Economics Group

Special Commentary

Housing Chartbook: December 2018

Modest Improvement Is Still Likely in 2019, Despite Recent Weakness

Home sales and new home construction continued to lose momentum this past month. While the hurricanes that impacted parts of the Southeast and fires out West likely influenced the data, there is no denying buyer sentiment has weakened considerably as higher mortgage rates have further eroded affordability. Builders also face intensifying margin pressures, as potential buyers demand more affordable product, yet they have seen little to no relief in land development costs and are seeing costs rise for building materials, financing and labor. The pronounced weakness in home sales is particularly vexing because it comes at a time when consumer confidence is near multi-decade highs and the unemployment rate is at its lowest level in decades. While the recent slide in home sales was likely prompted by higher interest rates, the persistent weakness in housing is likely due to demographic shifts and the exceptionally high costs of suburban development. These hurdles are unlikely to relent in coming quarters, which means home sales and new home construction are likely to continue to underperform the overall economy and underlying growth in households.

This past month’s housing data were mostly disappointing. Sales of new and existing homes and new home construction continue to come in below expectations, and most of the leading indicators show the trend is likely to continue and perhaps intensify. One of the most disturbing data points is the eight-point plunge in the NAHB/Wells Fargo Homebuilders Index to 60. Any reading above 50 means more builders rate current conditions as good than rate them as poor. While a reading of 60 is still a relatively high level for this survey, much of November drop was in prospective buyer traffic and expected future sales. Declines were evident in all four regions of the country.

November’s disappointing homebuilders’ survey was reinforced by weak pending home sales. Pending home sales reflect purchase contracts, primarily for existing homes, and typically close 45 to 60 days later. Pending home sales tumbled 2.6% in October, with sales down 8.6% in the West. That marks the second large drop in the past three months. October’s decline occurred before the wildfires disrupted activity in California and corresponds with reports of softer sales across many metro areas in the West. Pending sales also fell 1.8% in the Midwest and 1.1% in the South, marking the fourth consecutive drop for a region that accounts for 41% of existing home sales.

We feel the persistent weakness in housing is due to secular changes.

Figure 1

Builder Confidence & Single-Family Starts

Diffusion Index; Starts SAAR 1.9% in Thousands

Source: U.S. Department of Commerce, NAHB, NAR and Wells Fargo Securities

Figure 2

Pending vs. Existing Home Sales

Index 2001=100, SAAR in Millions

Source: U.S. Department of Commerce, NAHB, NAR and Wells Fargo Securities

This report is available on wells Fargo.com/economics and on Bloomberg WFRE.
The persistent weakness in home sales has come at a time when overall economic growth is running at the strongest sustained pace of this expansion. Real GDP grew at a 4.2% annual rate during Q2 and rose at a 3.5% annual rate in Q3. Strong job and income growth and increased job security typically provide a boost to home buying. While the homeownership rate has increased modestly this past year, the proportion of consumers stating now is a good time to buy a home in the University of Michigan’s Survey of Consumer Sentiment survey has fallen 23 points since April 2017. Declines of this magnitude have typically preceded pronounced slowdowns in the housing sector or outright recessions. More importantly, the slide in homebuyer sentiment accurately anticipated declines in both new and existing home sales and suggests sales will weaken further.

The dichotomy between stronger overall economic growth and weaker home sales begs the question as to whether housing demand is suffering primarily from secular rather than cyclical challenges. The old model of homeownership appears to have broken down. Household formation was slow to get on track in this recovery, as many younger households put off marriage as they established their careers and worked to pay down their student loan debts. Residential development has also faced new challenges. The old model saw developers push further out into the suburbs cycle after cycle, in search of less expensive land. In this cycle, however, land in the distant suburbs has become more expensive to develop, as municipal governments have required developers to pick up more of the costs for developing key infrastructure. In the past, part of this burden was shared by commercial developers, as shopping centers and office buildings followed the new rooftops. With the advent on online shopping, however, there are fewer new shopping centers being developed. Suburban office development has also been exceptionally restrained throughout most of this cycle.

