

Research

US: Gauging the potential from a turn in housing

- Along with the US economy moving out of recession, signs of stabilisation in the housing market have emerged. The correction in housing activity over the past three years has taken both construction activity and home sales substantially below any long-term sustainable level. We believe that a turnaround in sales and residential construction is on the cards for H2 this year and home prices are likely to follow.
- Housing fundamentals have turned considerably more positive over recent months. Affordability is close to an all-time high, construction as a percent of GDP is at its lowest level since WWII and the inventory of new homes for sale has dropped below its long-run average. Given our expectation that job growth will be back in the black by year-end, the backdrop is thus in place for a rebound in housing.
- We expect home sales to recover back to the underlying trend over the coming six to eight quarters, and residential construction to turn from a considerable headwind to a modest tailwind. Prices are in the process of bottoming and we look for positive growth in 2010. Unless home sales turn out stronger than we anticipate, we don't envisage much of an increase in house prices in 2009 though.
- Lagged effects from the plunge in household net wealth caused by declining home prices will continue to weigh on consumers through 2010, but at a diminishing rate. This leaves the overall contribution to growth from housing at 0.2-0.3pp AR in each of the coming six quarters compared to an average drag of 1.5pp over the past three.

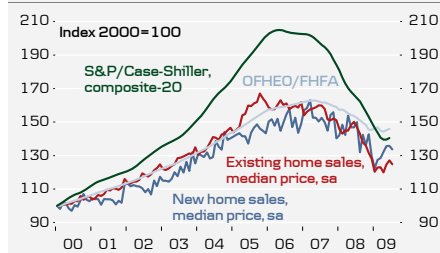
Don't disregard a turn in housing

The burst of the housing bubble and the subsequent plunge in home sales and residential construction has had severe consequences for the US economy. Households have seen the value of their housing assets shrink by more than USD 4000bn since the peak in late 2006. This in turn has fuelled major losses in the financial sector and a ramp-up in the household savings rate. On top of this, residential construction, which at the peak accounted for 6.3% of GDP, has shrunk to a mere 2.4% of GDP in Q2 2009, subtracting on average 1% AR each quarter from GDP growth over the past three years. A turnaround in housing activity and prices will thus remove a significant drag on the economy and a major factor of uncertainty for both the financial sector and US households.

While housing cycles are generally long, the current downturn has been unusually protracted. The boom in the housing market resulted in a relatively large overshooting in investment, home sales and prices, but over the past quarters, this overshooting has reversed into a general undershooting. A turnaround in the housing market is thus on the cards, and once the rebound materialises it has the potential to be hefty.

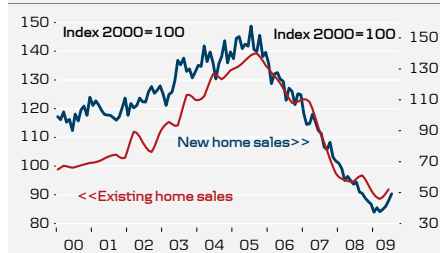
Indeed, the latest housing market data has been encouraging. New home sales have risen 30% from the bottom in March this year, existing home sales are up 4% and the latest Senior Loan Officer Survey showed an increase in demand for prime mortgages for the second quarter in a row. Furthermore, the two major home price indexes that we track, the S&P/Case-Shiller national and the FHFA purchase only, have shown sequential increases in June.

Signs of stabilisation in home prices...



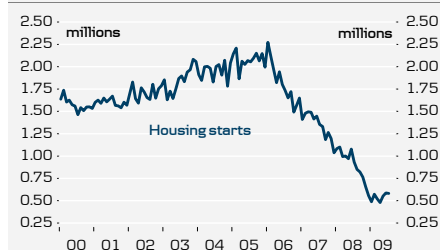
Source: Reuters Ecowin and Danske Markets

... sales...



