

ECONOMIC VIEWPOINT

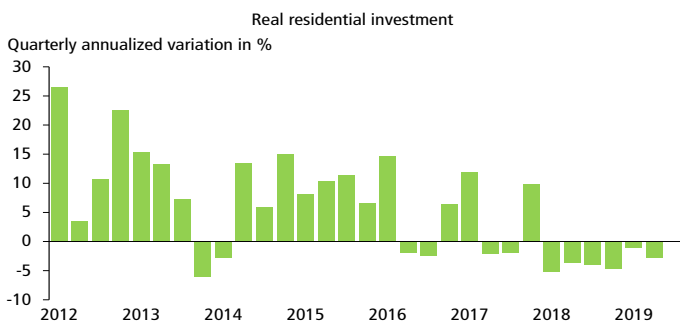
The Drop in Interest Rates Is Beginning to Stimulate the U.S. Housing Market

The U.S. housing market went through a rough patch in 2018 as the hike in interest rates caused residential construction and resales to decline. Since mortgage rates fell, some indicators have noticeably improved. With several risks clouding the U.S. economic situation, is it possible to feel confident about the U.S. housing market? As long as rates stay low, some optimism is possible, but this market is still fragile and its contribution to real GDP will remain modest.

A Fragile Sector

Last year was a banner year for the U.S. economy, with real GDP up 2.9%. However, the housing sector failed to contribute to this strong performance. Real residential investment declined 1.5% in 2018, recording four negative quarters in a row. Residential investment also fell in the first and second quarter of 2019, adding up to six negative quarters in a row (graph 1).

GRAPH 1
Residential investment is in trouble



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

In 2018, new builds also fell. Residential housing starts went from a high of 1,335,000 units in January 2018 to a low of 1,142,000 in December, a 14.5% slump in less than a year. The climb back up from this low has been halting, with a mere 4.2% recorded between December 2018 and July 2019. Total sales of existing homes (single-family and condos) and new single-family homes declined from 6,355,000 in November 2017 to 5,564,000 in

December 2018, a 12.4% drop. As far as these go, the increase recorded since then is slightly better at 8.8%.

Several factors hurt the housing market last year, but the main culprit is most likely the rise in mortgage rates. These, especially 30-year and 15-year maturities, generally follow changes in federal bond yields. Several factors combined in 2018, contributing to the rise in bond yields and mortgage rates. As a result, the 30-year mortgage rate rose from a low of 3.41% in July 2016 to a high of 4.94% in November 2018. The rate for 15-year mortgages jumped from 3.60% to 5.17% over the same period. Short-term rates also rose. The 5-year mortgage rate, adjusted annually, surged from 2.68% to 4.14%.

Rising interest rates in 2017 led to an average monthly mortgage payment of just over the US\$1,000 mark for the first time since 2008. Still, in relation to disposable income, financial obligations associated with a mortgage remained fairly modest at 4.3% at the end of winter 2019 compared with 7.2% in 2007.

The Positive Impact of Lower Mortgage Rates

One of the financial events of 2018 was the reversal in the trend of bond yields and mortgage rates at the end of the year. Sustained, in part, by the drop in the stock market that began in the fall—a decline provoked by renewed risks associated with the trade war—the outlook for the U.S. economy changed. Expectations concerning the Federal Reserve's (Fed) monetary policy also did a U-turn when it looked like it would not automatically tighten monetary policy. Communication from the main Fed leaders and, especially, the pause on key rates in the winter of 2019 and the decrease in July, completely changed

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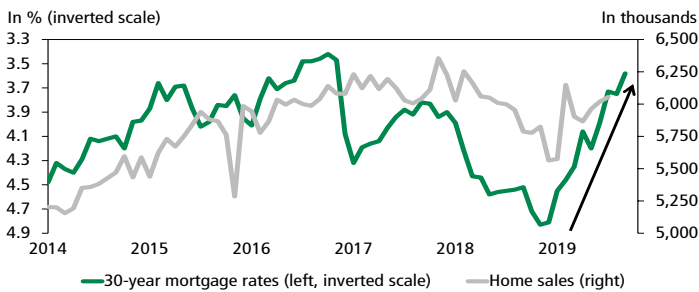
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things for the bond market. Thirty-year rates went from a high of 3.45% at the beginning of November 2018 to a historical low of 1.95% at the end of August 2019. The 150-point tumble in 30-year rates obviously had parallel consequences on the U.S. mortgage market. Fixed, 30-year mortgage rates went from a high of 4.94% to only 3.55%, the lowest rate since 2016.

