



**CARL HUDSON** is director of the Federal Reserve Bank of Atlanta's Center for Real Estate Analytics.

# The Housing Market Is Improving... Or Is It?

**R**ecent reports indicate home prices are appreciating, housing starts are up, mortgage rates are lower than ever, and housing affordability is good. These reports point to a clear upswing in the housing market—don't they? Well, that depends. The housing market does seem to be a bright—well, brighter—spot of late. Still, significant headwinds remain. Their strength and gustiness depend on the extent to which the Great Recession altered some short-term factors in our economy, including household formation rates and preferences for renting versus owning, the speed at which shadow inventory comes to market, and the accessibility of mortgage credit.

## Why are economists so concerned with housing?

The state of the housing market has a significant influence on the overall economic outlook. Housing dynamics directly affect the growth of construction activity and the employment of construction and affiliated workers. In the second quarter of 2012, for example, residential investment as a percent of gross domestic product (GDP) was 2.4 percent, compared to a long-run average (from first-quarter 1947 to second-quarter 2012) of 4.65 percent. Figures from the U.S. Bureau of Labor Statistics show that since July 2006, total nonfarm employment is down 3.04 million, and construction employment accounts for 2.23 million of those lost jobs. (Residential construction accounts for 1.41 million jobs; nonresidential, 0.68 million; and heavy and civil, 0.15 million).

The housing market also affects home values, which influence economic decisions

in other areas of the economy: consumer saving and spending, bank lending activity, and personal and new-business credit access. For example, a consumer who owes more on a mortgage than the house is worth is not likely to make a big purchasing decision like buying a new car. (Personal consumption expenditures represent around 70 percent of GDP.)

## On the one hand: The case for optimism

In his July 17 congressional testimony, Fed Chairman Ben Bernanke cited an upturn in house prices, new and existing home sales, and new home construction as signs of modest improvement in housing. The data clearly support the chairman's conclusion:

- The May 2012 CoreLogic figures, released in early July, mark the third consecutive increase in home prices nationwide on both a year-over-year and month-over-month basis.
- According to numbers from the National Association of Realtors, June's existing home sales were 4.8 percent higher than in June 2011. New home sales in June 2012 were 15.1 percent higher than they were in June 2011.
- After bottoming out in May 2009, residential construction spending was flat for some time, but has been on an upward trend since July 2011, according to figures from the U.S. Census Bureau.

## On the other hand: Looming short-term factors

Given that the numbers cited above are, in general, increasing from very low

levels, we have good reason to expect that residential investment will continue to make a positive contribution to GDP growth. When combined with demographic trends, the long-term prospects for housing look quite favorable. But the gustiest headwinds that could keep the housing market from continued growth relate to the short run. As I see it, the answer to three questions will dictate the growth in residential investment.

### **1. To what extent will shadow inventory dampen recovery?**

Seriously delinquent mortgages remain elevated, and thus an ongoing flow of foreclosed properties may continue to hold down home price appreciation. A rebound in home prices is important, given that many homeowners who would like to sell cannot because their current mortgage is underwater. The thought is that until home prices improve, negative equity will create a logjam, preventing those who may be move-up home buyers from entering the market.

In addition, negative equity plays a significant role in shadow inventory of homes. Negative equity does not automatically mean foreclosure, but it does mean that homeowners with negative equity are likelier to experience foreclosure if they experience a shock such as a job loss. Negative equity and its effect on shadow inventory warrant continued monitoring. Also, given the time it takes to process foreclosures in judicial states—states that require a court review for foreclosures—it is more likely that distressed properties will trickle to market rather than be a torrent. (Florida, the only judicial state among the states of the Atlanta Fed region, has a large backlog of homes that have yet to go through the courts, leaving this state with a large shadow inventory.)

Interestingly, we have some indication that a lack of houses for sale in a particular market—whether it’s because homeowners can’t or won’t sell—actually helps drive prices up. Recent analysis by Zillow indicates that markets with the

greatest percentage of homes with negative equity have experienced the greatest reduction in for-sale inventory. Anecdotes from contacts in the Atlanta Fed region are consistent with the idea that a lack of houses for sale is helping home price appreciation.

### **2. Housing may be affordable, but what about mortgage financing?**

As of midsummer 2012, the average rates for 30-year and 15-year fixed-rate mortgages stood at 3.49 percent and 2.8 percent, respectively. These rates are the lowest recorded average rates since the survey began in April 1971. With mortgage rates at such low levels and house prices still depressed, measures of home affordability are high, according to data from the National Association of Realtors and Zillow.

However, there is the problem of mortgage accessibility. Results from the Federal Reserve’s July 2012 Senior Loan Officer Survey point to elevated underwriting standards that make qualifying for home loans very difficult. Data from the real estate services and analytics firm Lender Processing Services (LPS) are consistent with these survey results. According to the LPS, the median FICO score at the origination of conventional mortgages has risen from 721 in October 2007 to 772 in May 2012. Thus, during a time when many consumers saw their credit score decline, the score required by lenders has increased.

### **3. How long will it take to meet demographic trends?**

The argument that demographics will eventually increase housing activity is based largely on two facts:

- Echo boomers (those born from around 1982 to 1995) represent a group larger than the baby boomers (those born from 1946 to 1964).
- Household formation slowed during the Great Recession.

Anecdotal reports indicate that echo boomers are living under their parents’ roofs longer than previous generations. The thought is that eventually, they will

exert themselves and move into their own homes, bumping up the lagging household formation rates. In turn, there should be an increase in housing demand and construction activity. (See “Econ 101: Household Formation” in the second-quarter 2011 issue of *EconSouth* for an explanation of why household formation matters.)

However, echo boomers bring with them record levels of student debt. Plus, tighter underwriting standards, a higher level of debt to income, and more stringent down payment requirements all point to more difficulty qualifying for a mortgage. Will young Americans choose or be forced to rent longer?

We also have to ask, where will the echo boomers want to live? As baby boomers retire or downsize and sell their houses, will the echo boomers be eager to buy their homes? Some observers say that the echo boomer preferences differ significantly from the suburban or exurban neighborhoods preferred by many baby boomers, the implication being that price appreciation in many of the locations where baby boomers now live may be very tepid. (Listen to “No Place Like Home? The Future of the Housing Market,” a podcast in the Atlanta Fed’s *Perspectives on Real Estate* podcast series on [frbatlanta.org](http://frbatlanta.org).)

### **Lingering questions**

Long-term demographics favor housing and construction. As the housing market moves from its current low levels toward levels that demographic trends might indicate, residential investment should be expected to make a positive contribution to GDP growth. But given questions about housing supply, demand, and financing, we might conclude that movement along the short-term path, while positive, may be slow and arduous. ■