

correcting, not collapsing

– the US housing market and the economy

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Some are worried that housing in the US will collapse, leading to a recession and lower interest rates. UBS believe the housing market is undergoing a correction, not a collapse, and that the impacts on the rest of the US economy should be limited.

Parts of the US housing market are due for a correction and that correction has begun. This is not in question. What is uncertain is the impact on the economy, both in the US itself and further afield.

Falling home sales and plummeting homebuilder confidence sent the bond market into a panic rally this summer. In response, a succession of Federal Reserve (Fed) officials stepped up to say, in no uncertain terms, that a housing market correction, even a 'severe' one, did not guarantee that they would cut rates. So who is right, the recession bears or the soft landing bulls? We believe that we are witnessing a correction, not a collapse.

Let's look first at the bears' argument for a housing led recession. Figure 1 shows how this typically runs. First, the housing market is a huge bubble that is now bursting. Then as the market collapses, so do house prices, drying up the reservoir of mortgage equity withdrawal that households have been dipping into to support consumption. Both consumer confidence and

consumption will collapse. Combined with tumbling residential investment, the US slips into recession and price deceleration. The Fed is left with no choice but to cut rates, desperately trying to reflate the economy. Some bears even throw in the prospect of widespread defaults and a banking crisis of 1989 savings and loan proportions.

This is a worrying scenario for investors, and so it should be – provided all the conditions are in place. Thankfully, the conditions are not all in place. There are good reasons to believe that the Fed view will prevail and that inflation, not the housing market, remains the key threat.

the housing bubble is smaller and more localised than you think

The median house price is now over six times disposable income, as compared to about three and a half a decade ago (according to data from OFHEO and BEA). Similarly prices are about 20 times rents, compared to

14 times in 1996. Surely this represents a bubble? No, not unless we all bought houses outright instead of taking out a mortgage. Households choose between renting and buying. The best comparison is therefore between rents (which reveal the current value of accommodation) and the costs of owning a home (interest, principal, tax, maintenance, insurance, transaction costs). Compared to the 1980s, lower interest rates have slashed the costs of owning a home. When demand is high, supply is constrained and the costs of owning have dropped substantially, then of course house prices must rise.

we are witnessing a correction, not a crash

There are two good fundamental reasons why the level of housing activity in the US should be higher now than in the past. The first is that households are richer, and when people get richer they spend disproportionately more on housing. In economic parlance, housing is a 'superior good'. Almost 9% of

Figure 1
the housing-led recession argument

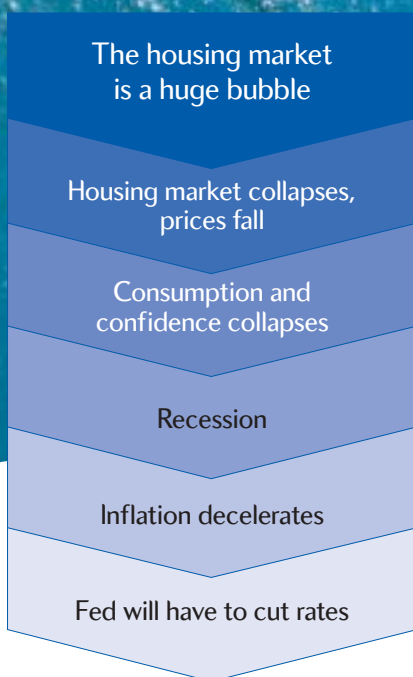
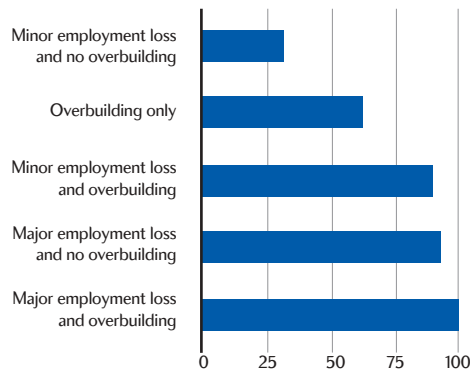


Figure 2 preconditions for house price decline

Per cent of times that various conditions led to a nominal price decline, based on metropolitan areas.



A major employment loss is a net decrease of over 5%.
Overbuilding is when permit levels per 1000 residents are at least double the 1980 - 2004 average for that metropolitan area.
Source: Joint Centre for Housing Studies of Harvard University.

households now have second homes (not for rent or sale), according to Census Bureau data. The second reason is demographics. The US population has just passed 300 million. In 2005 there were 1.7 million new households and the ageing population means that, if anything, household formation is likely to rise. Older households are keener to own their own home, which requires the construction of more suitable housing stock.

a housing market correction will not derail the consumer

The US has never exhibited a strong relationship between house prices and consumption. Households determine their spending based upon their expected lifetime incomes, and then choose how to divide this spending between housing and other forms of consumption. Sometimes a third factor, such as an oil crisis, has lowered incomes and thus reduced both consumption and spending on housing simultaneously. Those who fear a recession argue that housing wealth supports consumption. Wealth effects are overstated as a determinant of

consumption. House prices are determined by transactions between two people for an existing house. For everyone who is happy with rising prices there is someone equally unhappy. Nothing new is produced or even expected to be produced in the future (unlike with shares), so the wealth effect is likely to net out.

For the economy, and housing, the labour market is key. Incomes and spending are far more reliant on employment than on asset price fluctuations. Nothing curbs spending like unemployment. Historically, slumps in housing have been preceded by either sharp interest rate hikes, increases in localised unemployment or localised overbuilding (see Figure 2). For example, defence layoffs in California led to local house prices falling in the early 1990s.

Even if house prices fall, this may not mean that inflation will come down. Historically, house price inflation tends to lead general inflation with a lag of about two years. If this relationship holds true, then inflation won't benefit from a cooling housing market until mid-2008. Since 1992 that relationship

has disappeared, largely because inflation has been low and house prices have only been rising. In any event, there is no historical evidence to show that you can rely on falling house prices to counter inflationary pressure, and the Fed knows this.

listen to the Fed: the tightening bias remains

Most Fed officials argue, as we do, that the housing correction is 'substantial' but is unlikely to lead to a recession. Adjustment in the housing market will only bring down the economy if confidence collapses, and there is no sign of this. The clear and present danger is inflation.

The Fed's preferred core inflation measure has been above the 'comfort zone' of 1-2% for two years. If inflation becomes embedded and inflation expectations rise, restoring that lost credibility will be painful and difficult. Far better to allow the housing market to let out some steam and have a period of sub-trend growth, with constant or higher rates, than to cut rates and watch inflation creep further out of control.

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