# THE US HOUSING RECOVERY GATHERS MOMENTUM

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*The current strength of the housing market is also a reliable gauge of the health of the broad economy. Overall macroeconomic conditions are generally suboptimal when housing is in a slump. Housing is arguably the most reliable leading indicator of recessions. Historically, housing starts have peaked roughly 18 months prior to the onset of recessions. Using data back to 1950, the economy has never entered a recession when the housing market has been on a sustained growth path, as is the case currently.*

## Summary and Major Conclusions:


- The housing market has been on a roller coaster over the past several years, mainly driven by large swings in interest rates. Housing activity bottomed approximately one year ago in response to a steep decline in mortgage rates at that time.

- The housing market is currently in a gradual but sustained recovery and has gathered momentum over the past six months. Both sales and new construction are in an uptrend, as home buyers take advantage of attractive financing terms in an environment of full employment.

- Despite month-to-month volatility, traditional measures of housing market activity continue to herald a sustained recovery in sales and new construction. Single-family housing starts have jumped by 30% since their cyclical low one year ago.

- Sales of previously owned homes have risen by more than 10% from their recent cyclical low. Sales of new homes have risen to a 12-year high and are nearly 30% above their recent low.

- The cyclical rebound in housing sales and new construction would be even stronger in the absence of persistent supply-side constraints. Inventories of existing homes for sale have declined to only 1.4 million units — the equivalent of only three months' supply — the lowest level in nearly four decades.

- There are numerous fundamental 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, consumer confidence, affordability, and 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 3.55%.

- Demographic factors are also favorable for the housing market. Young adults within the ages of 25 and 35 are the fastest-growing segment of the population and are widely considered the prime homebuying age group.

- New households are forming at a rapid rate. Household formations slowed to a crawl during the Great Recession and during the early years of the economic recovery, but are currently in a rapid catch-up phase.

- Housing demand is critically dependent upon labor market conditions, which have remained strong, in the form of record-low unemployment and strong job creation. Wages are also rising at an accelerating rate.

- A comparison of average monthly rents and monthly mortgage payments shows a clear advantage for ownership. The average monthly rent is 15% to 20% above the average monthly mortgage payment on a nationwide basis.

- Although housing affordability has declined since the peaks of previous years, it remains at an above-average level. Rising house prices have been offset by lower mortgage rates and rising household incomes.

- The outlook for the housing market is positive and assumes a slow but sustained rise in both sales and new construction. Compared with an average of 1.3 million last year, total housing starts should increase by 15% to 1.5 million in 2020.

- I expect house price inflation to stabilize early this year and trend slightly higher over the next year. My forecast assumes a 3.5% rise in existing house prices in 2020, albeit with considerable variation among regions.

- The paramount risks to the housing market are rising mortgage rates and a sharp decline in credit availability; a further erosion in affordability; a slowdown in hiring and rising unemployment; a decline in consumer confidence; and deteriorating finances for young adults in the prime entry-level segment of the population.

- Although it comprises less than 5% of GDP, residential construction has a disproportionally large impact on the US economy because of its large multiplier effect. An estimated 15% of GDP is comprised of both direct and indirect spending on housing.

- Housing is also extremely sensitive to broad macroeconomic trends, most importantly those for mortgage rates, employment, household finances, consumer confidence, and the strength of the banking sector.

- The current strength of the housing market is also a reliable gauge of the health of the broad economy. The housing market is arguably the most reliable leading indicator of recession. The economy has never entered a recession when the housing market has been in a sustained cyclical upswing, as is the case currently.

- Powerful structural tailwinds suggest that continued housing market strength could lengthen the current economic expansion, with the assumption that the expected cyclical rise in long-term interest rates is gradual and orderly.

Despite steady improvement in housing market data, some investors remain skeptical regarding the outlook for the residential construction market. This week's *Economic Perspective* provides an update and analysis of underlying housing market trends and explores the outlook for 2020. The report also underscores the importance of the housing market for the broad domestic economy.

Chart 1: A Rising Trend in Homeownership for Young Adults
Homeownership Rate, Ages 35 and Younger
Source: US Census Bureau


**Mortgage Rates**: The housing market has been on a roller coaster over the past several years, driven mainly 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. Subsequently, the rising trend in borrowing costs that began at the end of 2017 triggered an abrupt downturn in the housing market during all of 2018. Housing activity bottomed in the fourth quarter of 2018, consistent with a steep decline in mortgage rates during the preceding months.

