The Housing Overhang
It was the tipping point of the recent recession and credit crisis. The housing market essentially fell off a cliff around 2006, and the impact of that plunge continues to be felt around the U.S. today. The problems with the housing industry have been front-page news for several years now, and there are significant structural issues that still need to be worked through. Years after the crisis, the housing market continues to bounce along the bottom, but there are some positive signs. Ultimately, the housing market seems to have a long road to recovery, which is one reason Manning & Napier continues to see a slow growth environment for the U.S. In this discussion, we take a deeper look at the current state of the U.S. housing market.
Weakness Persists

The drop-off in housing activity over the past few years has been extraordinary. This is perhaps best evidenced by the sharp decline in residential fixed investment as a share of GDP. Residential investment’s contribution to GDP is now about half of what it was in the late 1990s, and the decline is even more pronounced when compared to the bubble period in the early 2000s. While this shows how much the housing industry has shrunk in recent years, it also implies that there may be less distance to fall going forward. If the housing market were to take another leg down, it would be a smaller hit to overall economic output than the past downturn.

Driving the deterioration in residential investment, home prices and sales have plummeted over the past few years and have yet to really recover. With a 7.7% uptick in the month of August, existing home sales are now at a 5.03 million annualized rate – this rate was 7.08 million at the peak in 2005. While still mediocre, existing home sales have been supported by low prices (particularly on foreclosures) and record-low mortgage rates, although obtaining home loans has been more difficult. Meanwhile, new home sales have been hit by the competition from existing inventory – especially less expensive foreclosure properties. Given such tepid home sales, housing starts remain depressed at an annual rate of 571,000 as of August, the lowest pace since at least the late 1950s. To put this into perspective, a healthy rate of construction is considered to be around 1 million to 1.5 million starts per year. Reflecting this weakness, housing sentiment remains particularly depressed. Builders are pessimistic, and their outlook hasn’t improved noticeably since the depths of the credit crisis.
Much of the pressure on the housing market has been related to the large amount of foreclosures, which have weighed on prices and flooded the market with inventory. Working through these foreclosures has been bumpy and painful, but there are initial signs that the process is playing out. In fact, distressed properties represented 31% of all existing home sales in August. Similarly, cash transactions accounted for nearly 29% of purchases in August. Prices appear to have depreciated enough to begin to attract activity. Overall, the overhang of foreclosures remains, but conditions appear to be getting better and the pipeline of foreclosures appears to be getting smaller.

Past Examples
While the current U.S. housing market collapse is unprecedented in its size and scope, it is helpful to review past housing downturns for insight into the recovery process. During the 1980s, California and Massachusetts experienced noteworthy housing booms. Home prices rose rapidly, as did home sales. This lasted for several years, but activity peaked in the late 1980s and a prolonged period of weakness followed. While different than today’s environment, this shows that it can take years to work through a housing market correction, even one that may not have been as severe as the current “bust.” Looking at current conditions, limited access to credit and an elevated unemployment rate suggest the recovery process will remain slow, but there is evidence of small steps toward progress.
OUTLOOK: THE HOUSING OVERHANG

On The Positive Side
While the housing market will likely take a while to work through structural issues, the news isn't all bad. In some sense, housing conditions have deteriorated so much that the situation seems poised to improve, albeit at a slow pace. With home prices beaten down, buyers can take advantage of enticing deals – the entire housing industry is essentially on sale. Indeed, most metrics show this is a good time to buy a home. U.S. housing affordability is near all-time highs. Home prices to income have also fallen to pre-bubble levels, around the long-term average. Overall, this implies that consumers are in a better position to purchase homes, and an improvement in income would help conditions even more. True, the sharp home price decline has hurt existing homeowners that are now underwater, but the low prices should begin to stimulate activity at some point, which is beneficial for the economy. Record-low mortgage rates (around 4% for a 30-year, fixed rate loan) also help existing homeowners and new home buyers, making monthly payments more affordable.
OUTLOOK: THE HOUSING OVERHANG

With activity weak for such an extended period of time, there are also indications that pent up demand exists. People have postponed buying homes — waiting to see where the market settles, on job clarity, or even on lending conditions to ease. In fact, household formations have decreased substantially in recent years. College graduates have moved home with their parents, or people have decided to live with roommates instead of on their own. Such a historically low level of household formations implies that we could see a reversion to a more normal trend, which would result in a greater demand for homes.

Conclusion
All in all, the housing market is muddling through. Structural issues such as a large foreclosure inventory continue to pressure the market, but there are signs that the long healing process is starting to play out. Housing has reached near-record levels of affordability, and low prices could start to spur demand. Meanwhile, as we struggle through the effects of the housing boom and bust, the environment has changed. Credit has become more difficult to obtain, and more stringent lending standards are one factor that may lead to a slower recovery. Overall, the underlying fundamentals in the housing market point toward a slow, uneven recovery process, mirroring the broader slow growth environment in the U.S.

U.S. Household Formation
5-Year Annualized Growth Rate
(1960 - 2010)
Source: FactSet