Attitudes toward homeownership have also shifted. While roughly the same proportion of young persons would like to own a home at some point in their lives as previous generations, that milestone is now further out. The median age of a first marriage, an important precursor to home buying, has risen sharply since the last recession. Part of the problem is that Millennials graduated into a weak job market, often with significant student loan debt, and have seen only modest wage gains. The geography of jobs has also shifted, with a larger proportion of the creative, high-paying information-age jobs being added closer to the central business districts, where housing costs tend to be higher. With urban economies seeing stronger economic gains, demand for homes near the center city has skyrocketed, setting off a gentrification wave that has pushed home prices sharply higher and kept younger households in the rental market longer than previous generations.

We have gradually scaled back our housing forecast to reflect the lower level of home sales and new home construction through the first 10 months of 2018. Home prices are also expected to rise less rapidly, as homebuilders focus on building more affordable homes. After rising 1.1% this year, we expect sales of new homes to rise 1.6% in 2019. Resales of existing homes are expected to rise less than 1%, however, while home price appreciation slows to a 4% to 5% pace.
### National Housing Outlook

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<td>Total Housing Starts, in Thousands</td>
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Forecast as of: December 3, 2018

Mortgages

- Mortgage rates approached 5% recently, a level last seen in 2011. The reaction has been swift, with mortgage purchase applications falling 2% below their year-ago level and refi applications plunging 37%.

- With refinance applications pulling back so sharply due to higher mortgage rates, a large proportion of remaining borrowers are pulling cash out of their homes. The amount of equity withdrawn, however, is a mere pittance of what was pulled out near the peak of the housing boom.

- Banks loosened lending standards in Q3 but demand was broadly weaker as homebuyers struggle with affordability, particularly first-time buyers. While total debt outstanding rose to another record high in Q3, households are relatively well positioned to service this debt, most of which is fixed rate.
Single-Family Construction

- Attempts to tie the recent weakness in single-family starts to this past fall’s hurricanes appear to be misplaced. Single-family starts have been trending down for the past several months, largely reflecting a slowdown in new home sales and back-up in new home inventories. Moreover, much of the pullback has been in other parts of the country.

- Even with starts trending lower, single-family starts through October of this year are running 5.5% above their year-ago pace, but permits are now running 3.4% below starts, suggesting starts will moderate heading into the typically low activity winter months.

- The NAHB measure of expected single-family sales plunged in November to the lowest level since May of 2016, likely signaling further weakness in sales.
Multifamily Construction

- The multifamily market continues to outperform expectations, as stronger job growth and the lack of affordable for-sale housing has boosted demand for rental apartments. Multifamily starts rose 10.3% in October. Many renters have opted to stay put rather than sift through the thin supply of affordable homes on the market.

- Vacancy rates fell in Q3, despite a surge in completions, on the back of surprisingly strong demand. Absorption outpaced completions during the quarter, leading to lower vacancies and some firming in asking rents.

- Permits for apartments are running ahead of starts, which should, at a minimum, hold apartment starts near recent levels over the next few quarters.

Source: U.S. Department of Commerce, CoStar, Inc. and Wells Fargo Securities
Buying Conditions

- Homebuyer confidence measures broadly weakened over the past few months, with the Fannie Mae sentiment index falling to its lowest level in a year. The University of Michigan measure of buying conditions is around 25% below its peak in 2015.

- Higher mortgage rates and a lack of affordable houses are likely the two largest culprits behind worsening buying conditions, which have flowed through to lower sales. First-time buyers and trade-up buyers are most impacted, with the former priced out of the market and the latter content to remain in their current home and low-rate mortgage.

- With sales declining, price appreciation has moderated, which has slowed the slide in affordability. Home prices are still rising slightly faster than wages, however.

New Home Sales

- New home sales fell a sharp 8.9% in October, marking their fifth consecutive monthly drop. Sales fell across all four regions of the country.
- The lower level of sales means there is now a 7.4 months’ supply of new homes on the market. By nearly all accounts the weakness in sales is demand driven rather than a function of low inventories, as was the case in years past. The current level of new home inventory is the highest since February 2011.
- The rise in inventories has led to lower median home prices, with builders discounting homes or engaging realtors to move inventory. The median price of a new home fell 1.1% year-over-year, reflecting builder discounts as well as a shift by buyers to less expensive homes and a population shift toward less expensive parts of the country.

