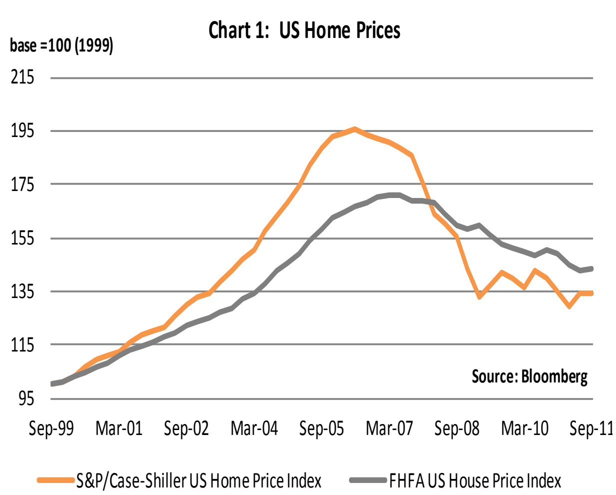
Brown Brothers Harriman
JANUARY 18, 2012
SPECIAL FX
www.bbh.com/fx

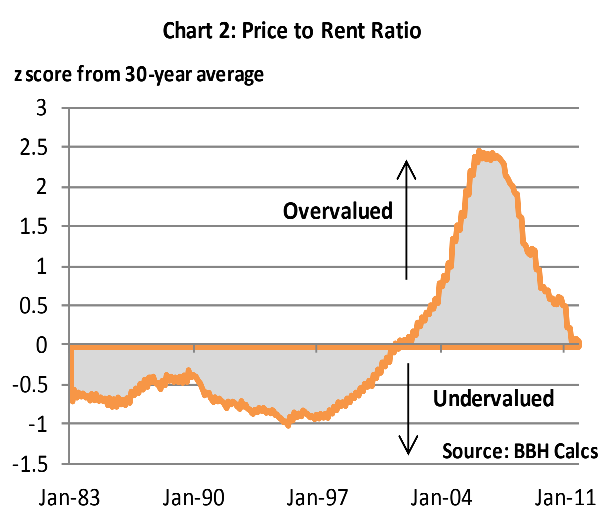
US Housing

In the next few weeks we will get the last data reports on the US housing sector for 2011. Above all, while the housing market – inch-by-inch- has been improving over the course of the year, the outlook for housing is likely to be tempered by still moderating prices and weak housing starts due to the excess inventory of distressed property. As a result, there have been reports that the US government is set to introduce new measures to facilitate the conversion of unsellable properties into rentals to improve market inefficiencies. And once this overhang of inventory is cleared, the housing market looks poised for a potential rebound.

It appears that the US housing market is stuck in a tug-of-war. On the one hand, valuations indicate that homes are much more affordable than they have been in the past decade. Borrowing costs are also at record low levels, if you can get a loan. On the other hand, the housing market remains constrained by a glut of excess homes and the current pace of foreclosures that are likely to add to the current stock of housing inventory, undermining the attractiveness of valuation and affordability. Taken together, while there is light at the end of the tunnel, we suspect that absent a policy response the US housing market is likely to restrain the underlying momentum in the US economy as excess supply weigh on home prices.

Chart 1 shows that home prices have declined in a range of 15-30% since the peak in 2006, suggesting that home prices appear to be stabilizing but lack impetus for significant move higher. At the same time, homes no longer appear expensive, at least when compared to renting (Chart 2). In particular, the price-to-rent ratio (which measures the relative cost comparison between renting and owning) has finally returned to its multi-decade equilibrium. As a result, buying a home now looks more affordable than renting. While the range of prices may deviate widely across cities, the price to rent ratio suggests that overall home valuations are now in line with the 30-year average.





Owner's equivalent rents (the denominator of the price to rent ratio) have increased by roughly 13% since 2006 driven in part by the increase in home foreclosures. Indeed, increased home foreclosures (up nearly 25% since Q4 2005) have forced prior homeowners into the rental market, placing upward demand on rental space, while causing the price of listed homes to decline. As a consequence, bargain hunters are likely to have in part helped stabilize prices. Moving forward, demand for rental space may help reduce the existing stock of current inventories. Yet given the shift from renting to owning, an expansion of the available rental stock (multi-family units, in particular) is necessary to prevent a sharp rise in rental costs.

The improvements in valuations, together with the historically low mortgage rates, have boosted homebuyer affordability to near record highs. Indeed, the National Association of Realtors Homebuyer Affordability index (which begins in 1986) reached an all-time record high in November 2011, driven in part by the sharp drop in home values. What's more, real disposable incomes per capita have also improved marginally, up over 3% since 2006, contributing in some part as well to the improvement in affordability.

Actions taken by policy makers to improve financial conditions (and thus keep interest rates low) have also contributed to the improvement in affordability (Chart 3). Specifically, the combination of asset purchases from the Fed and safe haven demand for US Treasuries are likely among the key driving forces keeping interest rates low. Mortgage rates hit record lows of 3.92% in early January 2012, down nearly 114bps from the recent peak in February 2011, while the Fed has added nearly $950B worth of long-term securities to its balance sheet since late 2008 in an attempt to improve financial conditions and increase lending.

