

Why Credit Unions Shouldn't Panic Over a 2019 Housing Slowdown

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Both home sales and price growth have slowed—and are likely to slow further—in the year ahead. Let's explore why, what's next and how CUs can respond.

You may have seen some recent media reports stoking fears of an impending housing meltdown by focusing on the quick onset of a slowdown in certain cities, such as Dallas, Texas and Seattle, Washington. But a broader and more nuanced reading of the housing market data suggest that in most metros we are just moving from an overheated environment to one that is more balanced.

It's as if the housing market is having its first head cold in many years—unpleasant, but hardly fatal.

In this article, we'll focus on why the fundamentals suggest widespread home price declines are unlikely, highlight the areas where affordability has deteriorated the fastest and discuss where mortgage interest rates and home prices are projected to go in 2019.

We'll also discuss the implications for CUs, including the impact a continued modest slowing would have on mortgage origination volume and increased demand for ARMs

and second liens.

HOUSING AFFORDABILITY

We start with a look at home sales and the months' supply of existing homes for sale compared to their own histories (Figure 1). Since spring, there has been a marked slowdown in sales, while the months' supply remains relatively tight.

The root cause of the recent decline in home sales is a lack of affordable homes for sale. The double whammy of higher home prices and the nearly 1% rise in mortgage rates over the past year has increased the size of the pay-

FIGURE 1: Home Sales Are Slowing, but Supply Remains on the Low Side

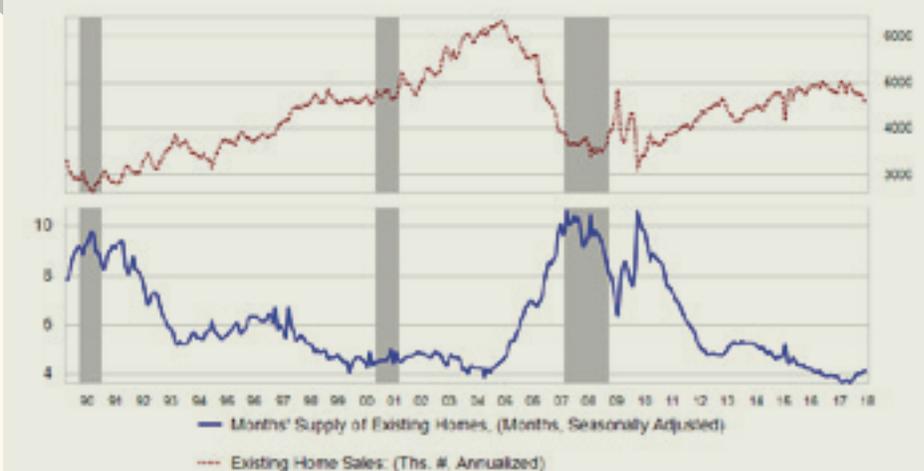


FIGURE 2: Percentage Increase in Size of Payments Needed to Buy a Home Over the Past Year



Source: Arch MI calculations using U.S. Census Bureau/Freddie Mac/NAR/Moody's Analytics data, assuming a 10 percent down payment.

ment needed to buy a median-priced home anywhere from 7% to 25% over the course of 2018 (Figure 2).

Higher rates, in particular, have caused some potential buyers to pause, at least temporarily, in the hopes that mortgage rates, or even home prices, would come down.

Even with this large increase in the cost of buying a home, overall affordability for the U.S. is still a bit better

than its historic average.

One reason that it feels like affordability has declined sharply is because it's easier to compare today's prices to those earlier in this decade, which was by far the most affordable period of time since the data started to be captured in 1975.

Of course, housing affordability varies greatly by location. Affordability is currently very poor in the West, but

for much of the rest of the country, it is better than it was during the 1990s.

To understand affordability locally, we estimate the percent of pre-tax income needed to cover payments on a mortgage (with a 10% downpayment) on a median-priced home (Figure 3). The national average is 32%.

