Weekly Economic Commentary

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Revisiting the Residential Recovery

John Canally, CFA
Economist
LPL Financial

Highlights

The sharp rise in mortgage rates should slow, but not derail the housing recovery.

Although it is too soon to gauge the impact of rising rates on the housing market, almost all of the housing indicators we watch suggest that the housing recovery still has a long way to go.

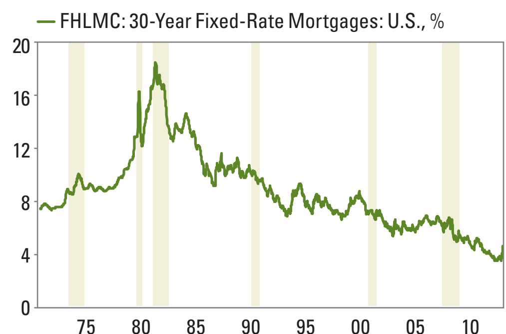
Please see the LPL Financial Research Weekly Calendar on page 3

The recent rise in mortgage rates — from just under 3.5% (for a conventional 30-year loan) to just under 4.5% since mid-May 2013 has led to widespread fears the housing recovery would come grinding to a halt. Those fears appear to be overdone, in our view, as almost all of the factors supporting an ongoing recovery in housing remain in place. At this stage of the recovery, satisfying pent up demand for housing rather than mortgage rates is likely to be the bigger driver of housing. Later on, when the pent up demand is sated, interest rates (and affordability) should be. Recent comments from publicly-traded homebuilders suggest that rising rates have had virtually no impact on demand for new homes, and that the sharp rise in rates may be pushing buyers into the market that had previously been "on the fence".

At just 2% to 3% of gross domestic product (GDP), housing's share of GDP remains well below what it was at the peak of the housing market in 2005–06, when housing accounted for more than 6% of GDP. This helps to dispel the notion that housing is already in a "bubble" and the bubble is about to burst. Many, if not all, of the other housing indicators we watch (see below) also suggest ongoing recovery in the housing market in the quarters and years to come.

To be sure, while the sharp increase in mortgage rates since mid-May 2013 will act to slow the pace of gains in the housing market, our view remains that the U.S. housing market is still in the early stages of recovering from the 2006–09 bust that followed the decade-and-a-half (early 1990s through mid-2000s) housing boom that began to show severe cracks in 2007, and collapsed in 2008. The collapse in housing, in turn, was a major contributor to the financial crisis and Great Recession of 2007–09. The housing market, along with many financial markets and global economies, is still feeling the after-effects of the housing collapse.

1 Despite the 100 Basis Points Rise Since Mid-May 2013, 30-Year Mortgage Rates Remain Very Close to All-Time Lows



Source: FHLMC, Haver Analytics 07/01/13

(Shaded areas indicate a recession)

"Location, Location, Location"

As the old saying goes, the real estate market is all about "location, location, location." When we discuss the housing market, we do so from a national perspective: what is happening to the housing market on your street or in your neighborhood, town, city, or state, may be completely different (better or worse) than what is happening nationwide.

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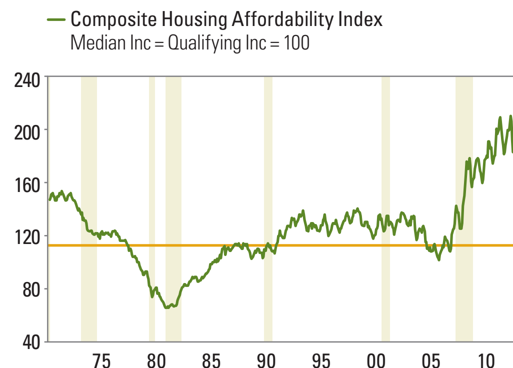
Despite the recent rapid rise in rates—unwelcome, in our view by Federal Reserve (Fed) policymakers—we still see housing making another significant (0.3–0.5 percentage points) contribution to GDP growth in 2013, as the positives driving the residential recovery more than outweigh the negatives.

