



TD Economics

Special Report

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SHE'S COME UNDONE: U.S. HOUSING MARKET SLOWDOWN IS UNDERWAY

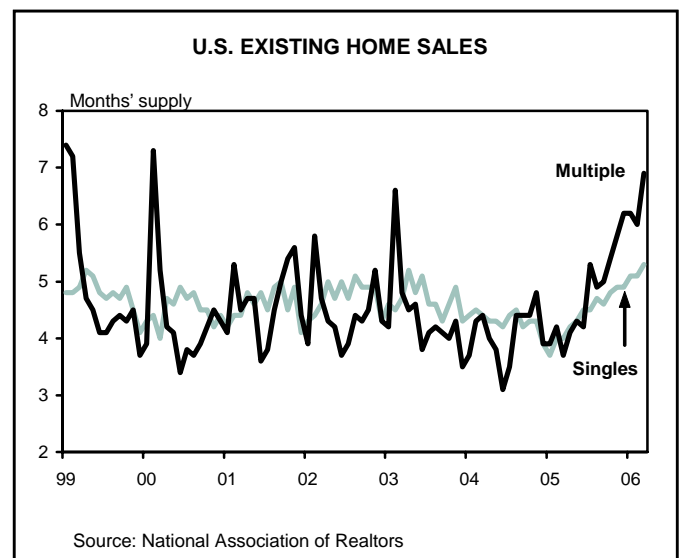
In the summer of 2005, TD Economics postulated that unsustainable consumer debt loads coupled with higher interest rates would skim the froth off the U.S. housing market by the second half of this year. As housing wealth effects unwound – a critical driver of spending growth over the past three years – economic growth would slow to a 2.5 per cent quarterly pace over a four-quarter period in late-2006 and into 2007.¹

With nearly a year having passed, we now check the health of the housing market to gauge its resiliency. A broad number of indicators leave the impression that a slowdown is indeed in progress, particularly among the more “bubble-exposed” regions. But, we find comfort in knowing that the adjustment thus far is neither abrupt, nor destabilizing to the economic outlook. If the housing market continues along a path of gradual normalization, it will be in keeping with our view that any economic slowdown in the U.S. will be relatively shallow and short-lived.

Sales and prices off their peak

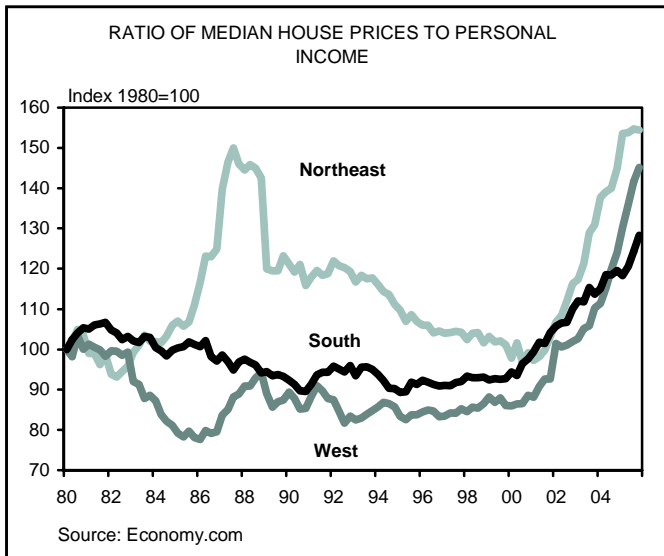
Winter weather anomalies wreaked havoc on housing statistics in early 2006. In January, housing starts boasted one of the best months on record with a 16-per-cent gain, as mild temperatures extended the building season. As winter finally reared its head, the construction boon was brought to an abrupt halt and housing starts fully reversed course in the two months that followed. Starts are still at a historically high level, but the peak is definitely in the rear view mirror with activity having edged below levels recorded prior to any weather-related distortions.