Source: Reuters Ecowin and Danske Markets

...and construction



Source: Reuters Ecowin and Danske Markets

Senior Analyst

Signe Roed-Frederiksen
+45 45 12 82 29
sroe@danskebank.dk

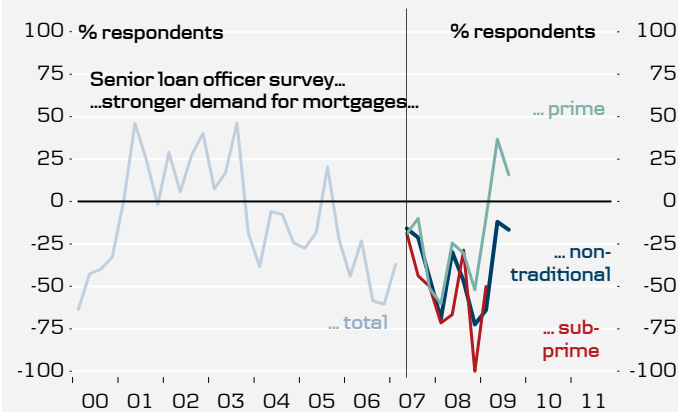
Senior Analyst

Pater Passing Andersen
+45 45 13 70 19
pa@danskebank.dk

Pent up demand coming on stream

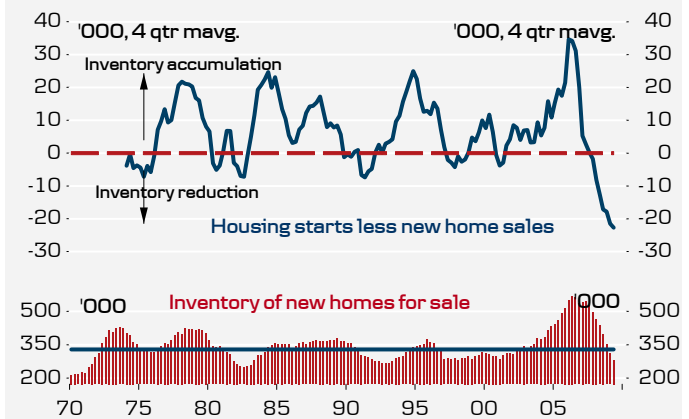
The inventory of new homes for sale skyrocketed from 2004 to 2006, far overshooting the long run average, but since then, a gradual correction towards more reasonable inventory levels has been ongoing. In order to get rid of the excess inventory of new homes, supply has to fall short of demand for a period of time. This implies that new home sales have outpaced housing starts. This has been the case for the last two years and the correction has now brought the inventory of unsold new homes below its long run average. With very lean inventories, a pick-up in demand for new homes or even a stabilisation would thus translate into a lift in “production” of new homes i.e. residential construction.

Demand for prime mortgages is rising again



Source: Reuters Ecowin and Danske Markets

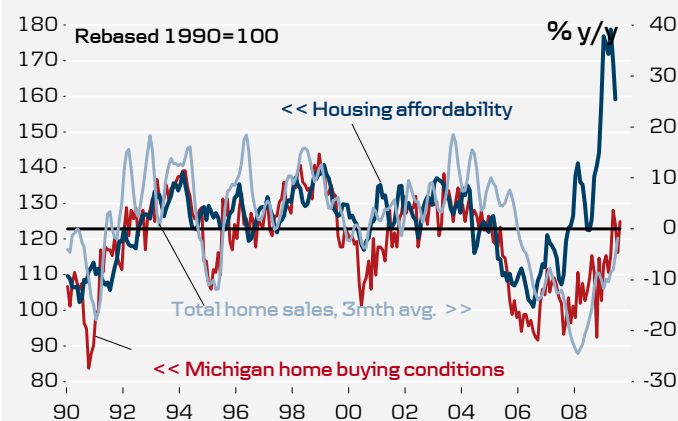
A fast run down in inventories as the pace of supply falls short of demand



