it's similar too, because there's euphoria again. And everybody's basically getting wasted on the idea they're going to get these unbelievable returns, and they're paying, there's dumb money, buying and bidding up land, somebody's going to get impacted. And at the end of the day, it's probably the investors that don't get their returns.

Larry Bernstein:
I want to change subjects to your new book, Gimme Shelter that you just put out. Why did you decide to write this book? Who is your audience? And what was the primary ideas that you wanted to tell the reader?

Ivy Zelman:
Well, thanks for asking about it. Actually, I started writing it a few ago, and it was really inspired

by young people that want to pursue a career in finance, that don't necessarily come from a traditional background like myself; I didn't go to an Ivy league school, I went to a state university, George Mason and getting a job on Wall Street was a big deal, and I wanted to inspire others.

Larry Bernstein:
Your book starts out with your getting a job at Salomon Brothers, and the career that you had there. I too worked at Salomon Brothers; I was there from 1986 to 1999. And I viewed myself as a lifer, until during the mergers, they decided to close the proprietary trading business. And so, I was out, you mentioned in the book that you also thought of yourself as a lifer until we merged with Salomon Smith Barney. And ironically, you mentioned that you were kicked out of Salomon Smith Barney because Smith Barney had the number one housing analyst in the form of David Dwyer. A little-known fact for you, David Dwyer was my roommate for four years in New York. So, it's just small world out there.

Ivy Zelman:
Oh yeah.

Larry Bernstein:
What did you think of Salomon? How did it let you grow? What was so special for you?

Ivy Zelman:
I loved Salomon from every aspect, from the just amazing professionals around me, and to really having to up my game. And there was so much grit; people just work endlessly. There was no bullshitting at the water cooler. I mean, you worked. There were young people there, started out in investment banking. And after my two years I went to Equity Research, went through Salomon Brothers' MBA training program despite not having an MBA. And I think it was just the competitive, but incredibly fun culture that, you're working side by side around people that are like-minded, and everybody's just incredibly high achievers.

So I just remember it as being a lot of fun and being at 7 World Trade Center, and walking around that trading floor. I don't know being a kid who grew up in New York, and being able to say, "I work at Salomon Brothers," which was the brains of Wall Street, I'm really proud to have been an employee there. I wish they didn't let me go, but I actually made more money on my next move, so worked out good for me.

Larry Bernstein:
I very much miss the institution. Another thing is that one of the topics of the book is the role for women on Wall Street, and when I joined Salomon, I immediately went to work for Jessica Palmer in the Capital Markets Department. And I worked for some incredible women at the

firm, and your growth at Salomon as a woman is also indicative of the opportunities available. That being said, still it's Wall Street; it's a male dominated culture. What were your thoughts on the ability for women to compete and succeed in that sort of place?

Ivy Zelman:
Yeah, it's funny because when I started in 1990, I didn't even think of myself as a woman, even though I was one of three women out of 70 in my training program. It was like, I was just this non-Ivy leaguer. So, I didn't even think of being a woman back then. I think it's more about recognizing if you're in a man's world, you've got to be able to talk and hang with the guys, and go in the locker room, and you can't get upset at maybe the way the guys are talking, or what the conversation might be that makes you a little uncomfortable. You have thick skin, and you have to be able to throw it right back at them. And I think there's times, and I write about some incidences where there was inappropriate behavior, but for the most part, I think it's not about being a woman or a man; it's about performance, about put your head down, work hard.

And I think the women that survived at Salomon Brothers, and there were more women MDs at Salomon Brothers than pretty much anywhere else, it's because they basically lived under that sort of premise. They're going to be in a man's world, they're going to have to have thick skin.

Larry Bernstein:
We had Anne Clarke Wolff on a show a few weeks ago. I don't know if you remember Anne Clarke, she was in Capital Markets?

Ivy Zelman:
I do. Yeah, we just spoke recently, actually, she's great.

Larry Bernstein:
And she's starting this organization, I think they're going to call it Salomon Sisters, of a women led investment bank. I mean, you've started your own investment bank effectively, at Zelman, tell us a little bit about it. What were the challenges, why was it successful? Why did you decide to do it in that approach instead of working for one of the larger banks?

Ivy Zelman:
Well, I don't know if it's getting to a point in your life where I am turning 40, and I'm sitting here at the boom boom of the housing market as a contrarian, and basically negative and I felt at that time, I wasn't getting renumerated for being utilized throughout the entire firm in every department, coupled with the fact that I had this unbelievable Rolodex of private industry operators, C-suite owners, and executives. And I was like, "You know what? I could take this and go out on my own and monetize what I've built and have hopefully clients follow me."
II didn't think about the things that you should think about before starting your own company that you learn while it's happening like, how do you actually get paid? Because at Credit Suisse,

I didn't have to think about that, or dealing with HR and establishing a broker dealer license and going out and having FINRA audit you.

