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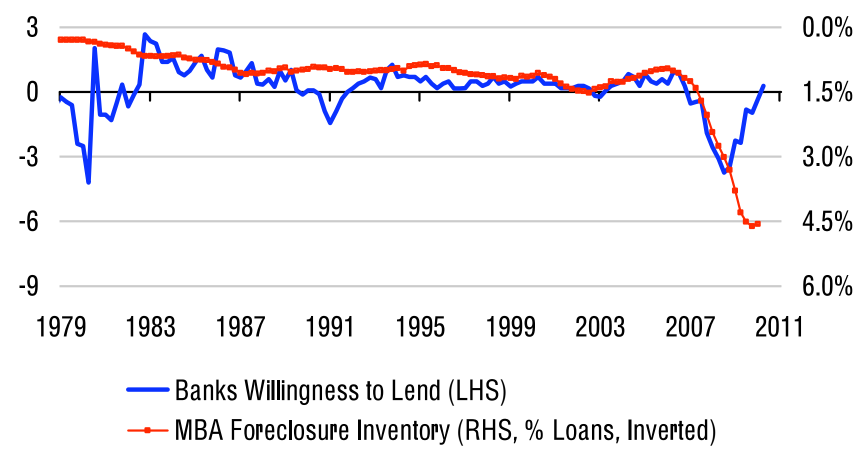
US House Prices

Research Analysts
Adnan Kucukalic
612 8205 4427
adnan.kucukalic@credit-suisse.com
Damien Boey
612 8205 4615
damien.boey@credit-suisse.com
Atul Lele, CFA
61 2 8205 4284
atul.lele@credit-suisse.com
Tamara Cooper
61 2 8205 4591
tamara.cooper@credit-suisse.com

ECONOMICS AND STRATEGY

Don't write off the recovery just yet

Figure 1: **Banks are willing to lend to help clear shadow housing inventory.**



Source: Datastream, Credit Suisse

- **Secondary relapse in US housing is becoming a *Consensus* call**. Most investors suspected that home sales would fall after the April expiry of the first homebuyers' tax credit. And it is well documented that there is a huge pipeline of option-ARM recasts to digest that could keep foreclosure rates high and the market oversupplied, putting downward pressure on prices.
- **But we have a more positive outlook.** Powerful healing dynamics are at work that cannot be ignored. Contrary to popular wisdom – the housing demand-supply balance that we can see in the data is more of an outcome of house price movements than a driver. The "less visible" hand of banks matters a lot more, and recently, banks have been easing lending standards. We think that banks may prove to be very effective market makers.
- **There has been a decoupling of lending standards from foreclosures.** Despite the foreclosure inventory rising to a record high of 4.5% of loans, banks are choosing not to force sales, with the actual foreclosure rate running at only 1.2%. Banks are preventing the inventory from weighing on house prices and destroying capital. Inventory management, together with policy efforts to strengthen bank capital positions are facilitating an easing of lending standards. In turn, this is promoting demand, by allowing households to take advantage of record-high housing affordability.
- **In the absence of adverse policy developments, it is quite plausible that this recovery dynamic will continue**, **supporting re-leveraging.**

US House Prices

The *Consensus* view

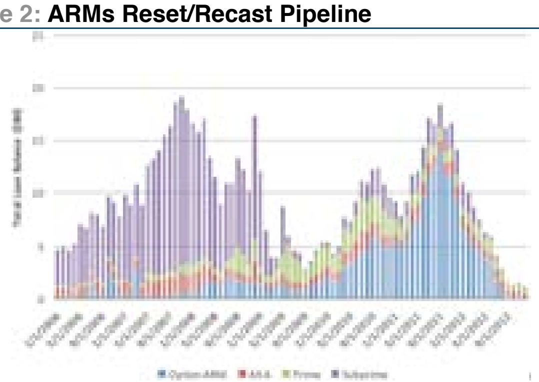
The Consensus view is that US housing will experience a relapse in 2010-11.

There are a lot of reasons to be bearish about the short-term outlook for US housing:

- Home sales could fall sharply after the April expiry of the first homebuyers' tax credit (just like they did after the initial November expiry). Already in May, we have seen new home sales plummet by 33%.
- Foreclosure rates are stubbornly high despite the fact that there has been labour market improvement.
- It is well documented that there is a huge pipeline of option-ARM resets and recasts to digest. Sudden payment shocks from resets and recasts could force many households into foreclosure – in turn keeping the housing market oversupplied at the margin and putting downward pressure on house prices. Over the next year or so, we are likely to see a peak in the (combined) option-ARM, prime and Alt-A mortgage pipeline that is just as large as the peak in the sub-prime pipeline (around US$20bn).