**Improving Fundamentals**: The housing market is currently in a gradual but sustained recovery that has gathered momentum over the past six months. Both sales and new construction are in a solid uptrend, as home buyers take advantage of attractive financing terms in an environment of full employment and rising household incomes. Home sales continue to be constrained by an acute shortage of inventory, most notably for entry-level houses. Following many years of decline, the homeownership rate has bottomed and appears to have embarked on a sustained upward trend (see chart 1).

## HOUSING MARKET INDICATORS

Despite month-to-month volatility, traditional measures of housing market activity continue to herald a sustained recovery in sales and new construction.

- Sales of previously owned homes have risen by more than 10% from their recent cyclical low. Sales of new homes have risen to a 12-year high and are nearly 30% above their recent cyclical low.

Chart 2: New Housing Starts at Highest Level Since 2006
Single-Family Starts, Hundreds of Units
Source: US Census Bureau

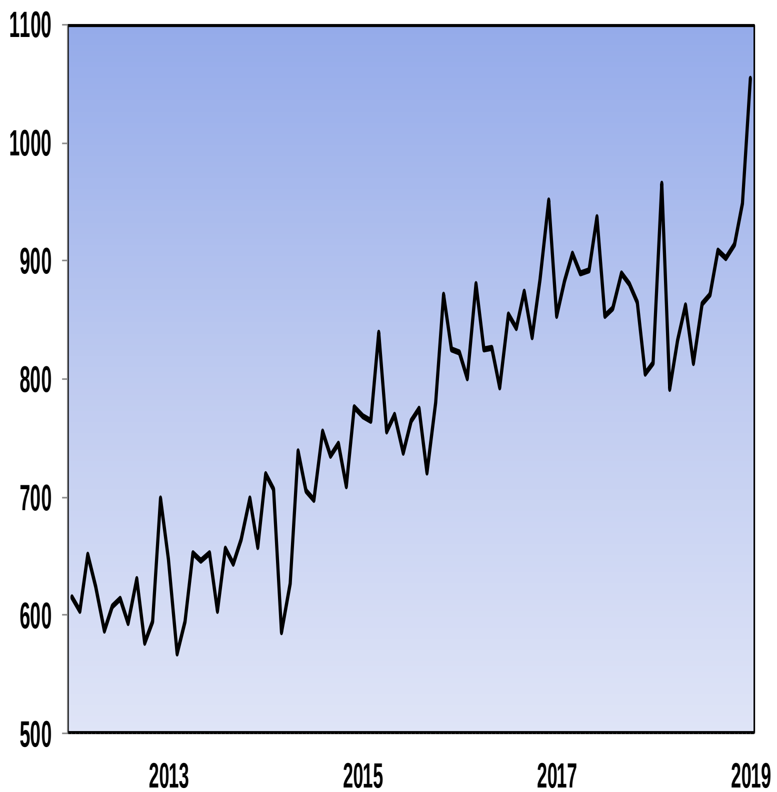



Chart 3: Homebuilder Confidence at a Multi-Decade High
Monthly Survey of Homebuilder Business Activity
Source: National Association of Home Builders


- Single-family housing starts and new building permits have jumped by 30% and 15%, respectively, since their cyclical lows one year ago (see chart 2).

- The monthly homebuilder survey conducted by the National Association of Home Builders has risen to a 20-year high. All three subcomponents of the index — current sales, sales expectations, and buyer traffic — have recorded significant gains in recent months (see chart 3).

**Supply-Side Constraints**: The cyclical rebound in housing sales and new construction would be even stronger in the absence of persistent supply-side constraints. Most important are very tight inventory conditions: Inventories of existing homes for sale have declined to only 1.4 million — the equivalent of only three months' supply — the lowest level since 1982 and well below the long-term average of six months (see chart 4).

- **Worker Shortages**: Shortages of construction workers and land have also impeded the pace of recovery. The number of construction workers per housing unit under construction is at a cyclical low of only 2.5, while the unemployment rate for experienced construction workers is 4.4%, close to an all-time low.

