Economists Forecast End of Housing Correction

Find out why analysts predict a soft landing.

by Libby Maurer

The industry has kept a watchful eye on housing starts and interest rates since mid-year to get a pulse on when and to what degree residential construction markets will decline this year and into 2007. Chances are excellent you've heard mainstream media outlets paint a pretty gloomy picture of the health and sustainability of national and regional markets. Recently, several renowned construction industry economists have responded by providing fact-based assessments of the drivers behind the declining market and forecasts of what type of outcome we can expect over the next few years. This article will summarize input from a recent NAHB webcast with speakers David Seiders, NAHB Chief Economist; Bernie Markstein, NAHB Director of Forecasting; and Mark Zandi, Chief Economist for Moody's. It also features information presented at BCMC 2006 by Stan Duobinis, PhD, President of Crystal Ball Economics, and data from Al Schuler of the USDA Forest Service.

Housing Market's Impact on U.S. Gross Domestic Product. There's no question about it; our industry contributes heavily to the industry's gross domestic product (GDP) growth each year. These analysts point out that the nation's housing growth contributes significantly to real GDP. Seiders recently testified to the U.S. Senate that the U.S. economy would be able to absorb the recent pull-back in housing starts and decline of new home sales, and wouldn't negatively impact consumer spending or confidence. Zandi reported that in 2005 the housing industry's contribution to GDP growth was 0.5 of 3.5 percent of its overall gain. Duobinis notes GDP slowed to just 1.6 percent during Q3 of 2006, pointing to sharp declines in housing production as the cause.

Duobinis notes that total housing starts fell from an annual rate of 2.123 million during the Q1 of 2006 to 1.735 million during Q3. While multi-family starts dropped by 53,000 (annual rate), single family housing starts tumbled by 334,000 (annual rate).

GDP: What to Expect. Schuler says the consensus GDP forecast for 2007 is about 2.8 percent, down significantly from the estimated 3.4 percent growth for 2006. Duobinis says GDP growth should improve in early 2007 since declines in housing production are expected to change to gains by the second half of 2007 and housing will once again contribute to economic growth.

Drivers of the Slowdown

There is little disagreement among this group as to why housing sales and production in many regions fell in Q2 of this year. Seiders outlines a combination of three main elements. One is a sharp decline in housing affordability in the United States.

Affordability. Here's the housing affordability picture. The Realtors housing affordability index plunged nearly 20 points to just above 100 from 2005 to Q2 of 2006. Seiders explains that on this index, a value of 100 means that a family with a median income has exactly enough income to qualify for a mortgage on a median-priced home. A value of 60 means that a family with a median income has exactly enough income to qualify for a mortgage on home priced at 60 percent of the median-priced home. Some point to the Federal Reserve's steady increase in interest rates over the last 18 months as the catalyst. This decline in affordability

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at a glance

- A combination of high home prices, excess inventory and the tightening of monetary policy and has led to a steady decline in U.S. housing starts.
- The outlook for single family construction should improve by Q3 of 2007, but depends largely on the sale of existing home inventory.
- Because home affordability has decreased in the last several years, the rental component of multi-family construction looks to be strong in the first half of 2007.
- The analysts' consensus forecasts total U.S. housing starts at just over 1.6 million for 2007.

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(the worst since the mid-1980s) is at the crux of this correction, says Seiders.

You've probably heard that in some areas of the country, housing markets have become extremely overvalued. Zandi points to the regions that have dipped below the Realtors 100 mark: most of the western coast, south and central Florida, Chicago, and the Northeast. Some regions have experienced drastic drops in affordability. For instance, the Miami metro area's affordability index has dropped from 120 at the start of the decade to 60 presently. Las Vegas finds itself in a similar situation: from over 130 to under 70. He notes some markets are still fairly affordable, namely Nebraska and Ft. Wayne, Indiana.

The good news is home prices (national average) have started to trend lower. Builders with excessive unsold inventory have been forced to get creative. The result is not only lowering prices, but offering help in fixing up your old home if you buy a new one, or offering to buy your old home.

