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GLOBAL DEBT

Should We Worry About the U.S. Housing Slowdown?

The U.S. housing sector is likely to remain soft this year after peaking in early 2018.

By Turgut Kisinbay | January 14, 2019

The U.S. housing sector begins 2019 weighed down by many of the carry-overs from a disappointing 2018.

Housing starts are declining and existing home sales have been slowing. Surveys suggest consumer confidence in the housing sector has weakened. Recent volatility in the financial markets – driven in large part by investor concerns over rising interest rates, which negatively affect demand for mortgage lending – combined with talk of a broader slowdown in the U.S. economy, leads us to an obvious question: Should we be worried about the softness in U.S. housing?

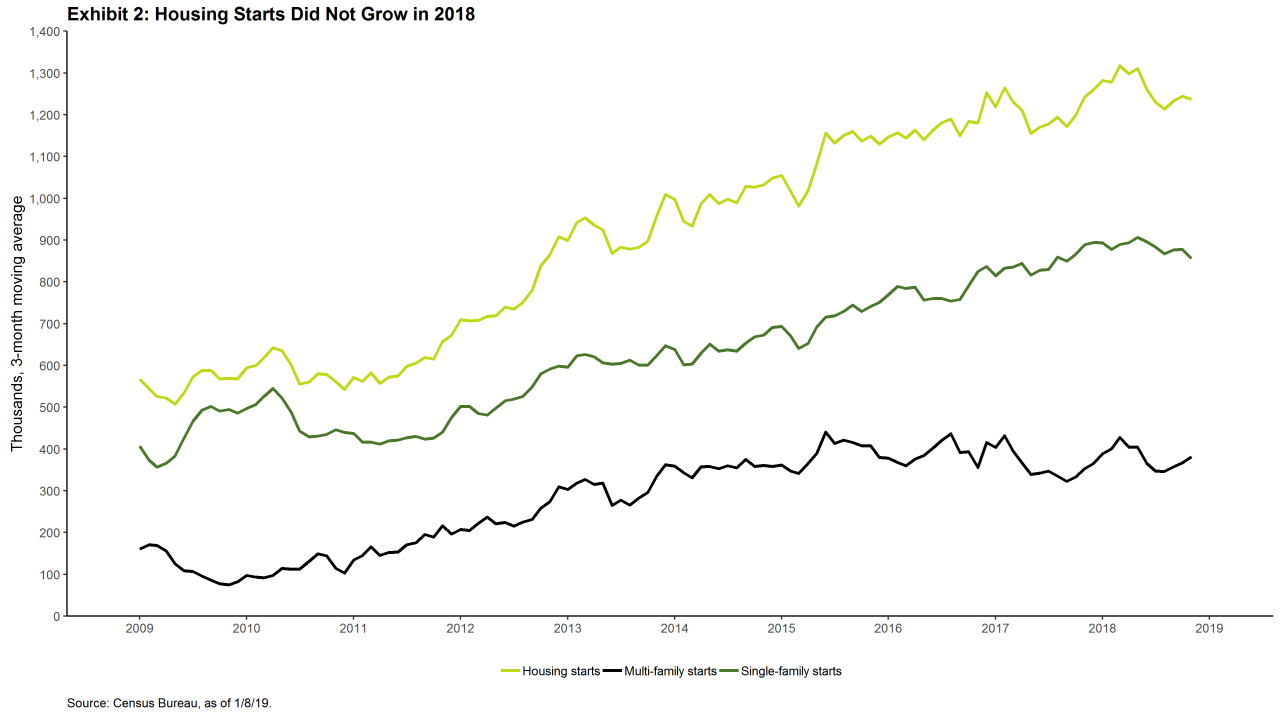
The Housing Sector Is Gently Cooling

In general, the answer to the above question is: No. However, several important indicators show that activity in the U.S. housing sector peaked around early 2018 and has softened since then. Both new and existing home sales have fallen throughout the last year. **Exhibit 1**

