Economics | United States
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Wake up and smell the roses

Michelle Meyer
US Economist
MLPF&S
mmeyer2@baml.com
+1 646 855 6261

US Economics
MLPF&S

May was a good month

May was a good month for the housing market. Existing home sales increased 4.9%, pending home sales climbed 6.1%, and new home sales surged 18.6%. Even mortgage purchase applications inched higher. While housing starts and homebuilder sentiment declined in May, confidence improved in June according to the NAHB housing index. Perhaps the spring selling season was late this year. Took time to defrost from this winter.

We are taking a sigh of relief from the recent data — in order for our annual forecasts to prove accurate, we needed to see positive data releases. However, one month does not make a trend, and there are still a number of lingering concerns as we look to the end of the year. Credit conditions remain tight, wage inflation sluggish and uncertainty high. These are factors that will continue to limit the pace of recovery but not restrict it. We are seeing incremental job gains and some gradual loosening of credit standards. Absent another spike in mortgage rates, the housing recovery should continue on its bumpy and gradual path.

We continue to look for moderating home price appreciation but a pickup in housing starts and sales. The April S&P Case Shiller index showed a notable slowdown in the rate of appreciation, increasing 0.2% mom, the slowest since February 2012. The CoreLogic home price data actually showed a decline in the monthly seasonally adjusted index in April and May. Some moderation in home prices is welcome given that prices have once again become overvalued relative to income growth in many parts of the country. However, the key is for price appreciation to be strong enough to keep expectations about future gains positive. Don't underestimate the importance of animal spirits when it comes to housing.

Hot topics over the past month

A good month: The housing data finally turned positive in May. While we are encouraged by the data, we do not believe the housing recovery is set to take off.

Less mobile: There has been a secular decline in household mobility. In the near term, we think the fall in the homeownership rate and rising home prices could boost mobility, but that the longer-term trend is lower due to the aging population and mortgage lock-in.

A slower trajectory: We look for housing starts to average 1.25 million next year, still showing improvement from our forecast of 1.03 million this year.

The haves and have nots: Slowing home price appreciation in Phoenix, Las Vegas and Atlanta should be partly offset by gains in regions which have lagged, such as Chicago and New York.

Refer to important disclosures on page 8 to 9. Link to Definitions on page 7.

Key takeaways

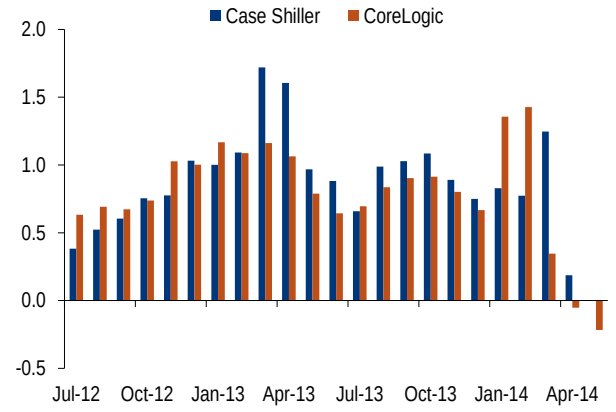
- We are forecasting housing starts to average 1.03 million this year, up 11% from last year. After also accounting for the slow trajectory in home sales, this means residential investment will only add 0.1pp to growth this year.
- We forecast home price appreciation is set to slow. We look for prices to be up about 5% this year (Q4/Q4).

Table 1: Summary of housing forecasts

	Quarterly								Annual average			
	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	2012	2013	2014	2015
Existing home sales (000s, saar)	4927	5100	5323	4943	4603	4846	5105	5225	4659	5073	4945	5250
New home sales (000s, saar)	447	447	382	446	433	468	498	536	368	430	484	575
Housing starts (000s, saar)	947	865	882	1025	925	1030	1055	1110	784	930	1030	1250
S&P Case-Shiller home prices (% yoy)	10.0	10.0	11.2	11.4	10.3	8.4	6.9	5.2	2.8	10.7	7.7	3.3

Source: BofA Merrill Lynch Global Research, Census Bureau, National Association of Realtors, S&P Case-Shiller; Note: S&P Case-Shiller prices are annual average, 4Q/4Q change are in the quarterly table. Shaded regions represent BofA Merrill Lynch Global Research forecasts.