Chart 4: Existing Home Listings Near an All-Time Low
Inventory of Existing Homes for Sale
Millions of Units
Source: National Association of Realtors

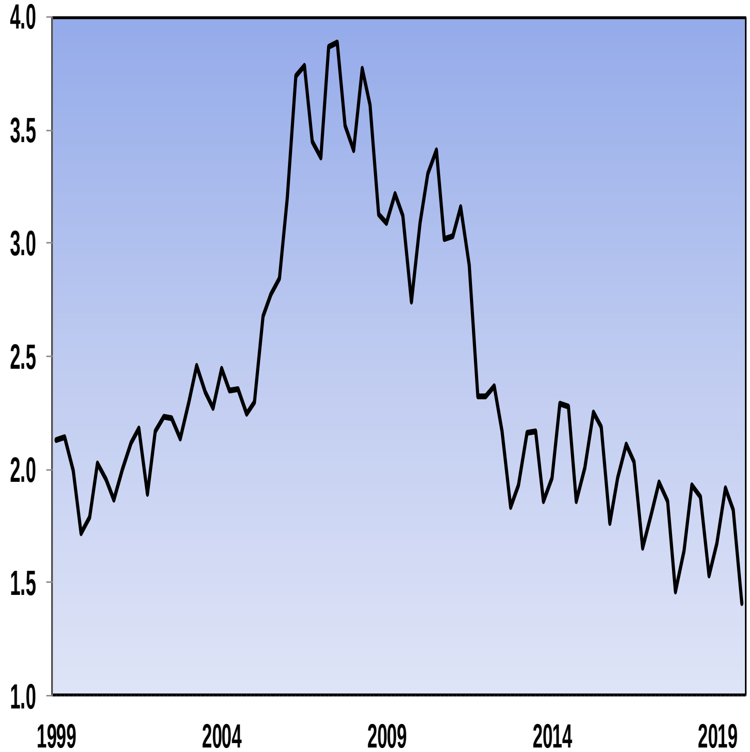



Chart 5: Home Mortgage Rates Plunge to Lowest Level in Several Years
Conventional 30-Year Fixed-Rate Mortgage Rate
Source: Freddie Mac


## HOUSING MARKET VARIABLES

There are numerous fundamental 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, consumer confidence, affordability, and inventories:

- **Mortgage Rates**: The primary driver of housing demand in the medium term is the level of mortgage rates. From a peak of nearly 5% more than one year ago, the current rate on a 30-year fixed-rate mortgage has declined to 3.55%, close to the lowest level in a decade (see chart 5).

- **Demographics**: Young adults within the ages of 25 and 35 are the fastest growing segment of the US population. This segment is generally considered to be the prime homebuying age group.

- **Household Formation**: New households are forming at a rapid rate. Household formations slowed to a crawl during the Great Recession and during the early years of the economic recovery, but are currently in a rapid catch-up phase.

Chart 6: Rising Wages Will Support Personal Consumption
Average Hourly Earnings, Annual % Growth
Non-Supervisory Production Workers
Source: Bureau of Labor Statistics