Exhibit 1: Home Sales Declined in 2018

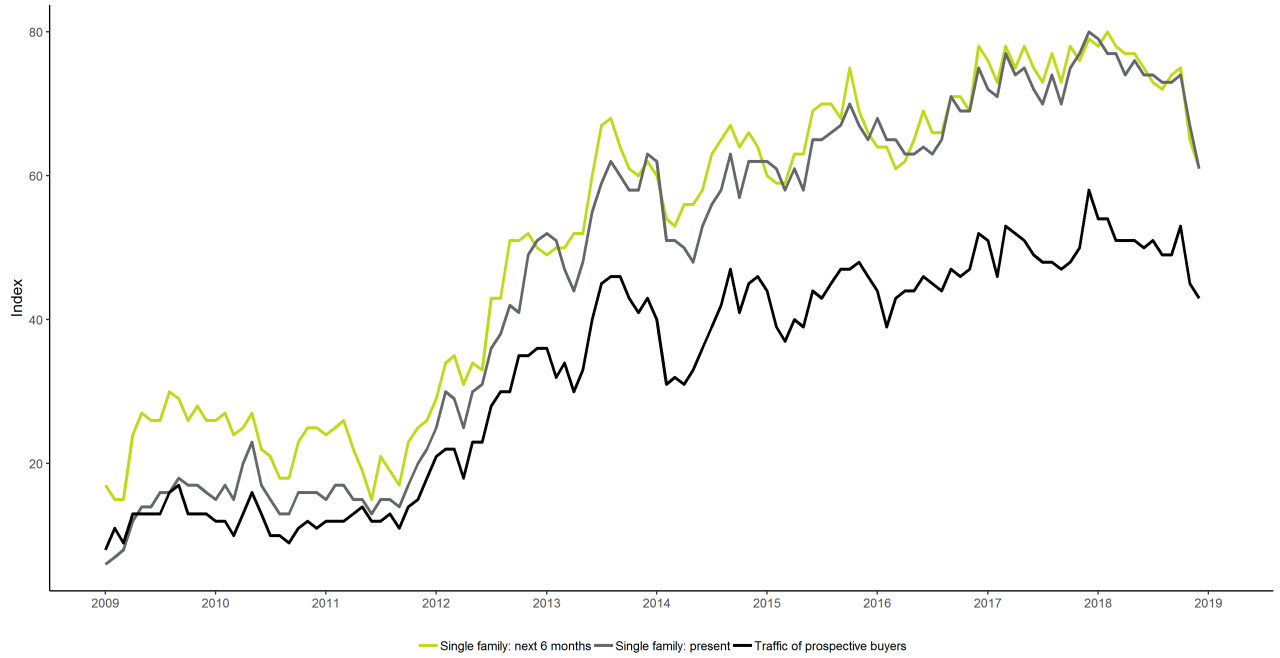
Sources: Census Bureau, National Association of Realtors, as of 11/1/18.

After the end of the last U.S. recession in June 2009,[1] housing starts grew steadily until 2017. Since then, however, housing starts have been stuck in the 1.2-1.25 million-units range, and not trending upward. The composition of starts shows that the more volatile multi-family starts have not been growing over the past few years, while the more stable single-family starts peaked in the spring of 2018 and have been trending lower since. **Exhibit 2**



Moreover, forward-looking indicators point to continued cooling of the housing market.The National Association of Home Builders (NAHB) Homebuilder Index, which measures sentiment in the sector, turned lower in 2018. The index components also suggest that both current and future builder sentiment, as well as expected prospective buyer traffic, are also heading lower. **Exhibit 3**

Exhibit 3: NAHB Homebuilder Survey Shows Declining Industry Sentiment



Source: National Association of Home Builders, as of 1/8/19.

In addition, data from the National Association of Realtors show that housing affordability has been declining since 2013. **Exhibit 4**

Exhibit 4: Housing Affordability Has Been Declining

Source: National Association of Realtors, as of 1/8/19.

