BBVA | RESEARCH

Housing Outlook

United States

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Economic Analysis

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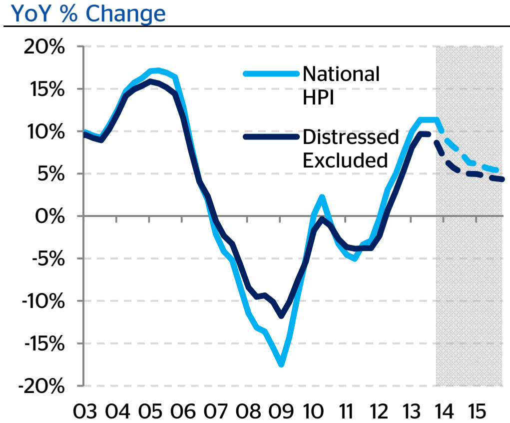
Seller's Market Persists in 2014

- **Tight inventory and low mortgage rates support further price appreciation, although at a slower pace due to declining affordability.**
- **Equity and net worth is up again: housing market confidence is up among older homeowners.**
- **Home prices are outpacing income growth for first-time homebuyers and early-career professionals.**

Our outlook for the housing sector this year is positive, although the dynamics of the mortgage market will change substantially. The sector's fundamentals have improved and mortgage lending appears less risky: home prices rose in all 50 states last year, delinquency rates have declined sharply, and the pace of foreclosures is slowing. This year, a low interest rate environment will support additional home sales and sustain new construction activity, but mortgage volume is poised to remain below trend.

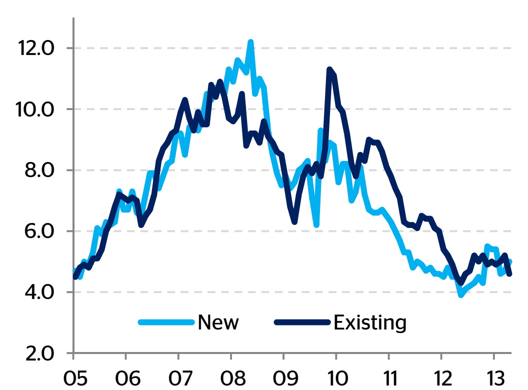
During 2013, home prices rose aggressively at a double digit pace – the best performance since the pre-crisis years of 2004-2005. The National Association of Realtors' median sales price averaged nearly $196,000 in 2013 – an 11.5% increase over 2012. December's Core Logic home price index is up 11.0% over the prior year. Several key demand and supply factors are behind last year's rapid price appreciation. Homebuyer affordability reached all-time highs during 2H12 through 1H13 as mortgage rates fell to historical lows. This high affordability and an improving labor market expanded the set of potential homebuyers and investors; however, housing inventory remained exceptionally tight and market power shifted to sellers who were able to command higher prices.

Chart 1
Core Logic Home Price Indexes and Forecast
YoY % Change



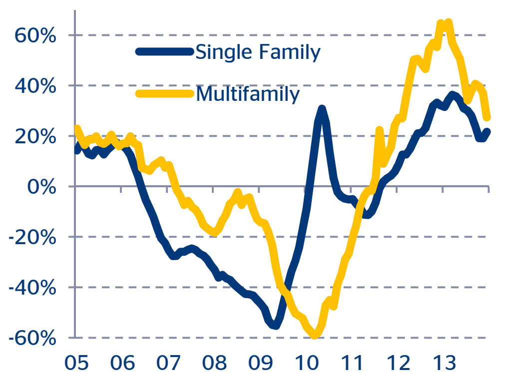
Source: CoreLogic / Haver, BBVA Research

Chart 2
Months' Supply of Single Family Homes for Sale



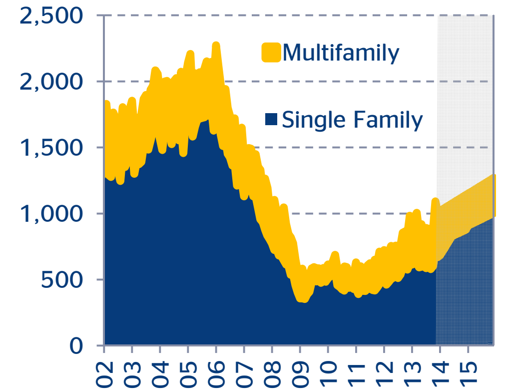
Source: National Assoc. of Realtors / Haver

