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CAPITAL MARKETS

US OCTOBER EXISTING HOME SALES STRONG BUT HIGHER RATES POSES DOWNSIDE RISKS

** US existing home sales advanced 2% m/m in October to an annualized 5.6mn, well above the Consensus forecast (5.44mn) and the highest pace since February 2007*

** The recent jump in mortgage interest rates could lead to a surge in home buying activity followed by subsequent declines*

**Despite the almost 50bp jump in mortgage rates over the last couple of weeks, they remain historically low around 4% so impact on activity may not be large or persistent*

US existing home sales advanced 2% m/m in October to an annualized 5.6mn, well above the Consensus forecast (5.44mn) and the highest pace since February 2007, and residential investment should contribute positively to GDP growth in Q4 for the first time since Q1. Sales are on track to rise over 3% in 2016, a deceleration from 2015's strong 6.3% gain. Home sales are likely to show only slight to moderate growth in the medium-term as the low inventory of for-sale homes constrains sales and places upward pressure on home prices. Improvement in residential investment will be driven mostly by new residential construction, as the short supply of homes and continued robust demand spur construction activity.

The recent jump in mortgage interest rates could affect existing home sales in the near term. After the "Taper Tantrum" in May 2013 which led to a spike in mortgage interest rates, there was an initial surge in home-buying activity (see Chart 1). Indeed, surveys of consumer sentiment in mid-2013 showed that persons sought to lock in interest rates in fear of further rate increases (see Chart 2). Therefore, strong home sales could continue through the end of the year.

If this spike in interest rates is sustained, expect to see a sustained drop in existing home sales early next year. After the initial surge in home sales in 2013 following the "Taper Tantrum", existing home sales declined every month between August 2013 and February 2014.

Further, empirical analysis also suggests that a jump in rates could weigh on home sales. The impulse response function from a simple vector autoregression (VAR) model including single-family existing home sales, 30-year mortgage interest rates and the median sales price of single-family homes indicates that a shock to mortgage rates has a persistent negative effect on existing home sales (see Chart 3).

Still, despite the almost 50bp jump in mortgage rates over the last couple of weeks, they remain historically low around 4% (see Chart 4). Moreover, continued improvement in labor markets and the economy should help housing become affordable for more individuals. So taken together, although a surge in interest rates will probably weigh on home sales activity, the magnitude of the slowdown may not be large or persistent.

Residential investment accounts for under 4% of US GDP, so it is not usually a major driver of growth. Housing has had a challenging year, subtracting from GDP growth in the last two quarters. The expectation is for residential investment to add a few tenths of a percentage point to GDP growth in coming quarters, but a sustained rise in rates could temper those expectations.

