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Signs of a Bottom Emerge

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Signs of a Bottom Emerge

BY CRISTIAN DERITIS

Recent Performance

Home sales showed signs of bottoming out recently as low inventories and stable interest rates supported demand. While this is a welcome change after a year of steep contraction, significant headwinds to the housing market remain, including a slowing labor market and rising recession risks.

Sales of existing homes fell to a seasonally adjusted annualized rate of 4.4 million units in March from 5.7 million units a year ago. Affordability of monthly mortgage payments is the greatest drag on demand as millions of would-be first-time homebuyers have been forced to the sidelines, unable to qualify for loans given their incomes and prevailing interest rates. Despite the loss of potential buyers, home sales would have been higher but for the dearth of houses available for sale. Over the past year, the steady rise in interest rates has caused many homeowners to become "locked in" to their homes, as taking out a new mortgage would be prohibitively expensive. With homeowners neither trading up nor down, the normal flow of houses onto the market has been disrupted, leading to an inefficient allocation of housing. The inventory of existing homes for sale is above its pandemic low at 1.1 million but remains near multidecade lows.

New-home sales have fallen precipitously over the past year but experienced an unanticipated jump in March to 683,000 annualized units. The lack of existing homes for sale is pushing some buyers to consider new construction. Homebuilders have aggressively offered incentives to move inventories in their developments, including rate buy-downs that allow buyers to pay a lower interest rate on their mortgages during the first few years. The supply of new homes for sale ticked down to 7.6 months in March, lower than its recent high but nearly double pre-pandemic levels.

Although the pickup in activity is welcome news and points to strong underlying demand, recent data on pending home sales and mortgage applications suggest that closed sales could be weaker than expected in May (see Chart 1).

House prices moderate

A change in home sales is typically the first sign of a turning point in the housing cycle, with house prices following with a one- or two-quarter lag. Even if sales have bottomed, prices are expected to fall gradually throughout the rest of this year and next until they find their footing.

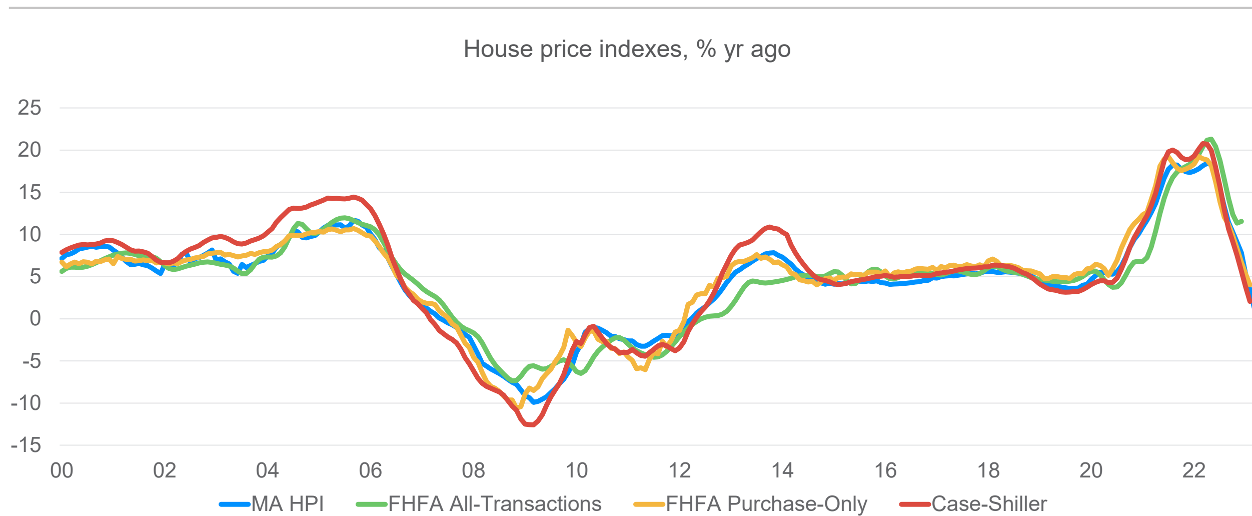
Given the low level of affordability and the imbalance between prices and incomes, house prices likely have further to fall.

