

U.S. Housing Market: Still a Fixer-Upper

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We've said it before and we'll say it again: The long-awaited economic recovery probably won't start until housing markets stabilize. Falling home prices encourage consumers to save more, owners to walk away from their homes, and banks to tighten credit standards. So, is the worst housing market slump since the Great Depression finally over?

With first-time buyers attracted by record affordability and an \$8,000 tax credit, one would think that home sales would be rebounding sharply (as in Canada). However, after tumbling 34% since 2006, existing home sales have risen just 6% from January's decade low (*Chart 1*). New home sales also remain in the cellar after swooning 75% from their peaks, as buyers prefer to kick the foreclosure tires, looking for good deals. Builders are taking twice as long as normal to sell a completed home. Underlying demand remains weak, with move-up buyers largely missing in action.

On a more positive note, fire-sale prices are driving home sales higher in three of the hardest-hit states — California, Nevada and Arizona (*Chart 2*). As well, home builders have reported a slight upturn in sales expectations. Sales could get a lift later this year if the government opts to extend the home buyers' tax credit beyond November 30 and make it available to all purchasers. Medium term, the market should receive a boost from the 75 million echo boomers (born between 1979 and 1995) who are now entering their prime home-buying years.

While sales are starting to see the light, construction remains deep in the tunnel. Despite tumbling 77% from peak levels, starts continue to hover near record lows of one-half million units — less than half the level required to support household formation (*Chart 3*). While this represents a payback from several years of over building, it does flag a pick-up in starts once demand improves.

However, there's no shortage of homes in the larger resale market. The supply of vacant homes for sale has stayed above two million for several years, and may need to fall to 1½ million to stem the decline in prices (*Chart 4*). And, this

CHART 1
SALES BOTTOMING BUT NOT BOUNCING

United States (mlns of units : s.a.)

Existing Home Sales

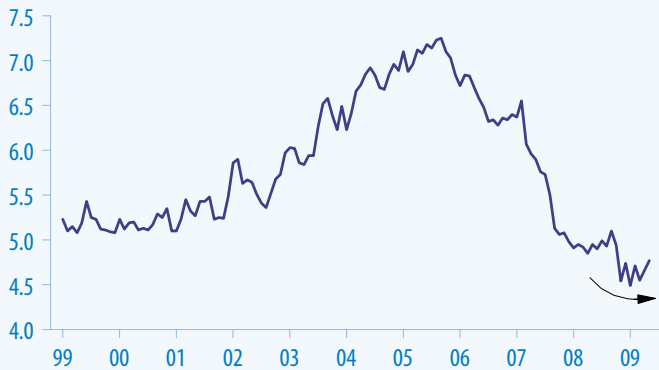


CHART 2
FROM WORST TO FIRST

United States (000s of units : s.a.)

Existing Home Sales

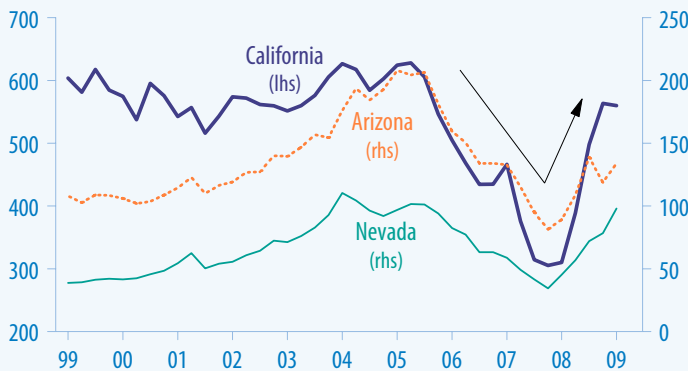


CHART 3
GROWING PENT-UP DEMAND FOR NEW HOMES...

United States (mlns of units)

