SPECIAL REPORT

TD Economics

May 15, 2014

U.S. HOUSING SUFFERS A SET BACK, BUT WILL RECOVER

Highlights

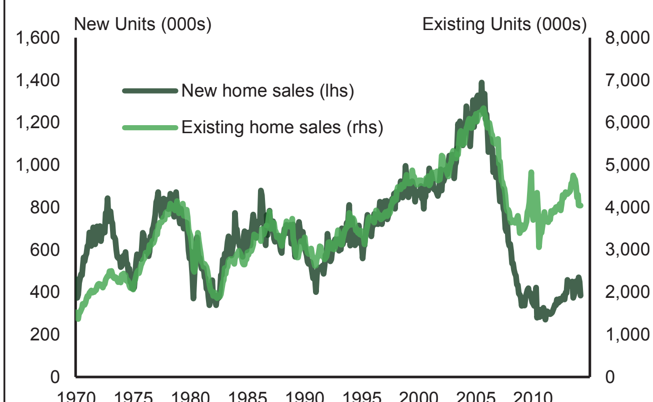
- Recent activity in the U.S. housing sector has been decidedly disappointing, with both sales and new residential construction falling below year ago levels.
- There is no single cause to the slowdown, but rather a series of unfortunate events. Some of the blame lies with harsh winter weather; however, a swift increase in mortgage rates and home prices, pullback of investor demand, and a tightening in credit standards under new regulatory policy have also played a role in pulling down activity.
- Many of these headwinds have faded. Mortgage rates have pulled back and are likely to increase at a more stayed pace going forward; house price growth has decelerated; and, regulators appear to be taking a more active approach in supporting liquidity to the mortgage market. This should set the stage for a housing come back in the months ahead.
- The reality is that with such a low supply of housing construction, the downside risk to the housing market is limited. A slower-than-anticipated recovery may slow near term economic growth, but it does not put the broader recovery at risk.
- Household growth remains weak relative to population growth, but the foundation for improvement has been set. As job growth strengthens, the propensity to form new households, as well as take on homeownership, will begin to move higher.

The recent slowdown in the housing market is hard to miss. Existing home sales have fallen consistently since July of last year and in March were 15% below their peak. New home sales had held up better, but are also down 15% from their peak in October of last year. With the economic outlook hinging on increased housing activity, the slowdown has led to concerns about whether the U.S. economy can muster up the much-anticipated acceleration in growth.

Rest assured; the housing market will not derail the economic recovery. In addition to the temporary impact of a particularly harsh winter, the downshift in activity reflects the sudden deterioration in affordability due to rapidly rising mortgage rates and sharply higher home prices. Both of these appear to be in the rear-view mirror. Home price growth has decelerated and mortgage rates have pulled back from the peak set last year.

While mortgage rates are more likely to move up than down going forward, the rate of increase is likely to be softer and more in line with the improvement in economic growth. Moreover, the deceleration in home prices is a symptom of the transition away from investors and towards traditional home buyers. But, with

NEW & EXISTING SINGLE FAMILY HOME SALES



Source: National Association of Realtors, U.S. Census Bureau

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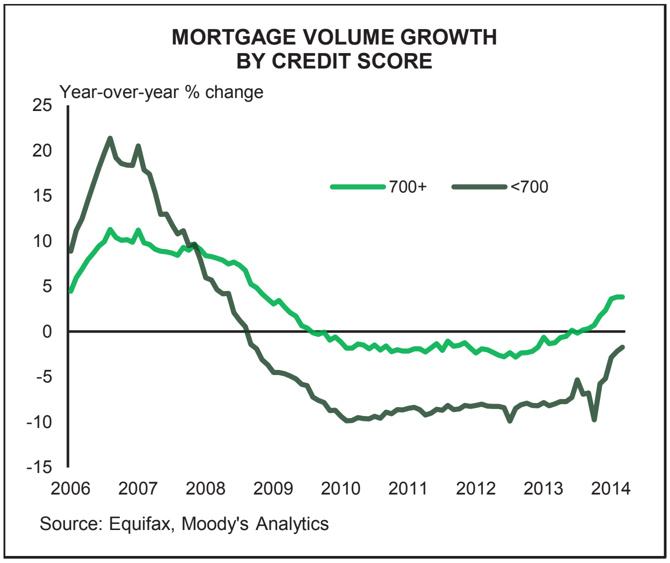


vacancy rates moving back to historical averages and a supply of new housing units that is close to record-lows, neither home price growth nor growth in housing construction are likely to fall into negative territory. As such, past gains in home prices, which have helped to pull households out of negative equity positions, are not at risk.

