October 4, 2013

Market Insight

ING PERSPECTIVES
MARKET SERIES

Tanweer Akram, PhD

Senior Economist, Quantitative Research

U.S. Macroeconomic Performance and the Housing Recovery

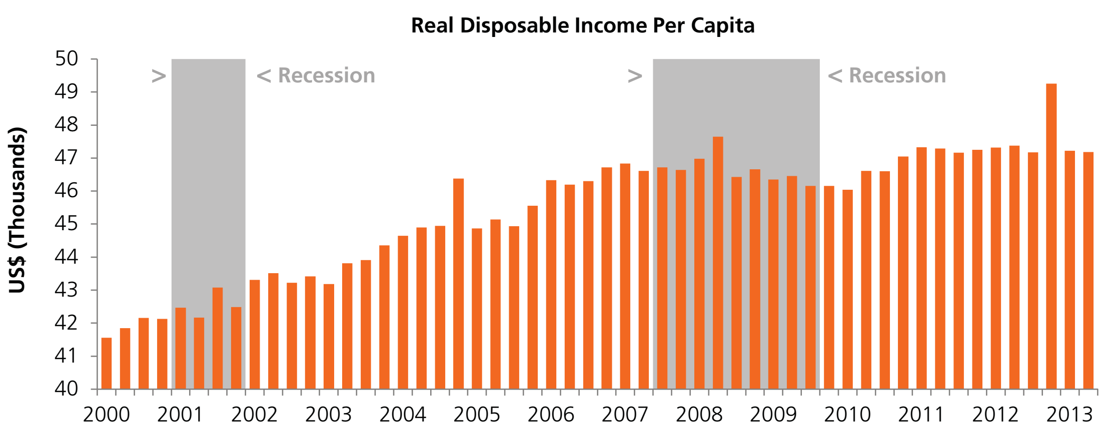
Despite the modest pace of U.S. economic growth since the end of the Great Recession, housing and job growth have gained some traction in recent quarters. However, with mortgage rates trending higher, the quality of job growth low and disposable income growth feeble, the domestic economy has reached a crossroads. Will the housing recovery be sustained, or will it be derailed by higher mortgage rates? Will real disposable incomes rise, or will jobs growth continue to be driven by low-wage industries? Will economic performance improve, or will it continue to muddle along at a sub-trend rate? This article addresses these questions in light of long-term drivers of the housing outlook and identifies risks to the outlook for the housing recovery.

The Disappointing Recovery Continues

The growth rate of the U.S. economy since mid-2009, when the Great Recession officially ended, has been mediocre, averaging just 2% per quarter on a seasonally adjusted annualized basis. Per capita real GDP growth has been muted since 2000, and remains below $50,000 on a 2005-dollar basis as of second quarter 2013. Real disposable income per capita has been virtually stagnant for nearly three years, as shown in Figure 1.

Real disposable income and real household net worth are the two main drivers of consumer spending; continued softness in these drivers has resulted in muted spending. Aggregate real disposable income growth — the most important driver of the growth in real personal consumption — has been feeble. And while household real net worth has gradually risen due to higher equity prices and the stabilization and subsequent increases of house prices — residential real estate accounts for nearly one-quarter of household total assets — house prices are still lower nationally than before the recession. Moreover, the share of cash-out refinancing is quite low compared to share that was typical before the recession. In the past, mortgage equity withdrawals and home equity lines of credit enabled households to borrow based on rising house prices, which fueled consumption despite only moderately rising disposable income. This

Figure 1. Real Disposable Income per Capita Has Been Stagnant for the Past Three Years



Source: Reuters EcoWin

source of support for consumption has ceased and is unlikely to be revived in the near future because banks have tightened their lending standards.

Residential investment's contribution to economic activity has slowly improved but is still less than half a percentage point of GDP. Housing was a substantial drag on growth during the Great Recession and for several quarters afterward. What's more, cyclically sensitive sectors of the economy — such as residential investment and motor vehicles — shrank from their 2005 peak of nearly 10% of GDP to just above 5% in 2012. This decline implies that lower nominal interest rates and accommodative monetary policy have had limited impact on economic activity.

