

Weekly Economic Commentary



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Highlights

Almost all of the factors supporting an ongoing recovery in housing remain in place, but the rise in rates will likely slow the pace of the recovery somewhat.

Many, if not all, of the other housing indicators we watch also suggest ongoing recovery in the housing market in the quarters and years ahead.

We expect housing to make a positive contribution to overall GDP growth in 2014, after housing added to growth in both 2012 and 2013.

Please see our full-page infographic about the housing market on page 2.

Location, Location, Location

As the old saying goes, the real estate market is all about “location, location, location.”

When we discuss the housing market, we do so from a national perspective: what is happening to the housing market on your street or in your neighborhood, town, city, or state may be completely different (better or worse) than what is happening nationwide.

We expect housing to add between 0.2 and 0.3 percentage points to overall GDP growth in 2014.

Residential Recovery Redux

Several key reports on the state of the housing market are due out this week (February 24–28, 2014), most of which will likely be negatively impacted by the colder and snowier-than-usual weather in much of the nation over December 2013 and January 2014. The data due this week include:

- Case-Shiller Home Price Index for December 2013;
- New Home Sales for January 2014;
- Pending Home Sales for January 2014; and
- Housing Contribution to gross domestic product (GDP) for Q4 2013.

The weather will eventually return to normal, but market participants are likely to be asking: Once the weather improves, will the housing data continue to feel the pinch of higher mortgage rates over the rest of 2014?

Solid Supports

The recent rise in mortgage rates—from just under 3.50% (for a conventional 30-year loan) in May 2013 to a recent reading of just over 4.25%—has led to widespread fears that the housing recovery will come to a grinding halt. Those fears appear to be overdone, in our view, as almost all of the factors supporting an ongoing recovery in housing remain in place. However, the rise in rates will likely slow the pace of the recovery somewhat.

In general, the housing market hit bottom in early 2009, and moved sideways between early 2009 and late 2011 before picking up momentum at the start of 2012 (please see “Location, Location, Location”). Until housing added 0.3 percentage points to overall GDP in 2012, housing construction (the most direct way housing impacts economic growth as measured by GDP) had not been a significant, sustained contributor to economic growth since 2005. The lack of participation from housing has been one of the main reasons for the sluggish economic recovery, along with the severe cutbacks in state and local governments.

When we last wrote in depth on the housing market in mid-2013, we forecast that “despite the recent rapid rise in rates, we still see housing making another significant (0.3–0.5 percentage points) contribution to GDP growth in 2013, as the positives driving the residential recovery more than outweigh the negatives.” Indeed, although the data are not final, housing contributed 0.3 percentage points to overall GDP growth in 2013. We expect housing to add between 0.2 and 0.3 percentage points to overall GDP growth in 2014.

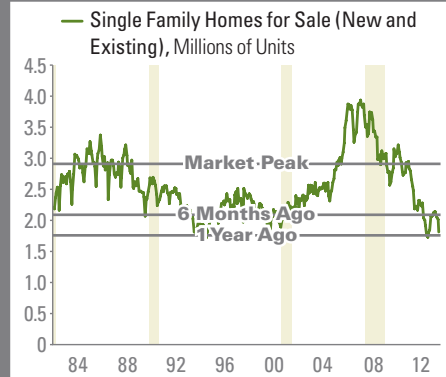


Is the Housing Market Getting Better or Worse?

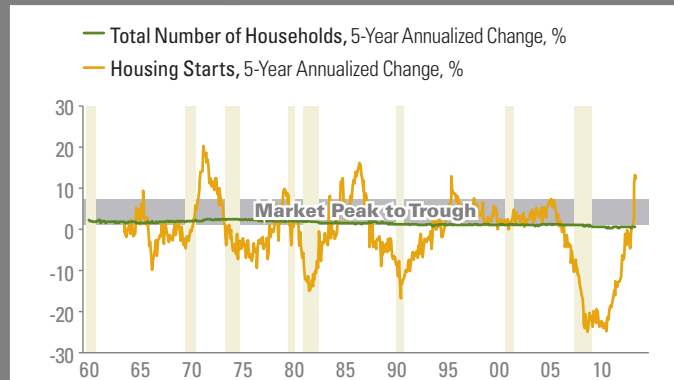
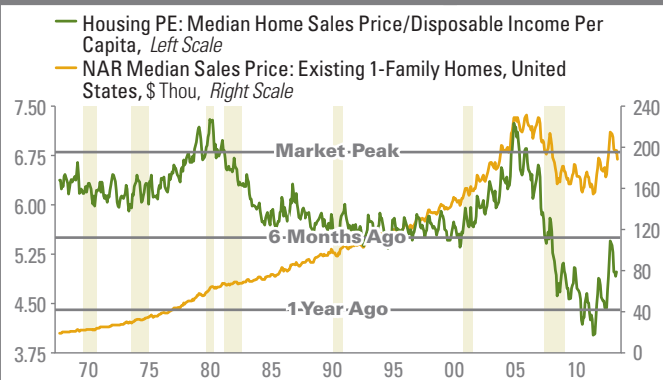
Housing Contribution to Real GDP Growth

