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Housing to stay on positive growth track

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Housing to stay on positive growth track

- The recent housing surge is likely to abate soon
- But a bubble has not emerged
- And fundamentals are favorable for continued moderate gains

Housing has so far weathered the Corona pandemic well. Indeed, the US housing market index reached a new all-time high in October (see Chart 1). In our view, the surge in housing activity is partly transitory and likely to abate in coming months. However, we believe housing remains on a positive growth track and is not entering a bubble.

Chart 1: US housing market index

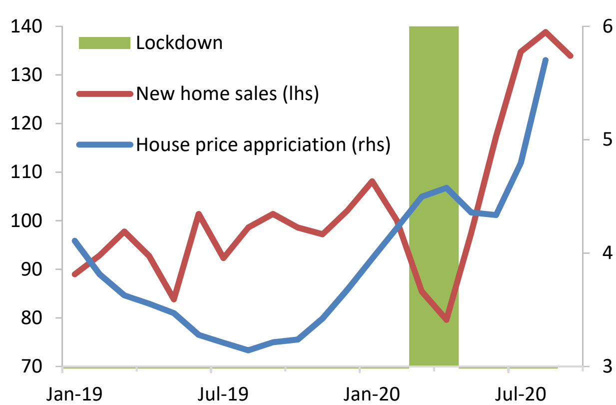
Index

Source: NAHB[1]

We were already positive on housing before the Corona Pandemic (see also ZAIS Insight "*Housing on track for moderate gains*", April 2019[2]). The lockdown in March and April interrupted the up-move in housing but activity and prices have rebounded strongly since then (see Chart 2).

Chart 2: US housing sales and prices

Index Feb-2020=100 (lhs), % over-year-ago (rhs)



Source: S&P Dow Jones Indices LLC and U.S. Census Bureau[3]

In our view, the housing surge has four drivers:

- The pent-up demand caused by the lockdown;
- Increased demand for single-family housing outside of big city centers;
- Lower interest rates; and
- The boost to disposable incomes from government transfer payments.

Table: US housing sales and starts

% change since February 2020 to:

	April	September	September cumulated
Existing home sales	-24.8	+13.5	-9.3
New single-family home sales	-20.4	+33.9	+12.5
Single-unit housing starts	-34.3	+7.2	-13.0
Multiple-unit housing starts	-52.2	-42.4	-33.1

Source: National Association of Realtors and U.S. Census Bureau[4]

The surge is transitory and likely to abate

Housing activity dropped between 20% and 50% in the two months to April during the lockdown (see Table). Yet by September housing sales and starts stood well above the pre-lockdown levels except for multiple-unit housing starts.

On a cumulative basis, however, the surge in activity was not enough to offset the prior declines except for new home sales, pointing to still pent-up demand. We expect these gaps will close in coming months, reducing the pressure from pent-up demand. Indeed, new single-family home sales already leveled off in August (see Chart 2).

The other transitory factor is the boost to disposable incomes from government transfer payments. Disposable personal incomes surged by 13% between February and April, but the transfer boost has faded since then and disposable personal incomes have gradually realigned with the trend before the Corona pandemic.[5]

Nevertheless, households had 7.8% more income at their disposal in the first nine months of the year than they did a year earlier. We believe some of that extra money was spent on housing given people spending more time at home and fewer other spending opportunities.

The political deadlock in Washington before the election has prevented a new stimulus package. We think this will change after the election but doubt that the next round of transfer payments will have the same effect on disposable personal incomes as in 2020.

The power of lower interest rates

A more powerful and lasting factor is, in our view, the effect of lower mortgage rates, as housing is traditionally one of the most interest-rate sensitive sectors of the economy.

Mortgage rates were already on the decline before the start of the Corona pandemic: the 30-year mortgage rate dropped from nearly 5% in November 2018 to a historical low around 2.8% now (see Chart 3). Based on our calculations that means a median family could afford to spend about 30% more on a home than two years ago.[6]

Chart 3: US 30-year mortgage rate

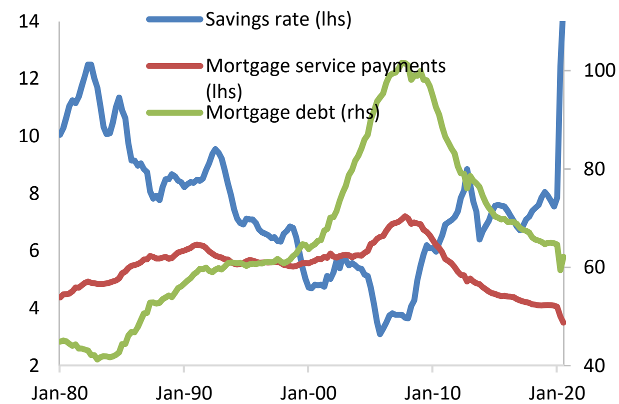
Percent p.a.