The labor market has improved, particularly in the last 12 months. As can be seen in the official unemployment rate and other indicators, however, job growth has not been strong enough to overcome the slack created by the recession and its aftermath. Moreover, the jobs that have been added largely have been concentrated in low-wage industries such as retail trade, leisure and food services, education/health and temporary services. As a result, unemployment and underemployment are substantial and labor income growth has languished.

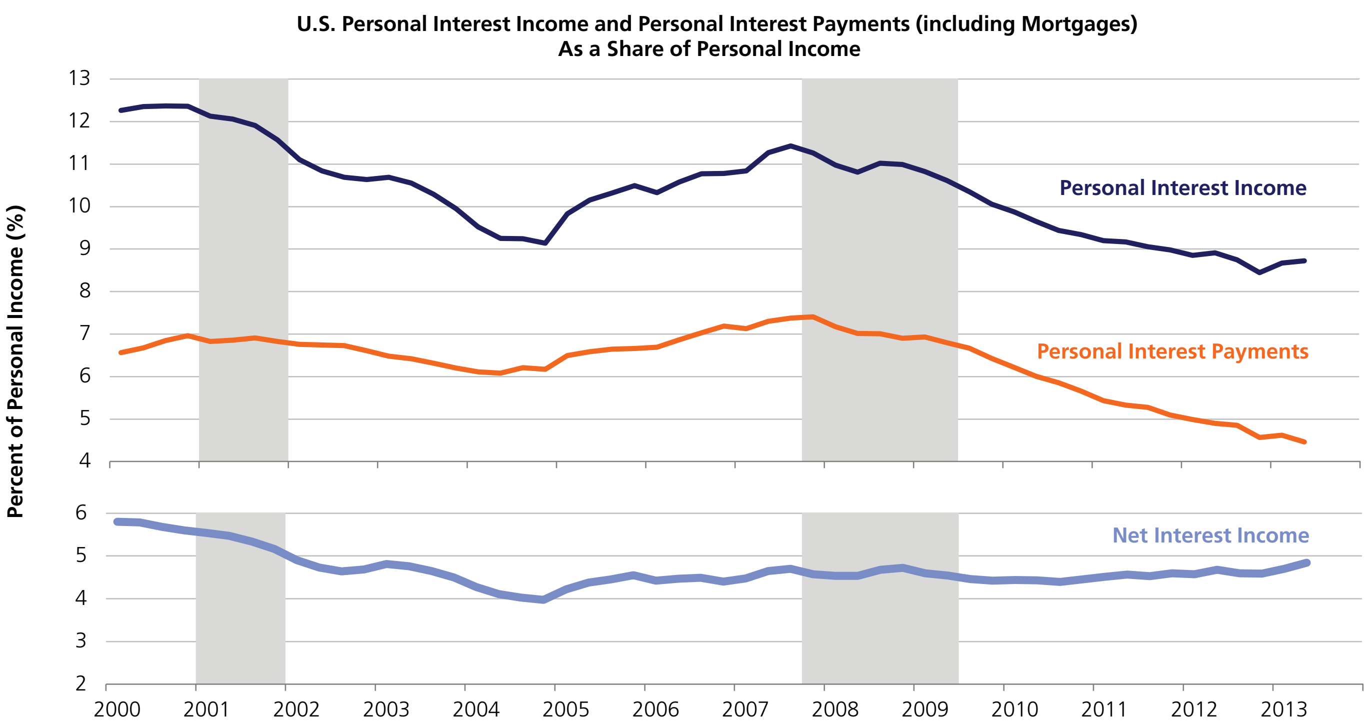
If slow recovery has a redeeming feature, it is that it has enabled households to repair their balance sheets. Household debt, compared to household income, had been rising since 1985; the increase was spectacular after the technology bubble in 2001. Since the Great Recession, it has started to decline gradually. Household financial-obligation and debt-service ratios also have declined due to such factors as lower rates, bankruptcies, defaults, delinquencies, less borrowing, higher personal savings and the tepid rise of disposable income.

