The Armchair Analyst

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Housing markets are affected by a myriad of seemingly complicated factors. Each week, a barrage of statistics on such things as retail sales, unemployment rates, GDP growth, exchange and interest rates, housing starts and so forth flood the air waves. Making sense of all the numbers may seem to be a daunting task for all but the most experienced economists.

However, a cursory understanding of some simple rules of thumb can empower anyone with an ability to provide remarkable insight into housing markets. This is the first in a series of articles aimed to help even the most economically challenged become a proficient armchair analyst. We start with supply and demand and their effect on home prices. In later issues, we'll delve into the engines of housing demand.

Supply and demand are central components to current home prices. Over the long term, the housing stock expands to meet the needs of a growing population. However, short term market imbalances are common, as it's difficult for home builders and city planners to respond quickly to fluctuations in consumer demand. The delay between changes in demand and the number of newly completed homes creates periods of under-supply and over-supply that impacts home prices. The number of homes for sale in the resale market typically has an even larger impact, as there are many more homes for resale than new. Since home builders take their cue from conditions in the resale market, we'll focus our attention there.

When a housing market is 'hot', there's a relatively high level of demand to the available supply, and the opposite in a 'cool' market. It's a myth that demand actually exceeds the overall supply in a hot market. What's closer to the mark is that the quantity of homes demanded at a certain price exceeds the supply available at that price. Under these conditions, home prices are bid up through competing offers on competitively priced homes. In a cool market, home sellers compete with one another in price to attract a buyer from a limited pool of house hunters. Thus, a buyers' or sellers' market depends on the relative level of demand and supply.

Real estate practitioners pay close attention to the number of homes for sale and the level of actual transactions. Active listings, the total number of homes for sale on the Multiple Listing Service® (MLS®), can be compared to the number of actual MLS® home sales in any given month. The ratio of home sales to active listings is a good indication of any upward or downward pressure on home prices. Figure 1 illustrates the relationship between the sales-to-active listings ratio (SALR) and changes in home prices in Vancouver.

As home sales rise relative to the number of homes listed for sale, home prices are pushed higher. In 2008, a contraction in demand and an increase in the number of home listings pulled the SALR down sharply, below 0.10 or 10%, leading to a strong buyers market and declining home prices. A dramatic increase in demand this year had the reverse effect, drawing down the supply of homes for sale and pushing the SALR above 0.25 or 25%, leading to upward pressure on home prices.

This is a good rule of thumb: home prices are typically pulled downward when the SALR is below 0.10 or 10% and pushed upward when above 0.25 or 25%. Home prices tend to exhibit little upward or downward pressure when the SALR is between 0.15 and 0.20. In other words, home sales are 15-20 per cent of the total active listings in a given month. At this level, a relative balance exists between supply and demand. Of course, consideration should be given to the direction of the SALR. A quick check of the SALR over the previous several months can help you understand if market conditions are deteriorating or improving.

In the next issue, we'll examine how mortgage rates are determined and their impact on housing demand.

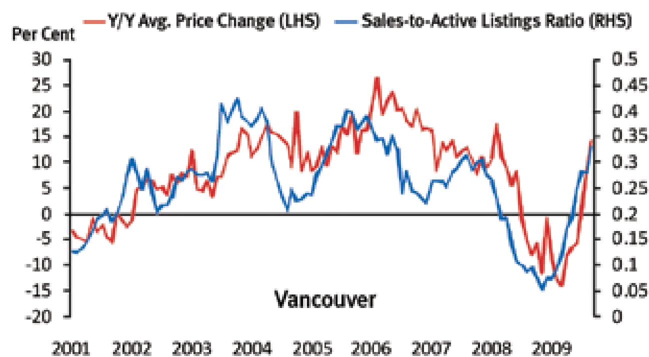

Figure 1