June 26, 2013

UP, UP, & AWAY: U.S. HOME PRICE GROWTH WILL GIVE WAY TO RISING SUPPLY

Highlights

- Home prices in the United States are on high-speed train. In the 20 cities monitored by the Case-Shiller HPI, prices were 12% higher in April relative to a year earlier.
- This pace is unlikely to be sustained. Supply has already shown early signs of rebounding and this will lead to a deceleration in price growth. After averaging 10.2% in 2013, we expect home price growth to slow to 3.7% in 2014.
- The fundamentals for home prices are strong. Past declines in home prices have improved affordability, supply overhangs have been worked off, and construction is below household growth.

After five years of declines – interrupted briefly by a temporary tax credit – U.S. home prices have been on a straight line upward since June of 2012. In April, the monthly Case-Shiller home price index rose by 12% relative to a year ago (see chart below).

For the most part, the gain is supported by fundamentals. Supply was reduced dramatically over the last five years, and the overhang of unsold homes has largely cleared. At the same time, demand has rebounded. Home sales are up over 40% from their post-recession low.

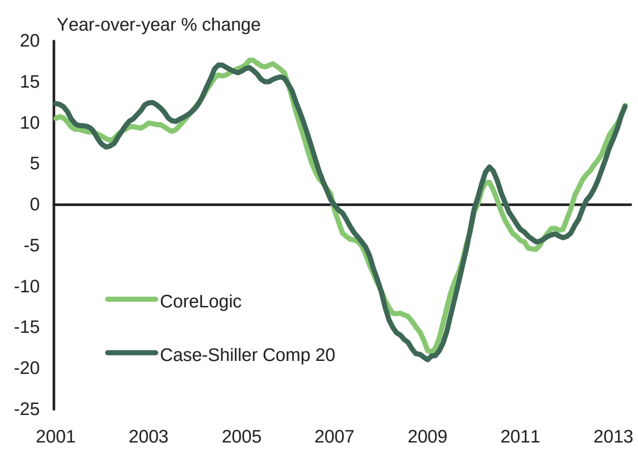
Just as important, the fastest price gains have come in states that were hit hardest by the foreclosure crisis. This is due to the magnitude of their past declines and the opportunity provided to investors to take advantage of the discounts offered on distressed properties.

Nonetheless, the recent pace of increase is not sustainable. Just as the fall in prices preceded a dramatic reduction in supply, the rise will invoke an increase in supply. On the demand side, the rise in prices has reduced the yield to investors and deteriorated affordability for first time buyers. While home sales will continue to rise, the pace is likely to move in line with added supply. After averaging 10.2% in 2013, we expect home price growth to slow to 3.7% in 2014.

Home price gains justified by fundamentals

The rise in home prices is due to both demand and supply factors, but it is primarily a supply story. Over the last five years, the housing market has seen a steep reduction in new housing construction and listings of existing homes. In the existing market, the inventory of homes available for sale has fallen 48% – from a peak of 3.8 million in January 2008 to under 2.0 million in the first quarter of 2013. The new housing market experienced an even larger reduction in supply, with inventory falling 75% from

U.S. HOME PRICES



Source: CoreLogic, Haver Analytics

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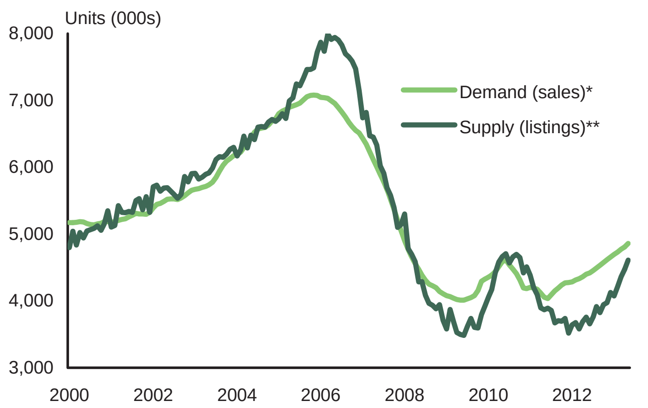
DEMAND AND SUPPLY OF EXISTING HOMES



*12-month moving average in home sales. **Sum of sales and year-over-year change in inventory homes for sale. Source: NAR, TD Economics

its peak in mid 2006.

Housing inventory falls when sales outpace listings and rises when the opposite is true. Early in the housing bust, inventories of unsold homes rose quickly, as listings piled up and sales began to turn down. However, in relatively short order, construction and listings plummeted. The decline was even swifter than that of sales, causing inventories to contract. This continued for three years, momentarily interrupted by the temporary home-buyer tax credit, which led to a short-lived rise in both sales and listings in 2010.

Notwithstanding this volatility, home sales have been on a measured rise upward since 2010. The increase in home sales has allowed the housing market to absorb more listings, including listings of foreclosed properties. However, even with the rise to date, existing home sales are still at relatively low levels. As of May, the level of existing home sales is in line with the average in the late 1990s and 30% below its peak level in 2006. By comparison, even with the slow pace of employment growth relative to the losses during the recession, employment today is 4% higher than it was in the late 1990s.

The relatively low level of sales is even more apparent in the new housing market where single-family home sales are over 30% below their historical average and are still at levels that, in previous housing cycles, would be considered recessionary.

The bottom line is that the steep fall in construction and listings, alongside improving demand has brought the housing market back into balance. The number of months required to clear the market of existing inventory has fallen from a peak of 11 months to an average of 4.5 months in the first quarter of the year. This has been accomplished alongside a rebound in sales that still has considerable room to grow.