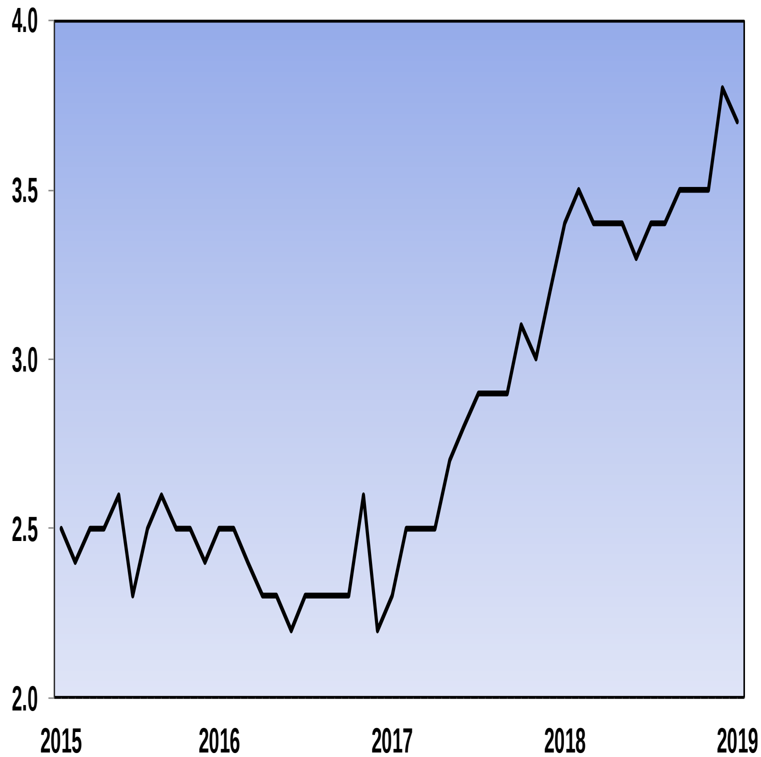
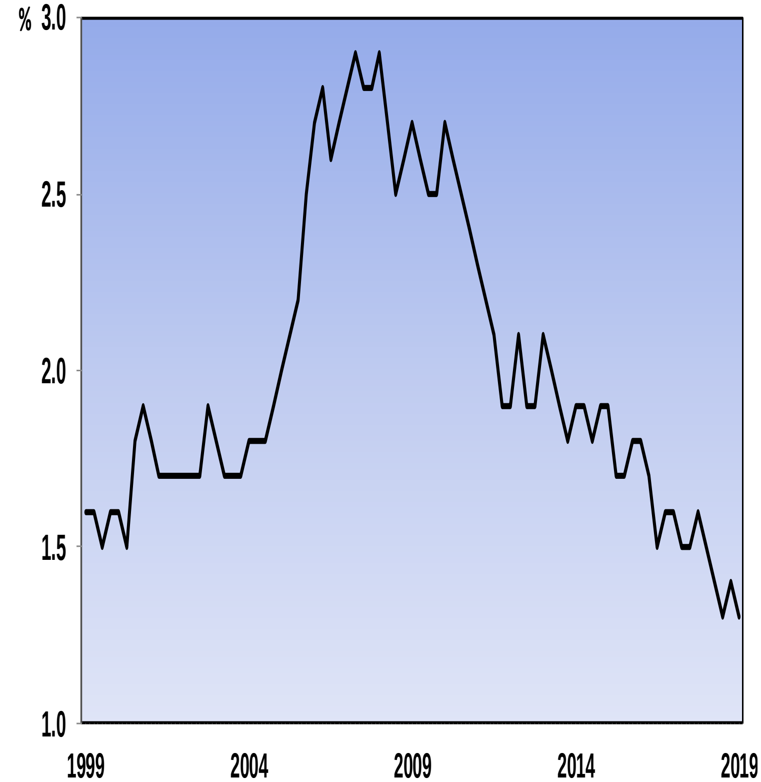



Chart 7: Homeowner Vacancy Rate Near an All-Time Low
Vacancy Rate, Owner-Occupied Rental Properties
Source: US Census Bureau



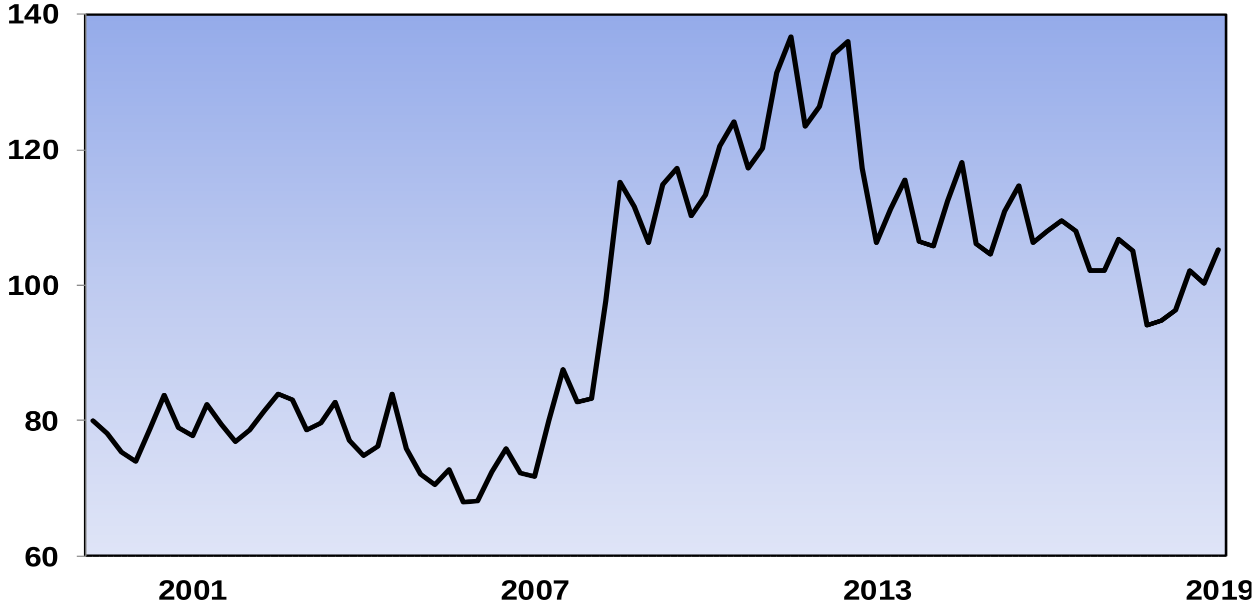

- **Employment**: Housing demand is critically dependent upon labor market conditions, which have remained strong. Job creation remains robust and wages are rising at an accelerating rate (see chart 6).

