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By Ralph DeFranco

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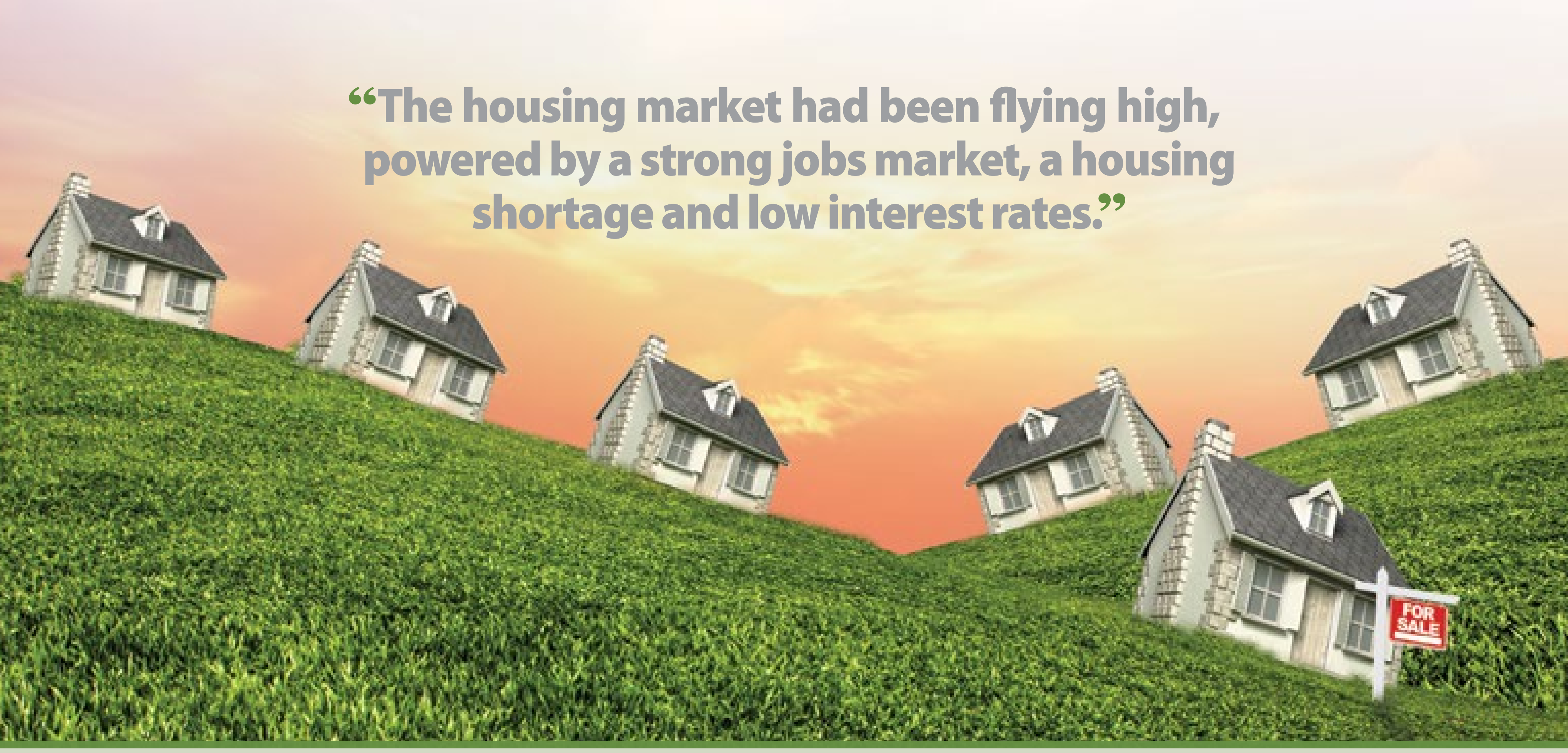
It's a Housing-Market Slowdown, Not a Bust

Rising interest rates have cooled sales, but unemployment remains low and the economy is riding high

All things must pass. For five years now, the housing-market story has been a story of strong demand and limited supply.

Now, demand has been abated by unrelenting price gains, higher mortgage rates and a widespread sense that homes have become unaffordable, which is keeping some would-be homebuyers on the sidelines. Thankfully, for mortgage originators and the country as a whole, supply remains tight in most areas, so an outright housing bust isn't expected.

What is the most likely scenario for 2019? What can originators expect? Sales may decline by 3 to 6 percent, and home-price growth will be slower. National home prices could still grow 2 to 4 percent next year, so long as the U.S. continues to have a constrained housing supply and ample job opportunities.



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The recent rise in mortgage rates will result in continued cooling over the next several months, but sustained price declines are unlikely in America's largest markets unless mortgage rates spike to 6 percent or higher.

Before looking more closely at where affordability has deteriorated the fastest, why a crash is unlikely, and why mortgage rates and home prices are still likely headed higher, let's examine a few examples that highlight the softening market:

- **New home sales and permits** are down and sales of previously owned homes were down 7 percent as of this past November.
- **Nationally, the supply of existing homes** ticked up slightly to 4.1 months as of this past Novenber, up from 3.6 months a year earlier, while the supply of new homes popped up to 7.4 months.
- **California, to name just one example,** has 28 percent more listings than a year earlier, and sales were down 8 percent as of this past October, according to the California Realtors Association.

