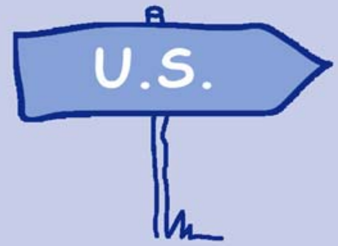
Economic Research Department

BBVA



Real Estate Observatory

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- Contrary to past recessions, residential investment won't lead recovery in the current economic environment
- Despite the upturn in home sales, housing starts remain weak due to historically high existing homes inventory
- To see an increase in housing production, we need to have a further rise in sales, coupled with fewer foreclosures, as well as price stability

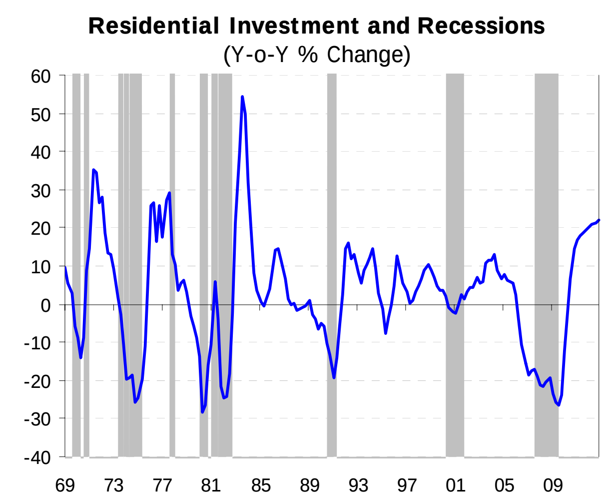
Housing investment will remain low

In past recessions, residential investment has been a reliable leading indicator of the economic cycle: it falls several quarters before the economic recession starts but it improves before the recession ends[1]. In the long term, residential investment, as well as housing sales, is a matter of consumer expectations: when they are positive, housing demand increases, and vice-versa.

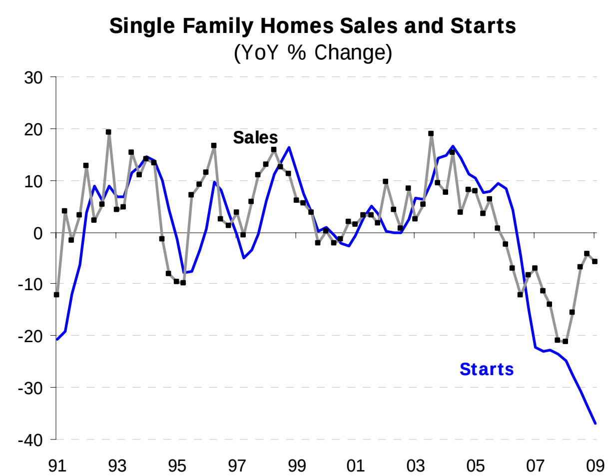
From a historical point of view, residential investment has been closely related to housing sales: when the latter rises, residential investment increases and when it drops, residential investment decreases. Historical correlation among those variables is currently close to 80%

Starting in mid 2008, the trend in housing sales has become more positive (despite they are still in negative figures, the home sales are already recovering when considered on a yearly basis). However, in the current economic environment some questions arise: Is total housing sales a consistent leading indicator of residential investment? Are there any other factors that need to be considered?

In order to have a positive effect in the economy, an increase in sales should be accompanied by an increase in housing starts. This is not the case in the present situation.



Source: NAR, Census, BEA and BBVA ERD
Note: economic recession in shaded



Source: NAR and Census

[1] According to Leamer, E in "Housing IS the business cycle" NBER Working Paper No. 13428, page 13, September 2007: "...residential investment is subtracting from GDP growth before the recession but starts to contribute more than normal in the second or third quarter of the recession ... Eight out of ten recessions were preceded by sustained and substantial problems in housing..."

Housing sales and inventories: a tale of two markets

Although housing sales have been falling since 2006, the rate of sales has been improving since mid 2008 and the trend indicates that it could be positive by the end of current year.

However, for the first time since data began, the evolution of existing and new home sales is following very different patterns: while existing home sales are recovering slowly, new home sales are still declining significantly. This divisive evolution of home sales is defining two “separated” housing markets: one for the existing homes and another for new homes.