Lower interest rates can benefit borrowers, but the low interest rate environment is not uniformly good for the economy. Lower rates are supposed to induce business investment, but this may not happen unless businesses expect a pickup in demand and the potential for higher sales and profits. While lower rates have reduced the bite interest payments, including mortgage payments, take from disposable income, they also have reduced the amount of personal interest income received. As a result, net interest income — the difference between these two measures — has remained fairly stable, as shown in Figure 2. The U.S. government's interest payments to the domestic private sector and the rest of the world have been low as a share of nominal GDP, implying that investors' U.S. dollar interest incomes also have been low.

Without strong growth of disposable income, the economic recovery is bound to stay mediocre. Restrictive fiscal policy has hindered growth since 2010, as government expenditures on goods and services have slowed. Business fixed investment and housing spending have risen but in a restrained manner. The Troubled Asset Relief Program (TARP) has failed to revive bank lending; in fact, higher capital requirements and regulatory forbearance have incented banks to shrink loan portfolios.[1] Low policy rates and the Fed's purchase programs may have supported financial asset prices and perhaps indirectly supported property prices, but these measures

[1] See Heather Montgomery and Yuki Takashi (2013), "The Economic Consequences of the TARP," https://sites.google.com/site/heatheramontgomery/research

Figure 2. Lower Rates Have Led to Reduced Interest Payments and Interest Income



Source: Reuters EcoWin

have done little to revive aggregate demand. Industrial production in the U.S. and most advanced countries is weak, though there are signs of improvement.

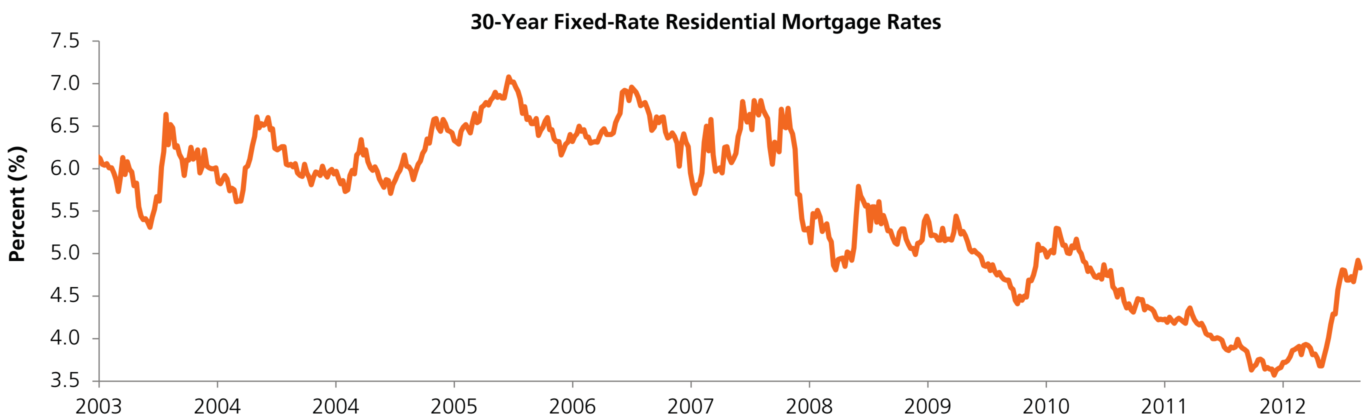
Higher Interest Rates Should Have Only Limited Impact on Housing

In our view, the recent rise in residential mortgage rates (Figure 3) will not derail the housing recovery, provided real disposable incomes continue to rise at least modestly.

Changes in mortgage rates historically are associated with changes in ten-year U.S. Treasury yields (Figure 4). Government bond yields have risen since mid-2012 and more sharply in third quarter 2013 on fears of Fed tapering; volatility also has risen, but in line with its historical average. For the near term, we believe ten-year Treasury yields are likely to range between 2.0–3.5%. As would be expected, mortgage rates have also risen as a result of higher Treasury yields and the increased risks of a selloff in government bonds; refinancing activity has plunged, though loan applications for house purchases have declined less sharply.

