US HOUSING MARKET: SLOW BUT SUSTAINED CYCLICAL RECOVERY

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The mid-cycle slowdown in the US housing market during 2018 has ended and an interim period of growth lies ahead. Growth rates in key housing indicators have stabilized and are poised to turn decisively positive in 2020. Developments in the single-family market should surprise on the upside as the next 12 months unfold. Unlike 2018 and 2019, residential construction should be additive to US GDP in 2020. Housing-related stock groups should outperform the overall equity market over the next year.

Summary and Major Conclusions:

- The housing market has been on a roller coaster over the past several years, mainly attributable to large swings in interest rates. The rising trend in rates that began in late-2017 led to a downturn in the housing market in 2018. Housing activity bottomed in the fourth quarter of last year.
- The housing market is in a gradual but sustained recovery — consistent with a steep decline in mortgage rates over the past nine months — that is slowly gathering momentum as this year unfolds.
- Monthly data on home sales and new construction are notoriously volatile but the underlying trend indicates that the recent downturn bottomed in the fourth quarter of last year and is on a gradual recovery path.
- Monthly surveys of homebuilders point to a strengthening in single-family home construction. New orders for major homebuilding companies increased at an 18% annual rate in July — up from a 10% increase in May — and the strongest growth rate since February of 2017.
- The outlook for the housing market is positive and assumes a slow but sustained rise in housing sales and new construction over the next year, at a minimum. Compared with an average of 1.25 million this year, total housing starts should increase by 8% to 1.35 million in 2020.
- Existing home sales suffered a peak-to-trough decline of 12% during 2018 but have stabilized in recent months. I expect sales to increase by 5% in 2020. New home sales fell by 10% (smoothed) during 2018, but are expected to rebound by 10% in 2020.
- Underlying fundamental trends within the single-family market are far superior to those of the multi-family market. Evidence suggests that the rental market is overextended, while homeownership should be bolstered by strong pent-up demand for single-family homes.
- There are numerous reasons to be optimistic regarding future prospects for the housing market. The most important drivers of growth pertain to interest rates, labor market trends, household formation, confidence, affordability, and the level of inventories.
- The primary driver of housing demand in the medium term is the level of mortgage rates. From a peak of nearly 5%, the current rate on a 30-year fixed-rate mortgage has declined to only 3.5%.

- Housing demand is also critically dependent upon labor market conditions, which have remained strong. However, employment could be at increased risk because of plunging business confidence caused by widespread uncertainty related to trade policy.

- Supply factors are also favorable: The inventory of existing homes for sale has declined to only a 4.2 month supply, well below the normal level of six months. The vacancy rate for single-family rentals is currently 1.3% — near an all-time low — all of which creates a positive backdrop for new single-family construction.

- Although down from its multi-decade high of 2012, affordability remains above its long-term average and should be supportive of housing demand. A combination of slower house price appreciation, depressed mortgage rates, and improving growth in household income should act as a stimulus for future demand.

- House price inflation has slowed dramatically and should stabilize around 2%, down from a recent peak rate in excess of 6%. Nationwide house prices could rise at a 2.5% annual rate through the end of 2020, albeit with considerable variation among regions.

- The main risks to the housing market are as follows: A sharp decline in credit availability; an erosion in affordability; a slowdown in hiring; a decline in consumer confidence; and deterioration of the financial condition of the prime entry-level segment of the population.

- Unlike 2018 and 2019, residential construction should be additive to US GDP in 2020. The long-term outlook is also favorable. While housing market trends in the medium term will always be driven by changes in mortgage rates, the favorable underlying imbalance between supply and demand may not be resolved for years.

