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U.S. Housing Outlook 2023: Going Nowhere Fast

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BY CRISTIAN DERITIS

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Consistent with a general economic slowdown, if not a declared recession, the housing market will struggle to find its footing in 2023. While sellers, buyers and builders face numerous challenges, the underlying fundamentals of the housing market remain strong. Strong credit quality and favorable demographics will support the market as it adjusts to a new equilibrium preventing a repeat of the crash in house prices experienced during the Great Recession.

In the sections that follow, we examine current trends and the outlook for the key supply and demand factors underpinning the market, including household formations, interest rates and construction activity along with regional house prices and valuations based on the Moody's Analytics House Price Index. We conclude our analysis with a summary of our baseline projection and a discussion of the key risks—both downside and upside—that may affect the outlook. Table 1 provides a convenient summary of our baseline five-year forecasts for top-line housing metrics.

Household formations to fall

One of the most significant factors driving future home construction and sales along with house prices is the number of new households that will be formed in coming years. To support a more accurate assessment and forecast of household formations, Moody's Analytics recently updated its estimate of the number of households living in the United States over the past 10 years based on recently released census data. Estimation of the number of households that exists at any given time in the U.S. is challenging for the census and other demographers due to the dynamic nature of the population with young adults transitioning in and out of education and the myriad living arrangements stemming from marriages, divorces, cohabitation, etc.

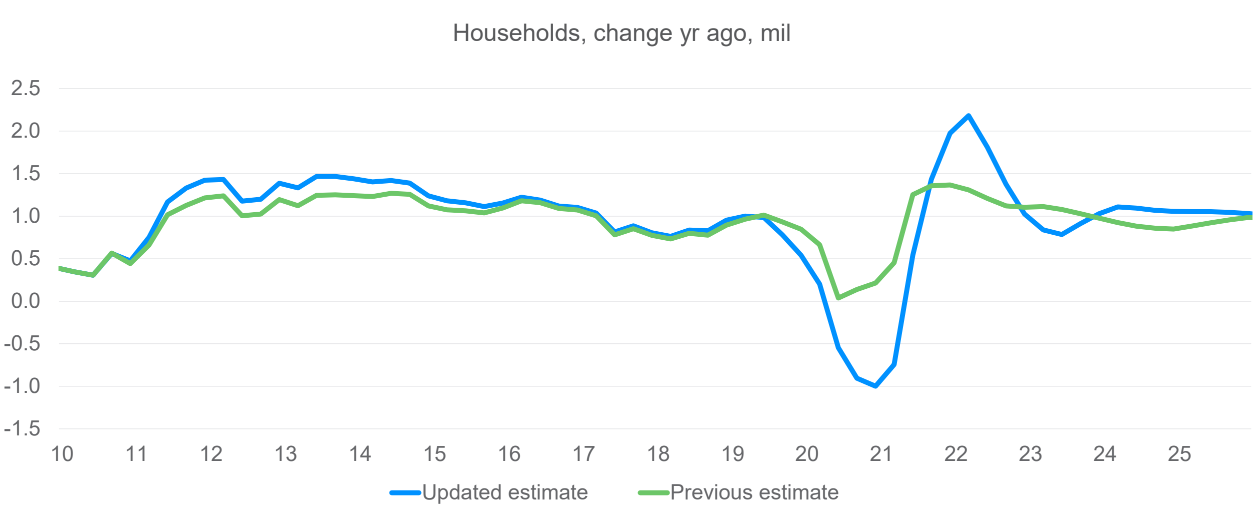
Table 1: Summary of Key Housing Indicators

Indicator	2017	2018	2019	2020	2021	2022	2023F	2024F	2025F	2026F	2027F
Household formations, ths	886	844	827	-561	801	1597	892	1081	1045	954	855
FHFA Purchase-Only HPI, % yr ago	6.17	6.17	5.06	7.88	16.79	13.98	-1.50	-3.49	-1.04	2.09	2.87
Case-Shiller HPI, % yr ago	6.13	4.50	3.69	10.45	18.87	5.13	-4.76	-3.63	-0.14	2.50	3.14
FHFA All-Transactions HPI, % yr ago	5.43	5.55	4.63	5.14	13.73	17.05	0.05	-3.48	-1.19	1.91	2.83
Existing-home sales, mil	5.53	5.33	5.33	5.64	6.13	5.16	4.77	5.62	5.47	5.33	5.68
New-home sales, mil	0.61	0.61	0.68	0.83	0.77	0.65	0.59	0.66	0.74	0.78	0.78
Interest rate, 30-yr fixed mortgage rate, ppt	3.99	4.54	3.93	3.11	2.96	5.35	6.53	5.73	5.56	5.74	5.77
Single-family permits, mil	0.82	0.85	0.86	0.99	1.12	0.99	0.85	0.97	1.13	1.20	1.19
Single-family starts, mil	0.85	0.87	0.89	1.00	1.13	1.01	0.84	0.99	1.17	1.24	1.24
Single-family completions, mil	0.79	0.84	0.90	0.91	0.97	1.01	0.98	1.05	1.14	1.19	1.20
Multifamily permits, mil	0.46	0.47	0.52	0.49	0.62	0.69	0.67	0.61	0.57	0.53	0.49
Multifamily starts, mil	0.36	0.38	0.40	0.39	0.47	0.55	0.54	0.50	0.46	0.43	0.40
Multifamily completions, mil	0.36	0.35	0.36	0.37	0.37	0.37	0.49	0.50	0.47	0.45	0.42

Source: Moody's Analytics

Summarizing the changes to our estimates, the number of estimated households prior to the onset of the COVID-19 pandemic increased by nearly 1 million relative to our previous figure. In addition, the revised data displayed much larger swings in household formations during the pandemic than previously estimated with the total number of households falling by close to 1 million in 2020 before rebounding by nearly 2.2 million by mid-2022 (see Chart 1).

Chart 1: Revised Estimates Show Pandemic's Impact on Household Formations

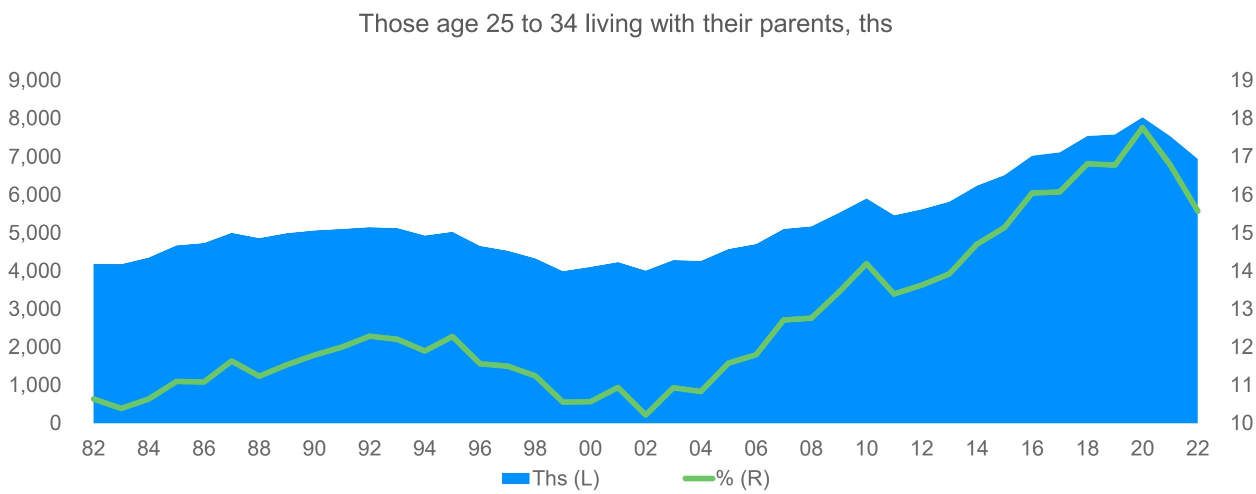


Sources: Census Bureau, Moody's Analytics

Although the revised data have large implications for understanding behaviors during the pandemic, including swings in house prices, the estimated number of households as of the second quarter of 2022 increased by less than 200,000 over the previous estimate. Going forward, cyclical factors, including employment, income growth and housing affordability, will impact our estimates of headship rates by age cohort, which in turn drive our forecasts for household formations above and beyond underlying demographic factors, including fertility and mortality rates.

