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Business Outlook: A Housing Recovery with a Solid Foundation

Even if policy supports are ended, home affordability and shrinking inventory point to a sector on the mend. But don't expect recent price increases to continue apace

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The broad improvement in the housing indicators in recent months leaves no doubt that the long-awaited housing recovery is finally under way. In fact, homebuilding added solidly to third-quarter economic growth, its first positive contribution in 3 1/2 years. The question now is: Will it last?

Unlike past housing rebounds, this one has received an extraordinary amount of policy support. Tax credits, programs to aid refinancing and loan modifications, and direct Federal Reserve involvement in the secondary mortgage market have all played roles in reversing the mother of all housing slumps. As this assistance ebbs, the recovery will surely feel the loss, but the upturn is built on a solid foundation of improving economic fundamentals that will keep the rebound going.

Policy alone cannot explain the 24% gain in existing home sales since January, nor the 22% increase in new-home purchases, the 40% rise in single-family housing starts, and the recent upturn in home prices. The primary driver is historically high affordability. Fixed 30-year mortgage rates are at 5%, a multi-decade low, and prices have plunged a total of 30% since May 2006, based on the Standard & Poor's Case-Shiller Home Price Index. By that price gauge, homes are well undervalued relative to both rents and aftertax income.

Affordability is typically the No. 1 issue for first-time buyers, who also have been helped by Washington's \$8,000 tax credit. The National Association of Realtors estimates the program will account for some 350,000 of this year's projected increase in sales of existing homes, but that's only about a third of the 1.1 million rise in existing-home sales since January. The NAR says first-timers accounted for more than 45% of all sales in the past year, somewhat above the 40% average for 2007 and 2008.

The share of first-time buyers has most likely risen in recent months, with people scrambling to get a closing date before the Nov. 30 expiration of the tax credit. It now appears Congress will extend the program, which will add a dollop of sales support in 2010. Still, some recent purchases may well have been pulled forward by the program, which could result in temporarily weaker sales in coming months.

The most important impact of stronger demand has been the rapid shrinkage in the inventory of unsold homes, a key reason prices are firming up. Builders' supply of new homes has shrunk dramatically. It would take 7.5 months to sell their inventory at the September sales rate, down from a peak of 12.4 months in January. Current trends in sales and inventories suggest supply will dip below the pre-2006 long-term average of about six months by yearend. Builders have cut output so far below sales that inventories can decline, even as starts increase.

The supply of existing homes in September fell to 7.8 months, down from a peak of 11.3 months in April 2008 and the lowest in 2 1/2 years. Given this year's trends, inventories will drop below seven months by yearend. A