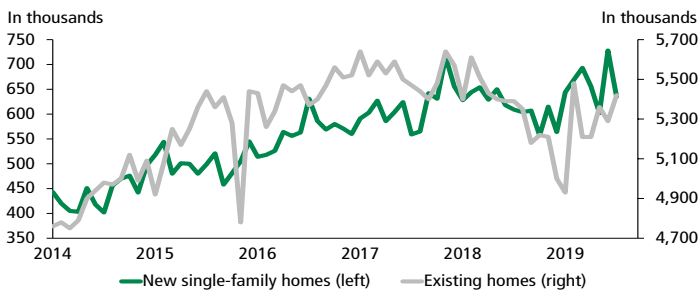
Lower mortgage rates ended up stimulating the residential real estate market, as shown by the rise in home sales since the end of 2018 (graph 2). However, the increase was much bigger in terms of new single-family home sales, which climbed to just over 30%, while existing home sales only rose 10% (graph 3).

GRAPH 2
Rate cuts help the housing market



Sources: National Association of Realtors, U.S. Census Bureau and Desjardins, Economic Studies

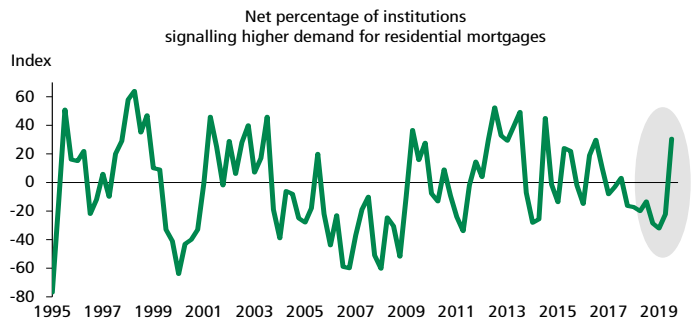
GRAPH 3
Home sales have taken off, in part, following mortgage rate cuts



Sources: National Association of Realtors, U.S. Census Bureau and Desjardins, Economic Studies

The drop in mortgage rates also reignited demand for mortgages. According to the financial institutions surveyed by the Fed, demand was consistently down from the summer of 2016 to the spring of 2019. But the trend reversed in the summer. The survey now shows a net increase in demand for loans (graph 4). This jump could continue to encourage home sales for the coming months and quarters. Still, the same financial institutions signal that they are continuing to moderately tighten credit conditions for new mortgages.

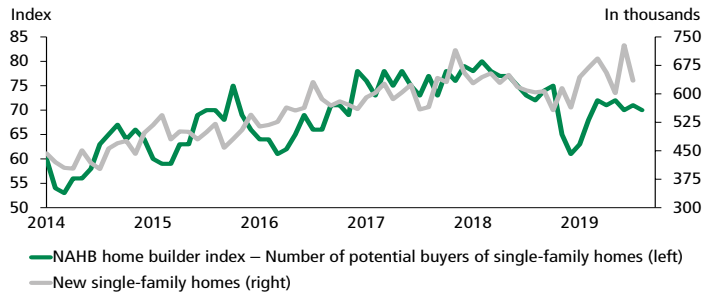
GRAPH 4
Mortgage rate cuts recently caused loan applications to jump



