Meketa Investment Group Global Macroeconomic Research Series

The U.S. Housing Market

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U.S. economic expansions, contractions, and subsequent recoveries are inextricably linked to the housing market. Housing has always played a major role in economic cycles, but for a number of reasons its direct and indirect impact on the overall economy has increased over time. Thus, any forecast of U.S. economic activity must include an analysis of the state of the housing market. In this paper, we examine the past and current role of housing in the economy, illustrate how this recovery has differed from past cycles, assess the current state of the housing market, and offer a brief outlook for what may lie ahead.

The Role of Housing in the U.S. Economy

While not a particularly large percentage of our country's GDP (see chart below), the impact of housing on the U.S. economy is easily understated due to its numerous indirect effects. Aside from the obvious links to construction employment and home-related retail sales, the modern U.S. economy has become even more dependent on housing through channels such as collateral for loans to increase consumption (e.g., home equity lines of credit).

Residential Investment/GDP [1]

A number of studies have attempted to quantify the "multiplier effect" housing has on the broader economy. For example, a home purchase usually results in further spending in other sectors of the economy (landscaping, appliances, etc.). The income earned by the landscaper or appliance maker is then re-distributed into the economy, leading to another round of income and purchases. The National Association of Realtors (NAR) estimates the multiplier effect to be between 1.34 and 1.62 in the first year or two after the initial housing purchase. This means that each dollar increase in direct housing activity will increase the overall GDP by $1.34 to $1.62.[2] An independent study by The Liscio Report yielded similar results, estimating that each dollar spent on residential construction generates $1.27 in additional economy activity.[3] Quantifying the impact of housing in the U.S. economy is far from an exact science, but needless to say, it is a critical component.

The Role of Housing in the Business Cycle

While housing is always an important part of the overall economy, its impact is often most pronounced during shifts in the business cycle. This is due to the fact that housing demand is quite sensitive to interest rates, and is thus a disproportionately important part of how monetary policy ultimately impacts the real economy. In other words, when the Federal Reserve lowers interest rates to stimulate the economy,

[1] Source: Bloomberg

[2] Source: *Economists' Commentary: How Home Sales Stimulate the Economy*, National Association of Realtors, March 27, 2009.

[3] Source: *The Peroxide Plot*, Barron's, August 14, 2006.

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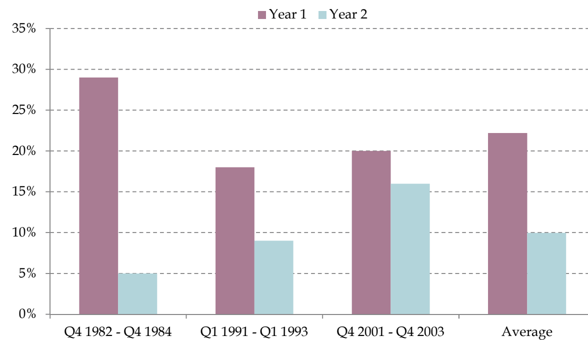
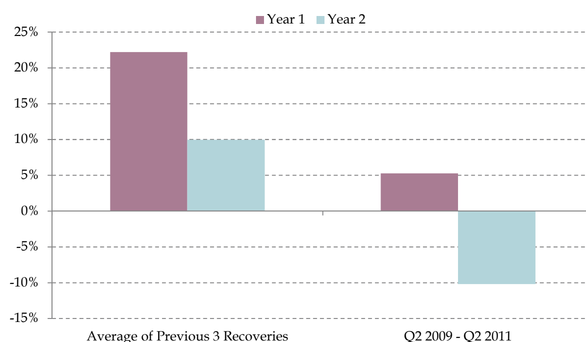
Residential Investment Share of GDP Growth (Previous Three Economic Recoveries) [1]



this typically has a direct flow through to mortgage rates and ultimately housing demand.

As shown in the chart above, in the typical business cycle recovery, residential investment contributes significantly more to growth than would be expected given its long-term share of GDP. In the past three recoveries, residential investment on average contributed more than 20% of GDP growth in the first year, and 10% of the growth in the second. Both numbers are far above the long-term average, suggesting that housing plays a critical role in the economy's initial recovery from recession.