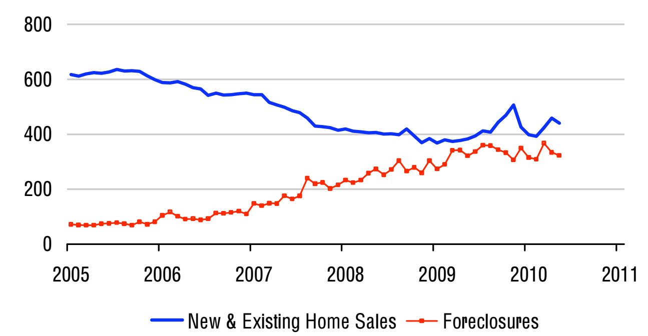
Most commentators expect housing oversupply to continue weighing on prices.

Figure 2: **ARMs Reset/Recast Pipeline**



Source: Loan Performance

Figure 3: **Home Sales & Foreclosures**



Source: Datastream, Credit Suisse

But we have a more positive view on US housing than the *Consensus*.

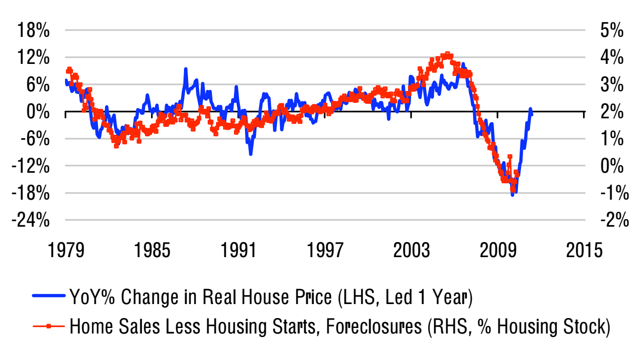
But we believe that a secondary relapse in US housing is becoming a *Consensus* call. In our view, the risks are that house prices surprise to the upside, because there are powerful healing dynamics at work.

Recovery dynamics

Oversupply may not matter as much as first thought.

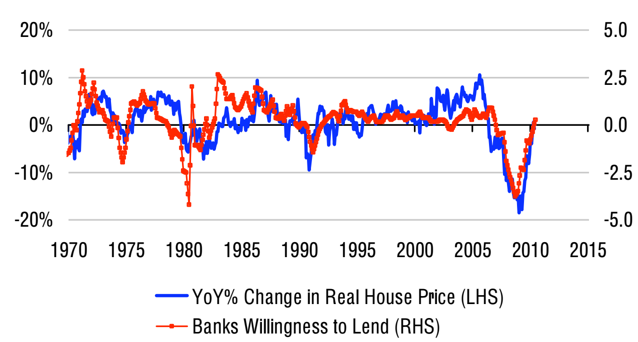
Contrary to popular wisdom – the housing demand-supply balance that we can see in the data is more of an outcome of house price movements than a driver.

Figure 4: **Real house prices & demand-supply balance**



Source: Datastream, Credit Suisse

Figure 5: **Real house prices & bank lending standards**



Source: Datastream, Credit Suisse

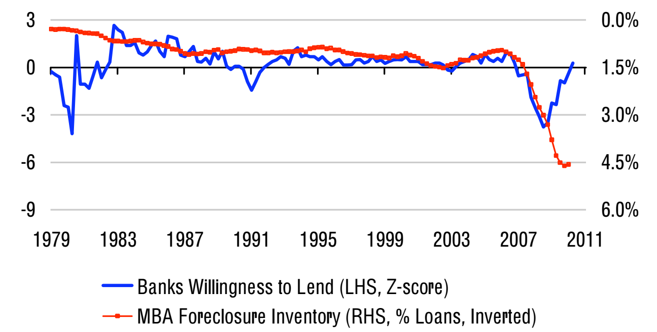
Indeed historically, house price inflation is a one-year leading indicator of where the housing demand-supply balance (measured here as home sales less housing starts less foreclosures) will go. Part of the reason for this relationship working out on the downside is that households choose to foreclose when they have entered negative home equity.

The "less visible" hand of banks seems to be a more important driver of house price movements. As we would expect, there is a strong positive correlation between house price inflation and banks willingness to lend (extracted from the Fed's Senior Loan Officers' Survey). Recently, banks have been easing lending standards, consistent with modest gains in house prices. This is contrary to what we might expect from housing demand-supply analysis which tells us that the housing market is still heavily oversupplied, and that house prices should fall.

Bank lending standards seem to matter a lot more for house prices than the demand-supply balance.

