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January New Home Sales: More A Supply Side Than A Demand Side Issue

- > New home sales fell to an annual rate of 593,000 units in January from December's revised sales rate of 643,000 units.
- > Months supply of inventory stands at 6.1 months; the median new home sale price rose by 5.1 percent on a year-over-year basis.

New home sales fell to an annualized rate of 593,000 units in January, short of both the consensus forecast (641,000 units) and our forecast (663,000 units). At the same time, prior estimates for sales over the prior few months were revised higher, including December sales, which are now reported at 643,000 units rather than the 625,000 units initially reported. Though the decline in the headline sales number is noteworthy in its own right, what to us is more telling is the decline in not seasonally adjusted sales – as our regular readers by now know, we have little use for the seasonally adjusted annualized basis on which the data on residential construction and sales are reported and instead focus on trends in the raw data. On a not seasonally adjusted basis, new home sales fell from 49,000 units in December to 44,000 units in January, which stands out because unadjusted sales typically rise during the month of January. So, the question then becomes whether the decline logged this January reflects issues on the demand side of the market or the supply side of the market. Our first point here is that the new home sales series is one of the most inherently volatile of any of the top-tier data series, so one should never draw broad conclusions from the data for any given months. Our second, and more relevant, point here is that supply constraints are acting as a drag on new home sales, as is also the case in the market for existing homes.

To our first point above, new home sales in the South region have been a bit volatile over the past several months, reflecting the impacts of and subsequent rebuilding efforts from Hurricanes Harvey and Irma. It is worth noting that the revisions to the most recent months of data on total new home sales almost exclusively reflects revisions to sales in the South region. This isn't to say the initial estimate of January sales in the South region will also be revised higher, but our miss on our forecast of not seasonally adjusted sales (50,000 units as opposed to actual sales of 44,000 units) mainly reflects our miss in the South region, where the 23,000 sales fell short of our forecast of 27,000 units. January sales in the Midwest and Northeast regions may have been impacted to some degree by atypically harsh winter weather, but this should not be much of a concern as these sales will be made up for at some point down the road.

As to our second point above, at first glance it may seem curious that, with the months supply metric sitting at 6.1 months in January (6.0 months is commonly seen as reflecting a balanced market), we are arguing supply side issues are weighing on sales. This is where it helps to look at the details of the data, including the not seasonally adjusted data, rather than settling for a cursory account looking to fit a narrative around the decline in headline sales. For instance, as we discussed in detail in our February 2018 *Monthly Economic Outlook*, reported new home inventories include units on which construction has not yet started, which in January accounted for just under one-fifth of reported inventories. Our focus is on what we refer to as "physical" new homes for sale, i.e., either completed units or units currently under construction. Inventories of physical new homes for sale remain far short of historical norms (our measurement of which does not include the pre-recession building frenzy), and sales of units on which construction has not yet started continue to account for a notably elevated share of total new home sales. As such, builders are facing increasingly large backlogs of unfilled orders and it is not inconceivable that these backlogs could lead builders to turn away prospective new sales, if they have not already begun to do so. It is also worth noting that sales remain significantly skewed towards higher priced homes, a trend we have been highlighting for some time. Despite there being a good deal of discussion around significant untapped potential at lower price points, we think there is a limit as to how low builders can, or will, go given rising costs for materials and labor and what in many markets are more costly and cumbersome entitlement processes.

We've consistently argued that there would be little relief on the supply side of the new homes market in 2018. Rising mortgage rates, however, pose a threat to an otherwise healthy demand side of the market. Not so much at present, but if rates continue to rise in conjunction with prices remaining elevated, affordability will suffer, as too will sales.

