U.S. Housing Outlook: Home on the Range [bound]

Michael Gregory, CFA
Deputy Chief Economist
michael.gregory@bmo.com
416-359-4747

For America's housing sector, 2018 is the year of losing steam. For example, although total home sales inched up 0.4% to 5.97 million units (annualized) in August, this followed four consecutive monthly declines for a cumulative 5.2% loss. Year-to-date, total sales are down 3.7%. Elsewhere, real residential investment contracted in both Q1 and Q2. The concern is whether recent data are indicating that housing activity has already seen its cycle high and might become a persistent drag on economic growth. While we can't rule out this scenario, we judge that **recent weak housing indicators are indicative of a downshifting, rather than a braking, of activity.**

Deteriorating affordability is dampening the demand for homes (*Chart 1*). Although the metric constructed by the National Association of Realtors improved slightly in August, housing affordability is still hovering around its least attractive levels in a decade, and not far off its long-run average. The deterioration is due to rising **mortgages rates** and **home prices**.

According to Freddie Mac, 30-year mortgage rates (now above 4.70%) are pushing their highest levels in nearly 7½ years, even surpassing the peaks after 2013's taper tantrum (*Chart 2*). Back in 2011, mortgage rates were dropping partly owing to Fed quantitative easing (policy rates had hit their zero lower bound at the end of 2008). Mortgage rates are on the rise now, partly reflecting the hikes in policy rates (200 bps since December 2015) and, since October 2017, reductions in the Fed's holdings of Treasuries ($152 billion) and MBS ($73 billion). Meantime, home prices are at record highs, according to the FHFA and S&P CoreLogic Case-Shiller indices. Price gains averaged 6.2% y/y in July, and are up more than 52% since hitting post-recession lows in early 2012.

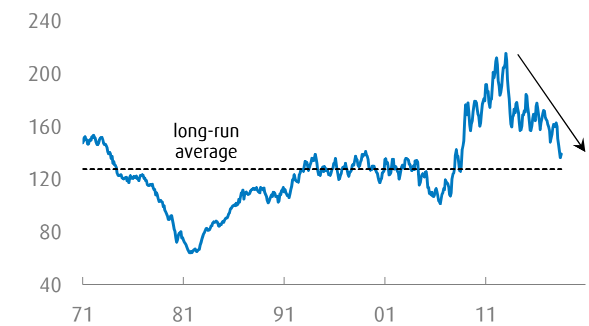
Although housing affordability has been deteriorating, it still remains above its long-run average. Presumably, "average" affordability represents a mix of home prices, mortgage rates and household incomes that neither hinders meaningfully, nor helps significantly, the demand for homes. The interval running from the early/mid-1990s until the early/mid-2000s saw affordability levels hovering around their long-run average, and this was a period during which real residential investment displayed low volatility… no huge negative or positive swings.

In addition to deteriorating affordability, housing activity is also being dampened as pent-up demand is being depleted. The combination of long-lasting, unfavourable, individual economic circumstances and the legacy of the housing bubble left the demand for homes running well below levels warranted by fundamentals such as household formation. As economic circumstances improved, and the housing bubble became a distant memory for mortgage

Chart 1
Harder to Afford

United States

Composite Housing Affordability Index[1]

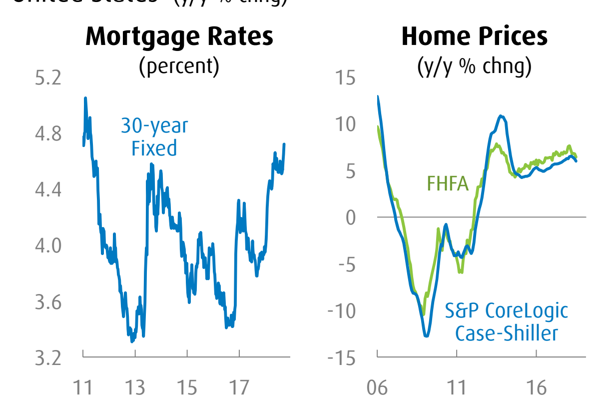


[1] (median income = qualifying income =100)

Sources: BMO Economics, Haver Analytics, Nat'l Assoc. of Realtors

Chart 2
Affordability Eroders

United States (y/y % chng)