All told, the recent slowdown in housing activity is unlikely the start of a new trend. The propensity to form new households has stabilized over the last year, and suggests that net household formation is likely to continue to move upward. As job growth strengthens, the number of new households should move closer to 1.3 million per year. With annual scrappage of around 200k a year, housing construction will need to rise to 1.5 million.

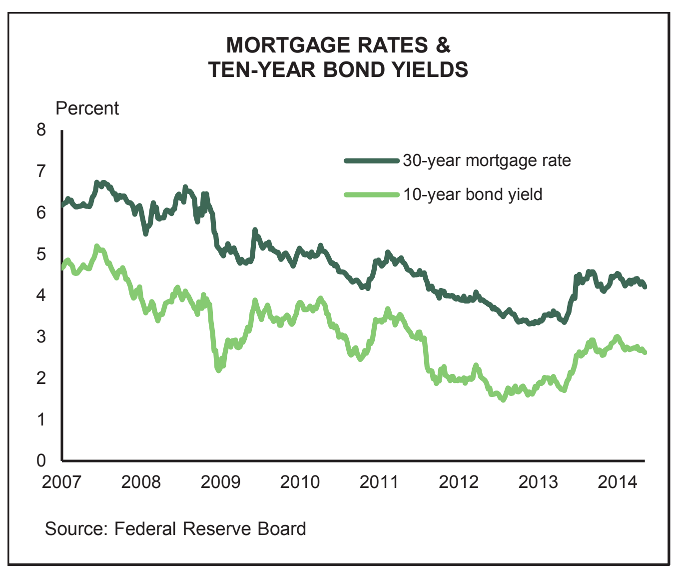
More than just a weather blip

Some of the blame for the weakness in housing indicators lies with harsh winter weather in many parts of the country. The Midwest, for example, experienced one of the coldest winters on record and saw the biggest slump in construction. Housing starts fell 60% from December to January, reaching levels last seen in 2011. Nonetheless, weather is not the sole culprit for decelerating activity in the housing sector. Existing home sales peaked in July, well before the cold weather hit.

Still, one does not look have to look very far for an explanation for the housing slowdown. From May 2013 through August, mortgage rates rose 120 basis points. Home price growth, which had already been on an upward trend, accelerated to over 13% year-over-year through the second half of 2013. While both advanced from a very low base, the double whammy weakened housing affordability considerably. The average monthly mortgage payment on newly issued mortgages increased by 24% from $636 in the fourth quarter of 2012 to $788 in the fourth quarter of 2013. Consequently, the share of annual household income going toward mortgage payments increased from 15.2% to 17.9%. At the same time, the minimum income needed to qualify for a mortgage on a median-priced house rose from $30.5k to $38k.

Access to mortgage credit has also weighed on housing demand. The difficulty in acquiring credit for households with less than pristine credit is evidenced by the concentration of mortgage growth among high credit-quality borrowers. In contrast to the housing boom, when mortgage growth was split close-to evenly between borrowers with FICO scores above and below 700, nearly all of the growth in mortgage credit since the collapse has been to high credit scores (above 700).

The introduction of new mortgage rules in January of this year, brought in as part of the Dodd-Frank Act of 2010 caused lending standards to tighten further. The rules require lenders to reasonably determine borrower's ability to repay and defines a new "qualified mortgage" (QM) standard. Qualified mortgages must meet certain criteria, namely, borrowers' monthly debt payments must not exceed 43% of documented income, and the mortgage cannot contain certain "risky" features such as interest-only periods, balloon payments, and amortization periods longer than 30 years. While the legislation does not preclude banks from issuing loans that do not meet QM status, mortgages that meet the standard are offered legal protection in the case



of default. There is therefore a high incentive for banks to offer loans that meet the standard. Given that the legislation was well telegraphed, lenders began tightening procedures even before its implementation.

