

The “Recovery” in U.S. Housing Prices

**Post-Crisis Supply Constraints and Prevailing Mortgage Interest Rates
have Severely Exaggerated True Demand and Distorted Prices**

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The “Recovery” in U.S. Housing: Restricted Supply, Cheap Money and Prices – The Crisis Never Ended

- Housing prices have recovered over 54% of their dramatic 33% decline from peak 2006 levels to their nadir in early 2012.
- Yet underlying data indicates that ***the price recovery is not a recovery in the demand for owner-occupied homes***. Rather, it is more the result of two factors:
 - (i) the knock-on effect of the mortgage bubble and crisis of the mid-2000s that has yielded a shortage of homes for sale; and
 - (ii) historically low mortgage interest rates unique to the present macroeconomic environment.
- Neither of these phenomena are characteristic of a normal recovery in the housing sector and are not likely to be sustainable in the absence of other supporting factors.
- Accordingly, it is unclear that we have reached a point of real price discovery in U.S. housing and, with deflationary pressures bearing down on the U.S. economy, whether the housing sector – as it has for the past two years – will continue in its role as nearly the only force holding service sector price growth positive.

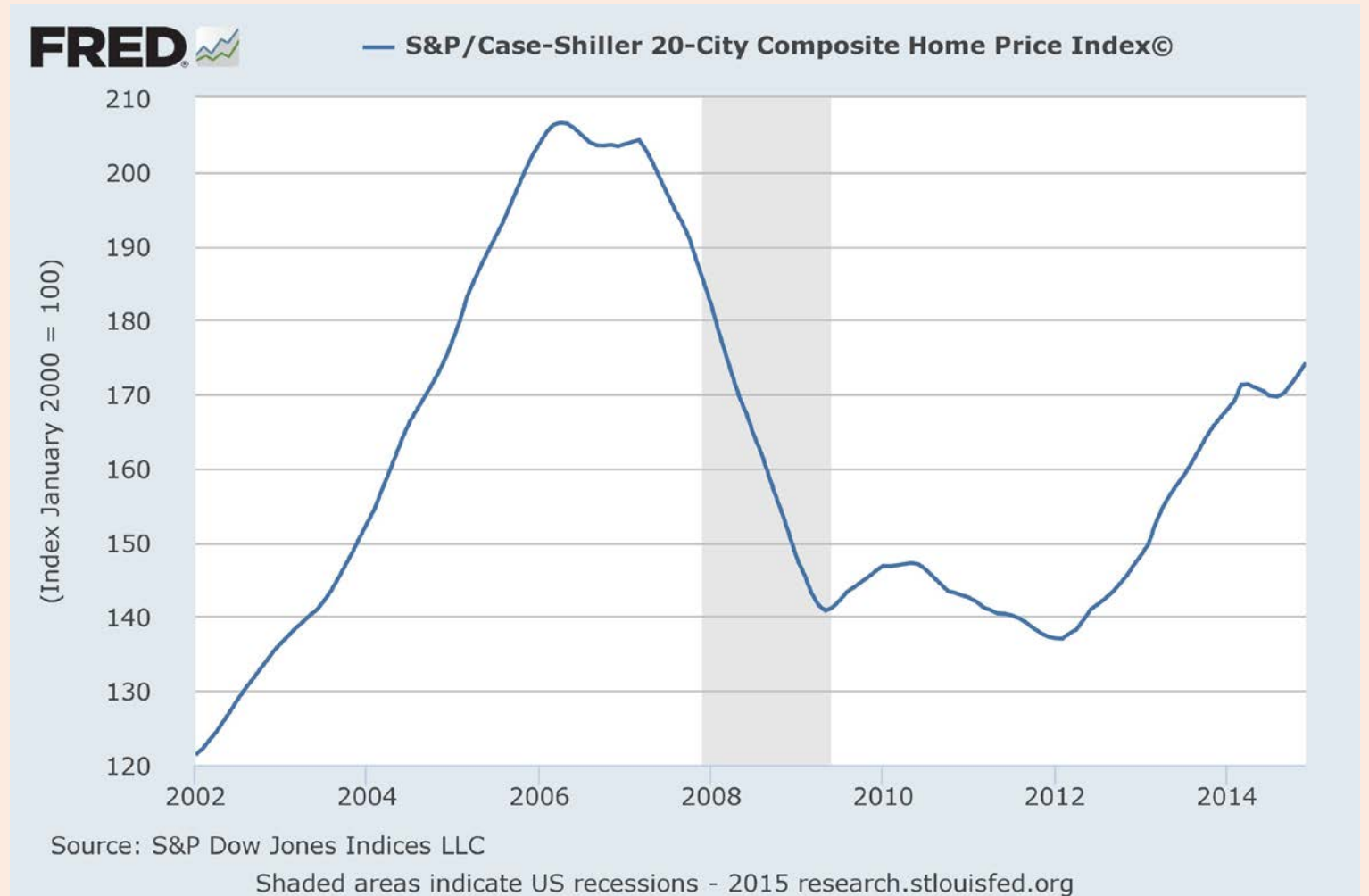
The Recovery in U.S. Owner Occupied Housing Prices Since 2012

From a crisis low in early 2012, U.S. housing prices have experienced nearly continuous recovery of over 54% of the value lost from 2006 through their nadir.

That long-term record-low interest rates have fueled much of that price growth is impossible to deny. That housing prices (as evidenced by the bobble in prices during the QE “taper tantrum” in the bond market during late 2013) are reactive to hikes in prevailing interest rates can hardly be ignored.

