
SPECIAL REPORT

TD Economics



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AMERICA'S HOUSING MARKET: RECOVERIES AREN'T ALWAYS AS THEY APPEAR

Highlights

- After years of decline and stagnation, recent data suggests national home prices are finally entering the early stages of recovery.
- Still, housing is inherently local and price momentum varies greatly from market to market. Leading the pack are states experiencing stronger job growth and healthy foreign demand like Texas, Florida, and Arizona. Meanwhile, states with soft demand backdrops – like Connecticut and Nevada – are still suffering price declines.
- Supply also matters. In the near-term, prices are more influenced by the share of sales related to foreclosures on the market rather than the total outstanding amount of foreclosures still stuck in the pipeline.
- The supply situation is currently benefiting Florida and hurting Georgia. However, if Florida, along with a number of other markets – like New York and New Jersey – finally have their backlog of foreclosures hit the market, it will place renewed downward pressure on home prices. In contrast, price gains in states like Arizona, where the stock of foreclosures is clearing, look to be the real deal and are at far less risk from the shadow market.

After years of stagnation, the housing market is finally showing signs of life. Construction is up, sales are rising, and housing inventories are declining. But, perhaps most importantly, home prices are increasing. There's no denying that the housing market remains plagued with a backlog of troubled mortgages. However, if rising home prices are sustained, it would be an economic game changer. First, it would signal that progress is finally being made on clearing the supply overhang. Second, it would create a self-reinforcing feedback loop where rising prices pull bargain-hunters off the sideline and lift household wealth, ultimately feeding back into confidence and spending.

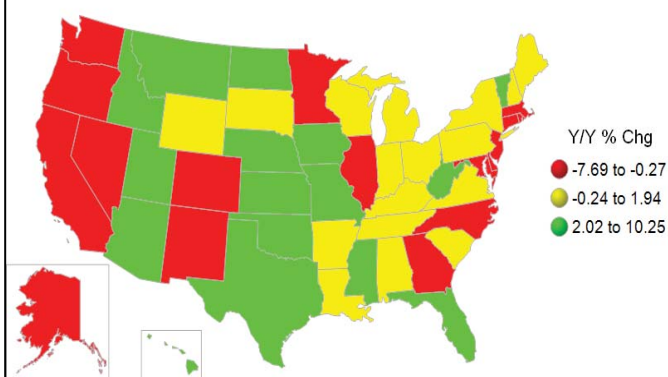
However, irrespective of what the national statistics show, we all know that real estate is local in nature. Price growth varies widely across the country, with some states and metros chalking up annual price gains of nearly 6%, while many others are still unable to shake that sinking feeling. The early stage of the housing recovery is benefiting regions that are at the forefront of employment gains, as well as regions that have historically attracted foreign interest. These are two tried and tested demand drivers that remain consistent to this day, even amidst a housing cycle that has been anything but typical. A third, but equally important factor, relates to supply. In states where the share of foreclosure sales is falling, home price growth is stronger. However, we must offer a word of caution here. The sustainability of price momentum hinges on why foreclosure sales are slowing. Florida was among the top-10 states for price gains in the first quarter, but the legal system is drowning in a flood of foreclosures. If the dam breaks, home prices will come under renewed downward pressure. By contrast, in Arizona, prices are rising as foreclosure inventory has been cut in half. Price gains there look to be the real deal.

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MAP 1: FHFA PURCHASE ONLY HOME PRICE INDEX



Source: Economy.com, FHFA.

Where does your state place?

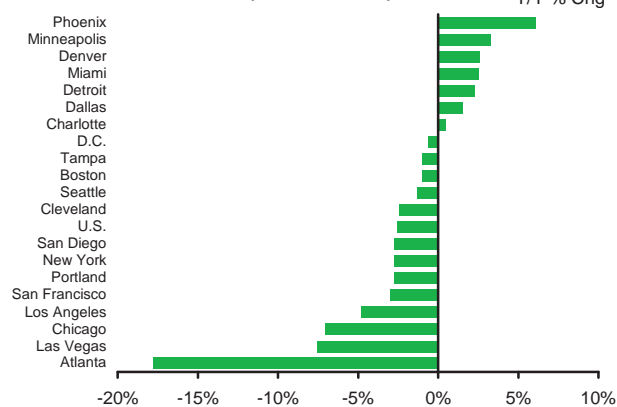
In April, the median existing home price rose a staggering 10.1% relative to a year earlier, marking the fastest increase since 2005. This increase likely reflects a shift in sales towards more expensive homes. However, there is confirming evidence that prices are rising in other indicators. The FHFA and CoreLogic home price indices show similar upward trends, and neither is skewed by a shifting composition of sales. The map and chart above show year-on-year price growth for each state and 20-metros areas. With some notable exceptions, the biggest price gains are rooted in the central part of the country spanning from Texas to the Dakotas. In contrast, markets on the West Coast remain under considerable duress. East of the Mississippi, price activity has been mixed, ranging from strong gains in Florida to persistent losses in many Northeast states.