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

- **Low Inventory**: The inventory of existing homes for sale is extremely depressed. The vacancy rate for single-family rentals is currently 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 as builders strive to satisfy the growing demand for single-family homes* (see chart 7).

- **Housing Affordability**: Although housing affordability has declined since its 2012 peak, it remains at an above-average level. Rising house prices have been offset by a sharp decline in mortgage rates and steadily rising household incomes (see chart 8).

Chart 8: Affordability Ratio Still Positive for Housing Sales
Index of Housing Affordability
First-Time Buyers
Source: National Association of Realtors




- **Rental Versus Ownership Costs**: A comparison of average monthly rents and monthly mortgage payments shows an advantage for ownership. Based upon a nationwide index, the average monthly rent is 15% to 20% above the average monthly mortgage payment. _The contribution to GDP from single-family construction dwarfs that of multi-family construction_.

## HOUSING MARKET OUTLOOK

The outlook for the housing market is positive and assumes a gradual but sustained rise in housing sales and new construction. 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 7% in 2020 to a level of 5.75 million, an all-time high. New home sales rose by 10% during 2019 and are expected to increase by another 12% in 2020.

**Entry-Level Homes**: Supply and demand conditions within the single-family market are extremely bifurcated by tier and selling price. _Because of massive pent-up demand by first-time buyers, there exists a critical shortage of entry-level homes for sale_. Moreover, extreme builder preference for more expensive home construction over the past decade has resulted in a paucity of entry-level homes and a large unsold inventory of upper tier homes. Since 2010, the percentage of homes built with prices below $400,000 declined from 80% to less than 65%.

- **Starter-Home Comeback**: Builders are working at a furious pace to increase the supply of moderately priced homes. However, restoration of equilibrium conditions is unlikely for several years, given the current severe supply/demand imbalance. The median size of newly built homes has declined from 2,600 square feet in 2012 to less than 2,300 square feet.

**GDP Contribution**: Compared with an average of 1.3 million last year, total housing starts should increase by 15% to 1.5 million in 2020. Construction spending should increase by more than 5%, ***augmenting*** US real GDP by 0.25 percentage points. Home construction has ***subtracted*** from GDP in eight of the past ten quarters.

**House Prices**: Following many years of very strong appreciation, house price inflation slowed markedly over the past year. Annual increases in house prices peaked in the first quarter of 2018 at an annual rate of 6.75% and ended last year at a rate of 3%. The average annual increase over the past five years was 5.25%.

- **Moderate Price Inflation**: My forecast assumes that house price inflation will stabilize during the early months of this year and trend slightly higher over the next year. Nationwide house prices could rise at a 3.5% annual rate through the end of 2020, albeit with considerable variation among regions.

