US: what is going on with the slowdown in the real estate sector?

The US real estate sector has begun to show signs of slowing down in recent quarters. This trend has opened up the debate about whether it poses a significant risk to the current expansive phase of the US economy, which is close to beating its record for the longest period of uninterrupted growth in the last 170 years. This is especially the case given that, as we all know too well, the real estate sector played a decisive role in the economic-financial crisis of 2008.

Confirmation of the slowdown and economic effect in the short term

Several variables in the real estate market have shown a clear slowdown in recent months. The growth of residential investment has dropped from nearly 3.5% in real terms in 2017 to less than 1.0% in the first three quarters of 2018, while sales of both new and existing homes have fallen since the beginning of the year and price growth has slowed down (see the first and second chart).

This change of trend was foreseeable to some extent, in view of the Fed's monetary normalisation process. As a result of the gradual withdrawal of monetary stimuli, the interest rate on 30-year mortgages has increased by 100 bps in just one year (up to around 5.0%, the highest in the past eight years). This accounts for nearly two-thirds of the slowdown registered in residential investment.[1] In addition, the tax reform approved by the US Congress in December 2017, which lowered deductions for both mortgage interest and property taxes, has also influenced the recent slowdown in the sector.

These downward pressures on the real estate sector will remain in place over the coming quarters, which to some extent will hold back economic activity. In particular, as a result of the slowdown in residential investment and the impact of housing wealth on consumption, the real estate sector will go from contributing around 0.3 pps to annual GDP growth in the US between 2015 and 2017 to probably having a zero contribution in 2018, and one of around 0.15 pps in 2019 and 2020.

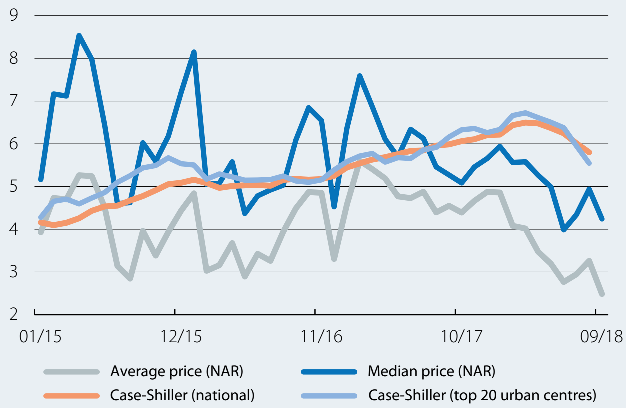
In the medium term, we believe that there is unlikely to be a major disruption in the real estate sector with consequences for the financial system and for economic activity, as occurred 10 years ago. In fact, as we shall see below, the current imbalances in the sector appear to be relatively contained, which should help it return to growth over the next few years.

1. As suggested by Goldman Sachs's estimates (2018), in «The Housing Slowdown».

US: home sales

Source: *CaixaBank Research, based on data from the National Association of Realtors.*

US: housing prices



Source: *CaixaBank Research, based on data from the National Association of Realtors (NAR) and Standard & Poor's.*

Contained imbalances: prices, supply and indebtedness

After five years of substantial growth (around 6.0% per annum), US housing prices are 50% higher than those recorded in 2012 (their lowest point) and 10% higher than those of early 2007 (their highest peak). However, in order to assess whether housing prices are too high (or low), we must first consider them in relation to other indicators that show the affordability of housing. A common measure is the ratio between housing prices and household income. If we take the case of an average household, between 1980 and 2017 this ratio has varied between 2.5 and 4, with a historical average of 3. Given that it currently stands at 3.3, the accessibility of housing, or the level of effort required for households to purchase a home, does not appear to be terribly different from what it has traditionally been in the country.[2]

All things considered, at this point, some caution is required. Firstly, in a country as large as the US, national aggregates can be misleading, since the real estate market is highly segmented and sometimes there are noticeable regional differences. As such, although the levels of effort required to access the housing market are generally at reasonable levels, there are certain major metropolitan areas on the West Coast, as well as in the North East, where prices are far less affordable for average-income households (see the third chart).[3] Secondly, it is worth noting that while the effort ratio at the national level is not far off the usual parameters, it has undergone a gradual but uninterrupted increase since 2012 (rising from 2.7 in 2012 to 3.3).