The housing market is not following a first-in, first-out behavior. There is no connection between depths of house price declines during the recession with the pace of the recovery today. If anything, states with the greatest home price decline between 2007 and 2010 are more likely to still be in the red today.

Atypical housing cycle does not break link between jobs and price growth

Some simple principles of economics remain at the heart of the housing recovery. As one would expect, there is a strong connection between the pace of job growth and the recent home price appreciation. Five states, including North Dakota, Oklahoma, Utah, Texas and West Virginia are among the top 10 states in home price growth over the

FIGURE 1: CASE-SHILLER HOME PRICE INDEX (MARCH 2012)



Source: Case-Shiller

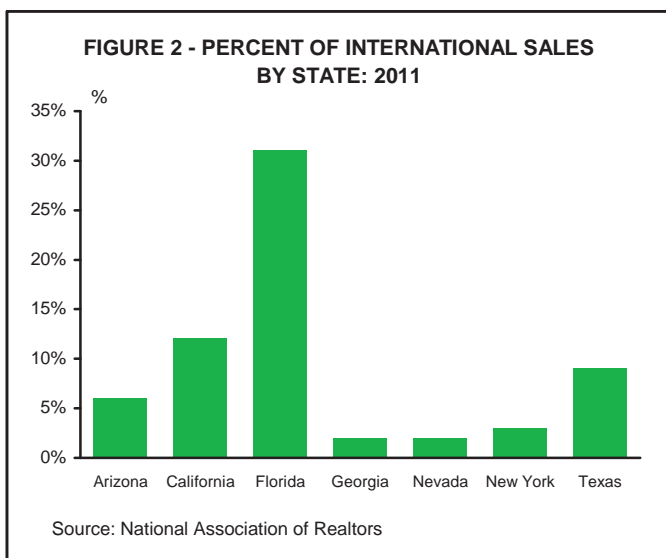
past year and, by no coincidence, also rank among the top 10 states for job growth. Drilling down to the metro level, the same connection is apparent, with cities like Dallas and Phoenix registering strong price and employment gains, while Las Vegas and Chicago reflect the opposite dynamic.

This economic dynamic offers some explanation regarding why vastly improved housing affordability among the hardest hit states has not necessarily translated into stronger housing demand. Take, for instance, California, where prices have fallen 47% from the peak, and remain in the red to this

Box 1: Picking a home price index

We use two price indices in this report: the S&P Case-Shiller index for metro markets and the FHFA purchase only index for states. Because of its accuracy and deep market penetration, the Case-Shiller home price index is among the most widely used national home prices indices, and where possible we've incorporated its metro data into our analysis. Unfortunately, the Case-Shiller's geographic range is limited to 20-metro markets. Thus, in order to expand our analysis more broadly, we've used the FHFA's purchase only home price index for states.

While both indices track repeat sales and are reliable guides to home prices, there are two important differences between the indices. First, the Case-Shiller is a lagging indicator, so it's registering less upward momentum than the FHFA. Second, the FHFA excludes home price changes on non-conforming mortgage products, limiting its sample size and making it less representative in markets where non-conforming loans make up a significant market share.



day. Improved affordability has not been sufficient to offset the state's lackluster job recovery.

Foreign demand lifting home prices in some markets

Variations in labor market health between states and metros are only part of the regional housing story. When it comes to real estate, some things never change. It's still very much about location, location, location. Improved affordability can go a long way in repairing markets that have been traditional magnets for foreign demand. On a national scale, international buyers accounted for a relatively small share of around 8% of all homes transacted in 2011.¹ However, foreign purchase activity tends to be highly concentrated in key markets. For instance, 58% of foreign related purchases were in Florida, California, Arizona, and Texas. In fact, Florida alone accounted for 38% of the foreign purchases.

Foreign demand is particularly important in the current environment because the domestic market is credit constrained. Foreign purchasers are more likely to pay 100% of their purchase in cash. Vacation destinations like Florida and Arizona, which have a larger portion of their market driven by foreign demand are, therefore, more likely to outperform their economic fundamentals. Miami stands out as one such market. Home prices have swung up by 2.5% relative to last year, even though the city has posted an average 1.3% increase in employment. A recent study by the Florida Association of Realtors revealed that 30% of foreign purchases in Florida are in Miami.