Sources: BMO Economics, Haver Analytics

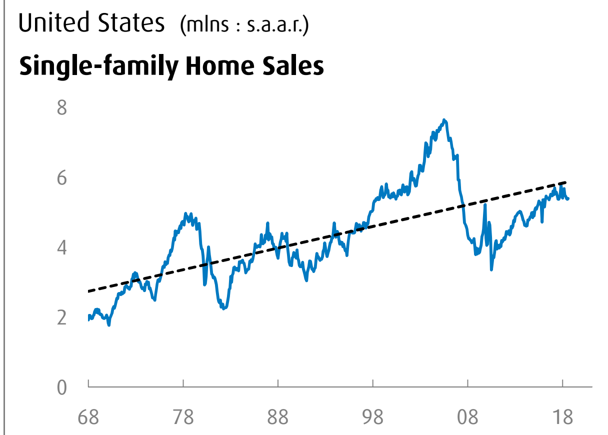
borrowers and lenders alike, demand started to catch up with fundamentals and thus served as a strengthening force underlying housing activity. Although most of this force has now been spent, a little still likely lingers. For example, total (single-family) home sales have yet to catch-up to their long-run trend (*Chart 3*).

Meanwhile, there are **several factors still stoking housing activity**, partly offsetting the impact of deteriorating affordability and depleting pent-up demand. For example, **consumer confidence** is currently running at 18-year highs, supportive of big-ticket purchases. More importantly, **household incomes** are being bolstered by sturdy job growth (payrolls averaging a monthly 194,000 in the past year), along with a modest pickup in wages (the latest readings on average hourly earnings and the Employment Cost Index are increasing at cycle highs). Additionally, **household balance sheets** are in a relatively heathy state despite the ramp-up in mortgages and other debt to record levels (*Chart 4*). As a share of disposable personal income (DPI), household debt has been moving sideways with a downward tilt. The ratio sat at 86.0% in 2018Q2, down more than 30 percentage points from the housing bubble peak, and the lowest level since 2002. The sector's net worth stood at 6.8 times DPI, just shy of a record high. Finally, the debt service ratio ran at 10.2%, still not far off its record low (9.9%).

These income and balance sheet developments suggest that **households have the capacity to take on additional debt** and **should be able to weather a further moderate rise in interest rates**. On the other side, banks continue to ease mortgage lending standards (*Chart 5*). Together, this is constructive for mortgage credit creation.

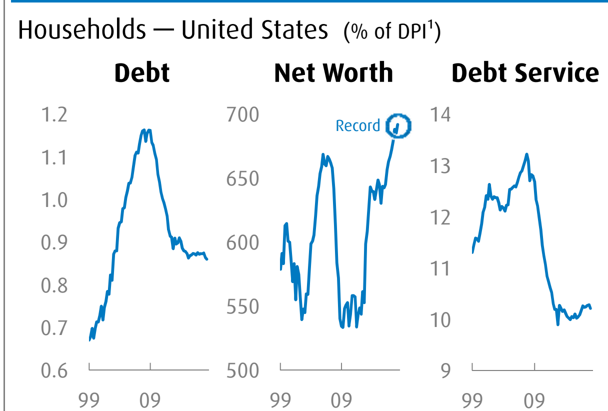
During the past year, housing starts averaged 1.25 million units and this pace should pick up a bit given building permits have averaged 1.32 million (*Chart 6*). And, both these figures fall short of the current and projected rates of household formation. Official estimates of the latest annual tally have averaged around 1.42 million, pointing (as in the case of sub-trend single-family home sales) to some lingering pent-up demand. Harvard's Joint Center for Housing Studies reckons the rate of household formation should run around 1.36 million per annum out to 2025. Some of this demand for dwellings will be satisfied by mobile homes; shipments here are running just under 100,000 units. However, starts will also be boosted by the demand for second homes and replacements (the latter reflecting tear downs, fires and natural disasters). As the trend in starts continues to drift up reflecting the above factors, housing activity should continue contributing to economic growth, assisted by home sales converging on their long-run trend and affordability staying close to its long-run average.