Source: Reuters Ecowin and Danske Markets

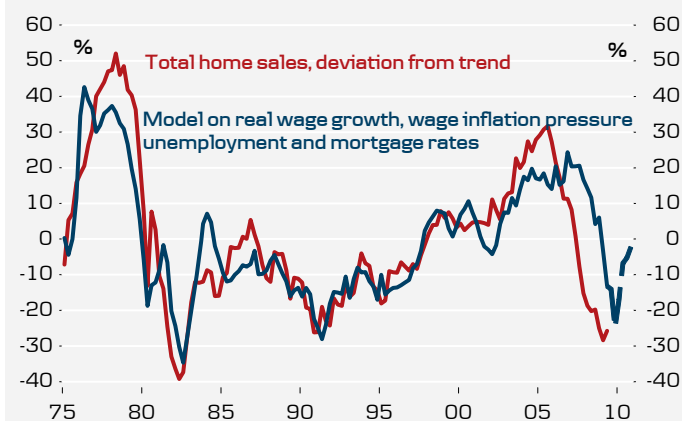
Fundamentals are generally positive for housing demand. The worst of the impact from the credit shock is behind us, house prices are at a low level compared to income and mortgage rates are relatively low. Nevertheless, home buyers have to a large extent stayed on the sideline and home sales are stuck at depressed levels. Total home sales have grossly undershot the level implied by our simple model based on mortgage rates, unemployment and growth in real compensation. This suggests that a recovery in sales is on the cards once consumer home-buying sentiment turns more favourable.

Improving housing fundamentals has encouraged buyers to step off the sideline



Source: Reuters Ecowin and Danske Markets

With employment growth back in black by year-end, home sales should recover

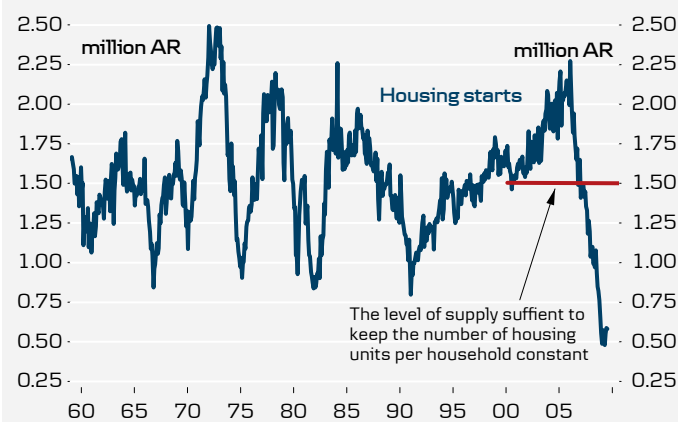


Source: Reuters Ecowin and Danske Markets

In our view, the final catalyst for getting pent-up housing demand on the market is a stabilisation in the labour market. We expect this to materialise by Q4 this year as GDP growth recovers to above trend. Given our expectation of a turnaround in the labour market and assuming that mortgage rates follow the trend in government bond yields, implying an increase of 100bp over the course of next year, home sales should return gradually to trend sales of around 7 million AR by late 2010 from the current level of 5.1 million AR. This implies a significant rebound in new home sales and consequently in residential construction in the coming quarters. Assuming that new home sales adjust to trend sales over the next two years, this implies growth rates of on average 35% q/q AR for the next eight quarters. The potential from a turnaround in the housing market is thus substantial.

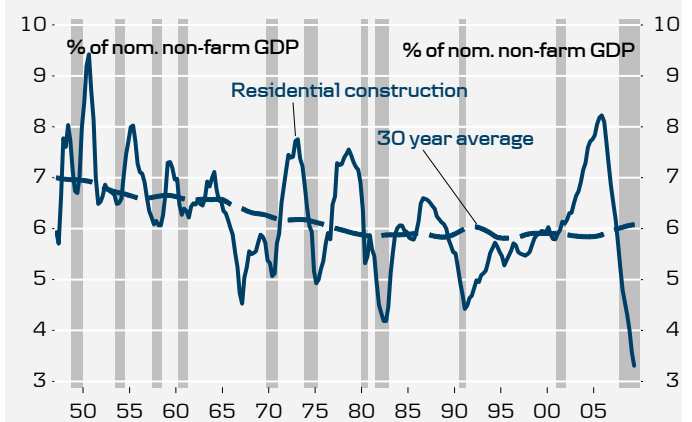
The longer run outlook for residential construction looks favourable as well. A general feature of housing cycles is that they are mean-reverting. This follows from the fact that there is a natural demand for new homes from demographics, i.e. population growth, and replacement of housing units lost from demolition, damages, conversions and other changes. New household formation in the US runs at around 1.4 million annually and demolitions around 600,000 per year, according to the US department of housing and urban development. Around 500,000 housing units are derived annually from other sources than construction which implies that 1.5 million housing units annually need to come onto the market in order to keep the stock of housing units per household constant. This is far below the current pace of housing starts at 580,000 units annually.

