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UNITED STATES: HOUSING MARKET DEVELOPMENTS AMID MONETARY TIGHTENING

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The massive monetary tightening policy undertaken by the Federal Reserve, starting in March 2022, in order to combat soaring inflation, has driven up mortgage interest rates. This sharp uptick in rates has in turn led to a significant deterioration in demand metrics of the US residential real estate market (notably mortgage applications and existing home sales).

Nevertheless, the buoyancy of the US economy at the aggregate level and the healthy financial situation of households have prevented the housing crisis from turning into a systemic crisis.

The surge in mortgage rates has also affected the existing home supply, prompting a lock-in effect which has led to an unprecedented divergence between new and existing home sales, which was although insufficient to support the whole market.

The short-term outlook for the residential real estate sector remains subdued.

RESIDENTIAL INVESTMENT RETURNED TO PRE-GFC LEVELS BEFORE MONETARY TIGHTENING

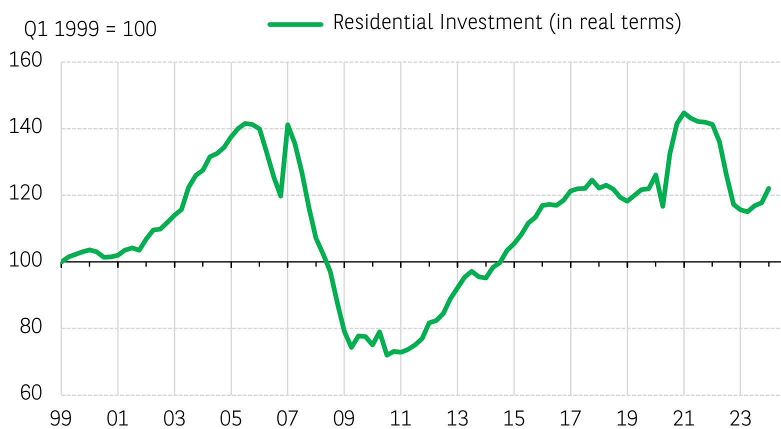

CHART 1

SOURCE: BEA, BNP PARIBAS

The US residential real estate market expanded substantially in the wake of the Covid-19 outbreak, a trend observed in most developed economies. To be sure, the trend was already on a positive footing since 2011, the year in which a sustainable recovery was launched after the sharp 2006-2010 correction. Residential investment, as a GDP component, has clearly taken advantage of this trend (chart 1), while the existing home market had been less buoyant in recent years. The private residential investment's rebound, in the wake of the pandemic-induced dip of Q2 2020, was still substantial, exceeding a mere catch-up process. As a consequence, in Q1 2021, residential investment in GDP reached a level above the pre-subprime crisis record level. In early 2021, the main other residential housing indicators, such as existing-home sales and housing starts, also recorded their strongest figures since 2007. All of these indicators have since started to decline, in a context of deteriorating consumer confidence, declining real incomes and higher interest rates. Here, we will start by analyzing the transmission of these higher rates to the housing market. Next, we will discuss the factors that prevented the housing downturn from reverberating through the US economy as a whole. We will also review the lock-in effect and the diverging trends between existing and new home sales, before concluding with an analysis of the prospects, which remains mixed.

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BOND YIELDS, VECTORS OF THE MONETARY TIGHTENING TRANSMISSION TO THE HOUSING MARKET

While a gradual lifting of the target range took place between late 2015 and late 2018 before a slight easing, the Covid-19 pandemic prompted the Federal Reserve (Fed) to significantly loosen the monetary policy. The central bank thus lowered the target rate by 150bps in March 2020 (such a sharp move, regardless of direction, had not occurred since 1982), before holding it at 0% - 0.25% for almost two years. As inflation soared from 2021 onwards, the Fed initiated a drastic tightening of the monetary stance in March 2022. This cycle of rate hikes was the swiftest and steepest since the 'Volcker II' episode (for the second monetary tightening undertaken under the direction of then Fed Chairman Paul Volcker) in the early 1980s (see chart 2). In addition, the increase in the target rate, which has stood at between +5.25% and +5.50% since July 2023, was complemented by a quantitative tightening action (i.e. a reduction in the size of the balance sheet).