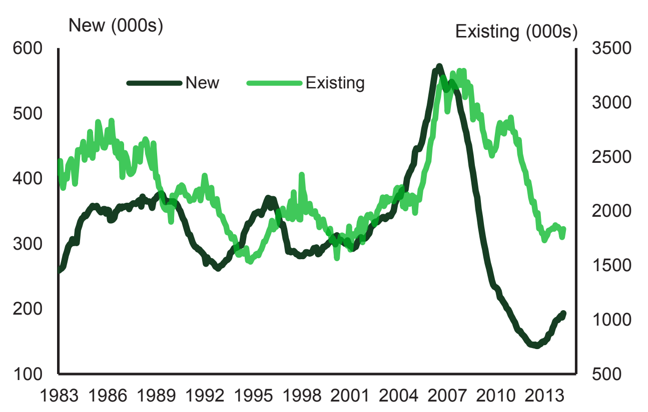
Finally, rising property values and falling inventories of distressed properties – which tend to be sold at steep discounts – have also reduced investors' appetite for residential real estate. According to RealtyTrac, institutional investors – defined as investors which purchased at least 10 properties in a calendar year – accounted for 5.6% of all residential sales in the first quarter of 2014. This was the lowest share since the first quarter of 2012 and marked a significant easing in institutional investors' participation from a year ago, when they purchased 7% of all homes on the market.

All told, there is no single influence behind the recent housing slowdown. It captures an unfortunate collision of events including a harsh winter, a steep and swift increase in mortgage rates and home prices, and a tightening in credit standards under new regulatory policy.

The housing market is not crashing

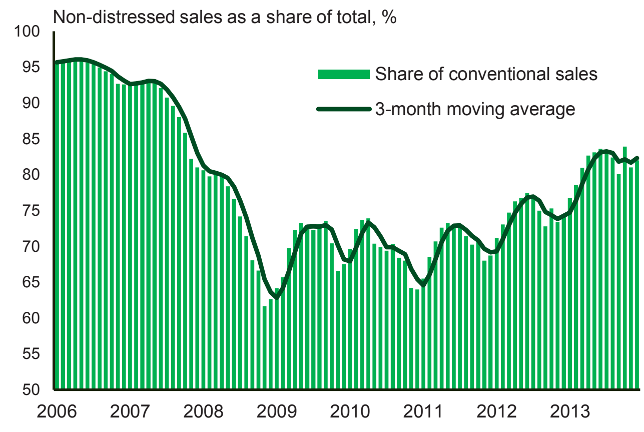
The decline in home sales is a setback to the housing recovery, but does not mean that it has come to an end. The 3.4% rise in pending home sales in March suggests that demand will bounce back in the months ahead. Even more important, the contributing factors to the slowdown – brisk home price appreciation and sharp upward adjustment in mortgage rates – have moderated. In particular, mortgage rates have fallen nearly 40 basis points from their previous peak. Home price growth has also decelerated. After peaking in November at 13.7%, year-over-year growth in the S&P Case-Shiller index decelerated to 12.9% in February. We expect the pace of home price growth will continue to gradually slow throughout this year, ultimately ending the year at 4%.

INVENTORY OF NEW AND EXISTING SINGLE-FAMILY HOMES FOR SALE



Source: NAR, Census Bureau

SHARE OF CONVENTIONAL HOME SALES



Source: CoreLogic

The deceleration in home price growth has long been imbedded in our forecast. The rapid pace of home price growth over the last few years was in large part due to the magnitude of the declines during the recession, and a high share of distressed properties, which created a feeding frenzy among investors. Unsurprisingly, states that were hit hardest by the housing crash – California, Arizona, Nevada and Florida – have experienced the largest increases in investor activity and home prices in the early stages of the recovery.