A large catch-up potential in housing starts



Source: Reuters Ecowin and Danske Markets

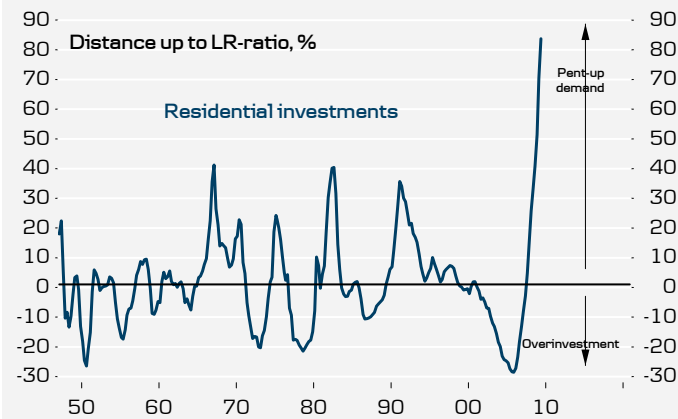
Residential investment as a percent of GDP is far below the long term ratio



Source: Reuters Ecowin and Danske Markets

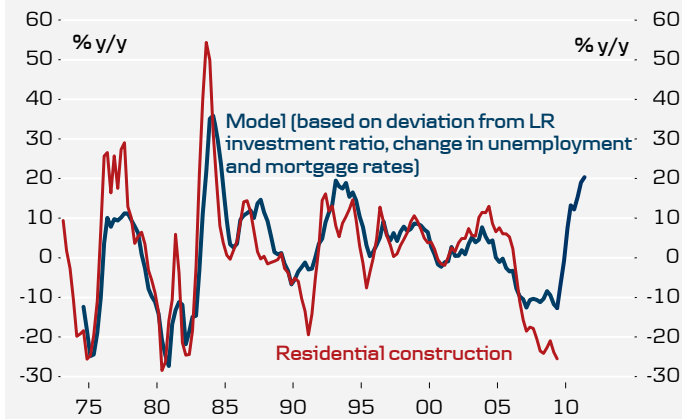
Another way to gauge the underinvestment in housing is to look at the value of residential investment as a share of nonfarm GDP, referred to as the residential investment ratio. This measure is now at its lowest level since WWII and has fallen far below the 30-year long run average. The mean reverting properties of the investment cycle means that the distance between the current investment ratio and the long-run average is able to explain at least some of the variation in residential construction. Currently residential construction will need to increase by 84% from its current level in order to get the investment ratio back at its long-run average.

Residential investment ratio deviation from long run average at an all time high



Source: Reuters Ecowin and Danske Markets

A rebound in residential construction is on the cards



Source: Reuters Ecowin and Danske Markets

A simple model based on this distance, the change in unemployment and the change in mortgage rates suggests that residential construction growth should increase to 20% y/y by Q2 2011. This is a somewhat more gradual adjustment than implied by new home sales.

Using the information from both models and taking into consideration that tight credit conditions is likely to remain constraining on the construction sector for some time yet, we expect residential construction to increase by 12% q/q AR in Q3, by 35% in Q4 and gradually decline to 20% q/q AR thereafter. Already in the current quarter residential construction should thus turn from a significant drag on growth of on average 1% AR per quarter over the past three years to a positive contributor. The boost to growth should rise to approximately 0.8-0.9pp AR in Q4 and Q1 next year and stay at 0.5-0.6pp for the remainder of 2010.