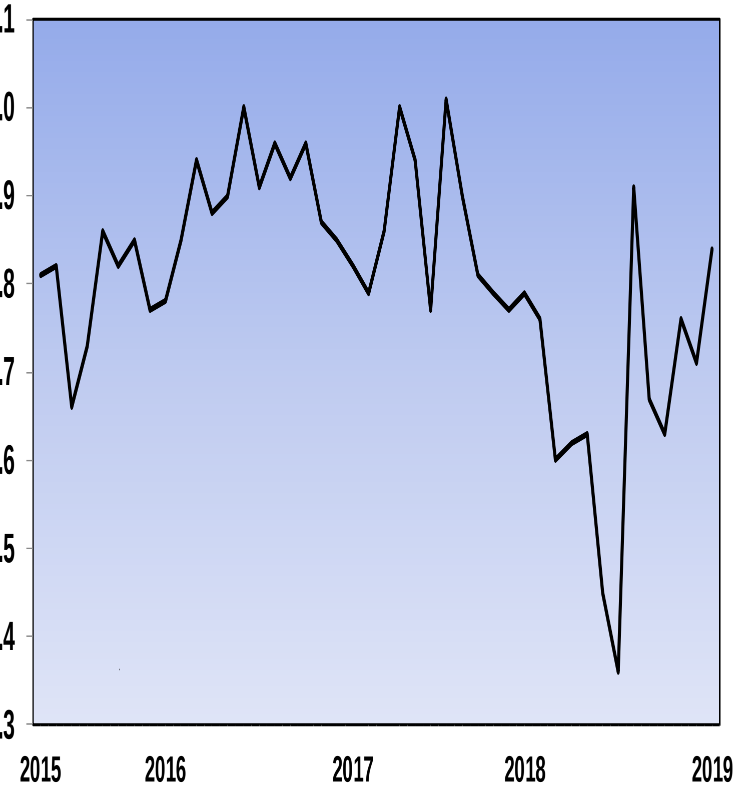
There is considerable debate regarding the outlook for the US housing market. In fact, analysts are unable to agree on the *current direction* of the market — whether housing activity is currently in an expansion or contraction mode! This week's *Economic Perspective* provides an update and analysis of underlying housing market trends and explores the outlook for 2020.

COULD YOU REVIEW HOUSING TRENDS OF THE PAST SEVERAL YEARS?

The housing market has been on a roller coaster over the past several years, mainly driven by large swings in interest rates. The steep decline in ***mortgage rates*** during 2016 led to a period of solid growth in sales and new construction during 2017. The rising trend in rates beginning in late-2017 led to a downturn in the housing market in 2018. Housing activity bottomed in the fourth quarter of last year, consistent with a declining trend in mortgage rates that began in November (see chart 1).

Chart 1: Plunge in Mortgage Rates Boosting Housing Demand
Home Mortgage Contract Rate (%)
Thirty-Year Fixed-Rate Mortgage
Source: Freddie Mac

Chart 2: Rebound in Single-Family Homes Appears Sustainable
Annualized Sales of Existing Single-Family Homes, Millions
Source: National Association of Realtors



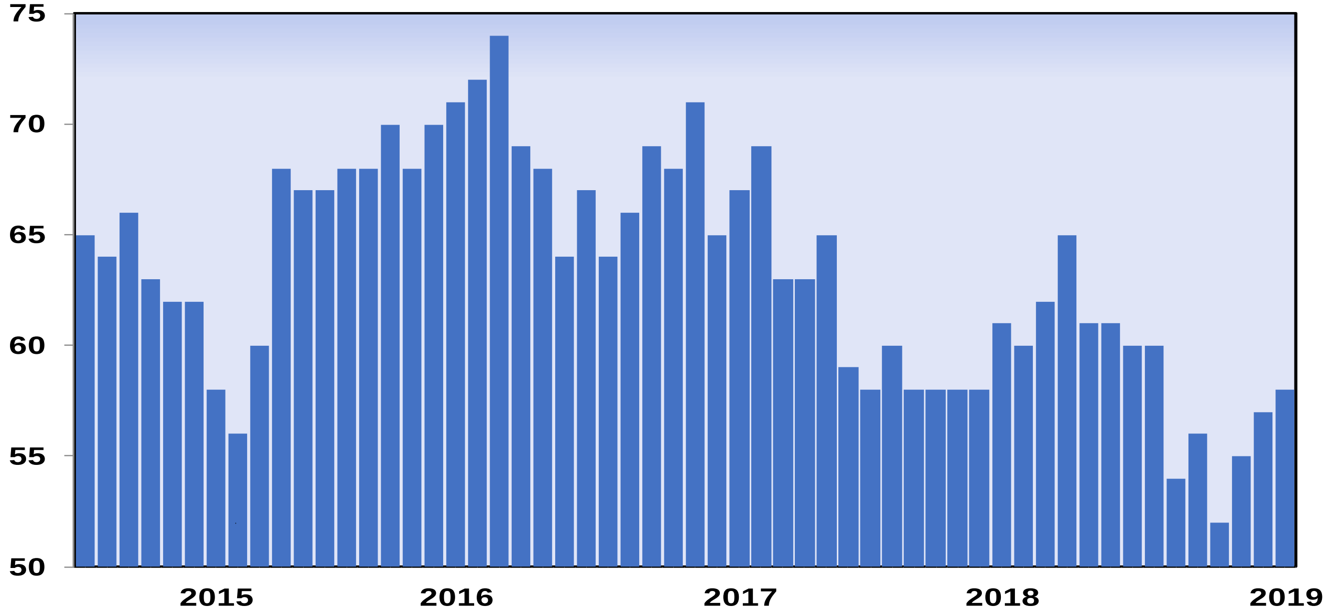
COULD YOU SUMMARIZE CURRENT CONDITIONS IN THE US HOUSING MARKET?

