Housing Knocked Down but Not Out by COVID-19

BY CRISTIAN DERITIS

The near-term outlook for the housing market is dark, but the lack of supply and strong underlying demand will provide support over the longer term, particularly in certain segments and geographies.

Residential construction came to a standstill in March and April in many parts of the country as lockdown and social distancing orders prohibited workers from entering job sites. Even in areas with few restrictions, demand for new homes collapsed overnight as buyers turned cautious in a world of skyrocketing unemployment and enormous economic uncertainty as well as fears of contracting COVID-19.

Running counter to these negative forces are pent-up demand, low vacancy rates, low interest rates, and a desire for homeownership, which will increase in the shadow of the pandemic.

Never fully recovered

The housing market never fully recovered from the last recession—at least from the perspective of housing starts and completions (see Chart 1). Prospective buyers have been waiting anxiously on the sidelines for inventory in their price range to become available.

Also lending support to the housing market are the relatively robust finances of homeowners today versus the 2006 housing bust. Larger down payments and stronger underwriting standards over the past decade have made today's homeowners more resilient to temporary price declines.

Specifically, while the implied or "shadow" value of homes may fall precipitously in the short term based on the homes that are transacting, most owners are in the favorable position of having significant equity in their homes. In contrast to the Great Recession, few owners currently feel pressured to sell. Provided the economy starts to re-engage over the next two to three months, long-term damage to the housing market will be avoided.

The income transfers to households and small businesses provided by the CARES Act along with low interest rates could potentially provide some stimulus to home sales toward the end of 2020 and into 2021, assuming that the spread of the pandemic is controlled in short order.

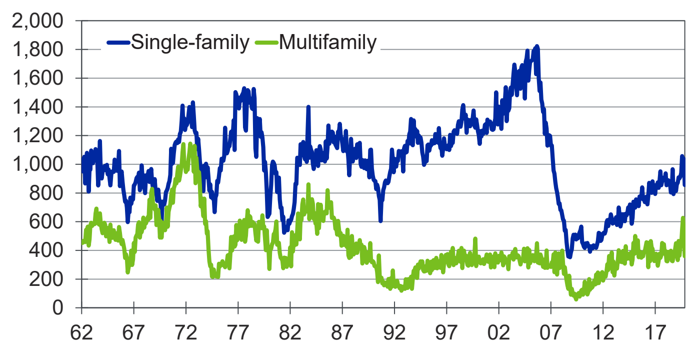
Although there is room for some optimism, it needs to be balanced against the reality of the current state of the labor market and consumer confidence. In the sections that follow, we consider the impact that the rise of COVID-19 has had and will have on home sales, construction and prices in coming months. We conclude with a discussion of the long-term impact that the pandemic may have on consumer preferences and costs. Though it is too early to conclude with certainty, in all likelihood the Great Coronavirus of 2020 will have permanently changed the trajectory of the U.S. economy along with the housing industry.

Sales sink

COVID-19 struck like a thief in the night during the first quarter of 2020. If not for the pandemic, housing was on an upswing having experienced weaker demand in 2019 as a result of the economic uncertainty related to the U.S.-China trade war and as the economy retreated from the sugar rush generated by the Tax Cuts and Jobs Act of 2017. With the signing of the Phase One trade deal with China in January, the economy was