Numerous factors have an impact on long-term rates, but the concomitance between the Fed's restrictive actions and the rise of the latter is noteworthy. The benchmark indicator, namely the U.S. 10-Year Treasury Yield, has increased sharply and reached unprecedented levels since 2007, ranging between 3.9% and 4.9% since September 2023, while it averaged 1.1% in 2020-2021. As mortgage rates are substantially driven by 10-year yields, this has mechanically impacted the cost of credit. The late rise in mortgage rates was all the more so greater because the spread between the 30-year fixed mortgage rate and the 10-year Treasury yield has widened. The spread traditionally oscillates at around 2pp, but it tends to increase as a result of growing uncertainty. As a consequence, 30-year fixed mortgage rates rose from 3.1% in late 2021 to 7.0% at the end of May 2024, while the 7.8% peak of October 2023 was an all-time high since 2000.

A HOUSING CRISIS BUT NOT A SYSTEMIC CRISIS

The substantial increase in the cost of credit, against a backdrop of renewed inflation and recession forecasts, has led to a significant decrease in demand for mortgage loans which furthered the downward trend that started in 2021, visible in the Mortgage Bankers Association (MBA) data. Initially, this could be depicted as a corrective move in the wake of the post-lockdown surge. The decline in mortgage applications, despite being mechanical and widely anticipated with respect to increased rates, is still sizable, with a historically unprecedented fall of 56.2% (annual average) in 2022 (data starts in 1991). The dip continued in 2023 (-31.4%) and brought the index of mortgage applications to its lowest since 1995. As a consequence, a widespread deterioration has emerged in the residential real estate market, illustrated by a fall in existing home sales close to that observed during the subprime crisis and the ensuing Great Financial Crisis. Two figures illustrate the fall's speed and severity: the 3.88 million sales (annualized rates) of December 2023 are close to the December 2010 floor, while the -36.7% y/y January 2023 decrease exceeds the annual declines observed over the 2006 – 2010 period. Most notably, the final result of 4.05 million existing-home sales in 2023 was the lowest since 1999 (2008 ended up with 4.1 million). New home sales also initially observed a significant decline (Chart 6).