Residential Investment Share of GDP Growth (Previous Three Economic Recoveries vs. Current Recovery)[1]



This Cycle Has Been Different

As seen in the chart above, however, this most recent cycle has been decidedly different. Our economy's tepid recovery from the Global Financial Crisis (GFC) is, in part, due to the uncharacteristically muted response of residential investment to historically low interest rates. In slashing interest rates post-2008, the Federal Reserve has done what they have always done to re-stimulate the economy, yet the housing market has not responded in the same way.

As discussed in previous newsletters, this occurred because the current economic cycle is structurally different from the typical economic recession and recovery. The more usual economic recession (or business cycle recession) is caused by a tightening of central bank monetary policy to suppress demand and cool down an overheating economy. The cycle begins to turn when policy is reversed, monetary conditions ease, and the economy starts to recover through the normal channels of borrowing and spending, including housing.

This most recent cycle was not caused by monetary tightening, however, but quite the opposite. Monetary policy that was too loose for too long played a major role in creating a nationwide real estate bubble that ultimately brought down the broader economy. Given the unique nature of this crisis, it should come as no surprise that the standard monetary response proved much less effective, at least initially.

Furthermore, while the Federal Reserve was successful in lowering the price of credit (i.e., interest rates), the real problem facing U.S. homeowners is access to credit. As a result of the housing bust, more than 20% of current homeowners are estimated to be "underwater" on their mortgages.[2] This makes it extremely difficult, if not impossible, for these homeowners to refinance mortgages or borrow more money regardless of the interest rate. Thus, the standard monetary policy response has little effect on those who need the most help.

Knock-On Effects

Residential investment and its direct impact on GDP growth is only one facet of the economy that suffered due to the drop in home prices. The negative "wealth effect" of declining home prices caused the multiplier effect discussed earlier to work in reverse. Overall household wealth (including financial assets) declined

[1] Source: Bloomberg

[2] Source: CoreLogic (www.corelogic.com), Zillow (www.zillow.com)