Decelerating home price growth in combination with strengthening income growth will limit future deterioration in housing affordability. However, while home prices are poised to decelerate, outright declines appear unlikely. The reality is that housing supply is extremely low. Last year, in a given month, there were on average 435k new houses on the market – half of the pre-housing-boom average between 1980 to 2002.

Now that much of the adjustment in mortgage rates appears to be in the rear view mirror and with pressures on affordability from rapid home price appreciation also easing, prospective home buyers should begin to emerge from the sidelines. There are already nascent signs of this occurring. While total home sales have fallen, non-distressed sales were up 14% from a year ago in March according to CoreLogic.

How many U.S. households are there?

There are three data sources for the number of households in the United States: the American Community Survey (ACS), the Household Vacancy Survey (HVS) and the Current Population Survey (CPS). According to the ACS there were slightly over 115 million households in 2012 (the last year available). According to the HVS there were 114 million in the same year. However, according to the CPS, there were over 121 million households. The differences are even more significant in growth terms. Focusing on the HVS and CPS where data is available for 2013, the number of households grew by just 373k between March 2012 and March 2013 according to the HVS, but by 1.3 million according to the CPS.

Complicating matters even further, the HVS also contains estimates for growth in the overall housing stock. According to the HVS, the housing stock grew by just 350k in 2013, well below the total number of housing completions at 762k. Even assuming scrappage of 200k, the completions data would imply growth in the housing stock of over 550k.

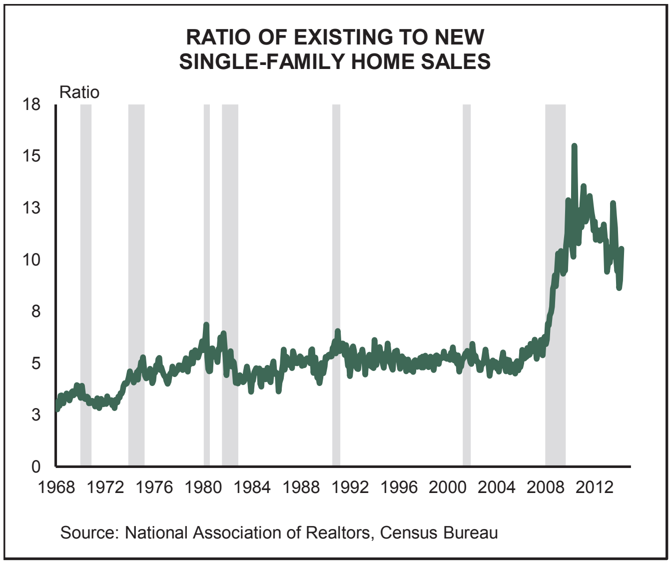
The truth is likely somewhere in the middle. Given that the rate of housing vacancies have been falling over the past several years for both homeowners and renters, households appear to have been growing at least modestly faster than growth in the stock of available housing. Housing completions average 864k in the first quarter of 2014. Assuming depreciation around 200k a year, this implies household growth of at least 650k in the first quarter of this year. Given the CPS shows much stronger growth, this may be a lower bound on the current level of household formation.

