September 2012

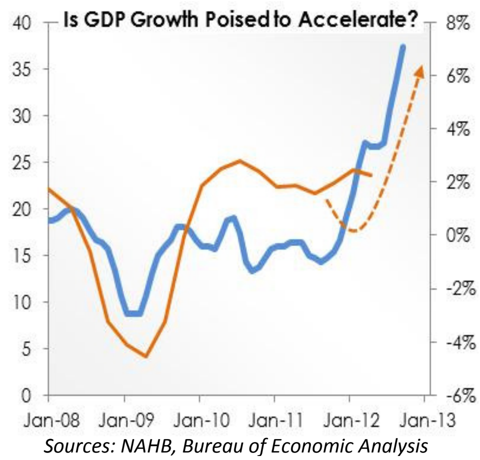
Housing: The Long and Winding Road to Recovery

The early days of the U.S. financial meltdown often were referred to simply as a "housing crisis." At first blush, it appeared that the crisis was brought on by too many Americans stretching their budgets to buy homes they could not afford. Economists actually had speculated for several years prior to the crisis whether the housing boom of the early 2000's would "rust or bust" – in other words, peter out slowly or pop spectacularly. When the economy slowed, a "pop" beyond most people's wildest imaginations was heard as a huge number of homeowners were unable to pay their mortgages, and a new boom began – this time in forclosures.

The ensuing years have made it clear that the problems went much deeper than just housing. The U.S. experienced a true financial credit crisis in which the willingness of counterparties to take any risk, as well as most market liquidity, almost vanished for a period of time. Virtually no one understood how leveraged the banks were to bad mortgages, including the banks themselves. The scars go deep. Bank mortgage lending practically stopped, and years later these institutions have failed to resume lending at a pace commiserate with the ultra-low borrowing rates at their disposal. Most individuals were no longer willing or able to take on additional debt. The already dismal housing market stagnated and without this important pillar of the U.S. economy growth flat-lined as well.

Historically, it is difficult to find a period of economic recovery that was not led by a housing recovery. The chart at right shows the relationship between real GDP growth and the index of single-family home sales tracked by the National Association of Home Builders (NAHB).

Nearly every inflection point in the direction of GDP growth was preceded by a turn in the NAHB index. Given this strong relationship, it is no surprise that economic growth has not bounced back sustainably in the face of a stagnant real estate market. What many people do not realize, however, is that we may already be in the midst of the long-awaited improvement in housing. Focusing in on recent data (right), one can see that the NAHB index has been rising for close to a year. Considering the depth of the hole housing had fallen into, we can expect that the lead time to impact growth will be longer than a few months this time around. We are already twelve months into the housing uptrend, and the breadth of the improvement in the data leads us to believe that a subsequent uptick in GDP may be closer than many skeptics may think.



Sources: NAHB, Bureau of Economic Analysis

The Undercover Recovery

The media continues to report on the many Americans who are pinned under the weight of an upside-down mortgage or have stopped paying their mortgage altogether because of a job loss or medical bills. Certainly there are still far too many of these situations in the U.S., but they no longer paint the entire housing picture. The reality is that bad news entices more viewers than good news, especially during a brutal election cycle, and the negative view of the housing market becomes even more deeply engrained. The real estate market is not back to where it was prior to the crisis – or even where it "should" be compared to previous economic recoveries – but there is broad improvement underway in the data.

The National Association of Realtors® (NAR) reported that existing home sales rose 7.8 percent in August from the previous month, and 9.3 percent in the previous twelve months. Gains were posted across all four geographical regions in which the data are divided – Northeast, South, Midwest and West. Sales prices of existing homes are up 9.5 percent from a year ago, with a whopping 16 percent increase in the Western region.