Chart 1: Housing Starts Below Equilibrium

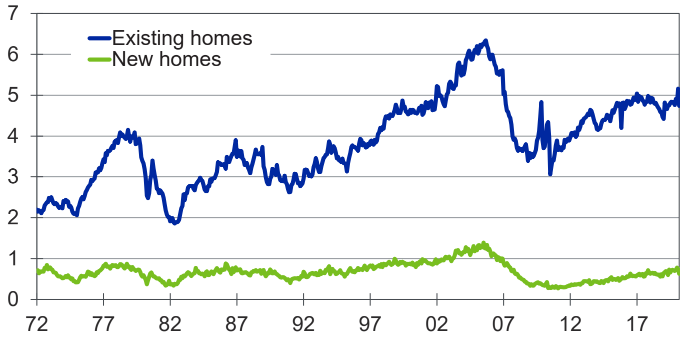
Housing starts, mil, 3-mo MA



Sources: NAR, Moody's Analytics

Chart 2: Sales' Slow but Steady Climb

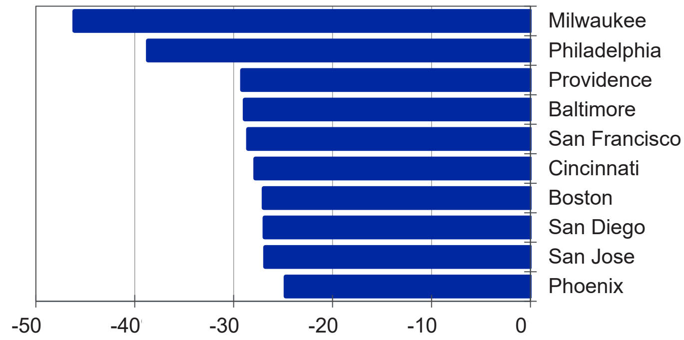
Home sales, mil, SAAR



Sources: NAR, Moody's Analytics

Chart 3: Listings Pulled Across Metros

Active listing count, % change yr ago



Sources: Realtor.com, Moody's Analytics

on track to post slower but steady growth in 2020.

Homes sales in January and February reflected this tempered optimism. Existing-home sales rose 5% from December while sales of new homes rose by 2.5% (see Chart 2). Though still well below the go-go years of the early-2000s housing boom, it looked as though sales were finally getting their groove back.

By early March, sales activity was already in free fall. Active listings of homes available for sale as reported by both Realtor.com and Redfin.com fell starkly as sellers woke up to the fact that the COVID-19 pandemic had arrived on U.S. shores and was spreading rapidly (see Chart 3). Potential homebuyers had little interest in visiting strangers' houses and sellers had little interest in having potential carriers of the coronavirus traipsing through their homes. While trends varied across the country, many existing listings were pulled while new listings were postponed.

More precisely, listings were pulled as long as sellers could afford to wait. Homeowners who had already purchased another home and were in the process of selling their current homes may have found themselves trapped with no other option but to proceed with their listings.

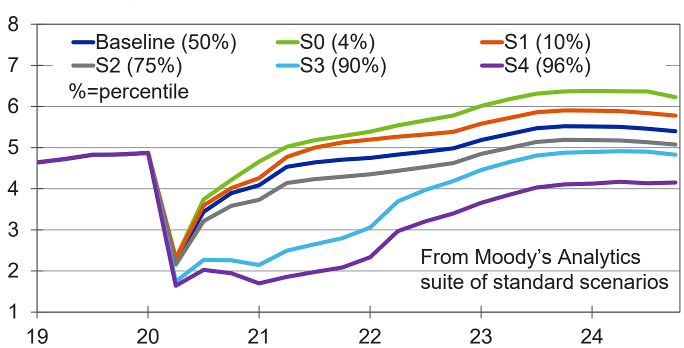
Other sellers facing financial difficulty may also have had little choice but to sell—at least until a 60-day foreclosure moratorium enacted as part of the CARES Act on March 27 provided them some breathing room.

Although lower mortgage rates and attractive home price discounts may have brought in some buyers, many local Realtors closed their offices—either voluntarily or involuntarily—in areas experiencing a significant COVID-19 outbreak.

Mortgage lenders facing financial as well as health-related challenges limited the number of workers available to underwrite new loans and tightened lending standards in order to control the volume of new applications, making it difficult for potential buyers to complete transactions for the few buyers in the mood to shop.

Chart 4: Home Sales to Collapse in Q2

Home sales, mil SAAR



Source: Moody's Analytics

Even all-cash transactions were impacted as many local government offices were closed.

