CAPITAL MARKETS RESEARCH

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Special Report:
Is US Housing Really On The Mend?

- **We survey the evidence and conclude that cautious optimism is warranted, but it could easily be short-lived should the fiscal cliff or global developments derail confidence again.**

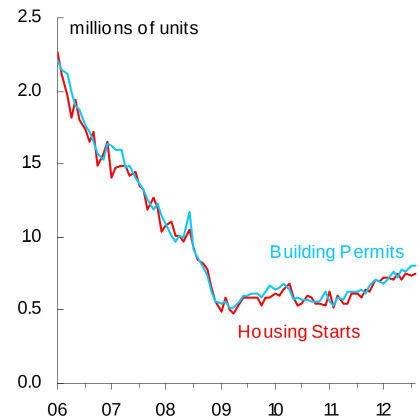
One of the top US macro themes governing the outlook for the United States is whether the housing sector is finally on the mend. In addressing this question, we review the mixed evidence across a variety of indicators and conclude that while there is limited cause for encouragement, frail job markets and the looming fiscal 'cliff' could make this just another head fake.

Unambiguously Better Readings...

The first batch of indicators we'll explore capture unambiguously better readings on the health of US housing markets than anything we've seen since the crisis began to unfold.

Chart 1 shows that the level of home building activity has steadily trended higher and currently sits at its most elevated reading since 2008 as building permits point to further strength ahead. Construction is still a fraction of what it once was, but the trend is right and it is contributing toward muted improvement in the economy by virtue of decent trend gains albeit off a low base.

Chart 1 **More Building!**

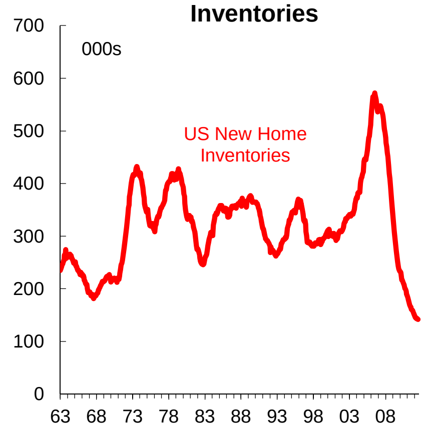


Source: U.S. Census Bureau, Scotia Economics.

Chart 2 backs this up. There is room for adding to the new housing stock by virtue of the leanest inventory of unsold new homes ever with records stretching back to the 1960s. We'll come back to the resale inventory picture.

Chart 2

Record Low For New Home Inventories



Source: Bloomberg, U.S. Census Bureau, Scotia Economics.

What is also encouraging is that new home sales (thick line) have trended mildly higher to the best reading since the Spring of 2010 (chart 3). What is puzzling, however, is the extreme disconnect between new home sales and the National Association of Homebuilders' measure of prospective buyers that captures foot traffic through model homes that is also shown on the same chart. Normally the two series are reasonably well connected, but this time around, foot traffic is far stronger. This could be because foot traffic is an index reading based upon qualitative answers to the question of whether traffic is better, the same or lower. Thus, it is not a volume measure like new home sales. So, there can be better traffic through model homes, but still just a trickle of the past. Another possibility is that new home sales may rise as foot traffic translates into sales. A third possibility is clearly just that foot traffic represents window shoppers with no intention to buy.

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Chart 4 also shows that markets have not been as positive toward homebuilder prospects as they are now since before the crisis hit. The homebuilder equity sub-index on the S&P500 is at its highest level in about five years. This will not just reflect housing market prospects, however, since equity valuations will also reflect factors such as capital structure shifts and changes in discount rates that are partly attributable to policy developments.

...Accompanied By More Ambiguous Indicators

The next batch of readings have posted improvements, but fall into the category of having seen it before as opposed to the prior section that focused upon consistently improving trends.

Charts 5-6 show that pending home sales and existing home sales have markedly improved since the lows set in 2010. Recall that pending home sales are transactions that are mostly 30-60 days away from closing off all of the paperwork and showing up in a completed resale transaction. The two often have a lagged relationship, with the risk that separations can occur due to turmoil that may cause contract cancellations for one reason or another. We are cautious toward both of these indicators, however, because we've seen evidence of strength in the past such as in 2009 and early 2010.

