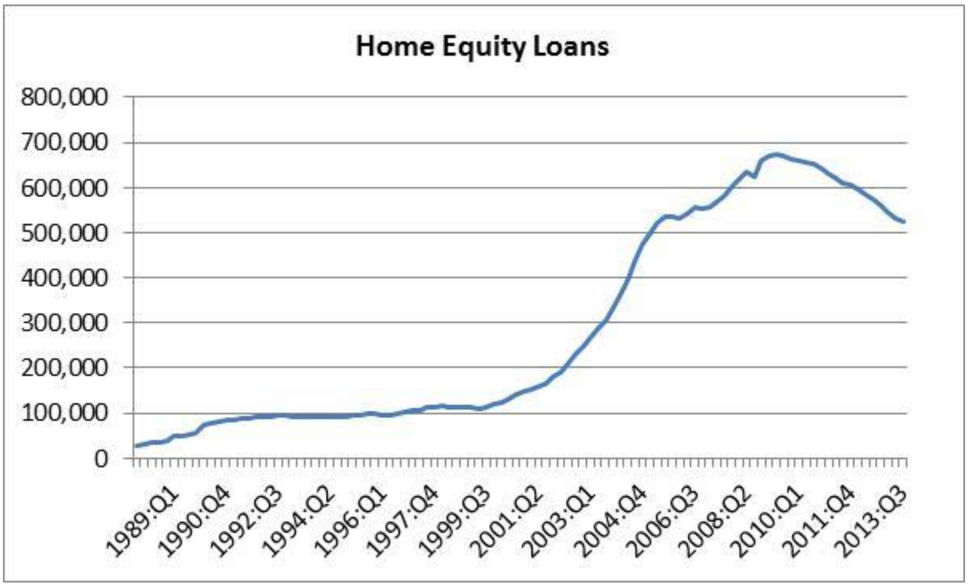
Do Rising House Prices Still Create a Wealth Effect?

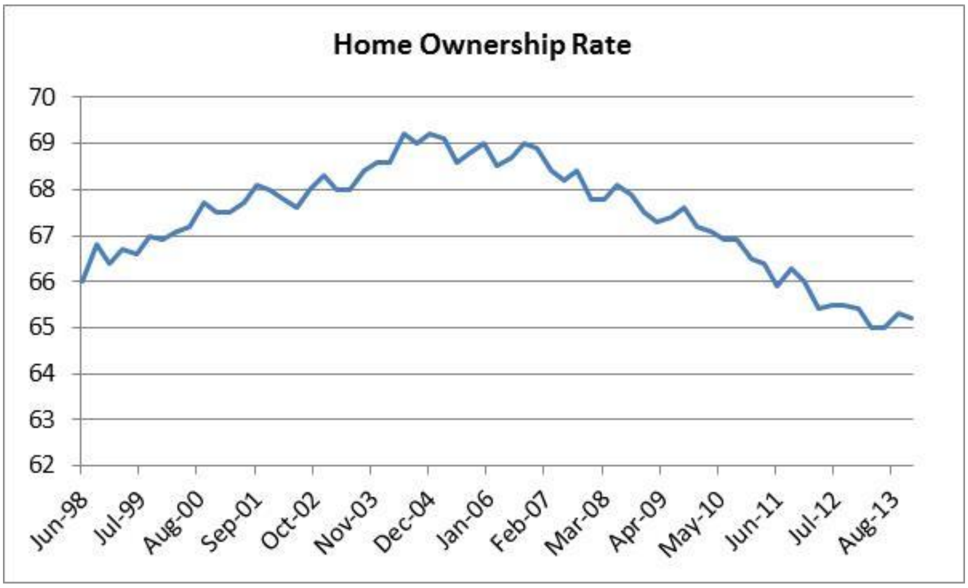
When I read market commentary on the US consumer I am assured that they are going to continue in the spending ways through 2014 and beyond. Although the US economy has rebounded we have yet to see any meaningful increase in wages in the US which you would think would be necessary for consumption growth.

Many commentators cite the wealth effect of rising house prices as being a key driver of US consumption. Received wisdom is that rising house prices make home owners feel wealthier which then encourages more spending. Certainly this was the case during the bull market from 2003 to 2007 in the UK and the US. Against the feel good factor of higher house prices, there was always the negative aspect that higher house prices requires people to save more to pay for a deposit.