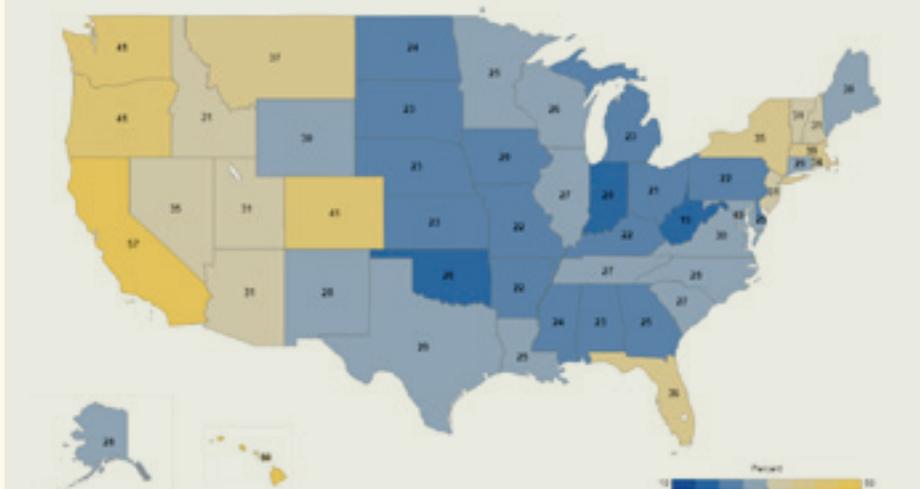
One implication of Figure 3 is that housing markets in much of the West, Northeast and in Florida have poor affordability and perhaps are more at risk of a housing market slowdown than the rest of the country.

STRONG FUNDAMENTALS REDUCE RISK OF HOME PRICE DECLINES

Reasons not to panic—more precisely, reasons why home prices are still likely to increase, albeit at a slower pace—include the following:

- **Job growth** remains robust and total employment is at record highs. The unemployment rate is the lowest ever experienced during peacetime, only 3.7%.
- A large federal “**stimulus package**” helps cushion the economy from shocks (such as higher interest rates and or a slowdown overseas). The economy is likely to remain strong over the next six to 12 months because the federal government has increased spending and passed a tax cut.
- **Household debt** as a percentage of disposable income is close to a 15-year low. In aggregate, the cost of servicing debt is relatively low since the bulk of outstanding debts are fixed-rate mortgages.
- **Loan production quality** remains better than in the early 2000s, even with DTIs and LTVs trending up. (For more information, see the Urban Institute’s Housing Credit Availability Index.)
- Even though the inventory of homes for sale has increased, the months’ **supply of existing homes** is still low, at 4.1 months in October. That is extremely low in a historical context, even if it is up from earlier in 2018.
- The **housing shortage** is not going

FIGURE 3: Percentage Median Income Needed to Buy a Median-Priced Home



Source: Arch MI calculations using U.S. Census Bureau/Freddie Mac/NAR/Moody's Analytics data, assuming a 10 percent down payment.

away anytime soon: New home sales and builders' incentives to break ground on additional housing have been hampered by higher fixed costs, such as local assessment fees, a labor shortage and tariffs.

Our own estimate of the national housing shortfall is in a range between 1.5 million and 2.5 million units, based on vacancy rates and a comparison of the growth in supply and demand over time. For example, new construction is currently around 1.3 million new units a year, while trend demand is somewhere between 1.5 million and 1.7 million new units a year.

Lastly, another way to judge if we are underbuilt is by looking at today's residential fixed investment as a percentage of GDP (Figure 4). It's now at 3.9%, as compared to the historical average of 4.6%.

In Figure 4, notice that construc-

30-year fixed-mortgage rate could average between 5% and 5.25% next year, but volatility is the norm.

Rising rates have historically caused a mild slowdown in transactions, slowed home price growth and resulted in a large reduction in refinances.



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One estimate of the size of the typical impact of higher rates comes from J.P. Morgan researchers, who found that each rate increase of 0.25% trims home sales by roughly 2%. That fits events over the past six months quite well.

Home sales in 2018 are on track to be 3% to 5% lower than the year before and could decline another 3% to 6% in 2019 if economic conditions follow current consensus forecasts.

Home prices are expected to grow at a more measured 2% to 4% nationally next year, supported by a constrained housing supply and, we hope, a job market that remains strong.

Of course, the size of future home-

damentals described in the previous section of the article provide some cushion against downside shocks, but limited and short-lived price declines are possible in some areas as markets rebalance and adapt to the higher interest rates.

