Euler Hermes Economic Research

Economic Insight

Cracks in the U.S. Housing Market?

November 5th 2013

Dan North (Chief Economist, North America)
✉ dan.north@eulerhermes.com

Clémentine Cazalets
✉ clementine.cazalets@eulerhermes.com

In summary:

- While GDP is expected to remain on a path of moderate growth through 2014, some risks have appeared in the housing market.
- A sharp rise in mortgage rates drove down housing affordability, mortgage applications and prices.
- Leading indicators suggest weakness for the next few months which could slow mortgage equity withdrawl and personal consumption.
- Mitigating factors include still historically high affordability, rebounding construction employment in September, and the Fed keeping a lid on mortgage rates. As a result, the weakness is probably temporary and poses minimal risk to the rest of the economy.

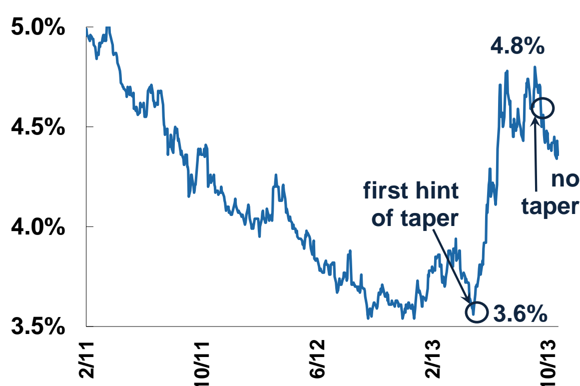
Risks in housing, while the gradual economic recovery continues

While the U.S. economy is expected to continue on a path of moderate growth at least through 2014, some risks are appearing in one of the main drivers, the housing market.

When the U.S. housing market bubble collapsed in 2005-06, prices and most measures of housing activity fell for five to six years. However a solid recovery in the housing market started in late 2011 and early 2012, driving up prices, sales, permits, and starts. The Fed's Quantitative Easing programs (QE) had supported the housing market by helping drive mortgage rates lower. The lower rates also drove investors to seek higher returns in riskier assets, thus bidding up the price of housing. As a result, the housing sector has been one of the brightest spots of the recovery.

While the housing market is expected to continue to grow, some "cracks" have started to appear which may slow the pace of the recovery. In May of 2013, Fed Chairman Bernanke gave the first hint that the Fed might start tapering its aggressive QE programs. The financial markets were caught off guard, and the interest rate on a fixed 30 year mortgage rose rapidly from 3.6% to 4.8% as shown in Chart 1.

Chart 1: Interest Rate on 30 Year Mortgage



Sources: Wall Street Journal, Euler Hermes

An Overly Sharp Negative Reaction

The spike in rates caused the Housing Affordability Index to fall sharply, putting downward pressure on sales. Yet affordability remains historically high at 156 as shown in Chart 2 (an Index value of 100 means that a median income can purchase a median price home on a mortgage for 80% of the home's value). In fact, before the housing bubble burst and prices collapsed from 2006 - 2012 the previous record high was 152 in February, 1972.

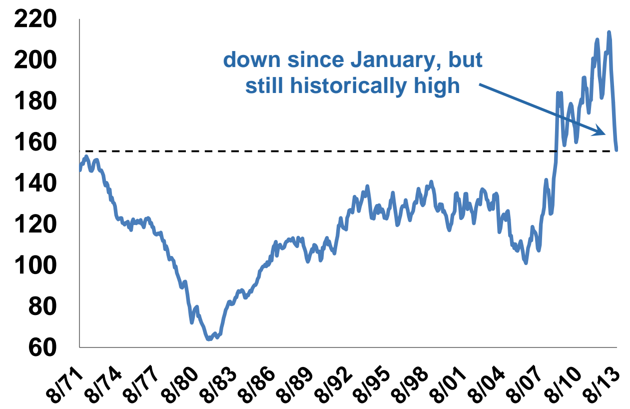
The increase in rates alone was enough to raise the average monthly mortgage payment by 16%. Not surprisingly, some buyers found themselves shut out of the mortgage market. Weekly mortgage application volume fell sharply as shown in Chart 3. Since Bernanke's first hint of taper in May, applications for mortgage refinancings have fallen 58%, while applications for purchase mortgages have fallen 16%. Damage to purchase mortgages may be on the mend however as they recovered slightly in the middle of October for the first time in four weeks.

The increase in mortgage rates has also caused prices to fall as shown in Chart 4. New home sales are booked during the month that the contract is signed, so those prices dropped the same month Bernanke hinted at tapering and have fallen every month since. Existing home sales are booked at the closing of the sale which happens one or two months after the contract signing (about the same time the mortgage rate is locked in). So sales of existing homes in May were based on rates approximately two months earlier, and it took until July for the rate increase to impact existing home sale prices. Those prices have fallen three consecutive months after having risen seven of the previous eight months.