Housing demand has been weak, but demographic surge keeps building

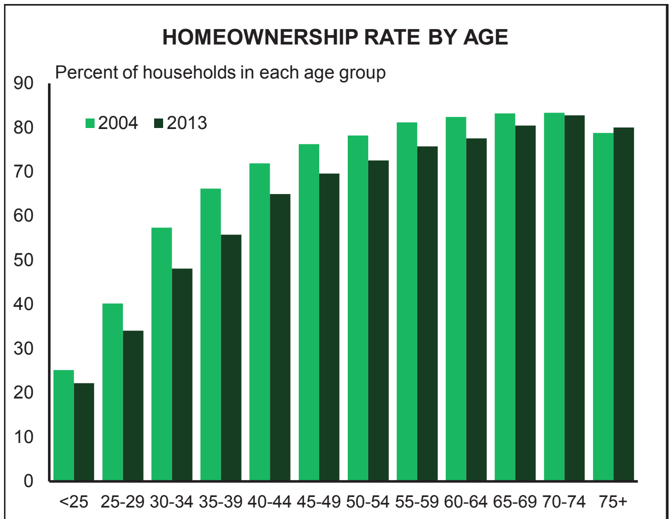
There is no denying that, at least for now, housing demand remains much weaker than would be suggested by population growth. The weakness is less apparent in existing single-family home sales, which have fallen only modestly below their long-run average relative to the size of the adult population, but is extreme for new single-family home sales, which are still pluming historical depths. Prior to the housing crash there were roughly five existing single-family home sales per new home sale, a ratio that was little changed over the previous thirty years. In the first quarter of 2011, this ratio reached a peak of 12.8 existing sales per new home sale, but it has since fallen to 9.3 as of the first quarter of 2014. In all likelihood, this ratio will continue to move towards its pre-crash average, which means that new home sales will outpace existing home sales. The key question for the housing recovery is how fast will new home sales grow?

The outlook for new home sales depends on the outlook for new owner households, which in turn depends on the number of new households and the homeownership rate. Both have been declining over recent years. The homeownership rate has fallen nearly five percentage points over the past ten years, from 69.4% to 65.0%. Fortunately, the rate of decline has softened over the last year. In 2013, the homeownership rate held steady at 65.1% over the final three quarters of the year, before ticking down to 65.0% in the first quarter of 2014. The picture looks better if you look at the homeownership rate of specific age cohorts. For people above 30 and below 70, the homeownership rate appears to have increased modestly over the last three quarters.

Without question there remain significant challenges to



Source: National Association of Realtors, Census Bureau



Source: Census Bureau

If housing continues to disappoint, what would it mean for economic growth?

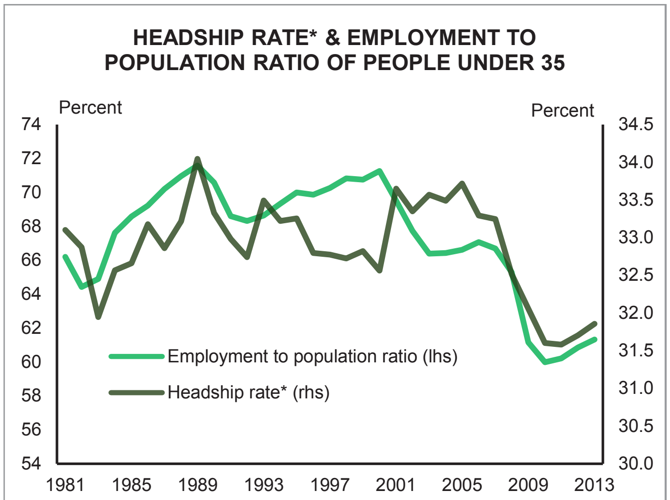
A continuation of recent weakness presents downside risk to economic growth in the near term. If access to credit remains an impediment to would-be homebuyers, existing home sales may not see the lift that we are anticipating. A plausible (but low probability) downside scenario is for existing home sales to remain around their current levels over the remainder of this year rather than rebound as we expect. Even in a downside scenario, new housing construction is likely to do better. However, this may imply more of the growth in households takes place among renters and therefore favor multifamily construction relative to single-family. Since multifamily units are smaller and require fewer resources to build, this compositional change would imply a smaller contribution to real GDP growth.

Residential construction investment includes both new construction as well as existing home sales (which is included in broker's commissions). Our March forecast called for residential investment to grow by 12% through 2014 (fourth quarter to fourth quarter). This encompassed growth in single-family starts of 25% and growth in multifamily starts of 16%. Our forecasts do not contain explicit expectations for existing home sales, but the growth in other residential investment is consistent with growth of around 3% to 4% in existing home sales over the remainder of 2014.