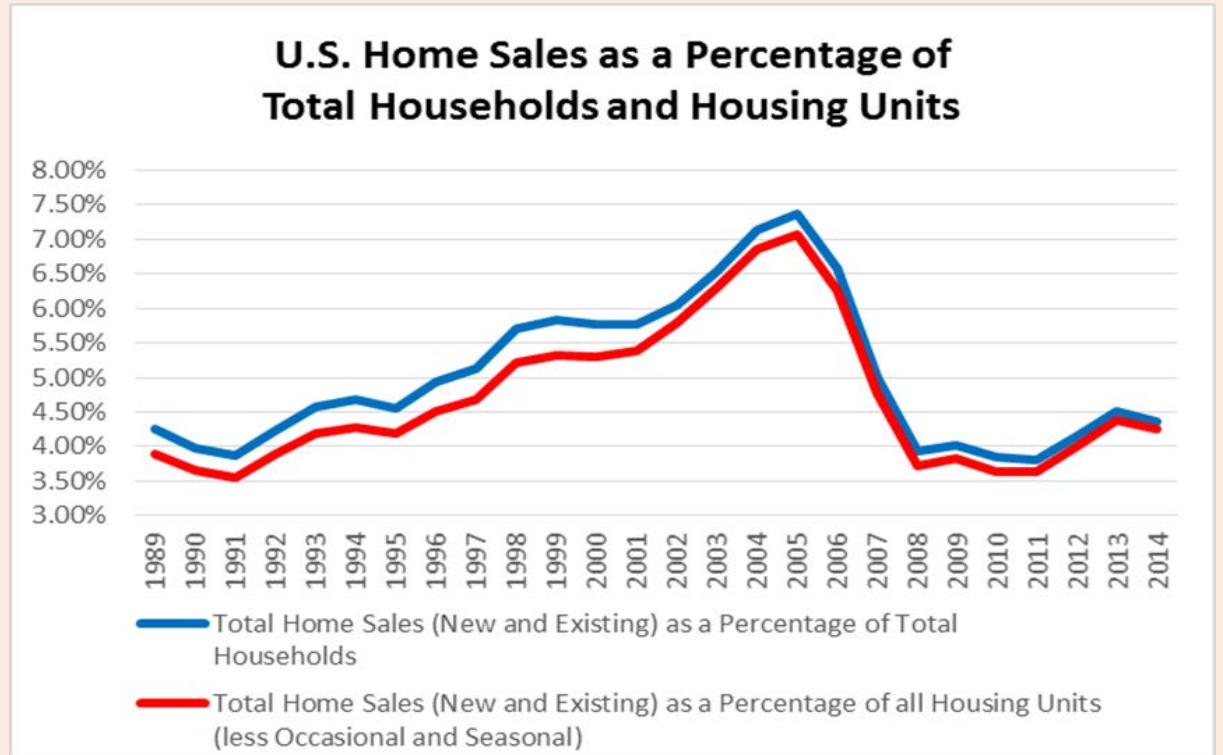
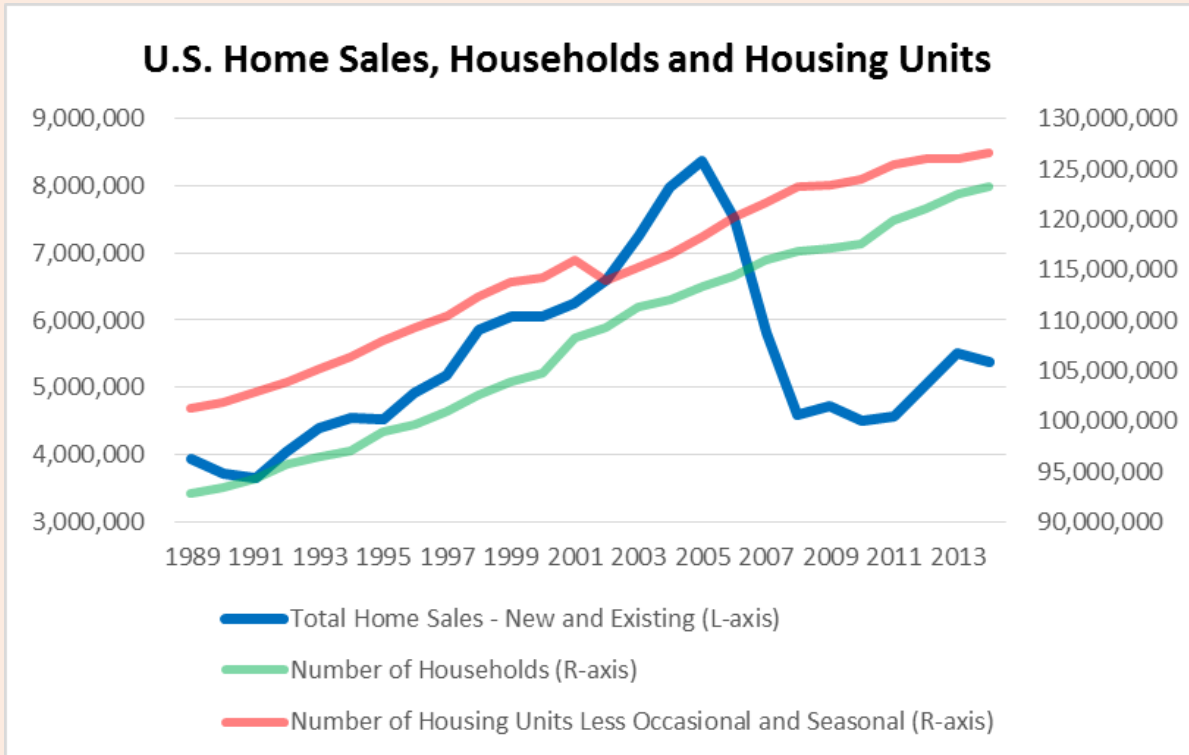
But there is more to this story than just interest rates...

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Demand for U.S. Housing has not Recovered Nearly as Much as Prices

Aggregate new and existing home sales volume expanded only 17.7%, cumulatively, during the three years that prices increased (2012 – 2014). Y/Y volume actually fell from 2013 to 2014. And cumulative sales growth is even lower when adjusted for growth in the number of households or housing units.