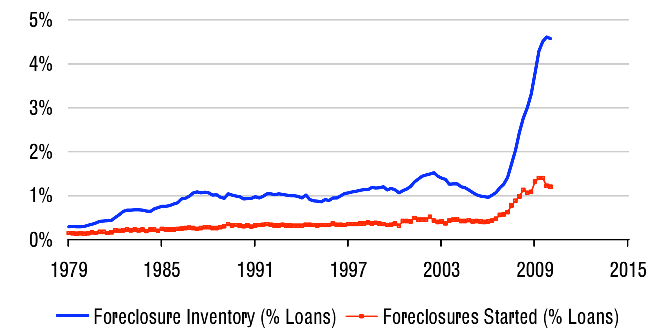
This is not to say of course that foreclosures do not matter – quite clearly, they have mattered in recent years because the rise in foreclosures triggered a sudden tightening of bank lending standards from 2007-2009, causing housing demand and house prices to fall. Interestingly, there has been a decoupling of bank lending standards from foreclosure rates over the past year.

Figure 6: **Bank lending standards & foreclosure inventory**



Source: Datastream, Credit Suisse

Figure 7: **Foreclosure inventory & foreclosures started**



Source: Datastream, Credit Suisse

Bank lending standards have recently decoupled from foreclosures.

Part of the reason for this is that policy makers have acted to strengthen bank capital positions so that they could afford to relax their lending standards despite rising bad debts. But, it is also important to note that banks are choosing to delay the foreclosure process, showing some comfort in carrying a large foreclosure inventory. Despite the foreclosure inventory rising to a record high of 4.5% of loans, the actual foreclosure rate is only running at 1.2%. In (rough) dollar terms, US$460bn of mortgages could be foreclosed – but only US$120bn worth of loans have been foreclosed.

Banks have effectively taken on a housing market-making role.

This suggests that banks have recognized that they could be their own worst enemies in rushing foreclosures and forcing down house prices. They are now looking to short-circuit the de-leveraging process by preventing the shadow inventory from weighing on house prices and destroying capital (for households and ultimately themselves). Inventory management, together with policy efforts to strength bank capital positions are facilitating an easing of lending standards. In turn, this is promoting demand by allowing households to take advantage of record-high housing affordability. Banks now have a significant hand in managing housing supply and demand. Effectively, they are operating as *de facto* market makers.

In the absence of a negative external shock (eg. stricter regulation, inadvertent policy tightening or sudden seizure of money markets unrelated to the state of US housing), it is quite plausible that this recovery dynamic will continue, supporting re-leveraging efforts. There is no necessary reason for lending standards to tighten significantly in response to high foreclosure rates if policy makers continue to support the banking sector.

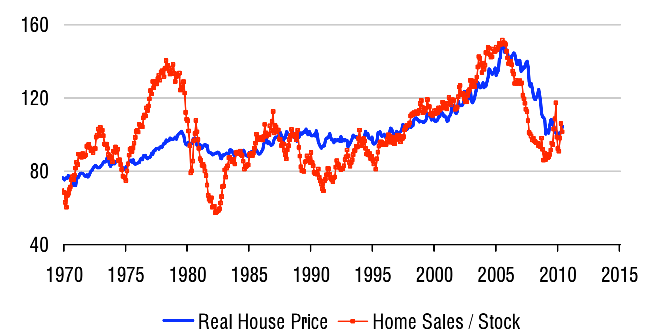
It is quite plausible that banks and policy makers could continue to prop up the housing market.

Outlook

There is a long-run one-for-one relationship between real house prices and home sales (as a percentage of the total number of households). A sharp rise (decline) in home sales foreshadows a rise (fall) in house prices soon after. Currently, the level of real house prices is broadly in line with home sales. This means that a rise in home sales from here should contribute to house price inflation, because unlike the 2005-2009 experience, housing is no longer expensive.

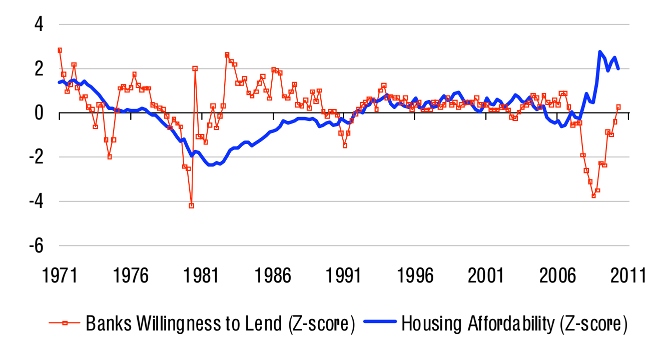
Housing is fairly valued relative to the level of demand.

