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Housing's renaissance could lead an economic recovery

By Mark Zandi, January 4th, 2013

A housing renaissance has begun. This may be hard to believe after the dizzying, six-year-long crash in home sales, construction and house prices. But housing turned the corner last year, and it will take off in 2013.

Driving this optimism is one certainty: Owning a home has never been as attractive. Potential home buyers have a two-step decision process. First, they determine whether they can afford to make a purchase — does their income safely cover their mortgage payment? Then they determine whether owning is a better financial choice than renting — are the costs of owning a home lower than the cost of renting it?

Housing has never been as affordable. House prices were slashed by more than one-third during the housing bust, and mortgage rates have plunged to record lows. The Federal Reserve is focused on keeping mortgage rates exceptionally low in its quest to jump-start housing and the broader economy. The rent-buy decision is also a slam dunk in much of the country. Rents are rising strongly almost everywhere, making owning a home financially compelling, even after accounting for the cost of maintaining and operating a home.

Buying a home wouldn't make much sense if house prices were likely to decline further; no one wants to catch a falling knife. But it seems increasingly likely that prices will rise. No one should expect the value of their house to appreciate quickly — counting on your home to be a significant part of your retirement saving isn't a winning strategy — but it is reasonable to expect that prices generally will rise with at least the rate of inflation for some time to come.

Getting a mortgage loan isn't easy, but it is getting easier. Lenders are increasingly convinced that the housing recovery is for real and that borrowers will pay them back. Lenders have been worried about lawsuits and other regulatory actions prompted by their poor lending decisions during the housing bubble, but these legacy issues are slowly being settled. Lenders still want borrowers to come up with bigger down payments and higher credit scores than government lenders Fannie Mae, Freddie Mac and the Federal Housing Administration require, but they aren't being nearly as tough on borrowers as they were. The mortgage credit spigot is slowly opening.

Housing is also set to get a big boost from a lot more households. When a household is formed, it, by definition, must live somewhere. Not many households got started during the Great Recession, as 20-somethings couldn't crack the tough job market and had a hard time striking out on their own. They stayed in school or with their parents. Immigration also tailed off as the bad job market forced some immigrants to go home and dissuaded others from coming here.

More households forming

While the job market still isn't great, it is much improved, and this is evident in increasing household formations. More people in their 20s are getting jobs and have quickly struck out on their own; staying with Mom and Dad can be wearisome for everyone involved. Since their first place away from home is traditionally an apartment, demand for apartments has soared, and thus the jump in rents. Immigration will be slower to revive, but it, too, will eventually pick up as the job market improves.

This powerful demographic force will propel the housing market. Adding up household formations, replacements for the homes blown down by hurricanes and tornados and weakened by old age, and second and vacation homes, builders should in a normal year put up 1.75 million new homes. Current home-building is running closer to 800,000 units. Some homes built during the housing boom still are vacant and must be sold before housing construction significantly ramps up, but that should happen by the summer.

There is a reasonable concern that the more than 3 million homes still stuck near or in the foreclosure process could further undermine housing prices. In more normal times, fewer than 1 million homes are in this predicament. Homes sold out of foreclosure or in short sales are often sold at big discounts that weigh on all house prices. But this threat is quickly fading given the seemingly voracious demand for such homes from investors looking to fix them up and rent them.

Government programs designed to prevent troubled homes from making their way through the foreclosure process to a distress sale are also working better. House prices will remain soft for longer in parts of the country where there is still a lot of foreclosed property to resolve — this is clearest in the region extending from New York City to Maryland — but in most of the country, this won't be much of a problem a year from now.

Washington's uneven boom

The broad Washington housing market is one of significant contrasts. Neighborhoods in the District and in Virginia were among the nation's first to turn the corner and are already experiencing bidding wars. Inventories of homes for sale are tight as potential sellers wait to put their homes on the market, holding on so to at least cover their mortgage and any transaction costs. Home prices will thus rise strongly in 2013 and there will be more apartment and single-family-home construction as developers recognize an opportunity.

Prince George's County won't have nearly as good a year. There remains a significant amount of distressed property to resolve as the foreclosure process has gotten bogged down in the state's courts. Mortgage companies have been especially concerned about pursuing foreclosures in so-called judicial states for fear of running afoul of a variety of legal and regulatory proceedings. These issues are getting resolved, and there will be more foreclosure and short sales in coming months, weighing on house prices. It will be the middle of the decade before things really get going again in this part of the region.

A housing revival is key to any optimism about the broader economy and jobs. In every recovery since World War II, a strengthening housing market has powered economic growth. This was not so during the current recovery, because housing was ground zero for the economy's problems. If housing had simply performed as it has on average, unemployment would have been almost 2 percentage points lower by now. The economy would have been disappointing, but not nearly as dysfunctional as it has been.

Now that housing is finally getting its bearings, it will turn from an economic headwind into a tailwind and become a significant source of jobs. There will be more construction jobs, construction-related manufacturing jobs, transportation and distribution jobs, retailing jobs, financial services jobs and a range of service jobs from cable hookups to landscaping. A better housing market is the principal missing link to a better job market.

Risks to the recovery

So what could derail this upbeat outlook for housing and the economy? Most obviously, lawmakers could botch their negotiations over how to address the nation's fiscal challenges. The fiscal cliff is no longer a lethal threat. But unless policymakers reasonably address the Treasury's debt ceiling, already fragile confidence will evaporate, and businesses and households will run for the proverbial bunkers. The economy will slide back into recession, taking the nascent housing recovery with it.

The housing outlook also critically depends on whether lawmakers can agree to a credible longer-term deficit reduction plan — government spending cuts and tax revenue increases — that puts the nation on a sustainable fiscal path. Failure would signal that lawmakers won't get it together until they are forced to by a serious financial crisis, characterized by surging interest rates. The cloud of uncertainty, meanwhile, would weigh on the collective psyche, resulting in much slower growth. No part of the economy would be hurt more by such a scenario than housing.

The politically influential housing industry — real estate brokers, home builders, banks and other mortgage lenders — has much to say regarding what lawmakers do. Arguably, no industry received a bigger government bailout during the Great Recession and receives more in ongoing taxpayer largesse. Without federal government support, 30-year fixed-rate mortgage loans would be rare, mortgage rates would be much higher and first-time home buyers would have a much tougher time getting a loan.

Homeowners also benefit from large tax breaks, including favorable capital gains treatment and, of course, the mortgage-interest deduction, which costs taxpayers more than $100 billion a year.

The housing industry is in a unique position to lead the way in the current debate over our fiscal future. Tax reform has to be part of that future, and scaling back the mortgage-interest deduction must be part of that reform.

Housing leaders should signal that they are on board with this. This would give political cover to lawmakers struggling to find common ground and may even prompt other political interests to compromise on tax breaks important to them. No industry will be hurt more than housing if the logjam in Washington isn’t broken, and no industry would benefit more if it is.

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