SWIFEST AND SHARPEST MONETARY TIGHTENING SINCE 1981

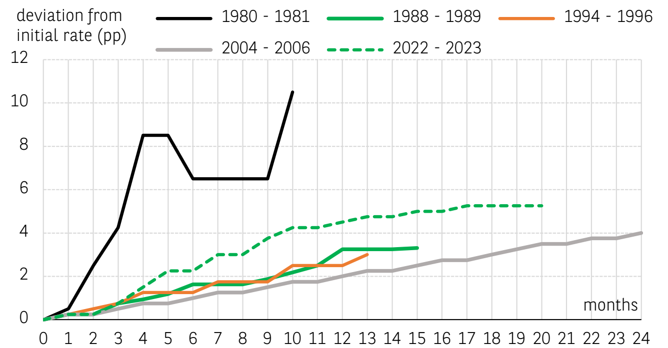

CHART 2

SOURCE: FEDERAL RESERVE, BNP PARIBAS

RATE TRANSMISSION THROUGH US GOVERNMENT BONDS

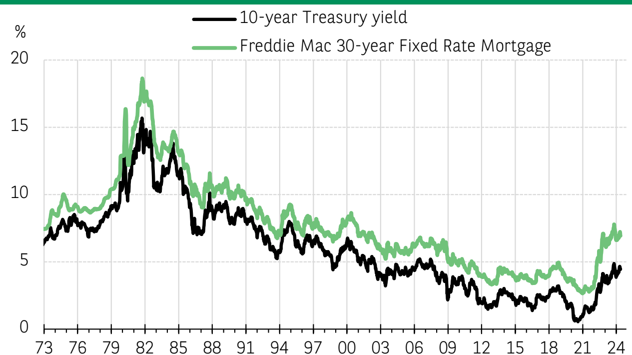

CHART 3

SOURCE: MACROBOND, BNP PARIBAS

SIGNIFICANT DETERIORATION OF MORTGAGE APPLICATIONS

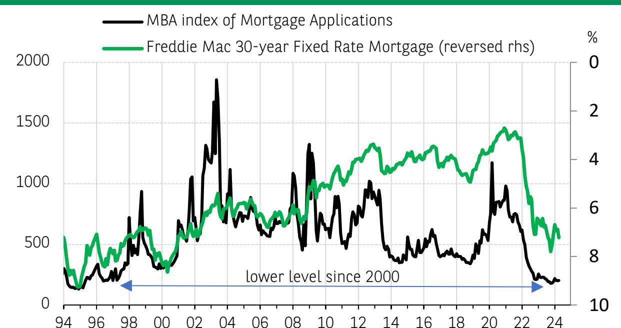

CHART 4

SOURCE: MACROBOND, BNP PARIBAS

Strikingly, the housing market deterioration has not reverberated to the US economy as a whole. In fact, the latter defied widespread expectations of a recession in 2022 – 2023 and remained buoyant, as illustrated by the +2.5% yearly annual growth in 2023. This resistance has, in turn, probably helped to contain the magnitude of the real estate crisis. Indeed, after a spike during the Covid-19 outbreak, the delinquency rate on mortgages has gradually receded, according to Fannie Mae data. For several quarters, the rate trended at standards slightly lower (0.5% - 0.6%) than those prevailing prior to the pandemic onset, which prevented a domino effect from taking place. This situation must also be linked to the labor market's resilience to monetary tightening thus far, as the unemployment rate increase has been relatively moderate since the beginning of rate hikes (+0.3pp to 3.9% between March 2022 and April 2024), while the pace of monthly increases in the non-farm payroll remains healthy (+232k annual average as of April 2024). The current structure of household mortgage indebtedness is also accountable. The share of adjustable-rate mortgages in total mortgage applications, which exceeded 30% in the years prior to the subprime crisis, currently stands below 7%. This has helped to reduce the speed of the monetary tightening transmission to mortgaged households[1]. Furthermore, household indebtedness, as measured by the debt-to-disposable-income ratio, has receded drastically since the GFC. After peaking at 137.2% (100.4% for the mortgage debt) in Q4 2007 due to a 77pp increase over 10 years, it amounted to 100.4% (63.6%) in Q4 2021, the last quarter before the first FOMC rate hike over the current cycle (see chart 5). Moreover, ratios linked to households' assets and net wealth have since resumed an upward trend, which has further underpinned household resilience.