Sources: Federal Reserve Board and Desjardins, Economic Studies

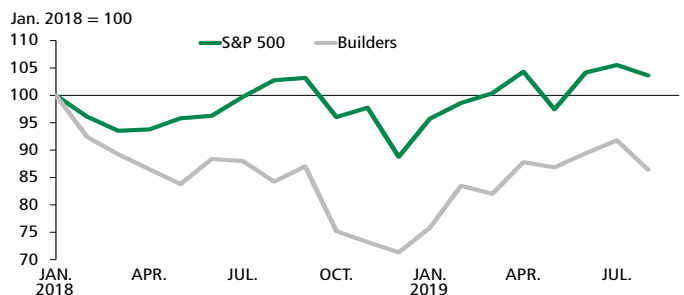
Home builders have also noticed an improvement. The NAHB home builder confidence index erased a large part of the drop it saw at the end of 2018 (graph 5). In a stock market turnaround compared with 2018, builders have performed better until now in 2019 than the S&P 500 index (graph 6).

GRAPH 5
Builder confidence is up, but below early 2018 levels



Sources: National Association of Realtors, U.S. Census Bureau and Desjardins, Economic Studies

GRAPH 6
Builder performance on the stock market was better this year, but it failed to make up for the delay in 2018



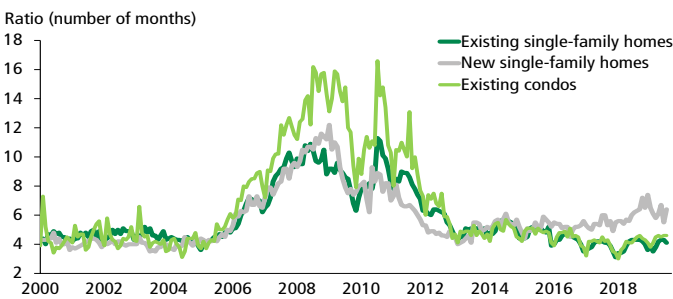
Sources: Datastream and Desjardins, Economic Studies

An Improvement That Is Slow to Support Construction

The increase in sales is already helping to ease an imbalance that was beginning to form in the residential market. In recent years, the number of unsold, new single-family homes rose. Normally, the inventory-to-sales ratio for single-family homes is fairly close to that of existing homes. However, this ratio has been inching up since 2016 (graph 7), suggesting that supply is seriously outpacing demand—a worrying trend that could, at the very least, signal a repeat of the start of the 2008 crisis. Fortunately, the inventory-to-sales ratio has started to come down, reflecting both the recent hike in sales and the somewhat stagnating construction sector.

One of the reasons for the imbalance in the new home sector is the cost difference between a new home and an existing home. This phenomenon is a consequence of the real estate bubble that burst at the end of the 2000s. Still, the feeling in recent quarters has been that this spread is narrowing bit by bit as new home prices stabilize due to excess supply (graph 9). According to the Conference Board consumer confidence index, new home buying intentions also improved somewhat in recent months (graph 10).

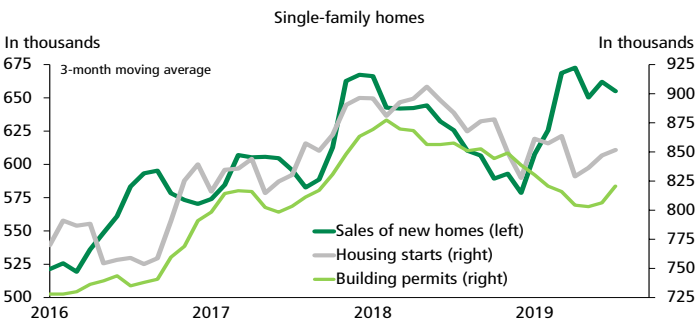
GRAPH 7
New home inventories rose



Sources: National Association of Realtors, U.S. Census Bureau and Desjardins, Economic Studies

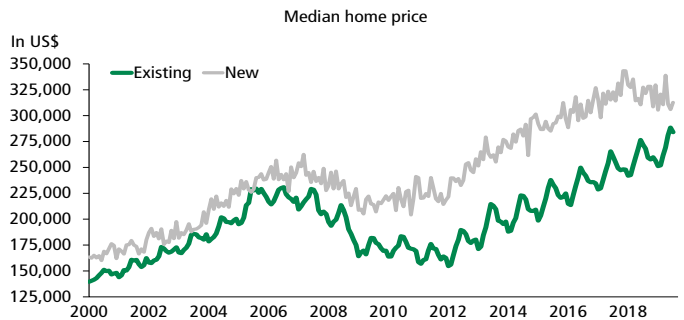
While sales of new single-family homes have risen significantly since mortgage rates came down, the number of newly constructed single-family homes and building permits issued have remained more stable (graph 8). In addition, there doesn't appear to be an acceleration in multi-unit housing construction.