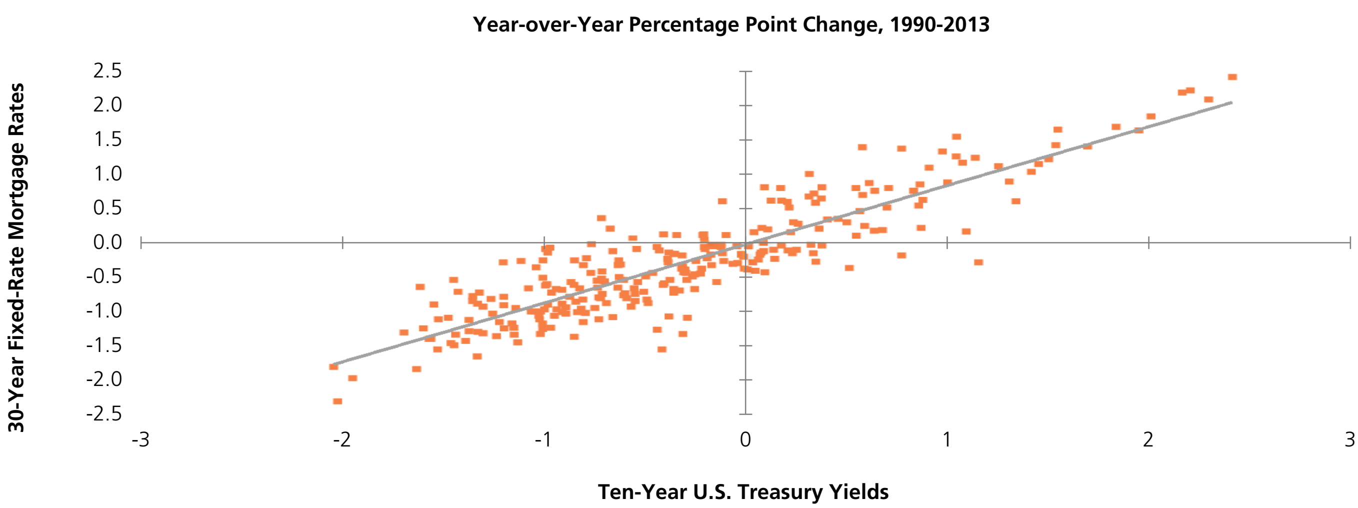
We think the upside risk for Treasury yields — and, consequently, mortgage rates — is fairly limited this year even if the Fed decides to trim its asset-purchase program moderately sometime in the final quarter of 2013. Contrary to investors' expectations, the Fed choose not begin tapering its asset purchase program at its meeting in September. The Fed has committed to holding the fed funds target rate low as long as unemployment remains above 6.5% and inflation remains contained. As mentioned previously, the unemployment rate has improved but remains well above the Fed's target. Inflation one to two years ahead, meanwhile, is projected to be no more than half a percentage point above its 2% long-run target, and longer-term inflation expectations are well anchored. Excluding food and energy, inflation is likely to stay below the Fed's targets for some time. And

Figure 3. Residential Mortgage Rates Are Trending Higher in 2013



Source: Reuters EcoWin

Figure 4. Changes in Mortgage Rates Are Associated with Changes in Ten-Year U.S. Treasury Yields



Source: Reuters EcoWin

even if mortgage rates and house prices did rise from current levels, their rates of increase are unlikely to be disruptive, as the ratio of mortgage payments to median household income, at 25%, remains well below its historical average of 30%.