The sector is also experiencing supply-side challenges. As the labor market tightens, demand for construction workers to build homes is increasing. That, in turn, pushes up wages, costs, and home prices. Producer Price Index data[2] show that inputs to residential construction rose rapidly over the past two years but prices leveled off since the summer of 2018. Other constraints to the

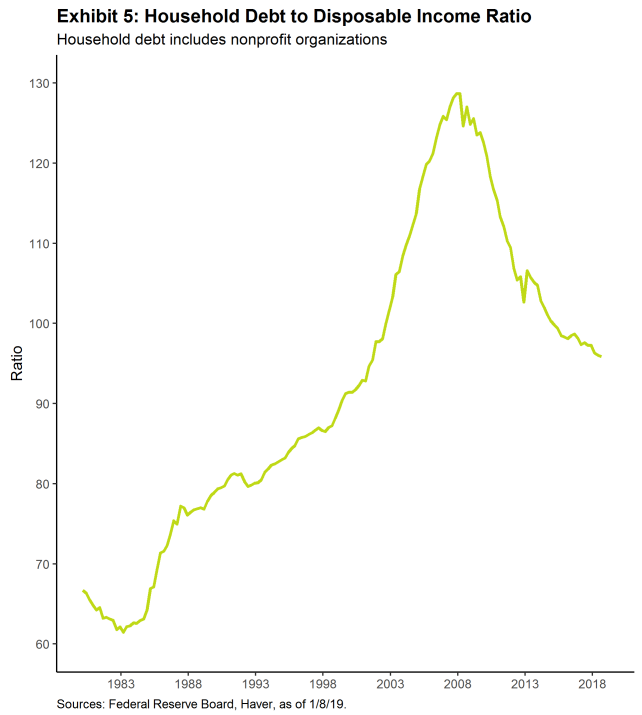
housing sector include shortages of available land on which to build in desirable areas.

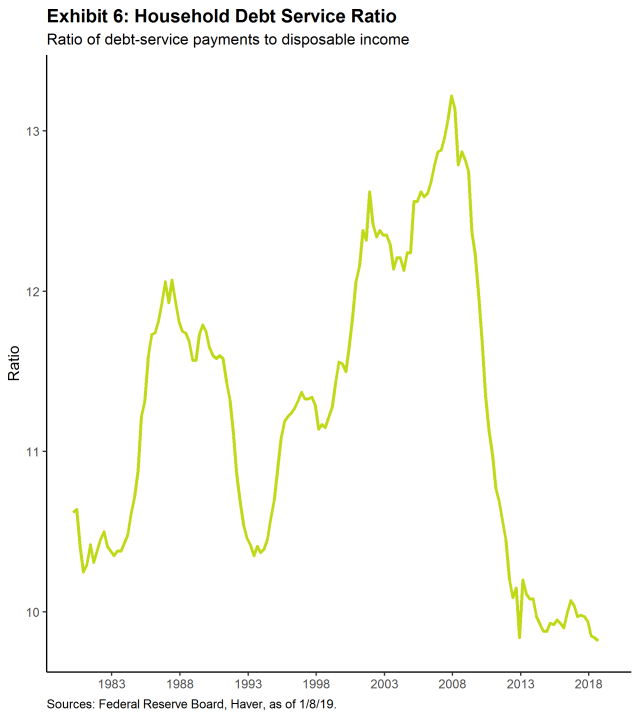
There are no surprises here: Houses are more expensive, mortgage rates are higher than in recent years, and consumers are more cautious about buying homes. We monitor a range of sector indicators, including those shown above, that broadly suggest the soft patch in the U.S. housing sector will continue in the near term.

Consumer Finances Are in Good Shape

On a more positive note, one of the main differences between the current state of the U.S. housing sector and the years leading up to the last recession is the relative strength of household finances. The mid-2000 housing bubble was fueled with credit, high household debt, and low savings.