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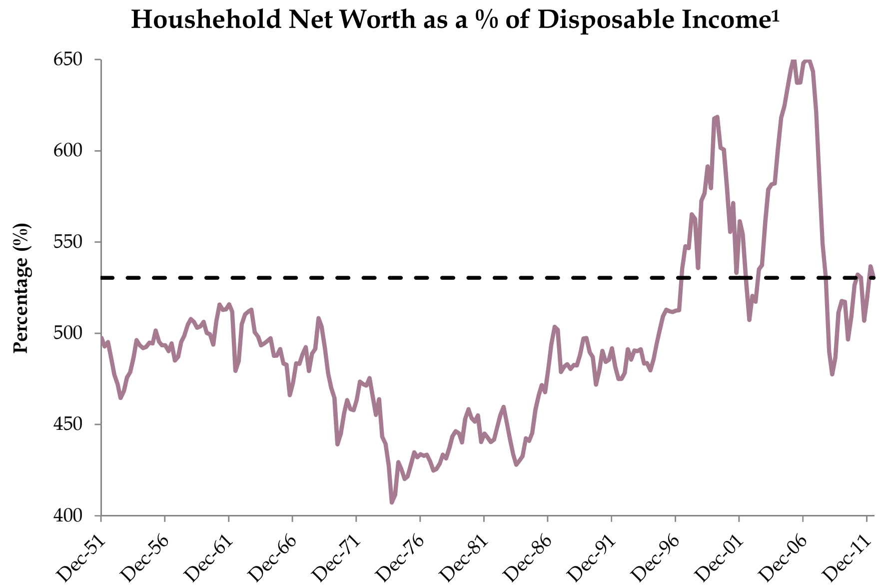
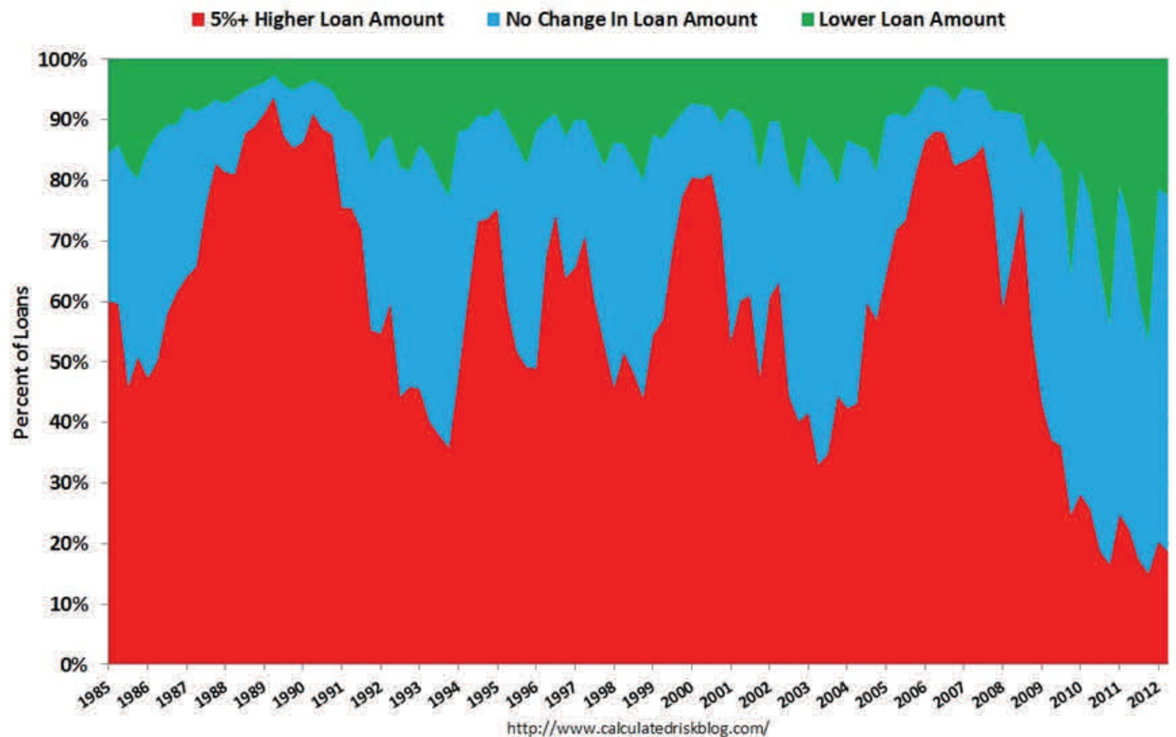
significantly as a family's home is often, by far, its largest asset. As shown in the chart to the right, while it rebounded off the Global Financial Crisis lows, household net worth as a percentage of disposable income is still at a level first crossed in June 1997.



Consumer spending, the lifeblood of the modern U.S. economy[2], was also impacted as homes were often used as collateral for loans to finance consumption. While many homeowners refinanced their mortgages in recent years to take advantage of lower interest rates, the number of "cash-out refinancings" (i.e., money withdrawn to presumably finance consumption) collapsed. This metric is represented in the chart below by the "5%+ Higher Loan Amount."

[1] Source: Bloomberg

[2] Household financial consumption expenditure (i.e., consumer spending) was 72% of U.S. GDP in 2011, according to the World Bank (www.data.worldbank.org)