The composition of resales is also encouraging. Distressed sales are a falling share of total purchases as a somewhat more normalized type of sale re-enters the market. Distressed sales accounted for about 22% of total sales in the latest report for August, and this is down from the 30% range late last year and into early this year. This is because of fewer foreclosure sales and fewer short sales.

In chart 7, we show that the recent pick-up in house prices as measured by the S&P Case-Shiller metric which focuses on repeat-sales can by no means be called a secular break-out. In fact, it's the fourth upward trend we've witnessed since the US recession — and while we work on the fourth, it bears noting that three of the four prior cases proved to be head fakes.

There Are Still Important Pressure Points

There is a third category of readings that we end upon because they counsel a bit more caution.

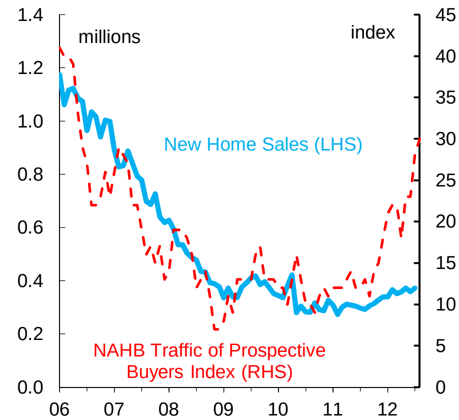
A) Affordability — Good, But Falling

One is that housing affordability had reached its best point on record by February of this year at which point house prices had bottomed. Since then, rising house prices and disappointing growth in jobs and incomes combined to drive affordability weaker (chart 8). Affordability has now deteriorated to levels that are more in keeping with the average of the late 2010 onward period. In the context of very weak job growth and still rising house prices, it is possible that this deterioration in affordability will spark a softening in housing demand going forward. In other words, house prices may have run ahead of the capacity of job and income growth to fund purchases.

Then again, perhaps accelerated job growth is not needed in order to sustain housing strengths. Eventually it would be, but for an interim period it is reasonable to think that pent-up demand from postponed purchases by employed individuals could be released and thus drive sustained housing strength until enough momentum has gathered to spill over into lagged job gains via multiplier effects upon the rest of the economy.

Chart 3

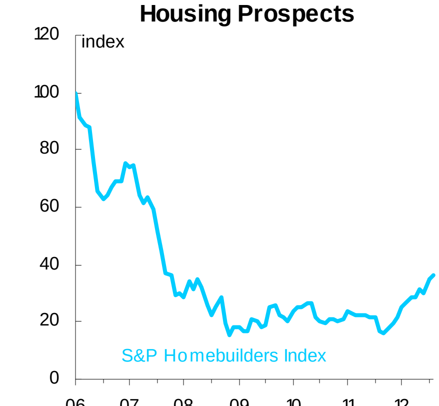
More Shoppers Than Buyers



Source: U.S. Bureau of the Census, NAHB, Scotia Economics.

Chart 4

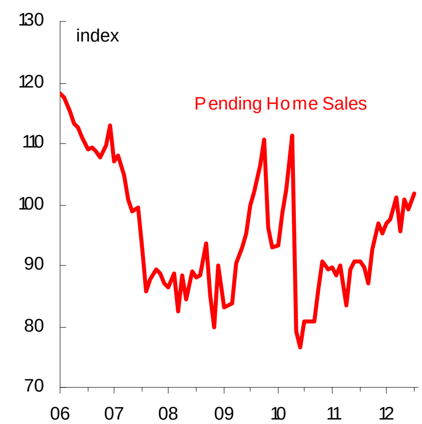
Markets More Optimistic Toward Housing Prospects



Source: Bloomberg, S&P, TSX, Scotia Economics.

Chart 5

A Leading Indicator...



Source: NAR, Scotia Economics.

Another complicating factor is the role of price expectations. Should employed prospective buyers believe that prices have bottomed and will continue to trend higher, then this could have them believing that affordability will further deteriorate. The motivation could well turn out to be supportive of additional buying activity. This therefore leads into a discussion on confidence on two counts.