A more convincing housing slowdown has emerged in the resale and new home markets. Even though both markets recently rebounded from the winter blahs, here too sales remain below pre-winter levels. And, underlying



details foreshadow weaker price growth ahead. In particular, an increase in the number of homes available for sale and longer selling times caused inventories in the new home market hit a decade high in the first quarter. Meanwhile, a two-month rebound in existing home sales at the end of the quarter still proved insufficient to push down supply. There is currently 5 ½ months' supply of resale homes on the market, with both single-resident and multiple units (ie. condos) on the rise. This is not a new phenomenon, as the supply of homes has been creeping higher since the summer of last year. But, the single-home market has now broken away from what appeared to have been an eight-year equilibrium supply range of 4 ½ -5.0 months. Meanwhile, the usually more volatile multiples market has displayed an undeniable upward trend, with supply now kissing the 7-month mark.

The lagging nature of prices has kept them at elevated levels, but the pace of growth has definitely shifted down



a gear in both home markets. Median resale prices have eased back 5 per cent from peak levels last summer, while new home prices have been flat-to-negative for the past five months. On a year-over-year basis, resale homes prices were still rising at a 7 per cent clip in March, but this marks a sharp deceleration from the double-digit pace of 2005. Meanwhile, new home prices already dipped into negative territory in March relative to year-ago levels. We believe looser supply conditions will continue to dampen price growth in both markets as the year rolls forward.

More tempering in housing market in store

At the same time, a host of other economic fundamentals will continue to weigh on housing demand. For instance, home affordability is no better today than it was in the early-1990s when mortgage rates were at least two percentage points higher. Since home prices have risen considerably faster than after-tax incomes, this presents a unique challenge for first-time homebuyers who don't have the capital gains on existing homes to help finance new purchases. So, it is little wonder why reduced affordability has led to an explosion in unconventional mortgages (also dubbed 'easy credit').

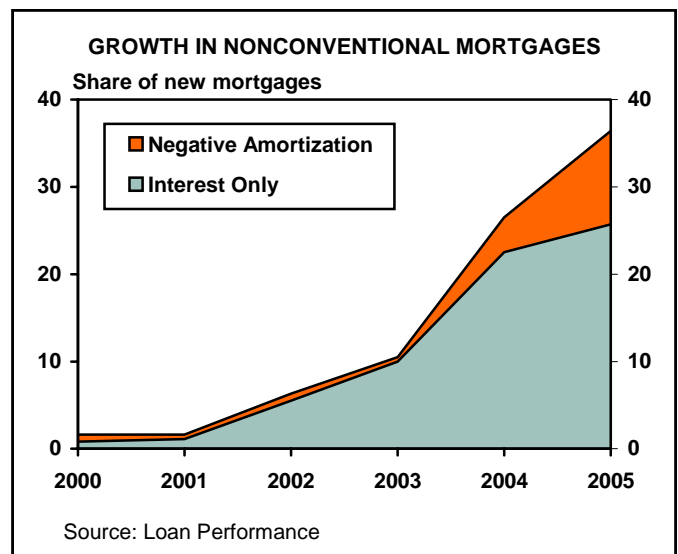
The adjacent graph reflects the dramatic increase in demand for non-conventional mortgages of negative amortization and interest-only loans.² These mortgages carry a higher degree of credit risk, especially if homeowners have underestimated future income growth. Mortgage rates have already risen a full percentage point since the trough in early 2005, suggesting that even these easy-credit products have become less accessible to potential homebuyers

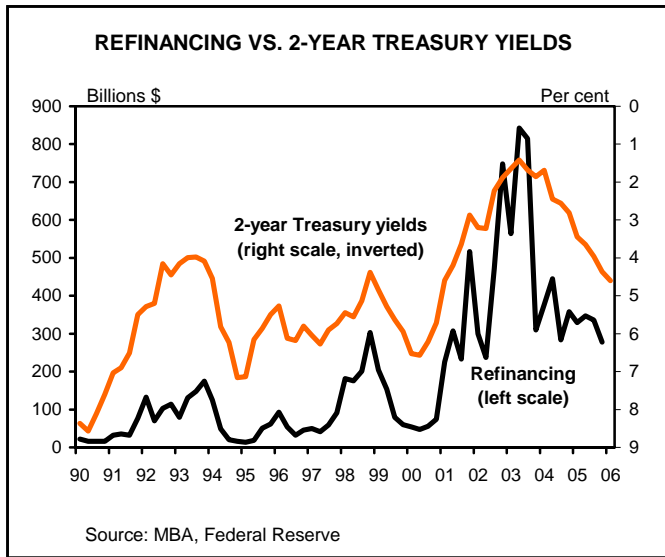
– especially those already on the margin to qualify.