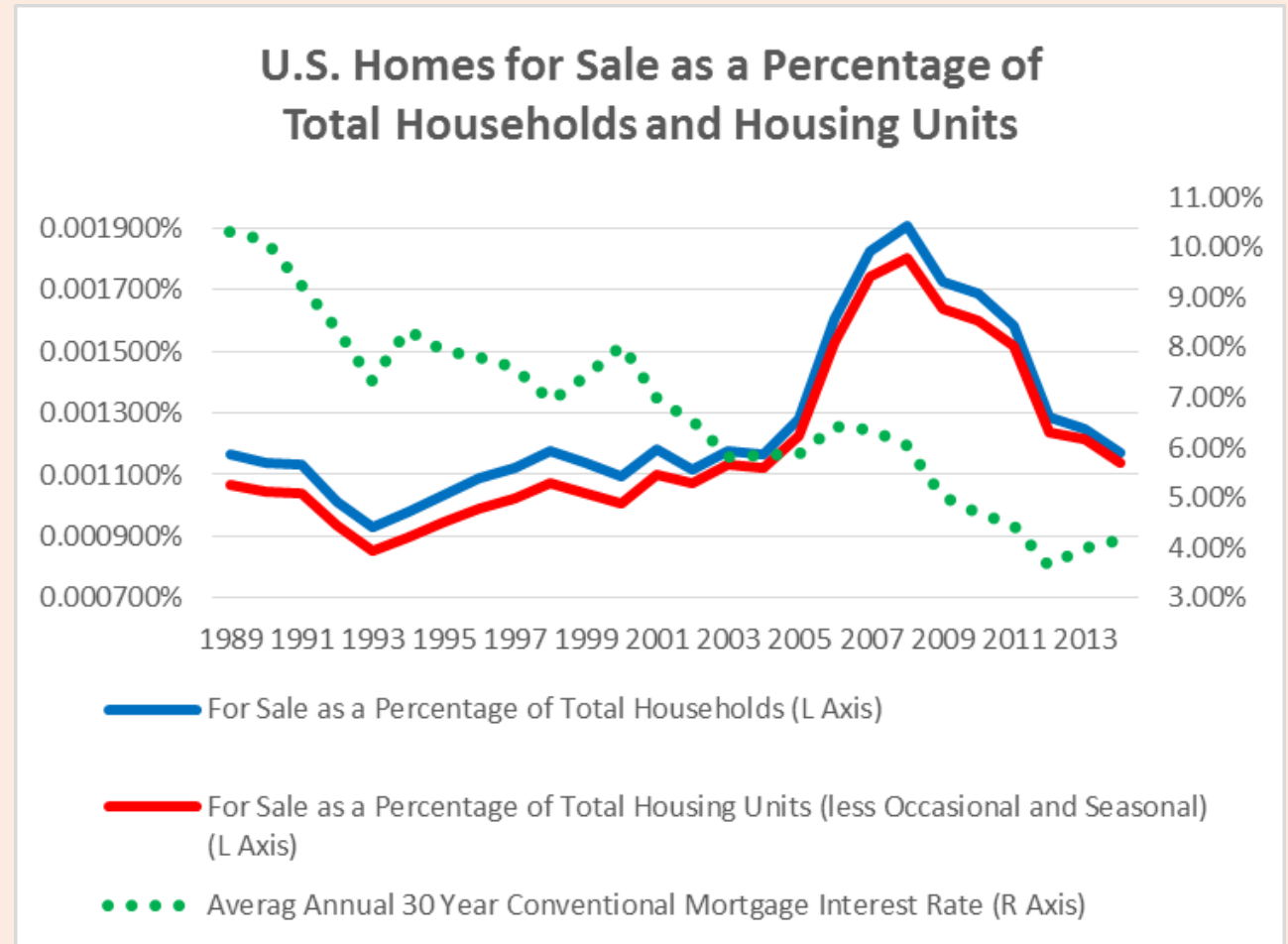


Sources: U.S. Census Bureau; National Association of Realtors, U.S. Federal Reserve Bank of St. Louis

The Number of Homes for Sale, Relative to the Total Number of Households or Housing Units, has not Recovered at all – Despite Low Interest Rates