GRAPH 8
New builds did not follow the recent surge in sales



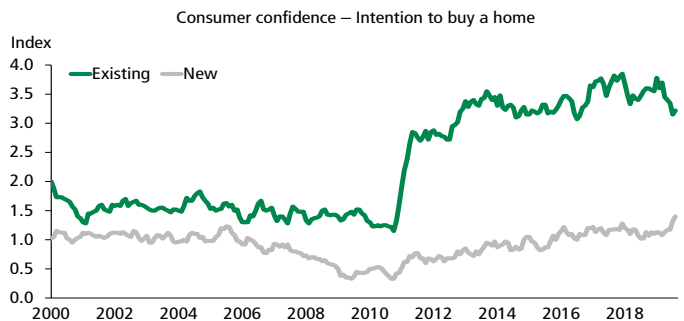
Sources: U.S. Census Bureau and Desjardins, Economic Studies

GRAPH 9
The cost of a new home seems to be a problem, but the spread with existing homes is narrowing



Sources: National Association of Realtors, U.S. Census Bureau and Desjardins, Economic Studies

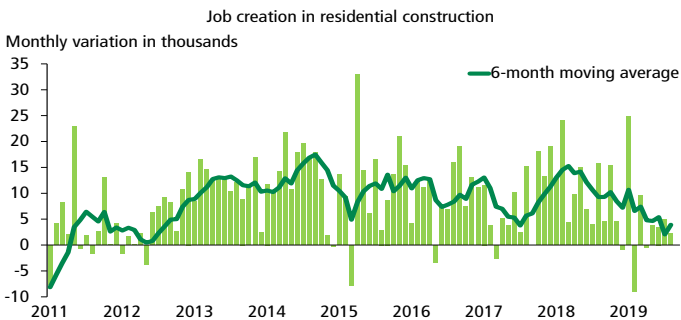
GRAPH 10
Buying intentions for existing homes remain high and those for new homes are rising



Sources: Conference Board and Desjardins, Economic Studies

The construction slowdown has had an impact on the job market. The pace of jobs creation directly relating to new residential buildings (construction and specialized entrepreneurs) has clearly fallen since the beginning of 2018 (graph 11 on page 4). Still, it appears that supply may have also tightened, leading to a shortage in some areas.

GRAPH 11
Job creation in residential construction has slowed



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Other Limitations

Aside from the housing market's situation brought on, in large part, by interest rate changes, other factors are influencing the residential sector.

Urban planning rules and **regulatory restrictions** are limiting housing construction and preventing adequate supply. This is especially the case in areas where demand is high for economic and demographic reasons. The example most often cited is the San Francisco area, where the boom in new information technology has increased demand for workers and housing, but where the restrictions on construction are significant. According to an [article](#) in Bloomberg, 373,000 new jobs were created in San Francisco over five years, but only 58,000 residential building permits were issued during that same period. This phenomenon can be seen to a lesser degree in other major cities, especially in the western and northwestern United States.

The tight supply, especially in the big cities, is clashing with what **new buyers prefer**. More than previous generations in the same age, who opted mostly for the suburbs, millennials seem to prefer to live in city centres, creating an imbalance between supply and demand.

Over the long term, **demographic shifts** may explain in large part the changes in demand for homes. As in most advanced countries, population growth is slowing in the United States. The growth in the age range of first-time buyers, i.e., 25-40 year olds, seems to have peaked in the mid-2010s and should be lower from now on according to U.S. Census Bureau forecasts.

