



Potential Risks to U.S. Residential Construction

Potential MID reductions, elimination of SALT deduction, changes to capital gain treatment, and overall affordability issues

At the time of writing, the Republican-led Congress appears likely on the verge of passing a tax reform package which may change (unfavorably) MID (on primary and secondary homes basis and for home equity loans), lengthen the time necessary to hold primary real estate to be exempted from capital gains taxes, and eliminate the majority SALT deductions (limited to \$10k). The *National Association of Realtors (NAR)* notes on their website that through its research, the reduction in MID to a lower loan figure (\$750k appears to be the compromised figure) from the current \$1mn in addition to the overall increase in standard deductions and elimination SALT deductions could ultimately lead to a "12% decline in property prices". The NAR appears to draw this conclusion from the fact that a materially higher standard deduction (contemplated under the tax reform) may eliminate an individual's ability/need to itemize and therefore eliminate the economic incentive of a home purchase. NAR notes that of the people who claimed MID in 2013, 55% earned less than \$100,000 and 88% earned less than \$200,000. We look at NAR's full argument with some reservations but do agree there are likely "unintended consequences" to changing long-standing dynamics in the housing market. These are also likely to manifest themselves more in higher-cost states like NY, CA, MA, CO, CT, and FL to name a few. However, as shown in the graphic below (Figure 14), less than 13% of the new home sold in October 2017 were priced above \$500k. Therefore, it seems unlikely to us that changes MID would have such a widespread, systemic impact as concluded by NAR.

Turning to changes in capital gains, the current tax regime requires that a homeowner own and use their primary residence for two of the previous five years prior to a sale which will allow the homeowner to avoid taxation on the capital gains up to certain limits. However, under both the Senate and House versions of the tax reform package, this figure is increased to five years out of the previous eight. This is likely to impact the velocity of existing home sales, decrease mobility of homeowners and generally slow the housing market.

Finally, with home prices (as shown in Figure 5) now rising nationally 6% above their prior peak general affordability has declined y/y (Figure 15). According to the NAR, its *Housing Affordability Index* measures "whether or not a typical family earns enough income to qualify for a mortgage loan on a typical home at the national and regional levels based on the most recent price and income data". As shown below, the *Affordability Index* has declined to 148.9 in 3Q17 from 163.7% (-9%) y/y. Using the NAR's methodology this has been driven by not only a 7% rise in the median existing single-family home price, but also an almost 40bp increase in the mortgage rate. Although the interest rate rise that many predicted in the beginning of 2017 (and discussed in our *2017 Outlook*) never materialized in the amount expected, 2018 is again expected to be another year where the 10Y Treasury yield (a general benchmark on which 30Y mortgage rates are set) is expected to average 2.87% by 4Q18 according to *Bloomberg*, auguring for a likely similar reaction in 30Y mortgage rates.