Consistent with the Moody's Analytics forecast of the general economy, and the labor market specifically, homes sales are projected to remain low throughout the second quarter of 2020 (see Chart 4). Some improvement is expected in the third quarter as most parts of the country are projected to emerge from lockdowns and relax other restrictions on movement by July. But this will be a gradual process with many buyers expected to exercise caution for at least the next few quarters.

Further economic weakening is expected in the latter half of the year as more businesses go out of business after attempting to reopen their doors. While government grants and loans will help to keep small businesses afloat in the near term, some of them will find that demand for their goods and services has shifted in the meantime.

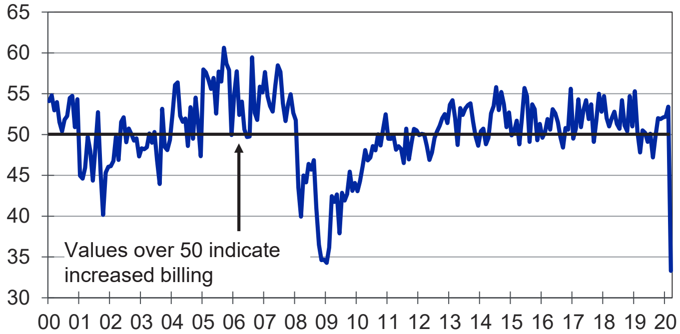
Consumers may be more reluctant to travel, visit restaurants, or gather in public places as they did in the past. Broad economic weakness and uncertainty will limit the amount of discretionary spending they engage in as well.

A pandemic-induced shift to online spending and delivery may accelerate the trend of closing of brick and mortar retailers and department stores, putting further pressure on jobs and incomes.

Business travel will likely be cut back significantly as companies limit the exposure of their employees to infection and learn to operate effectively through videoconferencing.

Chart 5: Demand for Architects Plummets

Architecture Billings Index, SA



Sources: AIA, Moody's Analytics

The knock-on effects of higher unemployment caused by a wave of business bankruptcies will translate into subdued home sales through the end of 2020. Sales will not start to return to their pre-COVID levels until 2022.

The discovery of a vaccine or effective anti-viral medications may alter this trajectory somewhat leading to a faster recovery as illustrated by the S0 and S1 forecasts, but even these remedies would take some time to roll out to the population.[1]

Significant downside risks remain, including a worsening of the spread of the pandemic leading to further government-imposed lockdown measures. Even if consumers adapt to the health risks posed by the coronavirus, they will still need to contend with the economic fallout resulting from bringing the U.S. economy to a standstill for more than two months.

Builders want to build

Residential home construction will follow a similar trajectory to that of sales, though regional patterns will vary widely. Some parts of the country, particularly in the Central and Mountain states, imposed few, if any, restrictions on movement and may be expected to continue with business as usual for the most part. These areas tend to be more rural with low population density and limited construction activity to begin with.

States that were impacted by the pandemic early on are expected to begin to relax their restrictions in May and June while areas that experienced later outbreaks may not fully emerge until later in the summer. As a result, analysts and other housing market participants will want to proceed with caution when examining national figures on construction activity, as it will be heavily influenced by the epidemiological spread of the virus.

Input costs for energy, lumber and other raw materials, which should remain near record low levels given the lack of overall demand, will provide some relief to homebuilders. However, availability of buildable lots and zoning restrictions remain large barriers for rapid expansion of construction in many communities. That could change as tax revenues fall and local governments look for ways to fill holes in their budgets and increase their tax bases.

The ongoing push to increase population density and create mixed zoning communities to reduce congestion may face renewed challenges by homeowners concerned about future pandemics. But this will need to be balanced against the economic realities facing homebuyers—particularly first-time homebuyers—who have had to tap into their savings and now face diminished employment prospects. The collision of health priorities with economic and environmental priorities may slow down the approval of future construction projects considerably.

Demand—or more precisely the lack of it—remains a major constraint to construction growth in the near term. The job market will play a critical role in any recovery as consumers will look for some certainty in their employment and income prospects before signing up for a major purchase such as a new home. Even if consumers do not require that certainty, mortgage lenders will.