Looking Forward

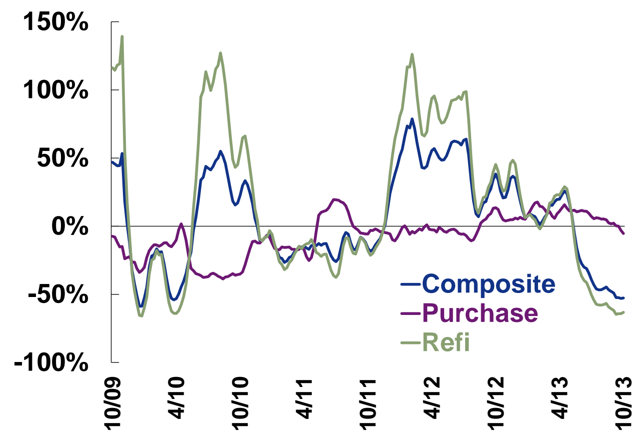
Leading indicators in the housing market, shown in Chart 5, suggest weakness in the next few months. Pending sales, which are intended to lead existing home sales by one to two months, fell for the fourth consecutive month in September, boding poorly for the upcoming months. Permits, which are the first step in the process of constructing a new home, have fallen in three of the past four months since the first hint of tapering, suggesting a slowdown in future construction activity. As a result, construction employment shown in Chart 6 was weak in May through August. But employment did rebound sharply in September, suggesting limited damage.

Chart 2 : Housing Affordability Index



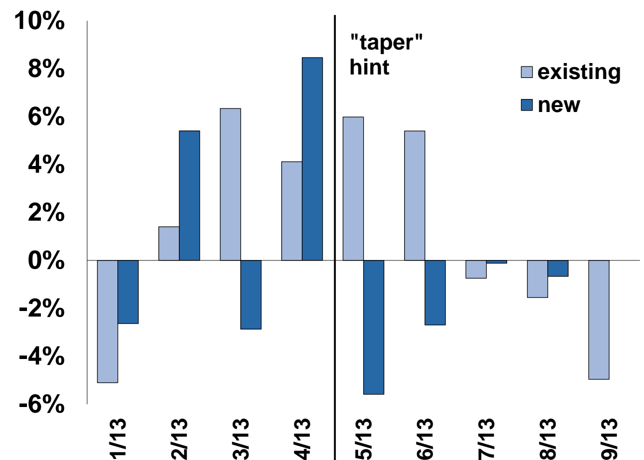
Sources: National Association of Realtors, Euler Hermes

Chart 3: Mortgage Application Volume, y/y change in the 4 week moving average



Sources: Mortgage Bankers Association, Euler Hermes

Chart 4: Housing Prices



Sources: National Association of Realtors, Census, Euler Hermes

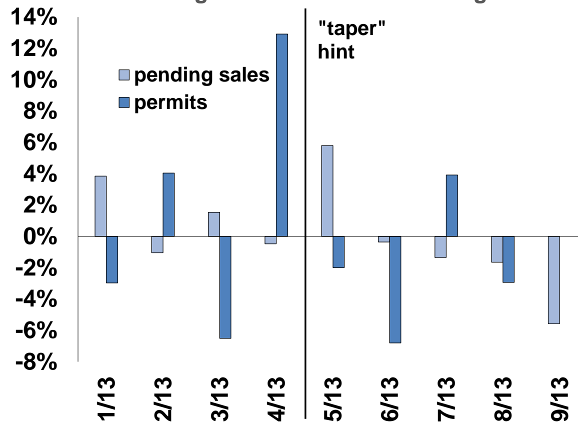
The Government shutdown has also put a temporary damper on the housing market recovery. With the Internal Revenue Service shut down, lenders were unable to check their clients' revenue record, causing mortgage applications to be delayed, or even refused. This, added to the closing of some administrations that provide and/or guarantee mortgage loans (Federal Housing Administration, Department of Veterans Affairs…), also temporarily affected home sales volumes and led to further downward pressure on housing prices. But since the shutdown lasted less than three weeks, the effects could be negligible, and the backlog may in fact temporarily put upward pressure on housing prices for one or two months.

Nonetheless, the household financial situation remains somewhat fragile and could suffer if housing prices were to continue to erode, putting downward pressure on consumption. The health of the housing market plays an important role in US economy owing to Mortgage Equity Withdrawal: households can spend cash from home equity extraction when the price of their house increases. Housing wealth impacts the marginal propensity to consume and thus the level of personal consumption expenditures as shown in Chart 7. Now, the household financial situation is still relatively precarious as shown in Chart 8: the delinquency rate on mortgage loans has decreased significantly but remains elevated (around 7% against 4.8% in average before the crisis) and the number of households with negative equity remains relatively high as well (23.8% of households with a mortgage in Q2 2013, representing more than 12.2 million households, but down from 31.1%). If housing prices were to keep falling, leading to a deterioration of housing wealth, it could pose a risk to the slowly recovering private consumption.

