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GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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GLOBAL MACRO

Could US housing prices plummet again ?

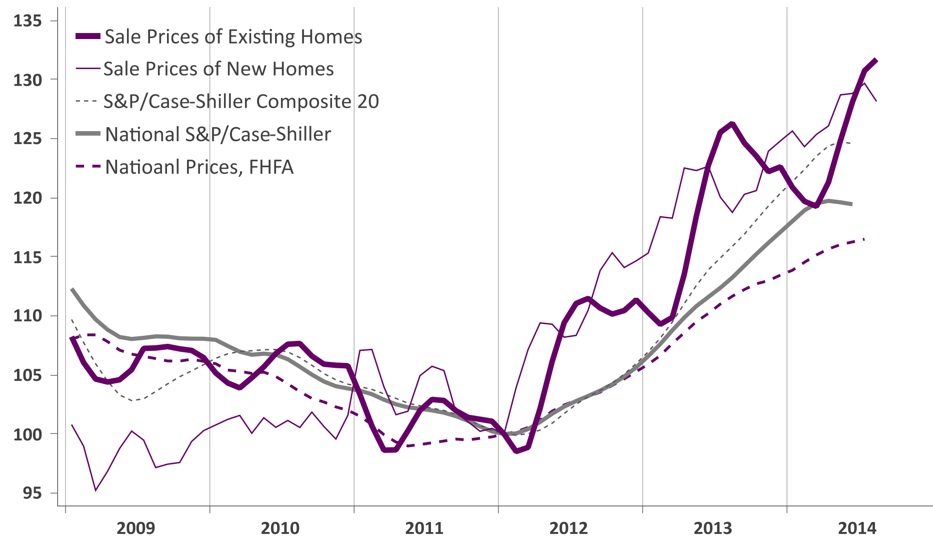
In the past two years, the contradictions on the U.S. housing market have continued to get worse. Higher property prices, often seen as an indicator of a healthier market, now seem disproportionate compared with the reality of a market that is still limping from the battering it took during the crisis. As Fed members seem increasingly impatient to trigger a rate hike cycle, the imbalances resulting from this distortion pose a serious threat that prices could fall again.

Observation #1: Prices have rocketed...

Real estate is no longer a hot topic and has fallen off of many analysts' radar recently. It's as if real estate has become a non-issue, particularly in economies where prices have headed upwards once again. In the United States, when prices began to rise in early 2012 it triggered the gradual return of confidence in the U.S. economy. Market observers have seen many different factors at play:

- evidence that demand is picking up and that individuals' indebtedness is no longer a serious impediment to growth,
- a factor rebalancing the financial situation of households and, as a result, banks' bottom lines - this scenario immediately translated into the beginning of the sector's recovery in the stock market,
- the possibility of a stronger recovery in household consumption, particularly in household goods; consumption is supposed to pick up as rising prices increase households' wealth effect.

U.S. Real Estate Prices



Sources : RichesFlores Research, Macrobond

The fact is that the revaluation of the housing sector has been spectacular in the last two years. The price rebound, depending on which measures and geographies are used, ranged from 16% for the FHFA's housing price index to over 30% for existing home sales or 25% for new builds.

...yet demand is not the cause.

The favorable trend in prices hardly reflects the scenario generally used to explain higher prices. Unlike the usual - and normal - way the real estate market works, no indicator measuring individual demand has justified the upwards revision to prices in the last two years.

Admittedly, housing starts have increased almost two-fold since the worst of the crisis but they are still weak. At a mere 1 million units per year, they are still a good deal off from their long-term average of 1.5 million and continue to flirt with lows not seen since the pre-2008 recessions.

- Homeownership rates have yet to stabilize: 64.7% in June 2014 instead of 65% the previous year and 69% before the crisis.

- the number of mortgage applications is stuck at levels that are even lower than those in 2008. Although home loans have recently improved, this uptick can be attributed to bigger mortgages and not an increase in the number of loans being requested.

