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Housing Fears Still Lurk in the Shadow

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Housing remains a focus of uncertainty and anxiety. Its collapse largely created the 2008–09 financial crisis and the subsequent recession. Housing concerns formed the basis of last year's "double-dip" recession scare. Many, understandably, fear that further problems in the area could thwart the present economic recovery. Of particular concern now is the still large overhang of vacant, unsold properties and the even larger overhang of properties on which lenders have delayed foreclosure, the so-called "shadow inventory." Though such issues could potentially cause many problems, and the inventory situation will hold back real estate prices and building activity for a long time to come, a second recessionary leg seems unlikely.

The inventory situation, though much improved from a year ago, remains daunting. Vacancy rates on owner-occupied housing stand (as of March 2011, the most recent period for which complete data are available) at 2.6%, down from 2.9% in 2008 and 2.7% in 2009, but still high compared with rates averaging 1.7% in earlier years. Rental vacancies, at 9.7%, are also down from their earlier peak of 10.6% last year, but remain high compared with the 8.5% rate averaged in earlier years. At current sales rates, the national market for homes has some 8.4 months' supply of unsold properties, a vast improvement from the 12.5 months' supply registered in July 2010 and the 10.4 months' supply averaged in 2008, but considerably above the long-term average of 5.0–5.5 months' supply.

On this basis, it is hardly surprising that residential real estate prices remain under downward pressure. According to the popular S&P/Case-Shiller Home Price Index [1] (from 20 major metropolitan areas), the median price of a home has fallen about 8% from a year ago and 31% from the highs of April 2006. Broader-based figures on median home prices compiled by the National Association of Realtors show less dramatic but still considerable price erosion nationally of about 6.0% during the past year and more than 20% from the highs. The median price of condominiums and co-operative apartments has fallen even more, dropping more than 10% during the past year and more than 30% from pre-crisis highs.

Looking forward, there is much that might alleviate these strains. Primary among these is the affordability issue. The drop in housing prices combined with low mortgage rates has brought the cost of maintaining a mortgage on the median-priced home in the United States into the range of more and more households. An index of affordability compiled by the National Association of Realtors shows that housing is 8.1% more affordable today than a year ago and 36% more affordable than in 2008. Longer historical perspectives show that housing is more affordable now than at any time since 1997. Reinforcing any sales gain that might spring from improved affordability is the pace of new household formation. To be sure, economic hard times have slowed the pace to 357,000 new households during the last 12 months, but there is every reason to expect this number to pick up as the economic recovery continues, even at a slow pace, and approach the annual pace of 1.3 million of new households on average between 2003 and 2007.

Clearly, a rise in sales in response to these influences would do much to reduce the inventory overhang and relieve downward price pressures on residential real estate. And recent figures point, at least tentatively, to some sales improvement, of about 5.1 million annually—up a smart 32% from the extreme lows of last summer and about 4.0% above last year's average level. Sales of new homes in March came in some 9.5% above their lows of last summer. At this pace, it will still take a while to reduce the inventory overhang and relieve the negative pressures on residential real estate. No doubt the still uncounted inventory of homes yet to come onto the market will extend the length of this adjustment.

This so-called shadow inventory consists of two elements. One is the homes held off the market by their owners in the hopes that the delay will net them a higher price. The other, larger part of this inventory are the homes on which mortgage lenders have thus far resisted foreclosure in order to avoid glutting the market and depressing prices. Gauging the size of this inventory, especially the first part, involves a large element of guesswork. But with mortgage delinquencies still close to 10% of all mortgages outstanding, and charge-offs close to 2%, the implication is that this shadow inventory may well exceed the measured number of unsold homes, leaving the market with an effective inventory overhang of upward of 24 months' supply of homes at current sales rates.

There is a chance that lenders will lose control of the situation and bring out this shadow inventory too quickly. In such an event, the downward pressure on real estate prices would no doubt intensify. But since these lenders have managed this situation reasonably well now for at least a year and a half, likelihoods suggest that they are more likely to feed this inventory out into the market gradually as it can bear the added volume. Such a managed situation should allow relative price stability, albeit without any real improvement for a considerable time. It looks as though it will take years before there is much room for much price increase or even a need for much construction, at least nationally.

[1]The S&P/Case-Shiller 20-City Home Price Index measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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