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Current Housing Recovery Is The Real Deal

But Downside Risks Remain

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Each new monthly data release tells us that housing recovery has finally taken root. After several false starts over the last few years, what we are witnessing today appears to be the real thing. Home prices have been rising for at least the last six months. According to most widely watched measures, price appreciation has been in the 3-9% range on a year over basis. That has improved consumer sentiment and has contributed to greater home equity or less negative equity which is clearly driving potential purchasers back to the market. Indeed, 2012 was the best year for housing since 2005 with all major measures rising for the first time since the peak of the housing boom.

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Fundamentals have clearly improved and we expect growth to be sustainable. For several years, housing was a drag on the broader economy as indicated by a negative contribution to the nation's Gross Domestic Product (GDP). That has changed and housing is becoming a driver of the broader economy. The fundamental reason is the shear size of the housing market and the inherent multiplier effect it carries with it. Typically, housing has led recession recovery; at least from 10 of the 11 recessions since World War II. Until now that has not been happening during this recovery. Today, however, we are seeing housing perform in a manner more consistent with previous recoveries. Both new and existing home sales are the strongest they have been since the tax credit fuelled pace of late 2009. Building permit issuance is roaring back. At the same time distress sales have declined and inventories have contracted. Similarly, the number of underwater homeowners declined in the fourth quarter according to Core Logic. The ratio of underwater mortgages compared to total mortgages outstanding nationwide was 21.5% as compared to 25.2% a year earlier. Some states, such as Florida are nearly double that rate but overall more homeowners are digging out of the negative equity hole.

Looking forward, the worst case in our view, is that housing will just chug along at a nominal sub-par pace. At best it will lead the way to broader economic recovery. The obvious and necessary caveat is that there will be no currently unforeseen economic shock that would derail the recovery or throw the fragile broader economy back into recession.

Despite all the indicators that bode well for the future of housing, there are still some downside risks. Fiscal policy continues to weigh heavily on both housing and the broader economy. The end of the payroll tax break affected not only high earners but raised the tax liability for an estimated 77% of working Americans. Additionally, higher marginal tax rates for high income individuals; a higher capital gains tax rate (15% to 20%) on high income households and the 3.8% tax surcharge on proceeds from a home sale for married couples earning more than $250,000 may take a bite out of the luxury or higher end home market and have negative implications for the jumbo mortgage sector. Overall, the impact is likely to be small.

Uncertainty over sequestration could pose a bigger threat in the form of job losses, particularly in the defense industry. A recent study commissioned by USA Today newspaper suggested that there may be upwards of 1.0 million job losses, primarily in states serving the defense industry. Only time will tell what the job losses will actually be but the uncertainty will weigh heavily and will likely dampen housing demand. With what we know at this writing, however, the overall housing market should survive sequestration successfully.

Although the share of distress sales has been edging down in recent months, they are still at historically high levels and may rise again, at least temporarily. Indeed, pre-foreclosure filings rose sharply in February (+10%) suggesting more distress properties may come to market later this year.