With that important caveat in mind, we can say that the housing market (sales, prices, construction, etc) hit bottom in early 2009, and moved sideways between early 2009 and late 2011 before beginning to pick up momentum at the start of 2012. Until housing added 0.3 percentage points to overall GDP in 2012, housing construction (the most direct way housing impacts GDP) had not been a significant, sustained contributor to economic growth since 2005 (as measured by GDP). The lack of participation from housing has been one of the main reasons (along with the severe cutbacks in state and local governments) behind the sluggish economic recovery so far. Despite the recent rapid rise in rates—unwelcome, in our view by Federal Reserve (Fed) policymakers—we still see housing making another significant (0.3–0.5 percentage points) contribution to GDP growth in 2013, as the positives driving the residential recovery more than outweigh the negatives.

There are a number of direct (housing starts, housing sales, construction spending, home prices) and indirect (homebuilder sentiment, mortgage applications, foreclosures, inventories of unsold homes, mortgage rates, housing vacancies, lumber prices, prices of publicly traded homebuilders) ways to measure the health of the housing market. The U.S. government and private sources collect and disseminate these data. A quick recap of these various indicators is below.

2 The Recent Rise in Mortgage Rates and Home Prices Has Outstripped Income Growth, Driving Affordability Lower From All-Time Highs



Source: National Association of Realtors, Haver Analytics 07/01/13

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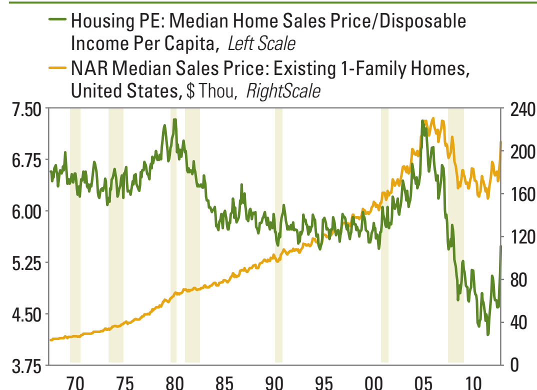
The affordability index measures whether or not a typical family could qualify for a mortgage loan on a typical home.

3 The Housing Price/Earnings Remain Well Below Normal, Indicating That Housing Is Far From a Bubble



Source: Haver Analytics 07/01/13

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Taking the Pulse of the Residential Recovery

- **Near-record housing affordability.** Housing affordability, the ability of a household with the median income to afford the payments on a median-priced house at prevailing mortgage rates, hit an all-time high in early 2013, before the big run-up in mortgage rates that began in mid-May 2013. The latest data point (April 2013) saw a 13% drop in affordability from the peak in February 2013. The 100 basis point increase in mortgage rates since mid-May 2013 will further erode affordability. However, rising incomes and the aftermath of the 20–30% drop in home prices nationwide between 2005 and 2009 will continue to support an elevated level of affordability. At this point in the housing recovery, pent up demand is likely to outweigh affordability as the main driver of housing demand.
- **Housing Price to Earnings (PE).** While not a perfect measure of the frothiness (or lack thereof) in the housing market, the ratio of the median sales price of an existing home ($209,000 in May 2013) to disposable personal income per capita ($38,219 as of May 2013) is one way to gauge the health of the market. The nearby figure shows that while the housing PE has moved higher in recent months, it remains well below average. Indeed, aside from the housing bust era (2007–2011), the housing PE is the lowest it has been in more than four decades. This also suggests that the housing recovery remains in its early stages, and is not in a bubble.
- **Housing market improvement is broadening out.** According to the National Association of Homebuilders Improving Market Index, in June 2013, 263 of 361 metropolitan areas across the United States are

