Is U.S. Housing Still Affordable?

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Alongside robust job growth, easier credit standards and favourable demographics, the U.S. housing market's recovery has been greased by healthy affordability. Following the bust, ownership was never cheaper in recent decades than in early 2013 (*Chart 1*). But since then, galloping house prices and rising interest rates have chipped away at buying power. If current trends persist, the affordability tailwind will reverse and the economy will lose a stable source of support from housing activity.

So far, housing remains affordable in most regions. Nationally, the median mortgage payment is still below 2006 levels, while family income is almost 30% higher. The typical family looking to buy a median-priced house spends 16.2% of gross income on mortgage payments, still below the two-decade norm (17.5%) and well below 2006's high (24.7%).[1] The mortgage-service ratio, however, is well above the 2013Q1 record low of 12.1%, for two reasons. First, the 30-year fixed mortgage rate is up one percentage point to 4.6%, accounting for a third of the 4-ppt increase. Second, house prices have jumped more than 40% to above long-run trends (*Chart 2*), outrunning a 28% increase in family income. On a regional basis, affordability has fallen the fastest in the West and, to a lesser extent, the South, while remaining relatively healthy in the Northeast and Midwest.

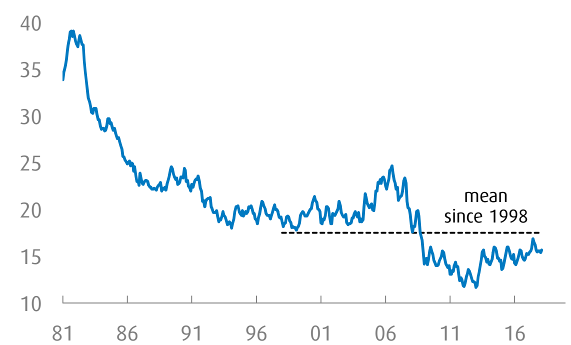
Rising house prices and interest rates threaten to spoil the affordability party. Fed policy tightening, a strong economy and firmer inflation are expected to lift long-term interest rates by 0.7 percentage points in the next two years, raising the mortgage-service ratio about one percentage point. While this alone would not drive affordability below long-run norms, house prices show no sign of slowing. In fact, the Case-Shiller national index is now climbing the fastest in nearly four years, up 6.3% y/y in February. A few regions, including Seattle and Las Vegas, are seeing double-digit gains. **If the current pace of appreciation continues and long-term rates increase as expected, mortgage payments will consume an above-average 18% of family income by the spring of 2020.**[2]

Heady house price gains are likely to persist this year. Sales are supported by rising wages and rents, looser credit standards and "fear of missing out". Ownership rates are rising after falling for a decade, as family-raising millennials abandon apartments (*Chart 3*). Demographic support should continue for several years, as the largest single-age cohort (27-year olds) approaches prime-home buying age (31). At the same time, **builders are struggling to keep up with demand amid worsening labour shortages and rising material costs** (no thanks to the softwood lumber duties). At around

Chart 1
Not Expensive

United States (percent of median family income)

Mortgage Costs

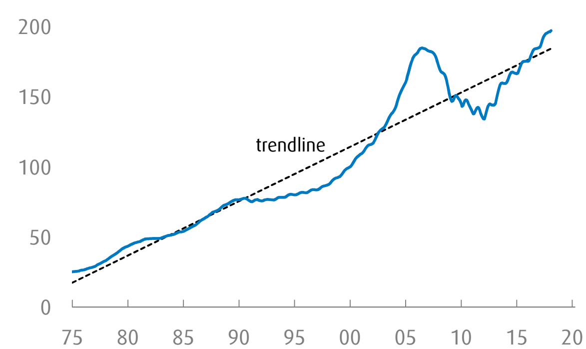


Sources: National Association of Realtors, BMO, Haver Analytics

Chart 2
Twin Peaks

United States (January 2000 = 100)

Case-Shiller Home Price Index



Sources: Standard & Poors/CoreLogic, BMO, Haver Analytics

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1 Even 2006 pales against the record 39% of income required to service a mortgage in 1981 when mortgage rates were 16%.

2 Median family income is assumed to pick up to a 4.0% rate from 3.7% last year due to a stronger economy and faster wage growth.

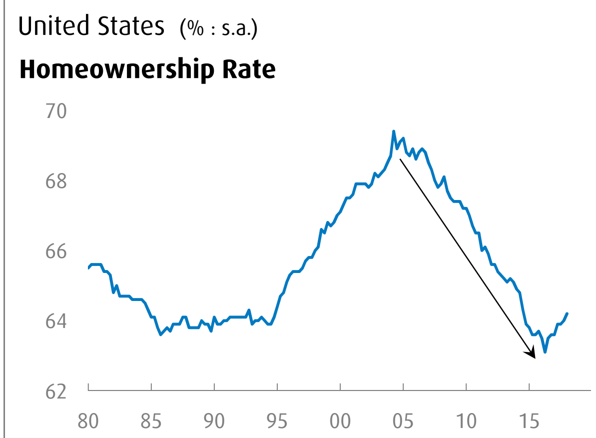
five months, the supply of new single-family homes remains below its long-run norm (six). Buyers will find no relief in the resale market, where the available number of single-family properties is among the lowest in at least three decades (*Chart 4*) amid low rates of foreclosure.

The takeaway is that ebbing affordability will likely begin to impact the economy in 2020. As home sales slow, so will the rate of appreciation and construction. The latter added a quarter percentage point to annual GDP growth, on average, in the past six years, while rising wealth from real estate likely tacked on a similar amount last year. If the housing market cools in response to fading affordability, the economy could lose a moderate source of support.

Bottom Line: Despite the rising cost of ownership, housing remains inexpensive across most of the country. However, this economic tailwind will fade in 2020 if house prices don't pipe down soon and interest rates rise moderately further.

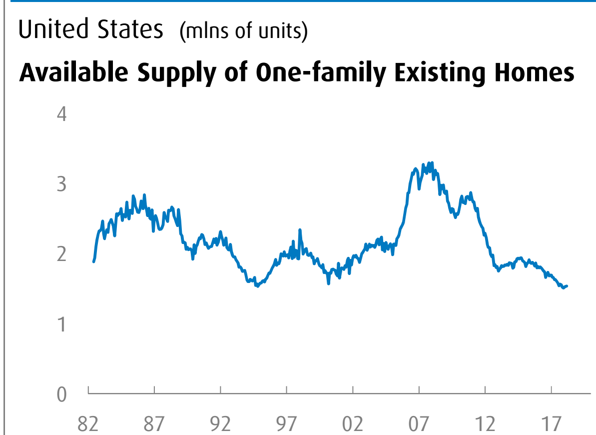
On a more positive note, even if house prices remain strong for the next two years, affordability should remain much better than at the height of the 2006 bubble, when mortgage payments gobbled up a quarter of family income. Combined with superior credit quality today, the risk of another large correction seems low.

Chart 3
Lost Decade



Sources: Census Bureau, BMO, Haver Analytics

Chart 4
Sellers Wanted



Sources: National Association of Realtors, BMO, Haver Analytics