1999: **0.29%** | 2000: 0.03%
 2001: 0.04% | 2002: **0.29%** | 2003: **0.47%**
 2004: **0.56%** | 2005: **0.41%** | 2006: **-0.50%** | 2007: **-1.13%**
 2008: **-1.12%** | 2009: **-0.73%** | 2010: **-0.07%** | 2011: 0.01% | 2012: **0.32%** | 2013: **0.33%**
2014E: 0.2 – 0.3%

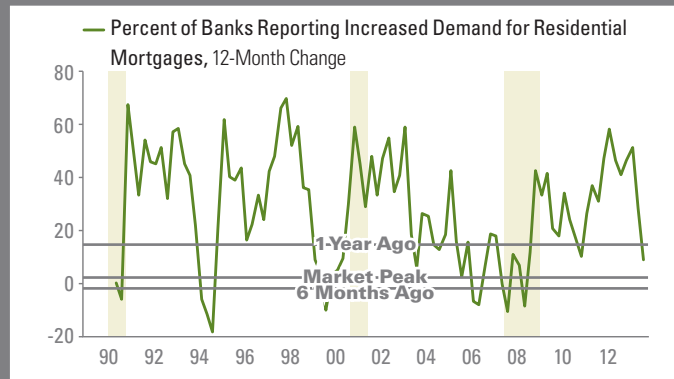
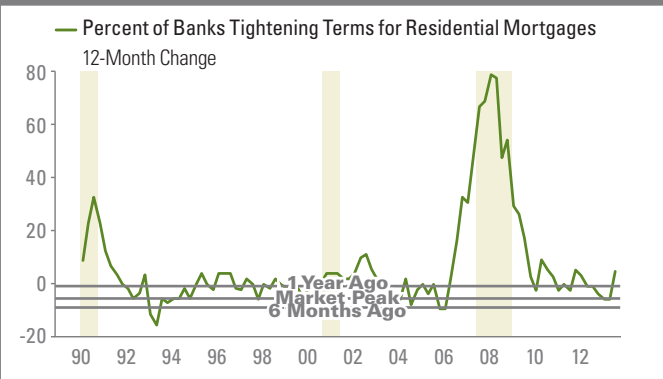
Relative to Market Peak: **Better**



Relative to Mid-Year 2013 (6 Months Ago): **Neutral**



Relative to Pre-Taper Fears (1 Year Ago): **Worse**



Source: LPL Financial Research, Bureau of Economic Analysis, Federal Home Loan Mortgage Corporation, National Association of Realtors, Census Bureau, Federal Reserve Board, Haver Analytics 02/21/14



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Although we continue to hear and read comments from housing market “bears” that the housing market is already back in a “bubble,” housing (represented by residential investment) currently accounts for just 3% of GDP. This is half of what it was at the peak of the housing market in 2005–06, when housing accounted for more than 6% of GDP. Since 1980, housing, on average, has accounted for 5% of GDP. At just 3% today, housing’s share of GDP is not only half of the recent peak, but also well below the long-term average of 5%. But what about the other housing indicators?

Key Housing Indicators

Many, if not all, of the other housing indicators we watch (see below) also suggest ongoing recovery in the housing market in the quarters and years to come.

To be sure, while the sharp increase in mortgage rates since mid-May 2013 may have slowed the pace of gains in the U.S. housing market, our view remains that the housing market is still in the early stages of recovering from the 2006–09 bust that followed the decade-and-a-half (early 1990s through mid-2000s) housing boom that began to show severe cracks in 2007 and collapsed in 2008. The collapse in housing, in turn, was a major contributor to the financial crisis and the Great Recession of 2007–09. The housing market, along with many financial markets and global economies, is still feeling the after-effects of the housing collapse.

The health of the housing market can be measured in many direct ways (e.g., housing starts, housing sales, construction spending, home prices) and indirect ways (e.g., homebuilder sentiment, mortgage applications, foreclosures, inventories of unsold homes, mortgage rates, housing vacancies, lumber prices, prices of publicly traded homebuilders). The U.S. government and private sources collect and disseminate these data. A quick recap of some of these indicators is below.

Taking the Pulse of the Residential Recovery

- **Near-record housing affordability.** Housing affordability, the ability of a household with the median income to afford the payments on a median priced house at prevailing mortgage rates, hit an all-time high in early 2013 before the big run-up in mortgage rates that began in mid-May 2013. The latest data point (December 2013) saw a 21% drop in affordability from the peak in January 2013. Despite the drop, affordability remains well above the long-term average, and it is some 70% higher than at the peak



of the housing market in late 2005/early 2006. Rising incomes and the aftermath of the 20–30% drop in home prices nationwide between 2005 and 2009 will continue to support an elevated level of affordability. At this point in the housing recovery, pent-up demand will likely outweigh affordability as the main driver of housing demand.

