The Housing Puzzle: Affordability Correction or Recession?

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The two developments in California since our last forecast are the nixing of the extensions of high-speed rail (HSR) into San Francisco and Los Angeles by Governor Newsom, and the weakness in housing. Though the extension of HSR has been put on hold, the economic impact is not to be felt until the distant future. The Central Valley segment under construction will continue. Moreover, the length of track to be completed has been extended, if only marginally. Construction is expected to conclude in 2021, but as these projects go, 2022 is the more likely completion date. So, we put aside this development and focus on the puzzle in housing as it impacts our California forecast. Our conclusion is that even though there is a concerted effort to increase home construction in the State, in the near term it is likely to fail, and as a consequence our forecast for the California economy is weaker for 2019 and 2020 than out outlook three months ago.

Employment: The Fundamental for Housing Demand

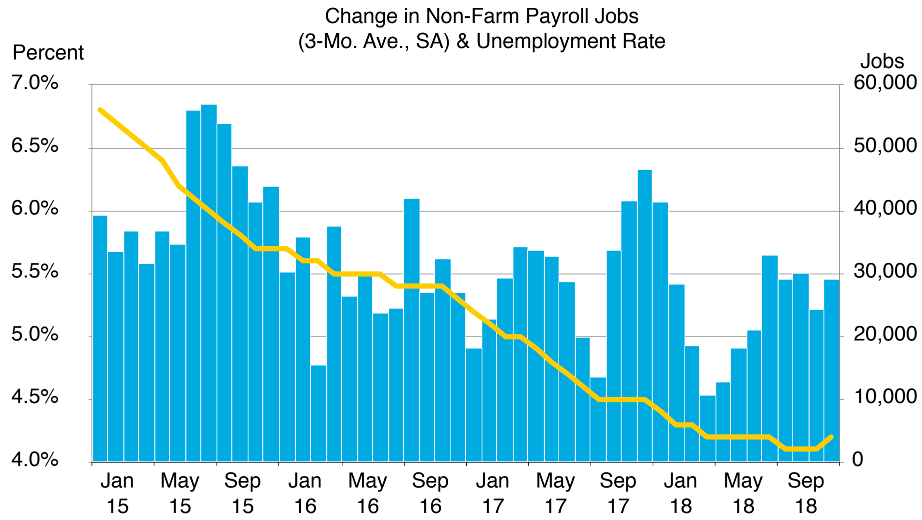
Though the unemployment rate has remained low at 4.2% the past quarter, employment growth has continued to be strong. After a slow start, non-farm payroll jobs increased to an average of 29,000 during the 2nd half of 2018; 1,000 more than the average job creation in the previous two years (Chart 1). This was fueled in part by a quarter million new entrants to the labor force. And while we keep thinking this will slow down, eventually one runs out of people, it has not done so yet.

The household survey which measures the number of people employed in the State is at record levels. It now stands at 18.8 million, 17.5% higher than the trough of the recession and 10.8% higher than the previous peak employment (Chart 2). With GDP growing at a faster rate than employment (2.9% in the first three quarters of 2018 and 3.5% in the third quarter), per capita income in California has been increasing as well. This job growth has been widespread across sectors as well. Although there remain perennially weak sectors; retail and wholesale trade and Federal employment, for the most part, jobs are being created in all skill categories (Chart 3).

The growth in employment in California is also geographically widespread (Chart 4). In the second half of 2018, the inland parts of the State—Sacramento and the Delta, the San Joaquin Valley, and the Inland Empire—all scored impressive gains, as did each of the three Bay Area Regions. The only parts of the State we measured that were lagging behind were the Central Coast and Orange County.

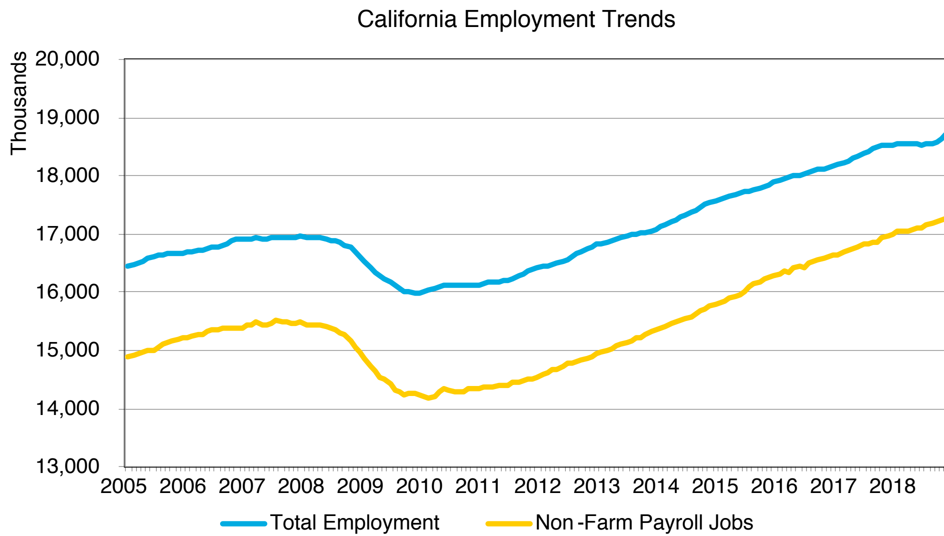
These fundamentals lead to increased consumption and to household formation. Thus, we expect a continuation of the monthly increases in demand for housing throughout the State that have been experienced the past five years. Except that this has not happened.

