THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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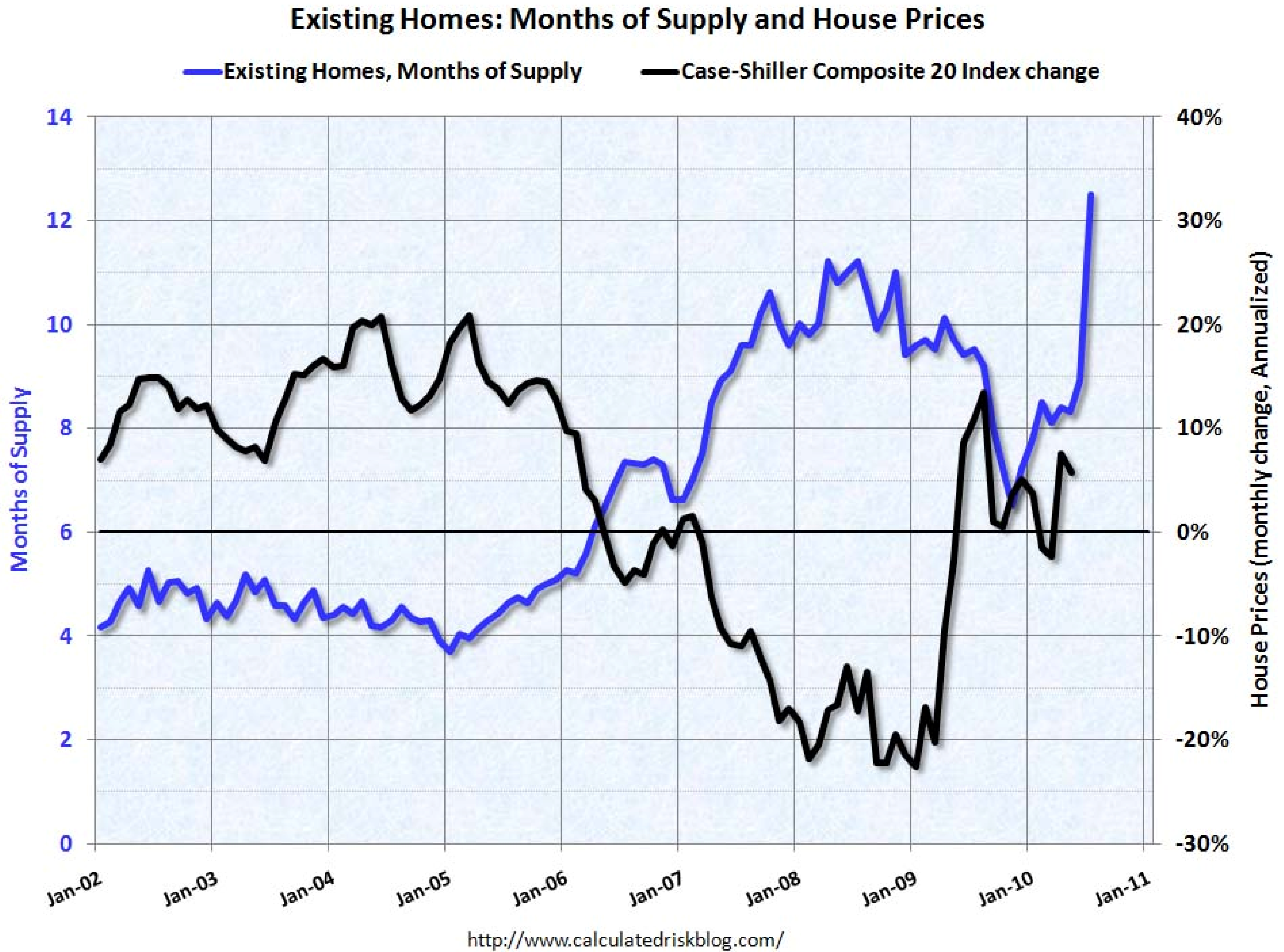
Excessive Housing Inventory to Keep Home Prices Under Pressure…the Work Out Will Take Time