Chart 3
Single-family Sales Home In on Long-run Trend



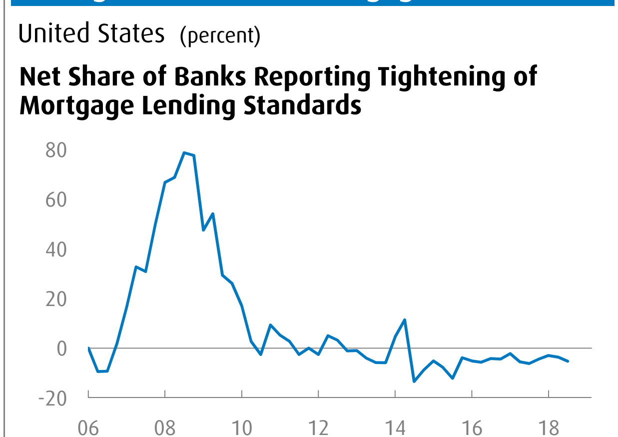
Sources: BMO Economics, Haver Analytics

Chart 4
Triple Strength



[1] disposable personal income
Sources: BMO Economics, Haver Analytics

Chart 5
Willing to Make More Mortgages

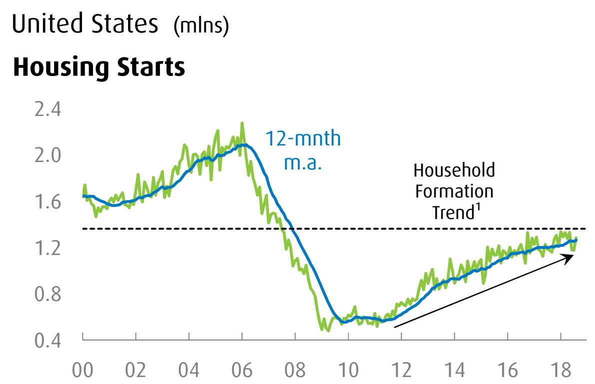


Sources: BMO Economics, Haver Analytics, FRB Senior Loan Survey

Residential investment, which includes new home construction, home renovations and repairs along with realtors' commissions, represents close to 4% of GDP. If housing activity, after adjusting for inflation, is advancing in-line with potential real GDP (around 2%), housing will end up contributing just under a tenth to economic growth. As recently as early 2016, housing's actual contribution was averaging as high as 30-to-40 basis points (*Chart 7*). As mentioned at the outset, the past two quarters have seen real residential investment contracting, resulting in just 1.3% growth over the past year (and sub-par contribution to GDP). The quarterly data can be quite volatile, easily whipsawed by the weather, but this year's contraction to date is interesting in that it has largely been price driven. Nominal residential investment grew a respectable 7.3% y/y in 2018Q2… prices jumped some 6% y/y. Steel and aluminum tariffs, along with the softwood lumber duties that came before them, have come home to roost, emphasizing yet another headwind for the housing sector (along with shortages of construction workers and lots).

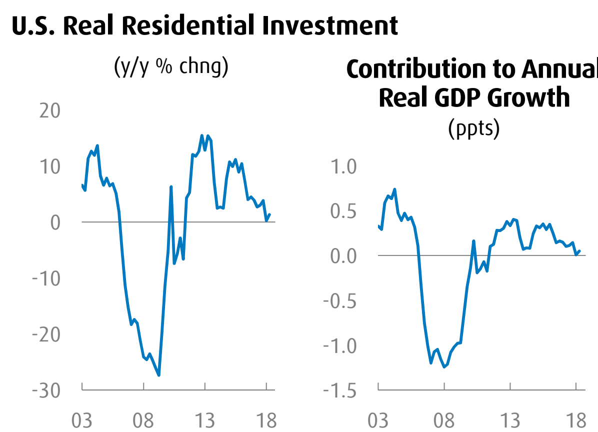
On balance, after years of punching above its weight class when it comes to contributing to real GDP growth, some cooling of housing activity was anticipated. On cue, recent weak housing indicators point to a plateauing of residential investment growth at a pace that no longer contributes more than its fair share to economic expansion, but still doesn't act as a net drag (call it, real residential investment increasing in the 0%-to-2% annual range).

Chart 6
Catching Up



[1] 2015-2025 projected total =13.6 mln (Joint Center for Housing Studies, Harvard University)
Sources: BMO Economics, Haver Analytics

Chart 7
Keeping on the Positive Side



Sources: BMO Economics, Haver Analytics