22 November 2016

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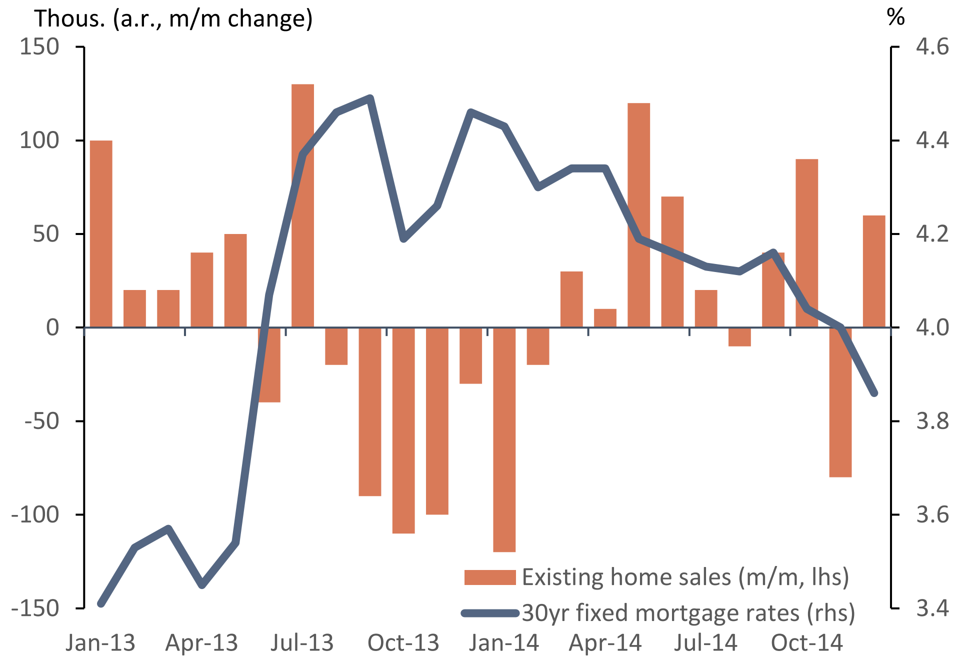
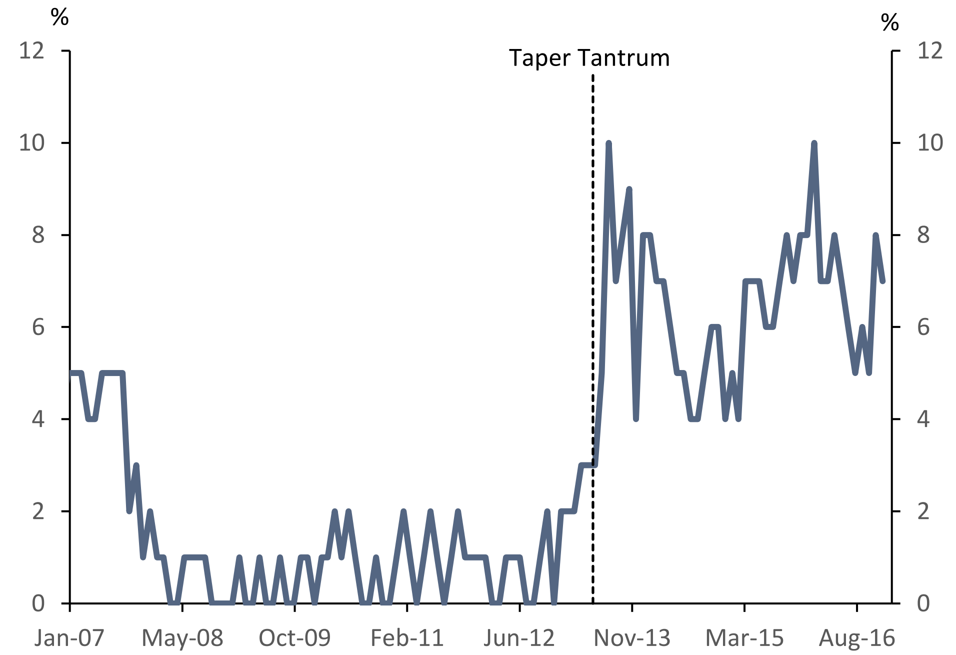
In terms of equity market reaction to the rise in rates, the S&P 500 residential REITs index has gone down in the last two weeks and has a strong negative relationship with mortgage interest rates (see Chart 5). Indeed, after the "Taper Tantrum", the S&P 500 residential REITs index fell 18% from its 2013 peak (May 21st) to its 2013 trough (November 25th).

Chart 1: Existing home sales (month-over-month change) and 30yr mortgage rate



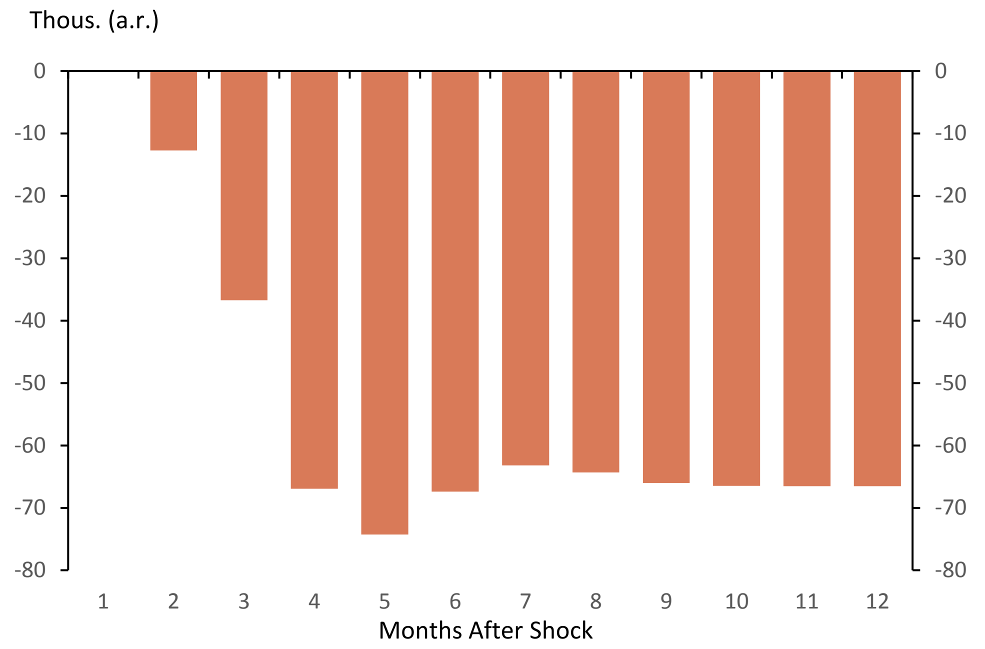
Source: Monthly data. Source: National Association of Realtors, Federal Home Loan Mortgage Corporation, Bankrate.com, and Berenberg Capital Markets

Chart 2: Share of consumers viewing current home buying conditions as good because borrowing in advance of rising rates