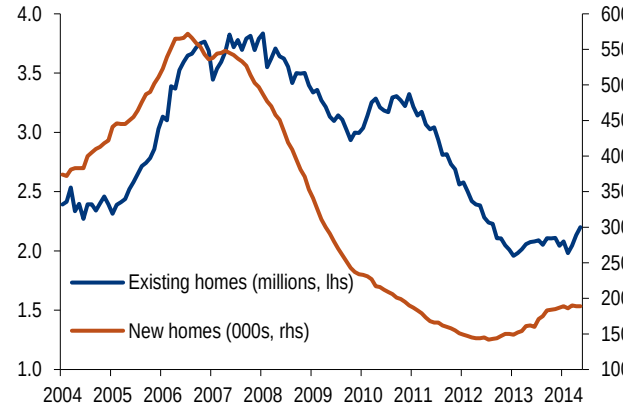
Chart 1: Monthly changes in CoreLogic and Case Shiller prices (% mom, SA)



Source: BofA Merrill Lynch Global Research, CoreLogic, S&P Case-Shiller

- Home price appreciation has started to slow after outsized gains at the start of the year. CoreLogic home prices actually declined on a seasonally adjusted basis in the past two months.
- The data have been particularly noisy. This could potentially be a result of poor seasonal adjustments, reflecting abnormal weather and the influence of distressed sales.
- Nonetheless, we think home price appreciation is set to slow, leaving us comfortable with our forecast that home prices will be up 5.2% yoy in Q4 compared to the 10.3% gain in Q1.

Chart 2: Inventory of existing homes has picked up, while new construction has remained low (number of units)

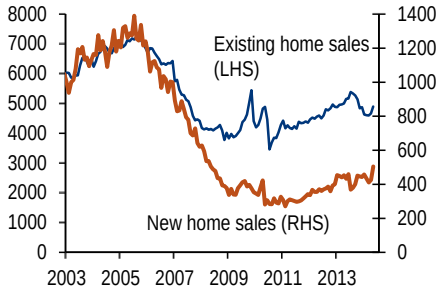


Source: BofA Merrill Lynch Global Research, Census Bureau, NAR

- Inventory of existing homes for sale ticked up in April and May. Part of the gain is seasonal – but it still looks impressive even controlling for seasonality.
- The housing market has been tight, so the rise in inventory could be a welcome development in terms of boosting home sales.
- Inventory of new construction homes for sale has remained stubbornly low as builders stay cautious.

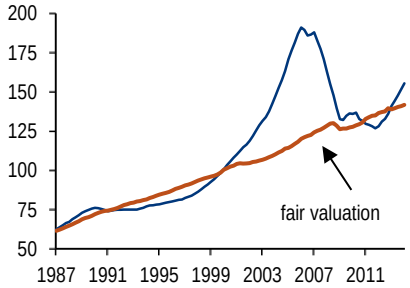
Michelle Meyer +1 646 855 6261

Chart 3: Tick higher in existing and new home sales in May



Source: NAR, Census Bureau, BofA Merrill Lynch Global Research

Chart 4: Home prices have exceeded fair valuation (indexed value)



Source: S&P Case Shiller, Census Bureau, BofA Merrill Lynch Global Research

A good month

Housing Watch: June 26

We finally had some good news on the home front. Existing home sales increased 4.9% mom in May while new home sales surged 18.6% (Chart 3). Even with a gain in sales, supply of homes on the market increased. Part of the pickup in inventory is seasonal — supply always increases during the spring selling season. After controlling for the typical seasonal patterns, inventory is still higher over the past two months. The hope is that greater supply will facilitate more sales.