Household indebtedness related to the real estate sector is another element that must be analysed when evaluating the level of imbalances in the sector. In this area we see how, on the one hand, household mortgage debt in relation to household property wealth is slightly below the historical average (35.5% at present, compared to an average of 37.2%).[4] On the other hand, during the real estate boom prior to the bursting of the bubble in 2007, there was a sharp increase in so-called housing equity withdrawal (through which households were obtaining consumer loans, using their home as collateral). This trend led to very high levels of household consumption (which was unsustainable following the sector's collapse). Today, however, these lines of credit have fallen sharply, reaching all-time lows.

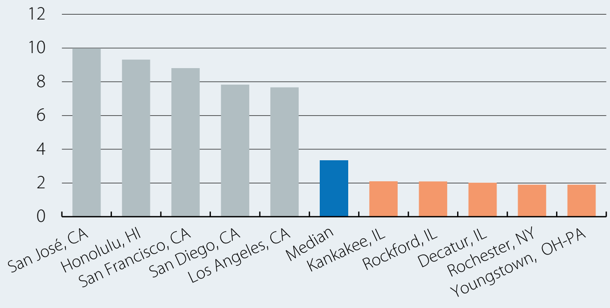
Lastly, there is not any imbalance between housing supply and demand arising as a result of the demographic trends in the US. In particular, the pace of construction remains at contained levels in relation to the demand generated by the formation of new households (see the fourth chart), which supports the current expansive cycle of the real estate market that began in 2012.

In short, in this new expansive cycle in the real estate sector, there are no signs of the more significant excesses that were present in the mid-2000s, such as the high levels of construction activity, runaway housing prices and the credit boom supported by the real estate market. Therefore, everything indicates that the current slowdown is not, in a general sense, a source of significant risk for the current expansion of the US economy. Nevertheless, some regions of the country should be closely monitored, since their indicators are somewhat less contained.

2. Ratio between the median housing price and the median household income (according to data from the National Association of Realtors), both at the national level. The results are similar to those indicated by other data sources for the price of housing and household income.
3. Honolulu, the capital of the archipelago of Hawaii, also appears near the top of the lists of the least affordable cities. On the other hand, this is a characteristic that is quite common among large cities on remote islands.
4. Although this ratio is not very informative during periods with unsustainably high property prices, this does not appear to be the case today, as is clear from the ratios indicating the effort required for households to purchase a home.

US: accessibility index by metropolitan area

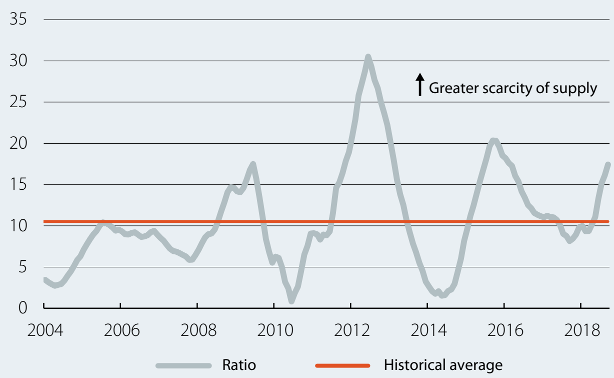
*Price over income **



Note: ** Based on the median household income by metropolitan area and the median housing price by metropolitan area (2017).*
Source: *CaixaBank Research, based on data from the American Community Survey and the National Association of Realtors.*

US: ratio between household formation and new homes built

Level



Source: *CaixaBank Research, based on data from the National Association of Realtors and the US Census Bureau.*