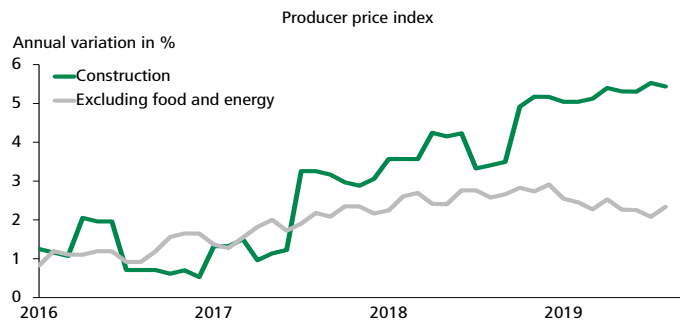
Fiscal policy is also a factor that can influence the real estate market. The tax reform rolled out at the end of 2017 by the Trump administration changed the game in many ways. Since personal income tax was first implemented in the early 20th century, the interest paid on mortgages has been deductible. However, the 2017 reform tightened up some of the criteria. To be deductible, the balance of the loan must be less than

US\$750,000, rather than US\$1,000,000. In addition, interest on a loan for a second home is no longer deductible (except if the loan is to be used to renovate). Less direct but just as important, the local tax deduction (state and municipal taxes, property taxes and sales taxes) was capped at US\$10,000. These measures were perceived as potentially harmful for areas where home prices were already high or those with high local tax rates. Still, the national effect of these measures seemed modest until now.¹

Credit constraints can also affect demand for homes. Historically-low interest rates have made homes more affordable, but past price increases are making residential investments relatively costly, especially for first-time buyers. Additionally, young households are often saddled with significant student debt; the cost of a college or university education has climbed considerably over the last few decades. According to the New York Fed, 10% of student loans are seriously delinquent.

The trade war may also have an impact through the cost of materials. The U.S. **tariff hike** on Canadian softwood lumber and on steel and aluminum imports and on almost all goods from China seems to have led to upward pressure on building materials (graph 12). According to the producer price index, inflation is now twice as high in the construction sector than it is for the entire economy.

GRAPH 12
The cost of construction-related goods has risen since the start of the trade war



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

The Trump administration's more restrictive policy regarding **immigration** and visitors is also leaving the real estate market hamstrung. It is one of the factors that has led to a drop in foreigners buying homes. Sales to foreigners plummeted from US\$121B between April 2017 and March 2018 to US\$78B between April 2018 and March 2019, a 36% drop. The decline is mostly seen among Chinese buyers. As for supply, the restrictions concerning immigration seem to be causing problems for builders

¹ Jim TANKERSLEY and Ben CASSELMAN, [As Mortgage-Interest Deduction Vanishes, Housing Market Offers a Shrug](#), *The New York Times*, Economy, August 4, 2019. (Consulted September 10, 2019).

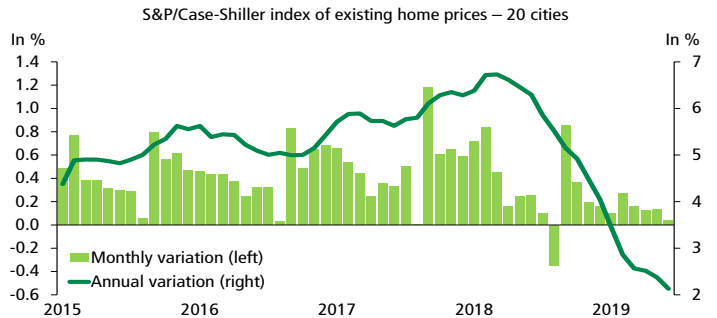
who are struggling to find workers in some areas. Moreover, immigrants are more likely to work in construction (and services) than workers born in the United States. In 2016, immigrants represented nearly 25% of construction workers.² In some states, the appeal to foreign-born workers is even more pronounced: more than 40% in California and Texas, and 37% in New York and Nevada. The restrictions on immigration seem to have already had an impact: in the Dallas area, the labour bottleneck could add roughly US\$6,000 to the cost of each house and delay delivery by two months.³

House Prices Are Slowing Down

As mentioned, new single-family home prices are slowing down, helping to balance the spread with existing home prices somewhat despite the constraints in the construction sector. Yet, we also see a slowdown in prices for existing homes.