Home price appreciation is also starting to moderate, which is a trend we think will continue. The S&P Case Shiller 20-city composite increased 0.2% mom (SA) in April, the slowest monthly gain since prices bottomed in the beginning of 2012. On the one hand, the slowdown in home price appreciation is welcome since home prices have exceeded fair valuation (Chart 4). A moderation in home price appreciation improves affordability, potentially increasing the population of potential buyers. On the other hand, slowing home price appreciation could cause homebuyers to downgrade expectations for future prices. Animal spirits are important for the housing market.

The slowdown in home prices has been accompanied by a decline in mortgage rates, underpinning affordability. The average rate on a 30-year fixed-rate conventional mortgage has declined from the recent peak of about 4.50% to 4.15% today. This equates to “savings” of $33/month based on an average home price of 200,000 and a 20% down-payment.

Problems are not fixed

While we are encouraged by the latest data, we do not believe the housing recovery is set to take off. The market is still restrained by tight credit conditions. Indeed, mortgage purchase applications are still trending lower. We suspect that the Mortgage Bankers Association (MBA) data may not be capturing the entire lending universe. We think the risk is that the sample underrepresents the smaller regional banks. Regardless, it is clear that credit is not flowing freely in the housing market.

Households are also coping with slow income growth. Wages have been increasing at a sluggish 2% yoy while real disposable income per capita is trending at 1.9% yoy. Moreover, the labor force participation rate has failed to recover, leaving the share of the population that is employed at low levels. The economy has enjoyed wealth gains, but it has been concentrated in the upper income cohort. Purchasing power is limited.

We reiterate: the housing recovery is ongoing, but it is a gradual. There are still speed bumps ahead.

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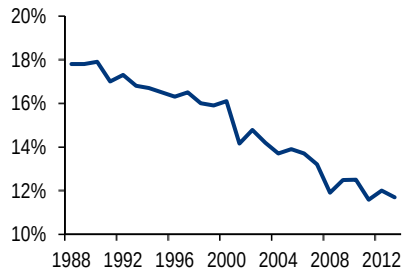
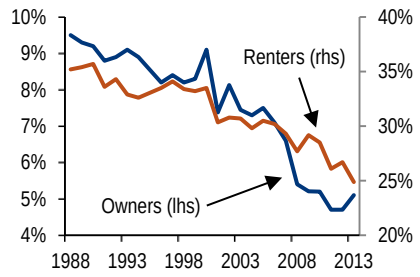
Chart 5: Mobility rate (% of total population)



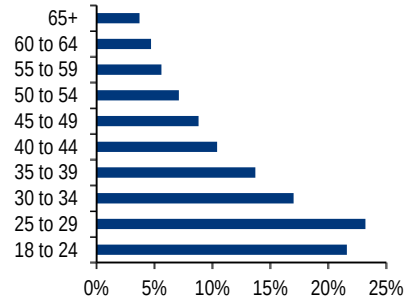
Source: BofA Merrill Lynch Global Research, Census Bureau

Chart 6: Owner vs. renter (% of group)



Source: BofA Merrill Lynch Global Research, Census Bureau

Chart 7: Mobility rate by age (% of age group)



Source: BofA Merrill Lynch Global Research, Census Bureau

Less mobile

Housing Watch: June 19

Housing turnover has been sluggish, in part due to weak underlying demand but also due to less mobility in the housing sector. The household mobility rate — the percent of the population that moves in a given year — has been on a downward trajectory since the mid-1980s (Chart 5). There are a number of explanations for the decline: more people owning rather than renting (particularly in the 1990s), aging population (starting in 2000) and changes in the labor market with a greater share of dual-earning households. We think the mobility rate can increase in the short-run, but we see a lower longer-term trajectory.

Driving it higher

The two primary factors which should boost the mobility rate in the short-run are the decline in the homeownership rate and rising home prices. The homeownership rate has plunged from the peak in late 2004, and we think the risk is that it continues to slide. As Chart 6 shows, homeowners are less mobile than renters — from 2012 to 2013, 25% of renters moved compared to 5% of owners. The shift toward greater renting should boost the aggregate mobility rate.

The cost of moving is higher for homeowners than renters. Homeowners are faced with steep transaction costs including realtor fees, homeowner insurance, and mortgage fees. It is also a longer and more complicated process to move as a homeowner. As a renter, you have a defined timeline based on your contract. Increases in rents or disputes with landlords can also encourage a move.

