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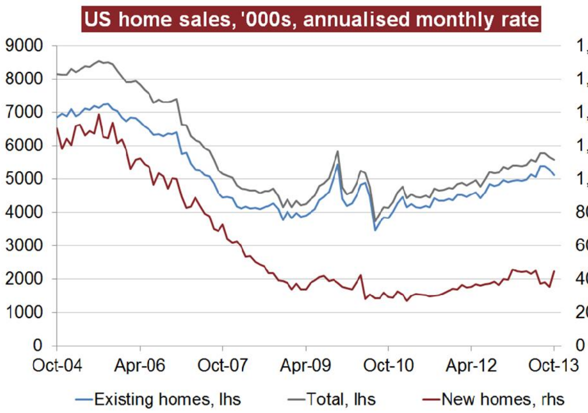
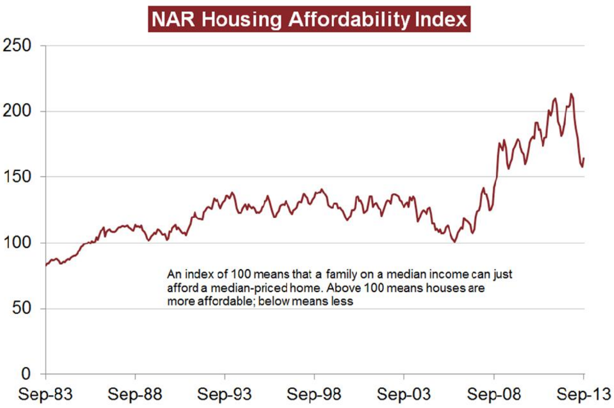
The modest strength of US housing

- **The October surge in new home sales disguises a more modest trend**
- **However, housing market activity should continue to strengthen**
- **Recent residential investment contributions to quarterly growth (0.4%) look sustainable**

US new home sales rose by more than 25% in October, the biggest monthly rise since May 1980. But some of the gloss of this news is removed by noting that it was partly a reaction to weak September data (and downward revisions to July and August as well); and, more importantly, that the overall trend of home sales, while rising, is doing so at a fairly modest rate. The weakness of home sales over the summer is partly due to higher mortgage rates, in turn a consequence of the Fed's 'taper terror' from May to September which caused a bond market sell-off.

In spite of the October jump in new home sales, the level of sales was still below that of June. Overall, home sales have risen by just under 50% from the low point reached in June 2010; but they are still down 35% from the July 2005 peak. This is in spite of record high housing affordability over the past five years (a combination of lower prices and lower interest rates) as well as a 20 million (7%) rise in the population since mid-2005.





Over the very near term, it therefore seems that US housing market strength will remain modest. However, there are a number of reasons to expect that activity will accelerate over the somewhat longer term, perhaps by the middle of next year.

One reason is the approach of the Fed's QE taper. While monetary policy under Janet Yellen is likely to remain loose for longer than previously expected, the Fed is clearly anxious to begin withdrawing the quantitative easing. That should put some further upward pressure on bond yields and thus also on mortgage rates. However, the relationship between mortgage rates and house purchases – as well as between prices and purchases – is not entirely straightforward. While higher costs and prices ultimately tend to dampen purchases, there is often an initial effect where they accelerate them. This is because buyers

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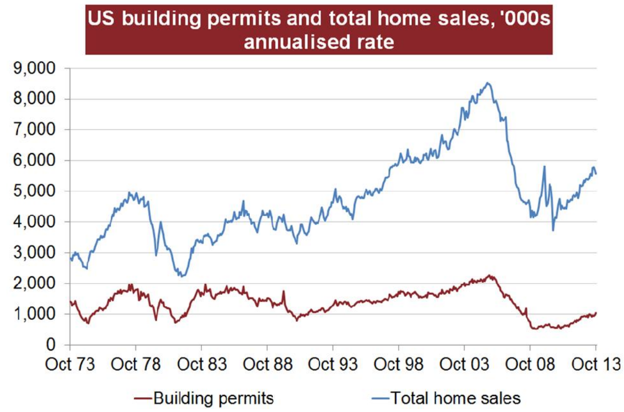
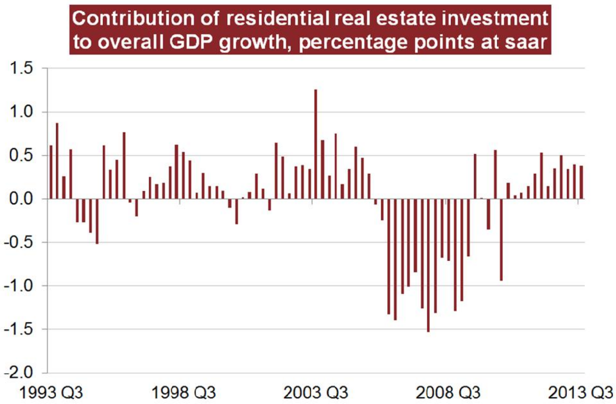
expect interest rates and prices to rise further and therefore try to lock in current costs and values. Moreover, although housing affordability has come down from previous peaks, it remains high by historic standards.

What is not clear is how much this will benefit construction activity. The inventory of new homes for sale was 4.9 months in October. It has been below the 6.1 months long-term average since September 2011. Building permits have edged up in the past two months and the October number (1.039mn units at an annualised rate) was the highest since June 2008. But that number is still only about 25% above troughs reached in previous housing busts. Since sales tend to lead permits (and thus also housing starts) a continued rise in sales, even if modest, should spur further residential construction.





Since the onset of the Great Recession, residential construction has on average subtracted 0.2% from quarterly GDP growth. Over the eight quarters since Q4 2012, the average has been a 0.4% addition to growth. That is above the very long-term average; but, more to the point, it seems to be a sustainable average contribution over the medium-term.

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