Figure 8: Real house price & home sales (average = 100)



Source: Datastream, Credit Suisse

Figure 9: Home-buying conditions



Source: Datastream, Credit Suisse

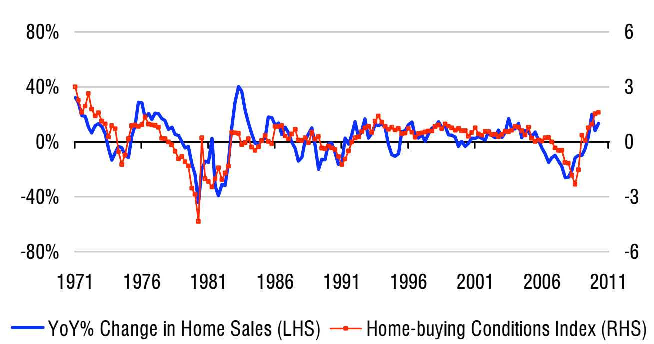
Home sales are notoriously difficult to model – but intuitively, housing affordability (wages divided by the product of house prices and interest rates) and bank lending standards should be powerful determinants. Very affordable (unaffordable) housing, combined with easy (restricted) access to bank funding should be consistent with rising (falling) home sales – and historically this is in fact the case. A weighted average of the NAR's housing affordability index and a diffusion index of banks' willingness to lend is highly positively correlated with the rate of change in home sales.

Housing demand is a function of affordability and bank lending standards.

Currently, housing affordability is at historically high levels, while bank lending standards are easing. This is consistent with organic growth in home sales (of around 20% per annum) even though the first homebuyers' tax credit has expired. Record high housing affordability mattered little in 2008 because bank lending standards were tight and households could not get access to funding. But now that lending standards have started to ease, home-buying conditions have improved significantly.

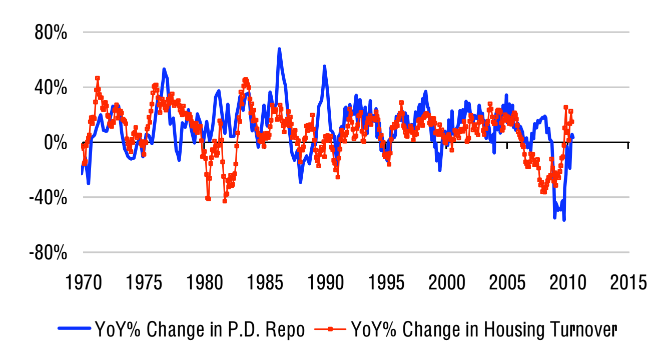
Fundamentals are actually supportive of rising home sales and house prices.

Figure 10: Home sales & Home-buying conditions



Source: Datastream, Credit Suisse

Figure 11: Housing turnover & primary dealer repo



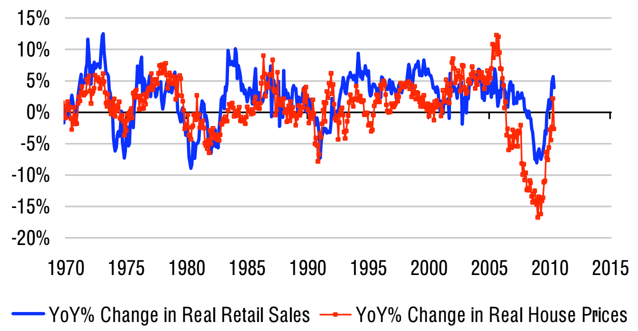
Source: Datastream, NY Fed, Credit Suisse

Rising home sales and house prices are critical for re-leveraging and self-sustaining recovery.

If home sales rise, we can also expect to see recovery in house prices. Rising house prices and home sales are consistent with growth in US retail sales and financial system leverage (as proxied by primary dealer repo outstanding) – and of course, re-leveraging is a critical requirement for self-reinforcing world growth recovery.

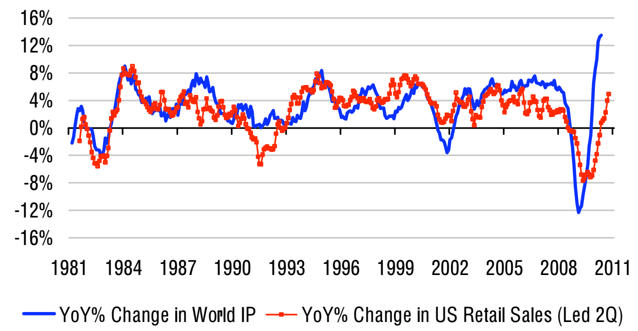
We will have more to say about these issues in future articles. For now, it suffices to say that rates will need to remain very low to keep housing affordability high, and to kick start global re-leveraging.

Figure 12: **Retail sales & house prices**



Source: Bloomberg, Datastream, Credit Suisse

Figure 13: **US retail sales & world IP**



Source: Bloomberg, Datastream, Credit Suisse

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