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This Article

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A Market of Contradictions: Turning the Corner of the Summer Market with Leading Economic Indicators

The economic news for the housing industry is constantly in flux. There is a mix of very positive indicators amidst a number of market factors that give market researchers, like me, caution. It is the tenuous place our economy resides; a teeter totter of sorts where we toggle between positive and cautionary economic news. It is a market of contradictions. Very positive economic news could reflect short-term gains in a field that is increasingly becoming an upward climb. The degree to which the pitch of the economic field increases, decreases or becomes flat is a confusing mix of public policy pertaining to household factors (price of oil during the winter – price of gas during the summer), taxes (tax credits etc.), government incentives for private investment and, even more difficult to interpret, indices pertaining to the various housing industries – builders, realtors, mortgage etc. – along with consumer confidence metrics and an ever-convoluted mix of international trade and banking policies.

Economics is a qualitative science, as it is enveloped by a number of quantitative indicators. The best practice is to keep a hand on the pulse of various economic indicators that can tell the economic story and what the ripple effects could be. There is a laggard effect, since quarterly economic news is released approximately 2-3 months after the numbers have been posted. As a result, there is always a challenge in the reporting, because indicators are a look backwards in an effort to look forwards. Our goal is to provide economic news and provide interpretation as it affects housing markets as close to publication as possible. This keeps the publication as relevant and current as possible for the professionals who rely upon it.

It wasn't long ago that home values were plummeting as thousands of foreclosures flowed into the housing market, forcing realtors and mortgage professionals to deal with the excess inventory. Now the tide has turned. As this inventory diminishes, various markets around the country tighten, forcing bidding wars and price increases. Housing is increasingly becoming the bright spot of our economy in the recent flow of disappointing economic reports. "Consumer confidence and jobs are down but real estate keeps going up. It is the plank that the rest of the economic clings to," says CEO of RedFin, Glenn Kelman. With low rates and a more narrow population of Americans who either have the excess cash or can quality for a loan to purchase this inventory of homes, you get a mix of good news and bad news in the housing market. While excess inventory is being purchased (good news), we get the consolidation of home ownership around a more narrow population and the establishment of a renter-landlord society (bad news). Economically this reflects good news, but it is wrapped around economic effects that may fuel broader cultural concerns among financial classes within the United States. Increasingly, we are seeing the tension rise between those who have money and those who do not; those who participate in the knowledge economy and those who struggle making the ascent from low income to middle class, from middle class to wealth.

Home ownership is central to this ascension for the American family. In an effort to make wealth, money or capital easier to get, the opposite becomes true. This reflects probably the greatest irony in government intervention in the housing market. There are always good intentions (which is typical of politicians), but even more typical are the unintended consequences. This has been rampant, especially in the 'too big to fail' (e.g., CFPB and Dodd-Frank) policies that are intended to distribute risk across more banks and alleviate consumer dependence on institutions that become 'too big to fail'. These policies have resulted in the most rapid consolidation of depository and non-depository banks in U.S. history, leaving larger more capitalized banks even larger, and squeezing small to mid-sized banks out of business due to liquidity and regulatory burdens intended to keep watch on larger firms.

Therefore as homes are being bought and sold, the demographic of the buyer is changing to older, wealthier Americans – excluding minorities, younger Americans, legal residents and those with catastrophic financial events that impair credit scores of otherwise very creditworthy borrowers. Having said this, units are moving; homes are being bought and sold, and excessive inventory is being consumed at a record pace, which is turning the tide of real estate's fortunes.

Here is what is driving inventory down and prices up, and what is boosting residential construction:

- **Bank-Owned Properties**: The inventory of REO or bank owned homes fell significantly over the past year from 817,000 in June of 2011 to just over 600,000 in June. This exists amidst new foreclosure filings, which means financial institutions are holding onto real estate assets because they are forecasting price improvement of properties and a demand for new homes. This actually is a good statement of confidence, an appreciating sign for our nation's homes, and good news for sellers as it will either maintain or increase sales prices.
- **New Home Construction**: With fewer foreclosures to be purchased in the market, more motivated buyers who are left on the wrong side of the bidding war end up putting down deposits with builders who now are seeing a demand for new construction inventory. This has improved the confidence of the National Association of Home Builders Association. As previously reported in the Niche Report, new construction permits in March were at four-year highs and builder confidence took its biggest jump in nearly 10 years. A renewed interest in newly built homes has generated an increase in sales of new construction homes over the past 12 months.
- **Seller's Remorse**: Before that short sale or downsizing, there are signs that sellers could be waiting for home price to increase before they sell. "Regular homeowners don't want to sell their home because they think they can wait two years to get better pricing," Kelman says. This is a good sign for homeowners to recover the net worth losses largely tied up in the value of their home and/or property. This, it in turn, helps bolster new construction demand. For a "normal" market, whatever that can really mean today no one really quite knows – however the expectation is to be doing 1.5 million starts to reflect a healthy market. The housing market has been stuck due to recessionary constraints holding back consumer demand, down to around 500,000 annually.
- **Investors Turned Landlords**: As a result of these factors, prices are rising and, in many cases, at the expense of consumers. This isn't a sign of a healthy recovery; it is a sign of a recovery of exclusion. Those who benefit are cash-rich investors and those excluded are average consumers who have consistent and sustainable incomes but challenged credit. There are many individual consumer investors such as a mid-40-year-old professor at a university in New England who purchased a tri-plex in Springfield, Massachusetts. It listed for $155,000 and was purchased for $59,000. With approximately $20,000 in construction costs, this property will be rented and more than likely sold in less than 10 years as the value of the property appreciates. There are thousands of opportunities in various markets, some of which are discussed below.

