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MACROCOSM

It's Okay You Didn't Build That

Friday, July 20, 2012

Donald Luskin

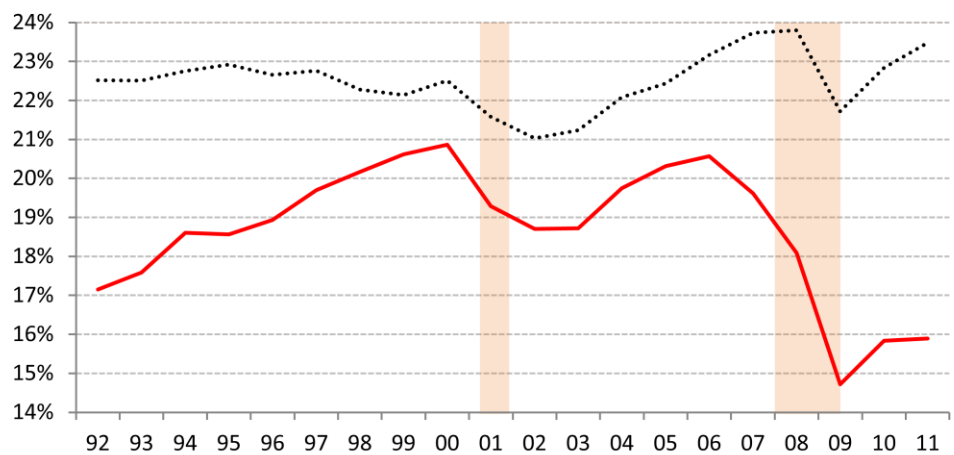
A housing recovery even without new construction is our second best hope for better growth.

Coming into 2012 looking for no acceleration in US growth (see "2011: A Lost Year" December 29, 2011), with deeply undervalued stocks melting up in the first quarter, we looked for points of vulnerability (see "What Could Possibly Go Worng?" March 8, 2012). As expected, the recovery remains distressingly L-shaped (see "On the June Jobs Report" July 6, 2012), and stocks have been mired in a correction for almost three months, and the year-end fiscal cliff draws nearer (see "The Fiscal Cliff Bites" July 12, 2012). So let us turn to a question we get frequently now from clients: *what could possibly go right?*

One candidate for your consideration is: *housing*. As we all know, it was ground zero for the Great Recession. And obviously, it's been a key factor missing from our current Not So Great Expansion. In fact, we've observed many times that the utter lack of recovery in fixed investment, of which housing is a component, is the signature shortcoming of the present cycle (please see the chart below, and again "On the June Jobs Report").

We're particularly drawn to this topic now because we just relocated from Silicon Valley to Chicago. It took three and a half years of trying, and one of the largest IPO's in history -- we sold our house to a Facebook

Fixed investment share of GDP ··· Global — US ▮ US recession



Source: IMF, NBER, TrendMacro calculations

Update to strategic view

US MACRO: There are anecdotal hints that housing is finally starting to recover -- it's not showing up strongly in the data, but it's been underway modestly and without fanfare for two years already. A housing recovery need not include a revival of new home construction. Much can be gained from the wealth effects that arise from more active exchange of existing homes. Other than a pro-growth outcome to the November election, for us this is the most tantalizing possibility for getting unstuck from an L-shaped recovery.

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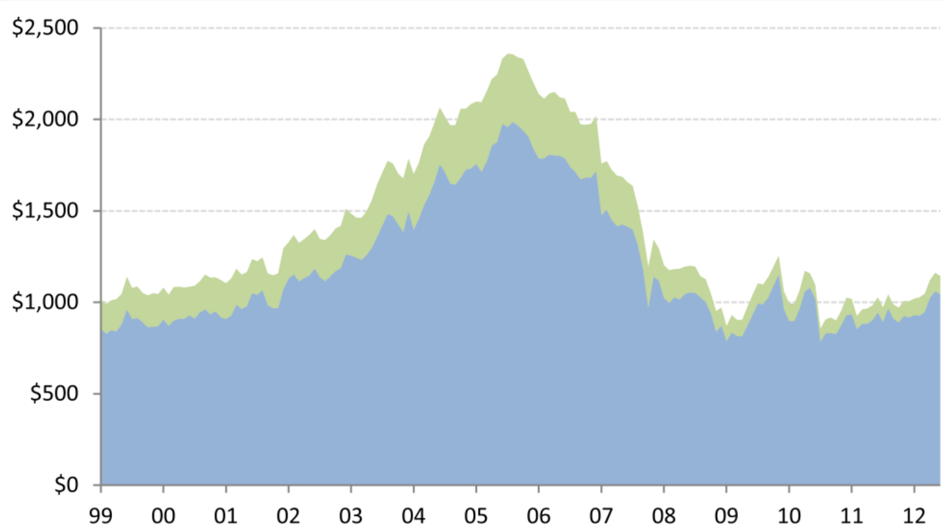
millionaire. Buying two condo units in Chicago (in different parts of the same building on Lake Shore Drive, one for home, one for office) was relatively easy, but we could feel the market there firming.