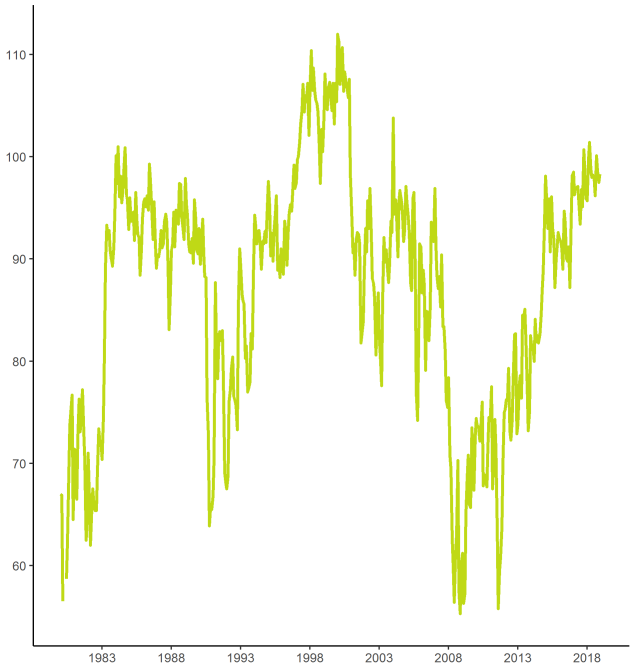
Since then, consumers have repaired their balance sheets. Household leverage, as measured by the debt-to-disposable income ratio that had peaked before the last recession, has since come down significantly and is not trending up noticeably in this expansion. Banks are lending more cautiously, and are constrained by regulators to be more prudent. The combination of higher savings and very loose monetary policy, both in the U.S. and globally, led to low interest rates, easing the debt servicing burden of households. The household debt service ratio is very favorable in historical terms. **Exhibits 5, 6**





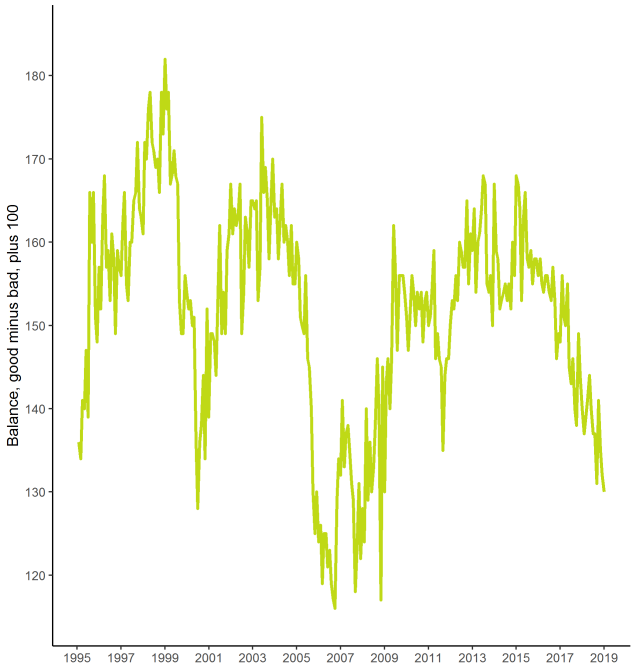
A strong U.S. labor market is another source of support for the housing market. The unemployment rate is near historic lows and job creation has been robust. Wages are slowly but surely increasing, nearing 3% growth per annum, and measures of consumer confidence are around cyclical highs. At the same time, however, consumers do not think this is the best time to buy houses. **Exhibits 7, 8**

Exhibit 7: University of Michigan: Consumer Confidence



Source: University of Michigan, as of 1/8/19.