NO HOUSEHOLD DEBT BUILDUP PRIOR TO MONETARY TIGHTENING

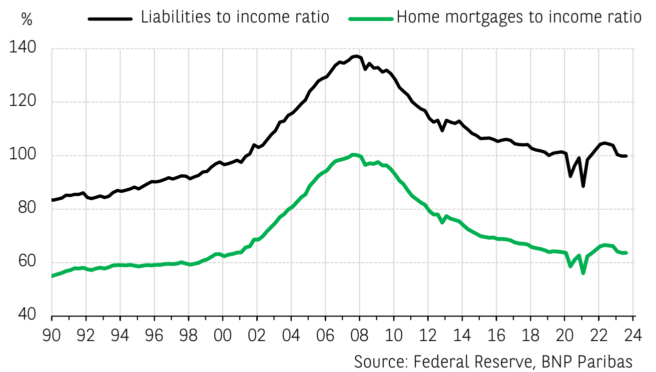

CHART 5

SOURCE: FEDERAL RESERVE, BNP PARIBAS

THE LOCK-IN EFFECT AND THE LACK OF REBALANCING THROUGH SUPPLY

The negative impact of tighter financial conditions on home sales was aggravated by the developments in real estate prices. House prices, as measured by the S&P Case-Shiller index, increased further in 2023, with an average annual growth of +2.4%, despite several months of monthly decreases. Admittedly, this figure marks a major deceleration after the 2021 (+17%) and 2022 (+15%) results. However, this does not in any way offset the rise in the overall cost of an acquisition as a result of higher interest charges. Theoretically, the collapse in mortgage demand should have exerted a strong downward pressure on prices. Nevertheless, the magnitude of the climb in 30-year mortgage rates (almost +5 pp between October 2021 and October 2023), unseen since 1981, has resulted in a lock-in effect.

This phenomenon ties in with households' reluctance to undertake new housing projects against the backdrop of much tighter borrowing conditions. Typically, the purchase of a new home, with a new mortgage, is associated with the sale of the current home which, in the case at hand, was probably previously acquired with a relatively favorable mortgage rate (the average 30-year FRM amounted to 3.9% over the previous decade). Thus, for example, for a $300,000 loan over 30 years, an increase in the mortgage rate from 4% to 7% leads to a 40% increase in monthly installments. As a result, the market has "frozen", with a constrained inventory of homes available for sale, already on a downward trend (estimated at 1.06 million in 2023 by the National Association of Realtors, compared with an average of 2.2 million between 2010 and 2019). This has limited the potential for the market's rebalancing through prices and contributed to the deterioration in the existing home sales volume.

DIVERGING TRENDS IN EXISTING VS. NEW HOME SALES

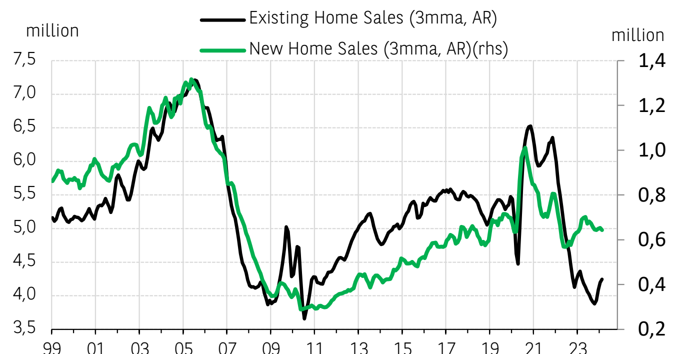

CHART 6

SOURCE: MACROBOND, BNP PARIBAS

New home sales have thus benefited from bolstered demand, underpinning a dynamism in this sub-component of the market, and contradicting the general tendency. This has led to an unprecedented divergence between new home sales (+6.7% in 2023) and existing home sales (-18.4%). It has also had a positive effect on residential investment (as measured by the national accounts), which has been recovering since Q3 2023, putting an end to a nine-quarter streak of contraction. However, this GDP component remains (in Q1 2024) very slightly below its end-2019 level, while the latest improvements remain insufficient to offset the previous deterioration phase (between Q1 2021 and Q2 2023).

1 For more details on the mitigated effects of monetary tightening on the US residential housing market, see Housing is One Reason Not All Countries Feel Same Pinch of Higher Interest Rates, FMI.

LIMITED RECOVERY PROSPECTS

The potential for a rebound in the housing market remains subdued in the short term, although the low level and the latest developments in terms of residential investment in the GDP suggest that there is scope for a catch-up. The red color remains predominant in our heatmap of the key indicators, reflecting a still negative situation (see table). Also, the pick-up in demand for new homes – a segment which, more generally, is structurally unable to supply the majority of demand on its own (new homes have accounted for an average of 11.4% of sales since 1999) – has turned out to be restrained. On the one hand, the final result for 2023 is rather modest (665.5k homes sold, below the 2019 level). This suggests that the current demand for new homes might be specific to a segment of potential buyers less constrained by the new interest rate regime. On the other hand, while the downturn in building permits has eased, the lack of a sustained and durable bounce-back underscores the current situation of uncertainty. Above all, the supply side of the sector is also facing many headwinds, including production cost inflation, higher interest rates, and an uncertain outlook, although the recent rebound in builder sentiment, as measured by the NAHB, is noteworthy (see chart 7).