Chart 3
New Residential Private Construction (Year-over-Year % Change in Value)



Source: Census / Haver, BBVA Research

Chart 4
Housing Starts, by Type, Thousands of Units, SAAR



Source: Census, BBVA Research / Haver

During late 2013, initial signs of stabilization in the housing market appeared. Declining mortgage rates during the past two years helped to stimulate homebuyer demand even as prices rose faster than household incomes; however, during 2H13, mortgage rates ticked up sharply and caused affordability to plummet. The consequences of lower demand were evident as home price appreciation slowed in tandem with the pace of existing home sales and mortgage applications. The net impact of these trends was a negative contribution of residential investment to GDP growth during 4Q13 - the first quarterly decline during the past three years.

This recent decline, however, is not a cause for alarm, because the fundamentals that drive residential investment are still strong. New construction and residential improvement spending continue to increase, and we expect home sales to follow an upward trend. The market will continue to favor sellers in 2014, because housing inventory will remain tight. But, home price appreciation will slow due to lower affordability and fewer eligible potential homebuyers. We project that **home prices will increase** at a relatively slower pace of **8.5%** this year.

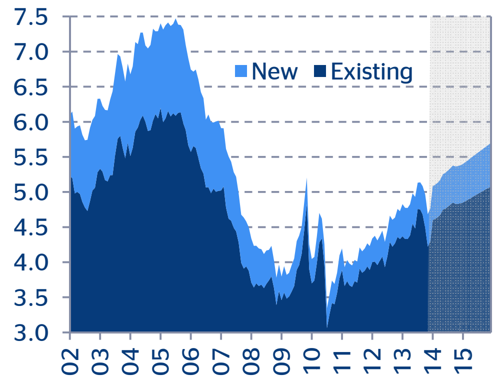
Single Family Home Sales to Rise in 2014, While Rental Demand Remains Elevated

The pace of **single-family existing home sales will expand by 4.2%** in 2014 to reach **4.7 million units** and new single-family home sales will rise 13.4% to reach approximately 490,000 units.

In our baseline forecast, GDP will expand by 2.5% and employment will rise by more than 2.4 million, and this pick-up of economic activity will help to drive the residential market. Lower unemployment and a stronger pace of job creation translate into greater consumer confidence and more prospective homebuyers. Furthermore, household formation will increase with economic growth because both immigration rises and young people move out of their parents' houses.

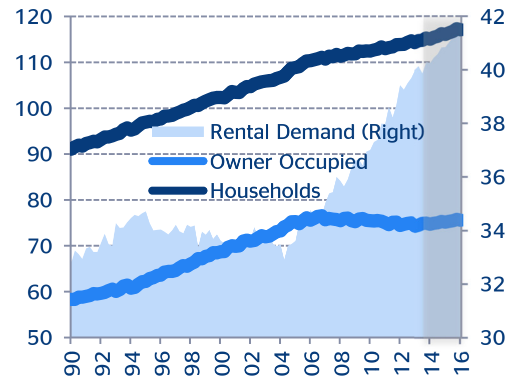
By January 2016, we project that the number of households will increase by approximately 2.1 million. Because the homeownership rate is projected to decline further, however, the majority of these new households will enter the rental market. During the next two years, number of renting households will expand by 1.2 million, while the number of owner-occupied homes will rise by approximately 900,000. The decline in the homeownership rate is slowing, however, and thus the number of owner-occupied homes will actually increase this year for the first time in seven years.

Chart 5
Home Sales



Source: National Association of Realtors / Haver, BBVA Research

Chart 6
Households: Owner-Occupied and Rental Demand, Millions



Source: Census / BBVA Research

One factor holding back the growth of owner-occupied homes has been weak purchase demand from young families and households. For these prospective homebuyers, home prices have risen faster than their incomes during the recovery. Currently, home prices are now on the high end of a historical relationship between median home prices and median family income, and young families will need to see faster income growth or save additional money to make a larger down payment. Furthermore, many early-career professionals are saddled with high student debt burdens that constrain their capacity to borrow.

At the other end of the spectrum, many late-career professionals and older homeowners are purchasing a new primary or secondary residence, because their home equity and net worth are up. Demand from these homebuyers will help to sustain sales. The National Association of Home Builders reported on Monday that "builder confidence in the 55+ housing market for the fourth quarter of 2013 is up sharply" because consumers in this demographic "have gained confidence in the economy and are able to sell their current homes and move into a new home or an apartment that fits the lifestyle they desire."

