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HOUSING HEALTH

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KEY TAKEAWAYS

We continue to expect housing may add to GDP growth in 2015 and for the next several years, as the market normalizes following the severe housing bust of 2005–2010.

Poor weather in Q1 2015 may again cause housing to be a drag on growth early in 2015.

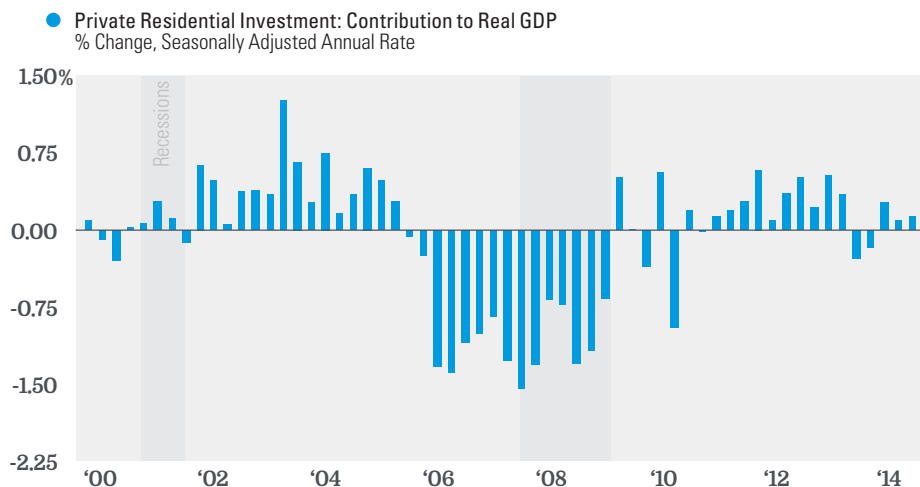
Housing affordability, housing supply, home mortgages supply, and home prices may largely determine the pace at which housing adds to GDP growth in the years ahead.

The week ahead will shed light on the state of the housing market as 2015 began and 2014 ended. Several key housing-related economic data releases are due this week (February 23–27, 2015) and include:

- Existing Home Sales (January 2015)
- S&P/Case-Shiller Home Price Indexes (December 2014)
- New Home Sales (January 2015)
- Pending Home Sales (January 2015)

In addition, the revised figure for gross domestic product (GDP) for Q4 2014 will be released this Friday, February 27. This report will provide an update on the impact housing had on the economy in Q4 2014 and in all of 2014. The initial report on Q4 2014 GDP (released in late January 2015) found that housing—as measured by residential fixed investment—added just 0.05 percentage points to GDP growth in 2014. The annual figure for 2014 is a bit misleading, however, as the quarterly data reveal that the harsh winter weather in the eastern half of the country in Q1 2014 led to a decline in residential investment. Housing bounced back in the final three quarters of 2014, adding 0.27, 0.10, and 0.13 percentage points to overall GDP in the second, third, and fourth quarters of 2014, respectively [Figure 1], and we expect housing to add to growth again in 2015, although poor weather in Q1 2015 may again cause housing to be a drag on growth early in 2015.

1 ALTHOUGH WEATHER MAY IMPACT HOUSING IN Q1 2015, WE EXPECT HOUSING TO CONTINUE TO ADD TO GDP IN THE COMING YEARS



Source: LPL Research, Bureau of Economic Analysis, Haver Analytics 02/22/15

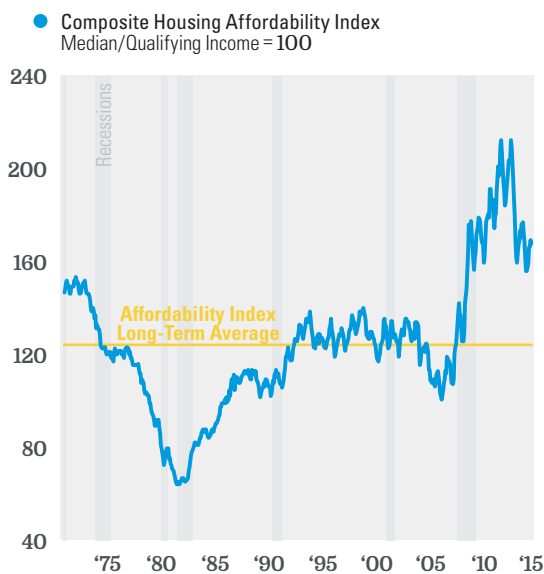
With the solid performance in the final three quarters of 2014, housing has now added to GDP growth in 14 of the 17 quarters since late 2010. Prior to that, between late 2005 and late 2010, housing had been a drag on the overall economy in 17 of the 20 quarters (or five years), as the economy endured the housing-induced Great Recession and its aftermath. We continue to expect (per our long-held view) housing may add to GDP growth in 2015 and for the next several years, as the market normalizes following the severe housing bust of 2005–2010.