Given the changes to the historical data and our baseline expectations for a slowing economy in 2023, we have reduced our assumptions for household formations in 2023 and 2024. We have shifted some formations to 2025 and 2026 and assumed a modest level of demand destruction with some households unable to form in the future due to affordability pressures. Abstracting from these cyclical variations, underlying demand for housing will remain strong over the next decade given the age profile of the population with millions of young adults in their early to mid-thirties and nearly 7 million 25- to 34-year-olds living with their parents (see Chart 2). Underlying demographic demand will support house prices as well as construction as the economy moves beyond 2023.

Chart 2: Nearly 7 Million Young Adults Living at Home



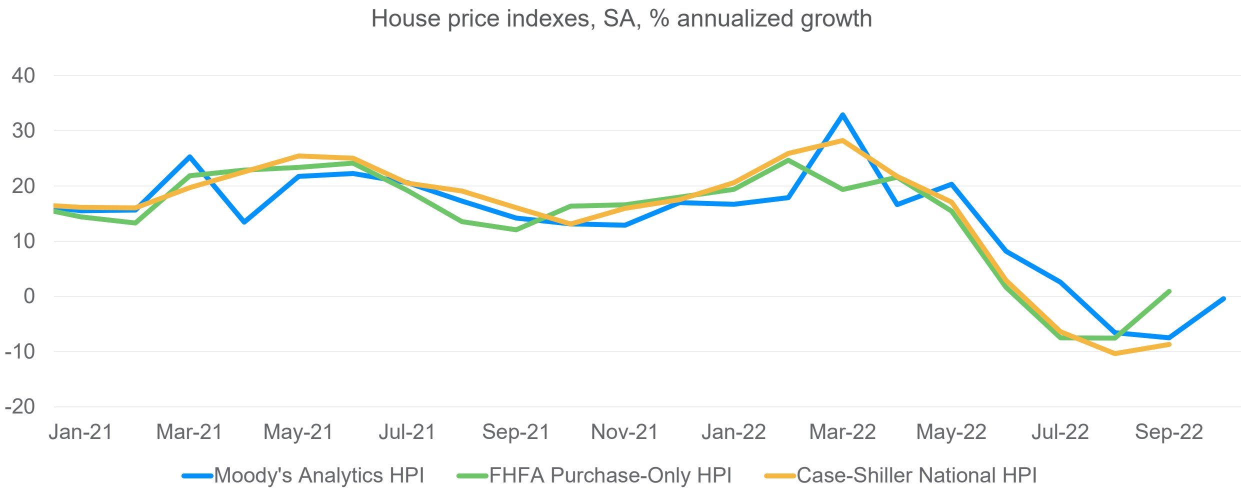
Sources: Census Bureau, Moody's Analytics

House prices

House prices experienced a "super-cycle" from 2020 to 2022 as record-low mortgage rates and increased demand for housing resulting from the COVID-19 pandemic and the possibility of remote work led buyers to bid prices up aggressively. Nationally, house prices rose by 41% from December 2019 to July 2022 based on the Moody's Analytics House Price Index. For comparison, it took nearly five years for prices to rise by a similar degree in the runup to the 2007 housing crash.

House prices moderated from their summer peak in the fourth quarter, ending the year down 1.2% below their July 2022 peak (see Chart 3). The slowing annualized decline in growth in October supports the view that prices may zig-zag on their way toward a new equilibrium rather than fall continuously. This behavior is consistent with previous housing cycles as buyers and sellers react to the evolving market. Potential buyers may withdraw as prices begin their initial descent in the hope that they may be able to secure an even better deal later. Similarly, potential sellers may choose to wait and see how the market evolves before mov-

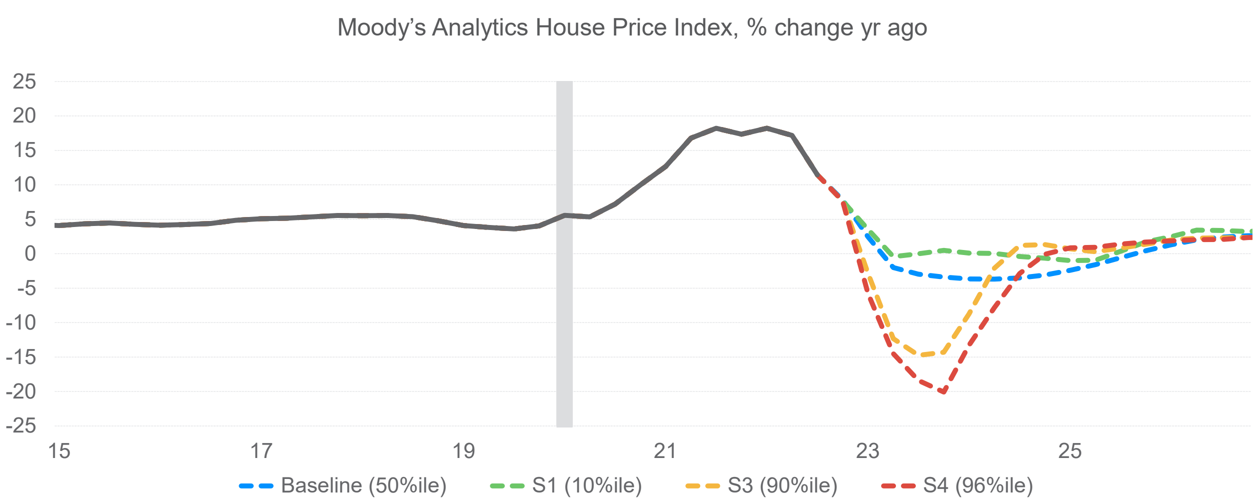
Chart 3: House Price Declines Moderated in October



Sources: FHFA, CoreLogic, Moody's Analytics

ing ahead with a listing. National house prices are expected to fall by 5% to 10% over the next two years before finding their footing (see Chart 4).

Chart 4: House Prices Appreciated 40% in Two Years



Source: Moody's Analytics

The basis for this forecast is our model of fair house price valuation, which compares the current price to the price implied by the historical relationship between prices and household incomes. Prices were an estimated 23% above fair value in the third quarter of 2022. A 10% decline in house prices combined with expectations for continued positive nominal income growth would effectively allow incomes time to catch up with house prices and restore the long-run historical relationship with house prices.