In addition to the slowdown in construction activity, delays in planning and permitting will prolong the recovery and may even cause a further pullback in construction in the fourth quarter as the project pipeline is refilled.

An index of architects' billing for design services fell to its lowest level ever in March, surpassing the lows of the Great Recession in the span of one month (see Chart 5). Given the time required to plan and approve new projects and the backlog piling up at state and local government offices, it will likely take until mid-2021 for the construction industry to fully re-engage.

Home financing foibles

With the Federal Reserve cutting the policy rate to near 0% and engaging in quantitative easing through the purchase of hundreds of billions of dollars of long-term Treasury bonds and agency mortgage-backed securities, analysts had expected interest rates on mortgages to fall quickly, providing additional support to the housing market, as monthly payments become more affordable.

Although rates did decline somewhat, they have not fallen anywhere near what was expected given the unintended consequences of policies intended to help the housing market (see Chart 6).

One factor was the speed and size of the Fed's unanticipated intervention in the MBS market.

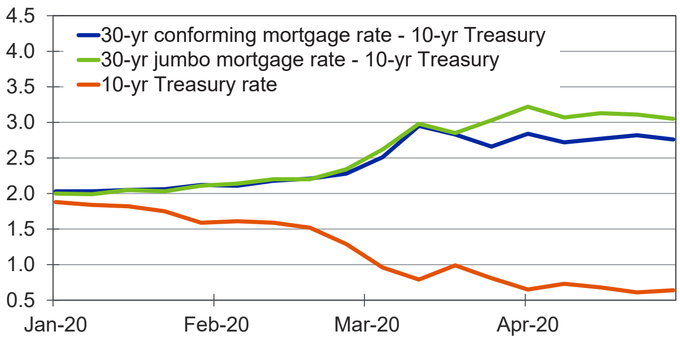
Loan originators typically hedge against movements in interest rates from the time they offer a mortgage to a borrower and the transaction is closed with the disbursement of funds to the time they sell or securitize the mortgage. Typically, the "lock-in" period is anywhere between 30 and 60 days. As a result of the Fed's extraordinary MBS purchases, the prices of these hedge contracts shot up, forcing originators to adjust either by shortening or eliminating the lock-in period or by increasing the interest rate offered to borrowers in order to offset their costs. Over time, lenders may be able to adjust their hedging strategies, but the effect on mortgage rates may linger for months.

Another factor impacting mortgage interest rates is related to the mortgage forbear-

1 S0 and S1 refer to alternative economic scenarios that Moody's Analytics publishes on a monthly basis. For additional information please visit: https://www.economy.com/products/alternative-scenarios/standard-scenarios

Chart 6: Mortgage Rate Spread Widens

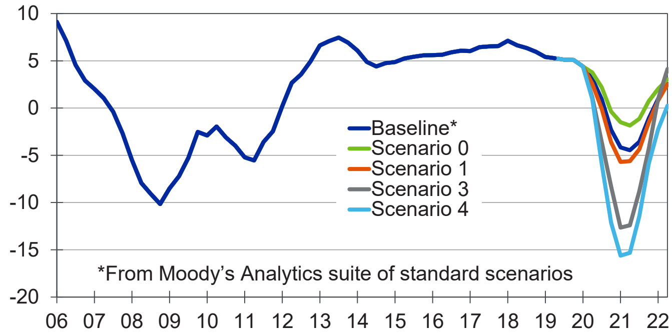
Spread between mortgage rate and 10-yr Treasury rate, ppt



Sources: NAR, Moody's Analytics

Chart 7: Selling at a Discount

FHFA purchase-only home price index, % change yr ago



Sources: BEA, Moody's Analytics

ance program that was put into place with the CARES Act. Through this program, borrowers who have been adversely impacted by COVID-19 and whose mortgages are guaranteed by Fannie Mae, Freddie Mac, the Federal Housing Authority, or the Department of Veterans Affairs may not be required to make a monthly mortgage payment for up to one year.

