

Housing expansion gains traction (September 3, 2009)

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One of the most common questions investors ask is: "When will housing bottom?" The answer is: the winter of 2009.

Evidence is overwhelming that housing activity bottomed last winter. Building permits, new starts, new homes sales, and existing home sales have all moved up from their winter lows. Vacancies and inventories are coming down. Prices are firming as inventories tighten.

The pessimists come back with the refrain that a housing recovery is doubtful and, at best, likely to be muted. Yet, the economic fundamentals don't support that outlook.

Consider the Housing Affordability Index (see chart). Low mortgage rates and lower home prices have made housing the most affordable in the almost 40-year history of this index, compiled by the National Association of Realtors. This is a powerful stimulant to demand, and, together with government aid to housing, such as the \$8,000 tax credit for first-time homebuyers, helps explain why housing is finally in an upturn.

In addition to much-improved affordability, there is a growing pent-up demand for houses. The share of home building in the overall Gross Domestic Product (GDP) has fallen to the lowest level in 60 years. As a result, in its latest summary, *The State of the Nation's Housing, 2009*, the Joint Center for Housing Studies of Harvard University finds that the excess supply of new homes for sale created during the last boom was worked off by the end of 2008. Indeed, the inventory of unsold new homes is down over 50% from its peak three years ago and back to normal levels.

Essentially, housing has been through a big inventory liquidation. New construction is now below trend to an extent seldom seen. This has allowed all the excess supply of new houses to be absorbed. Now that it's been absorbed, building has to rise to meet trend demand. And trend demand will be growing with the normalization of economic activity and growing population.

Housing is now far below its long-term trend. It won't stay there forever. It has to move up—unless people

start living in the street. The build rate that satisfies the normalizing demand for homes is about double current construction rates based on the demographics of household formation.

To return to its per capita trend level, real investment in residential real estate needs to grow a bit more than 10% per year over the next five years. This would take housing starts from about a 582,000 annualized rate to a one million annualized pace within five to six years. At this rate, the inventory of homes for rent, for sale, and held off the market would also be absorbed by new household formation. This process has already started and should help support home prices in the medium term.

Positive signs from housing are an important contributor to the rapid rise in leading indicators. The time for skepticism is past. The building blocks for recovery are in place, and housing should, as usual, be one of the leaders of the recovery. In our opinion, it already is. BJ

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