Unfortunately, this source of home demand may wane in the coming months. Canadians represent the largest source of foreign demand, especially for markets like Florida.

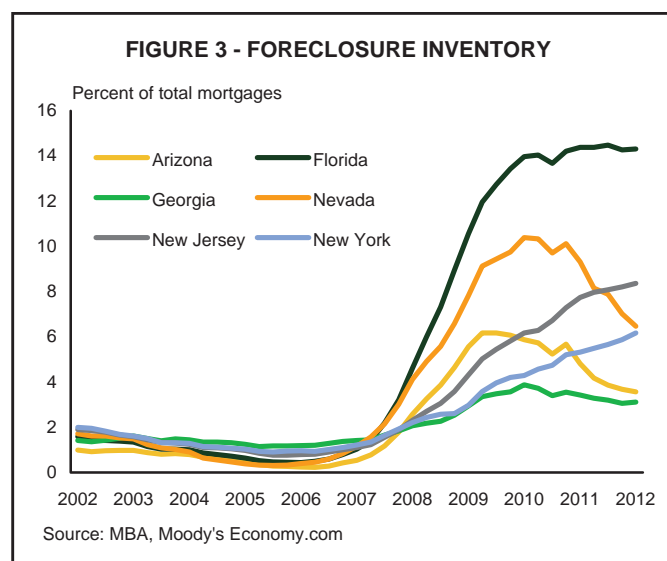
But, concerns that Canada's domestic housing market is poised for a slowdown could trickle into a slower pace of foreign purchases. Furthermore, slower economic growth in the other major markets like Europe and China may also dampen foreign demand.

Supply shows the Goldilocks nature of recovery

Employment and foreign demand represent the two key demand drivers of the housing recovery, but anyone who took even a single course in economics knows that demand is only half the puzzle. Supply is the other missing piece. On this front, the number of existing homes put up for sale has fallen considerably over the last year for the nation as a whole. This measure stands at 6.6 months, which is still above the pre-recession trend of 4-5 months, but well below the peak level of 12.1. While consistent inventory data is not available at the state level, the number of vacant homes for sale did drop across all four Census regions, suggesting tightening inventories is occurring broadly in America.

However, we are all too familiar with the unique characteristics of this housing market – supply is heavily influenced by the large number of delinquent and foreclosed homes. And, when it comes to foreclosures, Florida is ground zero. At 14.3% of all mortgages, Florida has the highest foreclosure inventory in the country. The next worst foreclosure market is in New Jersey, where the share is almost six percentage points lower than Florida. Given that home prices have risen 4.7% over the past year, does Florida defy the principles of supply and demand in economics? The answer is no.

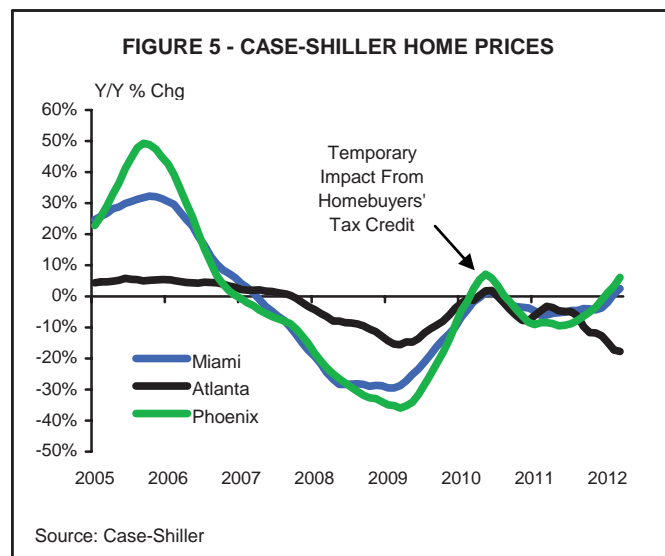
What drives prices is not the absolute amount of fore-



closures backlogged in a court system or review process. Rather, it is the rate at which they trickle onto the market and, thus, their share of total sales. Foreclosed properties typically sell at a 20-30% price discount relative to a non-distressed home because they are often in a more dilapidated state. The longer housing sits in a state of disrepair, the greater the chances that the house will simply be written off, torn down and rebuilt.

For Florida, the share of sales attributed to foreclosed homes has fallen by nearly 15 percentage points in the past year and this has acted as a release valve, buoying home prices. Unfortunately, because the lengthy foreclosure process in the state continues to build on the backlog of foreclosures, it raises the risk that if the dam opens, a rush of these properties onto the market would push prices down again. New York and New Jersey suffer from the same attributes.