LPL Financial Research Weekly Calendar

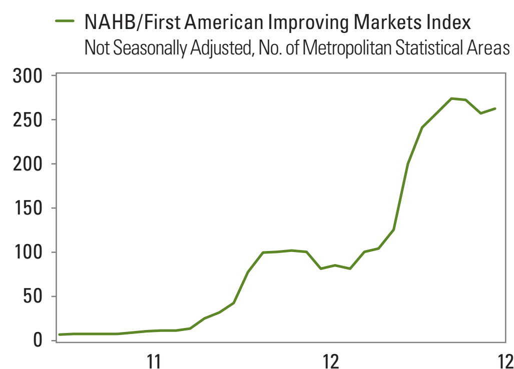
2013	U.S. Data	Fed	Global Notables
1 Jul	■ ISM (Jun) ■ Markit PMI (Jun) ■ Construction Spending (May)		■ **Eurozone: PMI (Jun)** ■ Eurozone: CPI (Jun) ■ Italy: New Car Registrations (Jun) ■ Eurozone: Croatia becomes EU's 28th member
2 Jul	■ Factory Orders (May) ■ **Vehicle Sales (Jun)**	**Dudley ***	■ **China: Service Sector PMI (Jun)** ■ Australia: Central Bank Meeting
3 Jul	■ Challenger Job Cut Announcements (Jun) ■ ADP Employment (Jun) ■ Trade Balance (May) ■ **Initial Claims (6/29)** ■ **ISM Non Manufacturing (Jun)**		■ Eurozone: Service Sector PMI (Jun) ■ Eurozone: Retail Sales (May) ■ **Japan: BOJ Governor Kuroda speech** ■ Germany: Bond Auction
4 Jul			■ **UK: Central Bank Meeting** ■ **Eurozone: ECB Meeting** ■ Spain: Bond Auction ■ France: Bond Auction
5 Jul	■ **Employment Report (Jun)**		■ Spain: Industrial Production (May) ■ **Germany: Factory Orders (May)**

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

4 Housing Is Improving in Virtually Every Market in the Country

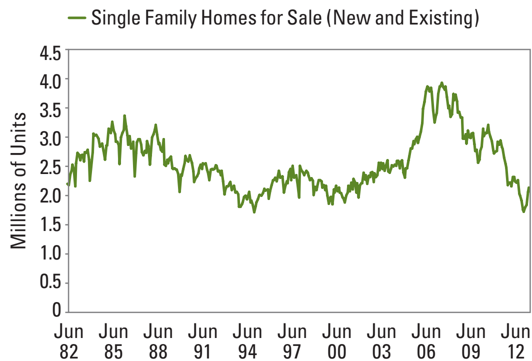


Source: FIBER, Haver Analytics 07/01/13

"improving," reflecting six consecutive months of increasing employment, increasing home prices, and increasing housing permits. In June 2012, just 80 markets made the list. The widespread improvement in the housing market nationwide is another sign that we remain in the early stages of the recovery. When the improvement narrows to just a few "frothy" markets, it may be a sign that the recovery is tiring out.

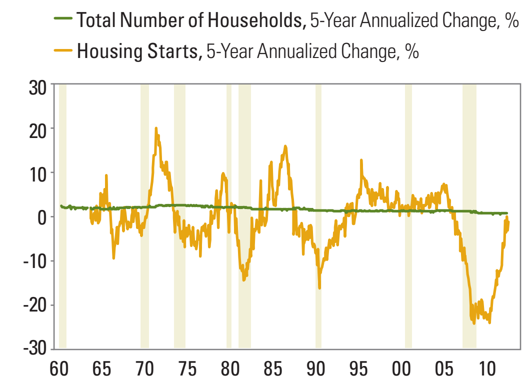
- **Homebuilder sentiment.** At 52 (on a scale of 0 to 100, where zero is the worst and 100 is the best), in June 2013, the index of homebuilder sentiment has surged over the past 21 months and now sits at its highest level since March 2006. However, during the peak of the housing boom, this index was as high as 70, and averaged 60. This is another measure that has a long way to go before signaling a normal housing market, let alone a bubble. The private sector's National Association of Home Builders compiles the homebuilder sentiment data.
- **Inventories of unsold homes are low.** Although the inventory of unsold existing homes has moved up from a 12-year low since the start of 2013, inventories of unsold existing homes remain below average. The official count of the inventory of unsold single-family existing homes (from the National Association of Realtors), along with the record-low inventory of new homes for sale, tells us that there are 2.0 million homes for sale. Depending on the data source cited (there is no "official" number for shadow inventory), the shadow inventory is in the 1.5–2.0 million range.