The housing market is in a gradual but sustained recovery and has been slowly gathering momentum as the year unfolds. Consistent with a steep decline in mortgage rates over the past nine months, the housing market is currently on a moderate recovery path. Both sales and construction are in a sustained uptrend, as home buyers take advantage of attractive financing terms in an environment of full employment. Following many years of decline, the ***homeownership rate*** has bottomed and appears to have embarked on a sustained upward trend.

HOW ARE THESE TRENDS REFLECTED IN CURRENT INDUSTRY DATA?

Monthly data on housing activity is notoriously volatile, but the ***underlying trend*** indicates that the recent downturn bottomed in the fourth quarter of last year and is on a gradual recovery path. *Existing home sales* have rebounded by 11% since their cyclical low in January, while *new home sales* have increased by 15%, using a smoothed three-month average. An index of *pending home sales* has increased by 10% from its cyclical low at yearend and confirms the uptrend in transactions (see chart 2).

Chart 3: US Homebuilder Confidence in a Gradual Rising Trend
Monthly Homebuilder Survey of Business Trends
Source: The National Association of Home Builders



New construction is also expanding at a moderate pace. *Housing starts* have risen by nearly 8% from the lows in the first quarter of this year, using a smoothed three-month average. *Building permits* for single-family home construction have risen by 6% from their recent low; including apartment construction, building permits have stabilized near the lows of the past 12 months.

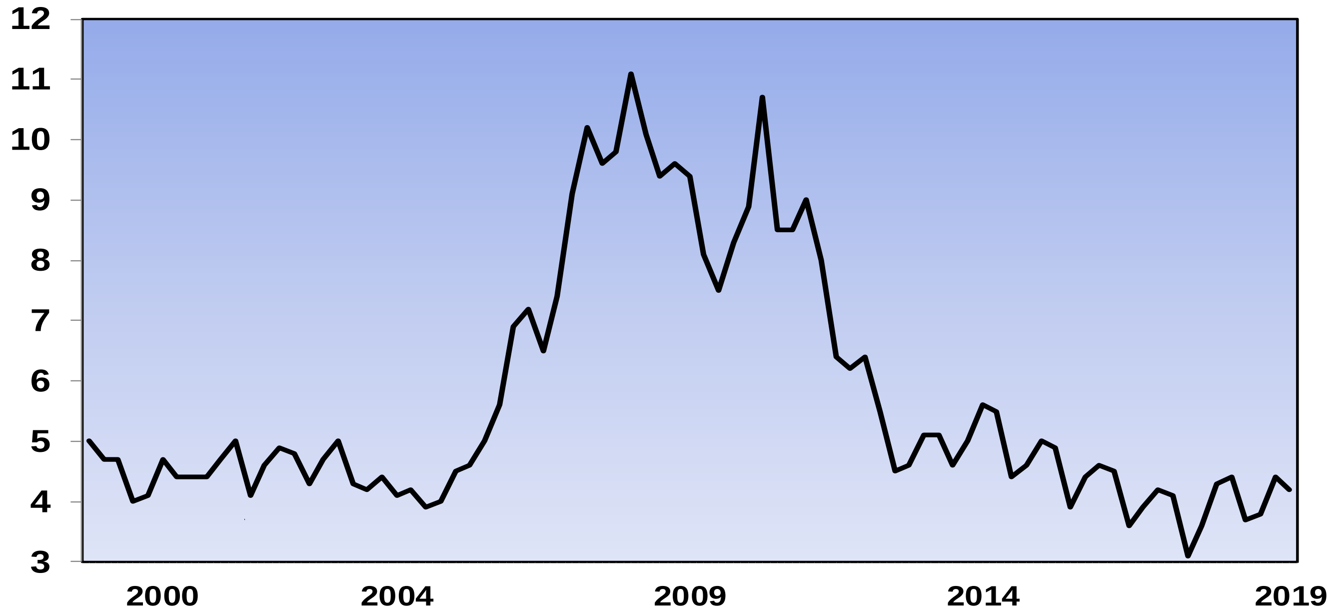
Finally, the most reliable intel on housing is derived directly from homebuilders — as opposed to monthly government data — and these surveys overwhelmingly confirm that housing market conditions are improving.