Housing Starts to Rise 17%, while Housing Inventory Remains Tight

Nationwide, the single-family inventory-to-sales ratio appears healthy at 4-5 months, but the actual levels of new and existing single-family housing inventory are exceptionally low. Existing home inventory is up only 1.6% year-over-year while new home inventory has increased 14% over December 2012.

Thus, new home construction activity will continue to rise in 2014. The growth rates of construction spending will ease in 2014; however, housing starts will continue their upward trend, and we project that nearly **1.1 million housing starts will occur throughout the year split between single-family (810,000) and multi-family (274,000) projects**. This pace is 16.9% above 2013's 927,500 starts, and twice the low pace during 2009. Elevated demand in the rental market will support additional investment in multi-family projects. In the single-family market, builders will continue to receive top dollar for new homes, because demand remains brisk. The median number of months-for-sale since completion of new single-family houses averaged 3.5 during 2013 - down from 6.7 in 2011 and 5.1 in 2012.

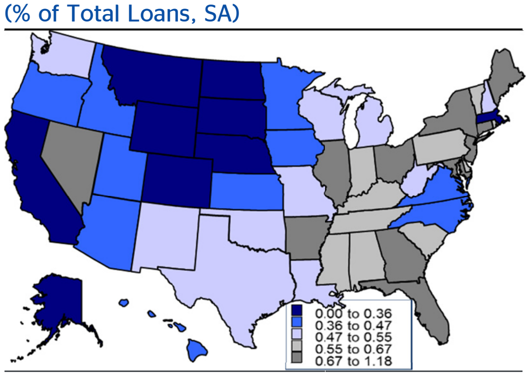
Further price appreciation will help to ease the tight existing home inventory, as rising prices encourage current homeowners to sell. Existing home supply will only increase substantially when current homeowners calculate that they will realize positive returns from selling their home. Additionally, price appreciation is reducing the number of homeowners in negative equity. During 2013, Core Logic estimates that more than 4.1 million properties returned to positive equity. As of 3Q13, fewer than 13% of all mortgages (6.4 million properties) are in negative equity – down significantly from nearly 22% at the end of 2012. As homeowners transition out of negative equity, they are more willing and able to list their home for sale without taking a steep loss.

Asset Quality at Commercial Banks Improves as Foreclosures Decline

During the past four quarters, the residential delinquency rate at the 100 largest commercial banks declined nearly 2.5 percentage points to 9.6% as of 3Q13. This dramatic reduction comes after it had been essentially flat for nearly three years. A falling delinquency rate signals that banks and borrowers are taking aggressive steps to resolve delinquent accounts as the labor market improves and home prices rise. The declining delinquency rate will translate into fewer foreclosures in 2014.

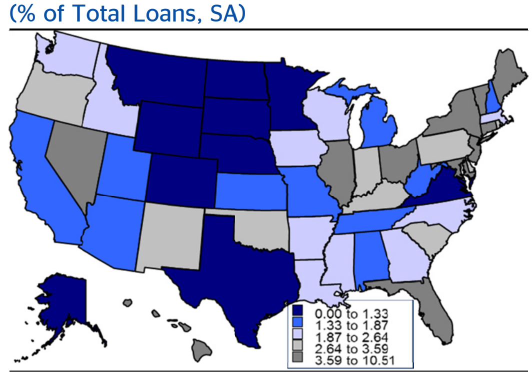
Last year, we estimate that there were approximately 1.0 million new foreclosures, and we expect that **new foreclosures in 2014 will be elevated at around 700-800K**, and decline to a historically normal filing range in 2015 of around 550,000 (1.3% of total mortgage loans per year). In spite of fewer new foreclosures, the market needs to absorb 1.2 million foreclosed homes because this inventory has not declined as fast as new filings. Slightly more than 1 in 5 of these foreclosed homes (nearly 22%) are in Florida, but Florida's inventory is now declining faster than average. The foreclosure inventories in California and Arizona have largely been dealt with, as inventory is at 1.4% and 1.3%, respectively. Aside from Florida, lagging states whose foreclosure inventory remains above 4.0% include Connecticut, Hawaii, Illinois, Maine, New Jersey, Nevada and New York. Notably, each of these states has a primarily judicial review process to resolve foreclosures.