While this program is instrumental for keeping borrowers in their homes and avoiding a wave of foreclosures, it can place a large burden on mortgage servicers who are contractually obligated to keep advancing payments even though individual borrowers may not be making their monthly payments.

Servicers will eventually be paid back either by the borrower or by the agencies in the event of a default, but in the interim they may lack sufficient liquidity to cover their costs, putting them at risk of bankruptcy. This risk can translate into higher rates—or limited credit availability—as investors grow concerned and servicers require higher fees to cover their costs.

Also related to the forbearance program is the risk that lenders will not be able to sell the mortgages they have originated to either Fannie Mae or Freddie Mac in the event a borrower receives forbearance after the mortgage is settled. Uncertainty around legal liability and an FHFA announcement that mortgages in this position would be insured by Fannie and Freddie at an elevated price injected additional uncertainty into the mortgage market. This translated into a higher than expected interest rate as lenders sought to cover their potential costs.

Lenders had responded by either stopping certain lending programs altogether or by tightening lending standards significantly. Fortunately, the GSEs have since clarified conditions under which loans receiving forbearance may still be eligible for sale. This should increase liquidity and ultimately serve to reduce the spread between primary mortgage rates and the yield on 10-year Treasury bonds.

Another concern, at least through early May, was that the risk-transfer facilities that Fannie Mae and Freddie Mac created after the last housing crisis in order to reduce taxpayer exposure to mortgage defaults have ceased to be issued throughout the coronavirus crisis. While it is too early to tell if investors will still be interested in purchasing these instruments in the future, currently the market is in limbo, creating a backlog for the GSEs to transfer some of their risk to other market participants, including insurance companies and private equity investors.

While concerning, policymakers, including the Federal Reserve, FHFA and the government-sponsored agencies, are aware of all of these issues and have been actively working on solutions to provide support and clarity to the marketplace.

Provided changes can be instituted quickly, interest rates should come down as investors' fears subside and ample liquidity is restored. That could provide a significant boost to overall spending as existing borrowers are able to refinance their mortgages and as homebuyers can take advantage of ultra-low interest rates.

Until these corrective actions are taken, the transmission of monetary policy to the housing market will be incomplete.

House price resilience

House prices are likely to follow the same trajectory as sales in the near term. As with many housing statistics, price data are lagged given the time it takes for buyers and sellers to agree on a price and execute their purchase contracts and for deed information to be recorded and transmitted to data aggregators.

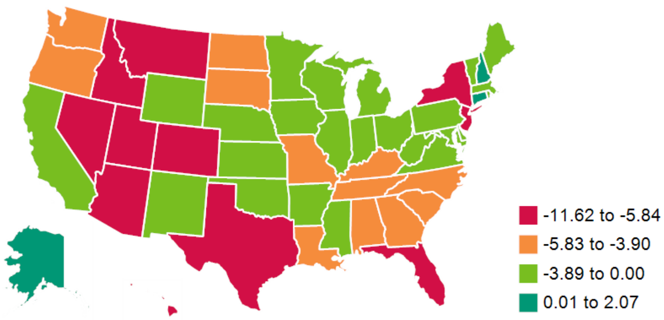
As of the latest Case-Shiller 20-City Home Price Index published on March 31, house prices rose in January by 3.9% relative to the year before. This was an improvement in the growth rate, which had slowed in the second half of 2019. The FHFA all-transactions index showed a similar pattern though growth in prices for homes with a conforming mortgage registered somewhat stronger growth of 5.2% year over year in December.

Unfortunately, these reports now represent a distant memory of a happier time. Home prices are projected to fall by 1% to 5% through year's end under the baseline scenario. But they could drop by 10% to 15% in a more severe scenario under which unemployment rockets higher and much of the country effectively remains shut down for a longer period of time (see Chart 7).