While the national price decline is notable, there is significant variation in prices and overvaluation across geographies (see Table 2). For example, the San Francisco metropolitan statistical area has already expe-

Table 2: Top/Bottom 10 Metro Areas for Valuation

Moody's Analytics Valuation Index as of 2022Q3

Top 10	Metropolitan area	% over/undervalued
1	Boise City ID	72.3
2	Muskegon MI	70.8
3	Sherman-Denison TX	66.8
4	Pocatello ID	66.4
5	Homosassa Springs FL	65.9
6	Myrtle Beach-Conway-North Myrtle Beach SC-NC	64.1
7	Kahului-Wailuku-Lahaina HI	63.5
8	Flagstaff AZ	62.2
9	Austin-Round Rock TX	61.7
10	Morristown TN	61.6
Bottom 10		
10	Trenton NJ	-1.5
9	Montgomery AL	-2.5
8	San Francisco-Oakland-Hayward CA	-2.7
7	Cumberland MD-WV	-2.9
6	Charleston WV	-3.0
5	Fairbanks AK	-4.2
4	Carbondale-Marion IL	-6.1
3	Lake County-Kenosha County IL-WI	-7.7
2	San Jose-Sunnyvale-Santa Clara CA	-9.5
1	San Francisco-Redwood City-South San Francisco CA	-19.0

Source: Moody's Analytics

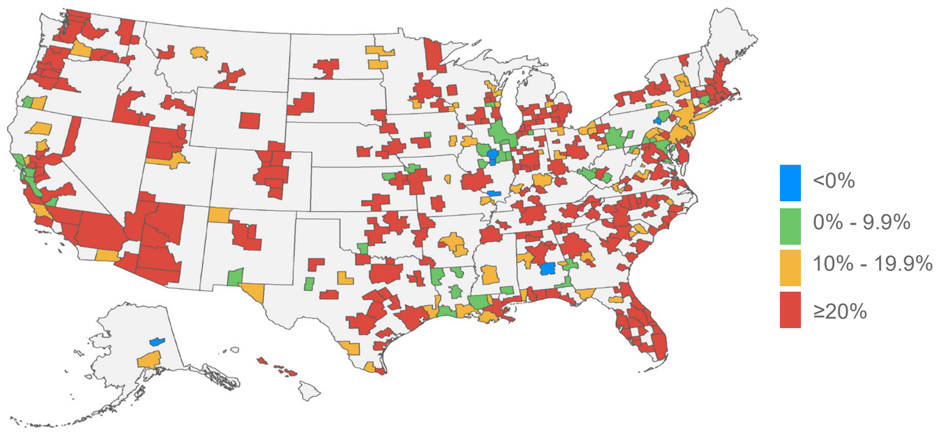
rienced a 9% decline from its peak and is expected to see a nearly 20% contraction in prices over the next two years. Other major metropolitan areas such as Phoenix, Nashville, Boise City and Las Vegas are expected to experience peak-to-trough declines in excess of 15%. Though concerning, context is important as many of these areas experienced house price growth over the past two years that was well in excess of both the national average and their own historical performance. Boise City, for example, saw its prices rise by nearly 70% over this time. Even with a double-digit decline in prices, most homeowners will continue to have large home equity cushions thereby reducing the risk of defaults and foreclosures that would push house prices down further.

At the other extreme, we note that nearly 20% of metro areas have yet to see prices fall. While this includes mostly smaller areas that did not experience large increases in prices, the list includes some notable exceptions such as Houston, Indianapolis and Oklahoma City. Although these areas are not expected to experience large double-digit declines, some will prove more resilient than others given their estimated level of overvaluation. For example, Houston with an overvaluation estimate of 40% is expected to experience larger house price declines than Indianapolis, which is 30% overvalued based on our model of fair value (see Chart 5).

In addition to differences across geographies, house prices are varying significantly by market segment with lower-price homes faring better than their higher-priced peers (see Chart 6). Buyers may have stretched to purchase higher-priced homes in recent years supported by ultra-low mortgage rates and a booming stock market. Now that those supports have been removed, the higher end of the market is adjusting more quickly than the bottom as homebuyers lower their prospects.

Chart 5: West and South Are Most Overvalued

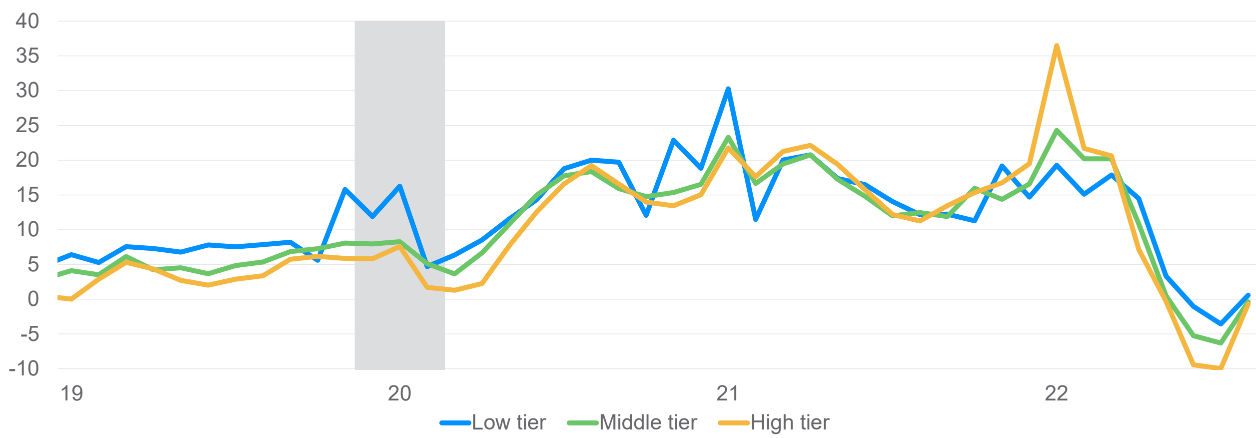
House price, % above/below estimated fundamental value



Source: Moody's Analytics

Chart 6: Lower-Priced Homes Experience Smaller Price Declines

Moody's Analytics House Price Index, % annualized growth



Source: Moody's Analytics

Strained affordability due to rising interest rates will support the lower end of the market going forward along with metro areas that are more affordable overall than other parts of the country. In addition to the higher cost of borrowing, demand for higher-priced homes is susceptible to a variety of issues, including weakness in equity markets, layoffs in the tech sector affecting higher-income households, and declines in demand from foreign buyers due to the strength of the U.S. dollar.