It should be pointed out that the rise in prices since the real estate market hit a low in 2012 is far from negligible. For example, after falling 33.9% from its high in 2006, the S&P/Case-Shiller index for the 20 major cities climbed 58.1% from the low until June 2019 (graph 13). Beginning in January 2018, the index surpassed its 2006 peak. It's important to remember that, when adjusted for inflation, the S&P/Case-Shiller index remains 18% below its previous peak.

GRAPH 14
Latest monthly variations in existing home prices are lower, and the annual variation is slowing



Sources: Standard & Poor's and Desjardins, Economic Studies

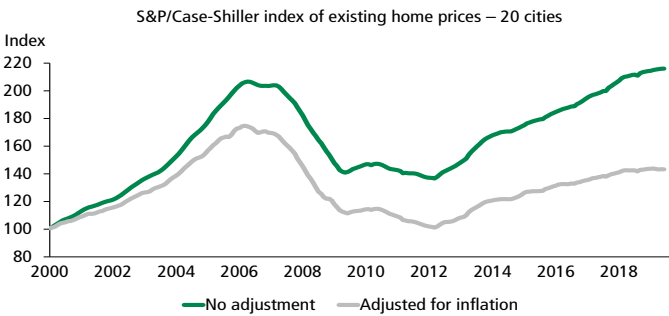
slowdown (graph 14). Most of the index's 20 cities are posting marked slowdowns (see appendix on page 7).

The deceleration can be explained by several of the factors restricting demand mentioned above and perhaps by a more sluggish U.S. economy. Still, it seems to relate more to past interest rate hikes. In this case, it's easy to believe that the downtrend will soon stop and that prices will now adjust to the mortgage rate cuts that began almost a year ago. If sales are stimulated by lower rates, as we are starting to see, then prices should follow suit.

If the Economy Is Strong, Will Housing Grow?

A popular saying equates a booming construction industry with a booming economy. Yet we've seen that, in the United States, this was not the case in 2018 and early 2019. And now that several housing indicators appear to have improved, especially sales and credit applications, the feeling is that other areas of the economy are worse off. This is the case with the sectors most affected by the trade war. Nevertheless, the economy should continue to grow—albeit at a slower pace—giving the real estate market a chance to maintain its recent improvement. Still, one essential condition can't change: mortgage interest rates must stay low. Our forecasts are based on rates remaining low (graph 15). This

GRAPH 13
Existing home prices in current dollars returned to their pre-crisis peak



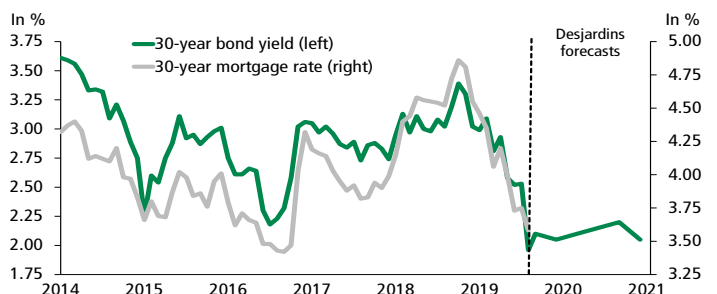
Sources: Standard & Poor's, Bureau of Labor Statistics and Desjardins, Economic Studies

The S&P/Case-Shiller index's nominal growth (with no adjustment for inflation) posted an average 12-month variation of 6.0% between 2014 and 2018. This variation fell to only 2.2% since the beginning of 2019, indicating a fairly major, even worrisome,

² Natalia SINIAVSKAIA, *Immigrant Workers in the Construction Labor Force*, National Association of Home Builders, *NAHB Economics – Special Studies*, January 2, 2018, 13 p.