The Flipper Factor. Seiders, Markstein and Zandi point to short-term investors looking to make a quick profit by purchasing homes, renovating them, and putting them back on the market as another factor that has impacted the housing market. Known as "flippers," these investors are exiting the market as they realize the price of homes is coming down. Markstein addresses the price of new homes in the south Florida and Phoenix markets directly, noting that spikes in demand there have been significantly affected by these flippers. He believes investors in those markets are resisting falling home prices and restrictive mortgage loan options, and it may take longer than expected for these markets to "correct." Markets such as Chicago, Minneapolis, Boston, and San Diego, have already begun this process and are reflecting lower home prices, reports Zandi.

Overbuilding & Excess Inventory. Widespread overbuilding has led to high unsold home inventories, according to economists, which has a direct impact on component manufacturer contracts. Zandi says the gap between new housing supply and demand has widened steadily and currently stands at about 500,000 units. Duobinis used Figure 1 to illustrate the current volume of new home inventory in the U.S. Clearly, new home inventory (national average) is at a record high. Zandi called out the regions that have excessive inventory to sell through: much of the Midwest, New England, coastal California, and Florida. "Homebuilders have put up too many new homes, an overhang that needs to be worked off before the market can right itself," he said.

Also extremely high is the national cancellation rate, according to Seiders. He said an NAHB survey of 30 large homebuilders (about one quarter of the industry) revealed a high and rising cancellation rate through Q2. Since the beginning of 2006, the cancellation rate has doubled from four to almost eight percent.