Housing Recovery Likely to Persist at a Slower Pace

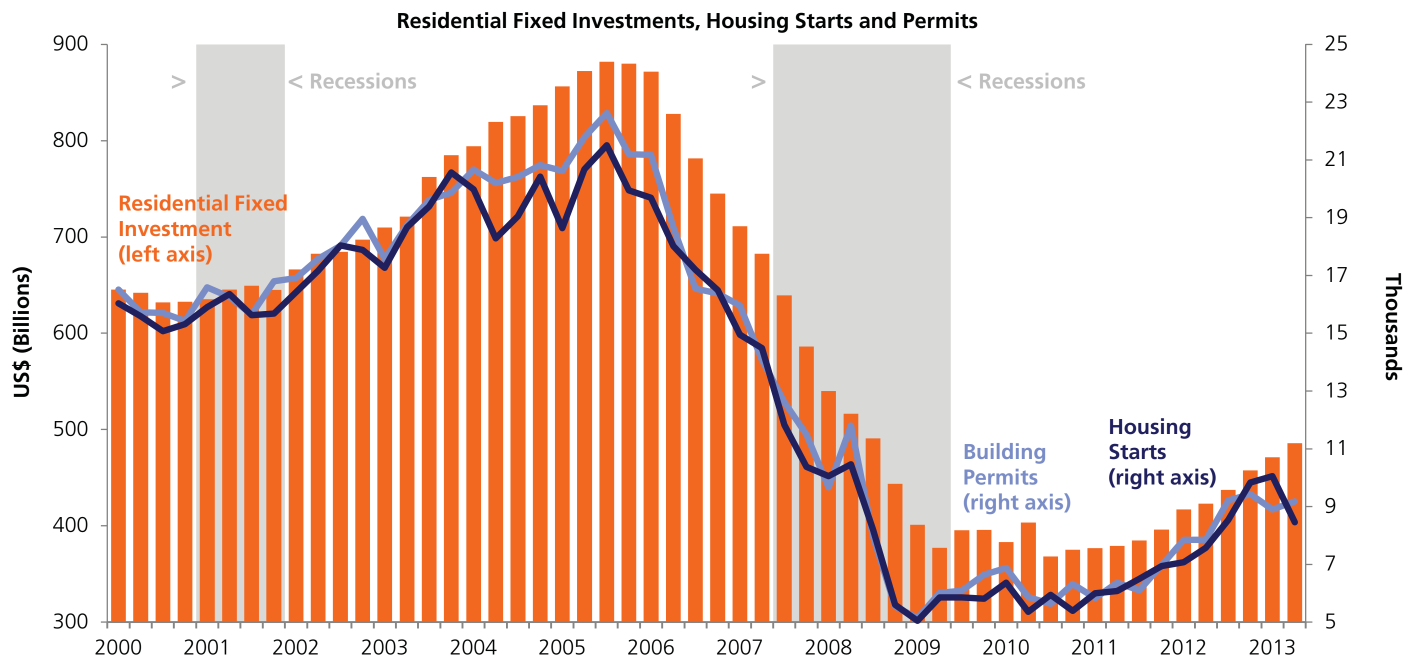
The housing recovery is likely to continue, but we expect it to slow in the coming 12 months. Positive factors such as reduced supply and greater affordability will be partially offset by higher mortgage rates, tight lending standards and fewer speculative purchases.

On the plus side, sales of new and existing houses have risen since 2010, and indexes of pending home sales suggest that the increase should continue over coming months. Homeowner and rental vacancy rates have declined. The supply of new and existing houses, as measured by the number of officially listed houses available for sale, is adjusting. Reduced supply supports house price appreciation. Delinquency and charge-off rates on residential mortgage loans are declining. The "shadow inventory" of houses — lender-owned properties that have been foreclosed and properties with delinquent loans — has shrunk in recent months, though it remains at elevated levels. Housing construction has risen for more than six quarters but is still markedly low by historical standards, as shown in Figure 5. Construction-related employment is well below its levels in the early 2000s.

Since mid-2012, house prices have risen at a decent pace in almost all major metropolitan areas of the United States. Many of the metro areas that experienced the steepest declines during the housing bust have witnessed strong recoveries, though house prices remain well below their peaks. Increases in these markets are partly driven by investor purchases, as evidenced by higher shares of cash sales for distressed and non-distressed residential properties. Such cash sales have declined slightly in recent months. As investor buying slows, house price appreciation could abate in these metro areas.

Housing affordability — which measures whether a typical family, earning the median family income, can qualify for a mortgage at the prevailing interest rate on a median-priced existing single family home — has improved substantially since the Great Recession,

Figure 5. Construction Activity Remains Low by Historical Standards Despite Recent Improvements



Source: Reuters EcoWin

though higher lending standards have partly offset its benefits. FICO scores at originations — a commonly used measure of credit risk — have risen notably, reflecting lenders' increased caution and regulatory restrictions. Lack of growth in the outstanding amount of real estate loans of commercial banks over the past four years confirms this caution.