Still, the rub is that not everyone who wants a loan can get one. While banks have loosened standards for some loans, the most recent survey of senior loan officer by the Fed indicates that credit conditions still remain tight. In addition, the still high unemployment rate and overall global economic uncertainty outweighs the allure of more affordable homes. In the end, while affordability should help boost demand in the housing market, tight credit conditions should limit loan qualification and thus restrain some of the impact from affordability.

Chart 3: US Financial Conditions & Home Affordability

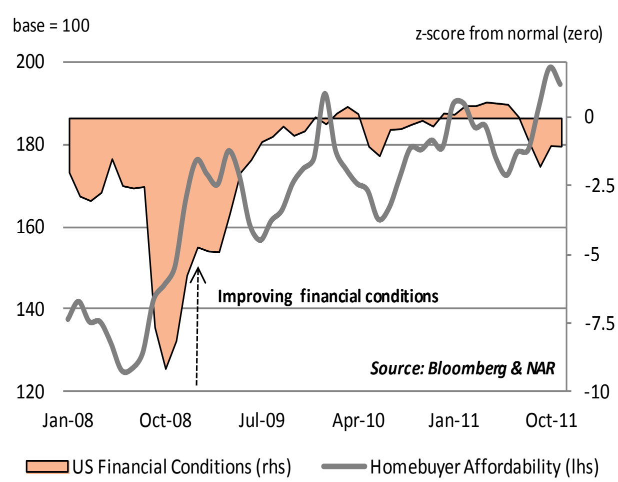
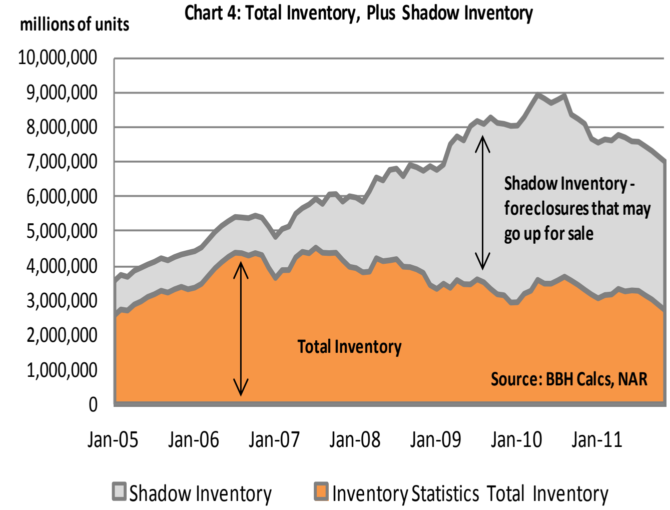


Chart 4: Total Inventory, Plus Shadow Inventory



New home sales (which normally surge after a recession) are bucking their historical trend. This is in fact the first time over the past 42 years that new home sales failed to surge in the aftermath of the recession. Instead, this time around sales have fallen 15-20%, with new home sales currently trailing the 40-year average by 55%, driven by foreclosures, tighter credit conditions and quite possibly by rising construction costs.

The residential construction producer price index, for instance, rose 5.5% y/y, up nearly 17% since early 2007. This contrasts widely with the -3.4% y/y decline in the value of home prices (measured by the CaseShiller index), suggesting that the costs of building have outweighed the costs of selling, putting additional strain on industry profit margins. What's more, revenue from homebuilders have declined nearly 90% since the peak in 2006 (although margins, while volatile, have improved somewhat since 2009).

Arguably, the most significant factor driving home prices is the pace of foreclosures. Foreclosures influence home values as the change in delinquency rate impacts existing home inventories. So while delinquencies as a percent of total loans have declined to 7.9% in Q3 from nearly 10% in March of 2010, foreclosures still remain at near record levels of 4.3% of total loans. According to Realtytrac new foreclosure activity in November 2011 was 224K, just shy of the 239K pace seen throughout 2011, suggesting that the pace of foreclosure activity still remains troubling. Consequently, the existing stock of housing inventory is likely to remain elevated, indicating that home prices may remain subdued.

The current stock of total housing inventory (existing plus new) is currently 2.7 million units. While this has steadily improved from the nearly 5 million units on the market in 2007, the existing supply still translates into 7 months worth of inventory, at current sales rate. This is also a few hundred thousand units higher than the average seen over the past 30 years. Similarly, estimates of the shadow inventory (foreclosures plus 90-day delinquent home that may be added to the existing stock of inventories) indicate the potential to see the current total inventory double, resulting in nearly a 20-month supply of homes (Chart 4).

While housing prices appear to have stabilized, there are still strong headwinds that are likely to limit the strength of the recovery. Fed Chairman Bernanke, for example, recently argued that without an additional policy response to support the housing market, the "deadweight loss" from the housing imbalance will continue to push housing prices lower. The Fed's plan would be to convert real estate owned (REO) properties to rentals, in an effort to boost the existing stocks of rental space and keep prices relatively affordable.

In the end, while valuations and affordability continue to provide tailwinds for the housing market, a policy response to convert the current stock of existing inventories into rentals is likely necessary to overpower the strength of headwinds coming from excess supply and high delinquency rates. And once these inventories of distressed homes are cleared, the US housing market looks poised for a potential rebound, adding momentum to US activity.

Mark McCormick