The Housing Market: Bust… or Just Blah?

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Growth in home construction or sales is generally good news, as people buy furniture to fill up their new homes. Unfortunately, most of the news coming from the housing sector these days seems bad. Housing data is downright discouraging and housing experts are talking about such dire things as bursting bubbles. So did the bubble burst in 2006? Or is the housing sector experiencing the proverbial soft landing?

Not many in the home furnishings industry are calling 2006 a great year. In a previous article, I noted that not even dramatically falling gasoline prices at the end of the year could rescue a mostly blah holiday season. For the most part, this reflected what happened last year in housing. Sales of existing homes in 2006 were 8.4 percent below the 2005 level, and drops like that don't happen without some spillover into other sectors. For example, Home Depot officials are blaming their recent losses at least in part on declines in housing.

Construction data for 2006 paints a similarly gloomy picture. Housing starts for single-family homes fell to 1.47 million units in 2006, down from 1.72 million units in 2005. That's a whopping 14.6 percent decline. Starts for multiple-family housing fell by somewhat less, only 4.5 percent. And the National Association of Realtors recently reported that home prices in the last three months of 2006 were an average of 2.7 percent lower than in the fourth quarter of 2005. That was the largest year-to-year drop on record, and it followed a 1.0 percent decline in the third quarter.

The data in early 2007 seems to be continuing the theme. The Census Bureau has reported that housing starts in January fell to their lowest monthly rate in nine years, and building permits for single-family homes fell to a six-year low.

But is the picture really so gloomy? After all, even with the drop in existing home sales in 2006, the market for existing homes posted its third-best year ever. To be sure, we witnessed tremendous, and in fact historic, growth in the housing sector during the go-go years of 2004 and 2005. But we had a wonderful combination of strong economic growth in the U.S., plus low interest rates. It's hard to top that. So while signs of a correction in the housing sector are unmistakable, perhaps that's only to be expected after the ride we've had.

Besides, not all housing indicators are terrible, though one has to drill down a bit to see the good stuff. The Census Bureau's housing data also includes the news that the average size of new single-family homes continued to increase in 2006, rising to 2,493 square feet from 2,462 square feet in 2005. That 1.3 percent increase might seem small, but it matches the average annual increase during the boom years earlier this decade. Unless people are going to leave that additional space empty, something's got to fill it.

Another positive note in the background is the likelihood that weakness in construction will pare down inventories of already-built homes. For months, that surplus has been like a lead weight pushing down on home prices. And applications for permits for multifamily residences, a tangible expression of builders' expectations about the near future, were strong in January for the second straight month.

We hear a lot about consumer confidence, but it appears that "supplier confidence" in the housing sector is recovering. The National Association of Home Builders recently released a survey of its members, who expressed a high degree of confidence for 2007 — even while acknowledging that the market is currently weak.

The National Association of Realtors forecasts essentially no growth in home sales in 2007 (and no growth is better than a decline!) and moderate growth in 2008. The association also forecasts a 1.9 percent increase in the median existing-home price in 2007.

The big economic story looming behind all of this is cheap money. Market interest rates show little sign of rising, in spite of the steady and gradual increases implemented by the Federal Reserve Board. How is this happening? Incomes in emerging economies like China and India are growing, and for the first time those countries are supplying significant savings and investment to global capital markets. But with financial institutions in those countries not yet able to funnel such large capital flows to their own businesses, the net effect on world interest rates has been negative.

Relatively low interest rates are a big reason why many analysts are cautiously optimistic about housing in 2007 and 2008. Back when the former President Bush claimed that then-low interest rates meant it was a good time to buy a house, he didn't get it quite right because interest rates were mostly a function of U.S. economic conditions. Low rates back then were a clear signal that consumers weren't keen on buying homes. But today's global financial network ensures that interest rates are global phenomena.

Consumer reluctance is only one factor behind low interest rates, which means that the low rates may well lure home buyers into the market.

Unfortunately, a stabilizing housing sector in 2007 will do little for the overall economy, which for a few years has been depending heavily on that sector for growth. The question is, what sector will step forward now to generate growth in the next few years?