One of the more curious developments in the housing market has been the leveling off in homeownership rates in 2004 and 2005, despite the strength in sales and prices at the time. This is an implicit indicator that a greater proportion of home buying may now represent second-home purchases for vacation and investment purposes – a notion recently confirmed in the statistics. According to the National Association of Realtors, vacation- and investment-home sales both set records in 2005, with the combined total of second home sales accounting for 4 out of 10 residential transactions. The market share of second homes rose from 36 per cent of transactions in 2004 to 40 per cent in 2005. This has two implications. First, the housing market is more vulnerable to volatility, since second home purchases carry a higher element of economic risk. Investors are quicker to sell their properties in the event of personal financial difficulties or capital losses. Second, rising mortgage rates and higher housing supply suggests that there won't be a repeat record performance in 2006, thereby blunting a key demand source.

Softer economic growth is likely outcome

So, what does this mean for the U.S. economic outlook? The American consumer represents 70 per cent of the real economy, and so anything that undermines consumer spending growth poses considerable downside risk to the economic landscape. Aside from the direct effects related to the housing boom, such as increased demand for construction workers and housing-related purchases, the current housing cycle also imparted a substantial eco-





conomic-kick through wealth effects. Readers may recall that in August of 2005, TD Economics wrote a topic paper highlighting the importance of real estate appreciation and refinancing activity as a key impetus to spending growth in the past three years. It was estimated that these housing wealth effects accounted for, on average, 2 percentage points of the annual growth in real consumer spending each year. By extension, the U.S. is now facing a situation where the unwinding of housing wealth effects via slower price growth and a reduction in refinancing will drag consumption growth.

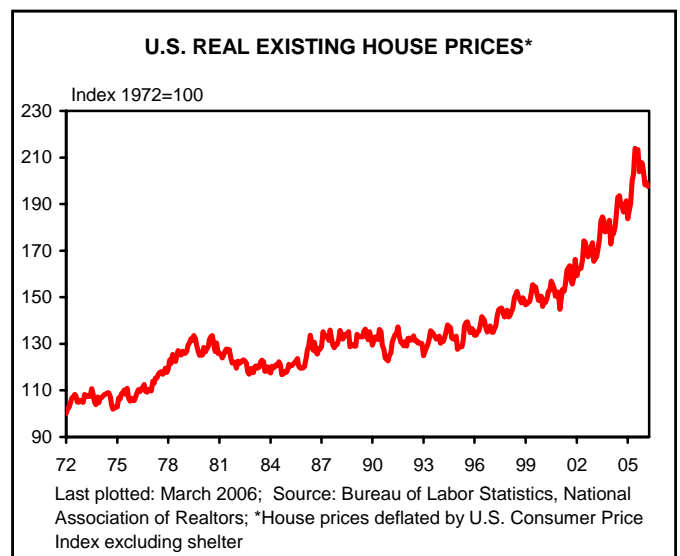
Refinancing at lower interest rates boosts GDP growth by providing households with a greater amount of disposable income. In addition to interest-cost savings, a Federal Reserve study in 2002 found that nearly three-quarters of refiners at that time were reducing mortgage payments by lengthening out their mortgage terms. The study also found that about half of the refiners were cashing out equity in their home and half of these funds were directed into home improvements or other consumer expenditures. Against this backdrop, it's easy to see why a housing market boom feeds through to higher consumer spending. However, refinancing originations have already plunged from their peak. The graph above reflects the tight negative correlation between movements in shorter-term Treasury yields and refinancing originations. As one would expect, refinancing hit a record high when interest rates dropped to decade-lows, as the Federal Reserve attempted to pump up liquidity to stimulate the economy and shore up confidence following a mild recession and terrorist attacks. Now that interest rates have returned to

