Is the Housing Recovery Stalling?

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- The housing market, which suffered from a 6-year bear market, has rebounded over the past year.
- However, with an increase in interest rates that occurred during mid-2013, the pace of the housing recovery may slow.

Last year the residential housing market began to recover after a six-year decline. Home prices had fallen 35% on a national basis by the spring of 2012 from their peak level in mid-2006. In 2012, residential home prices began to recover due to support from (1) low prices; (2) low interest rates; and (3) an improving employment market.

Though the job market has continued on its path of gradual improvement, which is supportive of a housing recovery, both home prices and mortgage interest rates have increased meaningfully during the past year, reducing the affordability of housing purchases and threatening the housing recovery. Over the past twelve months, home prices have increased 12.4% on a national basis (6.3% in the Boston area), according to S&P/Case-Shiller. However, the jump in interest rates has had an even more negative impact on affordability.

What does all of this mean for the nascent housing recovery?

Historical Perspective

Back in the fall of 2005, I wrote an article raising the prospect of a housing bubble. As I stated back then, “home prices generally increase in line with personal income, since income determines how much a homeowner may spend on housing.” However, in the several years leading up to the price peak in 2006, home prices had increased more than twice as fast as income levels. Until the housing bubble burst in 2006, the median sales price of existing homes had never suffered from an annual decline on a national basis (based on data from the National Association of Realtors).

Consequently, most real estate prognosticators believed back in 2006 that the housing market was unlikely to suffer from a price decline on a national basis, let alone a six-year bear market.

Current Situation

Since last year’s trough, the residential housing cycle has experienced a meaningful rebound based on price and sales trends. This past spring’s selling season witnessed bidding wars on properties in many areas of the country. Inventory levels were declining and considered tight in some communities, spurring further price appreciation and supportive of a seller’s market.

However, as referenced above, the increase in prices and interest rates has hurt the affordability of home purchases. As interest rates rise, the affordability of homes declines due to the resulting higher mortgage payment. The interest rate spike this past spring caused many prospective buyers to become more active and accelerated their home purchases in an effort to lock in their mortgage rates. Marginal purchasers may no longer have the means of purchasing the home that they could afford just a few months ago.

Future Prospects

Most expect interest rates on which 15- and 30-year mortgages are based to continue their upward trend as the Federal Reserve begins to “taper” and ultimately end its program of U.S. Treasury and mortgage-backed security purchases. However, the pace of interest rate increases is likely to moderate from the explosive pace of this past spring. Even so, further rate increases will reduce the pool of eligible purchasers unless bank underwriting standards are loosened, which was a primary factor leading to the bursting of the prior housing bubble.

As the marginal buyer is priced out of the market, inventory levels should stabilize or increase and price appreciation should moderate. Such conditions will ultimately lead to home price appreciation that is more consistent with income growth and a more balanced supply and demand outlook. For its part, the National Association of Realtors expects the median existing home price to advance nearly eleven percent in 2013 on a national basis, before decelerating to five to six percent growth in 2014.