Exhibit 8: University of Michigan: Buying Conditions for Houses

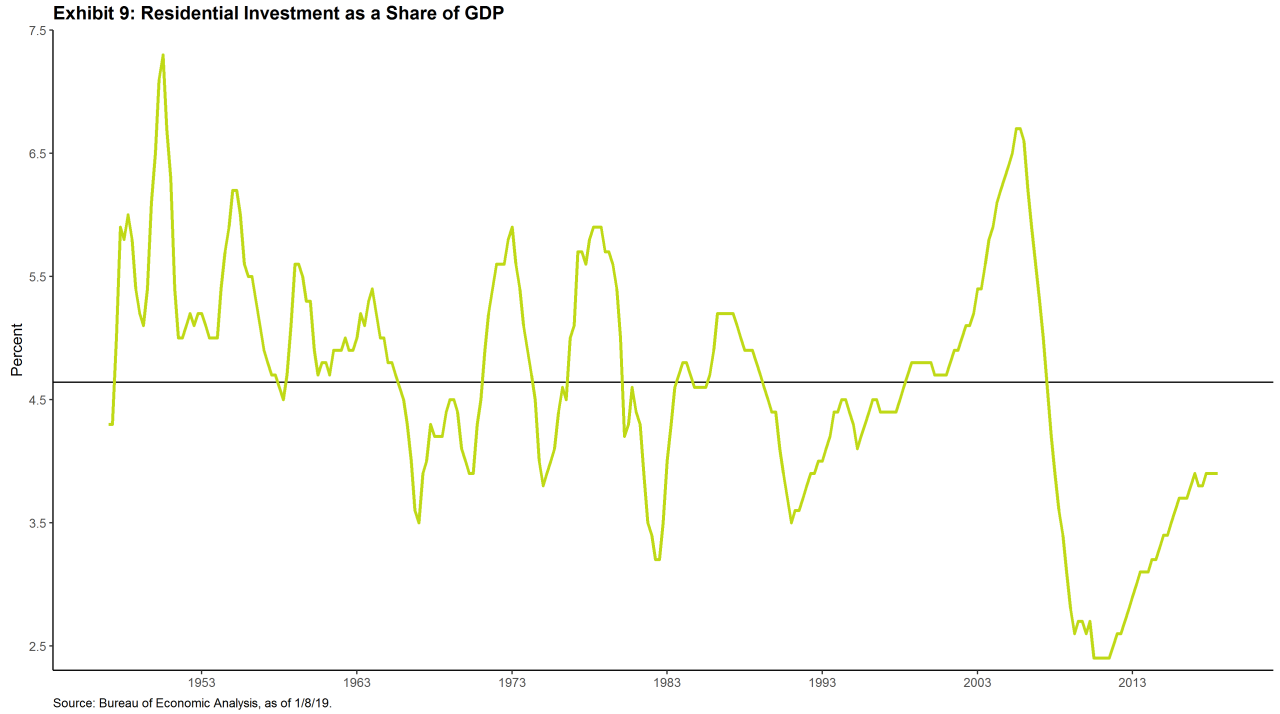


Source: University of Michigan, as of 1/8/19.

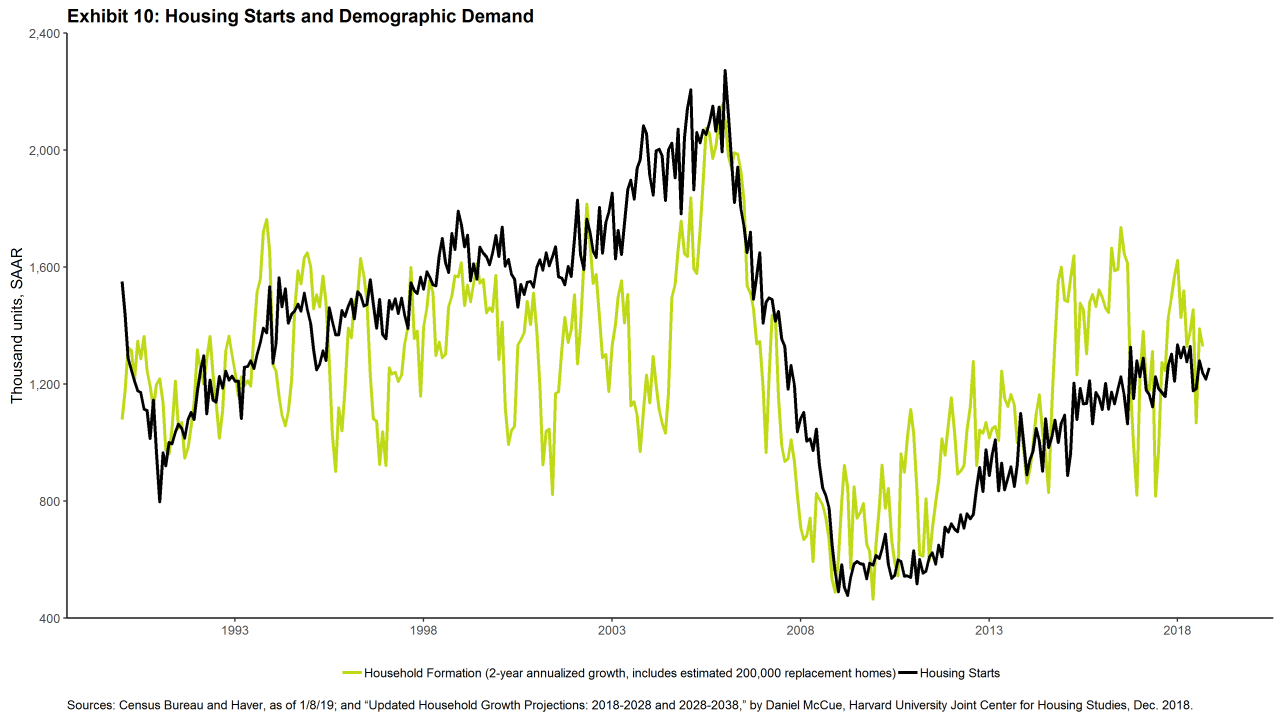
This evidence suggests that while consumers generally feel good, they are less keen on buying homes. This, in turn, looks like a sectoral (housing) issue rather than a broad deterioration in confidence. Households are likely waiting for the housing market to cool off a bit further, while their incomes are growing, both of which will improve affordability.