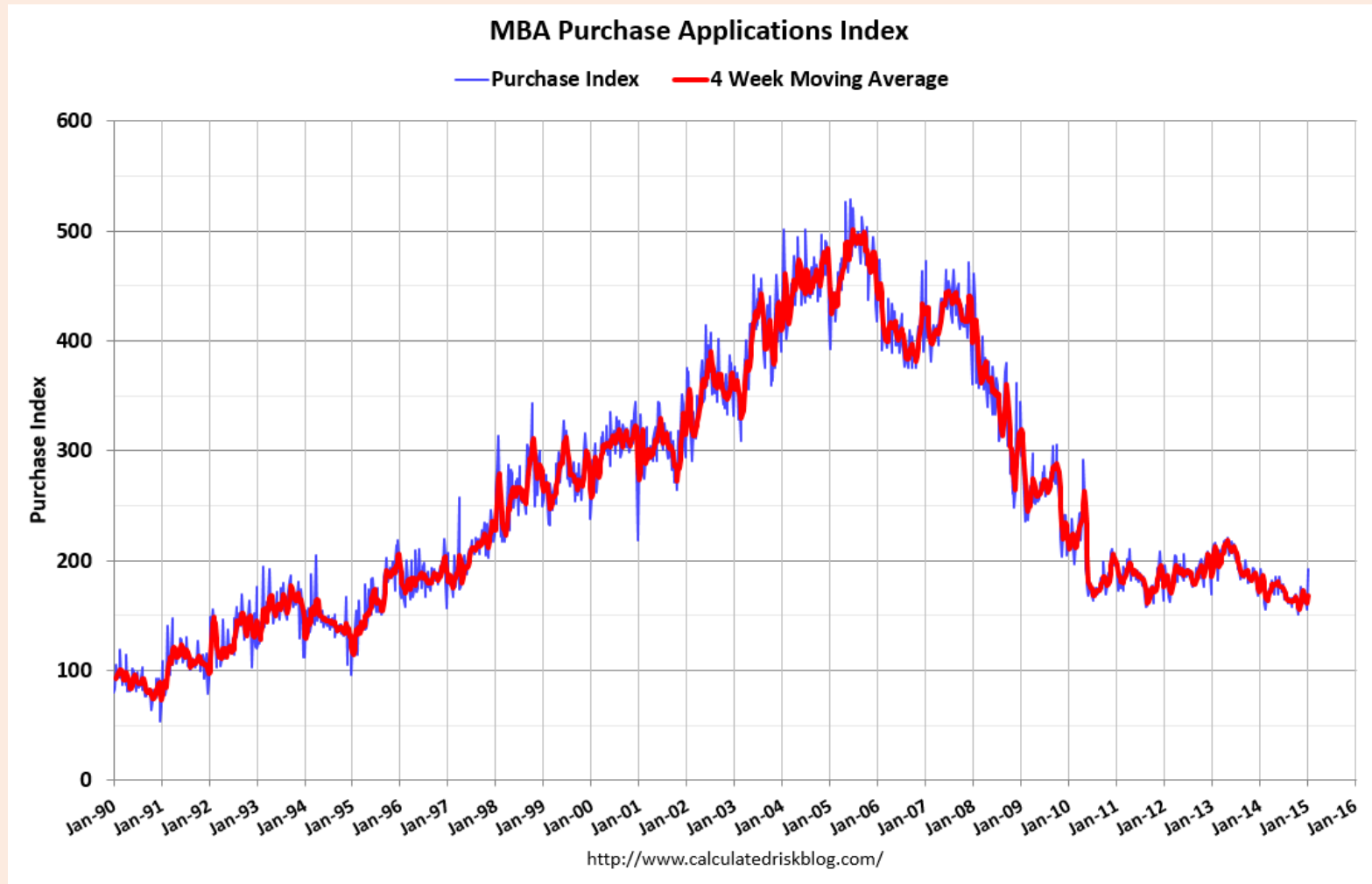
One would think that low interest rates alone, as a generator of higher home prices, would have drawn more buyers and sellers into the market.

Instead, the number of existing homes for sale, as a percentage of (a) the total inventory of homes and (b) the total number of U.S. households, continues to decline.



Sources: U.S. Census Bureau; U.S. Federal Reserve Bank of St. Louis

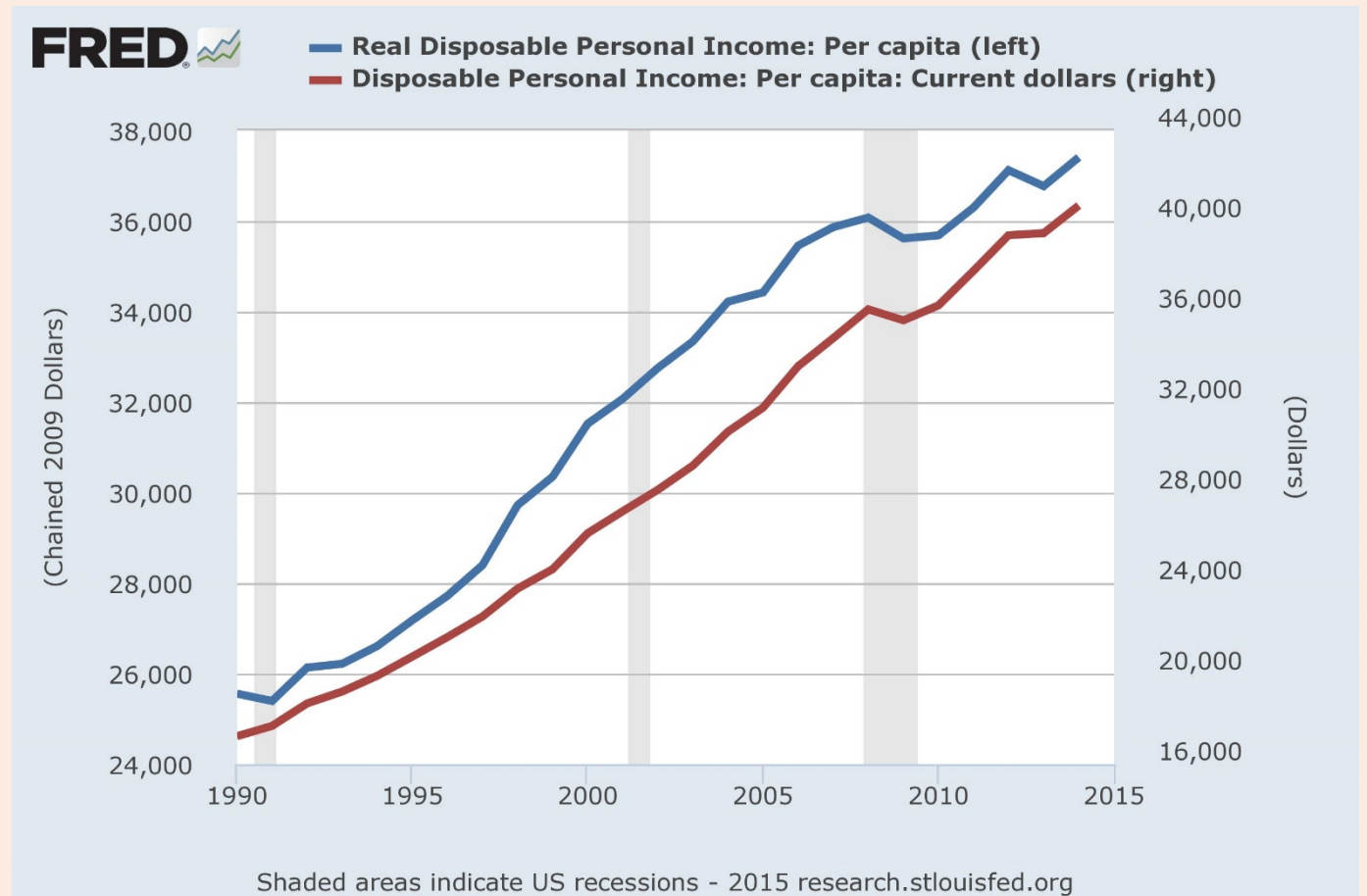
The Decline in Homes for Sale is Also Seen in a Decline in Mortgage Applications