WHAT IS THE MESSAGE FROM BUILDING COMPANY SURVEYS?

New orders are increasing at a solid pace. According to real estate consultant Zelman Associates, *new orders at major homebuilding companies increased at an 18% annual rate in July, up from a 10% increase in June* and the strongest growth rate since February of 2017. Orders have surprised on the upside in six of the past seven months. In a separate survey, builder confidence has risen by 15% from its low in December of last year (see chart 3).

At the same time, cost pressures are abating. *An index of builder cost inflation rose by only 2.5% in July, the lowest rate of increase since 2012*. Copper prices have declined by nearly 25% over the past year, while the price of lumber has fallen by 40%. As a result, most builders are reporting that profit margins are likely to expand over the next several quarters, increasing the incentive for more aggressive building plans.

Chart 4: Low Inventories Have Constrained Home Sales
Existing Homes For Sale
Monthly Supply of Homes For Sale at Current Selling Rate
Source: National Association of Realtors



WHAT EXPLAINS THE SHARP DIVISION AMONG ANALYSTS REGARDING THE OUTLOOK?

The significant disagreement among analysts is a result of the contrast between top-down and bottom-up analysis. From a broad macro top-down perspective, an expected contraction in the housing market is fully consistent with widespread market expectations for a US recession. Conversely, *a bottom-up analysis of specific industry conditions and the flow of housing market data clearly point to a sustained recovery in housing over the next 12 to 18 months*.

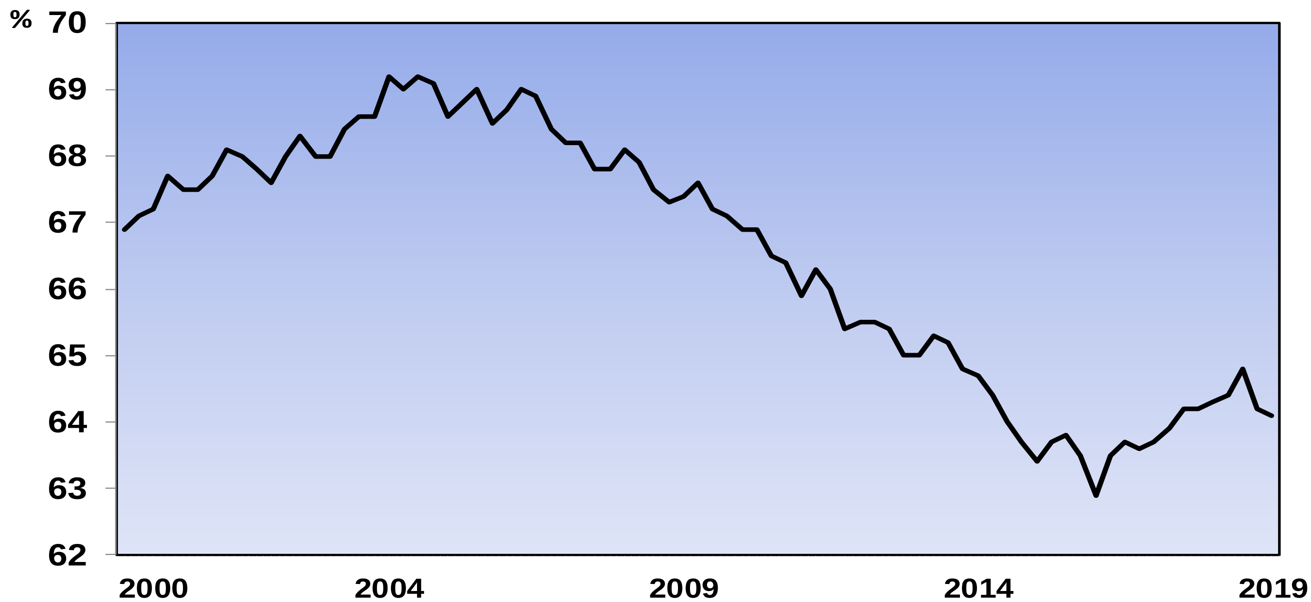
WHY HAS THE REBOUND IN HOUSING BEEN MUTED CONSIDERING THE STEEP DECLINE IN MORTGAGE RATES?