Several factors explain this unusual evolution of existing and new housing sales: the large inventory of existing homes for sale, more positive affordability ratios for existing homes than for new ones and frequent auctions of homes on foreclosure.

In regards to existing homes, inventories reached a peak in the first months of 2008 and have since decreased. Single family homes, for example, hit a historical high of 3.73 M in January 2008. The inventory has since diminished to the current level of 3.20 million of units, which was still 40% above the historical average.

In the case of new homes, as the inventory increased in 2006, housing starts moderated. By the time the inventory of new homes reached the peak in the summer of 2006, the rate of housing starts was already negative. After three years of decreasing housing production, the inventory of new homes for sale has diminished significantly: it is currently under 300.000 units, 15% below its historical average. Usually, a low inventory of new homes would stimulate new construction, but in this case, the high inventory of existing homes is eroding the market

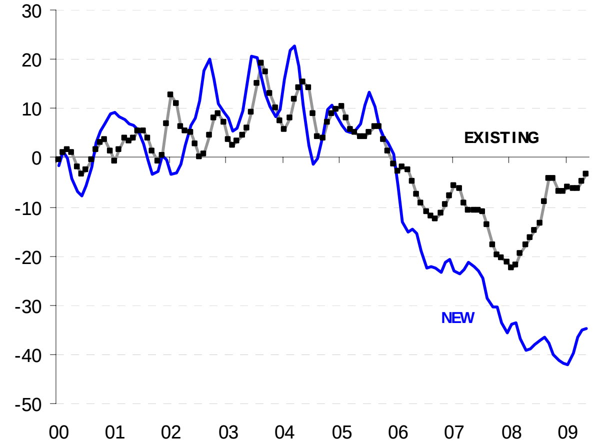
Due to higher inventory, home prices have adjusted more intensively in the market for existing home than in that of new homes. As a consequence, affordability ratios are more positive for existing houses than for new ones and the cost of home-ownership is lower.

Bottom line:

In order to have positive housing production we need to see a steep fall in existing home inventory, which would require an increase in sales coupled with fewer foreclosures. Once the oversupply of inventories is eliminated, new homes could be more competitive with the existing ones.

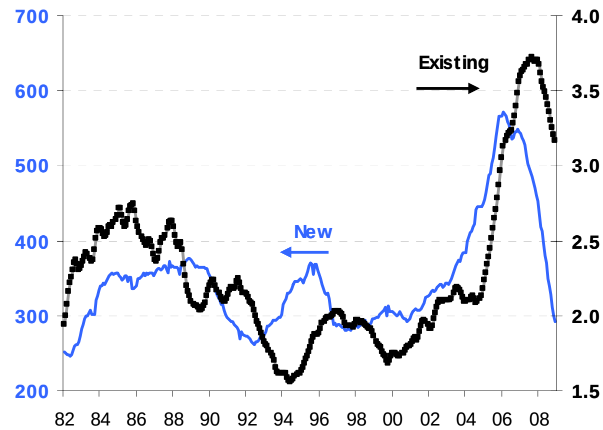
If inventories drop, prices would stabilize. If that point, there would be a strong incentive for households to return to the housing market, thus increasing not only demand but also housing production.

Housing Sales.
(New and Existing. Saar. Y-o-Y % Change)



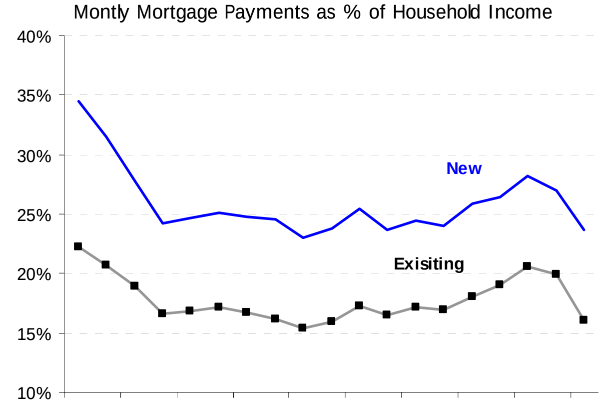
Source: Census & NAR

Single Family Home Inventory
New (thousands) and Existing (millons, saar)



Source: Census & NAR

Home Ownership Cost
Montly Mortgage Payments as % of Household Income



Source: BBVA ERD