Increases in Nominal and Real Per Capita Disposable Income do not Support Post-crash Home Price Escalation

While housing prices grew by some 27% during the 2012 to 2014 period, per capita disposable income grew only 3.1% on an inflation adjusted basis, and 7.6% on a nominal basis.

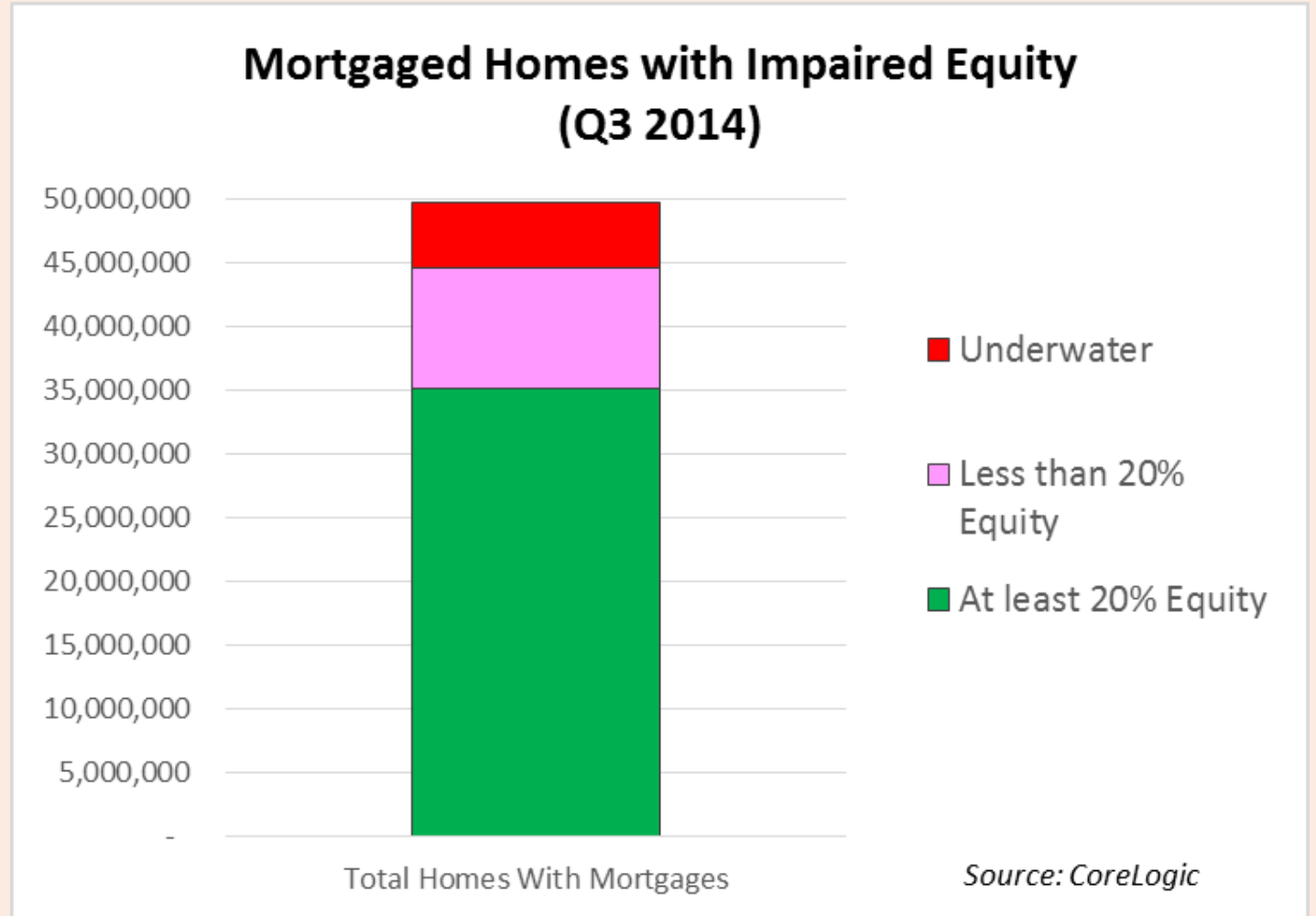
The last time that the supply of existing homes for sale, and the pace of home price growth, were at present relative levels (in the early 2000s) disposable incomes were growing much faster.