NAR chief economist Lawrence Yun commented on improved buying conditions in the group's latest news release[1]:

> *"The housing market is steadily recovering with consistent increases in both home sales and median prices. More buyers are taking advantage of excellent housing affordability conditions. Inventories in many parts of the country are broadly balanced, favoring neither sellers nor buyers. However, the West and Florida markets are experiencing inventory shortages, which are placing pressure on prices. The strengthening housing market is occurring even with difficult mortgage qualifying conditions, which is testament to the sizable stored-up housing demand that accumulated in the past five years."*

The equation is simple: stored-up housing demand + balanced inventories = increases in sales and prices. As with many aspects of the economy, the pendulum swings to extremes. Rabid housing demand in the mid-2000s swung to zero demand in the aftermath of the crash, which has led to pent-up demand for homes. On the supply side, overbuilding in the hay days left a huge glut of inventory exacerbated by a flood of foreclosed homes into the market. That supply has been slowly diminished in the last several years finally leaving a more balanced relationship with demand. In fact, as Mr. Yun notes, the West and Florida are actually experiencing a shortage of inventory. These were two of the regions hardest hit in the crash, but it appears that the complete cessation of building has finally reduced the over-supply. Current inventories have fallen 18.2 percent from a year ago, which represent a 6.1 month supply of homes on the market. This is down from a peak of over 12 months supply in mid-2010. The amount of time it takes to sell a house has also fallen. Thirty-two percent of homes sold in August were on the market for less than a month, while 19 percent were on the market for six months or longer[2].

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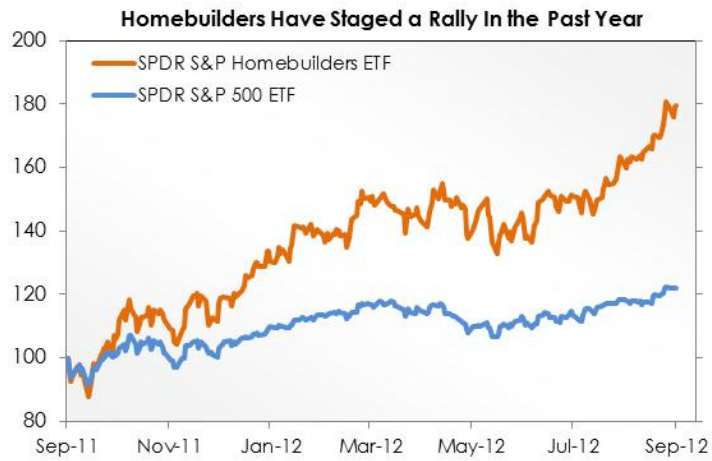
[1] "August Existing-Home Sales and Prices Rise," NAR News Release, September 19, 2012
[2] Ibid