B) Large And Rising Shadow Inventory

The first confidence factor concerns the outlook for prices. As chart 9 demonstrates, the stock of vacant primary-occupancy homes held off-market continues to rise. This is a key component to measuring shadow inventories. The normal pre-crisis run rate for this measure was around the 2.6-2.8 million range and we're now pushing toward 4 million. This extra roughly 1¼ million vacant homes mostly represents foreclosed homes that lenders are keeping off the market. To this is added vacant non-primary occupancy homes like seasonal residences. The normal run rate on that was around 3 million prior to the crisis, and now stands at about 3.7 million. This extra 700,000 should be added to the extra 1¼ million vacant primary homes held off-market for a grand total of about two million vacant residences being held off-market. Of course, there are also homes that are going through foreclosure that may not yet be vacant, and homes that have not yet started foreclosure proceedings but that might should lenders have more confidence toward the prices they may fetch upon resale. Added to this is the possibility of pent-up demand for foreclosures by banks that have been increasingly reticent to do so either because of regulatory pressure or because they fear being stuck with an asset they can't sell and that might diminish in value if left vacant.

This leads to our concern about the sustainability of house price gains in a general equilibrium sense. As housing recovers — if it has legs — there will be pressure upon lenders to shed their inventory of empty homes. Add to this the likelihood that more people who have not been foreclosed upon may well list their homes if they think they have finally clawed back losses. These two forces could bring idled supply back into the market just as demand improves. How this happens only time will tell, but it bears mentioning that the supply side will adjust alongside the demand side in such a manner as to constrain any tendency toward a strong trend improvement in house prices for some time yet. If it happens, then the supply side is likely to respond and thus cap the gains.

C) Not Showing Up In Mortgage Debt Growth

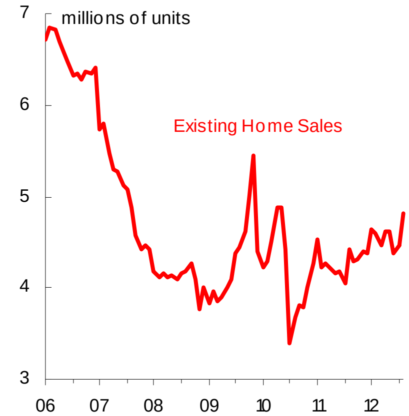
Finally, consider the implications for lenders. As yet, mortgage purchase applications and mortgage debt are not picking up in any material sense (chart 10). Indeed, the Fed's flow of funds report just noted that mortgage debt outstanding fell by 2.1% q/q in 2012Q2 and this continued the long string of crisis-era negatives.

Conclusion

In our opinion, an overall take on US housing market developments cannot be expressed stronger than to point to cautious market optimism. Market timers should be more careful than buy-and-hold patient money. The structural and more recent cyclical improvements across a broad array of indicators is encouraging, and lean new home inventories are an important offset to still-high shadow resale inventories. All of this must be expressed in the context of sound demographic supports as the kids of the aging baby boomers gradually begin moving into the owned accommodation housing segment. Born roughly since the late 1970s, the oldest among them are pushing into their early 30s while the full generation covers roughly a two-decade cohort skewed toward younger than this leading edge. On the assumption that the parents will eventually wish their kids well (a push effect) and that a longer-run recovery will support their kids to become heads of their own households (a pull effect), the structural demand drivers should be supportive.

Chart 6

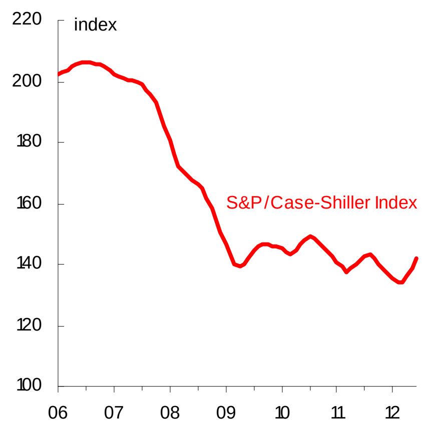
... For An Accelerating Resale Market



Source: NAR, Scotia Economics.