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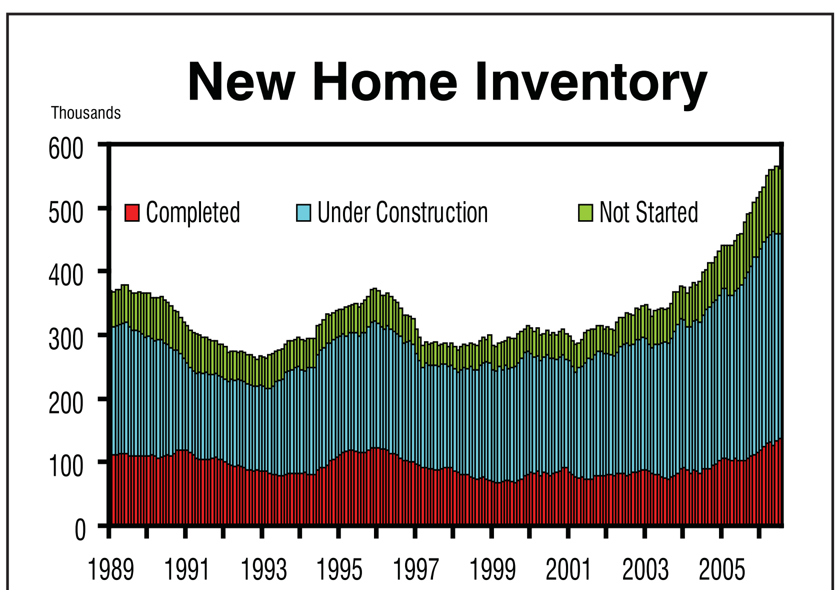
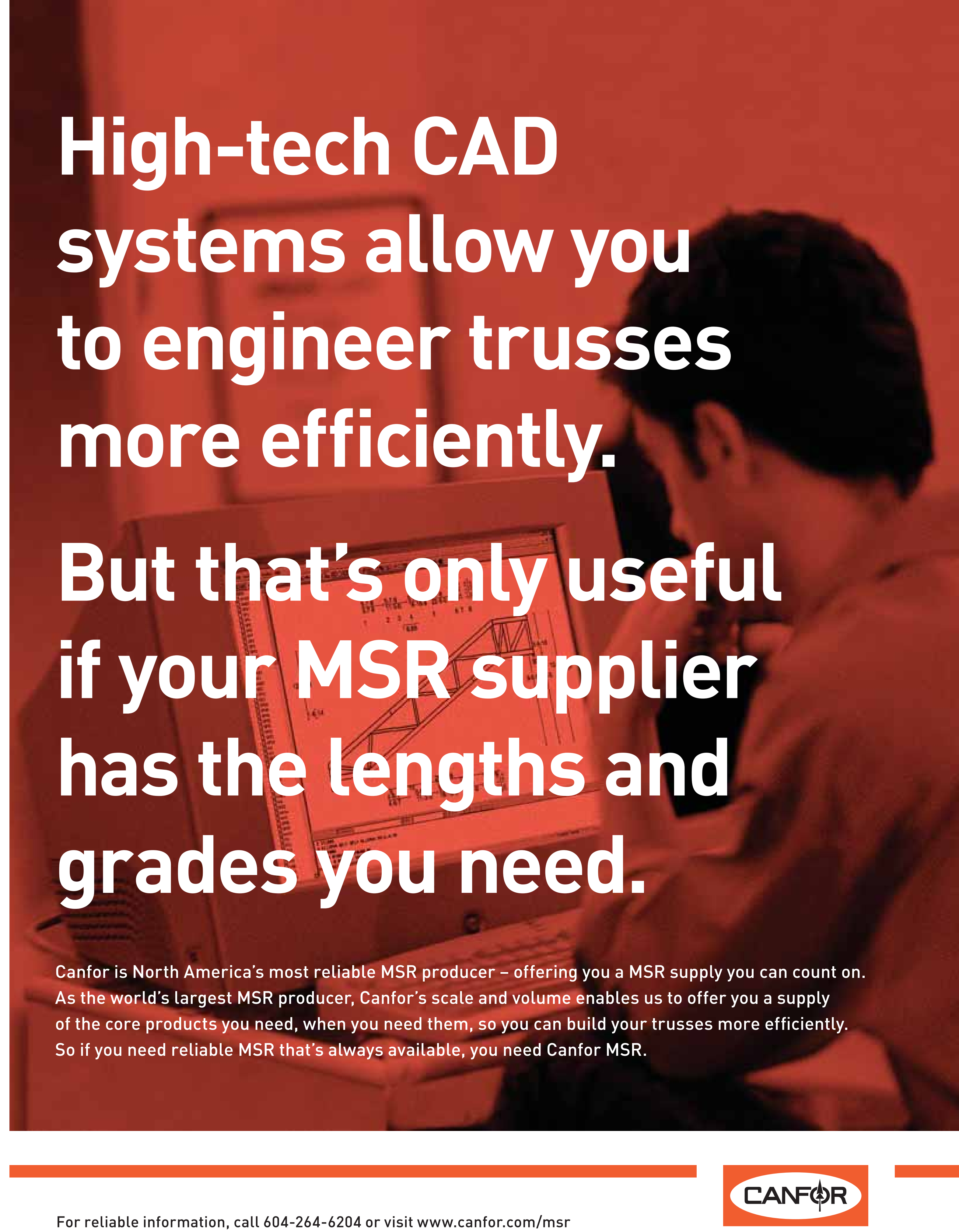


Figure 1. Is The Sky Falling? (Source: Stanley F. Duobinis)



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Multi-Family Report

For those of you supplying the multi-family market, we turn to a forecast by Ron Witten of Witten Advisors, LLC with additional comments from Seiders. With condominium plus rental unit starts totaling 352,000 from Q2 2005 to Q2 2006, the multi-family component of housing has been strong. The question is how long before we can expect a slowdown?

Renting versus buying gap. First we'll look at the rental unit picture. Witten says the premium to buy—the difference between mortgage payment and rental payment per month—is a gap that has widened in the last few quarters. This has created increased rental demand, since buying a home is not an affordable option for most people (see housing affordability section above). Witten notes that the national average of disposable income required to own a home is over 30 percent versus about 17 percent of disposable income to rent. Seiders adds that in rental markets, vacancies rates are falling dramatically and that rents are on a strong upward trend, due to increased rental demand. If the trend on the cost of renting continues, there will be a shift in demand back to purchasing housing. Much of this depends on where interest rates go.

Condo Market. In condominium markets, Witten reports that prices are softening and inventories rising. From August 2005 to August 2006, condo sales fell 16 percent. Conversely, as of July 2006 condo listings rose and the market reflected an eight month supply. It's clear that multi-family markets will have to work through the excess condo inventory, due to conversion of condos to rental units before the complete housing picture moves in a more positive direction. Witten projects selling down the condo inventory depends on just how much builders are willing to cut prices. Seiders notes that due to a hole in government data collection, there is no real data on existing condo inventory, so this is merely a projection based on recent multi-family starts and permits.