States most at risk of having price declines include both those with the highest prices, such as those on the West Coast, and in states with currently weak housing markets, including Alaska, Connecticut, Mississippi, Louisiana and West Virginia. (Arch MI publishes estimated probabilities of home price declines from the Arch MI Risk Index® online at archmi.com/hammr.)



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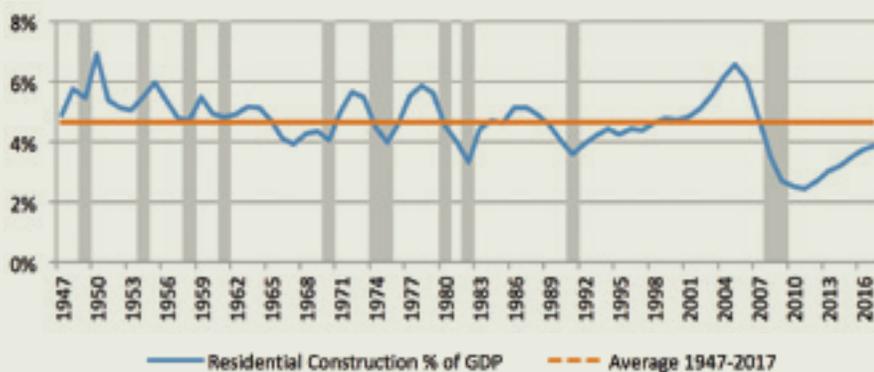


Of course, when discussing forecasts, it is worth remembering that the economy has repeatedly proven very capable of generating both positive and, more commonly, negative surprises.

For example, the already strong economy would benefit in the event that Congress passes a major infrastructure bill, which would further tighten the job market and put more upward pressure on interest rates.

There are also many potential risks that could result in a weaker housing market, including negative feedback loops from tariffs, turmoil in emerging markets or a breakup of the Euro, to name just a few possibilities.

FIGURE 4: Residential Construction Remains Well Below Normal



Recessions are indicated by gray bars.
Sources: U.S. Bureau of Economic Analysis/ARCH MI

tion is still at what would be a low rate compared to past recessions and is well below its 2005 peak of 6.5%.

SO WHAT'S NEXT?

What is the most likely scenario for 2019? Financial markets currently expect further gradual interest rate increases over the next few years. The

price changes depends on the condition of the local housing market. Some areas will have flattish home prices, which would allow incomes to help catch up to recent price increases, but other areas are likely to see home price growth in the 2% to 4% range, more in line with income growth.

The strong underlying housing fun-

WHAT FEWER HOME SALES MEAN FOR CREDIT UNIONS

Housing markets have already downshifted into a lower gear. One silver lining is we are moving to a more sustainable rate of home price growth. This will help limit worsening affordability, thus lessening credit risk when the economy eventually does go into a recession.

Based on the premise that the hous-

ing market will be a little slower, but still OK in the coming year, you may want to consider the following options:

1. Educate potential buyers currently “on the fence” that affordability is forecasted to worsen, as rates may increase further and the housing shortage continues to put upward pressure on home prices.
2. For members in need of cash, help them understand the monthly costs of alternatives to cash-out re-fi's, such as HELOCs or fixed-rate second liens.
3. In addition to offering fixed-rate mortgages, discuss the pros and cons of ARMs and hybrids (which have a lower initial rate, but could easily have higher payments down the road) since these products are becoming a little more popular.
4. If you are in one of the few regions where home prices have hit extremely unaffordable levels, keeping the credit box relatively tight will help lessen your default risk. (You can see Arch's estimates of local home price over-/undervaluation at archmi.com/hammr under the “Click here to view our HPI Maps and Charts” button.)

SUMMARY

Even with higher mortgage rates and some markets (particularly out West) now looking overvalued, solid economic growth, a healthy labor market and a shortage of entry-level homes should result in 2019 being decent, if lackluster, when compared to 2017, the most recent peak home sales year.

The rise in mortgage rates over the past quarter — and likely further increases of a 0.25% to 0.50% over the next year or two — could result in continued cooling, at least temporarily. Nevertheless, sustained home price declines are unlikely in America's major markets unless mortgage rates spike above 6% (very unlikely) or we are hit with a full-blown recession. ▲

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