Pending Home Sales Point to Weakness in April and May

Sources: NAR, Moody's Analytics

To be sure, house price indexes show a range of values on a month-to-month basis, with some indexes reporting positive growth and others indicating contraction. Some of this divergence is attributable to the specific housing-market segments measured with house price indexes that focus on lower-value homes such as the FHFA showing greater resilience than broader market indicators such as the Moody's Analytics House Price Index (see Chart 2).

House Price Growth Broadly Consistent but Varies by Index

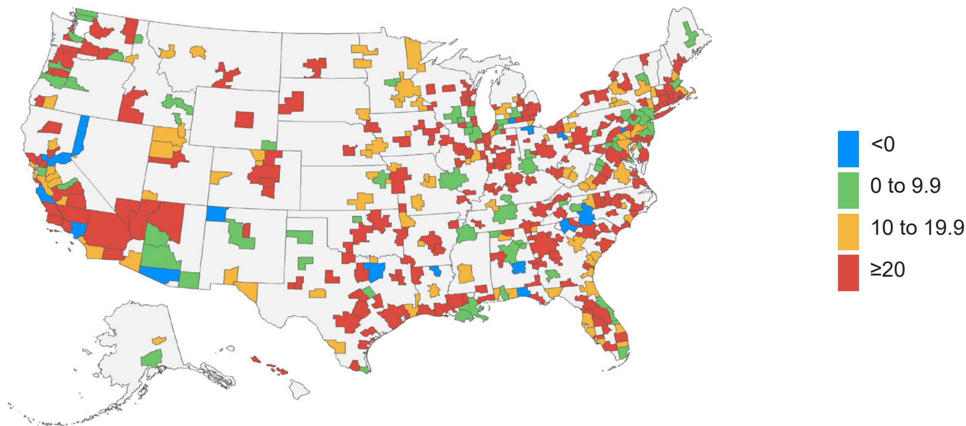


Sources: FHFA, CoreLogic, Moody's Analytics

With national prices down just over 2% from their 2022 second-quarter peak, overvaluation has improved. However, most metropolitan markets remain overvalued, with nearly half overvalued by 20% or more (see Chart 3).

Overvaluation Remains Widespread

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



Source: Moody's Analytics

Given the expectation for mortgage rates to remain relatively high and for income growth to decelerate in coming quarters, Moody's Analytics expects that house prices will continue to face downward pressures as the pool of eligible borrowers shrinks. The key mitigating factor to an even sharper price correction in the face of high levels of overvaluation is demographics. The large imbalance between the number of young adults looking to purchase homes and the lack of homes for sale will keep prices from declining precipitously in most markets.

FHFA mortgage rate adjustments

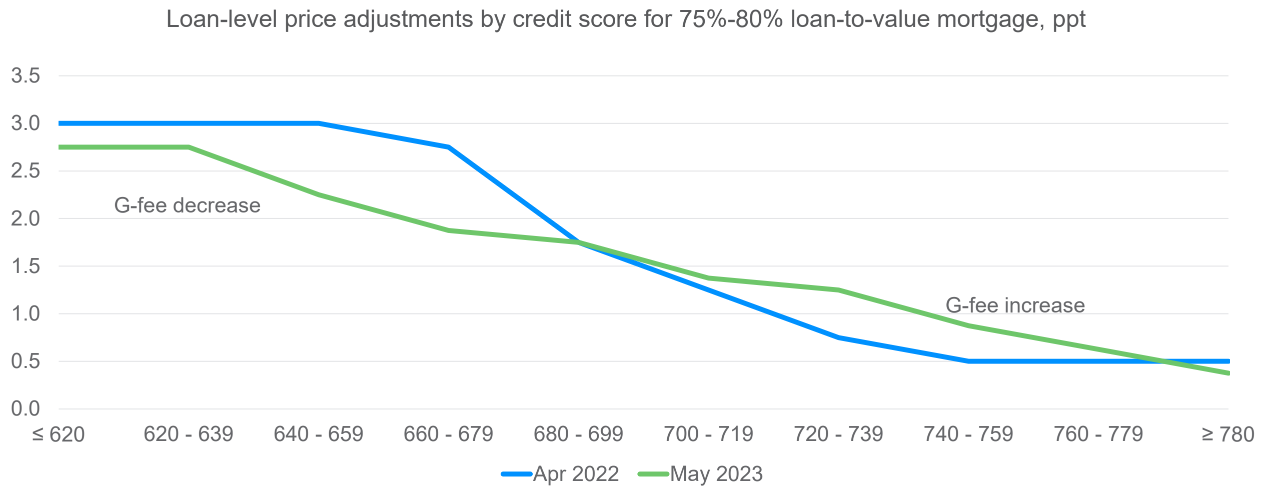
Adjustments to the guaranty fees that Fannie Mae and Freddie Mac charge mortgage originators changed as of May 3, causing a stir among housing market analysts and politicians. These pre-announced changes were intended to improve affordability for lower-income borrowers while maintaining stability in mortgage markets.