The amount of equity in the house also plays a role in influencing mobility. Negative equity — when debt exceeds the value of the home — will reduce mobility. A NY Fed Paper found that homeowners with negative equity were one-fourth less likely to move than equivalent owners with positive equity.[1] As Chart 6 shows, the homeowner mobility rate has declined more quickly than the rental rate since the housing bust. As home prices continue to rise, a growing number of homeowners will move into positive equity, allowing for greater mobility.

Pushing it down

While the increase in the number of renters and positive equity will support mobility, it is countered by an aging population and higher mortgage rates. The greatest propensity to move is when people are in their late 20s. The mobility rate steadily declines thereafter as people age (Chart 7). We should also be concerned that mortgage "lock-in" will reduce mobility over the medium term. We expect rates to head higher in the coming years, increasing mortgage payments. It will be difficult for those homeowners who bought or refinanced to a fixed-rate mortgage over the past few years to give up the record low rate.

[1] Ferreira, Fernando et al., *Housing Busts and Household Mobility: An Update*. Federal Reserve Bank of New York Staff Reports. November 2011.

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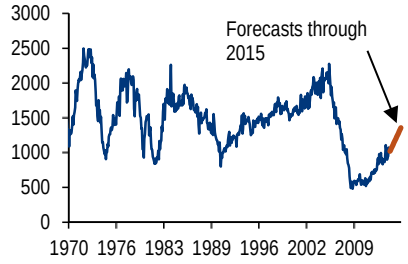
Chart 8: Housing starts on a slow trajectory higher (000s of units)



Source: BofA Merrill Lynch Global Research, Census Bureau

Chart 9: Median days on the market for sale of existing homes (days)

Source: BofA Merrill Lynch Global Research, National Association of Realtors

A slower trajectory

Housing Watch: June 12

We are trimming our forecast for housing starts next year, consistent with the downward revision to GDP growth. We now look for housing starts to average 1.25 million next year, which is still a solid 20% gain from our estimate of 1.03 million this year (Chart 8). We also look for the pace of existing home sales to pick up while home prices moderate. This will leave residential investment adding 0.4pp to growth next year, after the feeble 0.1pp contribution this year.

Repairing the broken links

The normal mechanisms that underpin a recovery in the housing market are impaired in this cycle. Typically there will be a supply response to an increase in prices, which in turn moderates the pace of home price appreciation. The normal cycle looks like this:

Decline in interest rates → home sales pick up → home prices increase → supply increases → home price appreciation moderates

Although borrowing costs have declined, credit conditions remain tight, limiting the flow of credit and the pool of perspective borrowers. This has been offset to a certain extent by an increase in all-cash buyers and investors. But investor appetite has declined amid a shrinking supply of distressed properties. Even with the weak trend in home sales since last summer, the market has remained tight, keeping upward pressure on prices (Chart 9).

This typically prompts sellers to engage – either existing owners or builders. However, the supply response has been slow. Homebuilders are reportedly facing a number of constraints: difficulty finding attractive lots and good labor in certain markets. Moreover, many smaller builders are still struggling to get financing. Builders have also remained cautious and have not actively put up speculative communities. In general, they seem to be sacrificing volume for pricing.

The slow turn in homebuilding makes it more difficult for existing sellers. Where do you move if you sell your home? Another challenge for potential sellers is that many do not have a sufficient equity cushion to finance the move. Transaction costs about 5% to 10% of the purchase price and a standard downpayment is 20% (note that FHA loans can be as low as 3.5% and borrowers also have the option of mortgage insurance (MI) for conventional loans). Nonetheless, homeowners need to be able to pull equity out of their homes in order to move, and that is still a challenge.

These issues will be resolved over time, slowly generating momentum in the housing market. We need to remember, however, that this is far from a normal recovery in the housing market.

