Will Housing Take Furniture Down With It?

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Brod, Andrew (2008). Will Housing Take Furniture Down With It? *NHFA's Home Furnishings Retailer*. January 2008, 26-28

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Article:

2007 has been a year of surprises for those who thought the housing sector had nowhere to go but up. The cautiously optimistic forecasts of a year ago were proven wrong, as each new release of housing data was more depressing than the one before it. The rule of thumb in home furnishings is that a fifth of all sales derive from a home purchase, so this is all pretty unsettling to retailers. Does the housing slump have the U.S. economy primed for a serious downturn, or are things less dire than they seem?

In March, when I last wrote in this space about the housing sector, it was clear that 2006 had been a very bad year. The median home price in the U.S. fell after a couple of years of double-digit growth. Housing starts fell nearly 15 percent after four years of solid increases.

A survey by the National Association of Home Builders showed that while builders didn't expect 2007 to be a great year, they did expect it to be better than 2006. But even that was too optimistic. According to the federal Department of Commerce, housing starts in the first three quarters of 2007 were 28 percent lower than in the first three quarters of 2006.

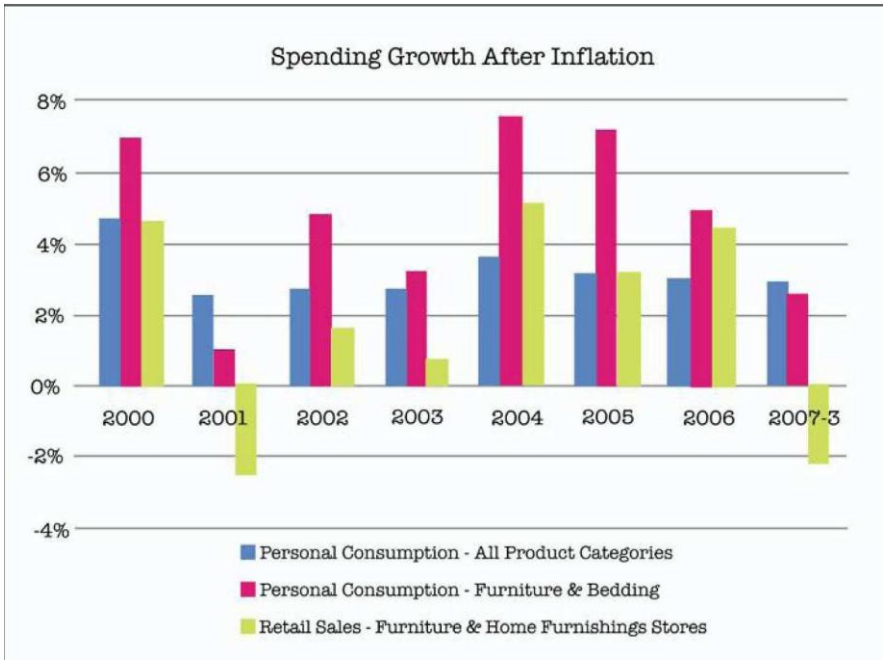
The always upbeat National Association of Realtors predicted a small increase in home prices and flat home sales in 2007. But in October the median home price was 5 percent lower than a year earlier, and sales of existing homes for the year are likely to be at least 11 percent lower than in 2006.

It's hard to find much encouragement in the housing data. The number of unsold existing homes in October was 15 percent greater than a year earlier. In 2005 this inventory varied between four and five months of home sales. Now it will take nearly 11 months to sell off the current inventory. And these figures don't include the number of unsold new homes, which has also risen sharply.

Moreover, the homes sitting out there are now less affordable to the typical buyer. The NAHB's measure of affordability is its Housing Opportunity Index. The HOI is the percentage of homes that are affordable to a family earning the median income, based on standard mortgage-lending practices, prevailing interest rates, and so on. In 2002 and 2003, the national HOI averaged 64 percent. Now it stands at 42 percent.

How did we get here? We can blame a combination of the low interest rates put in place by a frightened Federal Reserve after 9/11, aggressive mortgage lending by the nation's banks, and a lax regulatory environment for mortgage derivatives. There's nothing new about converting mortgages into tradable securities. But the prices of newfangled instruments like collateralized debt obligations failed to incorporate enough risk. Had those securities been priced and rated correctly, financial markets would have sent the right signals to lenders.

Instead, the signal to lenders was to keep allowing borrowers to bet on rising home prices. That worked as long as prices kept rising.



Now that home prices are no longer bubbling ever upward, the big questions are whether the correction in the housing sector will continue in 2008, to what degree this will affect the overall economy, and of course, how it will affect spending on home furnishings.

Let's look at the link between housing activity and consumer spending. News reports talk about consumers using their rising home equities as a kind of ATM, with the implication that falling home prices will lead to large declines in consumer spending. But the statistical evidence for such a strong linkage is mixed at best, and in any case consumers are continuing to spend amid the housing declines. After inflation, U.S. personal consumption in the third quarter of 2007 was 2.9 percent higher than a year earlier (see diagram).

But that's consumer spending on all product categories. When we focus on home furnishings, the statistical linkage between housing activity and home furnishings purchases is pretty strong, and the housing slump appears to be having an effect. As the diagram shows, growth in spending on furniture and bedding (in all stores, not just home furnishings stores) has slowed since 2004. The picture is even grimmer for retail sales in home furnishings stores. In the 12 months that ended with the third quarter of 2007, sales dropped for the first time since the recession year of 2001.

In spite of the bad news for home furnishings, it's unlikely that the housing bust will throw the entire economy into recession in 2008. The U.S. economy is a model of resiliency, in spite of our apparent attempts to screw it up. To be sure, a recession is possible. The persistence of the housing slump led economists surveyed last month by the National Association for Business Economics to raise their assessment of the odds of a recession in 2008. But even so, 82 percent of them put the risk of a recession next year at less than 50-50, and roughly 60 percent put it at less than one in three. That's not the most ringing endorsement I've ever heard, but it's better than nothing.

The NABE survey predicts that the economy will grow by 2.6 percent next year, which is in line with other major forecasts. For example, both Wachovia Bank and the Bush administration are forecasting 2.7 percent growth in 2008. Growth of less than three percent indicates a weaker economy than we'd like, but it does not indicate a recession.

However, there are no indications that the housing sector will turn around quickly. There will probably be more pain in 2008. The NABE survey predicts an 11 percent drop in housing starts next year, and Wachovia predicts

a 9 percent drop. The combination of a weak national economy and continuing declines in the housing sector makes for an unpleasant outlook for home furnishings in 2008.

But things will get better. They always do. The housing sector has exhibited boom-and-bust cycles for decades, and even though the damage this time around was at least partly self-inflicted, the bust won't last forever.

Wachovia's economists believe the turn-around in the housing sector will happen as soon as 2009, when they predict a five percent increase in housing starts.

Sometime around then, things will start looking up for home builders, mortgage lenders, home sellers, and home furnishings retailers.