Chart 7

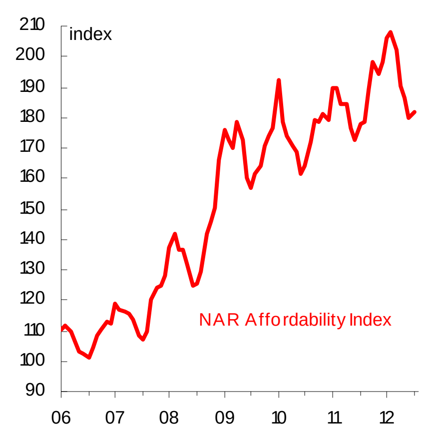
For Real, Or Just Another False Start?



Source: Bloomberg, Scotia Economics.

Chart 8

Affordability Past Its Prime



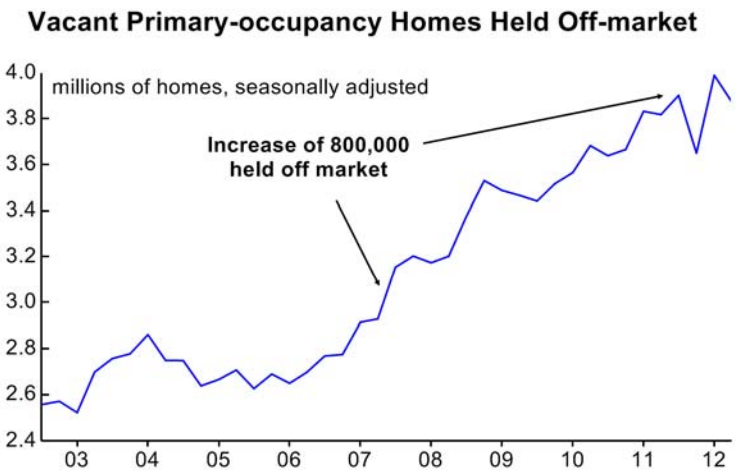
Source: NAR, Bloomberg, Scotia Economics.

When coupled with still-excellent housing affordability in a long-run historical sense, the conditions are ripe for a turnaround in US housing markets.

You may recall that we mentioned there were two confidence factors to consider. What will determine the outcome to the US housing story is exactly what has scuttled hopes several times in the recovery period already: confidence and jobs. Pent-up demand will only be released should fiscal 'cliff' turmoil not derail markets into year end. This depends one part upon how the process is handled and two parts upon the outcome defined in terms of the magnitude of retrenchment in both taxation and expenditure policies. Via the interconnectedness of the global economy, the ability of Europe and China to stabilize growth risks and market confidence while averting greater turmoil in the Middle East also plays into the outlook for U.S. housing.

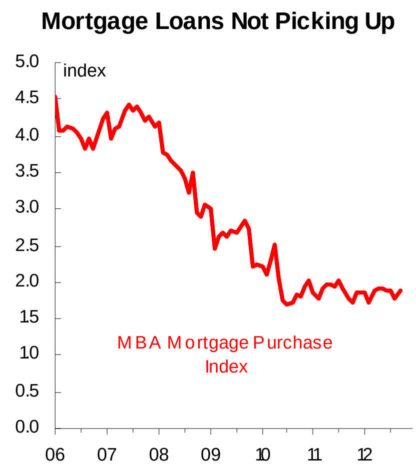
The final broad takeaway is to remind our readers that housing and asset bubble corrections like that which the United States has experienced take many years to work through. For instance, it took about seven years for Canadian housing starts to bottom in the correction of the 1990s and it took prices in markets like Toronto a decade and a half to recoup their losses. Canada's deleveraging was considerably less significant in the household sector back then, although it was much more focused upon public and corporate finances. As supply and demand adjust dynamically in the US housing market, a path toward improvement is bound to be long and bumpy.

Chart 9



Note: Primary occupancy homes, excluding seasonal & occasional use.
Source: U.S. Census Bureau.

Chart 10



Source: MBA, Scotia Economics.