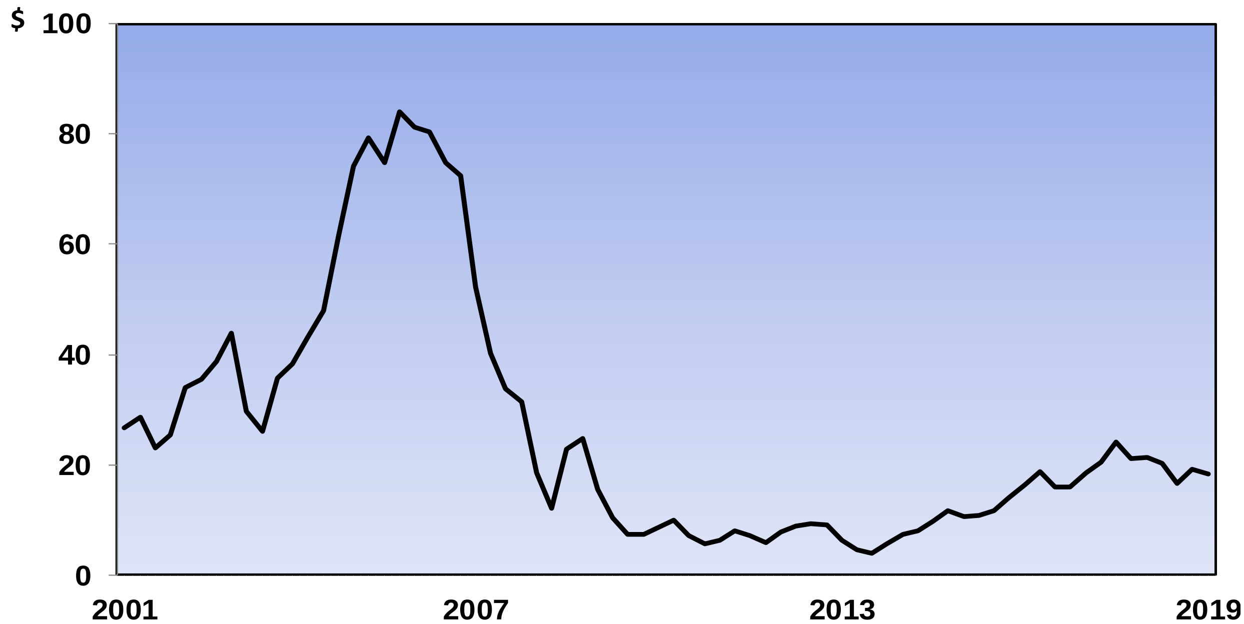
**Housing Market Risks**: The paramount risks to the housing market are a sharp decline in credit availability; a further erosion in affordability; a slowdown in new hiring and a rise in the unemployment rate; a decline in consumer confidence; and a deterioration of the financial condition of young adults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

- **Cash-Out Refinancing**: Using the rising equity in their homes, homeowners have increased the volume of cash-out refis to the highest level since 2005. History clearly reveals that this practice introduces financial risk into the economy. However, while the upward trend is worrisome, the *absolute volume* has increased at a benign pace in recent years (see chart 9).

## HOUSING AND THE ECONOMY

Residential construction has subtracted from GDP over the past two years, but was additive in the most recent quarter. I expect housing to be a progressively larger positive contributor to US GDP over the next four to six quarters, at a minimum.

Chart 9: Rising Trend of Cash-Out Refinances
Cash-Out Refinances From Home Equity
Billions of Dollars
Source: Freddie Mac




**Multiplier Effect**: Although it comprises less than 5% of GDP, residential construction has a disproportionally large impact on the US economy because of its large multiplier effect. Large purchases of housing-related goods — including furniture, appliances, and home furnishings — are triggered by housing completions. Spending on housing-related services include that for security systems along with legal, architectural, and landscaping services, just to name a few. An estimated 15% of GDP is comprised of *direct and indirect spending* on housing.

**Economically Sensitive**: Residential construction is the most volatile sector within the US economy, swinging wildly between expansion and contraction. *The housing market is also extremely sensitive to broad macroeconomic trends* — most importantly those for mortgage rates, employment, household finances, consumer confidence, and the strength of the banking sector. Finally, rising house prices also boost consumer spending through the *wealth effect*.

**Recession Indicator**: *The current strength of the housing market is also a reliable gauge of the health of the broad economy*. Housing is arguably the most reliable leading indicator of recession. Historically, housing starts have peaked roughly 18 months prior to the onset of recessions. Using data back to 1950, *the economy has never entered a recession when the housing market has been on a sustained growth path*, as is the case currently.

**Structural Forces**: Powerful structural tailwinds suggest that continued housing market strength could lengthen the current economic expansion, assuming that the cyclical rise in long-term interest rates envisioned is gradual and orderly. *Rising homeownership, pent-up demand for household formation that was deferred in the past decade, and an acute shortage of existing home listings* provide support for an extended housing cycle.

*The key point is that the housing market is integral to the overall domestic economy. Housing is a very reliable indicator of underlying economic and financial conditions*. Overall macroeconomic conditions are generally suboptimal when housing is in a slump. Conversely, the domestic economy seems to perform best when housing is in a healthy upswing. *The current strength of housing in the midst of a manufacturing recession points to the resiliency and internal strength of the US economy*.

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The financial indices referenced herein are provided for informational purposes only. You cannot invest directly in an index. The statistical data regarding such indices has been obtained from sources believed to be reliable but has not been independently verified.

**Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index**: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

**MSCI World Ex US Index:** Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

**S&P 500® Index:** Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.