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HOUSING CLIMBING OUT OF BASEMENT, WILL SUPPORT GROWTH IN 2012, 2013

- Housing data released this week show better homebuilding and sales in November.
- Activity remains at low levels, but is improving; most of the growth in construction is coming from multifamily housing.
- There were downward revisions to existing home sales from 2007 forward, but this does not change the outlook.
- A housing turnaround will contribute to modest but sustained economic recovery in 2012.
- Failure of Congress to pass an extension of the payroll tax cut and the extended unemployment insurance benefits would be a major downside risk to the economy in 2012.

Housing market data released this week have been better, and the sector looks to be finally breaking out of its years-long slump. The National Association of Home Builders housing market index rose two points in December, with an especially strong gain in the South. This was its highest level since May 2010, when the homebuyer tax credit expired, and before that since August 2007.

Housing starts jumped more than 9 percent in November, led by a 25 percent increase in multifamily starts, with single-family starts up by only 2 percent. Year-to-date starts through November were up 2 percent from the comparable period in 2010, reflecting a 52 percent increase in multifamily starts, and a 10 percent decline in single-family starts. Permits also increased in November, indicating further improvement in housing construction in the months ahead. November permits were up 14 percent for multifamily and up 2 percent for single-family dwellings. The big growth in residential construction is on the multifamily side (see Chart 1). Apartment vacancy rates are low as households switch from homeowning to renting and the labor market has improved.

Another sign of improvement in housing came from sales of existing homes, which rose by 4 percent in November to 4.42 million units at an annualized pace. Sales have gradually moved higher since the summer, and are now at their strongest pace since January 2011. The median sale price for an existing home was down 3.5 percent in November from one year earlier, with the pace of declines slowing. Inventories of homes for sale are declining, both in absolute numbers and on a months' supply basis.

The National Association of Realtors has revised down its data on existing home sales, after correcting for methodological problems. According to the NAR, sales of existing homes were about 14 percent lower than previously reported since 2007, with a steeper drop in sales during the worst of the housing market collapse. The data revisions, however, do not change the shape of the housing market recovery. Sales started to fall in 2006, then plunged in 2007 and bottomed out in early 2009. They surged in both late 2009 and spring 2010 in response to tax credits, but then fell after they expired. Sales have been in a narrow range for the past year, with a small improvement in recent months (see Chart 2).

The housing market will gradually strengthen over the next several years as economic fundamentals improve. In construction, multifamily will continue to lead the way. Single-family construction will lag through 2012, but will start to pick up toward the end of next year as job gains increase, consumer confidence improves, and mortgage credit becomes more available at very low rates. With the improvement, residential construction is shifting from a drag on growth to neutral in 2011, and will become a "back-seat" driver of growth throughout next year and into 2013.

Home sales will also continue their modest rebound next year, with stronger growth in 2013. As the labor market further improves, high affordability—the result of price declines and continued low mortgage rates—will draw more households into the market. Greater availability of mortgage credit as the financial system continues to heal will also support homebuying. Household formations are up as the labor market has turned around, and will further strengthen over the next several years as job growth accelerates, leading to stronger home sales.

House prices will continue to lag, however, falling through most of 2012. It will take some time for currently distressed homes to work their way through the foreclosure process, keeping downward pressure on prices. Eventually, however, a slowing in foreclosures, stronger demand for homes and income gains will drive price improvements.

Congress's dithering on passing an extension to the payroll tax cut and extended unemployment benefits (up to 99 weeks) for 2012 is another prime example of dysfunction in DC. Is it any wonder that Congress's approval rating is single digits? If the 2 percentage point payroll tax cut is not extended, that would raise taxes of working Americans by close to $100 billion in 2012, with middle-class workers bearing a disproportionate share of that "tax hike." Failure to renew the extended unemployment benefits would reduce employment compensation to the long-term unemployed by close to $35 billion. Together, this would reduce the Federal deficit by $135 billion in 2012, all else equal. But all else will NOT be equal. This combined $135 billion of federal fiscal "contraction" would reduce real GDP growth in 2012 by close to 1 percentage point and would be a significant downside risk to our forecast of 2.5 percent real GDP growth in 2012 (assuming Congressional passage of the extension). This drafts the downside risk to the U.S. economy of a likely recession in Western Europe, which we estimate would reduce U.S. real GDP growth in 2012 by 0.3 percentage points. I still hope (and pray) that some semblance of putting the American people's interest before partisan politics will prevail in the waning days before the House adjourns for the holidays (the Senate has already split). If not, the sting may linger well into 2012, when American voters have an opportunity to send a clear message to Congress with the November elections.

Chart 1: Multifamily Is Driving Permit Growth

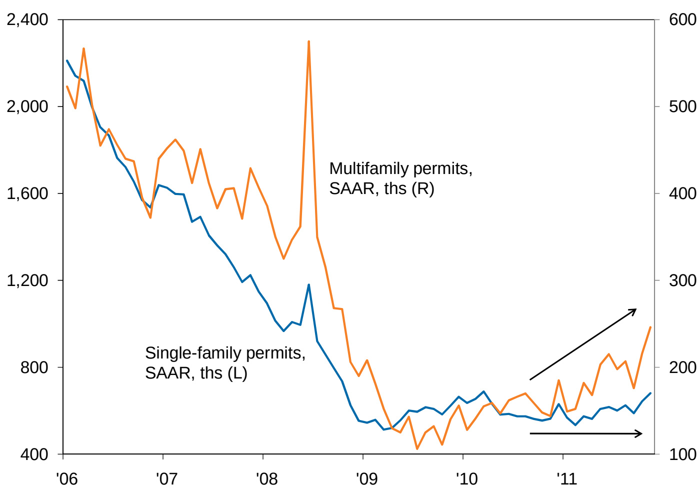

Chart 2: Revision to Home Sales, But Pattern Is Same