The change in guaranty fees varies across loan characteristics, including the borrower's credit score and down payment, or loan-to-value ratio. For loans with a 20% down payment, the g-fee fell for borrowers with a credit score less than 680 and rose for those above 700 (see Chart 4).

While the slope of the relationship between credit scores and g-fees is now flatter, government-sponsored enterprises are still utilizing risk-based pricing, with lower credit-score borrowers paying a higher fee than high credit-score borrowers.

Whether these price changes adequately capture underlying risks or expose the GSEs to greater losses will depend on the future trajectory of house prices and the broader economy. Independent of the impact of the changes on GSE finances, lowering g-fees for lower credit borrowers should lead to a net increase in demand even as fees on higher-score borrowers rise, given their greater price sensitivity.

The overall impact on demand and executed home sales will likely be marginal as borrowers may face other challenges to buying a home beyond the interest rate such as down payment savings and insufficient



Sources: Fannie Mae, Moody's Analytics

income. The lack of available homes, especially lower-priced homes, remains a binding constraint for home sales in most markets.

Homebuilding slowly recovers

While the rapid decline in homebuilding over the past year may not fully reverse any time soon, recent trends suggest that a bottom is forming. Single-family housing permits and starts continued to rise in March after posting sizable gains in February. Multifamily construction was weaker in March, but this was largely a reversal of some of February's outsize gains. Given the lumpiness of projects, it is useful to focus on either three- or six-month moving averages; both show signs of flattening.

Single-family home completions continued to rise at a modest but consistent pace, chipping away at the long-run housing deficit. Nearly a third of all homes available for sale today are new construction as a result of the increased pace of homebuilding and the lack of existing-home listings.

As supply-chain issues abated, year-over-year increases in multifamily completions shot up by nearly 60% in March. The increased supply has pushed up vacancy rates higher across most markets, leading to stabilization, if not outright declines in asking rents. Although this trend will weigh on commercial real estate prices, downward pressure on housing costs will help to bring down overall inflation levels.

Outlook

Home sales are expected to slowly recover throughout the rest of 2023 and 2024 as high interest rates weigh on affordability. With strong underlying fundamentals, any dip in mortgage rates below 6% will likely spur additional demand. Limits on the supply of homes for sale will be the binding constraint. House price growth is expected to remain muted nationally, with some regions performing better than others. A peak-to-trough decline of 5% to 10% is expected to move prices into closer alignment with incomes. Given the strength of household balance sheets, the second-order effects of a weaker housing market will be limited. While homeowners stand to lose upward of $4.5 trillion in wealth with a 10% house price decline, it is after realizing an $11 trillion gain over the past two years as house prices rose more than 40%.

Risks

Risks to the housing market are weighted to the downside, with the strength of the labor market being a determining factor. A sharp increase in unemployment could drive foreclosures up and house prices down. Interest rates are a key secondary risk as the high cost of monthly mortgage payments has sharply reduced the ability of young buyers to purchase homes.

The supply of existing and new homes is a risk to the health of the housing market as it impedes the ability of young adults to form their households and start families. Lack of inventory also affects the ability of existing homeowners to trade up or down or move, leading to inefficient housing allocation.

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