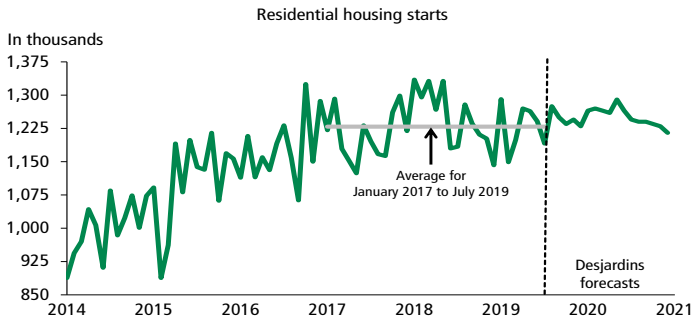
³ Eduardo PORTER, *Short of Workers, U.S. Builders and Farmers Crave More Immigrants*, *The New York Times*, Economy, April 3, 2019. (Consulted September 10, 2019).

GRAPH 15
Mortgage rates should remain low



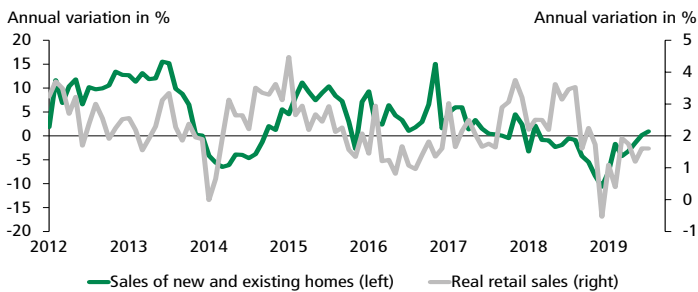
Sources: Datastream and Desjardins, Economic Studies

GRAPH 16
Building starts should slightly surpass their recent trend



Sources: U.S. Census Bureau and Desjardins, Economic Studies

GRAPH 17
The housing recovery is a positive factor for retail sales



Sources: National Association of Realtors, U.S. Census Bureau and Desjardins, Economic Studies

should help maintain a certain level of new builds (graph 16). After several quarters of negative support, residential investment should, from now on, contribute positively to real GDP growth. Additionally, the residential real estate market's more solid performance will have positive consequences for consumption by supporting certain types of retail sales (graph 17). That being said, the primary risks threatening the U.S. and global economies must not materialize in the coming months either. A deterioration of the economic situation that would lead to a reversal in the job market and a drop in confidence and of financial markets would cut short the improvement in the housing market.

Francis Généreux, Senior Economist

Appendix

TABLE
S&P/Case-Shiller index per city

	VARIATION IN %			12-MONTH VARIATION IN %	
	From the 2000s peak to the 2010s low	From the 2010s low to June 2019	From the 2000s peak to June 2019	Average between 2014 and 2018	June 2019
Atlanta	-37.4	78.4	11.6	6.4	4.6
Boston	-17.7	49.3	22.9	5.5	3.9
Charlotte	-17.8	48.6	22.1	5.2	4.6
Chicago	-37.5	35.1	-15.6	3.5	1.6
Cleveland	-21.4	28.9	1.3	3.2	3.5
Dallas	-9.5	67.6	51.7	7.7	2.7
Denver	-11.6	79.7	58.8	8.5	3.4
Dérouit	-47.7	90.3	-0.5	6.8	4.2
Las Vegas	-61.6	112.6	-18.4	9.3	5.5
Los Angeles	-41.5	78.6	4.5	6.9	1.6
Miami	-51.0	76.6	-13.4	7.3	2.8
Minneapolis	-36.6	60.5	1.8	5.2	3.8
New York	-25.9	24.7	-7.6	3.5	1.2
Phoenix	-56.4	93.5	-15.7	5.8	5.8
Portland, OR	-29.0	79.9	27.7	8.6	2.4
San Diego	-42.2	78.6	3.1	7.0	1.3
San Francisco	-45.3	122.8	21.8	9.5	0.8
Seattle	-30.5	88.0	30.7	10.1	-1.4
Tampa	-47.6	74.9	-8.4	7.3	4.7
Washington, DC	-32.9	36.9	-8.2	2.7	2.9
Index for 10 cities	-34.2	53.5	1.0	5.6	1.9
Index for 20 cities	-33.9	58.1	4.5	6.0	2.2
National index	-26.0	53.1	13.2	5.9	3.2

Sources: Standard & Poor's and Desjardins, Economic Studies