As we've mentioned this to clients around the country, pretty much without exception we've heard reports of various degrees of recovery in their local areas -- some of it quite energetic. Even Ben Bernanke seems to agree, saying in his Senate testimony this week, "We have seen modest signs of improvement in housing." Regardless of the source, it's difficult to find much data to get wildly enthusiastic about. The best Bernanke could come up with was to say "both new and existing home sales have been gradually trending upward since last summer…"

For reasons we will expand on momentarily, we think the relevant metric is the *aggregate dollar value* of housing transactions -- this takes into account both price and quantity, and both new homes and existing. Seen this way, the trend Bernanke is talking about is tepid, and only brings us back to levels of a decade ago (please see the chart below). But the trend is better than he makes it out to be: it's been consistently in place since *two* summers ago.

TrendMacro Housing Transaction Value Aggregate
Existing homes **New homes** USD bil, SAAR, nominal



Source: Census Bureau, National Association of Realtors, TrendMacro calculations

The chart above gives the impression that all the improvement has been in existing homes, and none in new homes. This is only partially true.

- Actually, the value of new home sales has improved more since they both bottomed in July 2010 -- up 41.7% versus 32.9% for existing.
- But the value of new home sales remains 74.1% off its July 2005 peak. The value of existing home sales is 47.5% off its August 2005 peak.

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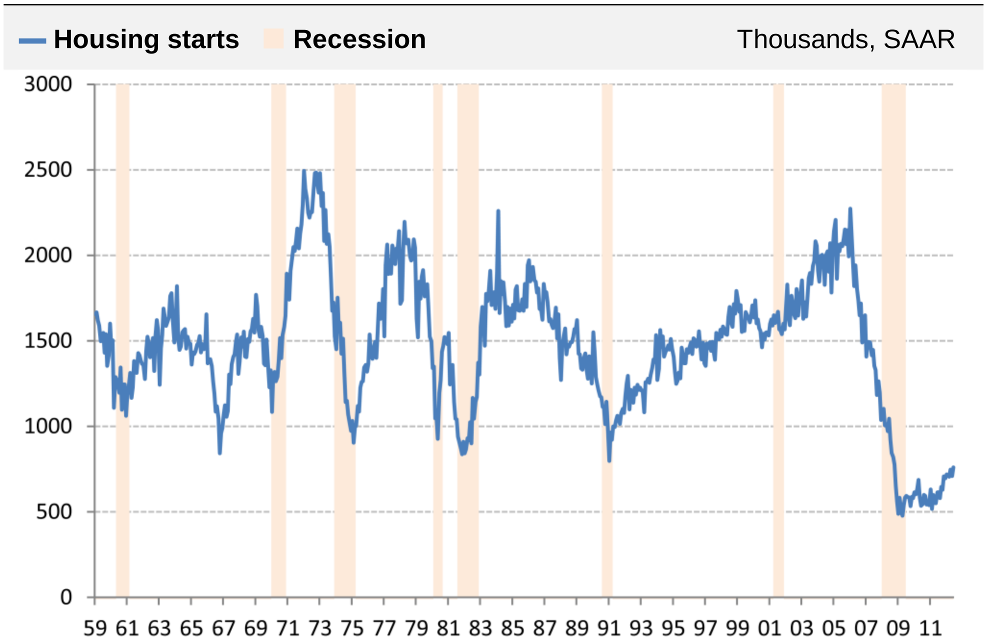
- It's hard to see what improvement there has been in the value of new home sales because it is swamped by existing, and it always has been.
- The greater percentage improvement in the value of new home sales since the bottom translates to $29 billion on an annual basis. The smaller percentage improvement in existing translates into $258 billion.

It would be *especially* helpful to see more dollar improvement in the value of new homes sales, because -- obviously -- that would imply growth in housing starts that would re-employ an army of construction workers displaced since 2005 (please see the chart below). But we think it would



Source: Census Bureau, NBER, TrendMacro calculations

be a mistake to think that the improvement in the value of *existing* home sales won't be helpful, too.