There are several explanations for the sluggish recovery. Most important is the very tight inventory situation: Inventories of existing homes for sale have declined to only 1.8 million — the equivalent of only a 4.2-month supply — the lowest level in many years. The supply of low-end homes — those geared to first-time and first-move-up buyers — is especially tight. Shortages of construction workers and land have also impeded the pace of recovery (see chart 4).

WHAT IS YOUR OUTLOOK FOR THE NEXT ONE TO TWO YEARS?

The outlook for the housing market is positive and assumes a slow but sustained rise in housing sales and new construction. Compared with an average of 1.25 million this year, total housing starts should increase by 8% to 1.35 million in 2020.

Chart 5: Homeownership Rate in a Gradual Uptrend
Percentage of Households Living in Owner-Occupied Homes
Source: US Census Bureau



Existing home sales suffered a peak-to-trough decline of 12% during 2018 but have stabilized in recent months. I expect sales to increase by 5% in 2020. New home sales fell by 10% (smoothed) during 2018 but are expected to rebound by 10% in 2020.

In terms of the overall economy, residential construction has subtracted from GDP in each of the last six quarters and eight of the past nine quarters. *I expect housing to be a slight positive for GDP in the next two quarters and a significant contributor to GDP growth in 2020*.

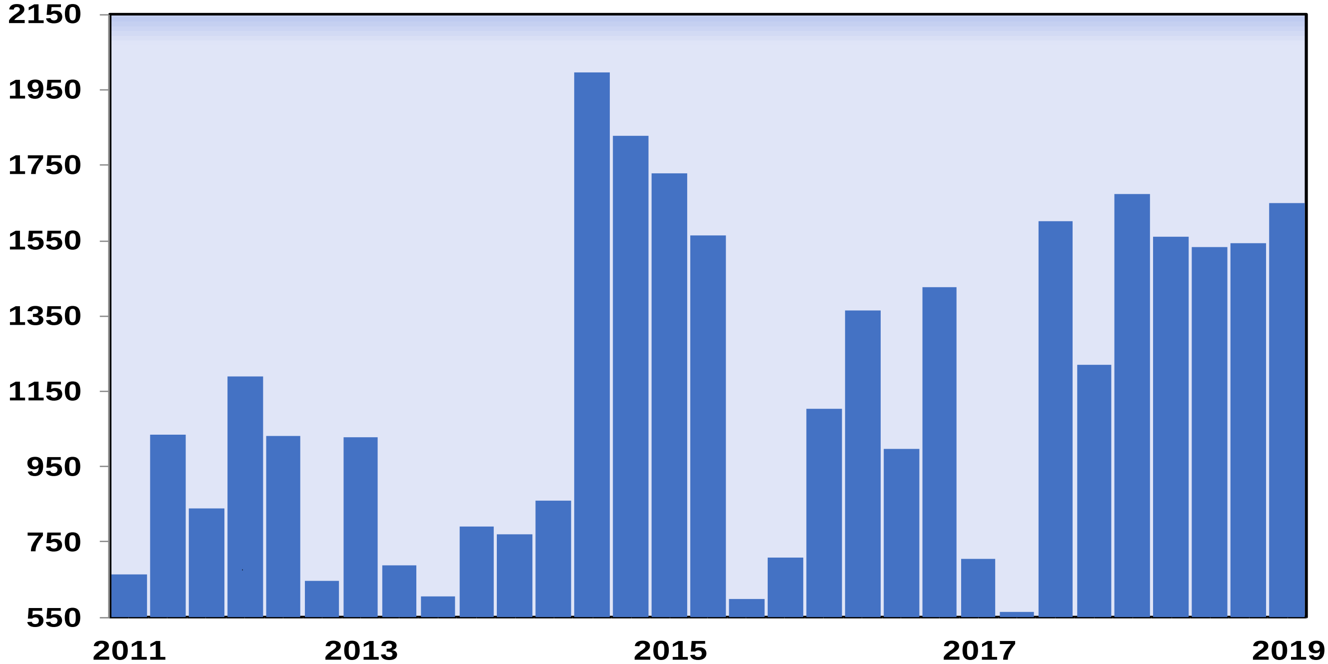
ARE PROSPECTS FOR SINGLE-FAMILY AND APARTMENT CONSTRUCTION SIMILAR?