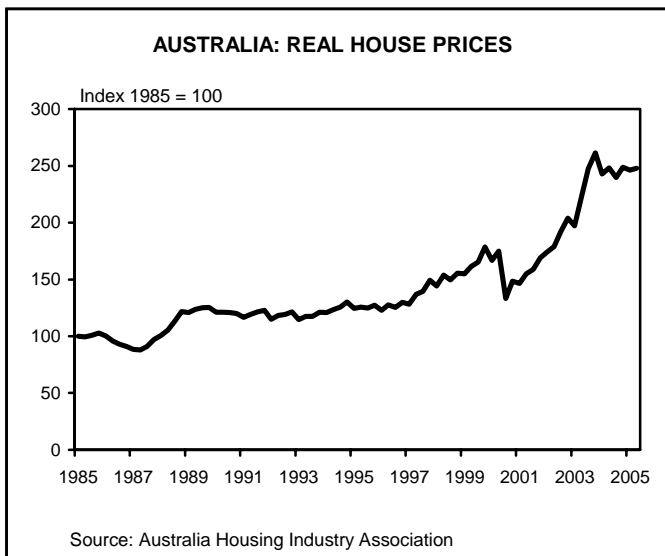
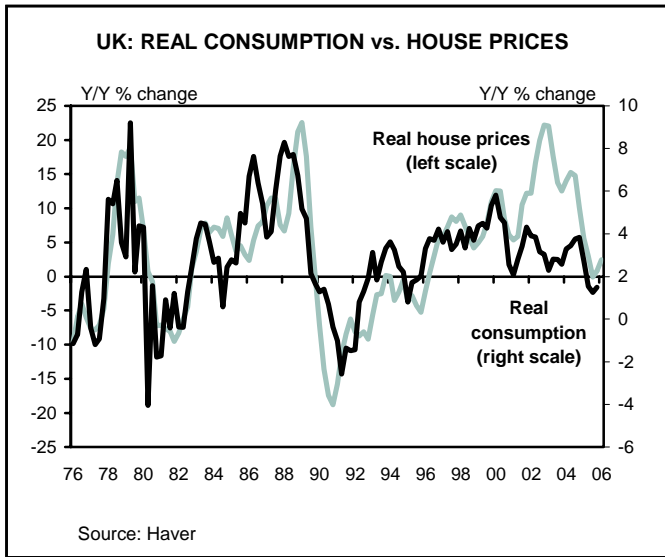
more neutral settings, there is far less of a financial advantage in incurring penalties or fees to refinance mortgages – not to mention that most homeowners may have already done so in the past three years. As such, refinancing is unlikely to remain a key impetus to spending growth.

Soft landing skeptics should look overseas

The direct and indirect effects of a slowing housing market are expected to crimp consumption growth significantly in late 2006 and early 2007, but we anticipate neither a broad, national housing market correction, nor an outright retrenchment in consumer spending. Rather, consumer spending is likely to slow to a 2.5 per cent annualized quarterly pace for a four-quarter period. While this may seem idealistic to some, the U.S. has the benefit of tight labour markets to help sustain income growth, thereby mitigating the possibility of a more detrimental pull back in consumption. In addition, unlike past housing boom-bust episodes, inflation and interest rates are low and stable in the current cycle. This imparts two benefits. First, it reduces the odds that the central bank will need to aggressively tighten monetary settings in order to stay ahead of the inflation curve. Second, the Fed is also well-positioned to quickly lower interest rates to provide immediate monetary stimulus once it becomes apparent that a broader economic slowdown is underway, thereby mitigating the downside risk of a harder landing in consumption.