Source: U.S. Bureau of Economic Analysis[7]

Importantly, households are not excessively leveraged which, in combination with lower mortgage rates, has significantly reduced mortgage-debt service payments (see Chart 4). Households have also increased their savings rate, giving them more capacity to take on loans and make down-payments.

Chart 4: US household finances

% of disposable personal income



Source: U.S. Bureau of Economic Analysis and Board of Governors of the Federal Reserve System (US)[8]

Furthermore, we believe banks will remain supportive of the mortgage intermediation process. Banks have tightened lending standards,[9] but we think are in better shape than during the financial crisis (see also ZAIS Insight "*Banks are in better shape to weather the Corona fallout,*" August 2020[10]).

The combination of very low mortgage rates with good household and banking balance sheet health is a positive driver for housing. We believe Fed interest rate policy will support this favorable environment for several years to come.

Changing housing preferences

The other more lasting factor, in our view, is the impact of the Corona pandemic on housing preferences. As described below, the evidence so far points to a shift from city-center living to suburban single-family homes.

Sales of new single-family homes, which are typically located in suburban areas, have surged, while multiple-unit housing starts have failed to recover in contrast to single-unit housing starts (see Table above).

The trend change is also reflected in house prices. Nationwide house prices rose 5.0% annualized between February and August yet house prices in New York City, for example, inched 0.1% lower.[11]

We are mindful of a temporary overreaction but believe that housing preferences are changing due to the Corona pandemic and that this change will last a few years. Spending more time at home, working from home and the desire for more space and distance are likely to be important criteria for homebuyers in coming years.

This is not 2006

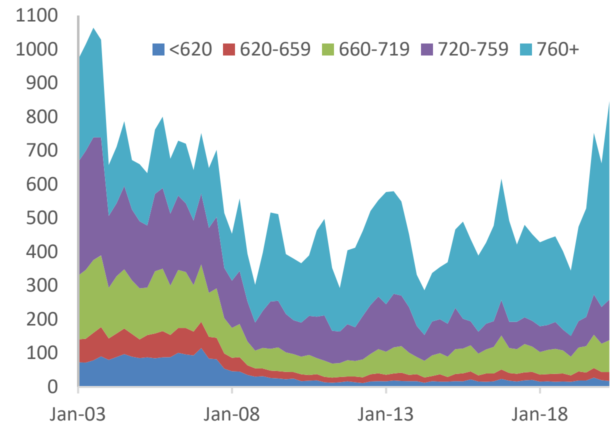
Despite the current buoyancy, developments in the housing market show no resemblance to the excesses of the housing bubble in the mid-2000s.

- First, and as pointed out above, household balance sheets are in much better shape due to less leverage, a lower debt-service burden and a higher savings rate (see again Chart 4).

- Second, the regulatory environment has tightened a lot since the financial crisis, especially for mortgage-lending standards. As a result, mortgage origination for those with the top credit scores now accounts for roughly 70% of all mortgages versus just 25% in the years prior to the financial crisis (see Chart 5)

Chart 5: New mortgages by credit scores

$ billion

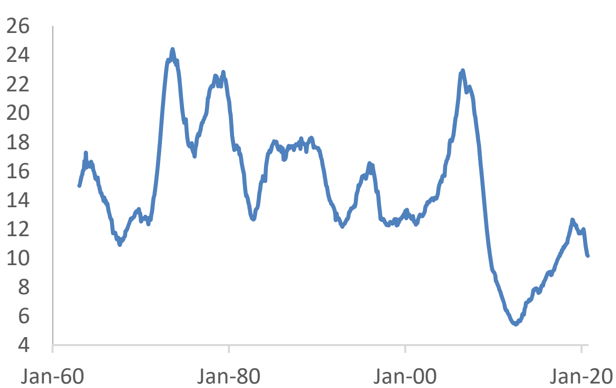


Source: Federal Reserve Bank of New York Consumer Credit Panel/Equifax[12]

- Third, housing construction activity is not excessive. New home sales have recovered since the financial crisis, but have not made up the prior losses (see Chart 6). In our view, there is actually a shortage of housing.