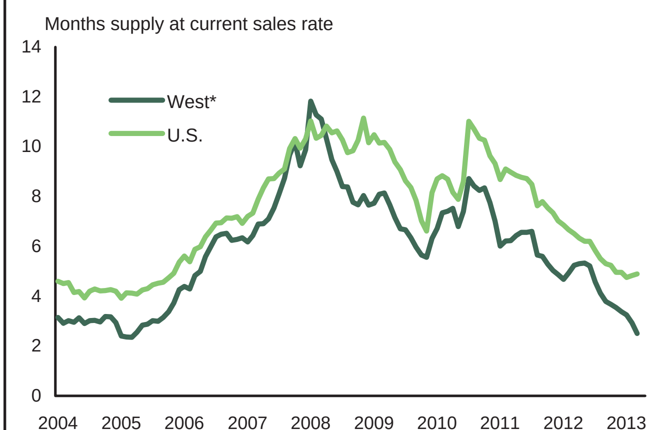
Regional home price gains also tell story of dwindling supply

Home prices were up on a year-over-year basis in all but two states in April (Alabama and Mississippi), but the strongest gains took place in Nevada, Arizona and California. In fact, Nevada has seen the fastest home price growth in the country, with prices up a whopping 24.6% relative to a year ago. This may seem counter intuitive given that the sand states (Arizona, Nevada, California and Florida) led the country in seriously delinquent mortgages. However, the price gains are simply a by-product of the dramatic fall in supply and improvement in demand.

Data on the supply of unsold homes is not readily available at the state level, but it is at the broader Census region. The West census region – made up over 60% by California, Nevada and Arizona – has experienced a 62% drop in the number of vacant homes available for sale, far bigger than the 20% decline in the rest of the country.

These states have also seen some of the fastest progress over the last two years in clearing shadow inventory of unlisted foreclosed homes. At its peak, seriously delinquent loans represented 19.6% of all mortgages in Nevada. These have been nearly cut in half to 10.6% as of the first quarter of this year. Similarly, in Arizona, seriously delinquent mortgages have fallen from a peak of 13.2% to just 3.8%. As a result, the share of home sales taken up by distressed properties has also fallen dramatically. In the first quarter

U.S. MONTHS SUPPLY OF EXISTING HOMES



*Estimate by TD Economics.
Source: Census Bureau, NAR, TD Economics

of 2012, distressed sales represented a whopping 56% of all home sales in Nevada. This ratio fell to 26% in the first quarter of this year.

Falling construction has been essential in returning the housing market to balance in the sand states. However, investor demand has also been an important element in clearing distressed sales. In these markets, the rising share of distressed sales was met with a rising share of sales to investors. Investors are estimated to have purchased 60% of the homes in foreclosure auctions.[1]

The entry of investors has been vital in clearing markets of the overhang of distressed sales. It has also created concern that markets where investors are heavily present are more vulnerable to a correction. However, investor demand does not appear to have departed from fundamentals. A number of facts bear this out:

1) The rental vacancy rate is at its lowest level in over 10 years. Rental vacancy rates are especially low in the West and the South relative to other parts of the country.

2) As with the rest of the country, both the level of homes for sale and the volume of sales remains low in high-foreclosure states relative to history and demographics.

3) Foreclosures worsened home price declines and made them ripe for investors. Even with the rise to date, prices are severely below pre-recession peaks. In Nevada, home prices are still 50% below 2006 levels.

Ultimately, investors who purchase foreclosed homes have a strong financial incentive to maintain them and to find renters to occupy them. This is a huge improvement over allowing homes to sit vacant.

As supply rises, home price growth will decelerate

Rather than signalling a market divorced from fundamentals, the rise in prices is a signal to the market to supply more housing. This is exactly what we expect to happen over the next several years.

Increased supply will come both in terms of new housing construction and additional listings of existing homes. Vacant homes held off market have risen from 4.8% of the housing stock to 5.6% in 2012, representing an excess of over 1 million homes that could return to the market. Listings have fallen in large part because of the past decline in prices. Would-be sellers are less likely to put their home up for sale in a declining price environment. Moreover, homeowners are even less likely to list if the value of the home has fallen below the value of their mortgage. However, as home prices rise, homeowners who have been waiting on the sidelines will re-enter the market.

Importantly, there is already evidence that this is taking place and price gains have attracted supply back into the market. From a low of 1.96 million in January, the inventory of existing homes available for sale has risen 8.8% over the last five months to 2.13 million in May. Similarly, the number of new single-family homes for sale has risen 14% from its nadir last year. This is still low by historical standards, but the supply response to rising prices is underway.

Bottom line

The rise in home prices is one of the most positive elements of the economic outlook. In some corners, however, it has also led to concerns that the housing market is forming the early stages of another bubble. But, housing bubbles are characterized by oversupply, and it is the dearth of supply across the country that explains the recent rise in home prices. At the same time, demand, while rebounding, is far from frothy. Relative to history, it also remains muted.

Nonetheless, as investor demand is satiated, first-time and move-up home buyers must take over. The prospects for ongoing improvement in housing demand remain good. Rising home prices should also draw in buyers who were previously waiting on the sidelines for a better deal. However, the recent rise in mortgage rates – the conventional 30-year rate has risen close to 50 basis points over the last month – will slow this transition. In a rising supply environment, this will slow the pace of price growth.

All told, the next phase of the housing recovery will be a deceleration in price growth alongside a stronger rebound in construction and listings. From its current pace of just under one million units, housing starts are likely to rise to 1.3 million units by the end of next year. The rebound in construction will go a long way to supporting economic growth and offsetting the drag from fiscal policy.

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Endnote

1. Timaros, Nick. “Investors Pile Into Housing, This Time As Landlords” Wall Street Journal. 25 March 2013. http://on.wsj.com/YyOyeu