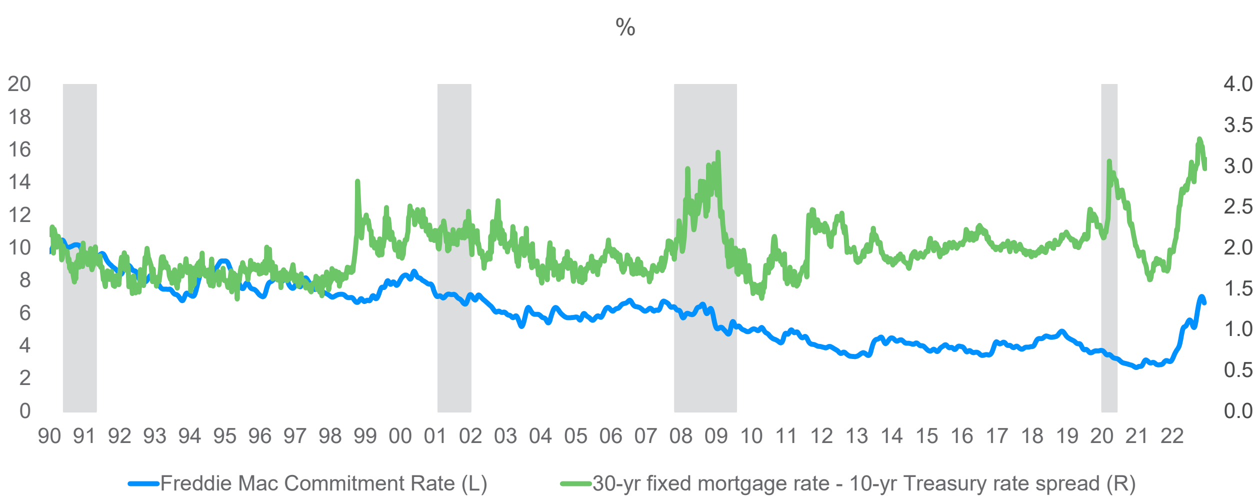
In summary, Moody's Analytics forecasts house prices to decline nationally and to correct sharply in certain markets. However, a repeat of the Great Recession housing bust is unlikely for two primary reasons. First, the favorable demographics described in the previous section will provide a base of support for home sales and prices. With millions of young adults still interested in purchasing a home, buyers will materialize as prices start to fall, especially if mortgage rates stabilize or decline as well.

Second, the finances of existing homeowners are strong in sharp contrast to the 2007 experience. Given tight mortgage lending standards over the past decade, today's homeowner has a much stronger credit profile and has significantly more equity in their homes than they did prior to the Great Recession. Prices would need to decline by 30% or more to put most homeowners in a negative equity position today. If the labor market holds up reasonably well, the number of mortgage defaults and foreclosures should remain low, removing one of the preconditions for a collapse in house prices.

Interest rates

While demographics may determine underlying long-run trends in demand, interest rates will drive short-term cyclical movements. Mortgage rates followed an extraordinary trajectory in 2022 having started the year near the record low recorded in 2021 at 3.2%, according to the Freddie Mac Primary Mortgage Market Survey. Rates proceeded to climb rapidly throughout 2022 hitting 7.4% by early November, their highest level since 2002, before falling back down to 6.6% by mid-December (see Chart 7).

Chart 7: Mortgage Rates and Spreads Decline From Recent Peaks



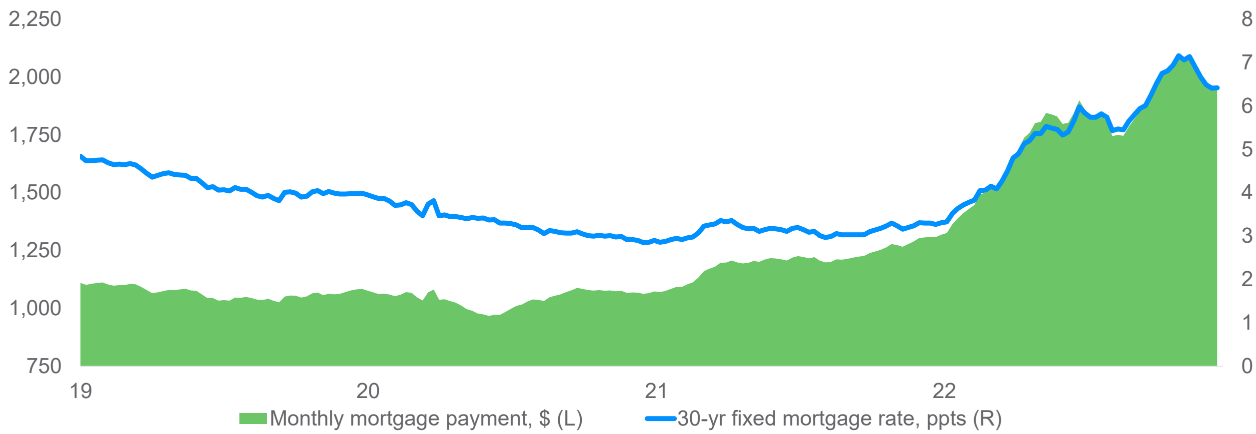
Sources: Freddie Mac, Federal Reserve, Moody's Analytics

To the extent that homebuyers focus more on monthly mortgage payments than house prices when making their buying decisions, the doubling of mortgage rates has had profound implications for affordability. The monthly mortgage payment required to finance the median-priced home with a 30-year fixed mortgage rate assuming a 20% down payment was just under $2,000 as of December 14, a 50% increase from the start of the year and nearly double what a homebuyer would have paid at the end of 2020 (see Chart 8)

While rates are nearly double what they were at the beginning of the year, there are some reasons for optimism. First, mortgage rates have declined by 50 basis points from the peak levels observed at the start of October as rates on benchmark 10-year Treasury bonds have fallen. As concerns for persistently high inflation ebb and bond investors become increasingly worried about the prospects of a recession taking hold in 2023, yields on Treasury bonds are likely to remain low.

Second, the mortgage rate spread or the difference between the rate on a 30-year fixed mortgage rate and the yield on a 10-year Treasury bond is elevated at just over 3%. This level of spread is unusual and previ-

Chart 8: Falling Mortgage Rates Provide Little Relief



Sources: NAR, Mortgage Bankers Association, Moody's Analytics.

ously had only been observed during times of extreme financial stress such as the Great Recession and the onset of the COVID-19 pandemic.

Moody's Analytics expects the mortgage rate spread to narrow and return to its historical average of 1.8% as investors step in to fill the void left by the reversal of the Federal Reserve's quantitative easing program. Assuming the 10-year Treasury rate averages 4.2% in 2023, the interest rate on a 30-year fixed mortgage rate should fall to around 6% as the spread comes in. Though supportive of demand, affordability will remain an issue for many would-be homebuyers unless and until house prices fall sufficiently to realign monthly mortgage payments with household incomes.

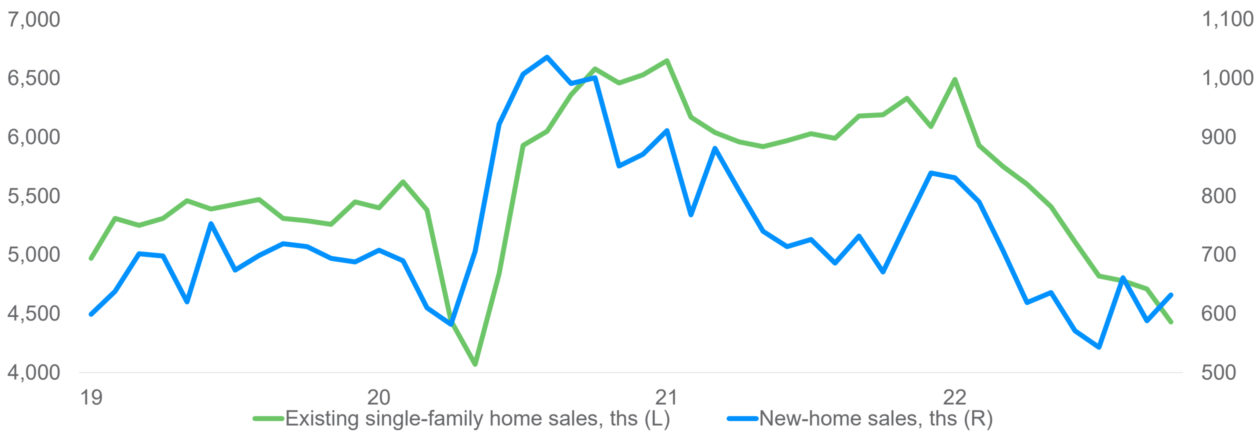
Sales and inventory

Home sales fell steadily throughout 2022 as high interest rates not only drove away potential buyers but also dissuaded existing homeowners from listing their homes for sale and giving up their ultra-low mortgage rates. Homeowners who ordinarily may be looking to downsize or move will think twice given the increased cost of either financing or renting another home.