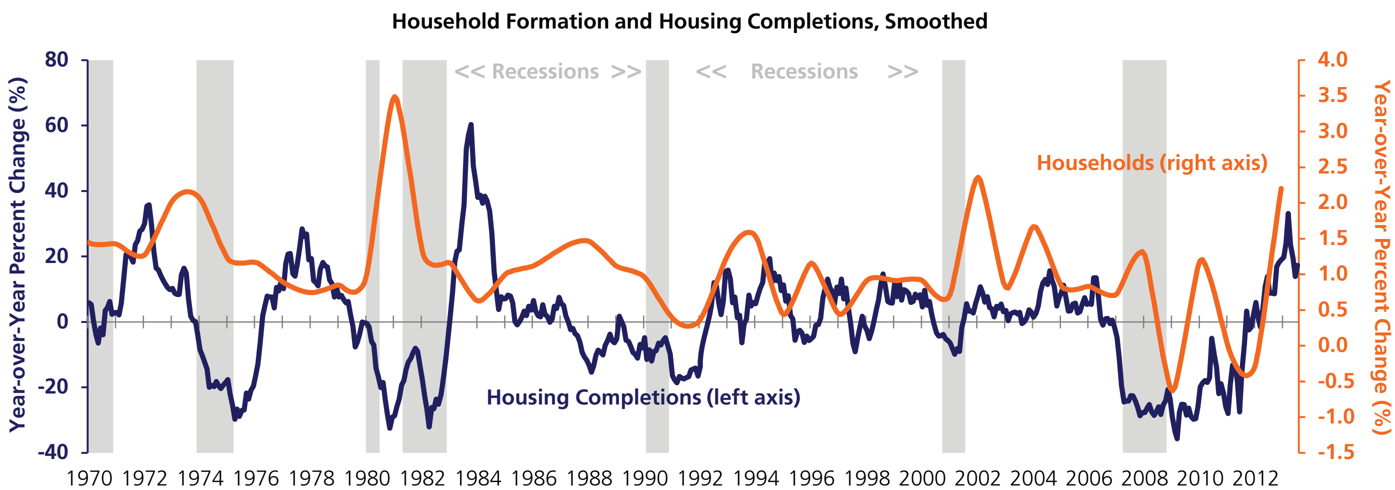
Immigrants, Aging Populace Will Drive Housing Demand

Household formation slowed markedly following the Great Recession as unemployment rose, economic activity dwindled, job vacancies declined and disposable income growth disappointed. The result has been slower residential construction and home sales, as shown in Figure 6. In the coming years, anticipated U.S. demographic developments — namely, immigration-driven population growth and an aging population — will be important features of the housing market.

Population growth in the U.S. is projected to remain decent. Not only does the U.S. have a higher fertility rate than most other advanced countries, it attracts huge numbers of migrants from the rest of the world; nearly 13% of the U.S. population is foreign-born. Foreign-born share of the population is a crucial factor in new household formation nationally, not just in states with large numbers of immigrant arrivals. Between 2000 and 2010, foreign-born share constituted nearly 36% of the total increase in households, compared with less than 9% of the growth in households between 1970 and 1980. While the pace of immigration has slowed a bit since the Great Recession, we expect immigrants will continue to come to the U.S. for higher real wages, a better quality of life and family ties. As such, immigrants will be important buyers of homes in their new places of residence.[2] For example, the five most-common surnames in residential real estate transactions in the huge California market appear to be Latino, reflecting the housing demand from both new arrivals and from the established Latino community.