Chart 6: New one-family homes for sale

Per thousand of population

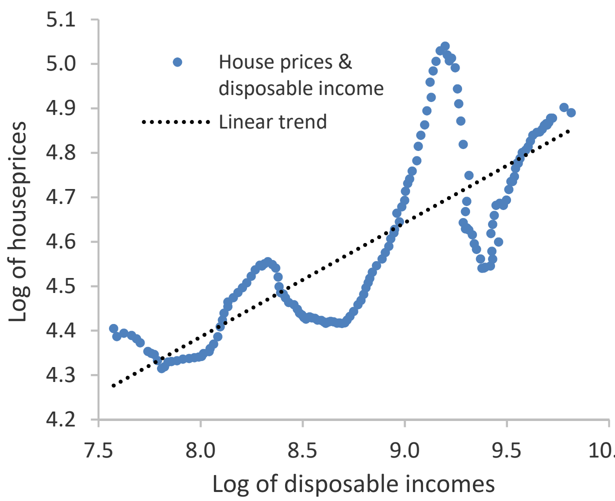


Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis [13]

- Fourth, house price appreciation is not out of line with income growth, as it was before the financial crisis (see Chart 7). We believe that rising house prices will over time have an automatic stabilizing function as banks no longer offer mortgage affordability products like zero down-payments and teaser payment loans.

Chart 7: House prices & household income

1980:Q1 to 2020:Q3



Source: Bank for International Settlement, Federal Reserve Bank of St. Louis and ZAIS calculations.[14]

Note: Each point forming the blue line above represents a sequential quarterly observation beginning with Q1 1980 at the left-most point and ending with Q3 2020 at the right-most point.

Not 100% bullet proof

We have entered uncharted territory with the Corona pandemic and it would be foolish to think that housing can thrive no matter what happens in the economy otherwise. Two risk factors stand out in our view.

- First, a financial crisis triggered by the Corona pandemic. We think the Fed will be able to prevent this from happening, but that is not assured.

- Second, a structural rise in unemployment. We believe the labor market will take many years to recover and may potentially experience temporary setbacks. A risk for the housing market, however, would be a trend-shift to a structurally deteriorating labor market. We think the probability of that happening is not large, but acknowledge that labor market developments must be watched closely for signs of change.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

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[1] NAHB/Wells Fargo National HMI. https://www.nahb.org/news-and-economics/housing-economics/indices/Housing-Market-Index

[2] https://www.zaisgroup.com/news/04-2019/ZAIS-Insights-Housing-On-Track-For-Moderate-Gains-04-2019.pdf?pdf=Housing-Insight

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[3] S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis; October 27, 2020.

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[4] National Association of Realtors, Existing Home Sales [EXHOSLUSM495S], retrieved from FRED, Federal Reserve Bank of St. Louis; October 24, 2020.

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Multiple units is the difference between total and 1-unit structures.

[5] U.S. Bureau of Economic Analysis, Disposable Personal Income [DSPI], retrieved from FRED, Federal Reserve Bank of St. Louis; October 30, 2020.

https://fred.stlouisfed.org/series/DSPI

[6] The change in affordability is calculated assuming 80% loan-to-value and a full amortization of the mortgage over 30 years.

[7] Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; October 30, 2020.

https://fred.stlouisfed.org/series/MORTGAGE30US

[8] U.S. Bureau of Economic Analysis, Personal saving as a percentage of disposable personal income [A072RC1Q156SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; October 27 2020.

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[9] The July 2020 Senior Loan Officer Opinion Survey on Bank Lending Practices.

https://www.federalreserve.gov/data/sloos/sloos-202007.htm

[10] https://www.zaisgroup.com/us-banks-in-better-shape.html

[11] S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis; October 27, 2020.

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[12] Federal Reserve Bank of New York Consumer Credit Panel/Equifax; Quarterly Report on Household Debt and Credit, August 2020, page 6.

https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/hhdc_2020q2.pdf

[13] U.S. Census Bureau and U.S. Department of Housing and Urban Development, New One Family Homes for Sale in the United States [HNFSEPUSSA], retrieved from FRED, Federal Reserve Bank of St. Louis; October 31, 2020.

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[14] Bank for international Settlement; Residential Property Prices: Selected Series (nominal and real);

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