It is important to note that these price declines only reflect transacted sales. The shadow price of housing may have fallen

Chart 8: Home Prices to Fall in the West

FHFA purchase-only index for 2021Q1, % change yr ago



Sources: FHFA, Moody's Analytics

steeply in March and April as any seller in a position where they had to sell may have had to accept a discount given the lack of potential buyers and the large uncertainty premium placed on the future.

However, even this conclusion cannot be drawn universally given shifts in both the supply and demand curves of housing. To the extent demand remains robust in some markets, sellers may still be able to command close to their asking prices.

Unlike the housing bubble that preceded the Great Recession, homeowners today are in a much more solid financial position.

Homeowners' share of home equity is significantly higher due to larger down payments and tighter lending standards, providing them with a cushion. Risky mortgage products such as those with negative amortization or requiring no verification of income or employment are virtually nonexistent.

Furthermore, low interest rates have allowed millions of borrowers to refinance their mortgages, further reducing the financial burdens they face.

As a result, relatively few sellers find themselves in a position where they must sell their homes immediately. In addition, payment forbearance and the 60-day foreclosure moratorium for government-backed mortgages that went into effect as part of the CARES Act will further limit the number of distressed properties hitting the market—at least in the short term. The number of foreclosures in a particular market is a key determinant of house prices as buyers often take their cues from the pool of existing listings and recent transactions to determine if a market is worth buying into.

Regional economic trends will play a predominant role in determining house prices as those areas that experienced faster price growth in recent years may be more susceptible to corrections (see Chart 8). States that are more exposed to the tourism, leisure and hospitality industries such as Hawaii, Arizona or Florida may experience larger drops than midwestern states with relatively low exposures.

A significant unknown is the impact that the coronavirus will have on the future number of retirees and where they decide to live. Given smaller nest eggs and emerging fears of assisted living facilities, many may choose to age in place rather than migrating to warmer climates.

As with the rest of the economy, the future trajectory of home prices and sales depends entirely on the spread of COVID-19.

If the spread of the virus is successfully contained by July, then there is a good chance that households and lenders will be able to restart their lives and the broader economy, albeit slowly. Lenders will take a financial hit due to deferred payments, but their capital resources should be sufficient to allow them to rebuild their balance sheets. Home sales and construction should follow at a modest pace in the quarters to come as households get back on their feet and confidence is restored.

If instead the coronavirus is not contained and lockdowns and social distancing measures are extended for an indefinite period of time, then the situation will become much more critical. Some lenders, particularly nonbank lenders, will face solvency issues as will homebuilders and an increasing number of households. Even if the viral situation is contained by the fall, significant permanent damage will have been done with a number of businesses unable to recover in the aftermath. In such a scenario, the housing market recovery may take years, much like in the aftermath of the Great Recession.

Separate and more unequal

The next few quarters will undoubtedly be rough for the housing market and the economy overall. Even in the absence of a second wave of infections, the recovery will move ahead in fits and starts.

While there is little doubt that a recovery will come, it is unclear what the housing market will look like on the other side of the COVID crisis. Will consumers still want to become homeowners? Will they still prefer urban living, or will suburban and rural lifestyles be preferred? As with all things, the answer likely lies somewhere in between the extremes and depends on specific demographic groups.

The simultaneity of a health scare and an economic shock will have a differential impact across households and will likely exacerbate the trends towards greater inequality and separation across sociodemographic classes that were already in place.

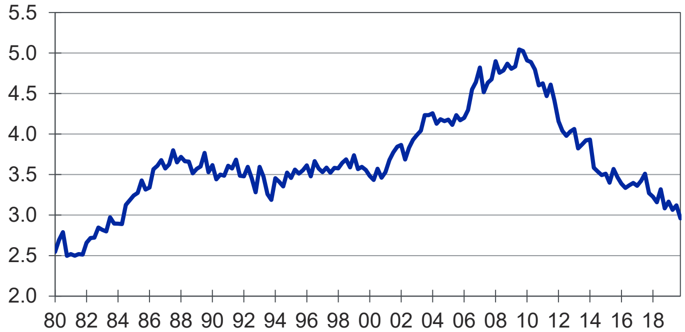
Weeks of isolation and social distancing along with fears of future contagion will undoubtedly lead to an overall preference for additional space.