KEY DRIVERS OF HOUSING IN 2015 AND BEYOND

Several factors will likely determine the pace at which housing adds to GDP growth in the coming years. Among them are:

- **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

2 DESPITE THE DROP IN MORTGAGE RATES IN THE PAST YEAR, HOUSING AFFORDABILITY HAS WORSENE SINCE THE 2013 TAPER TANTRUM



Source: LPL Research, National Association of Realtors, Haver Analytics 02/22/15

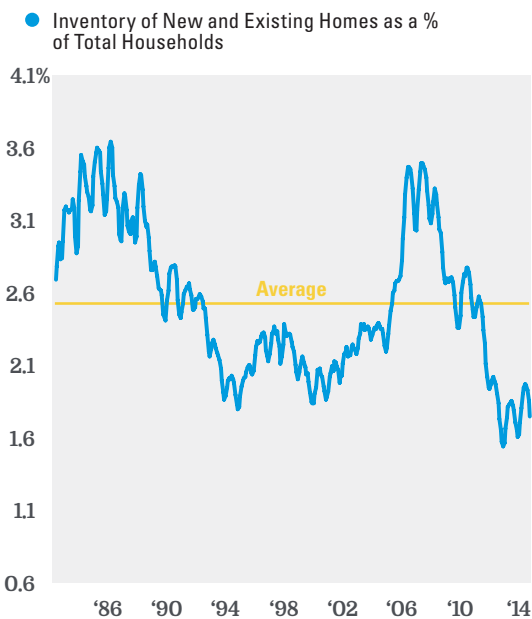
in early 2013, before the big run-up in mortgage rates that began in mid-May 2013 as a result of what is now known as the “taper tantrum.” Since then—despite another sharp drop in mortgage rates in 2014 and early 2015—a combination of rising home prices and sluggish income growth have driven affordability some 20% lower. (Although mortgage rates have moved lower since the end of the taper tantrum ended, they remain 25–50 basis points [0.25–0.50%] higher than the 2013 lows that preceded the taper tantrum.)

Despite the drop, affordability is well above its long-term average [Figure 2] and also well above the levels during the mid-2000s housing boom. The three components of affordability—incomes, home prices, and rates—could all continue to move higher, potentially driving affordability lower, back toward its long-term average, but not much below.

- **Housing supply.** At just over 200,000 units, the number of new single-family homes for sale at the end of December 2014 was well below the peak of nearly 600,000 units for sale in 2006, but above recent lows (140,000 to 150,000 units). The number of existing single-family homes for sale (1.63 million in December 2014) is less than half its peak (3.4 million set in mid-2007), but within 50,000 of its all-time low, hit in early 2013. Combined, the level of new and existing homes for sale remains well below average [Figure 3], relative to the number of households in the economy—and the low level of inventory is likely to be a big factor in driving housing construction in the coming years. We’ll get an update on both new and existing home inventories this week.

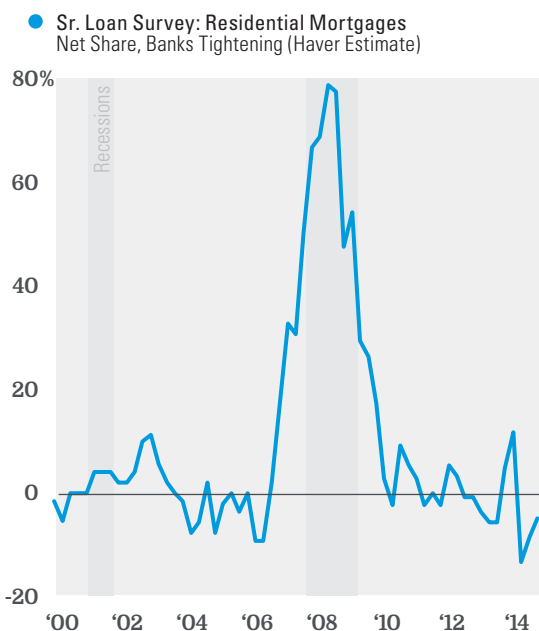
Combined, the level of new and existing homes for sale remains well below average, relative to the number of households in the economy — and the low level of inventory is likely to be a big factor in driving housing construction in the coming years.

