MOODY'S
ANALYTICS

COMMENTARY
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U.S. Housing's Rebalancing Act: Prices Fall, but Market Remains Overvalued

Existing-home sales have bottomed and are trending higher, and mortgage purchase applications are moving sideways, signaling some stabilization in demand.

- National house prices have fallen more than 2% from their peak in July, but the U.S. housing market remains overvalued.
- Most metro areas are overvalued, with prices exceeding their estimated equilibrium value by more than 20% in 214 out of 403 areas.
- With the national housing market still overvalued, prices will continue to decline even as sales volumes stabilize.

National house prices are falling, but the U.S. housing market remains overvalued. Prices peaked in July and have since fallen more than 2%, according to the Moody's Analytics House Price Index. For the first time since mid-2021, national house prices exceed their estimated fundamental value by less than 20%. While the U.S. market is still overvalued, the decline in valuations is an important step in restoring balance in the housing market.

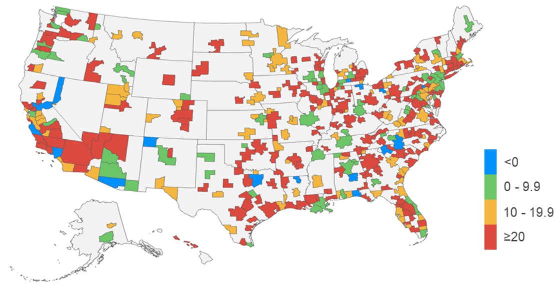
Moody's Analytics estimates overvaluation by comparing the Moody's Analytics House Price Index for a given geography to its long-run equilibrium home value. This equilibrium home value, or fundamental value, is determined by estimating the long-run statistical relationship between house prices and per capita wage and salary income. House prices that exceed their fundamental value by more than 10% are considered overvalued and those that are more than 20% higher are considered extremely overvalued.

The housing market was frothier than ever last spring, with real estate markets more overvalued than at the top of the 2000s housing bubble. Rock-bottom interest rates and a tight supply of homes sent prices soaring over 2021 and into 2022, ultimately resulting in values unhinged from economic fundamentals.

However, when the Federal Reserve began its campaign of rate hikes to quell soaring inflation, housing's meteoric rise ceased. Under tighter monetary policy, the rate on a 30-year fixed-rate mortgage jumped more than 300 basis points over 2022. By year's end, the monthly mortgage payment on a median-priced home with a 20% down payment was more than 40% higher than at the start of the year—or close to an additional $550 per month—and many buyers were priced out of the market. Home sales have fallen more than 50%, and house prices are down in nearly half of U.S. metro areas.

Overvaluation Remains Widespread

House price as a share of estimated fundamental value, 2023Q1, %



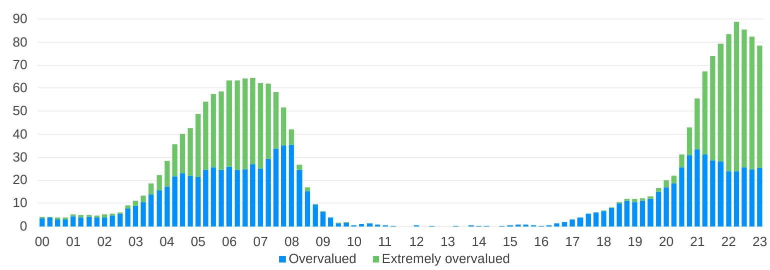
Source: Moody's Analytics

View a larger version of this map

Even amid the correction, most metro areas are overvalued, with prices exceeding their equilibrium value by more than 20% in 214 out of 403 areas. This is fewer than last month, and below the record high of 261 in the second quarter of 2022. The number of fairly valued metro areas continues to climb as prices fall back toward their equilibrium value in many markets. Despite the improvement, overvaluation remains more widespread than during the height of the 2000s housing bubble. Today there are more than 300 metro areas that are overvalued or extremely overvalued compared with 260 during the final quarter of 2006.

As Prices Fall, Fewer Markets Are Extremely Overvalued

Share of metro areas that are overvalued or extremely overvalued, %



Source: Moody's Analytics

Of the largest metro areas in the U.S., Boise City ID tops the charts as the most overvalued. Prices exceed their estimated fundamental value by more than 54%, which is a sharp reduction from last quarter when Boise was overvalued by more than 63%. House prices there have fallen about 5% from their August peak. Additionally, a red-hot labor market has led to heady wage gains, which in turn lifted the fundamental value of housing. With the unemployment rate further below its pre-pandemic peak than average, per-capita wage and salary income is rising faster than elsewhere.

Boise ID Tops Valuation Chart, While Bay Area Sinks

House price as a share of estimated fundamental value for metro areas with more than 750,000 residents, 2023Q1

Top Five		Bottom 5	
Boise City ID	54.0%	Chicago-Naperville-Arlington Heights IL	-2.1%
Nashville-Davidson-Murfreesboro-Franklin TN	46.7%	Baton Rouge LA	-3.4%
Grand Rapids-Wyoming MI	43.6%	Lake County-Kenosha County IL-WI	-11.8%
Knoxville TN	42.9%	San Jose-Sunnyvale-Santa Clara CA	-21.4%
Fort Worth- Arlington TX	42.2%	San Francisco-Redwood City-South San Francisco CA	-25.7%

Source: Moody's Analytics

Absent from the top five list this quarter are Austin TX and Las Vegas. Both metro areas posted a sharp decline in prices over the last six months. Additionally, Grand Rapids-Wyoming MI and Knoxville TN have landed spots on the list. While house prices in Grand Rapids and Knoxville rose less than in Austin or Las Vegas over the last two years, they have avoided the sharp declines of these more unaffordable housing markets.

San Francisco and San Jose CA are the two most undervalued metro areas in the nation. Prices in these areas have fallen by more than 13% from their peaks, due to an exodus of residents, staggering tech layoffs, and rock-bottom affordability. However, the worst months for housing in San Francisco and San Jose are in the rearview mirror, and the FHFA purchase-only forecast is flat over the next two years. Regions with undervalued housing have greater upward pressure on prices due to a combination of reduced listings plus opportunistic purchases of homes, often for use in the rental market.

The outlook.

The housing market is at an inflection point; housing activity has found a floor and sales volumes will recover in the coming months. Existing-home sales have bottomed and are trending higher, and mortgage purchase applications are moving sideways, signaling some stabilization in demand.

Greater interest rate stability over the next year will bring some buyers back into the market. Many who could postpone moving plans last year did so due to the fear that rates would quickly rise, making their purchase more expensive. Last year had the largest swings in mortgage rates since the late 1980s. This year, the Fed is set to slow the pace of interest rate hikes, causing rate volatility to normalize. More stable rates will increase buyer confidence and minimize the risk that buyers will miss out on a more favorable interest rate.

Nevertheless, with the national housing market still overvalued, prices will continue to decline even as sales volumes rise. Our baseline forecast expects that house prices will decline by 5% to 10% during the next two years. While a 10% decline in house prices is significant, the correction will be a far cry from the crash that followed the 2000s housing bubble.