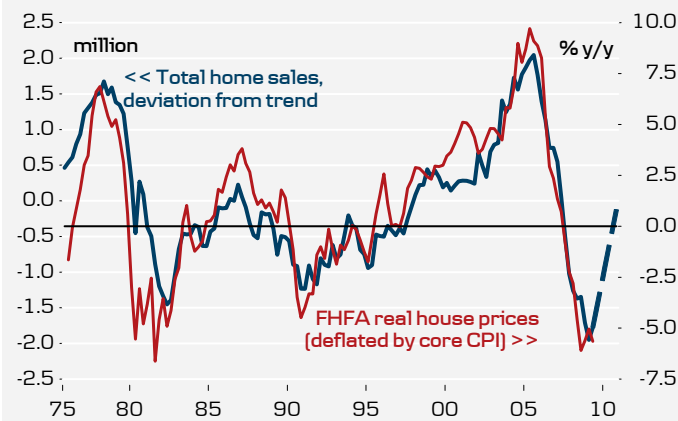
Home prices to follow with a lag

Historically, the pace of home sales and house prices has been closely correlated. It is however not the absolute level of home sales that matters for prices but rather the deviation from trend sales. Home sales should trend upwards over time to keep up with the growth in households and the housing stock. In order to get upward pressure on real house prices, home sales need to rise at a pace close to or above this underlying trend. Even though we expect the recovery in home sales to continue in the coming months, home prices is likely to follow with a lag.

The historical relationship between total home sales and real house prices implies that a return to trend sales by end 2010 will be accompanied by a 1.25% annual growth rate in real prices corresponding to 2.5% y/y growth in nominal prices.

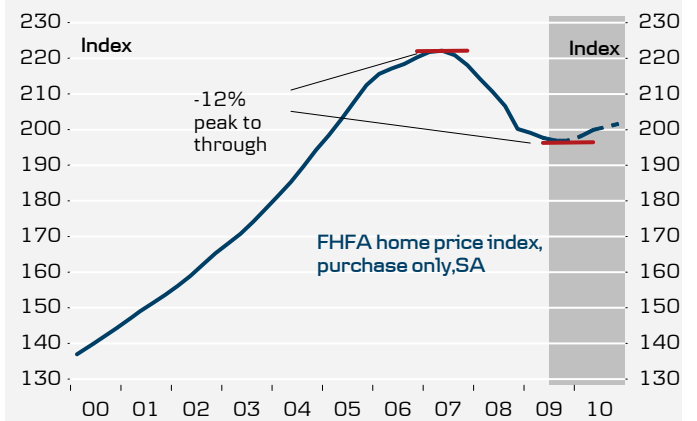
Currently, house prices are in a bottoming process and we expect that to continue throughout this year. Unless home sales recover even faster than we expect, we do not see scope for a major increase in home prices this year though. An additional factor which is likely to weigh on home prices for a while yet is the elevated inventory of existing homes for sale and the continued rise in foreclosures and distressed sales.

Home prices to start growing again as we get closer to 2010



Source: Reuters Ecowin and Danske Markets

House prices and Danske Banks forecast



Source: Reuters Ecowin and Danske Markets

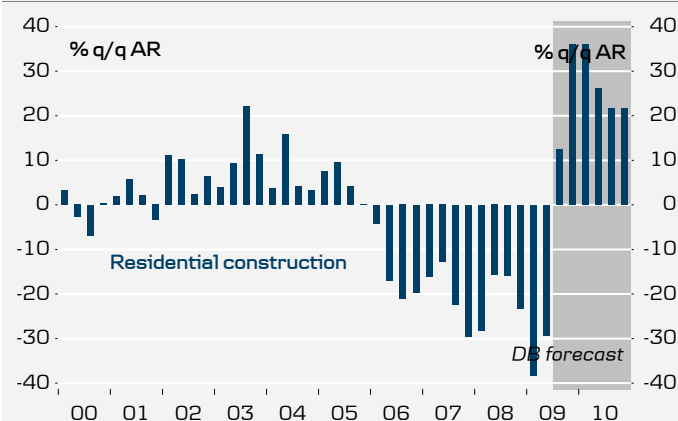
Housing headwinds turning

The most direct impact on GDP growth from changes in house prices comes through the wealth effect on private consumption spending. Generally, consumers adjust to changes in their net wealth very gradual and the negative impact on consumer spending from the house price bust has only just peaked. Looking forward, although house prices are set to rise by year end, the impact on private consumption will be negative throughout 2010. Importantly though, the drag on growth will diminish from here.