These are things that you learn on the job. And if you think about all of those things, it'd probably scare the shit out of you and you would never do it. I just took a risk and at 40 years old I needed a change.

Larry Bernstein:

What I find amazing about the story is, most of the time when you're in equity research, it's an add-on to the investment banking business. And here you've done the reverse. You started with equity research and you were able to segue that into investment banking. How did you pull that off and why has that been successful?

Ivy Zelman:
Well, I think you're right. It's definitely a research-led firm. I think that we didn't even think about doing any investment banking initially when we started and launched in October of '07, but it was actually about a year later when my co-founder, Dennis McGill, and I have been together for 21 years, and his brother approached us in '08 and he had been at Bear Stearns running capital markets. And he's like, "You guys have this unbelievable Rolodex that you should try to monetize through investment banking." And I was like, "I don't really want to do investment banking. I don't like investment bankers very much."

And he convinced me that we could take what we'd built and the brand that we've dominated in the market and we could get these companies that are confidants and relationships that are so strong to utilize our services. So it was really Tony McGill who I should credit because he was the one that came to us with the idea and I was initially reluctant.

Larry Bernstein:
Earlier, you mentioned HR as a complicated issue and one is love in the office. I was dating the woman who would be my wife, Julie Bernstein, when she was an equity analyst at Smith Barney. And then when Smith Barney merged with Salomon, my girlfriend worked one floor below me and I discussed it with my boss. He said it was fine. We were in different departments. No big deal. And then later when I got transferred to Japan we got married. I found love at work. And that's also true for you. You also found your husband at Salomon Brothers. And currently, the firm, many large financial institutions, most corporations discourage love at the office. So, my question for you is, where do you stand on finding your spouse at work?

Ivy Zelman:
If anyone within my organization, we're a small place, would find a spouse or a perspective

spouse, go for it. I don't think it's a problem. I think it's about the person and their professionalism, and I think we both know that you and I are examples where it didn't impact our performance. And I think that it's probably pretty shortsighted and you'd lose good people if you had that type of stringent policy.

Larry Bernstein:
In your book, you mentioned that you had some health issues and you were very open about it. Do you want to talk a little bit about how that affected your business, your life, how you think about your career

Ivy Zelman:
Sure. I think that anyone that has gone through any type of health crisis, for me, it was breast cancer, and unfortunately finding out about it within a year, a little bit more than a year, since starting Zelman and I had, at that time, my kids were four, six, and eight. Talk about rocking your world and you're at the peak of your career, or you thought you were, and you're right in the thick of the housing, great financial crisis. So I think that it really grounded me into what was important and to appreciate that my health mattered more than anything else. And having built a loyal team that enabled me to take the time I needed to get better and get through what I needed, it was only because of the people that were by my side that was able to actually make that happen, including my husband and my sister and my girlfriends and all the people in my life and work colleagues.

I just think it changed my prioritization and maybe slowed me down for a little bit and maybe contemplate what matters the most, and being ranked or money and all those things don't matter if you get sick. None of it matters. And it's a pretty lonely road you travel when it's you. Your loved ones can only be there so much for you, but when it's you alone under a radiation machine or you're dealing with these challenges, you've got to really decide, am I going to get out of bed tomorrow and am I going to keep going? And I think you either persevere or you don't. But I think it was a lot of support around me and recognizing I had three little babies that needed their mother and it pushed me forward.

Larry Bernstein:
It's a great, great story. I want to change topics to some of the struggles you had at work when you were a contrarian. The first story that you tell in the book is the asbestos catastrophe and how it would affect a number of corporations such as Owens Corning. And one of the stories you tell is that the Head of Investment Banking at Credit Suisse called you and harassed you about your negative statements about Owens Corning and then your unwillingness to back down. Can you tell us a little bit about what it's like working in larger institutions when you're going after a client even though you're supposed to provide independent and thoughtful research, the challenges that you faced?

Ivy Zelman:
Oh, I was scared shitless, to be honest. I was sitting in T. Rowe Price at a marketing meeting in a conference room and I get called out, which doesn't happen unless it's an emergency. And I come out of this big conference room and I'm told I have a phone call and I go sit down in the lobby and I pick up the phone and I get basically berated by, I don't even know this man, he's the Head of Investment Banking, telling me, “Do I know where my bread is buttered, young lady?" And it was about Owens Corning and they weren't happy with what I was writing. And I tried to explain to him that our fundamental view is what it is and we've done the work to support it. But I didn't waiver and I didn't change my view.

And I got that phone call and it was sort of threatening, but I didn't do anything about it. I remember I probably went in the bathroom and maybe called my husband and cried. I just think I was definitely scared, but I just couldn't alter my view just because I was threatened. It's not my DNA.

Larry Bernstein:
How do you think of the independence of equity research both at a large bank and then the equity independence that you now have in your own firm as a comparison?