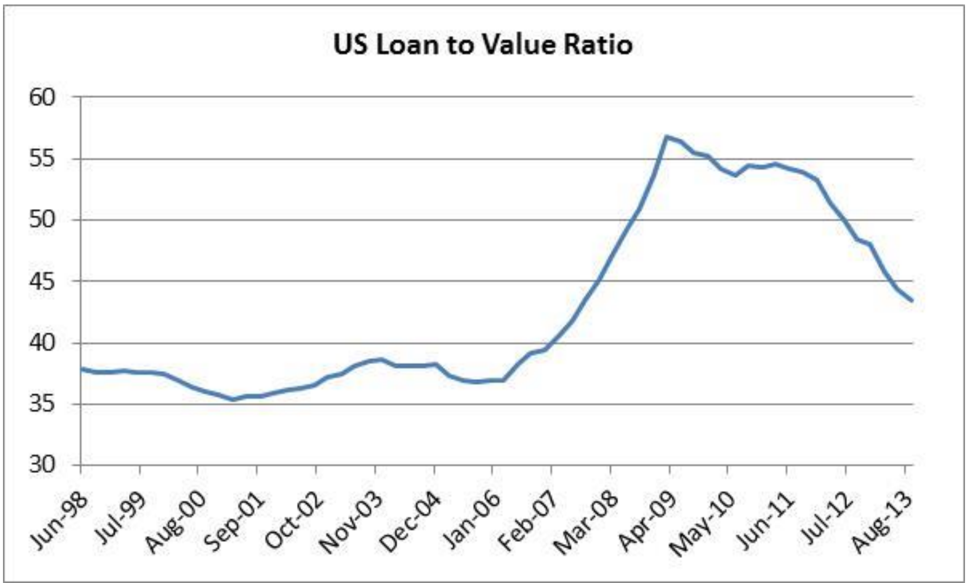
One aspect of home owning "wealth effect" is very easy to measure. For some home owners as the value of homes rise they could use home equity loans to extract value of their homes for consumption. As FDIC data shows, this type of behaviour has not returned, implying that the wealth effect of rising homes is somewhat diminished.



Further the decline in home ownership in recent years would also suggest the wealth effect of home ownership is reduced.

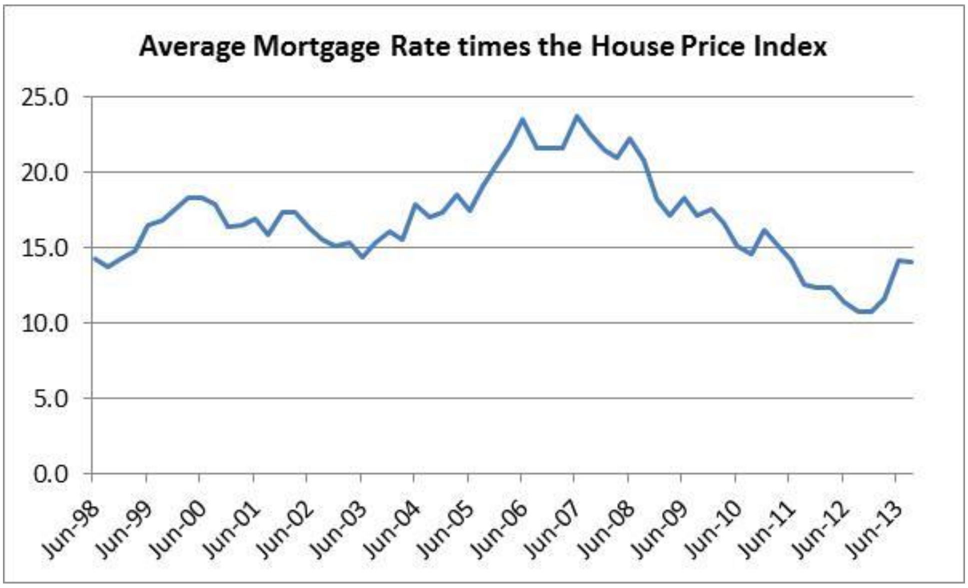


Of course both of these measures are backward looking, perhaps the recent surge in house prices could presage a burst in new housing related borrowing by US consumers.



Looking at the loan-to-value ratio we can see that the US housing market has not deleveraged to historic levels yet, suggesting banks would be reluctant to significantly increase home loans in my view. All of this suggests the wealth effect of higher house prices could be much more muted than the market expects.

Against this reduced wealth effect, the combination of the recent rises in house prices and long term bond yields in the US has greatly reduced the affordability of housing in the US in the last six months. To track this we use a very simple measure, taking the average house price and multiplying It by the average mortgage rate. Homebuyers are facing the first decline in affordability since the financial crisis.



All this leads me to suspect that unless we see a marked change in lending practices of banks, market predictions of strong US consumption growth may be misplaced.

Information

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