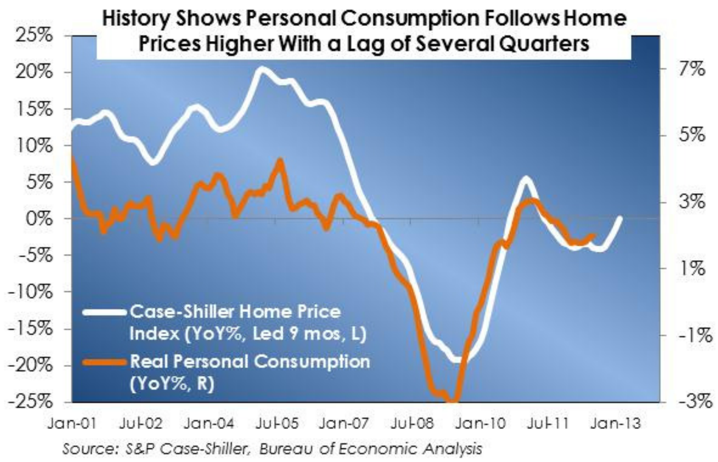
Less Distress

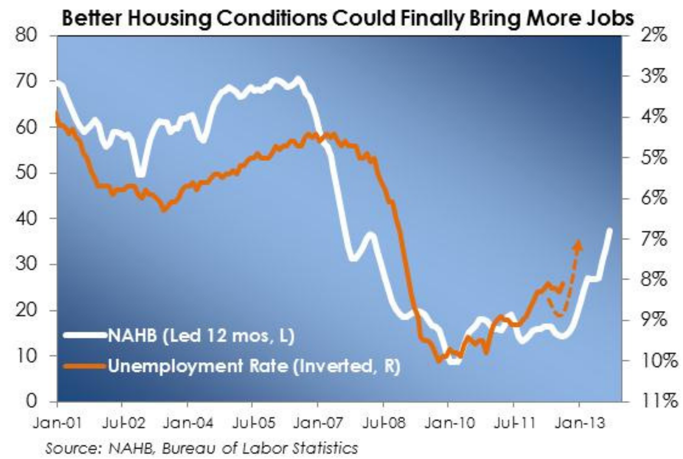
Part of the improvement in sales and prices is due to a change in the mix of homes that are being sold. Distressed sales in August represented the lowest share of transactions since October 2008 with a share of 22 percent. The NAR forecasts at this pace distressed sales next year will represent just 10 to 15 percent of total transactions[3]. Working through the glut of distressed supply should boost the construction industry as inventory needs to be replenished, and we have seen this begin to happen. The Commerce Department reported that new housing starts in August were up 29 percent from a year ago and permits for single-family homes were at their highest level since April 2010. The chart at right shows that risk-taking investors certainly believe in the bounce in construction. The SPDR S&P Homebuilders ETF (XHB) has scaled a "wall of worry" over the past 12 months with a high beta relative to the S&P 500 ETF (SPY).



Trickle Down Economics

An increase in construction is not the only economic benefit that tends to flow from a housing recovery. Consumer confidence and spending are apt to follow a rise in housing prices as Americans gain equity in their homes allowing them to feel wealthier. The chart below left shows that an increase in the growth rate for housing prices tends to lead an improvement in real personal consumption about nine months later. The current rate of change in home prices, as shown below by the Case-Shiller Home Price Index, implies that spending may pick up in the next several quarters. As we showed earlier, a strengthening housing market tends to herald stronger GDP growth as well. If these historical trends hold, they could bring about a virtuous circle of more spending, higher GDP, and finally more jobs. The chart at bottom right illustrates how the unemployment rate tends to drop (rise on the chart) when the NAHB home sales index increases.





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[3] "Sales of existing homes surge in August," September 19, 2012, Market Watch, The Wall Street Journal

Water, Water Everywhere…

The supply/demand imbalances that have weighed on the housing market since the bubble burst finally appear to be equalizing. One area that has shown little normalization, however, is the willingness of banks to lend. In theory, a strengthening real estate market should allow banks to ease lending standards since rising prices would imply a lower percentage of potentially upside-down borrowers. Years of pent-up demand implies there are willing buyers on the sidelines – especially in an environment where thirty-year fixed rate mortgages remain near historical lows – but relaxed standards have yet to materialize. Banks may be clinging to conservative lending practices due to uncertainty over pending regulations, according to the National Association of Realtors®. The NAR claimed in their August report that the current recovery would be even stronger if it were not for the still-difficult lending standards banks continue to implement.

No one believes that a return to the free-money days of the mid-2000's is prudent, but the lending statistics present a grim picture for all but the highest-quality borrowers. A report last week from The Federal Financial Institutions Examination Council, a regulatory body, confirmed how high the bar is to obtain a mortgage. The report noted that last year banks required increasingly higher credit scores to qualify for loans.[4] The median credit score for successful home buyers in 2011 had risen about 40 points since the end of 2006, and "despite the surge in the government-backed share of home purchase loans…credit scores of home-purchase borrowers are considerably higher now than at any point in the past 12 years."[5] The result was 800,000 fewer home loans made in 2011 than in 2010.