Home Prices are Rising Due to a Shortage of Supply, Not Robust Demand

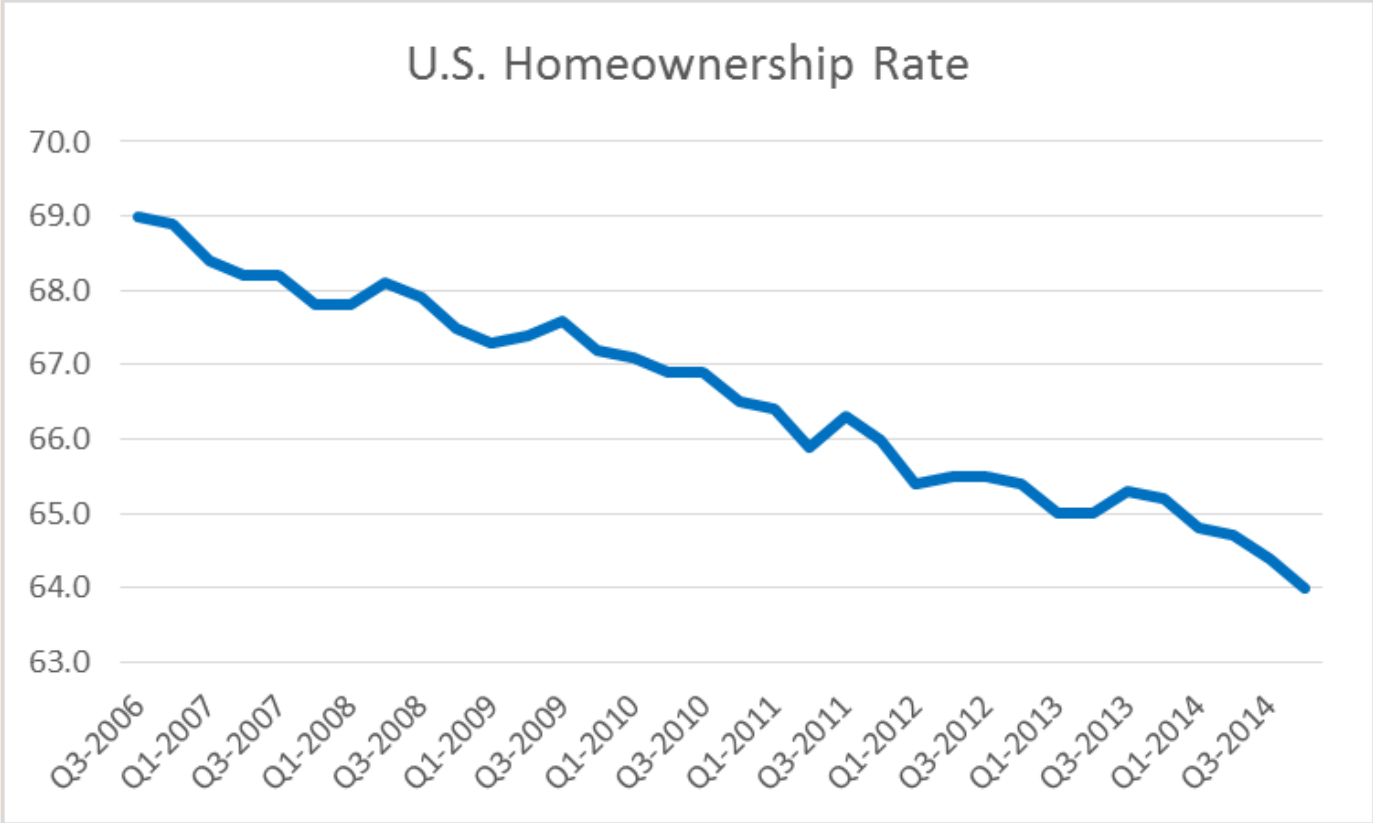
Here's why:

- Even with the recovery in U.S. home prices, just under 30% of homeowners with mortgages either remain underwater or have insufficient home equity to trade an existing home for a new residence;
- An unknowable number of homeowners who have 20% or more of their home's value in equity, cannot qualify for a new mortgage for income or other reasons.



Those who Must Sell or Default, and Cannot Buy, are Forced to Rent

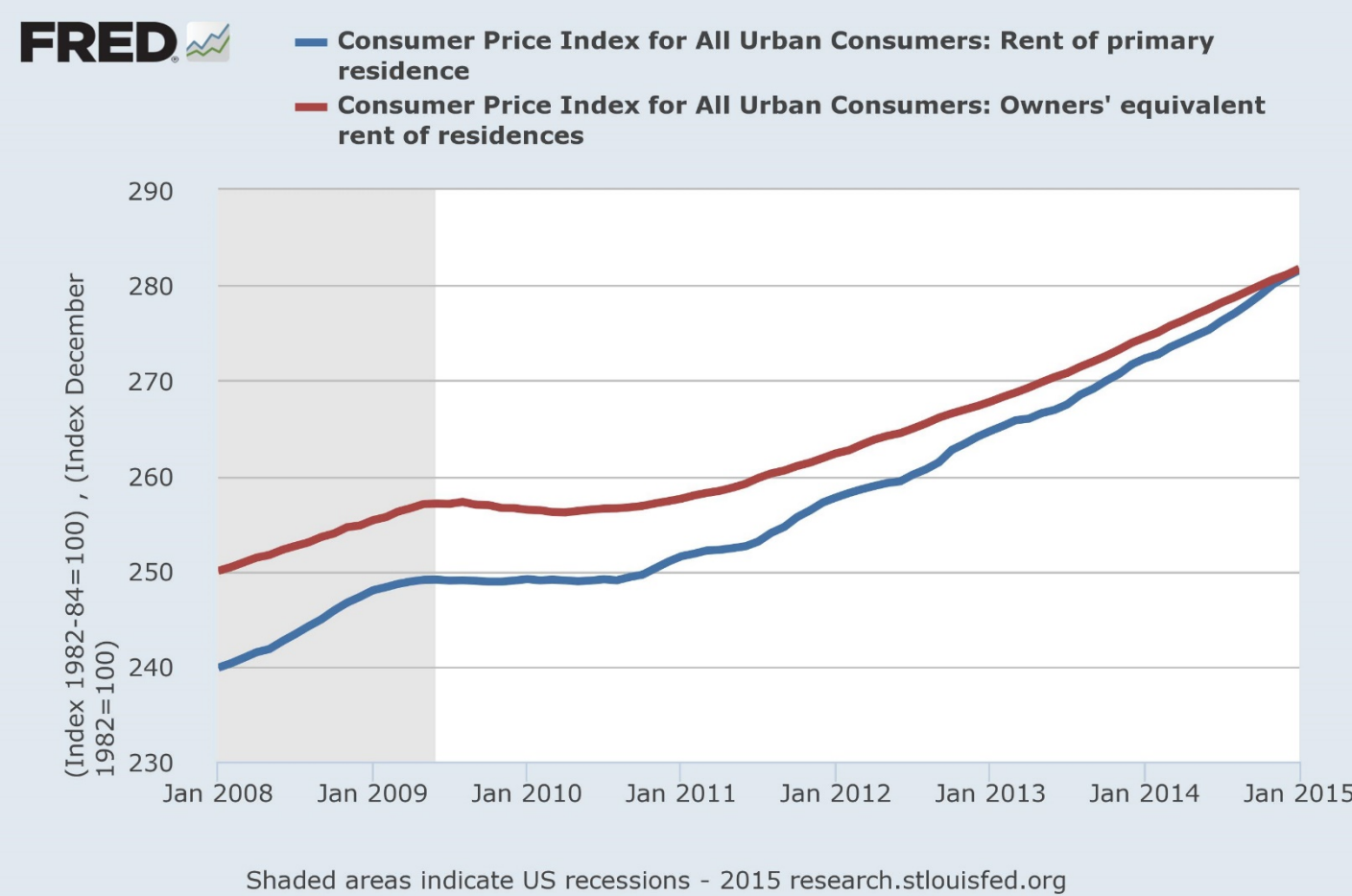
With short supply of homes for sale, the Homeownership Rate in the U.S. therefore continues to fall. But with supply artificially choked off, home prices have risen nevertheless. In the absence of rising incomes, this produces increased unaffordability which, in turn, forces even more American households into the rental market and....