To illustrate this trend on a more institutional level, Blackstone Group LP (BX.N) spent more than $300 million to purchase over 2,000 foreclosed homes, reflecting their bet on the recovery of the U.S. housing market. "Our bet is over time, vacant homes will fill up and markets will begin to recover," said Jonathan Gray, senior managing director and global head of real estate. "Our exit will be to sell the individual homes to the renters themselves, or there could be a very large market for public housing REITS." Blackstone is a very successful hedge fund and private equity firm with plans to raise money to acquire more foreclosed homes, and to rent them out for several years before selling them as the housing recovery takes hold.

Another example of this is Beazer Homes USA, Inc. (BZH.N). In early May Beazer announced a Pre-Owned Rental Homes, Inc. program founded in partnership with investment group and private equity firm, Kohlberg Kravis Roberts & Co (KKR.N). This leasing program capitalizes on borrowers who can't afford to qualify for a home but desire to one day own a home. At the end of the lease, the borrower can purchase the home, but at a handsome profit to Beazer Homes. This creates an 'affordable housing' market for the broader public, which once again benefits a select group of investors and owners and not the citizenry as a whole.

It is in the best interest of the housing market and the public to spread the risk and the 'skin in the game' to as many homes' occupants as possible. Otherwise, occupants feel little attachment to their homes, which has been the hallmark of homeownership over the last 50 years in the United States. In investor-owned, occupant-rented property arrangements, something is lost. If the emotional connection to the property is diminished and if occupants feel less vested in their domiciles, something is lost to the American character to home ownership, let alone specific economic metrics concerning how much occupants are willing to spend to maintain the property and improve its value. A landlord spends as little as necessary to maintain the property; an owner-occupier will spend as much as they want given their love of the home or as much as they need to improve its value. In both of the latter cases, this is lost in these otherwise very attractive arrangements for investors.

Home Appreciation Indicators: June Home Prices Rise, but Sales Drop.

Home resales fell in June, but the median sales price was higher than a year earlier as fewer people sold their homes under distressed conditions. As previously mentioned, this reflects the duplicitous conditions of the U.S. housing market and its recovery. The National Association of Realtors (NAR) released on July 19th that sales slipped 5.4% to an annual rate of 4.3 million homes last month (June). This was the slowest pace in eight months, and well below analysts' expectations of 4.6 million units. The median price for a home resale rose to $189,400 in June, up 7.9% from a year earlier. Reflecting this trend and for reasons already discussed, the nation's inventory of homes (those for sale on the market) fell 3.2%, which contributed to the rise in prices. The key to this indicator is what is for sale. As banks perceive a recovery in home prices, they sit on the bank-owned inventory until they can sell at prices that will return a profit. While the broader U.S. economy is losing its recovery strength, the housing market is gaining traction.

Concluding Thoughts on Risk, Loan Applications & Economic Liquidity

Because of the mix of surface-level improvements and underlying fault lines to these improvements, a robust and self-sustaining recovery is probably not in the cards for quite some time. Nouriel Roubini, an economist who is famous (and infamous) for his prediction of the 2008 economic crisis, outlined five reasons those bullish to our economic recovery have been wrong, and argues that continued challenges in Europe and lack of Congressional agreement in limiting the impending tax increases due to reset in January 2013 will keep spending and growth slow. Roubini believes the U.S. is looking upon a "fiscal cliff" built by a growing public sector, unfunded retirement systems, and declining economic growth in light of China and emerging markets.

"And now, after getting the first half of 2012 wrong, many are repeating the fairy tale that a combination of lower oil prices, rising auto sales, recovering house prices, and a resurgence of U.S. manufacturing will boost growth in the second half of the year and fuel above-potential growth by 2013," says Roubini. Roubini is referring to the bullish economists who predicted a greater than 3 percent annual GDP growth rate when less than 2 percent has been realized. The "fiscal cliff" that Roubini refers to could knock 4.5 percent off the growth that will take place in 2013 should all the tax cuts be allowed to expire. In this scenario, growth will be foreseeably less than 1% since much of the global economy is built on U.S. spending – and with the expiration of these tax cuts, disposable income growth and consumption will slow. China's slowdown, uncertainty in U.S. elections, an unstable Middle East and unresolved debt and currency issues in Europe could realistically add to the drag in the U.S. economy.

How does this impact the housing Industry? The above issues are at the very HEART of the mortgage rates, consumer demand for homes, qualifying criteria and whether or not sellers are confident they can sell their home should they put it on the market. To facilitate this process, the U.S. Federal Reserve has carried out various rounds of quantitative easing to purchase financial assets from private banks and institutions in order to increase capital reserves of said institutions. This in turn is intended to lower lending rates to end consumers. This practice moving forward will be ineffective as long-term interest rates are already very low, and lowering them further would not boost spending, only the liquidity of banks. "The credit channel is frozen and deal velocity has collapsed," says Roubini. Banks and investors only continue to increase their reserves, which doesn't equate to lowering credit standards or broader consumer lending.

This is the reason for the mixed forecast and the series of positive and cautionary indicators that fuel the debate between economists and confuse real estate professionals as to how to position their businesses. If housing professionals are confused, just imagine the confusion of the seller as to when to put their home up for sale. or the buyer looking to identify the right time to buy. It is no wonder politicians struggle to understand why businesses aren't spending and hiring, and banks aren't lending. One thing is for sure – it will be an interesting election this November, and an even more interesting 2013.

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