5 Inventory of New and Existing Homes Remains Near All-Time Lows



Source: National Association of Realtors, Haver Analytics 07/01/13

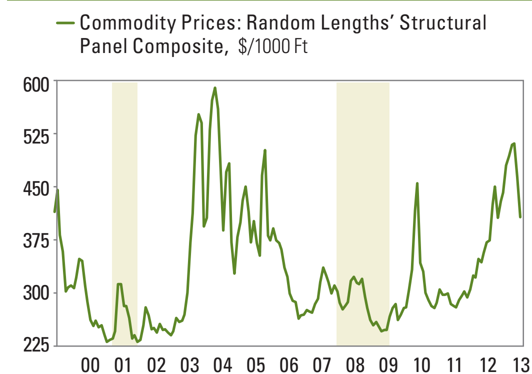
6 Household Formation Still Outstripping Housing Starts



Source: Census Bureau, Haver Analytics 07/01/13

(Shaded areas indicate a recession)

7 Lumber Prices Have Come Off of Multi-Year Highs, but Factors Outside of Housing May Be Impacting Prices



Source: FIBER, Haver Analytics 07/01/13

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While still well above average, the shadow inventory has moved sharply lower over the past 18 months. The low inventory of unsold homes supports ongoing improvement in housing construction and housing sales.

- **Housing starts and building permits.** Responding to less demand for housing, difficult credit conditions, and a glut of unsold inventory, homebuilders drastically cut the number of new housing starts in recent years. Housing starts peaked at 2.3 million units in early 2006, and by early 2009 had dropped to under 500,000 units, an 80% drop. Since then, as inventories of unsold new and existing homes shrunk and the economy and financing conditions improved, starts have more than doubled, to nearly a one million annualized rate in early 2013. Still, despite the 100% move off the bottom, housing starts remain 60% below their all-time high. The U.S. Commerce Department collects housing starts and building permits (a key leading indicator of starts).
- **Homebuilder stocks.** Although they are not a perfect leading indicator of the health of the housing market, the S&P 500 Homebuilders' Index has nearly tripled since October 2011-despite a 20% pullback since mid-May 2013. Homebuilding stocks—as measured by the S&P 500 Homebuilders' Index—are still nearly 60% below the peak hit in mid-2005, suggesting that we are not anywhere close to the bubble period of the mid-2000s
- **Lumber prices.** Lumber is a key input to the homebuilding process. Lumber prices peaked in mid-2004—a year or so before the housing market peaked—and declined by nearly 70% by early 2009. Between early 2009 and May 2013, lumber prices nearly tripled (in fits and starts). Since the rise in mortgage rates that began in early May 2013, lumber prices have dropped by 25%, and remain almost 30% below their 2004 peak. This is one of the few signals on the housing market that is flashing caution, although it should be noted that housing is only one of the drivers of the price of lumber. Demand from China, trade negotiations between the U.S. and Canada, growing conditions for trees, transportation costs, etc., are all key elements driving lumber prices. Lumber prices are set in the open market and trade on several global commodity exchanges
- **Supply of home mortgages.** From the mid-1990s through late 2006, bank lending standards (down payment required, credit scores, work history, etc) for residential mortgages were relatively easy. Coupled with low rates and rapid innovation in financial products backing residential mortgages, this easy credit helped to fuel the housing boom. The banking industry began tightening lending standards in early 2007, and continued to tighten for more than two years. Lending standards eased in 2009 and 2010, but remained more restrictive than they were in the peak boom years from 2004 to 2006. The latest survey (May 2013) reveals that bank lending standards for home mortgages are the easiest since mid-2006. The improvement in this indicator in recent quarters is a good sign, and should help to offset the recent rise in the rates banks are charging for mortgages

The housing recovery is dependent upon low interest rates, but not necessarily the lowest interest rates. History shows us that if job and income growth can rise along with mortgage rates, the growth in housing can continue.

