Housing is a Drag

By Andrew Brod

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This has been a year of surprises for those who thought the housing sector had nowhere to go but up. The cautiously optimistic forecasts of a year ago were proven wrong, as each new release of housing data was more depressing than the one before it. Does the housing slump have the U.S. economy primed for a serious downturn, or are things less dire than they seem?

A year ago it was clear that 2006 had been a very bad year in the housing sector. The median home price in the U.S. fell after a couple of years of double-digit growth. Housing starts fell nearly 15 percent after four years of solid increases.

A survey by the National Association of Home Builders showed that while builders didn't expect 2007 to be a great year, they did expect it to be better than 2006. But even that was too optimistic. According to the federal Department of Commerce, housing starts in the first three quarters of 2007 were 28 percent lower than in the first three quarters of 2006.

The always upbeat National Association of Realtors predicted a small increase in home prices and flat home sales in 2007. But in October the median home price was 5 percent lower than a year earlier, and sales of existing homes for the year are likely to be at least 11 percent lower than in 2006.

It's hard to find much encouragement in the housing data. The number of unsold existing homes in October was 15 percent greater than a year earlier. In 2005 this inventory varied between four and five months of home sales. Now it will take nearly 11 months to sell off the current inventory. And these figures don't include the number of unsold *new* homes, which has also risen sharply.

The homes sitting out there are now less affordable to the typical buyer. The NAHB's measure of affordability is its Housing Opportunity Index. The HOI is the percentage of homes in a region that are affordable to a family earning the median income in that region, based on standard mortgage-lending practices, prevailing interest rates, and so on. In 2002 and 2003, the national HOI averaged 64 percent. Now it stands at 42 percent.

The Triad's Numbers

Things are only a little better in the Triad. In the third quarter of 2007, existing home sales in the Triad were 8 percent lower than a year earlier, and the inventory of unsold homes rose to equal nine months of sales. The average home price increased slightly in the third quarter, but it didn't quite keep up with overall inflation. On the other hand, homes are still relatively affordable in the Triad, with HOI values of 67 percent in the Greensboro-High Point metro area and 73 percent in Winston-Salem.

How did we get here? We can blame a combination of the low interest rates put in place by a frightened Federal Reserve after 9/11, aggressive mortgage lending by the nation's banks, and a lax regulatory environment for mortgage derivatives. There's nothing new about converting mortgages into tradable securities. But the prices of new-fangled instruments like collateralized debt obligations failed to incorporate enough risk. Had those securities been priced and rated correctly, financial markets would have sent the right signals to lenders. Instead, the signal they received was to keep lending aggressively, even to borrowers betting on rising home prices. That worked as long as prices kept rising.

Looking Ahead

The big questions now are whether the correction in the housing sector will continue in 2008, and to what degree this will affect the broader economy. The media keep talking about consumers using their rising home equities as virtual ATMs, with the implication that falling home prices will lead to large declines in consumer spending. But the statistical evidence for such a strong linkage is mixed at best, and in any case consumers are still spending. U.S. personal consumption in the third quarter was 2.9 percent higher (after inflation) than a year earlier.

The major forecasts see a continued weakening of the economy in 2008, but few are predicting a recession. The U.S. economy is a model of resiliency, in spite of our apparent attempts to screw it up. To be sure, a recession is possible. Economists surveyed last month by the National Association for Business Economics raised their assessment of the odds of a recession next year. But even so, roughly 60 percent of them put the risk of a recession at less than one in three. That's not a ringing endorsement, but it's better than nothing.

The NABE survey predicts that the economy will grow by 2.6 percent next year, which is in line with other major forecasts. For example, both Wachovia Bank and the Bush administration are forecasting 2.7 percent growth. Growth of less than 3 percent indicates a weaker economy than we'd like, but it does not indicate a recession. I should note that these forecasts were made before the Bush administration announced its plan to help troubled mortgage borrowers. However, few analysts think the plan (which is really an industry-led agreement rather than a government bail-out) will make much difference.

The housing slump has been pretty bad news for the home-furnishings industry, which of course has a huge presence in the Triad. The rule of thumb in the industry is that a fifth of all sales derive from a home purchase. Sure enough, in the 12 months that ended with the third quarter of 2007, retail sales in furniture stores dropped for the first time since the recession year of 2001.

Turnaround by '09?

Unfortunately, there are no indications that the housing sector will turn around quickly. There will probably be more pain in 2008. The NABE survey predicts an 11 percent drop in housing starts next year, and Wachovia predicts a 9 percent drop. But things will eventually get better. They always do. Wachovia's economists believe the turn-around will happen as soon as 2009, when they predict a 5 percent increase in housing starts.

The housing sector has exhibited boom-and-bust cycles for decades. The current bust isn't the first one and it won't be the last one. This one is certainly unpleasant, especially for home builders, mortgage lenders, furniture retailers, and anyone who's trying to sell a house. But at least the housing bust is unlikely to drag the rest of the economy into a recession.

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