Existing-home sales started the year at a 6.5 million seasonally adjusted annualized pace but fell to 4.4 million by October, a million units short of the 5.4 million sales recorded in 2019 prior to the onset of the COVID-19 pandemic (see Chart 9).

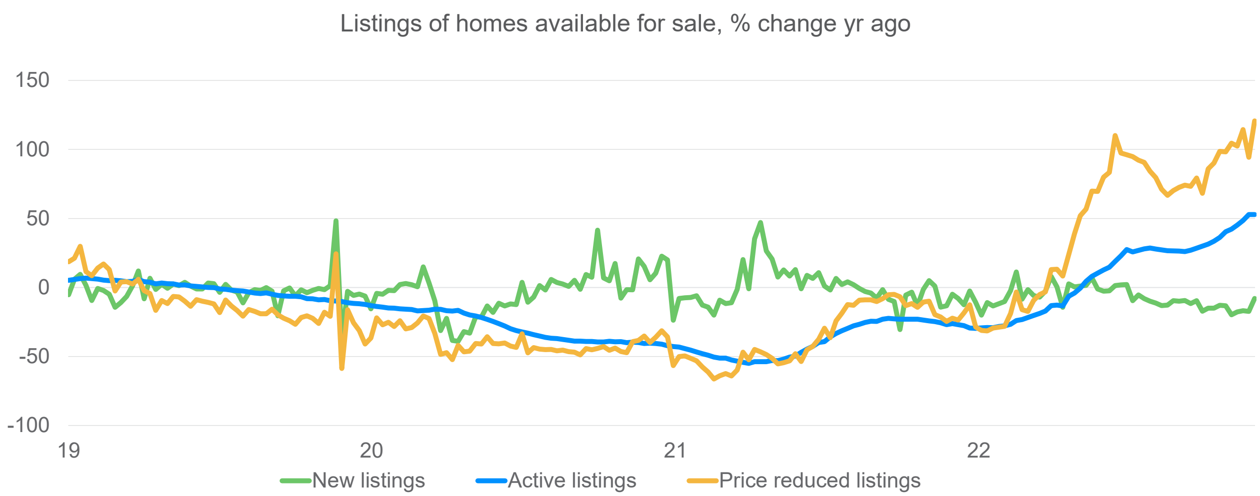
In a clear sign that most homeowners are not interested in selling, the number of active real estate listings rose by more than 50% over last year's levels in December even as the number of new listings fell (see Chart 10). The few homes that are being listed are taking longer to sell with the number of listings with a price reduction rising sharply as sellers deal with the new market reality. The days of sellers listing a home for sale on a Thursday and receiving multiple, competing offers by Sunday are gone. Sellers are having to reset their expectations regarding price and accept buyer contingencies including home inspections and financing if they hope to sell their properties in a reasonable amount of time.

Chart 9: Home Sales Fall Below Pre-Pandemic Levels



Sources: NAR, Census Bureau, Moody's Analytics

Chart 10: Fewer Homes Listed and Take Longer to Sell



Sources: NAR, Moody's Analytics

The pace of new-home sales fell throughout the year from 831,000 in January to 632,000 by October, well off of the cyclical high of just over 1 million units observed in August 2020. Unlike the decline in existing-home sales, which has yet to show signs of slowing, the pace of new-home sales appears to have stabilized around 600,000, at least temporarily.

The inventory of new homes available for sale has risen steadily since the third quarter of 2020 and is now near levels last seen during the 2006 housing boom (see Chart 11). While the number of months of available inventory has skyrocketed by nearly 60% from the start of the year, some caution is needed in interpreting this figure as the increase has been driven in part by the decline in sales. Nonetheless, with so many new homes available for immediate sale, homebuilders are in no rush to complete existing projects or to break ground on new developments.

Chart 11: New-Home Inventories Rising Quickly

Sources: Census Bureau, Moody's Analytics

Looking ahead to 2023, Moody's Analytics expects sales to remain weak through the first half of the year as buyers and sellers continue to adjust their expectations and economic uncertainty leads to restraint. The National Association of Realtors pending home sales index declined 4.6% to 77.1 in October, its third lowest level in history after the start of the pandemic and the Great Recession, and down 37% from October 2021 (see Chart 12).

Chart 12: Declining Pending Home Sales Point to Further Weakness

Sources: NAR, Moody's Analytics

Existing sales are highly correlated with the lagged pending sales index, all but guaranteeing that completed sales will continue to fall through the first quarter of 2023. Declines are expected to be largest in the West, which saw its pending home sales index drop the most, by 11% on a monthly basis in October and 46% year over year. A drop in sales will be notable in the South as well where pending sales were down 6% on a monthly basis and 46% from a year earlier. The Northeast will fare a bit better with pending sales down only 4% from September and 30% from October 2021. The Midwest is expected to perform the best given a small increase in pending sales in October, though this will do little to offset the 32% decline in pending sales observed on a year-ago basis.

These relative regional trends are expected to continue throughout 2023 even as overall sales activity slowly recovers along with the broader economy. Price-sensitive homebuyers may find markets in the Midwest and Northeast, which missed the large runup in prices during the pandemic, attractive thereby slowing—if not reversing—some of the migratory outflows observed in 2020, 2021 and 2022. Given the increased possibilities for remote and hybrid work, individuals and families have greater flexibility to locate in markets where housing is more affordable.

Although surveys suggest that most young adults still aspire to own a home someday despite the current affordability and inventory challenges, souring consumer sentiment about the housing market may delay a recovery in sales even if mortgage rates should stabilize at a lower level. The Fannie Mae Home Purchase Sentiment Index for November indicates that nearly 80% of respondents said it is currently a "bad time" to buy a home, well above the 29% rate reported in 2019. Respondents were more optimistic when it came to selling a home with 54% identifying this as a "good time" to sell, but this is a sharp decline from last November's 75% share.

Opinions on the prospects for house price growth over the next 12 months were mixed with 30% expecting prices to rise and 34% expecting them to fall. On a positive note, more respondents believe their own personal financial situation will improve rather than deteriorate over the next 12 months. However, 71% of respondents said the economy is on the "wrong track," which may explain the reticence they face in making a large purchase at this time.

Given this backdrop, Moody's Analytics expects existing-home sales of 4.77 million in 2023. New-home sales are projected to fall to just under 600,000 from 650,000 in 2022. These projections assume a baseline scenario of low but positive growth and an unemployment rate that remains below 4.25%. Should the economy enter into a broad-based recession with significant job losses across industries, declines in sales will be more severe as described by the Moody's Analytics Alternative Scenarios S2, S3 and S4.