The underlying root cause of the slowdown is a lack of affordable homes for sale. Higher home prices and rising mortgage rates have increased the size of the monthly mortgage payment needed to buy a median-priced home by anywhere from 7 to 26 percent over the past year, depending on which state you live in.

Housing affordability varies greatly by location. It remains favorable to homeownership in most locations but is deteriorating quickly as rates rise. The National Association of Realtors' Affordability Index is still 15 percent better than its historic average for the U.S. overall, which may explain why government-sponsored enterprise (GSE) data indicates an increasing first-time homebuyer share.

Also, the homeownership rate started growing in the past couple of years after declines for more than a decade. Nevertheless, markets that have had the largest deterioration in affordability could see larger slowdowns than the nation as a whole.

A soft landing

The housing market had been flying high, powered by a strong jobs market, a housing shortage and low interest rates. Now that the engine of low rates is sputtering, the ride just got bumpier.

Thankfully, a soft landing is a lot more likely than a crash since two engines are still going strong, for the moment at least. Job growth remains robust with total employment at record highs.

The economy is likely to remain strong over the next six to 12 months because the federal government increased spending and passed a tax cut, resulting in a large "stimulus package" that will keep the economy humming even with higher interest rates.

The housing shortage is not going away anytime soon: New home sales and builders' incentives to break ground on additional housing have been hampered by higher fixed costs such as local assessment fees, a labor shortage and tariffs.

New residential construction is around 1.3 million new units a year, while trend demand is likely somewhere between 1.5 million and 1.7 million new units a year. Another way to see how the country is underbuilt is by looking at today's residential fixed investment as a percentage of gross domestic product. It's now 3.9 percent compared to the historical average of 4.6 percent.

Flattish prices

A strong labor market and a shortage of housing should result in a soft landing for the housing market. Just how soft a landing depends on local housing-market conditions.

For some areas, it means flattish home prices, which would allow incomes to help catch up to recent price increases. For other areas, it could mean home-price growth in the 2 to 4 percent range, more in line with income growth.

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Minor price declines are certainly possible. The states most at risk for seeing price declines (according to the Arch MI Risk Index) are similar to those that have the weakest housing markets this year, including Alaska, Connecticut, Mississippi, Louisiana and West Virginia.

Interest rates are set for a further gradual rise this year — but keep in mind that rate spikes in today's global economy are somewhat self-correcting because they cool economic growth, creating pressure for rate moderation or decreases. The average 30-year fixed mortgage rate may average between 5 and 5.25 percent this coming year.

Rising rates have historically caused a mild slowdown in transactions, slowed home-price growth and a large reduction in refinances. One estimate of the size of the typical impact of higher rates comes from J.P. Morgan researchers who found that each rate increase of 0.25 percent trims homes sales by roughly 2 percent.

With supply still tight, history suggests the odds of seeing widespread material home-price declines are slim. Looking back at past bump-ups in mortgage rates finds that higher rates didn't result in falling home prices, with one glaring exception — the housing bust of 10 years ago.

It isn't that this time is different. It's that last time was different. A decade ago, the U.S. was oversupplied with homes and was awash in crazy loan products that no longer exist, such as no-doc loans. History suggests that while higher mortgage rates cause some buyers to temporarily hold off, employment is a more important determinant of housing demand in the long run.

Painful, but overdue

Mortgage rates are likely headed higher over the next year. The Federal Reserve is gradually reducing, or tapering, its purchases of agency mortgage-backed securities to replace run-offs. This alone may increase mortgage rates by roughly 0.25 percent over the next few years.

The federal government's budget deficit is large and rising rapidly. In order to find buyers for all those additional bonds, higher interest rates may be needed. The Federal Open Market Committee has raised the funds target rate by 0.75 percent so far this year and their projections imply several more to come.

KEY POINTS

Reasons to be optimistic about the housing market

- **Total employment is at a record high.**
- **Federal spending remains up.**
- **The stimulus tax cut is adding dollars to economy.**
- **The housing shortage continues.**
- **Mortgage rates are still historically low.**

While there are many reasons to expect mortgage rates to increase modestly, the direction and pace of interest rate increases is uncertain since it depends on future inflation, policy changes, economic and financial market conditions and events overseas. Painful higher rates were overdue, but if rates had risen to more normal levels sooner, home prices in hot markets would not have gone up as much.

What's next

Mortgage originators can see that a long-anticipated slowdown has finally arrived. Both home sales and price growth are slowing quickly, particularly in the West. The slowdown is likely to worsen, given mortgage rates could rise another quarter to half a percentage point over the next few years.

This will cause home-price growth to continue to slow, but a housing bust doesn't seem imminent, thanks to the strongest job market in 20 years, a shortage of housing and strong (but temporary) federal stimulus — at least for the next six to 12 months. In addition, mortgage rates are up but are still relatively low. Mortgages rates have been higher than today's rates more than 80 percent of the time since 1970.

Even with higher mortgage rates and some markets now overvalued, solid economic growth, a healthy labor market and a shortage of entry-level homes should prevent material declines in home prices. More specifically, national home prices could grow in the 2 to 4 percent a year range as long as the U.S. continues to have an overall healthy job market.

Price growth has been too strong for several years, fueled in part by abnormally low interest rates. A mild deceleration in home sales and Home Price Index growth is actually healthy, because it will calm excessive price growth — which has pushed many markets, particularly in the West, into overvalued territory. ■