As for demand, it remains constrained, as evidenced by the Conference Board survey on household sentiment. The report has recently pointed to deteriorated expectations regarding the economic outlook, a low level of home-buying plans, and poor anchorage of inflation and interest-rate expectations. While receding interest rates could bolster demand, a significant decrease in Treasury yields in the short run is unlikely, notably because of the interplay between supply and demand. In this respect, the increase in the US budget deficit (the Congressional Budget Office anticipates an average GDP of 5.9% between 2024 and 2034, excluding legislative changes) points to an increase in bonds issuance, while the Fed's quantitative tightening is associated with a lower absorption by the central bank.

HOMEBUILDER SENTIMENT DOESN'T SUGGEST A STRONG RECOVERY

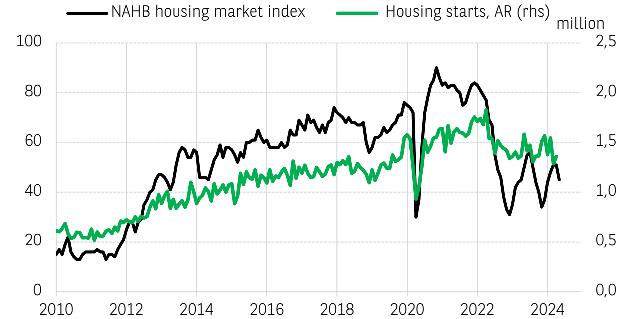

CHART 7

SOURCE: MACROBOND, BNP PARIBAS

We expect the monetary stance to remain restrictive in the short run, with the upper end of the Fed's target range standing at 4.25% at the end of 2025, and the 10-Year Treasury yield (currently around 4.45%) not falling below 4.20%. The fall in mortgage rates will therefore be constrained, although a form of habituation and a reduction in the 30Y FRM - 10Y Treasury spread could have a positive downward influence. Furthermore, the Consensus forecasts point to a very gradual recovery in indicators, with existing home sales reaching 4.2 million (+0.1 million y/y) in 2024 and 4.5 million in 2025, while building permits and housing starts are expected to come in at around 1.5 million.

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	10/23	11/23	12/23	01/24	02/24	03/24	04/24
GDP - RESIDENTIAL INVESTMENT (q/q, %, AR)		0,7			3,3		#N/A
HOUSING STARTS (y/y, %)	-5,2	6,3	17,0	1,1	10,1	-4,1	-0,6
PERMITS (y/y, %)	-1,7	7,6	9,3	4,5	-3,5	-0,5	-2,0
NEW HOME SALES (y/y, %)	16,6	2,5	3,5	3,9	1,0	3,3	-7,7
EXISTING HOME SALES (y/y, %)	-14,3	-6,7	-5,8	-1,7	-3,3	-3,0	-1,9
NAR - MONTHS SUPPLY	3,6	3,5	3,1	3,0	2,9	3,2	3,5
NAHB - HOMEBUILDER SENTIMENT	40,0	34,0	37,0	44,0	48,0	51,0	51,0
FANNIE MAE - HOME PURCHASE SENTIMENT INDEX	64,9	64,3	67,2	70,7	72,8	71,9	71,9
S&P/CASE-SHILLER HOME PRICE INDEX (y/y, %)	4,7	5,1	5,6	6,0	6,4	-	-
NAR - AFFORDABILITY INDEX	91,4	94,2	102,2	105,7	103,2	101,1	-
FREDDIE MAC - 30-YEAR FIXED RATE MORTGAGE (%)	7,6	7,4	6,8	6,6	6,8	6,8	7,0

KEY REAL ESTATE MARKET INDICATORS HEATMAP

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