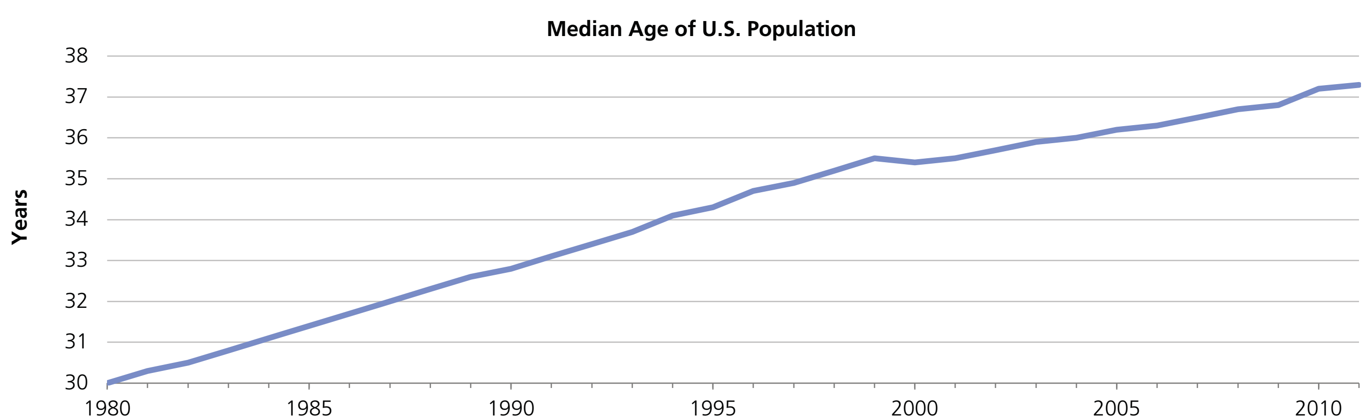
[2] See Dowell Myers and John Pitkin (2013), "Immigrant Contributions to Housing Demand in the United States," (Research Institute for Housing America) for further discussion of immigrants as a source of housing demand, based on detailed examination of demographic projections for the United States.

Figure 6. Slow Household Formation Suppresses Residential Construction and Home Sales



Source: Reuters EcoWin

Figure 7. The Median Age of the U.S. Population Has Risen Due to the Higher Share of Seniors



Source: Reuters EcoWin

The other important demographic factor that will affect housing demand is the aging of the U.S. population. The share of the total population under 25 years is declining, whereas the share of the population between 55 and 74 years is increasing; as a result, the median age of the U.S. population has trended steadily higher, as shown in Figure 7. The aging of the population will affect the pace, the pattern and the volume of housing transactions in the U.S. For example, whereas those from 35 to 55 years old will be net buyers of homes, those 55 and above will be net sellers.

A confluence of the aging and immigration trends can be seen in the demographic profiles of the groups that constitute net buyers and net sellers going forward. It is projected that by 2020 in California, for example, the majority of net buyers will be young and middle-aged Latinos while the majority of net sellers will be senior, non-Latino whites.

Conclusion

U.S. economic performance since the Great Recession has been disappointing. Fiscal stimulus was necessary, but it was not large enough to revive the labor market. Employment growth, confined mostly to low-wage industries, has been sclerotic even as the unemployment rate has declined. As a result, real disposable income per capita has been flat for the past few years. Meanwhile, accommodative monetary policy has kept Treasury yields and thus mortgage interest rates low until recently, supporting a sharp recovery in the housing market. While we do not believe the recent rise in mortgage interest rates will derail the housing recovery — provided real disposable incomes rise at least modestly — the pace of house price appreciation is destined to slow in the coming 12 months.

While demographic factors are favorable for housing demand in the U.S., real income growth will be essential to realize that demand. Although housing should be well supported in the long run by new household formation, near-term risks to recovery remain tilted to the downside. The combination of slow job growth centered in low-wage industries, feeble labor income growth, fiscal restraint and higher mortgage rates could impede the housing recovery, particularly the pace of construction activity and home price appreciation. Policymakers will need to foster high-quality employment and income growth to improve the nation's macroeconomic performance and sustain the housing rebound.

Acknowledgements

I thank David Goodson, Peter Guan, Mehmet Ozhabes, Anuranjan Sharma, Torsten Slok and Jeremy Wohlberg for their invaluable help. Participants at the ING Fixed Income Research Workshop provided useful comments. I am grateful to Dan Donnelly and his team for their indispensable editorial and graphic support. ■