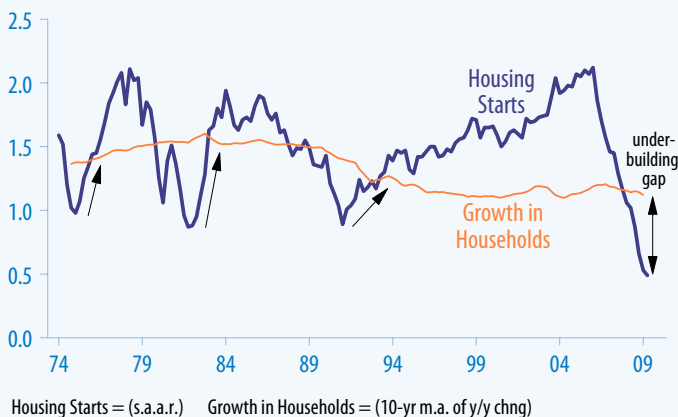


CHART 4
...BUT TOO MANY VACANT HOMES ON THE MARKET

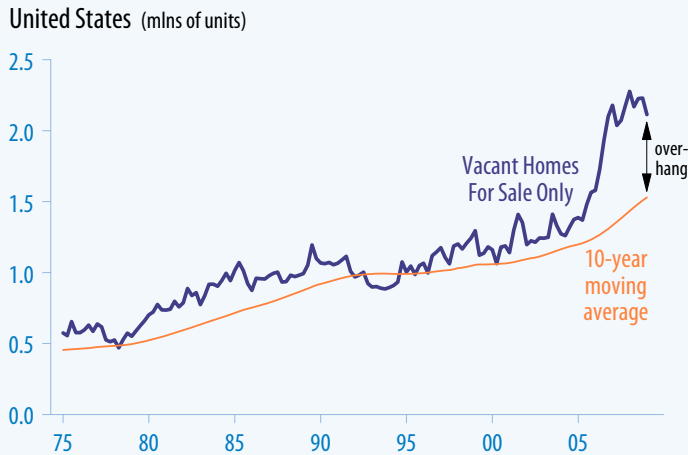


CHART 5
PRICES STILL FALLING FAST...

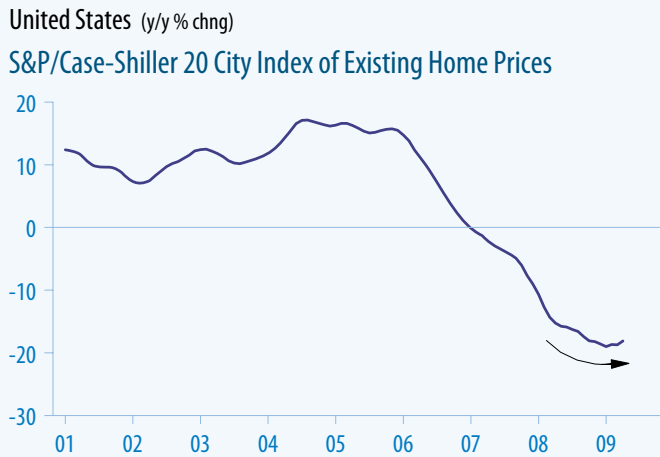
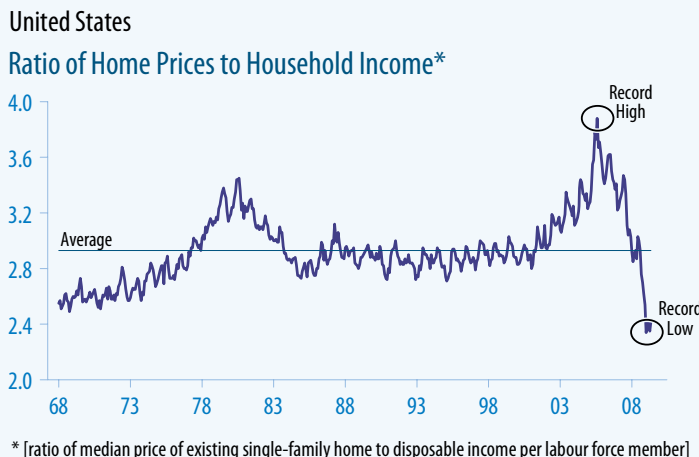


CHART 6
...AND NOW OVERSHOOTING ON DOWNSIDE



doesn't include a possible excess of one million vacant homes not for personal use that are held off the market.

The overhang could take a while to deplete because of the foreclosure crisis. The percentage of mortgages at least 30 days past due hit new highs in May, flagging more foreclosures ahead. The government's slow-moving \$75 billion mortgage-modification program has had limited success in keeping troubled owners in their homes. Should the homeownership rate decline a further one-percentage point to pre-boom levels, one million more homes could flood the market, adding to the record inventory of 1.7 million properties in foreclosure. While people need somewhere to live, there are still plenty of pickings in the rental market, with a vacancy rate near a record-high 10%.

Because of the glut of unsold homes, the three-year slide in prices shows few signs of slowing, let alone stopping. The Case-Shiller index sank 18.1% y/y in April versus 18.7% in March. It is down a massive 33% from mid-2006, wiping out more than \$6 trillion of wealth (Chart 5).

While excess supply points to lower prices ahead, the bottom is probably within reach. Prices have fallen to historically low levels relative to household income (Chart 6). In some regions, low prices have sparked bidding wars, with first-time buyers competing against investors. When most of the distressed properties are sold, prices in the broader market should begin to stabilize.

But the risks remain on the downside. Prospective buyers are crowding the sidelines waiting for the steep decline in prices to slow. Deferred demand begets still-lower prices, thereby keeping credit standards tight, destroying wealth, and driving more mortgagees underwater. Roughly one-in-five owners (15 million) owe more than their house is worth. On a more positive note, an eventual bottoming in prices should unleash some pent-up demand.

Bottom Line: The long slump in U.S. home sales is likely over, thanks to record affordability. However, demand remains too weak to absorb the still-high number of vacant and unsold homes that is driving prices down and prolonging the recession. Still, home prices have likely overshot their fundamental levels (on the downside), and may not have much more room to fall.

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