A recent report from Capital Economics claims that in the second quarter of 2012 the average household's FICO score was 690 yet lenders were demanding a score of 745 to approve a mortgage.[6] The report adds that anecdotal evidence suggests that lending volume is being held back by "administrative problems at banks, with the time taken to approve a mortgage application climbing to three months from the normal one…A further fall in mortgage rates is unlikely to trigger a rapid housing recovery when rates are already at record lows and when tight credit conditions mean many households cannot qualify for a new loan."[7]

The Chicken or the Egg

This situation presents a conundrum for the Federal Reserve. Monetary policy officials are injecting massive liquidity in order to lower borrowing rates and spark growth, but only the former is happening. The latest – and infinite – round of quantitative easing launched by the Fed this month was a promise to buy mortgage-backed securities until employment improves. An inherent goal of this policy is to further reduce mortgage borrowing costs, boost housing, and buoy consumer spending. It is difficult to believe that incrementally lower interest rates will make a difference. The national average thirty-year fixed mortgage rate was 3.51 percent as of Friday according to Bankrate.com – only 2 basis points above the historical low reached a few months ago. Some analysts would argue that rates should be even lower considering the stimulus undertaken, but rates of zero percent would likely mean little for the housing market if banks still refuse to lend to a broader group of Americans. Meanwhile, rock-bottom rates continue to punish savers and investors trying to keep up with inflation.

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[4] "Home lending hit 16-year low in 2011: regulators," Reuters, September 18, 2012
[5] Ibid
[6] "Are you better off now than you were four years ago?" Capital Economics, September 14, 2012
[7] Ibid

Covering the Spread?

A *New York Times* article published last week suggests that fear of new regulations may not be the only impediment for banks to lend at lower rates. In fact, it claims that banks are now making twice as much as they normally would on each mortgage loan they issue. Basically, since 2008 most of the home loans made by banks are sold into the bond market as mortgage-backed securities in order to take advantage of the government repayment guarantee. The banks' profit on this transaction is the difference between the rate they charge homeowners and the rate they pay these bond market investors. This gives the bank considerable control over their profit margin. Since these institutions are being squeezed in other areas of their business, it is of little surprise that the banks are maintaining the higher rates they *charge* mortgage borrowers while the market rate of interest they *pay* out to the mortgage-backed security holders drops.[8]

The *Times* reports that a year ago banks were originating mortgages with an interest rate of about 4.10 percent. They were then selling those mortgages into the bond market at interest rate of 3.36 percent, according to Bloomberg index data.[9] The gap between these two rates – the bank's profit margin – was 0.74 percent, which was close to the 0.77 percent average since 2007. During the past twelve months, however, that interest-rate gap has nearly doubled to 1.4 percent. The *Times'* analysis bears out that if banks were maintaining historical margins on these transactions the thirty-year mortgage rate would be only 2.83 percent instead of closer to 3.5 percent. There are several explanations offered for the change in rate structure, including that charging borrowers higher mortgage rates maintains the flow of applications at a manageable level. Regardless of the reason, the result is the same: if banks remain unwilling to lend at a market rate the Federal Reserve's efforts to further lower borrowing costs may never spark that turbo-powered economic recovery.

Are We There Yet

The good news is that more healing is taking place in the housing arena than many people believe. Supply/demand imbalances are normalizing, home prices are rising, and new construction is underway. It is true that this has not been a "typical" post-recession recovery, but 2008 was not a typical recession; it was a credit-driven slowdown and those are a different kind of beast. The last several years surely were frustrating for policy makers who grew accustomed to the Alan Greenspan days of precisely driving the economy with the wheel of monetary policy. After the excesses that built up in our system over a number of years, however, it should not be shocking that unwinding them is taking almost as long.

Without a doubt there is a serious employment crisis in this country, and a healthy housing market is certainly one of the remedies. We are encouraged by the housing data and are cautiously optimistic that the current trends are sustainable. From an investment point of view, it has not been an area we wanted to dive into too early. The fragile nature of this recovery requires a certain level of risk aversion for conservative investors, and our primary focus is to protect the wealth of our clients. We maintain a positive view toward equities, but expect that stimulus-induced inflation may rear its head toward the end of the year. For now, we believe the old mantra still applies: "Don't fight the Fed."

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[8] "An Enigma in the Mortgage Market That Elevates Rates," by Peter Eavis, The New York Times, September 18, 2012

[9] Ibid

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