Source: U.S. Census Bureau

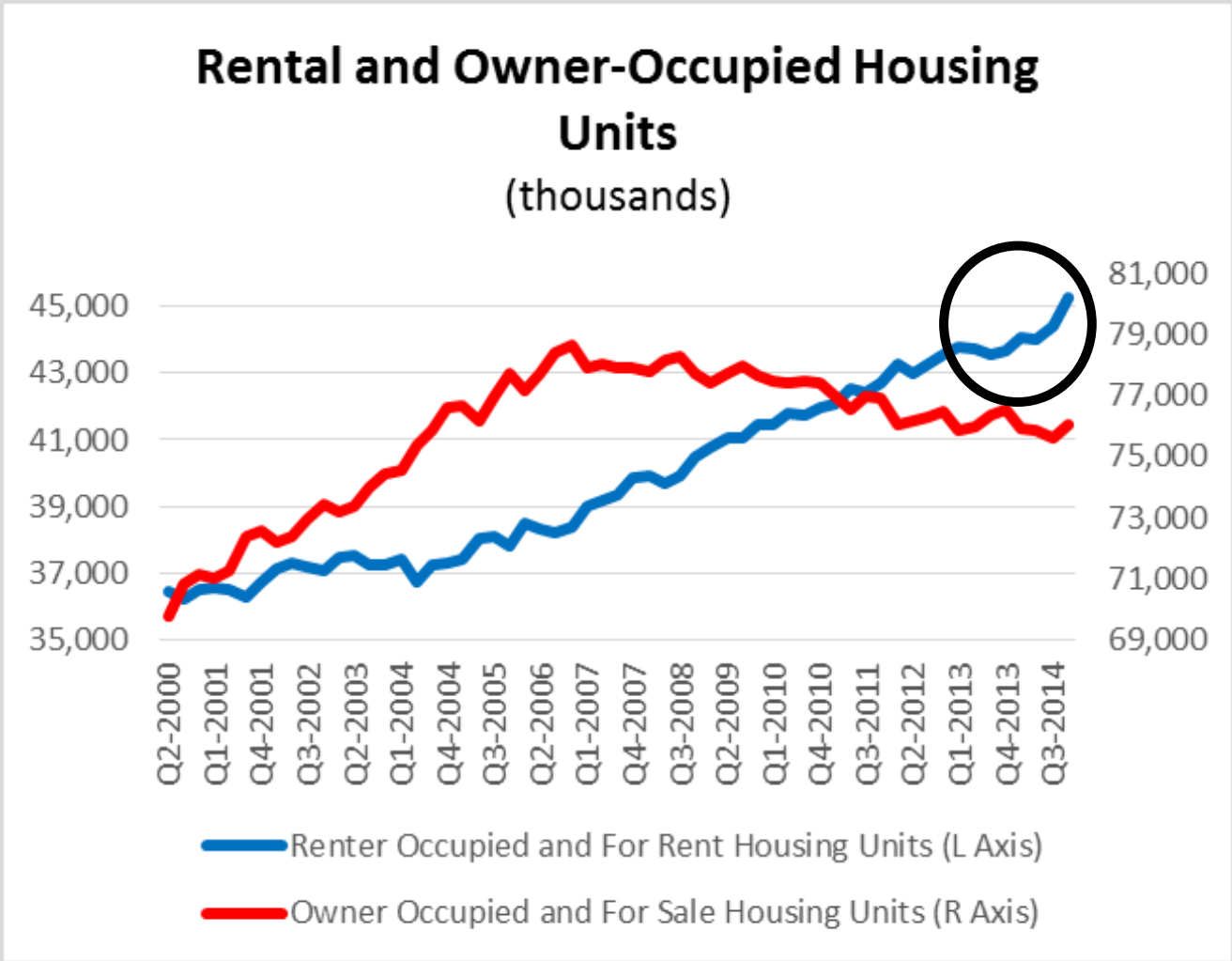
New Entrants to the Rental Market Continue to Apply Upward Pressure to Rents (both Primary Rents and Owners' Equivalent Rents)

Thus, the dislocations in the U.S. owner-occupied housing market raise issues of true price discovery in the rental market as well.