- Yes, transactions in existing homes are only exchanges. It's easy to underestimate the importance of that, and succumb to the cliché that "America doesn't *make* anything anymore -- we just trade stuff."
- That's a mistake. For one thing, exchanges -- the transfer of control of resources from one person to another -- are what make an economy dynamic. It is possible that one contributor to the stagnation of the labor market -- in which it seems no one can either leave an existing job or get a new one (see "On the February Jobs Report" March 9, 2012) -- is that labor can't relocate to find its highest use, immobilized by the inability to exchange housing.
- More important, *the mere act of exchange creates wealth, just as surely as "making things" does.* Whenever people voluntarily exchange things, they only choose to do so because it will make

them better off -- that is, that they will make themselves wealthier, simply by virtue of the exchange itself. It is a positive-sum game.

- Macroeconomists are, effectively, trained not to see this dynamic. They judge the economy's health primarily by measuring production, through such measures as gross national product. GDP *does* include new home construction (in the residential fixed investment category). Stipulating the overhang of new home inventory still left over from the bubble era, viewed as a production phenomenon housing seems hopeless for many years to come.
- Yet GDP completely ignores the value of exchanges of existing homes. That value is currently running at about $1.1 trillion on an annual basis -- a very *large* number, representing 6.7% of GDP (please see the chart below). Ignore the run-up to the bubble peak in 2005 -- compared to even pre-bubble levels, today's seemingly large value of housing exchanges is, in fact, anomalously *small*. No wonder the present expansion -- in output terms -- is L-shaped. It is also L-shaped in terms of the contribution of wealth-creating housing exchange.

Value of existing home transactions as fraction of GDP

Source: National Association of Realtors, BEA, TrendMacro calculations

- When we become wealthier through exchange, the "wealth effect" comes into play. We spend more, we invest more and we risk more.
- The wealth effect arising from exchanges in housing is especially powerful.
- Housing is by far the largest exchange that most people make, so it creates the largest wealth effect.
- And when one has just acquired a new house, that wealth effect immediately comes into play in the myriad expenditures and investments inevitably required to adapt a new house to one's personal requirements.
- *That is to say: housing is uniquely subject to positive externalities -- or "multipliers."* So it is uniquely able to generate a self-sustaining virtuous cycle of economic growth.

- Massive government stimulus in 2009 was unable to kick-start growth because it was targeted at personal consumption. In the age of Walmart, consumption has no multiplier. Indeed, the logistics gurus at Walmart are all about reducing the multiplier to zero -- from their standpoint, positive externalities are wasteful leakage from their perfectly controlled supply-chain.
- Further, the exchanges enabled by stimulus programs (or Fed suppression of mortgage interest rates) are not truly voluntary -- they are *forced* exchanges. As voluntary exchanges are wealth-creating, forced exchanges are wealth-reducing -- they are negative-sum games. Even if the recipient of a stimulus dollar is wealthier for having received it, that is offset by the subtraction of that same dollar (now or in the future) from the taxpayer who will have to provide it. And they leave *everyone* in the economy uncertain as to whether, in the future, he or she will end up a winner or loser.
- We believe that over the last four years the economy has been systematically weakened by a regime of increasing forced exchanges, and the threat of more forced exchanges (see, most recently, "On the SCOTUS Obamacare Decision" June 28, 2012).

What we have outlined here is mostly a thought-model for understanding the contribution to growth made by housing, one that relaxes the typical requirement that the improvement come in new home construction. This is not intended as a fearless prediction that housing is about to take off, lifting the whole economy with it. We can't let ourselves get carried away with what are, so far, merely hints based mostly on casually acquired anecdotes. But what finally shows up objectively in the data must, necessarily, begin with hints. The hints are there, and the data doesn't contradict them.

Forgive us, please, for what may be mistaken as a political statement, but our best hope for a phase-shift to higher growth lies in a pro-growth outcome to the November election, and a repudiation of the present regime of forced exchanges (see "Light at the End of the Cliff?" June 11, 2012). Such an outcome would help what may be a nascent housing recovery -- indeed, it would help *everything*. But *not* getting that outcome wouldn't completely kill a housing recovery. Even with the present regime as an unchanging background, a recovery in housing -- thanks to the "multiplier" it implies, and starting from what is still a very low base -- could nevertheless become self-sustaining and make a positive difference.

Bottom line

There are anecdotal hints that housing is finally starting to recover -- it's not showing up strongly in the data, but it's been underway modestly and without fanfare for two years already. A housing recovery need not include a revival of new home construction. Much can be gained from the wealth effects that arise from more active exchange of existing homes. Other than a pro-growth outcome to the November election, for us this is the most tantalizing possibility for getting unstuck from an L-shaped recovery.