Chart 1



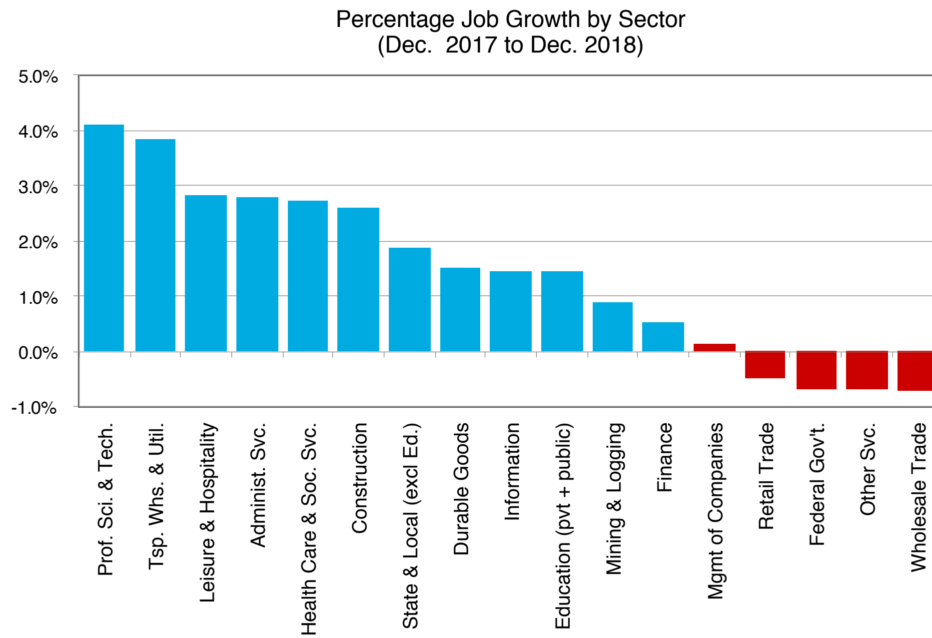
Source: EDD.ca.gov

Chart 2



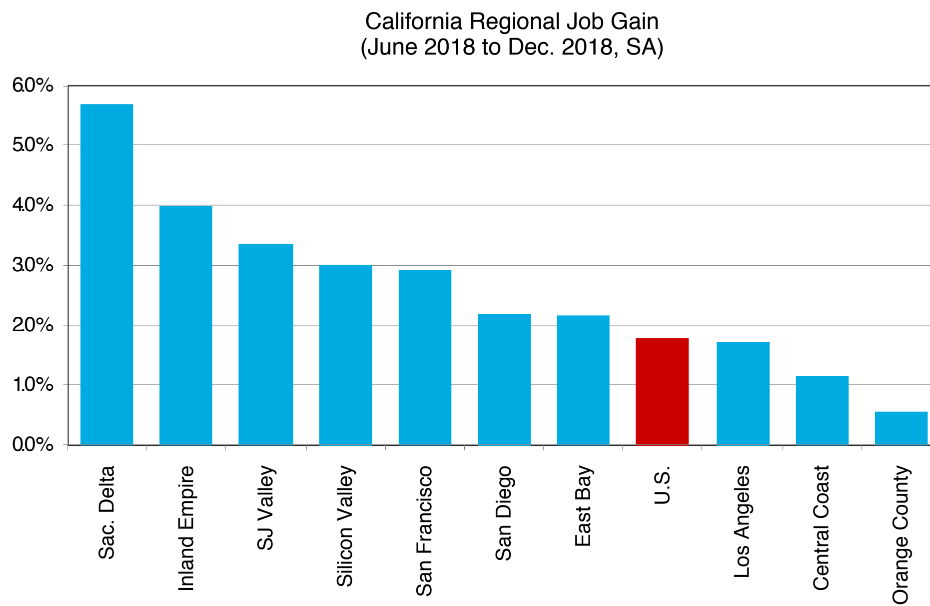
Source: EDD.ca.gov

Chart 3



Source: EDD.ca.gov, UCLA Anderson Forecast

Chart 4



Source: EDD.ca.gov, UCLA Anderson Forecast

What is Happening in Housing?