- **Demand for home mortgages.** On the demand side of the equation, consumer demand for mortgages remained muted during the first two-and-a-half years (early 2009 through late 2011) of the housing recovery, as consumers remained uncertain about prospects for home price appreciation and their own financial and labor market status. Since then, an improved labor market, Fed actions to lower mortgage rates, and rising home prices have driven consumer demand for mortgages to levels not seen since the early 2000s. The Fed compiles these data in the Senior Loan Officer Survey, which is released quarterly. Low mortgage rates — thanks to a sluggish economy and aggressive Fed — are making home ownership an attractive alternative to renting. The housing recovery is dependent upon low interest rates, but not necessarily the lowest interest rates. History shows us that if job and income growth can rise along with mortgage rates, the growth in housing can continue.
- **Mortgage applications.** Measured by the private sector's Mortgage Bankers Association, the volume of mortgage applications (for both purchase and refinance) has doubled since late 2008, but remains well below its early-to mid-2000s peak. Since the start of the sharp rise in mortgage rates in mid-May 2013, the volume of applications for purchase have actually increased slightly, while applications for home refinancing have dropped by 40%. Weekly mortgage applications are a key gauge of consumer demand for housing, and we will watch this metric closely in the coming weeks and months. Mortgage applications are a component of our weekly *Current Conditions Index*.
- **Foreclosure activity.** After a de facto moratorium on new foreclosures was put into place in late 2010, as the U.S. and individual state governments sued mortgage processors and banks, the pace of new foreclosures slowed down. By early 2012, new foreclosures were at the lowest level since mid-2007. This legal action was settled in late 2011, and many housing market observers expected that the foreclosure pipeline would pick back up again. However, there was no discernible uptick in foreclosures after the moratorium was lifted, and now, in mid-2013, the pipeline of new defaults and overall mortgage delinquencies continues to drain, aided by a better economy and job market. A sustained rise in mortgage rates may lead to an increase in delinquencies in the coming months, and we will monitor the data closely. There are various public and private sources for foreclosure and delinquency data. On the private sector side, firms like RealtyTrak, Lender Processing Services, and the Mortgage Bankers Association provide data. Freddie Mac, Fannie Mae, and the Federal Housing Finance Administration (FHFA) are among the government agencies that compile data on delinquencies and foreclosures.
- **Construction employment.** As measured by the U.S. Department of Labor, employment in residential construction increased by more than one million between the early 2000s and 2006 to nearly 3.5 million workers. Since then, workers employed in the construction of new homes dropped by nearly 50%, bottoming out at just under two million

in late 2010. Construction employment has since moved up modestly, adding just 50,000 jobs in 2011 and another 40,000 in 2012. Year to date through May 2013, the economy has added another 15,000 construction jobs, and more are on the way. At the peak of the housing market in early 2006, jobs in the construction of new homes accounted for nearly 1% of all jobs in the economy. In a sign that the housing market is not overheated, today, employment in the construction of new homes is less than 0.5% of all jobs. Construction employment is poised to make a consistent contribution to overall employment in 2013, and may add as many as 10,000–20,000 jobs per month to overall employment.