- One of the main reasons we are forecasting minimal growth in consumer demand three years after the collapse of the real estate bubble is the number of households with mortgage debt that exceeds the value of their homes, i.e., negative equity. According to First American CoreLogic, "11 million, or 23 percent, of all residential properties with mortgages were in negative equity at the end of the second quarter of 2010, down from 11.2 million and 24 percent from the first quarter of 2010. Foreclosures, rather than meaningful price appreciation, were the primary driver in the change in negative equity." When home prices were rising, consumption was boosted by the 'feel good' wealth effect and by homeowners withdrawing equity from their homes in the form of credit lines. Now the economy is experiencing the reverse effect.
- We believe home prices will remain depressed for several years due to excess supply, and would not be surprised to see prices fall modestly in the second half of the year. New home construction has been cut back to 25% of peak levels, but increased foreclosures are driving inventories to record levels relative to monthly sales (see Weekly Chart). We see no quick fix for the housing market but are hopeful that, as foreclosure rates rise, negative equity is finally peaking as the debt is written off by the lenders. Similarly, mortgage delinquency rates have eased to 14.4% in the second quarter (from 14.7% in the first) as employment has stabilized. Unlike Japan, the US housing market is working out its problems through the pricing mechanism, as over-indebted homeowners sell to those with stronger balance sheets. This is a positive longer-term development, but it will likely continue to weigh on short-term consumer confidence.
- Judging by Federal Reserve Chairman Bernanke's Jackson Hole speech last week, we think it is clear that the Fed is still setting monetary policy to support the housing market – the 'weakest link' in the economic chain. Household balance sheets and income remain critical, as Bernanke explains, because:

  > "Stronger balance sheets should in turn allow households to increase their spending more rapidly as credit conditions ease and the overall economy improves. Household finances and attitudes also bear heavily on the housing market, which has generally remained depressed. In particular, home sales dropped sharply... the overhang of foreclosed-upon and vacant housing and the difficulties of many households in obtaining mortgage financing are likely to continue to weigh on the pace of residential investment for some time yet."

  Such housing woes are why we think the Fed welcomes lower long-term interest rates – mortgage rates are at record lows, which should help support house prices at the margin. Hence, although we still expect home prices to fall, the decline should be gradual. So long as the economy does not fall back into recession, we think prices are within 10% of their ultimate bottom.
- Our July 19 *Weekly View* listed several reasons why we thought Treasury yields are so low: low inflation, slower economic growth, a flight to (relative) safety, and the widening trade deficit. Declining home prices are influencing the first three. Shelter represents almost a third of the CPI and thus exerts significant pressure on keeping inflation low, and the negative wealth effect is hurting growth and confidence. Ultimately, we think long-term interest rates are unsustainably low but acknowledge that they tend to reflect investors' expectations of nominal economic growth. If house prices resume month-to-month declines, a 2% 10-year Treasury yield is conceivable. However, if nominal GDP growth is around 3% (1.5% real growth plus 1.5% inflation) over the next 12 months, as we expect, and if investors come to believe that Bernanke will use all the resources at his disposal to prevent deflation, then we think yields will be higher a year from now.

Weekly Chart: House prices likely headed lower again



The chart above, courtesy of Calculated Risk, suggests that house prices [dark black line, right hand scale, monthly annualized change] are likely to resume monthly declines as the supply of existing homes (housing inventory divided by current monthly sales rates) hit a 27-year high -- 12.5 months. Typically, when supply at current sales rates is below six months, house prices have tended to rise. However, when inventories are above six month's supply, prices have trended downward. If unemployment was to decline substantially and household incomes ramped up, sales could increase and mitigate house price declines. Unfortunately, given the economic environment we anticipate over the next year, we expect sluggish employment and income growth.

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