

FINANCIAL FAQS

Is Inventory of Unsold Homes Becoming Excessive?

One of the leading indicators of a downturn in housing is typically a run-up in unsold inventories, as housing demand wanes and the number of units for sale increases - both in absolute terms and relative to home sales. The July figures for new and existing home sales were recently released, along with estimates for inventories. Do these new figures show that inventories of unsold homes are rising? Are they at levels that suggest a downturn is in the offing? Or is there little to worry about at this point? The evidence is mixed.

There are two ways to look at housing inventories: the absolute number of homes for sale, and the months' supply of units for sale (what economists would term the inventory/sales ratio). Both are useful measures, and both are available for new and existing homes. Note that the concept of unsold inventories is somewhat more tangible for new homes than for existing. This is because a homebuilder has a significant incentive to quickly sell a home that he has built for sale (otherwise the carrying costs become prohibitive), whereas the owner of an existing home can take that home off of the market if it doesn't sell for what he considers to be an adequate price. Of course, if the seller of an existing home were forced to sell the house (because, for example, of a life event that reduced his ability to make mortgage payments or a move to a new city for job or retirement purposes) then the unsold existing home would be just as tangibly unsold inventory as an unsold new home.

New Home Inventories

Because the pace of new home sales is so strong (July's annualized sales pace of 1.41 million units was a record by a significant margin), the inventory-sales ratio is low. In fact, this ratio has been at historical lows for the past eight years. Since hikes in this measure have always been well correlated with housing downturns, the low level suggests no danger.

Unlike the inventory-sales ratio, the actual inventory of unsold homes has climbed to record highs. Historically at the beginning of housing downturns, home sales have fallen before declines in the number of homes for sale -- indicating that builders have lagged behind buyers. If the same thing should occur this time, then the record level of unsold inventories suggests that the inventory-sales ratio could soar. Fortunately, the portion of unsold new homes represented by completed units is not especially high. Instead, the total inventory figures have been elevated by unsold homes under construction and unsold homes not yet started. This last category has risen to all-time highs -- and it suggests that builders may have become more cautious in this cycle than in previous ones. If home sales should decline, then a builder would have lost the cost of a building permit -- but this would be considerably less onerous than if the builder had a completed house to sell in a down market.

Existing Home Inventories

At the beginning of 2005, the inventory-sales ratio for total existing homes (single-family plus condos and co-ops) dropped to all-time lows, but has been rising since then. Even with this rise, the ratio has climbed only back to the levels of 2003 -- perhaps suggesting that the market is moving more into balance (after a year in which demand exceeded the supply of homes for sale). The longer historical data on the inventory-sales ratio for single-family existing homes tells a similar story: a recent uptick, but to still historically low levels.

The picture is less sanguine, however, with regard to condos and co-ops -- where the inventory-sales ratio increased from 3.1 months in June 2004 to 5.3 months in July 2005 (the time series only goes back to the beginning of last year). Even without a lot of historical data, this is a pretty hefty hike.

Actual unsold total existing home inventories have been rising for the past five years, pushed up by single-family units as well as condos and co-ops. Even so, the level of inventories remains far less than the average level during the strong housing market of 1984-1989. But, as with the inventory-sales ratio, the picture is more worrisome for condos and co-ops. For this segment of the market, the level of unsold inventories has soared -- nearly doubling from the beginning of 2004 to July 2005.

We have been concerned for some time about the sharply rising investor share of housing demand, and there have been many reports that investor buying has been concentrated in the condo market. If investors have been more active in the condo market, then the recent rise in unsold inventories (as well as the inventory-sales ratio) may be a sign that investors are beginning to disengage from the condo market.

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