Real estate market health is normally a good indicator of the overall health of the economy. The last six months seem to suggest that is not always the case, but why remains a bit of a puzzle. Home prices are falling in California as is the level of building. Yet, the fundamentals that suggest a surge in buying are present. Let's look at three possible explanations; housing is so expensive that everyone (well a lot of everyone) is leaving; higher mortgage interest rates are depressing prices but not the underlying demand; and expectations about the future interacting with the first two explanations are dominating demand.

Let's begin with the data. Home prices are relatively difficult to measure as each home is different. However, the fall in home prices is consistent across different measures. The S&P Case Shiller Index (CS) which measures changes in same home sales for three cities in California—Los Angeles, San Diego and San Francisco—records an annual rate of decline in home prices of 0.8%, 5.1% and 5.0% from June 2018 to December 2018.[1] The California Association of Realtors (CAR) price data for existing single family detached homes in California records a 15% annual rate of decline in median prices over the same period and a further decline in January 2019.[2] Their measure of median condo prices, while higher than a year ago, has also been declining by more than at any time since the collapse of condo prices in the Great Recession. The Federal Housing Finance Agency (FHFA) has a more modest decrease in home prices from the 2nd Quarter of 2018 to the 4th Quarter of 2018 of 3.4%, however the computations understate the decline.[3] Clearly home prices are falling in California, and the decline is widespread and substantial. To put this in perspective, the annual rate of decline in the CS Los Angeles home prices in the time of the great aerospace contraction of 1991 to 1994 was 5.4%. Of course, that continued for four years and the current price decline has been running for only seven months. Nevertheless, the quarterly percentage change magnitudes are not dissimilar.

On the supply side of the market, the quantity of housing is changing by very little, if at all. According to the U.S. Census Bureau, there are approximately 14 million homes in California.[4] In the twelve months leading up to the decline in home prices a total of 120,000 new units were permitted. But 2018 was a year of devastating wildfires with approximately 20,000 homes destroyed. Thus, the net gain in homes was a paltry 0.71%. Since the supply of homes is growing slowly over the last seven months, the fall in price must be a consequence of a fall in demand. The sales statistics confirm this intuition. CAR's data on existing single-family home sales show a nine-month negative trend overall with the Bay Area down by 5.8% through January, Southern California by 4.2% and the Central Valley by 13.2%. These trends have taken their toll on residential construction as well. Building permits in the second half of 2018 fell by 6.3% from the same period in 2017.

So, what is happening in housing markets? From the previous section, we know that job growth and economic growth remain strong. The latest figures from the U.S. Bureau of Economic Analysis put California's GDP growth at a healthy 3.5%. Jobs and income provide the basis for household formation, the underlying demand component for housing.

Let's start with the first hypothesis, there is a mass exodus from California. It is hard to imagine that this is the case with 1.4% growth in employment to 18.8 million Californians employed at the end of 2018. The best estimates from the California Department of Finance has California's population growing, not declining. But, even if there is net out-migration, it is relatively small. Net domestic migration out of California has been about 130,000 per year for the last few years and there is no indication that it is picking up. Indeed, with more people coming into the labor force, 252,000 in the last six months of 2018, the opposite may well be true. Moreover, there is net positive foreign migration into California and the domestic migrants into the State tend to be better educated than those that left. Over the past eight years this has kept the demand for housing growing. So, while this hypothesis may have some truth to it, particularly in light of an easing of foreign demand from China in some California markets, at best this is a marginal factor and does not explain the seven-month trend we are observing.