Suburban areas are likely to see increased demand as city dwellers desire homes with yards, ample pantries, and comfortable home office arrangements. Having been forced to adopt technologies that enable their employees to work from home, businesses will likely continue these trends as they look to cut costs and reevaluate their needs for large office buildings in urban locations. Attitudes toward public transportation may shift as well with workers preferring to use their own vehicles. Resulting congestion may motivate more businesses to relocate to smaller cities and exurban areas.

While more space may be preferred, moving to the suburbs may be a luxury that few are able to afford. Against a backdrop of rising unemployment and stagnant wages, younger families may have no other option than to remain in cheaper, more densely populated areas. Just when many millenni-

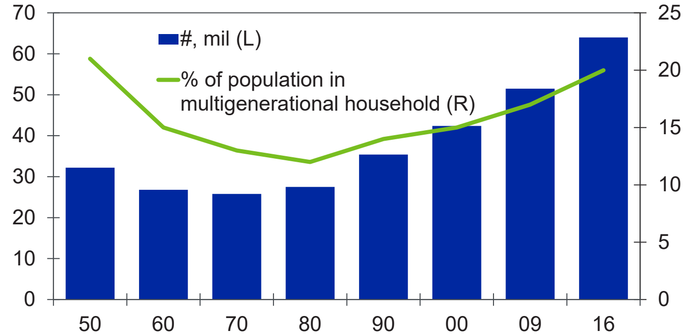
Chart 9: Vacancy Rate

Vacancy rate, homes for sale and rent, %



Sources: Census Bureau, Moody's Analytics

Chart 10: Multigenerational Housing Rises



Sources: Pew Research, Moody's Analytics

als were finding their financial footing after the last recession, the COVID-19 crisis has knocked them back down. Still struggling with student loans and other debt burdens, the dream of homeownership may remain just a dream for many.

Urban rents and house prices may see a drop with an exodus to the suburbs, but this will likely be at the upper end of the market. Starter homes and other affordable housing will remain in high demand given the lack of supply across markets, making it even more difficult for many younger individuals and families to save for down payments.

Even with some additional supply of homes coming on line in the past year, the home vacancy rate remains near the low levels experienced in the early 1980s (see Chart 9).

As a result, trends in the 2020s may mimic those of the 1920s with the well-to-do flocking to the suburbs as the cities fill up with renters stuck at the lower end of the income distribution.

Increasing multigenerational households

Additionally, the pandemic may spur an increase in the number of multigenerational households, a trend that had been silently growing over the past 40 years (see Chart 10).

As the population ages, elderly parents have increasingly relied on their adult children for care. At the same time, rising childcare expenses have led many younger families to turn to grandparents to provide support.

As a result, the number of households where two or three generations are living under the same roof has risen. Given the number of coronavirus infections and deaths associated with nursing homes, this trend may accelerate as more families opt to care for aging parents and grandparents at home rather than risk future illness.

A return to multigenerational living could significantly alter both the location and form of future home construction with buyers preferring larger spaces, separate entrances and first-floor bedrooms.

The only certainty is change

The marks of the Great Coronavirus of 2020 will be felt for years to come. Not only will the effects of the economic shocks to employment and income take years to fully absorb, but consumer preferences have permanently changed as a result of the health scare. Even with a vaccine, individuals who lived through the pandemic will be on continuous alert for the next outbreak.

The silver lining is that the overall need for housing remains and could even increase as families spend more on their homes and less on travel. Given the dearth of available housing, the residential construction industry will rebound and serve as an engine of future growth in many local communities, though the location and type of housing built may change. While the downside risks in the short term are numerous, the upside risk of a stronger rebound over the long term remains.

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