- **The housing PE.** Although not a perfect measure of the frothiness (or lack thereof) in the housing market, the ratio of the median sales price of an existing home (\$197,700 in December 2013) to disposable personal income per capita (\$39,726 as of December 2013) is one way to gauge the health of the market. Our infographic shows that while the housing PE “has moved higher in recent months, it remains well below average. Indeed, aside from the housing bust era (2007–11), the housing PE is the lowest it has been in more than four decades. This also suggests that the housing recovery remains in its early stages and is not in a bubble.
- **Inventories of unsold homes are tight.** Although the inventory of unsold new and existing homes has moved up from a 32-year low since the start of 2013, inventories of unsold homes remain well below average. The official count of the inventory of unsold single-family existing homes (from the National Association of Realtors), along with the record-low inventory of new homes for sale, tells us 1.8 million homes are for sale. Depending on the data source cited (there is no “official” number for shadow inventory), the shadow inventory is in the 1.0–1.5 million range. The low inventory of unsold homes, particularly in areas where housing demand is the highest, supports ongoing improvement in housing construction and housing sales.
- **Supply of home mortgages.** From the mid-1990s through late 2006, bank lending standards (down payment required, credit scores, work history, etc.) for residential mortgages were relatively easy. Coupled with low rates and rapid innovation in financial products backing residential mortgages, this easy credit helped to fuel the housing boom. The banking industry began tightening lending standards in early 2007, and continued to tighten for more than two years. Lending standards eased in 2009 and 2010, but remained more restrictive than they were in the peak boom years from 2004 to 2006. The latest survey (February 2014) reveals that bank lending standards for home mortgages are now back to “normal,” as defined by the 10 years between 1995 and 2005. It’s too soon to tell whether or not the tightening of standards in the latest period (February 2014) is the start of a new trend, or just a wiggle in the data. Either way, relatively normal mortgage lending standards are supportive of more gains in housing in the coming quarters. The Federal Reserve (Fed) compiles these data in the quarterly Senior Loan Officer Survey.
- **Demand for home mortgages.** Consumer demand for mortgages remained muted during the first two-and-a-half years (early 2009 through late 2011) of the housing recovery, as consumers remained uncertain about prospects for home price appreciation and their own financial and labor market status. Between mid-2011 and mid-2013, an improving labor market, Fed actions to lower mortgage rates, and rising

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How the U.S. Government Defines Households

The U.S. government defines a household as any single person or group of persons residing in a single housing unit. Households are formed when children move out of their parents' homes to go to college, get a job, or get married, or when couples separate, or even when previously unrelated people (a group of roommates) find their own places to live.

home prices drove consumer demand for mortgages to levels not seen since the early 2000s. But the rise in mortgage rates since mid-2013 has had a meaningful impact on demand for mortgage loans in recent quarters, and a further pullback in consumer demand for mortgages would be a threat to the sustainability of the recovery. The housing recovery is dependent upon low interest rates, but not necessarily the lowest interest rates. History shows us that if job and income growth can rise along with mortgage rates, the growth in housing can continue. The Fed compiles these data in the quarterly Senior Loan Officer Survey.

- **Demand for housing.** Net household formation boomed in the mid-2000s (2004, 2005, and 2006) but began to slow just prior to the start of the Great Recession in 2007. Unemployed new graduates were living with their parents or renting in large groups rather than moving into homes of their own for years after the 2007–09 recession. But that is ending. Over the past five years, (2009–13) household formations have stabilized, partially due to the better labor market, but also thanks to the echo boomers reaching their mid-to-late 20s. Although new household formation has slowed from its pre-Great Recession pace, it is still running at almost 1.0% per year. By early 2011, the gap between new household formation and new housing starts had never been wider. Soon thereafter, housing starts began to recover, and the healing in the housing market began to accelerate. However, there are still more than 18 million vacant homes—down from the peak of more than 19 million, but still well above the pre-Great Recession level of 14–15 million. This indicator continues to suggest that the housing recovery is still in its early stages. The U.S. Census Bureau collects the data on household formation and housing vacancies.

On balance, the sharp rise in mortgage rates that commenced in mid-May 2013 will likely slow the pace of housing activity that had accelerated noticeably between mid-2011 and mid-2013. Despite the rise in rates, most of the indicators we watch suggest that the housing recovery remains firmly entrenched. The pace (and sustainability) of the housing recovery will help to determine the pace of the overall economic recovery. We expect housing—as measured by the residential investment component of GDP—to make a positive contribution to overall GDP growth in 2014, as it did in both 2012 and 2013. However, it will likely take several more years before the national housing market is back to normal. ■



IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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