The second hypothesis is higher mortgage rates. Initially we thought this would be the explanation. However, our initial thoughts are not panning out. Higher mortgage rates imply lower home sales prices as the total price including mortgage interest is the cost to the buyer. From September 2017 to

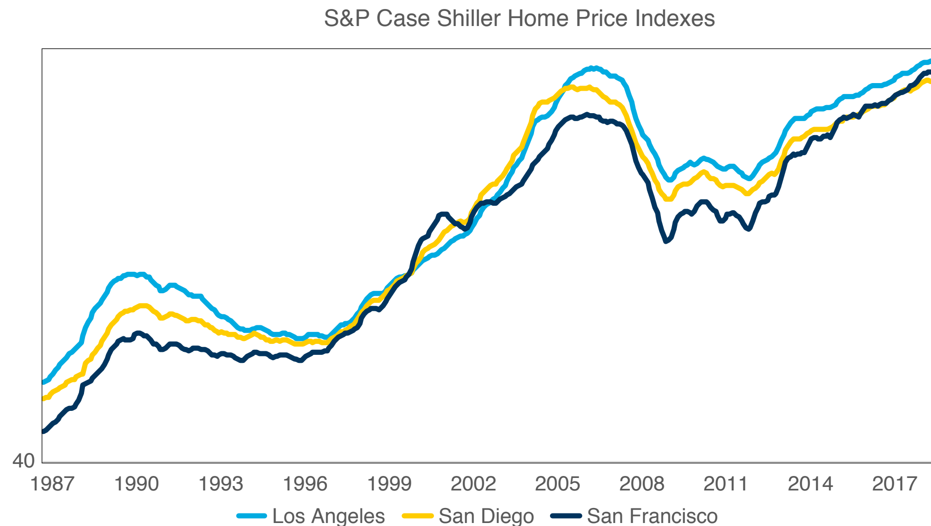
1. *https://us.spindices.com/indices/real-estate/sp-corelogic-case-shiller-20-city-composite-home-price-nsa-index*
2. *https://www.car.org/marketdata/data/countysalesactivity*
3. *https://www.fhfa.gov/DataTools/Downloads/Pages/House-Price-Index.aspx*
4. *https://factfinder.census.gov/faces/nav/jsf/pages/community_facts.xhtml?src=bkmk*

October 2018 mortgage interest rates increased by about 1.2% percentage points.[5] But since then they have declined by 0.5% points. Moreover, there was a similar increase in mortgage interest rates in late 2013 and a smaller, but significant, increase in 2016 and neither had the same pattern of impact as the current increase. Further evidence against this hypothesis is seen in Chart 5. This chart shows the CS home price index from 1987 in logarithms. In a logarithmic chart, straight lines represent constant rates of growth. It is difficult to see downturns in CS home prices except in recessions. Certainly, if mortgage interest rate increases were the bulk of the story, something is different now.

That brings us to the last explanation and it tends to tie the other two together. What is different in real estate markets today is the buyer. Buyers have more information with the advent of Zillow, Trulia and other online home price analysis websites. And, buyers today had the experience of the Great Recession's collapse of home prices. Higher interest rates would have triggered some easing of price pressure as we discussed in December. The knowledge of that, the continual discussion in the press about when the next recession will hit (both outgoing Governor Brown and Governor Newsom have made a point of stating that a recession is somewhere on the horizon), and the memory of dramatically falling prices in 2008, and 2009 is enough to change expectations. Who wants to purchase a home at the top of the market, especially if the lack of affordability causes one to stretch—maybe stretch quite a lot? Perhaps those buyers who might have held up home prices are now spooked. They don't want to be suckers when they could wait six months or so, and purchase a lower price home with a lower interest rate mortgage.

However, this is speculation and whether or not the trend continues through 2019 remains to be seen. With our national forecast for slowing economic growth, continued discussion on when the next recession will be (we don't have one in our forecast), and the Fed indicating that the peak of the interest rate cycle could be near, we now expect weaker housing markets into 2020. As a consequence, our forecast for housing starts in 2019 and 2020 has been revised downward to with a recovery in building beginning in 2021.

Chart 5



Source: S&P Case SHiller Index

5. *The national average for fifteen year fixed mortgages.*

The Forecast (with William Yu)

As a consequence of the weakening U.S. forecast, the above discussion on housing and net additions to the labor force, we expect California's average unemployment rate to rise slightly to an average of 4.5% in 2019. For 2020 and 2021 we expect an average unemployment rates of 4.3%.

Our forecast for 2019, 2020 and 2021 total employment growth is 1.3%, 0.6% and 0.5%, a slowing of 0.1 percentage points from our December outlook. Payroll jobs are expected to grow at a 1.8%, 0.6% and 0.3% rate respectively.

Real personal income growth is forecast to be 3.2%, 1.8% and 1.6% 2019, 2020 and 2021 respectively. The continued growth in real personal income in 2020 is reflective of the changing mix of employment in California and tight labor markets in high wage occupations. Homebuilding will be lower by 4,000 to 5,000 units per year than previously forecast for the next two years, but then will accelerate to about 148,000 units per year by the end of the forecast horizon 2021. This will be a response to easing zoning and regulatory requirements for developers and an expected reduction in interest rates by 2021.