For the skeptics out there, we need only look to the U.K. and Australia as proof that a housing market slowdown can be orchestrated without dire consequences to the consumer sector. Over the entire period between





2002 and 2004, home prices in England maintained double-digit growth rates, both in nominal and real terms. Once the red-flag was raised over a potential housing market bubble, the Bank of England (BoE) responded by increasing its benchmark repo rate by 125 basis points between November 2003 and August 2004. And, tighter monetary settings proved effective. In 2005, annual home price growth decelerated to 5 per cent, one-third the pace seen in prior years. Although, consumer spending growth was cut in half to 1.8 per cent in 2005, the BoE appears to have successfully avoided a hard landing. The same is true in Australia, which was also confronted with the prospect of an overheated housing market in 2002. Tighter monetary settings there have flattened real home prices and eased private consumption growth to 3.1 per cent in

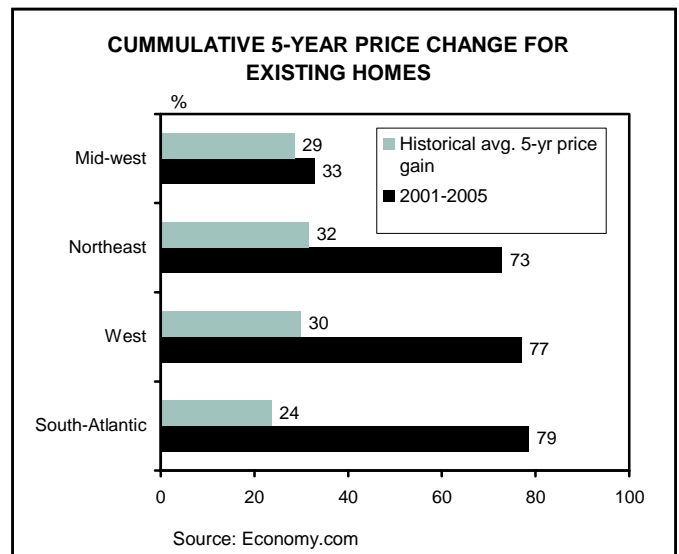
2005 from nearly 6 per cent in the prior year.

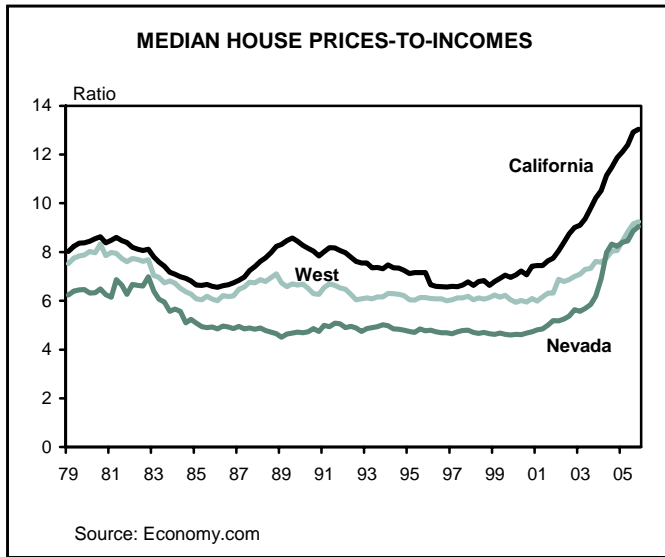
Regional markets face possible price-corrections

While we do not believe a national price correction looms in the U.S. housing market, we cannot rule out this possibility for some of the regional markets. Although this may seem counter-intuitive, housing markets are only partially driven by national influences, such as interest rate settings. Unique local elements also enter the equation, like regulation, proximity to major urban centers, population growth, and land constraints. As such, housing market bubbles are sustained at the local level, rather than on a national scale. That said, it does not preclude regional markets from having national repercussions, especially if the regional centers are heavy-weights when it comes to their national representation of jobs, production and income – which seems to be the case this time.

We are certainly not alone in voicing concern over the ‘bubbly’ nature of a number of Western, Southern and Northeastern markets in the United States. It was already apparent in the fall of 2004 (see TD Economics topic paper entitled “Time to pay the piper”) that housing markets in California, Nevada, Florida and the broader New England area were departing from fundamentals.