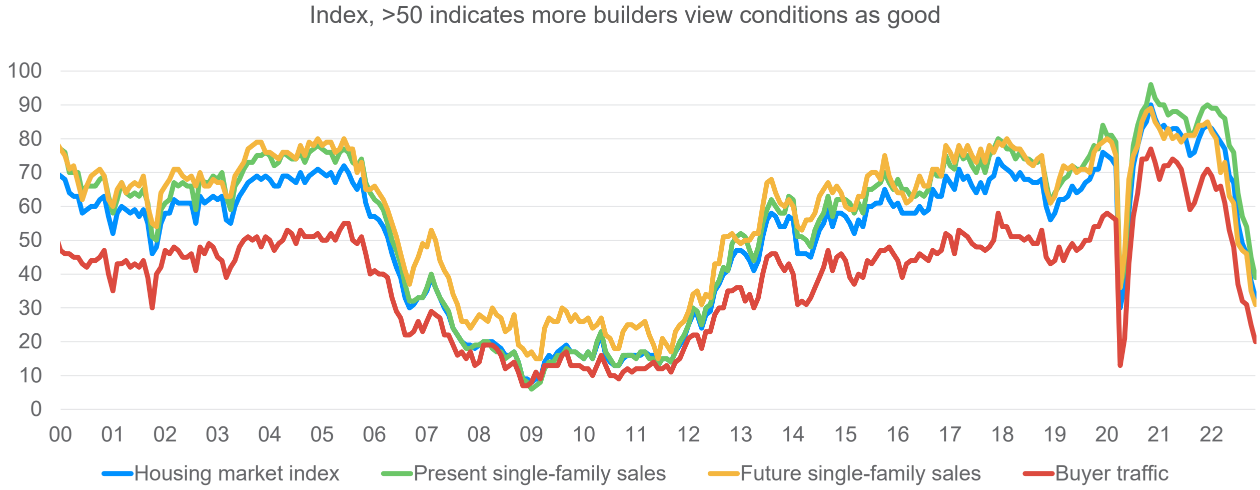
Single-family construction retreats

Rising interest rates took a toll on the home construction industry in 2022 despite a housing vacancy rate that is near its record low and a large housing deficit stemming from a decade of suppressed construction activity in the wake of the Great Recession. Despite improvements in supply chains that had restricted activity in 2021, builder confidence fell 60% from the start of 2022 approaching levels last seen during the 2009 housing bust (see Chart 13).

Consistent with builder pessimism, single-family housing permits have fallen below pre-pandemic levels and are unlikely to turn around soon given the high interest rate environment and future economic uncertainty.

Changes to our household formation assumptions impacted our outlook for future home construction as well. Consistent with a slowing in the number of new households added next year, Moody's Analytics lowered its outlook for 2023 single-family permits and starts to 853,000 and 843,000 units, respectively,

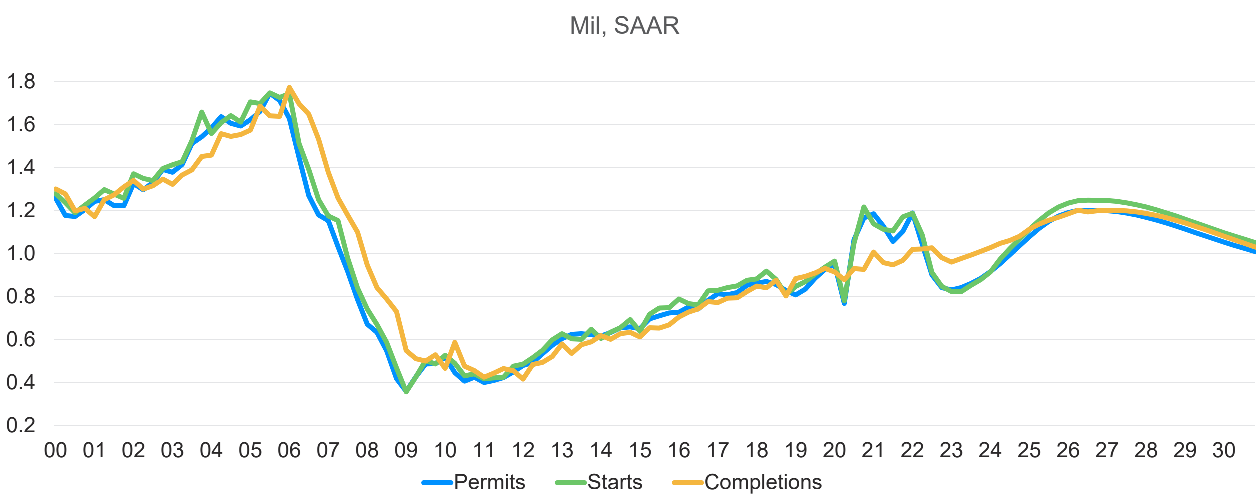
Chart 13: Homebuilder Sentiment Reminiscent of Housing Bust



Sources: NAHB, Moody's Analytics

from 993,000 and 1,007,000 in 2022 (see Chart 14). Reductions to the projected number of single-family homes completed next year were more modest given the large number of homes in the pipeline at the end of 2022.

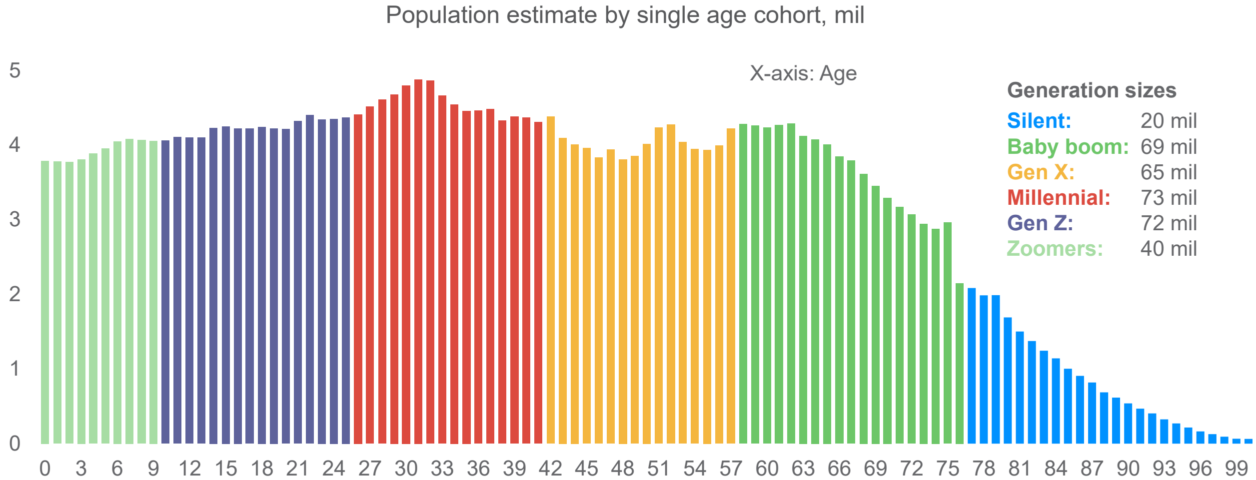
Chart 14: Single-Family Construction to Slow in 2023