One final factor which may contribute to weakness going forward is the fact that a record high proportion of home sales are now all cash. All cash sales suggest that instead of being bought as a dwelling, houses are being bought by investors who intend to re-sell the houses for a profit as prices rise rapidly. If prices start to fall instead due to rising mortgage rates, investor purchases would likely dry up.

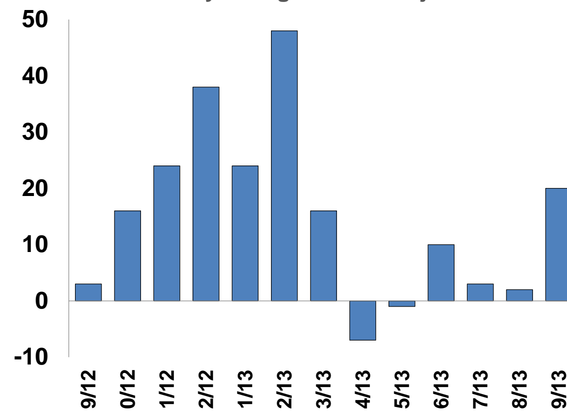
The recent spike in mortgage rates clearly slowed the housing market during the summer, yet high affordability, an upturn in purchase mortgage applications, and a rebound in construction employment all suggest temporary damage. Furthermore, just as the Fed's hint of tapering drove rates up, the Fed's decision against tapering in September drove rates back down (see Figure 1). In fact, continued weakness in the overall labor market is expected to keep the Fed's QE programs well-entrenched into 2014, helping keep a lid on mortgage rates. Therefore while the housing sector has suffered recently and it is a potential source of downside risk, the weakness is likely only temporary and will not derail the on-going gradual GDP recovery.

Chart 5: Leading Indicators of the Housing Market



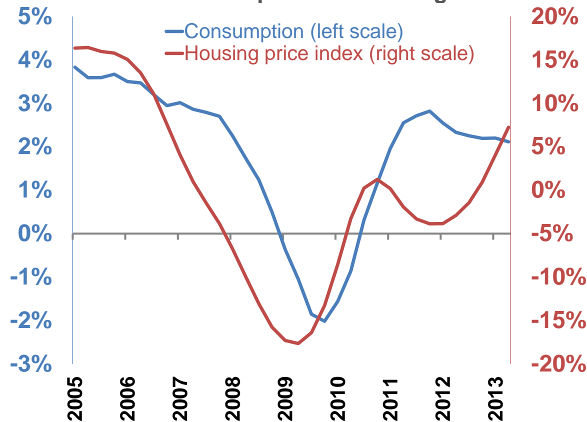
Sources: National Association of Realtors, Census, Euler Hermes

Chart 6: Construction Employment monthly change in 000s of jobs



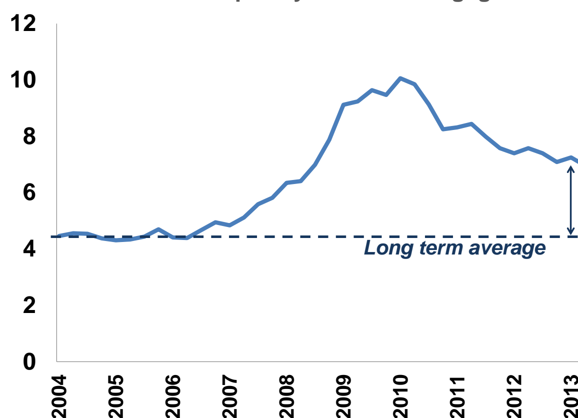
Sources: Bureau of Labor Statistics, Euler Hermes

Chart 7: Consumption vs. Housing Prices



Sources: BEA, S&P/Case Shiller, Euler Hermes

Chart 8: Delinquency Rate on Mortgages



Sources: Mortgage Bankers Association, Euler Hermes

DISCLAIMER
These assessments are, as always, subject to the disclaimer provided below.

This material is published by Euler Hermes SA, a Company of Allianz, for information purposes only and should not be regarded as providing any specific advice. Recipients should make their own independent evaluation of this information and no action should be taken, solely relying on it. This material should not be reproduced or disclosed without our consent. It is not intended for distribution in any jurisdiction in which this would be prohibited. Whilst this information is believed to be reliable, it has not been independently verified by Euler Hermes and Euler Hermes makes no representation or warranty (express or implied) of any kind, as regards the accuracy or completeness of this information, nor does it accept any responsibility or liability for any loss or damage arising in any way from any use made of or reliance placed on, this information. Unless otherwise stated, any views, forecasts, or estimates are solely those of the Euler Hermes Economics Department, as of this date and are subject to change without notice. Euler Hermes SA is authorised and regulated by the Financial Markets Authority of France.

© Copyright 2013 Euler Hermes. All rights reserved.