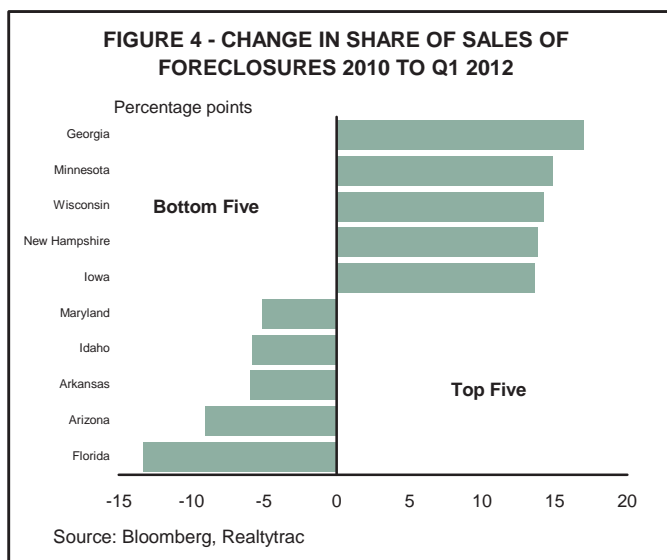
By extension, the ability for prices to push higher in the future may be capped by a steady trickle of supply from the backlog of foreclosures onto the market. In fact, Atlanta looks to be experiencing this phenomenon. After weathering the initial downtrend in home prices relatively well, Atlanta area home prices are now down 18% year-on-year. This is the greatest decline of any metro area that Case-Shiller reports. Likewise, the share of sales attributed to foreclosures has risen by nearly 20 percentage points across Georgia in the past year. However, this downward pressure is unlikely to persist much longer, given that the share of mortgages related to foreclosures is steadily whittling away. Georgia's foreclosure rate stood at only 3.1% of all mortgages in the first quarter, which puts it in the middle of the pack among states.



Unfortunately, Georgia's demand drivers for the housing market are weak as employment growth has trailed the nation over the past year. Hence, any rebound in prices from an improvement in the supply side, would be tempered by the drivers on the demand side.

Arizona offers a good example of a state that is capturing the right blend of foreclosure supply and price impacts. Like Florida, this was a state that at one point was characterized as having some of the highest foreclosure rates in the country. But, unlike Florida, the shadow market has been steadily clearing, in part because it is a non-judicial state which permits a faster processing of foreclosed properties. It's no coincidence that seven of the top 10 states for price increases are non-judicial states. Arizona has seen a 10 percentage point drop in foreclosed sales in the past year alongside a steady drop in the backlog of foreclosure properties. In the first quarter, the share of foreclosure mortgages was 3.6% of its total market, down from over 6% at the peak.

So, here we have an interesting finding. It is the flow of distressed properties into the market that matters most for prices in the near term rather than the outstanding stock in backlog. But, the latter materially raises the risk that upward momentum in prices will eventually stall or reverse course. Essentially, when it comes to supply drivers, the three states of Florida, Georgia and Arizona represent the Goldilocks nature of the supply side of the housing market. Florida prices look hot relative to its foreclosure backdrop, Georgia's plummeting prices are too cold relative to its supply backdrop, but Arizona is just right.



Bottom line

Of all the economic indicators that have come out over the past several weeks, some of the most positive have been on the U.S. housing market. The rebound in home prices across the country is in part due to improvements in demand. This is particularly true of housing markets across the central part of the country, which have seen the strongest job growth. Similarly, home prices have performed better in parts of the country where foreign demand has helped to fill in for weak domestic demand. However, reductions in housing supply are equally important in driving recent home price movements. A slowing in the number of foreclosure sales helps to explain why some states have seen home prices rebound more than others.

Unfortunately, the reduction in foreclosure sales has little relationship to the stock of seriously delinquent mortgages

and foreclosures that still need to be cleared. In many cases declines in foreclosure sales appear to be due to judicial backlogs.

Thus, supply issues remain a wild card in the housing outlook. In many judicial states, court proceedings have stifled the flow of foreclosure inventory onto the market. This means in places like New York and New Jersey, distressed sales could easily rise as a share of sales and put downward pressure on prices. In other (typically non-judicial) markets, like Arizona, the share of distressed sales is likely near a peak, limiting future downward price pressures.

So, while there are reasons to cheer the recent turn in home prices, there are also reasons to be cautious about the pace of future increases. In states where there remains substantial foreclosure inventory, home prices are likely to come under renewed pressure with time.

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Endnotes

1. National Association of Realtors. "Profile of International Home Buying Activity 2011." Downloaded from <http://www.realtor.org/sites/default/files/2012-profile-international-home-buying-activity-2012-06.pdf> on June 14, 2012.

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