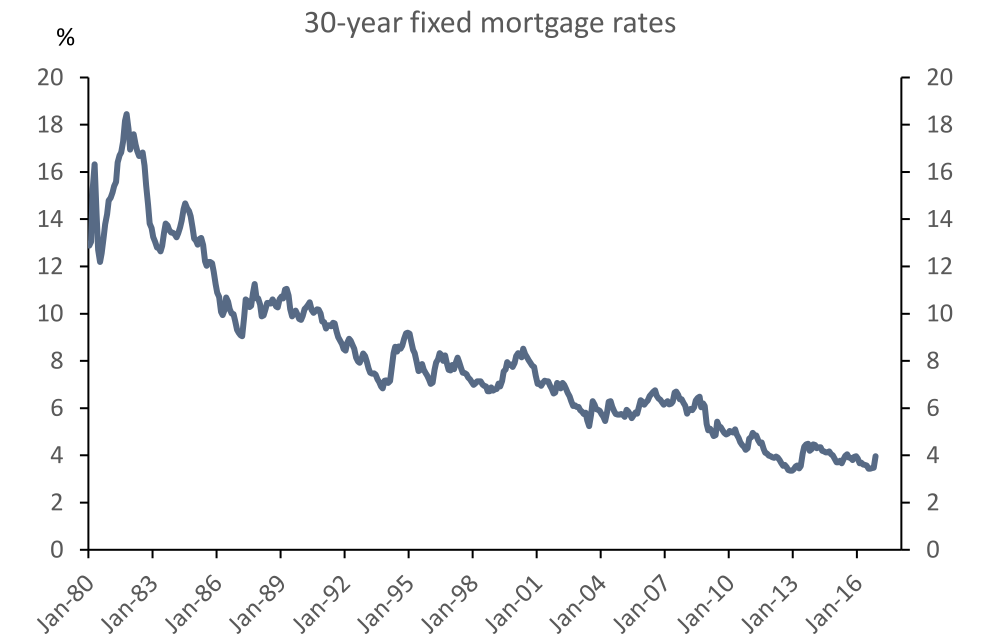
Source: Monthly data. Source: University of Michigan, Bloomberg and Berenberg Capital Markets

Chart 3: Response of Single-family Existing Home Sales to Shock in Interest Rates*



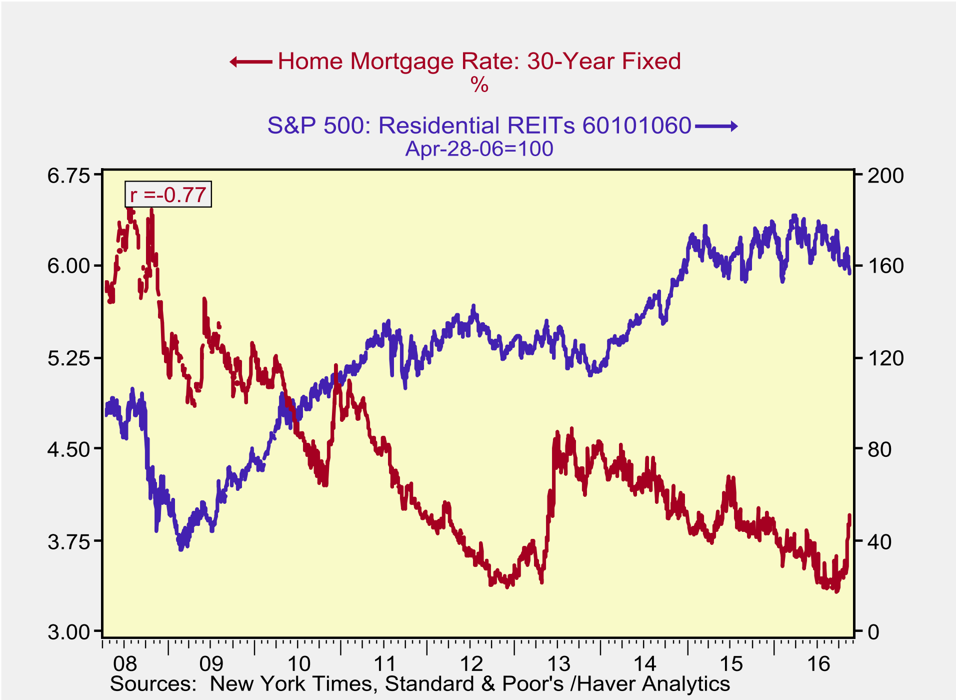
Note: Impulse Response from a one standard deviation shock to 30-yr mortgage interest rates model error from VAR including single-family existing home sales, 30-year mortgage interest rates and the median sales price of single-family homes. Source: National Association of Realtors, Federal Home Loan Mortgage Corporation and Berenberg Capital Markets

Chart 4: 30-year fixed mortgage rates



Source: Federal Home Loan Mortgage Corporation and Bankrate.com and Berenberg Capital Markets

Chart 5: 30-year fixed mortgage rates and the S&P 500 Residential REITs index



Source: New York Times, Standard & Poor's and Haver Analytics

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