Multi-family permits rose to 390,000 as of September, but actual starts remained pretty flat at 346,000. Between Q2 and Q3, multi-family starts average fell only 18,000, about five percent. "This could be due to pre-sale programs and high construction costs where developers are waiting for material and labor costs to go down to get building budgets down," says Witten.

Housing Starts Forecast

All analysts positioned U.S. housing starts to continue retreating through Q1 or Q2 of 2007. Starts peaked in January 2006 at about 2.25 million, and Seiders forecasts a 25 percent peak to trough correction before moving back up in Q3 of 2007. He predicts a somewhat optimistic 1.62 million total starts in 2007, and about 1.725 in 2008. Zandi predicts 1.62 total starts in 2007, and 1.60 in 2008. Doubinis predicts total

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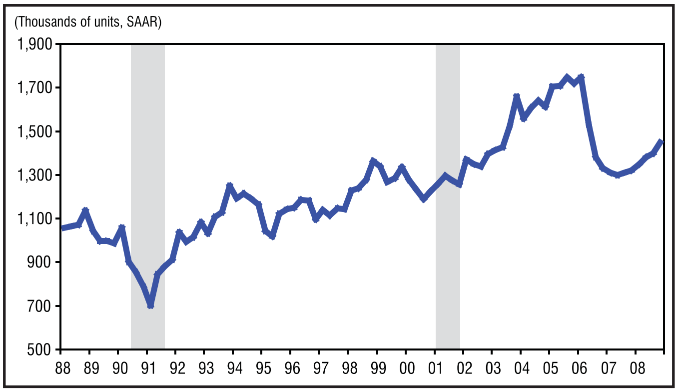

Figure 2. Single Family Housing Starts (Source: Seiders, NAHB, 9/27/06)

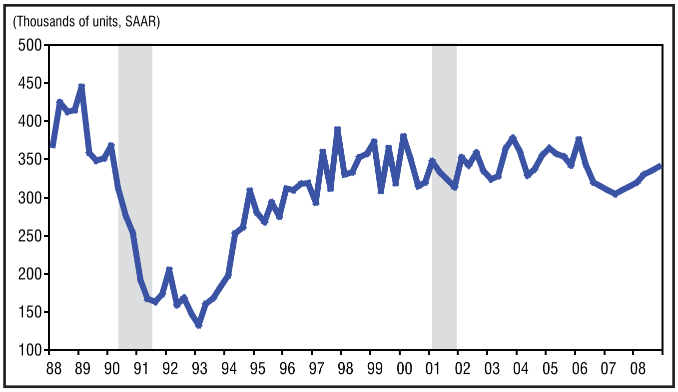

Figure 3. Multi-family Housing Starts (Source: Seiders, NAHB, 9/27/06)

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housing starts will drop by 11 percent from 2006 to 2007, but rebound by 5.2 percent in 2008. A decline of 12.2 percent for single family housing starts is expected in 2007 (about 1.4 million), with multi-family housing starts dropping by six percent (about 300,000).

Witten's combined single and multi-family forecast puts total starts at 1.5 million in 2007. He thinks the multi-family construction picture will improve slightly in 2008. Duobinis says for most of the forecast period through the end of 2008, the multi-family housing market will continue at a pace almost equal to that achieved during Q3 of 2006 (about 350,000). A dramatic rise in the share of this market that is condominiums has helped (and will continue to help) this market to maintain production levels.

Conclusion: "Soft Landing" Projected

Tired of hearing about an alleged "soft landing" for the housing industry? Get used to it. Seiders has been very surprised how quickly the correction has come on, and is encouraged that home prices have started to drop. "The house price topic is so central to how this adjustment will play out," he said. Markstein, Zandi and Duobinis also predict a soft landing, and deny talk of an impending recession. As long as interest rates remain stable through 2007 and builders sell off remaining unsold inventory, the correction is more likely to take months, not years. SBC

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