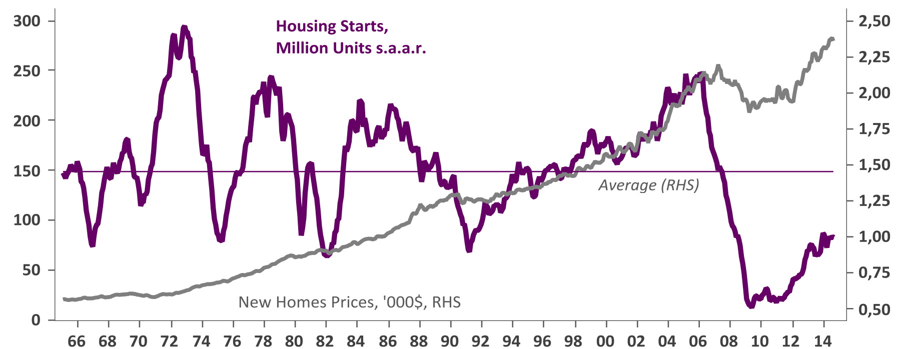
Given the conditions on the ground, it is difficult to find any argument explaining why prices have soared in the past two years; Rather, it seems like higher prices can be chalked up to the combination of the following two factors:

- lack of supply, due to 1) the bulldozing of many existing homes in neighborhoods that fell on hard times during the subprime crisis 2) given the low prices at the time, homeowners found themselves in negative equity (i.e. the

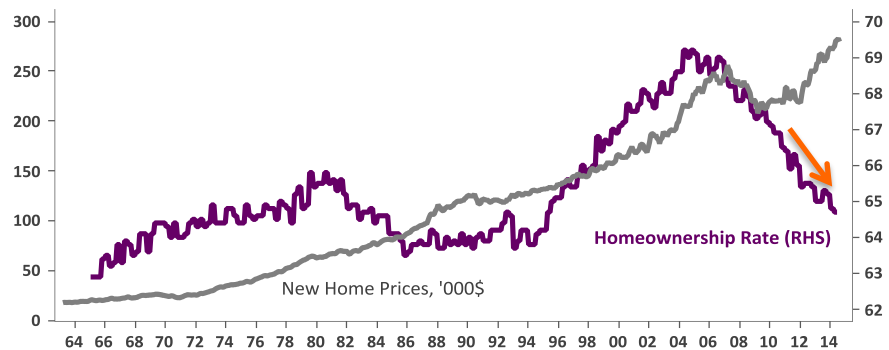
market price of their home was less than the aggregate of their future mortgage payments) and 3) a sharp reduction in the mobility of Americans due to both the crisis and the ageing population.

- a shift to new homes whose average price is now higher than before the crisis
- massive acquisitions by institutional investors who have artificially inflated prices, which could very well be collateral damage of the Fed's quantitative easing.

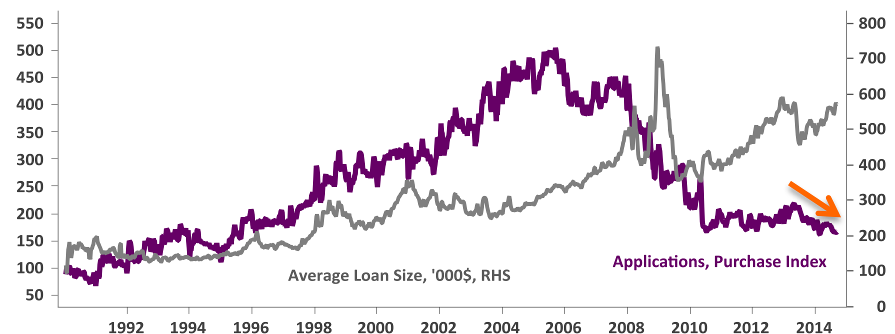
Housing Starts and Prices



Homeownership Rate and Prices



Mortgage Applications and Average Loan Size



Sources : RichesFlores Research, Macrobond

Such a situation fuels imbalances that harm the return of more solid fundamentals on this market.

Americans' real wages have hardly budged in the past two years and high prices seem increasingly out of step with the economic situation of a population whose financial situation has deteriorated considerably on average, although this varies tremendously depending on socio-professional category and region.

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Serious possibility that prices will fall if interest rates increase

Current developments are, on balance, well removed from the ideal scenario imagined by many market players. Not only have higher prices failed to increase the wealth effect, which was a highly-disputable argument to begin with but the present situation has raised a number of red flags:

1- First, the risk of over-estimating the health of U.S. households. An erroneous analysis of housing market trends would thus skew the consumption outlook and, consequently, the U.S. growth forecast.

2 - Second, the risk of over-estimating the ability of households to handle more onerous lending conditions, which would result from anticipations of tighter Fed monetary policy.

3 - Third, the risk deriving from the fact that individuals, who are starting to feel the positive effects of higher job creation, are largely shut out of the housing market given soaring prices.

4 - Lastly, the risk that investors holding property assets will be unable to offload their properties under the conditions they had been hoping for. This could eventually lead to lower prices, which currently seem over-inflated seen against current demand.

Given this analysis, the possibility of a Fed rate hike in the foreseeable future should be scrutinized very closely. Such a move could provoke adjustments to an equilibrium that remains altogether too tenuous...

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