Moody's ANALYTICS

COMMENTARY
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Author
Matthew Walsh

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

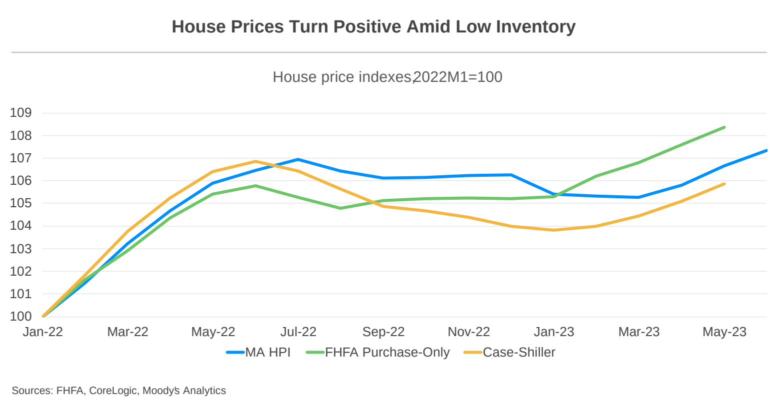
Is the U.S. House Price Correction Over?

Key to the outlook for house prices is the significant headwind posed by an unaffordable and overvalued housing market.

- U.S. house prices have reversed course and risen after falling over the second half of 2022.
- This is surprising given the upward path of mortgage rates over this period and challenges to affordability.
- While tight supply has pushed prices higher, it would be premature to celebrate the end of the housing correction.
- House prices will fall about 5% from their peak before bottoming out in early 2025.

It has been nearly a year since the U.S. house price correction began, and some are asking the question: Is it over already?

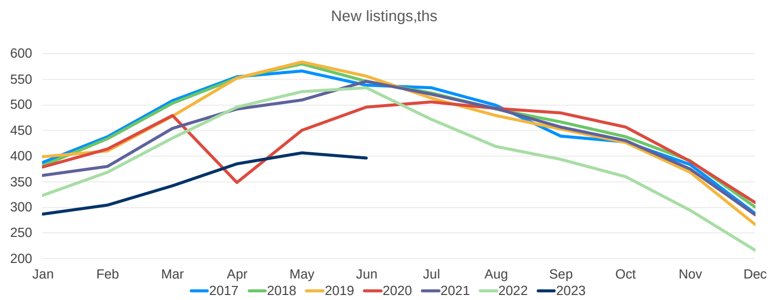
That is a good question given the recent bout of positive housing market data. House prices have reverse course after falling over the second half of 2022. The Moody's Analytics House Price Index—our new repeat sales index constructed from transaction data—has risen since April and, in June, topped its prior peak.



The rebound is a bit surprising given the path of mortgage rates over this period. The 30-year fixed-rate mortgage has averaged north of 6.5% and is quickly approaching 7%. The high rate on a mortgage is pricing out many potential homebuyers, and existing-home sales are near their lowest level since the depths of the Great Financial Crisis. Nevertheless, an extremely tight supply of houses is providing a floor under prices.

The inventory of homes for sale is off its record low but remains well below the pre-pandemic average. A significant gap between the average mortgage on outstanding loans and the one offered on a new loan is proving to be a significant headwind to new inventory coming on line. Numbers of new listings of existing single-family properties are averaging about 25% below what is typical this time of year.

New -Home Listings Trail Typical Year



Sources: Realtor.com, Moody's Analytics

While tight supply has pushed prices higher, it would be premature to celebrate the end of the housing correction. Temporary shifts in price are typical as demand and supply adjust into a new equilibrium. Further, the national housing market remains highly unbalanced and unaffordable despite the significant moderation in annual house price appreciation. The baseline outlook expects the modest correction in prices to resume before bottoming out in early 2025.

Overvalued and unaffordable

Key to the outlook for house prices is the significant headwind posed by an unaffordable and overvalued housing market. Nationally, housing remains overvalued, with prices exceeding their estimated fundamental value by about 16% in the second quarter. To be clear, this is a significant improvement from last year, when the measure of overvaluation hit a record high, topping its previous peak set during the height of the 2000s housing bubble by nearly 5 percentage points. Nevertheless, this index indicates that prices remain highly inflated relative to what economic fundamentals historically have supported. With weak demand, prices will be pulled back toward their fundamental values.

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.