No, *underlying fundamental trends for the single-family market are far superior to those of the multi-family market*. All evidence suggests that the rental market is overextended, in sharp contrast to the strong pent-up demand for single-family homes. The current trend in homeownership is upward and should continue in coming years (see chart 5).

WHY ARE YOU OPTIMISTIC THAT RECENT TRENDS IN THE SINGLE-FAMILY MARKET CAN BE SUSTAINED?

There are numerous reasons to be optimistic regarding the outlook for the housing market. The most important drivers of growth pertain to interest rates, labor market trends, household formation, confidence, affordability, and inventories:

Chart 6: US Household Formations Outpacing New Construction
New Households Formed Annually, Thousands of Units
Source: US Census Bureau



- **Mortgage Rates**: The primary driver of housing demand in the medium term is the level of mortgage rates. From a peak of nearly 5%, the current rate on a 30-year fixed-rate mortgage has declined to only 3.5%.

- **Household Formation**: Over the long term, the single most important variable is the underlying trend in new household formation. New households are forming at a rapid rate, for two reasons: **(1) Demographics**: The fastest growing segment of the US population are 25-to-35-year-old adults — generally considered to be the prime homebuying age group; and **(2) Pent-Up Demand**: Household formation slowed to a crawl during the Great Recession and during the early years of the economic recovery, and is currently in a rapid catch-up phase (see chart 6).

- **Employment**: Housing demand is critically dependent upon labor market conditions, which have remained strong. However, employment is a growing risk because of plunging business confidence emanating from trade policy uncertainty.

- **Consumer Confidence**: Although recent monthly surveys have been inconsistent, The Conference Board survey of consumer sentiment fluctuated near the highest level in nearly two decades.

Chart 7: Housing Affordability Still Above its Long-Term Average
Affordability Index Calculation Includes Mortgage Rates,
Median House Price, and Household Income
Source: National Association of Realtors

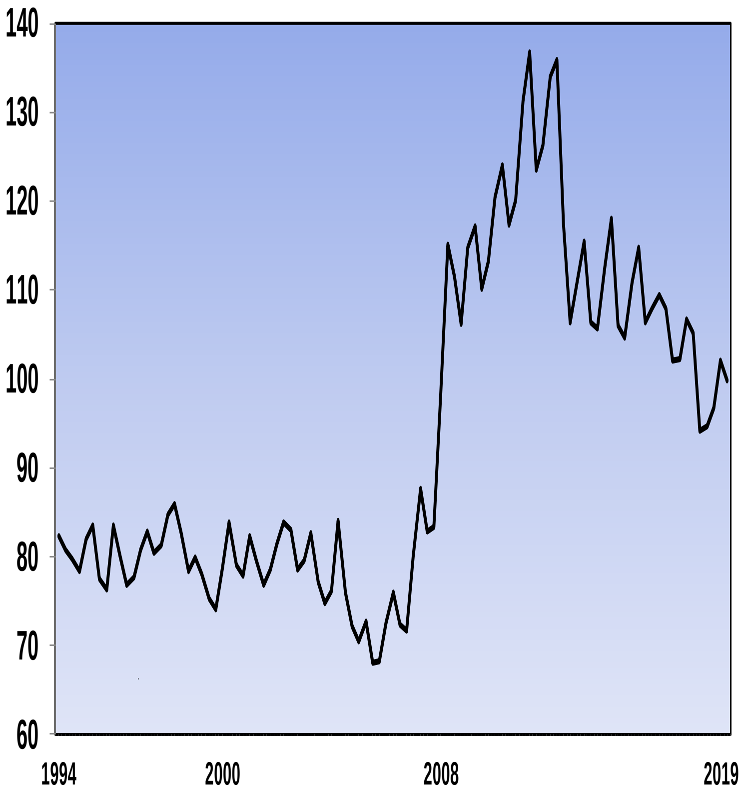
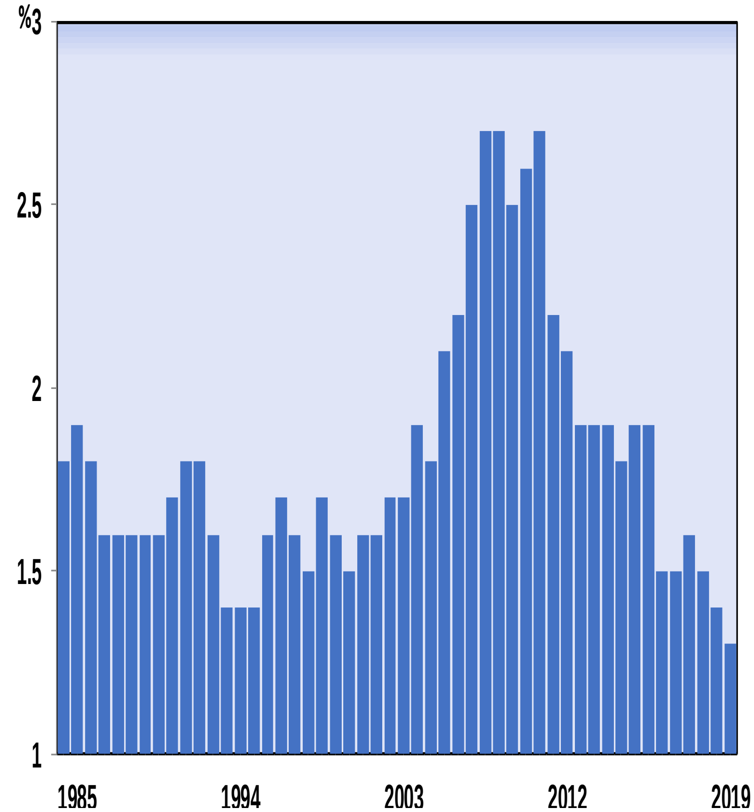