Rents are Rising Despite the Addition of Nearly Five Million Rental Units Since the Great Recession

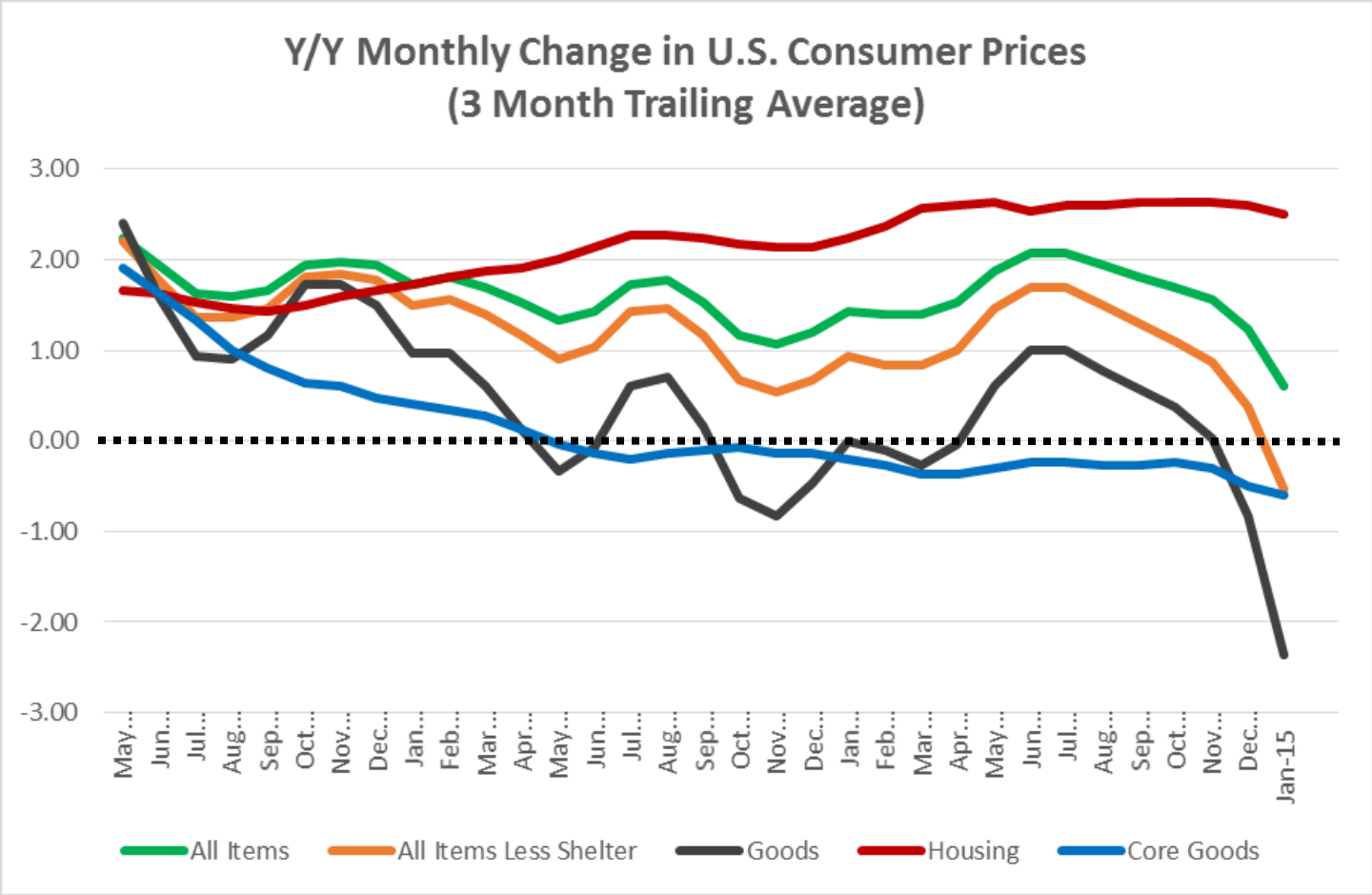
Rental unit inventory has been growing steadily led by, at first, the period of owner-occupied home unaffordability at the end of the housing bubble and, subsequently, by the issues discussed throughout this presentation after the Great Recession. Recently, rental development has spiked considerably. Owner occupied home inventory has declined by approximately 1.5 million units since the Great Recession as obsolete units are not being replaced and some single family units have been converted to rentals.



Source: U.S. Census Bureau

With Housing Expenses Comprising over 42% of the U.S. CPI, the Dislocations in Housing Supply and Pricing are Sending Misleading Broader Price Signals

Housing is now clearly the only sector holding the broadest price data in positive territory, and for reasons summarized on the following page, this is unlikely to continue to be a sustainable phenomenon.



Source: U.S. Bureau of Labor Statistics

Conclusion

- U.S. home prices – as they did in the mid-2000s – once again threaten to disconnect from other economic fundamentals, with a supply/demand mismatch that has its roots in the mortgage crisis itself and in post-crash monetary policy.
- Most analysts, whether they express it or not, know that a material rise in long term interest rates is incompatible with prevailing home prices – unless it is accompanied by significant growth in household incomes. And such growth is incompatible with present global economic realities.
- But few focus on the degree to which home prices are a reflection of the unique post-crash circumstances that severely restrict the supply of for-sale housing, in terms of restricting both the number of homeowners who are able to trade their present home for another, as well as access to credit.
- These constraints have served to flood the rental housing market with demand that has, in turn, escalated rents beyond levels that would be obtained if the inventory of owner-occupied housing was turning over at rates traditionally associate with economic expansion.
- The impact of such exaggerated rent growth has skewed overall inflation statistics in a manner that overstates prevailing levels of inflation in the absence of the foregoing factors.

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