Source: U.S. Department of Commerce, Freddie Mac, FHLMC and Wells Fargo Securities
Existing Home Sales

- Existing home sales rose 1.4% in October, ending a streak of six declines. Even with the gain, resales are down over 5% from year-ago levels, as higher prices and higher mortgage rates have curbed sales.
- With sales cooling off, the inventory of existing homes is climbing. Inventories of existing homes had fallen to record lows previously, however, so even with recent gains inventories are still at a relatively low 4.3 months’ supply.
- Price increases for existing homes have steadily moderated over the past year and are now up just 4.4% year-over-year. Tales of bidding wars are now largely a thing of the past and homes are often selling below asking prices, which used to be the market norm.

Source: National Association of Realtors, FHLMC and Wells Fargo Securities
Condos and Co-Ops

- Condo and co-op sales have not been immune to the recent weakness, falling 3.2% year-over-year in October. The West and Northeast both declined and have been trending lower for much of the year. The South fared slightly better, however, with sales rising 3.8%. Sales in the Midwest were flat.

- While single-family home price appreciation has merely eased, median condo prices posted an outright decline in October, falling 0.2% year-over-year. Condo inventories remain relatively tight, however, at a 4.4 months’ supply. New condo development has lagged considerably this cycle.

- With the exception of San Francisco, nearly every major condo market has seen sales fall over the past year. New York, Los Angeles and Chicago have registered double-digit drops.

Source: U.S. Department of Commerce, National Association of Realtors and Wells Fargo Securities
Home Prices

- With sales declining, price appreciation has moderated. Homes are taking longer to sell and sellers are becoming anxious, reducing asking prices or offering discounts to sell new homes. The average days on market for an existing home rose to 33 in October, up from 26 in May of this year. While that is still short from a historical perspective, the trend is clearly shifting to a soft-sellers’ market.

- Another new trend is that the national HPI is now up slightly more year-over-year relative to the composite 10- and 20-city indexes. This is largely a function of the significant cooling that has taken place in some of the nation’s formerly hottest markets, many of which were also among the largest markets, which carry more weight in the 10- and 20-city indices.

**S&P CoreLogic Case-Shiller Home Price Index**

- Year-over-Year Percentage Change

- National HPI: Sep @ 5.5%
- Composite-10: Sep @ 4.8%
- S&P/Case-Shiller Composite-20: Sep @ 5.1%

**Home Prices**

- Year-over-Year Percentage Change

- Median Sale Price: Oct @ $227,900
- FHA Purchase Only Index: Sep @ 6.0%
- Composite-10: Sep @ 4.8%

Renovation and Remodeling

- As a consequence of a slowing housing market, residential fixed investment (which factors directly into GDP) has been a net drag on overall economic growth in five of the past six quarters. Residential improvement spending, however, has been a bright spot, growing 12.2% year-over-year in Q3.

- The combination of rising home values and higher mortgage rates is giving homeowners, especially those who had previously refinanced at lower rates, justification to stay put and undertake large improvement projects.

- Spending typically coincides with resales, as a great deal of spending occurs before and after a purchase. Given slowing activity, the JCHS Leading Indicator of Remodeling Activity projects some moderation in 2019 off the strong pace seen recently.

Source: Harvard Joint Center for Housing Studies, U.S. Dept. of Commerce, NAHB and Wells Fargo Securities
**Construction Costs**

- The rise in building material prices appears to be subsiding, which may provide some relief for builders and developers amid rising labor costs. Material prices eased to a 5.5% year-over-year gain in October after running even higher for much of the past year.

- As we anticipated, lumber prices eased up as the peak homebuilding season has come to a close. Lumber prices surged nearly 20% year-over-year in July, yet prices are now up just 0.8% year-over-year. Other construction input prices have also pulled back, notably for copper, plastics and aluminum. Fuel costs have also moderated but steel prices continue to rise.

- The latest JOLTS reported a record number of job openings in construction, which continues to pull compensation costs higher.

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**Softwood Lumber Prices**

- Year-over-Year Percent Change, 3-Month Moving Average

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**Producer Price Index**

- 3-Month Moving Average, Year-over-Year Percent Change

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**Construction ECI vs JOLTs Job Openings**

- Year-over-Year Percent Change, Percent

Source: U.S. Department of Labor and Wells Fargo Securities
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