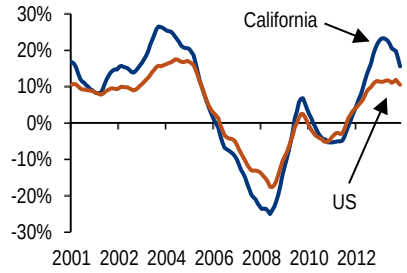
Michelle Meyer +1 646 855 6261

Table 2: Regional home prices (%, MSAs ranked by gain since trough, data as of April 2014)

	Decline during bust	Gain since trough	% yoy
San Francisco	-24.2%	53.4%	17.4%
Phoenix	-52.8%	48.6%	10.3%
Las Vegas	-59.9%	48.5%	15.0%
Miami	-52.9%	45.5%	13.3%
Detroit	-52.0%	44.3%	13.1%
Los Angeles	-39.3%	40.5%	15.4%
San Diego	-38.4%	36.2%	13.8%
Atlanta	-33.6%	32.4%	12.5%
Seattle	-32.2%	32.4%	11.7%
Portland	-30.4%	31.1%	11.9%
Denver	-14.6%	30.0%	9.5%
Houston	-12.7%	29.2%	14.1%
Washington DC	-33.5%	28.8%	7.0%
United States	-32.6%	27.3%	10.5%
Tampa	-48.2%	25.4%	9.1%
Dallas	-13.8%	24.3%	10.4%
Charlotte	-17.2%	23.7%	6.9%
Minneapolis	-30.8%	22.0%	9.7%
Boston	-25.8%	21.1%	6.6%
Chicago	-36.5%	17.8%	11.4%
New York	-20.1%	16.0%	10.5%
Cleveland	-29.1%	13.6%	5.0%
Philadelphia	-17.0%	8.8%	5.8%

Source: BofA Merrill Lynch Global Research, CoreLogic

Chart 10: California prices have peaked (% yoy)



Source: BofA Merrill Lynch Global Research, CoreLogic

The haves and have nots

Housing Watch: June 6

The gain in home prices has been widespread, with prices up on an annual basis in all 20 metropolitan areas surveyed. However, the improvement has been particularly notable in certain markets, which have disproportionately pulled up the national composite. The areas with the fastest home price appreciation have generally been those that have attracted the greatest amount of investor buying. As investor demand wanes in these markets, home price appreciation slows.

The prime examples are Phoenix, Las Vegas and Atlanta. As Table 2 shows, home prices (using CoreLogic data) plunged 53% from the peak to the trough in Phoenix but have since rebounded 49%. Price appreciation peaked at 24% yoy in late 2012 and has been slowing since. The cycle was a bit later in Las Vegas with prices peaking at 28% yoy last summer and most recently in Atlanta at 16.5% in February. The distressed backlog has been greatly reduced in these regions, making it less attractive for investors. We would expect price appreciation to continue to slow, returning to a pace more consistent with income growth.

If not for these markets, where will the boost to national home prices come from? There are still a few regions with a large supply of distressed properties: Chicago, New York and Philadelphia. Prices have recently started to accelerate in all three markets, particularly in Chicago which has made progress at clearing the overhang. However, these markets have a judicial foreclosure process which means it will take time to work through the foreclosure backlog, potentially limiting the speed of the rebound.

The major markets in Texas have also been showing strength, particularly Houston where prices are up 14.1% yoy, with notable momentum. Prices only fell 13% peak-to-trough during the downturn and have already rebounded 29%. This is not a story of distressed buying, but we think investors have been active in this region as well.

Surfs up

The trend in home prices in California is particularly important when gauging the risks to national home prices. About 10% of the national housing stock is in California; it is about 20% if measured by the value of the owner occupied housing stock. Home prices also tend to be more volatile in California than the nation and seem to be an early indicator of the turns in the overall market. As Chart 10 shows, home prices in California have recently peaked at 23% yoy in August and have slowed to the current pace of 15.6% yoy. If history is a guide, this suggests a slowdown in national prices is coming. This is consistent with our forecast. We are looking for the pace of home price appreciation to be nearly half of the current 10.5% pace by the end of the year.

Link to Definitions

Macro

Click here for definitions of commonly used terms.

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