June 2013

Improved Housing Market Impact

The housing data released on Thursday June 20th shows continued strong improvement in the US housing market. The US sales of occupied homes (not new homes) surpassed the 5 million unit mark in May. **This is the first time to reach that sales number in three and a half years.** Overall, US home sales were up 4.2% sequentially in May- the highest level since late 2009. The May rate is up 12.9% on a year-over-year comparison. We are feeling these numbers locally as well.

In recent months it has become clear that the local housing market (Southeastern PA and Northern Delaware) has turned around following the national market. Sales of existing homes have increased robustly. **The year-over-year change in existing home sales has seen double-digit or near double digit gains for the last 10 consecutive months.** All indicators are on the way up. In addition to home values and supply, positive indicators include the number of multiple-bid situations, new home construction and continued low mortgage rates.

Sales are not exactly the same as “demand” because they require a supplier, but in the case of housing, one can often compare ‘listings for sale’ against the sales pace to find an inventory figure based on the velocity of sales. This is a rough indicator of the balance of supply and demand in the housing market. As supply increases, generally housing prices flatten or decline. After peaking at nearly 12 months of inventory in July 2010, the **nationwide supply of existing homes for sale has declined precipitously to around 5 months,** meaning that if no other homes were added to the existing number of homes for sale, the market would have burned through the inventory of homes for sale within five months. As a result of a tight supply of available homes for sale, we have seen price increases as more money chases fewer available homes for sale.

How can we have a shortage of inventory? Investor demand, population growth and rising household formulation has all combined to remove excess inventory despite the economic downturn. Balancing these factors, homeowners who owe more on their mortgage than the underlying values of their homes are reluctant to sell because they would have to come up with the balance at the settlement table. In addition, we have seen a slowing of household formation because of the economic downturn. As the economy is picking up steam, even people who have lost their homes to foreclosure are now re-entering the market to either purchase or rent.

Inventory and price affect each other in three ways:

1. **Less housing inventory leads to higher housing prices**. That's because buyers are competing for a limited number of for-sale homes.
2. **Rising home prices lead to less inventory—*in the short-term.*** Everyone wants to buy at the bottom; no-one wants to sell at the bottom. When prices start to rise, buyers get impatient while many would-be sellers elect off putting their homes on the market in hopes of selling at higher prices.
3. **Higher prices eventually lead to more inventory—*in the long term***. As prices keep rising, more homeowners decide it's worthwhile to sell, especially those who get back above water, which adds to inventory. Also, builders take rising prices as a cue to rev up construction activity, which also adds to inventory.

Low interest rates have been a boom to the housing recovery. These low rates have enabled qualified buyers (and owners looking to refinance) to access cheap financing, adding to already record high levels of home affordability. It's helped bolster a surge in both home sales and price.

The housing recovery benefit extends beyond just the new owners. The housing industry drives a significant portion of the country's economy. According to the National Association of Home Builders**, the average single family detached home under construction results in an additional three jobs for one year.** This includes employees working on the house as well as those employed in producing products to build the house. Residential construction and upkeep generates between 15% and 18% of Gross Domestic Product (GDP).

We are seeing locally on an anecdotal basis in the southeastern Pennsylvania and Delaware areas, multiple offers on the same properties listed for sale and properties selling above the existing appraisal prices. Locally, the market is not frothy, but it has definitely recovered particularly for homes in good condition, in a desirable location and priced realistically close to the market to begin with.

Housing financing is still difficult on a nationwide basis. **Conventional bank financing requirements are still tight** and at this point we are not seeing easy excess lending occurring though the lending capacity is there as interest rates are still low. Credit requirements for conforming FHA loans, are still tight. FHA allows a credit score of 580 to underwrite a loan. However the investors of those loans now currently require credit scores to be around the 640 level.

First time home buyers, are generally regarded as an economic bellwether and, as far as housing ownership is concerned, they are at the bottom of the food chain. As of May, **first time buyers were only 28% of the housing market.** ***These buyers should be closer to a normalized rate of 40% of the home buying pool.*** In an expanding economic cycle with rising prices, first time buyers tend to be squeezed out of the market because first time buyers are already constrained by a limited (lower) price range. In an economic recovery, first time buyers are competing in an environment where other buyers have more cash and the prices of existing homes are running away from a range that first time buyers can afford. We are seeing this event occurring now.

What we will see going forward:

1) The continuing overall **recovery in the economy**- this is all good.
2) **Slowly rising bond and mortgage interest rates** as the economy continues to improve and the fed trims its monthly bond purchases and backs off its stimulus programs over the next year. We would continue to migrate from longer term bond maturities to shorter term bond maturities to minimize market risk as we see the bond market steadily declining over the next two years.
3) A stronger housing market translates into a **stronger employment market** but housing in and of itself is not enough to turn spike the employment numbers. As the housing market heats up, new construction accelerates. Building 100 average single family homes translates into 305 jobs, $23.1million in wage and business income and $8.9 million in taxes and revenue for state, local and federal governments. This is all good for the overall economy.
4) **We see a choppy but overall improving stock market** as improved bond yields become more attractive relative to equities, investors chase higher yields and move to debt from equities. For those that can stomach the periotic drops in the stock market, we would be opportunistic buyers of stocks on any periodic sell offs in equities.