Sources: Census Bureau, Moody's Analytics

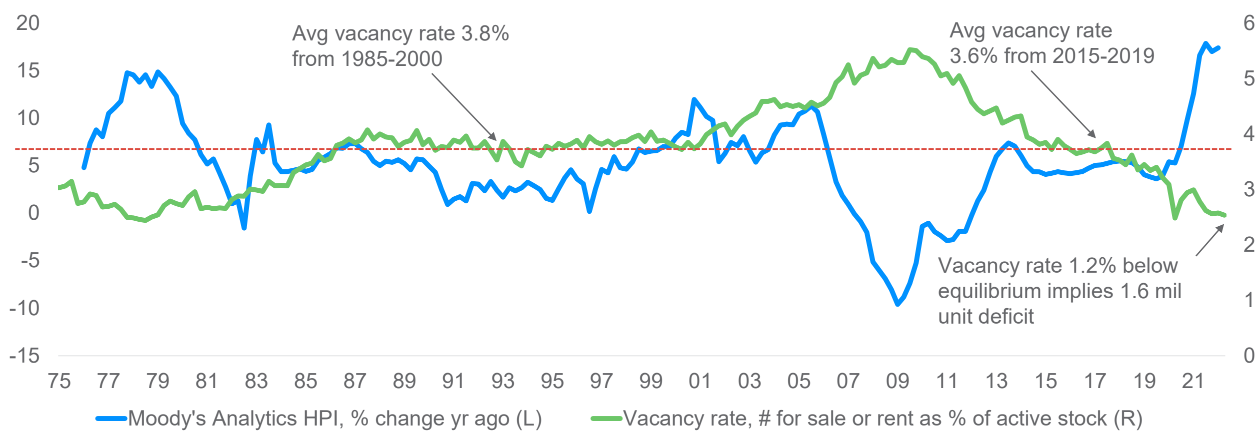
Although single-family home construction activity will pull back in the short term, the long-run outlook remains bullish given the low level of vacancies and expectations for household formations to accelerate due to the large number of young adults currently in their thirties (see Chart 15). Based on the existing housing stock and trend expectations of population growth, the housing market needs to add an additional 1.6 million units to return the vacancy rate to its long-run equilibrium (see Chart 16). This presumes only a modest increase in foreign immigration. Should immigration levels accelerate to address the long-run deficit in labor supply, even more construction would be needed.

Chart 15: Large Millennial Population Will Support Housing Demand



Sources: Census Bureau, Moody's Analytics

Chart 16: Housing Unit Deficit of 1.6 Million Based on Equilibrium Vacancy Rate



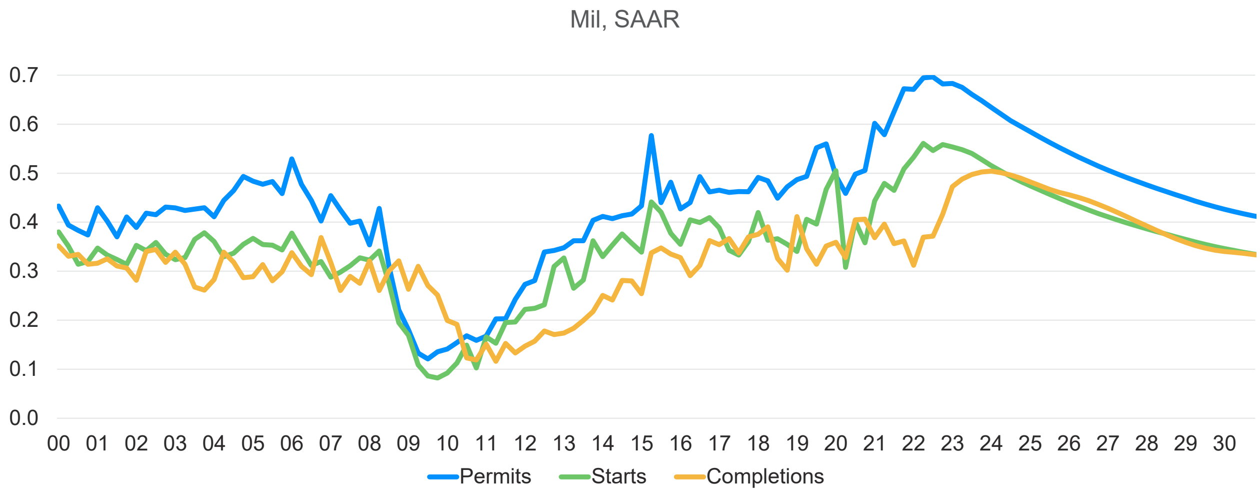
Sources: Census Bureau, Moody's Analytics

Multifamily construction remains strong

The outlook for multifamily construction is brighter than that for single-family under the assumption that demand for apartment rentals will remain robust as high mortgage rates and the restricted supply of homes available for sale will limit the possibility of households to purchase homes in the short term. As long as the job market holds up and mortgage rates stay high, underlying demand for housing will continue to support apartment leasing.

Given this assumption, our baseline outlook for 2023 calls for a modest reduction in multifamily permits from 690,000 to 670,000 and starts from 550,000 to 540,000 units (see Chart 17).

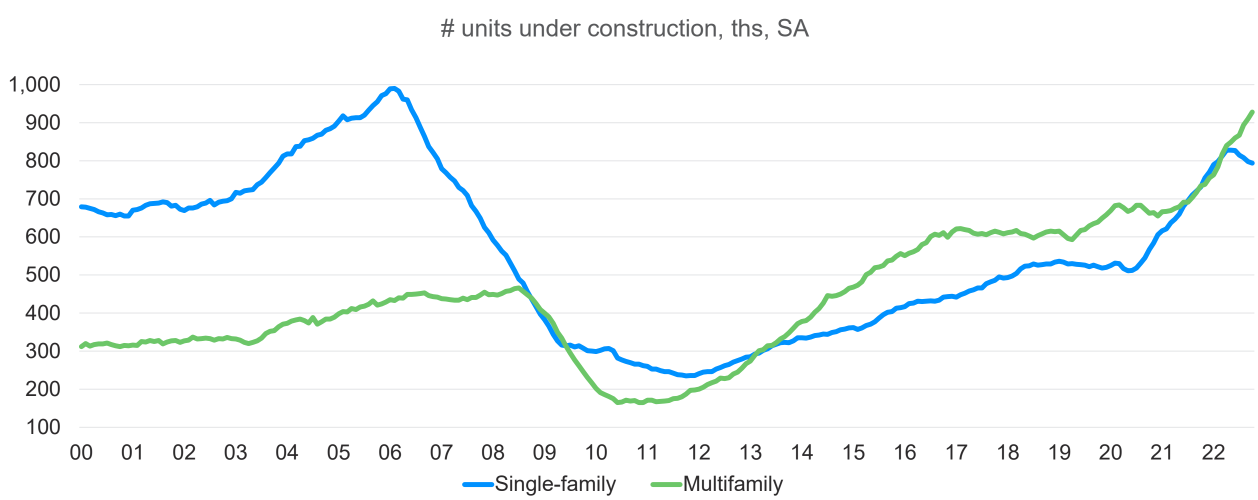
Chart 17: Multifamily Completions to Remain Elevated…



Sources: Census Bureau, Moody's Analytics

Despite the modest decline in permits and starts, the number of multifamily units completed in 2023 is expected to accelerate to 490,000 units from 370,000 units as the pipeline for multifamily homes under construction is at an all-time high (see Chart 18). Even at this pace, builders will face a backlog throughout the year supporting construction jobs throughout 2023, 2024 and possibly 2025 even as single-family homebuilding retreats.