The rebound in residential construction will remove a significant drag on GDP growth which has been in place for three years now. We expect the contribution to growth to turn modestly positive in Q3 this year and provide a boost to growth of app 0.8-0.9pp q/q AR in Q4 and Q1 next year fading to a boost of around 0.5-0.6pp through the rest of 2010.

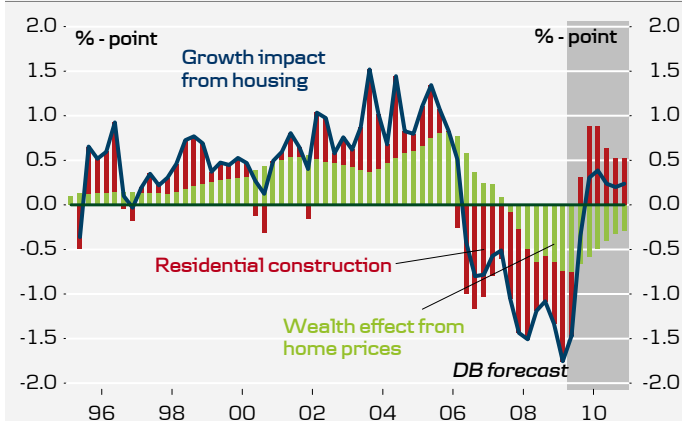
Overall the housing market will turn from a significant drag, subtracting 1.5pp AR from overall growth on average over the last three quarters, to a modest tailwind adding around 0.2-0.4pp AR to growth from Q4 this year and throughout 2010. This measures the direct effect on GDP growth but on top of this, a stabilisation in the housing market will remove a large factor of uncertainty from households and banks balance sheets. While the direct effect on GDP is difficult to quantify it will most certainly have positive spill-over effects on the broader economy.

Residential construction and Danske Bank's forecast



Source: Reuters Ecowin and Danske Markets

A significant headwind to growth will head off



Source: Reuters Ecowin and Danske Markets

Disclosure

This report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority. The authors of this report is Signe Roed-Frederiksen and Peter Possing Andersen.

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high quality research based on research objectivity and independence. These procedures are documented in the Danske Bank Research Policy. Employees within the Danske Bank Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and to the Compliance Officer. Danske Bank Research departments are organised independently from and do not report to other Danske Bank business areas. Research analysts are remunerated in part based on the over-all profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Danske Bank research reports are prepared in accordance with the Danish Society of Investment Professionals' Ethical rules and the Recommendations of the Danish Securities Dealers Association.

Risk warning

Major risks connected with recommendations or opinions in this report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

First date of publication

Please see the front page of this research report for the first date of publication.

Disclaimer

This publication has been prepared by Danske Markets for information purposes only. It has been prepared independently, solely from publicly available information and does not take into account the views of Danske Bank's internal credit department. It is not an offer or solicitation of any offer to purchase or sell any financial instrument. Whilst reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and no liability is accepted for any loss arising from reliance on it. Danske Bank, its affiliates or staff, may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives), of any issuer mentioned herein. The Equity and Corporate Bonds analysts are not permitted to invest in securities under coverage in their research sector. This publication is not intended for retail customers in the UK or any person in the US. Danske Markets is a division of Danske Bank A/S. Danske Bank A/S is authorized by the Danish Financial Supervisory Authority and subject to limited regulation by the Financial Services Authority (UK). Details on the extent of our regulation by the Financial Services Authority are available from us on request. Copyright © Danske Bank A/S. All rights reserved. This publication is protected by copyright and may not be reproduced in whole or in part without permission.