TrendMacrolytics

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INTELLECTUAL AMMUNITION

The Housing Cool-off In Perspective

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A strong economy will keep the housing sector and the consumer from crashing.

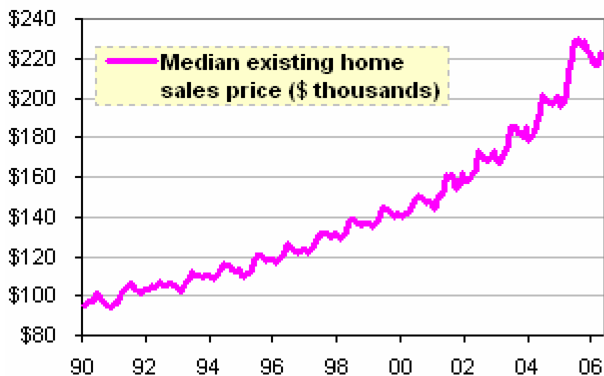
Update to strategic view

US MACRO: An inevitable cooling in housing will not become a broad-based collapse either in that sector or in consumer spending. A strong economy supports a strong housing sector and a strong consumer, not the other way around.

[see Investment Strategy Dashboard]

Thanks to the tireless efforts of the financial media and much of the economics establishment, it's now accepted wisdom that a sharp housing downturn is at hand -- one that risks pulling the economy into a ditch along with it. We think these worries are vastly overdone, and see the fundamental strengths of this economy in capital formation and risk taking as highly unlikely to falter in the face of an inevitable cooling of residential real estate. In fact, it's entirely possible that some slowing in the housing market will free up resources for activity in areas with a higher economic return.

Tuesday's report that housing starts rose a stronger than expected 5% last month underscores that for all the handwringing over the supposedly faltering housing sector, this market continues to demonstrate considerable resilience. Starts are now running at an annual rate of about 1.9 million which, while down from the best levels of the past year or so, remain at historically high levels. Yes, by most indicators -- starts, sales and prices, for example -- a moderate slowdown is underway. Considering the extent to which the housing boom was fostered and sustained by highly accommodative Fed monetary policy over the past several years, it's not terribly shocking that movement toward a less accommodative stance would take out some of the market's froth. Some perspective, however, is warranted. Existing home sales are running at a three-month moving average of 6.8 million. That's down from 7.2 million last summer, but higher than at any other time prior to last year. At the same time, while an impression has arisen that home prices are in something of a free fall, the data simply don't bear that out. While there are some localized areas where overheated markets are going through painful corrections, the process reveals little sign of distress nationally. The median sale price of an existing home has fallen from a



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peak of nearly $230,000 in the third quarter last year to about $223,000 in April. But that's still 4.3% higher than a year ago, and sale prices over the last few months have actually risen marginally. In February the median price was less than $217,000.

Historically, major housing downturns, such as in the late 1970s, the early 1980s and early 1990s, have occurred as a consequence of recessions caused by aggressive Fed tightening episodes correcting for earlier inflationary errors. While we see a moderate inflation uptick as likely to continue surfacing due to the Fed having stayed too easy for too long, the possibility of a sharp inflation breakout which would occasion a damaging Fed response remains remote. A healthy economy will continue to support the housing sector. Here, it's important to properly distinguish between cause and effect. If, as we see the empirical record convincingly showing, housing responds primarily to broader economic conditions, it's unlikely that the macroeconomy faces significant risk arising from a housing slowdown. Tails don't wag dogs.

Nevertheless, conventional wisdom insists that one of the primary economic risks is the impact on "the consumer" of a reversal in the wealth effect due to falling real estate values. Quite apart from the question of whether real estate prices are actually all that vulnerable to deep retrenchment, growth in consumption has owed relatively little to gains in housing wealth in the first place, so the potential for some decline in housing values represents little real risk to growth. Over the past year, gains in the value of real estate holdings have amounted to about $2.3 trillion which, by the way, amounts to less than half the overall increase in household net worth. Nominal personal consumption grew by about $540 billion in the past four quarters, a growth rate of 6.3%. An accepted rule of thumb is that about three cents on the dollar of higher net worth feeds through to higher consumption through the wealth effect. If that's the case, the increase in housing wealth translated to less than $70 billion of increased consumption. Another way of looking at it: entirely excluding the housing wealth effect would have yielded a 5.5% increase in nominal consumption. While the difference is not entirely negligible, it's clear that housing wealth has not been the primary determinant of increased consumer spending.

In our model, we take it as axiomatic that it is impossible to consume that which has not been produced. So we view the producer, not the consumer, as the key actor on the economic stage. Since consumption is the reward for production, prospects for consumption are actually determined in the economic processes that form the foundations for income creation, such as risk taking, capital formation and job creation. It can plausibly be argued, in fact, that because the housing boom was fostered by a monetary policy that kept rates artificially low, it actually represented a distortion that diverted resources from higher-valued uses. In the banking system, for example, it appears that credit creation for commercial and industrial uses is actually accelerating as demands for housing finance ebb somewhat. Growth in C&I lending is now running at better than 20-year highs approaching 15% at an annual rate, up from a growth rate of less than 10% in the first half of last year. This increased flow of credit to finance productive economic endeavor is likely to more than offset whatever reduction in economic activity can be attributed to a moderation in housing.

BOTTOM LINE: The prospect of a cooling real estate market has given rise to fears of a housing depression that would take down the overall economy as well. We find these fears misplaced both in relation to the prospects for housing and the macroeconomy's vulnerability to a slowdown. This economy continues to exhibit fundamental strength in the basic building blocks of income growth, and is unlikely to be derailed by a housing sector that returns to a semblance of normalcy. TM