Chart 8: Homeowner Vacancy Rate at an All-Time Low
Single-Family Homes For Rent, Vacancy Rate (%)
Source: US Census Bureau



- **Housing Affordability**: Although down from multi-decade highs of 2012, the affordability index remains above its long-term average and should be supportive of housing demand. Moreover, a combination of slower house appreciation, depressed mortgage rates, and improving growth in household income should act as a stimulus for future demand (see chart 7).

- **Low Inventory**: The inventory of existing homes for sale has declined to only a 4.2-month supply, well below its normal level of six months. The vacancy rate for single-family rentals is currently at 1.3%, near an all-time low. *The exceptionally low level of unsold single-family homes assures a strong rebound in construction in coming years in order to satisfy the growing demand for single-family homes* (see chart 8).

- **Rental Versus Ownership Costs**: A comparison of average monthly rents and monthly mortgage payments shows a clear advantage for ownership. Using a nationwide index of apartment rents, the average monthly rent of $1450 compares unfavorably with an average monthly mortgage payment of $1200 [this monthly mortgage payment assumes the median home price, a 10% down payment, and a conventional 30-year fixed-rate mortgage].

COULD YOU UDATE THE TREND IN HOME PRICES?

Following many years of very strong appreciation, house price inflation slowed for the fifteenth consecutive month in June, with a year-over-year rise of only 2.1%. Annual increases in house prices peaked in the first quarter of 2018, with a gain of 6.75%. The average annual increase over the past five years was 5.25%.

My forecast assumes that house price inflation will stabilize around 2% over the next several months and trend slightly higher over the next year. As a rough estimate, nationwide house prices could rise at a 2.5% annual rate through the end of 2020, albeit with considerable variation among regions.

WHAT ARE THE MAJOR RISKS TO THE HOUSING MARKET?

The paramount risks to the housing market are a sharp decline in credit availability; a further erosion in affordability; a slowdown in hiring and rise in the unemployment rate; a decline in consumer confidence; and deterioration of the financial condition of young adults in the prime entry-level segment of the population.

COULD YOU SUMMARIZE KEY CONCLUSIONS IN THE OUTLOOK?

The mid-cycle slowdown in the US housing market during 2018 has ended, and an interim period of growth lies ahead. Growth rates in key housing indicators have stabilized and are poised to turn decisively positive in 2020. Developments in the single-family market should surprise on the upside as the next 12 months unfold.

Unlike 2018 and 2019, residential construction should be additive to US GDP in 2020. The long-term outlook is also favorable. While the housing market will always be driven by changes in mortgage rates, the favorable underlying imbalance between supply and demand [severe shortfall in the availability of single-family homes for sale and for rent, especially at the low end of the market] may not be resolved for years. Housing-related stock groups should outperform the overall equity market in 2020.

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