3 INVENTORY OF UNSOLD NEW AND EXISTING HOMES REMAINS NEAR ALL-TIME LOWS



Source: LPL Research, U.S. Department of Commerce, National Association of Realtors 02/20/15

4 ALTHOUGH THEY TIGHTENED IN THE PAST QUARTER, BANKS' LENDING STANDARDS FOR MORTGAGES ARE EASIEST SINCE MID-2000s

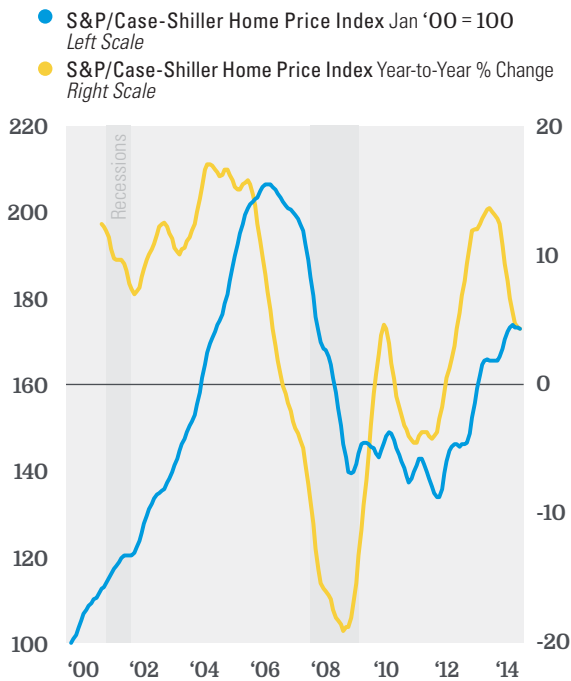


Source: LPL Research, Federal Reserve Board, Haver Analytics 02/22/15

- Home mortgages supply.** From the mid-1990s through late 2006, bank lending standards (required down payments, 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 standards 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 2004–2006. The latest survey (Q1 2015) revealed that although bank lending standards for home mortgages tightened a bit between Q4 2014 and Q1 2015, they are the easiest since mid-2006 [Figure 4]. The improvement in this indicator in recent quarters is a good sign and may help to offset the recent rise in the rates banks are charging for mortgages. The market will get an update on this metric, via the Federal Reserve's Senior Loan Officer Survey, in April or May 2015.

- Home prices.** The market will also get an update on home prices this week, in both the new and existing home sales report and the S&P/Case-Shiller Home Price Indexes for December 2014, Q4 2014, and all of 2014. There are various measures of, and sources for, home prices—which, as noted above, are a component of housing affordability. In general, home prices rose rapidly (much faster than inflation or income growth) in the early 2000s, peaked in 2004–2006, fell between 25 and 30% through 2009–2010, and have been in recovery mode since then. The Case-Shiller Index [Figure 5] is a good proxy for home prices nationwide. It shows the big run up in prices in 2000–2006, the big drop in prices from 2006–2009, the sideways move in house prices in 2009–2012, and more solid gains in 2013–2014. On a year-over-year basis the Case-Shiller Home Price Index has been moderating in the past 18 months or so, after peaking at an unsustainable 14% year-over-year increase in

5 HOME PRICE APPRECIATION TRENDING BACK TO LONG-TERM AVERAGE NEAR 4% PER YEAR



Source: LPL Research, Standard & Poor's, Haver Analytics 02/22/15

late 2013, to a more sustainable 4–5% pace in recent months. We would view a return to that pace—which is consistent with the average housing price gain in the past 35 years—as a sign that the housing market is stable, and poised to be a consistent contributor to GDP growth in the years ahead.

CONCLUSION

We continue to expect that housing may add to economic growth in the years ahead. Although interest rates could move higher in the coming years, we expect the trends that have helped the housing market out of the housing bust to remain in place. Still, like other segments of the economy that have struggled to recover from the Great Recession, the housing recovery remains choppy and uneven. ■

IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted.

The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. This index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arm's-length transactions. The index is named for its creators, Karl Case and Robert Shiller.

The Composite Housing Affordability Index is published monthly by the National Association of Realtors and measures median household income relative to the income needed to purchase a median-priced house.

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