Ivy Zelman:
Well, I think at the large banks, it's tough to speak to any other bank than the ones I obviously was employed by, but I do think that there was, at least in my years at the bulge bracket, more pressure. And it came from investment banking prior to Elliot Spitzer with FD and all the changes that came to fruition. There was a tremendous amount of pressure to basically put out positive views, but it was never said, just assumed. And I think that the world changed when Elliot Spitzer took the veil down and everybody recognized what was going on.

And I think that's where I think having my own firm, if we're not comfortable with, let's say, a capital market transaction, we don't have to do it. Nobody's going to threaten us or tell us that it's going to depend on how we get paid. And that independence really suits me because I didn't play well in the sandbox with the bankers at times. And I think it caused some problems and fortunately I persevered, but I definitely had some internal battles.

Larry Bernstein:
As a contrarian in the industry, which may mean that there are times when you're quite negative, like your introductory remarks today. You mentioned in the book that some of the industry people would call you Poison Ivy or say you're on a jihad.

What is it like to be opposed to valuations generically within your industry?

Ivy Zelman:
I think if it hadn't been for private companies that were during the boom, boom period that were telling me to stick to my guns and giving me ammunition through stories they would tell me about the shit that they were seeing in the market and the craziness that was going on, it was constant feeding the information, marrying that with actual data.

So it was tough. I mean, I will tell you, the stocks are ripping up in my face. Clients don't want to hear anything negative when they're all making money. And it was many nights, and my husband would tell you, of tears at home and recognizing that if I'm not right, at some point, I'm going to probably get fired. And I'd say right now being a contrarian is not necessarily as challenging because I don't fear that I'm going to lose my job. Obviously we have to continue to make sure that we're monitoring the market and that our underlying premise of today, cautiousness is warranted. But we have proprietary surveys of every silo in the housing mosaic. So, whether we're talking home building, land development, mortgage, multi-family, single family rental, the brokers, building products, we have our pulse on the market. So, if we have to change course, we will. We just published a report called cradle to grave that is available on our website, but is a definite sobering report that is really stirring the pot and causing a lot of friction with the industry.

Back then, it was I was laughed at, poison ivy, jihad, Ivy voodoo dolls that people would just basically say that she doesn't know what she's doing. So, I feel more confident and recognizing that there's more respect from the executives that would have just blown me off if it hadn't been for the fact that I had been right last time.

Larry Bernstein:

I can't believe the annualized rate of increase in prices in residential real estate nationwide. It's shocking. And the only other time I really saw it in my lifetime was pre-2008. And I think in 2005, I was already saying, oh my God, this is going to crater and that was still years ahead away from the crisis. Is it possible that these glory days in real estate will last a very long time? Is that one of the lessons that the music will play for a lot longer than you expect when you're on the short side? I mean, that's what will get me worried, shorting some of these home builders or real estate companies.

Ivy Zelman:

Well, actually we're neutral right now, so we're not short because I do think that timing matters. So, our research will help us determine when it's time to go outright and short and sell the stocks. Maybe it lasts for another year to two years. It's somewhat contingent on rates. And my joke is I spoke at one of the industry conferences and they said, well, what happens if mortgage rates go to 1%? And I said, then party on, more free money.

So I think that the important perspective is to recognize that prices can't go up indefinitely, wages are not rising as fast as home prices. And if rates start to move higher, I think that would be a more likely catalyst to slow down the market, but sure, it could go longer than we're currently expecting because we expect '22 to see home prices still up 3% nationally and then 1% in '23, but that's for the existing market. And the new home market, we actually expect new home prices to go negative in 2023.

Larry Bernstein:
I end each episode on a note of optimism. What are you optimistic about?

Ivy Zelman:
I'm optimistic to watch my children's lives evolve and see where they go and watch them grow into mature adults and hopefully get off the payroll. I'm optimistic for that at some point. Hasn't happened yet, but I'm working on it.

Larry Bernstein:
Yeah. Same on our side. Ivy, thank you so much. I really appreciate you taking the time.

Ivy Zelman:
My pleasure, Larry. Best wishes for the new venture. It's exciting.

That ends today's session. I want to make a plug for the next episode of What Happens Next on Sunday 11/21.

The speaker will be Tim Bale who is a Professor of Politics and International Relations at Queen Mary at the University of London. Tim's research focuses on European and British politics.

I want to find out from Tim what are Europe's most pressing political issues and about the ongoing success of center/right political parties. In particular, I want to learn what German politics will like post-Merkel, will Macron win reelection, and how does Boris Johnson fit into the mix.

If you are interested in listening to a replay of today's What Happens Next program or any of our previous episodes or wish to read a transcript, you can find them on our website Whathappensnextin6minutes.com. Replays are also available on Apple Podcasts, Podbean and Spotify.

I would like to thank Ivy Zelman for her insights. I would also like to thank our listeners for their time and for engaging with these complex issues. Please stay tuned next Sunday to find out What Happens Next.