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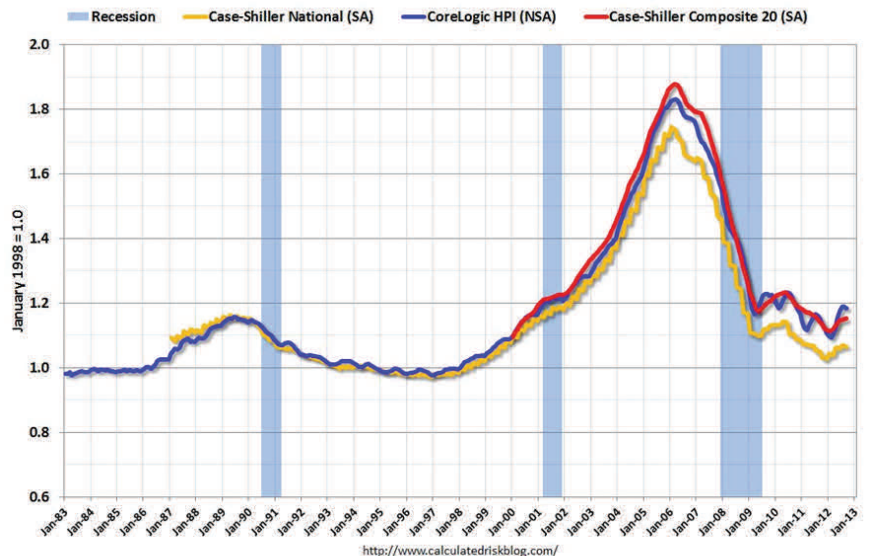
Current State of the Housing Market

New Housing Starts[1]

On the bright side, there is some evidence that housing prices are beginning to stabilize. The widely-followed S&P Case-Shiller National Home Price Index has shown signs of improvement in recent months, rising 4.3% in the 12 months ending October 31, 2012. Furthermore, other key housing-related metrics such as housing starts (see the chart above), affordability and price-to-rent ratios have improved substantially in recent years.

Overall supply and demand dynamics continue to improve, and the overhang of unsold housing inventory continues to shrink. Realtor.com recently reported that the total U.S. for-sale inventory of single family homes, condos, townhomes and co-ops was down over 17% in December 2012 compared with one year prior; and stood at roughly half its peak of 3.1 million units in September 2007.[2]



There remain several serious obstacles, however, to a full-blown housing recovery. General economic weakness caused by the ongoing deleveraging environment should continue to weigh on unemployment and household formation (two significant factors influencing housing demand). Furthermore, tighter lending standards implemented by banks post-2008 (e.g., requiring a meaningful down payment again) means that even those not encumbered by an underwater mortgage will find it much harder to purchase a home than in prior years.

"Shadow Inventory"

An ongoing concern and potential impediment to a robust housing recovery has been the so-called "shadow inventory." There are slightly varying definitions of shadow inventory, but one of the more widely-used proxies is calcu-

[1] Source: Bloomberg

[2] Source: www.realtor.com

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lated by CoreLogic, who defines it as the number of distressed properties not currently listed on multiple listing services (MLSs) that are seriously delinquent, in foreclosure, or real estate owned (REO) by lenders.

In other words, shadow inventory is an estimate of pending housing supply that could come to market when housing prices begin to recover. The fear, of course, is that any recovery in demand will be overwhelmed by this new supply of homes for sale, pushing prices back down. As the following chart illustrates, shadow inventory is at a level three times greater than what it was pre-GFC.

Fortunately, there are signs that this risk is dissipating. CoreLogic recently reported that the residential shadow inventory as of October 2012 fell to 2.3 million units, representing a supply of seven months. This was a 12.3% drop from October 2011, when shadow inventory stood at 2.6 million units, approximately the same level as in March 2009.

Perhaps contributing to the recent decline in observed housing inventory, however, is some evidence that banks are delaying foreclosures to avoid overwhelming the market with more homes for sale. While this has a stabilizing effect on prices in the short-term, it also means that it will take that much longer for the market to truly "clear" and begin a robust recovery.

Looking Ahead

The lack of recovery in the housing market has been a significant factor in the sluggish recovery of the overall economy. While there are a number of reasons to believe that conditions have stabilized, a market "bottom" and a strong market "recovery" are two very different things. We believe recent evidence points more to the former than the latter. Simply removing housing as an economic headwind, however, is a positive in itself. Thus, while we do not expect housing to be its typical engine of economic recovery, we do not expect it to be a material drag on economic growth going forward either.

Shadow Inventory Detail
Count in Millions, Not Seasonally Adjusted