Boise ID Tops Valuation Chart, While Bay Area Sinks

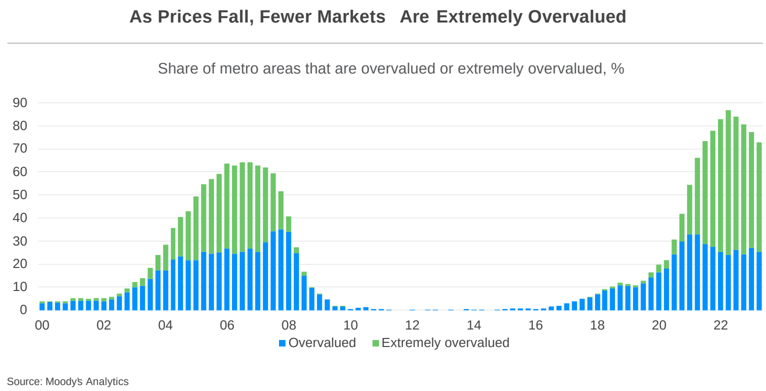
House price as a share of estimated fundamental value for metro areas with more than 750,000 residents, 2023Q2

Top Five		Bottom 5	
Boise City ID	50.6%	Chicago-Naperville-Arlington Heights IL	-1.3%
Grand Rapids-Wyoming MI	46.3%	Baton Rouge LA	-1.8%
Nashville-Davidson-Murfreesboro-Franklin TN	45.0%	Lake County-Kenosha County IL-WI	-11.8%
Knoxville TN	42.4%	San Jose-Sunnyvale-Santa Clara CA	-17.2%
Fort Worth- Arlington TX	42.3%	San Francisco-Redwood City-South San Francisco CA	-27.2%

Source: Moody's Analytics

The most overvalued metro areas will see the sharpest decline in prices over the near term, and the list of frothiest markets is unchanged from last quarter. Once again, Boise ID remains the most overvalued metro area. Here, prices exceed their estimated fundamental value by more than 50%.

The geographic breadth of overvaluation remains unprecedented. There are more metro areas that are overvalued or extremely overvalued than during the height of the 2000s housing bubble. With widespread overvaluation, more metro areas are at risk of further declines in house prices.



Furthermore, low affordability will remain a weight on the housing market. With the mortgage rate expected to end the year above 6.5%, homes will remain prohibitively expensive, keeping many potential buyers on the sidelines.

Affordability collapsed over the past two years as mortgage rates soared following a years-long double-digit increase in house prices. The increase has made purchasing a home nearly impossible for many households, with the amount needed for a down payment on a home ballooning to a near record high. Qualifying incomes average 80% higher than they were before the pandemic began. Additionally, the share of monthly principal and interest payments on a median-priced home to income is within striking distance of its 40-year high.

To restore affordability, house prices will need to fall absent substantial income growth or a significant decline in the mortgage rate, both of which are unlikely. Though the labor market remains strong, it's clear that wage growth is moderating in line with labor demand, and higher interest rates and a risk-premium on mortgage-backed securities will keep mortgage rate higher for longer.

Existing market will remain tight

On the supply side, the inventory of homes for sale will remain tight, but more listings will slowly come on line. Interest rate lock will remain a powerful disincentive to trade-up or -down buying, keeping new listings of existing homes low for the next year. The effective mortgage rate, which is the average rate on all outstanding mortgages, is 3.6%, more than 300 basis points below the rate currently offered on a 30-year fixed-rate mortgage. This gap represents an additional monthly payment of nearly $650 on a median-priced home.

Nevertheless, some additional inventory will begin to come on line as homeowners cannot postpone moving plans forever; eventually households will need to relocate for work or inevitable life events including divorce, death or births. For many households, mortgage rates are only one consideration in the decision to sell. While a homeowner's low rate on an existing mortgage will prove a strong financial disincentive for some, many will move regardless.

The outlook

The outlook for the U.S. housing market has not changed meaningfully amid the recent upturn in house prices. Moody's Analytics has revised the existing single-family home sales forecast lower for the remainder of 2023 and 2024. This reflects the hurdles to new supply posed by the quick hike in interest rates and the ultra-low rates on most existing mortgages.

House prices will fall about 5% from their peak, before bottoming out in early 2025, restoring balance and affordability in the housing market. The magnitude of the decline is a far cry from the crash observed during the Great Financial Crisis, and risks posed by the 5% decline are small. House prices appreciated by about 40% since 2020, and this decline will only set prices back to where they were in mid-2022.

There is reason to be hopeful that downside risk to the housing market has diminished. The U.S. economy is on more solid footing and biting inflation has begun to roll over. There is still the possibility for a Fed policy misstep, but the odds that the U.S. economy fall into a recession in the near term, sinking house prices even further, are fading.