- **Construction put into place.** The value of new residential construction put into place peaked at $525 billion in early 2006. Construction of new homes plummeted as the housing bubble burst, and by mid-2009, just $122 billion in new home construction was underway. This data series moved sideways for about 18 months, hitting another low ($120 billion) in early 2011. Home construction has since increased by more than 65% to $198 billion, but new home construction is still running more than 60% below its peak, suggesting a long runway for the housing recovery. The U.S. Commerce Department collects these data.
- **Home prices.** As of the latest available data (April 2013), home prices are rising at the fastest pace since early 2006, with a 12% year-over-year gain according to the Case-Shiller home price data. Price gains are occurring all over the country, but the largest year-over-year gains are in markets (San Francisco, Phoenix, Las Vegas, Atlanta, Detroit) that saw the largest price declines during the housing bust. Price gains in places like New York, Washington, D.C., and Dallas, that did not see big price declines between 2006 and 2011 are more modest. Builders are concentrating on those areas where the demand is strongest. There are a variety of sources for home prices from both the private sector—Case-Shiller Home Price Index, CoreLogic, Zillow, RadarLogic, National Association of Realtors—and the U.S. government—Freddie Mac, Fannie Mae, Federal Housing Finance Agency, etc. In general, these indices all suggest that home prices fell by between 20% and 30% between mid-2005 and early 2009. Over the next two-and-a-half years, home prices moved sideways. Today, home prices have risen by between 5% and 15% from their cycle lows. Price changes before, during, and after the bubble vary widely by region, price of home, and type of property (single family versus condo, distressed, and non-distressed, etc).
- **Demand for housing.** Unemployed new graduates were living with their parents or renting in large groups rather than moving into homes of their own for years after the 2008–09 recession; but that is ending. Over the last year, "household formation" has been picking up. In fact, the number of net new formations on a rolling 12-month basis is back to levels last seen in 2006, thanks to the echo boomers reaching their mid-to-late 20s. Most importantly, 2012 marked the second year in a row that housing formations (demand) outstripped housing completions (supply). Housing starts are headed consistently higher, boosting housing-related stocks.

How the U.S. Government Defines Households

The U.S. government defines a household as any single person or group of persons residing in a single housing unit. Households are formed when children move out of their parents' house to go to college, get a job, or get married, and/or when couples separate, or even when previously unrelated people (a group of roommates) find their own place to live.

Although it has slowed from its pre-Great Recession pace, new household formation is running just under 1.0% per year. By early 2011, the gap between new household (see nearby box) formation and new housing starts had never been wider. Soon thereafter, housing starts began to recover, and the healing in the housing market began to accelerate. However, there are still more than 18 million vacant homes—down from the peak of nearly 20 million, but still well above the pre-Great Recession level of 14–15 million. This indicator continues to suggest that the housing recovery is still in its early stages. The U.S. Census Bureau collects the data on household formation and housing vacancies.

On balance, it is likely that the sharp rise in mortgage rates that commenced in mid-May 2013 will slow the pace of housing activity that had accelerated noticeably since late 2011. However, while it is probably too soon after the rise in rates to tell for sure, most of the indicators we watch suggest that the housing recovery remains firmly entrenched. The pace (and sustainability) of the nascent housing recovery will help to determine the pace of the overall economic recovery. We expect housing to make a positive contribution to overall GDP growth in 2013, but that it will still take several more years before the national housing market is back to normal. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasure securities).

INDEX DESCRIPTIONS

The Chicago Area Purchasing Manager Index that is read on a monthly basis to gauge how manufacturing activity is performing. This index is a true snapshot of how manufacturing and corresponding businesses are performing for a given month. A reading of 50 or above is considered a positive reading. Anything below 50 is considered to indicate a decline in activity. Readings of the index have the ability to shift the day's trading session one way or another based on the results.

The National Association of Home Builders (NAHB)/First American Improving Markets Index measures the number of housing markets that are showing signs of improving economic health each month. The metro areas which see growth in employment, house prices, and single family housing at least six months after each indicator's respective trough, are categorized as improving and included in the index.

The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. The S&P/Chase-Shiller U.S. National Home Price Index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arm's-length transactions. The index is named for its creators, Karl Chase and Robert Shiller.

The Standard and Poor's 500 Homebuilding Index is a capitalization-weighted index. The index was developed with a base level of 10 for the 1941-43 base period, the parent index is SPX.

The Empire State Manufacturing Index is a seasonally-adjusted index that tracks the results of the Empire State Manufacturing Survey. The survey is distributed to roughly 175 manufacturing executives and asks questions intended to gauge both the current sentiment of the executives and their six-month outlook on the sector.

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