Chart 18: …As Pipeline of Multifamily Projects at Record High



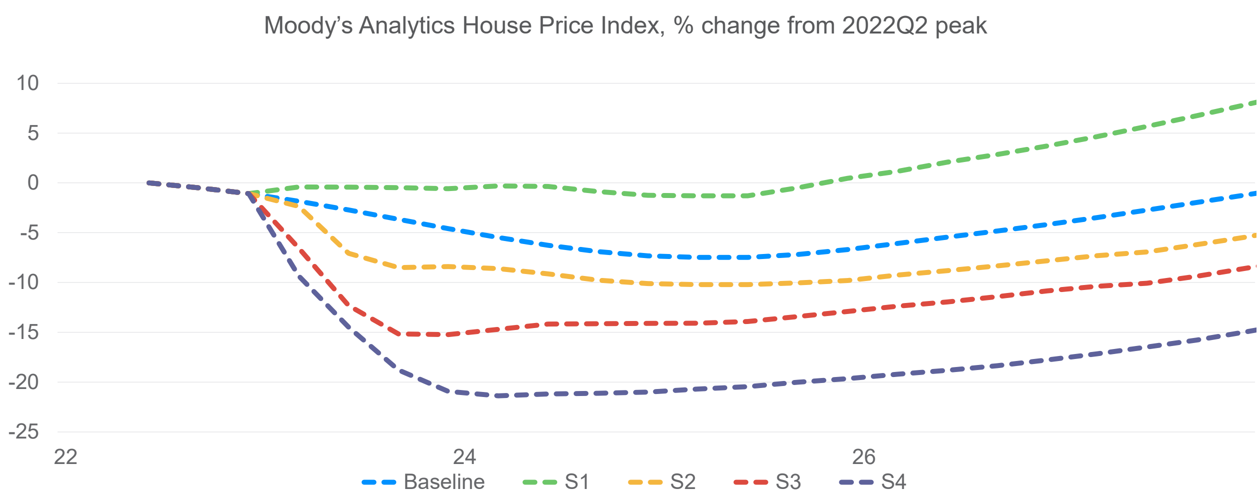
Sources: Census Bureau, Moody's Analytics

The increased supply in the number of available apartments will go a long way to fill the nation's housing deficit and help to reduce rent prices and overall inflation. Nonetheless, the additional supply will not come soon enough—or be affordable enough—for some individuals who will end up living with their parents, relatives or roommates rather than forming their own households in 2023.

Outlook

Putting all the assumptions and near-term trends together, the Moody's Analytics baseline view calls for slowing single-family construction and sales in 2023 along with a 5%-10% decline in national house prices over the next two years. Risks are weighted to the downside with further reductions in demand likely if either interest rates or unemployment rise as assumed in the Moody's Analytics Alternative Scenarios (see Chart 19).

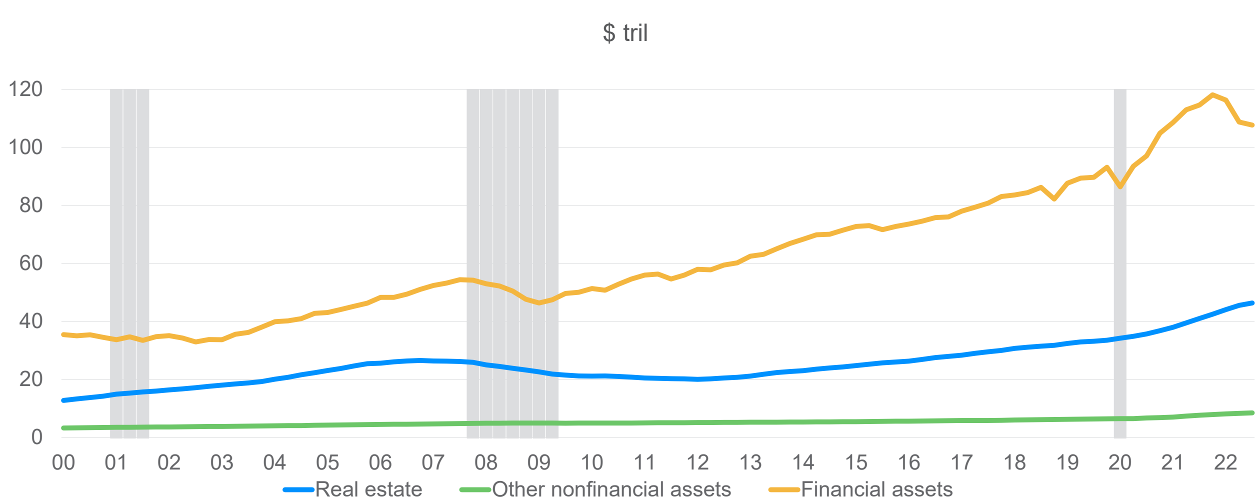
Chart 19: House Prices Expected to Fall 5%-10% Nationally



Source: Moody's Analytics

A 10% house price decline represents a significant loss of housing wealth on the order of $4 trillion that could lead to lower consumption as a result of wealth effects. However, such a potential reduction in wealth follows an $11 trillion increase in housing wealth since the pandemic as a result of house price appreciation in excess of 40% (see Chart 20).

Chart 20: Household Wealth to Fall Further as House Prices Decline



Sources: Federal Reserve, Moody's Analytics

Key to preventing a more significant housing decline will be the strength of the labor market and disposable incomes. Large equity cushions and strong mortgage underwriting should prevent a sharp rise in foreclosures, but a low growth environment would keep prices from rebounding quickly.

Even with a modest reduction in house prices, the availability of affordable housing will remain a top concern for households, businesses and governments. While remote work may open up possibilities for individuals to move to locations where the cost of housing is low, the option applies to a relatively small share of the labor force today. With businesses continuing to evaluate both the benefits and costs of remote work, households face additional uncertainty regarding the long-term prospects of remote or hybrid work across all occupations.

De-globalization and the onshoring of more manufacturing domestically will further increase the demand for housing regionally to support the expansion of factories, suppliers and related industries. Local communities may be challenged to provide sufficient affordable housing in the areas where these factories locate. Regions that are unable to adjust their zoning rules and other restrictions quickly may find themselves at a disadvantage when competing for these new business opportunities.

Risks

The primary short-term risk to the housing market is the availability and cost of mortgages. Monthly mortgage payments have risen to unaffordable levels for millions of families and individuals, particularly first-time homebuyers. Additional mortgage rate increases would reduce the pool of qualified buyers causing house prices to fall further.

Disruptions to the labor market and associated wage and salary income are a significant risk to the stability of the market as well. Should the number of layoffs accelerate, existing homeowners with a mortgage may be forced to sell their homes or risk foreclosure putting downward pressure on prices. Although the credit profile of mortgage borrowers is strong today relative to the Great Recession, a decline in prices of 20% or more consistent with the Moody's Analytics Alternative Scenario 4 cannot be fully discounted should the unemployment rate spike above 8%.

Inflation remains a secondary risk to the outlook as the cost of food, gas, utilities and other essentials continues to strain household budgets and crowd out spending on housing or the ability for renters to save for down payments. Some young adults will be forced to delay forming their own households with the risk that they are never able to recover. This "demand destruction" along with other demographic trends such as a reduction in foreign immigration could cause prices to fall faster than anticipated in the short-term and lead to a longer recovery in prices over time.

The primary upside risks to the outlook include a significant improvement in inflation, which would support household budgets and allow the Federal Reserve to tighten its monetary policy gradually without risking a sharp rise in unemployment or foreclosures. A return to target-level inflation would allow financial markets to stabilize and reduce the uncertainty premium currently embedded in mortgage rates. Lower rates would help to restore the affordability of mortgage payments and encourage builders to increase the supply of homes, thereby returning the market to a more stable equilibrium with house price growth consistent with household income growth.

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