The South-Atlantic, Northeast and West regions have experienced massive home price gains over the past 5 years. We focus on the South-Atlantic region rather than the South as a whole because the hottest markets are concentrated in the coastal states (i.e. Florida, Virginia etc), not those traditionally known as the “deep south” (i.e. Alabama, Mississippi, Louisiana etc). The cumulative price gain in all

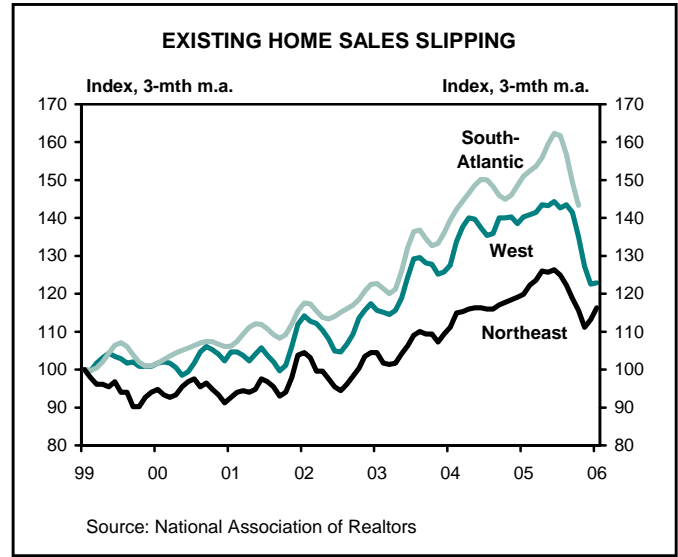




three regions from 2001-2005 was two-to-three times the historical experience.

There is definitely a ‘hockey stick’ dimension to the ratio of home prices-to-incomes in these three regions. For a ratio that is generally flat and stable over time, it has shot up over the past three years. This departure in behaviour is usually a textbook sign that some level of ‘irrational exuberance’ has been built into the market. Using the West as an example, Nevada and California stand out like sore thumbs (see graph above). The median price for a home in California was half-a-million dollars by the end of 2005. Nevada is doing its very best to catch up, with median prices doubling over three years. Both of these States have the unenviable distinction of being among the least affordable regions in America. As such, both are high users of ‘easier credit’ products.

With affordability seriously eroded in a number of key states, new entrants face an onerous barrier. No doubt, reduced affordability also impacts decisions towards second-home purchases for investment or vacation purposes. Even though State level data for the first quarter of this year are not yet available, they are on hand for the broader regions. The above graph shows plain-as-day that existing home sales are well off their peak, even with favourable unseasonably warm weather distortions at work. Though price movements operate under a lag, there is preliminary evidence of a deceleration in growth. In fact, prices in the Northeast and West were actually lower in the first quarter of 2006 when compared to the same period last year. This is particularly astonishing for the West, which came off double-digit growth. Meanwhile, prices



in the Northeast are down nearly 10 per cent, while the South experienced relatively flat growth. Price measures on a regional basis can be quite volatile, but there’s no escaping the fact that all three metrics mark the worst performances in two or more years.

Conclusion

If the U.S. economy has taught us anything, it is that imbalances can be sustained for long periods of time. But, we also know that nothing defies gravity indefinitely and a number of regions are overdue for pay-back. It is uncommon to see sustained nominal declines in home prices at the national level, but this is not true at the regional level. For instance, after a period of rapid price growth in the Northeast through the 1980s, the first half of the 1990s proved less fruitful for homeowners. Given the key role housing wealth has played in driving American consumption in recent years, even a flattening in national home prices would be sufficient to slow annual spending growth by a percentage point, as this would still undermine a homeowner’s ‘feeling of wealth’ and reduce refinancing and equity cash-out demand. However, wealth effects operate with a lag. Estimates indicate that it takes about one year for the full impact to feed through to consumption behaviour. As such, a more engrained slowdown in consumption is unlikely to become evident until later this fall.

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Endnotes

- ¹ For greater detail see topic paper "U.S. Expansion on 'Borrowed ' Time", August 2005.
- ² The mortgage payment is smaller than the interest due in a negative amortization loan, causing the loan balance to increase rather than decrease. Although this is considered a borrower-friendly feature because it can increase the affordability of a home, equity in a home would actually decline in a persistently rising interest rate environment if the negative amortization isn't offset by house appreciation. In addition, at some future date, negative amortization must be repaid, resulting in a rise in future payments. The larger the negative amortization, the greater will be the required increase in future payments.

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