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The Home Buyer Tax Credit Is Over, Now What?

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(Reprinted from National Association of Home Builders, David Crowe, Chief Economist)

In the aftermath of the deadline for the home-buyer-tax-credit, which advanced a significant amount of housing demand into April, monthly housing indicators turned negative.

Single-family starts fell 17% in May to a seasonally-adjusted annual rate of 468,000, which was a return to the level of May 2009. Single-family permits also dropped to similar year-earlier levels. The June NAHB/Wells Fargo Home builder sentiment index fell back five points to 17. May new home sales plunged 33% to their lowest level on record.

The deadline for signing a purchase contract has passed, but the deadline for closing is June 30 and could be extended to September if legislation already passed in the House passes in the Senate and is signed into law.

Since existing home sales are reported at closing, they are not expected to fall off until July. Nevertheless, they were down 2% to 5.66 million in May, although this could be due in part to a crush of closings causing delays and backlogs.

Putting the May sales decline into perspective, it was preceded by a 15% increase in sales in April. The average sales pace for the two months combined was 373,000, which was a 3% increase over the average for this year's first quarter. A similar, although smaller, decline occurred in December, when the 2009 home buyer credit was scheduled to expire but was extended.

Beyond the influence of the tax credit, the more volatile multifamily starts jumped 33% to 125,000 in May from April's 94,000 and multifamily permits were up 10%, suggesting that the apartment market may finally have reached bottom.

While vacancy rates remain high, they are down from their recent peak.

Expected improvement in labor markets has also encouraged multifamily developers to begin planning new projects that can easily take one to two years to complete after they receive permits.

The real question now is whether what occurred in May is a harbinger of a housing market still unable to work up enough momentum on its own to sustain a recovery or simply a temporary side-effect of the tax credit doing its job.

Although housing activity in May was generally weaker than anticipated, several factors continue to support NAHB's forecast for improvements in 2010. Mortgage interest rates are expected to remain at historically low levels for the remainder of 2010, with only a modest increase in 2011. House prices are back to where they were in 2003.

Although prices have been bouncing around, with small positive and negative changes from month to month, some markets have been inching upwards. The economy continues to show improvement in total output and employment growth, a vital element to housing demand. New home inventories are at their lowest level in almost 40 years, and any uptick in demand for new homes will almost certainly require increased residential construction.

From a longer perspective, the U.S. population continues to grow. Household formations have lagged behind trend as a result of the recession, and those unformed households represent the prospect of moves out of the overcrowded homes of friends and relatives.

And the economy in general has been advancing. Industrial production rose 1.2% in May and was up 7.6% from a year earlier. May capacity utilization rose to 74.7% from73.7% in April and 68.5% a year earlier. Retail sales stumbled in May, falling 1.2% from April, but were still up 6.3% from a year earlier. Despite May's pullback in retail sales, both the University of Michigan's consumer sentiment index and the Conference Board's Consumer Confidence Index showed solid improvement for the month.

Meanwhile, according to government estimates, only a little over half of the funds from the American Recovery and Reinvestment Act — $409 billion of the $787 billion — has been distributed, leaving well over $300 billion in economic stimulus yet to come.

These economic and demographic forces are expected to provide sufficient stimulus to slowly push the housing market forward in the second half of this year.

Financial Market Turmoil

Turmoil in the Euro currency union stemming from fiscal problems in Greece and Spain and some other member countries has spilled over to the U.S. financial markets.

For now, the United States is benefiting from foreign investors seeking safety in Treasury securities and other U.S. fixed-income assets, pushing long-term interest rates lower. Below the 5% threshold for seven consecutive weeks, 30-year, fixed-rate mortgage rates are now among the lowest on record.

Although lower long-term interest rates are a positive for housing and the economy, the rising value of the U.S. dollar against the euro will increase the prices of U.S. exports and dampen demand for them in Europe.

Demand in Europe is likely to weaken further as governments on the continent impose stricter fiscal measures out of concern over their sovereign debt. On balance, lower interest rates but fewer exports will likely impose a minor drag on U.S. economic growth.

Federal Reserve Policy

In statements from its June 22-23 meeting, the Federal Open Market Committee (FOMC) has indicated it will be continuing its monetary policy of "exceptionally low" interest rates for an "extended" period.

The FOMC's assessment of the economy is in alignment with NAHB's outlook. "The labor market is improving gradually," and "household spending is …constrained by high unemployment, modest income growth, lower housing wealth, and tight credit," the Fed said. It acknowledged that "housing starts remain at a depressed level."

NAHB expects the federal funds rate to remain in the 0.0% to .25% range through the middle of 2011 as a relatively slow and prolonged recovery puts little stress on capacity and resources, keeping inflation in check. Low inflationary expectations, along with the situation in Europe, should help keep mortgage rates low.

NAHB projects that mortgage rates will remain below 6% through 2010 and most of 2011.

Inflation Remains Tame

The seasonally adjusted monthly Consumer Price Index was down in May for the second month in a row, falling 0.2% following a decline of 0.1% in April, but up 2.0% from a year earlier. Meanwhile, core inflation — excluding food and energy prices — rose a modest 0.9% from a year earlier, a rate consistent with the April data.

For the past year, the rental component of the CPI has been essentially flat, and as of May, it was down 0.1% from a year earlier. Homeownership “prices” are measured by using an owner’s equivalent rent that is largely driven by the rent index without utilities. That measure has also been drifting down — 0.3% over the past year.

The rent and owner components of the CPI make up 31% of the CPI. The soft rental market and excess vacancies have kept rents from rising, which has been a challenge to apartment owners who have seen other costs rising. It also has made it more difficult for multifamily projects to obtain financing.

Once the rental sector begins recovery and rents return to a more normal path, the CPI will also reflect the major influence housing costs have on overall inflation.

The Producer Price Index (PPI) for finished goods also fell for the second month in a row, down 0.3% in May after falling 0.1% in April. The May reading was up 5.3% from a year earlier, though that is down from March’s year-over-year increase of 6.0%.

Despite year-over-year declines in cement and gypsum prices, overall building materials prices in May rose 0.7% for both single-family and multifamily construction, their seventh consecutive monthly increase, and 4.6% and 4.7%, respectively, from a year earlier.

Some near-term price relief is likely at hand, with lumber prices in recent weeks retreating rapidly from their earlier increases.