Implications for the U.S. Economy

Housing is always important for the economy, but less so now than in previous times for the simple reason that it is a smaller share of the economy compared with the past. Residential investment as a share of GDP declined to historically low levels after the last recession and still remains below the historical average. **Exhibit 9**



Contrast this to the last recession, when housing was double its current share of the economy and at historical highs as a share of the economy. In **Exhibit 1** above, we can see that activity tilted towards sales of existing homes in an attempt to reduce the inventory of homes, instead of new construction. In fact, home building has been broadly in line with the demographic trend of number of households formed in this expansion, a measure of structural demand for housing. **Exhibit 10**



To that, we need to add housing that must be replaced, such as demolitions and homes lost to natural disasters, fires, and other factors. We assume that number is around 200,000[3] and add it to the household formation data estimate from the U.S. Census Bureau shown in **Exhibit 10**.

The demographic trend comparison with housing starts shown in **Exhibit 10** suggests that the housing market supply and demand dynamic is roughly in balance. Housing inventory levels are low, also in line with this evidence. The chart also suggests household formation is trending upward, which should support the housing sector in the future as affordability improves.

The Bottom Line

Our view of the housing slowdown is rather sanguine at this stage. On the demand side, a combination of lack-of-affordability and deteriorating sentiment is holding consumers back. But overall consumer finances and sentiment are favorable, so this is more of a sectoral slowdown as opposed to a broader slowdown in demand, in our view.

On the supply side, builders have been cautious and, in fact, did not build over and above what demographic trends indicate. There is not an excess supply issue, in our view; and housing as a share of U.S. GDP is at a low level, limiting downside risks to the economy.

Having said that, housing is always a key sector of the economy and we will continue to monitor the sector and evaluate our baseline as data accumulate. For the time being though, while we don't expect housing to be much more of a contributor to growth in the short-run, we also don't see it as a major downside risk for the economy.

The soft patch in housing is consistent with our 2019 outlook that foresees a gradual slowdown of the U.S. economy to 2% growth, combined with moderate interest rates and inflation, and low risk of a recession.

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1. ^Source: U.S. National Bureau of Economic Research (NBER), which is the official arbiter of when recessions begin and end. According to the NBER, the recession, which was triggered by the collapse of the housing market that led to the 2008 global financial crisis, began in December 2007 and ended in June 2009.
2. ^Source: U.S. Bureau of Labor Statistics, 11/30/18.
3. ^Source: "Updated Household Growth Projections: 2018-2028 and 2028-2038," by Daniel McCue, Harvard University Joint Center for Housing Studies, Dec. 2018.

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How valuable is this article? VALUABLE OK NOT VALUABLE

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