Should the pace of existing home sales remain relatively flat over the remainder of the year and new construction grow at half the pace we expect, with a greater share going to multifamily construction relative to single-family, overall residential construction investment would grow by around 5% over the remainder of 2014. Instead of contributing 0.4 percentage points to growth, it would add just 0.1 percentage points. In other words, as a direct result of slower residential construction growth, real GDP growth would be reduced by 0.3 percentage points. Slower growth in residential construction will create negative spillovers to the rest of the economy that would likely further reduce growth by another 0.1 percentage points, implying total growth of 0.4 percentage points less than we had previously forecast.

As a result, economic growth would slow to 2.2% (Q4/Q4) from 2.6% in 2013. This would imply a weaker pace of job growth and an unemployment rate that ends 2014 around 0.3 percentage points higher than otherwise. Slower progress on lowering unemployment would likely lead to lower interest rates and may push the Federal Reserve's first rate hike into 2016.

homeownership. For young people, the increase in student debt makes the prospect of taking on additional mortgage debt even more daunting. For slightly older people, who are more likely to have suffered from the housing bust, the hit to their credit history from an experience in delinquency or default may also put homeownership out of reach. Even so, there is reason for optimism about a rebound in the aggregate homeownership rate going forward. If it simply stabilizes for each group within the population, the movement of people into higher age groups (where the propensity to own a home is higher) will lift the aggregate homeownership rate by roughly 0.1 percentage points a year. Should homeownership rebound among the age groups where it declined the most precipitously, the overall rate will move up at a faster rate. Even with the roadblocks in place, there is scope for this to occur. For people between 30 and 70, the homeownership rate was at its lowest level on record in 2013 (data going back to 1982).



*Households over population in age group.
Source: Census Bureau, Bureau of Labor Statistics

The second half of the picture is the number of households. Unfortunately, it is difficult to get a precise measure of the number of new households (see text box on page 4). Still, there appears to be little doubt that household growth has slowed appreciably since the housing collapse and has underperformed growth in the adult population. As with the homeownership rate, this appears likely to improve going forward. The determining factor will be the extent to which the propensity of younger people to form independent households rebounds over the next several years. Headship rates (the number of households divided by population) for younger people have moved in the same direction as employment relative to population (see chart on left). As employment rates move up, so too should headship rates. As long as headship rates stabilize, the number of households will increase by around 1.3 million a year.

Putting the two together, after several years of declines, with modest improvements in homeownership and headship rates, the number of homeowner households will begin to increase. In short, more robust housing demand is not a question of if, but of when.

Bottom Line

Recent U.S. housing data has been decidedly disappointing. On the demand side, existing home sales were down 7.5% year-over-year in March, and 15% since their cyclical high in July of 2013. The new housing segment had fared better overall, but the slowdown has eventually made its way there as well, with sales of new single-family homes plummeting by 13.3% in March alone. The weakness has also manifested itself in terms of housing construction. Housing starts moderated from a 1-million annualized pace set at the end of last year to 923k units in the first quarter of 2014.

In addition to disruptions caused by an abnormally harsh winter, the weakness in housing is explained by a rapid deterioration in affordability and tightening in credit standards. These elements have taken some of the energy out of the housing recovery, but won't be sufficient to stymie it. The housing market has several factors working in its favor, including a low level of new supply relative to population growth and household formation, a strengthening job market, and persistence in historically high affordability, in spite of the sudden adjustment last year. Moreover, we cannot overlook the fact the recent downshift in housing characterizes a market that could not (and should not) run at a break-neck speed on the back of investor demand. The gradual rotation of demand towards traditional buyers is a healthy development that will temper the speed at which housing recovers, but certainly doesn't put into question the recovery itself. Add to this list other support mechanisms, like the recent announcement by the FHFA that they will hold off on reducing the size of loans that the GSEs can purchase and focus on providing liquidity to the mortgage market. This should help reverse some of the recent tightening in lending standards.

The potential exists for the recovery to take longer than we anticipate, but the downside risk is limited by still record-low levels of housing construction. While a slower than expected housing recovery would temper U.S. economic growth over the next year (see text box at top of page 5), this would imply even more pent up demand, and faster growth in the future.