Chart 7
Foreclosures Started, 3Q13 by Quintile (% of Total Loans, SA)



Source: Mortgage Banker's Association, BBVA Research / Haver

Chart 8
Foreclosure Inventory, 3Q13 by Quintile (% of Total Loans, SA)



Source: Mortgage Banker's Association, BBVA Research / Haver

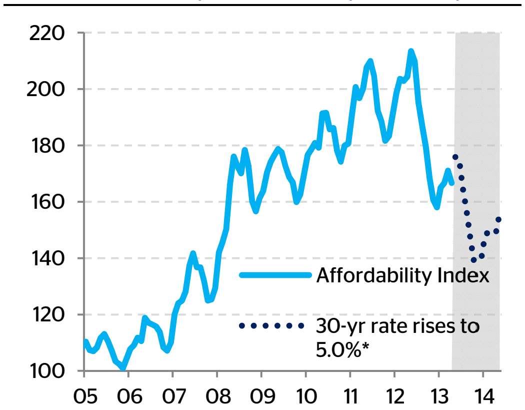
New Mortgage Originations Remain Low; Return of Home Equity Lending

The household balance sheet has improved greatly since the depths of the Great Recession. With the rebounds of both home prices and stock markets, household net-worth is up, and owners' equity as a percent of household real estate has returned to 50.8% - well above the 1Q09 low of 36.5% and closing in on the 1992-2006 average of 59.3%. The household financial obligations ratio that includes mortgage debt, homeownership-related mandatory expenses, rental payments and auto loan/lease payments is historically low at just above 15% - a level not seen in more than 32 years. In contrast with 1981, however, today's 30-year fixed mortgage rate is around 4.5% (with less than 2% inflation) - much lower than 1981's 16.6% average rate (with 10% inflation). Low interest rates will remain a strong incentive for potential homebuyers to now take on leverage.

It appears that we have turned the corner on the de-leverage process, and households are once again willing to take on consumer and mortgage debt, because for the first time in more than five years, the household sector's home mortgage debt increased in 3Q13. Much of this increase appears to be driven by rising home prices, because the volume of new purchase mortgage applications and originations slowed sharply with the rise in mortgage rates during 2H13. The volume of new purchase originations is expected to remain tepid as the low mortgage rates of 2013 are unlikely to return.

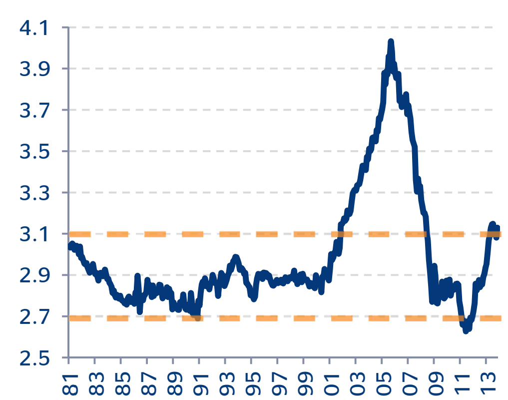
Furthermore, investor demand and demographic trends are behind a rising share of all-cash transactions. According to RealtyTrac, 42.1% of December's residential sales were all-cash transactions – up from 18.0% in December 2012. This rising share and the slow pace of mortgage originations are partly explained by the reduced participation of first time homebuyers in the market. Their share of purchases remains below trend, and these buyers typically need a mortgage to purchase a home. Second, older homeowners are increasingly able purchase a new residence with cash only after they sell their current home.

Chart 9
Housing Affordability Index, Composite 100=Median Family Income Likely to Qualify



Source: National Assoc. of Realtors / Haver, BBVA Research
*Projection if 30-year fixed rate were to reach 5.0% by Aug. 2014

Chart 10
Price-to-Income Ratio (Median Home Sales Price / Median Family Income)



Source: National Assoc. of Realtors / Haver

In spite of these trends, there are ample opportunities to increase residential-backed lending. Homebuyer demand is on the rise for the baby-boomer generation, and low interest rates may entice these older homeowners to use leverage to purchase a new or upgraded home – rather than cash alone. For example, high-income late-career professionals are working longer and may prefer to use shorter duration jumbo mortgages to reduce their interest expense on a $1 million+ home purchase.

Furthermore, this demographic is particularly well-suited for a one-time close construction loan, because in areas with tight inventory, a prospective buyer may prefer to build a custom home.

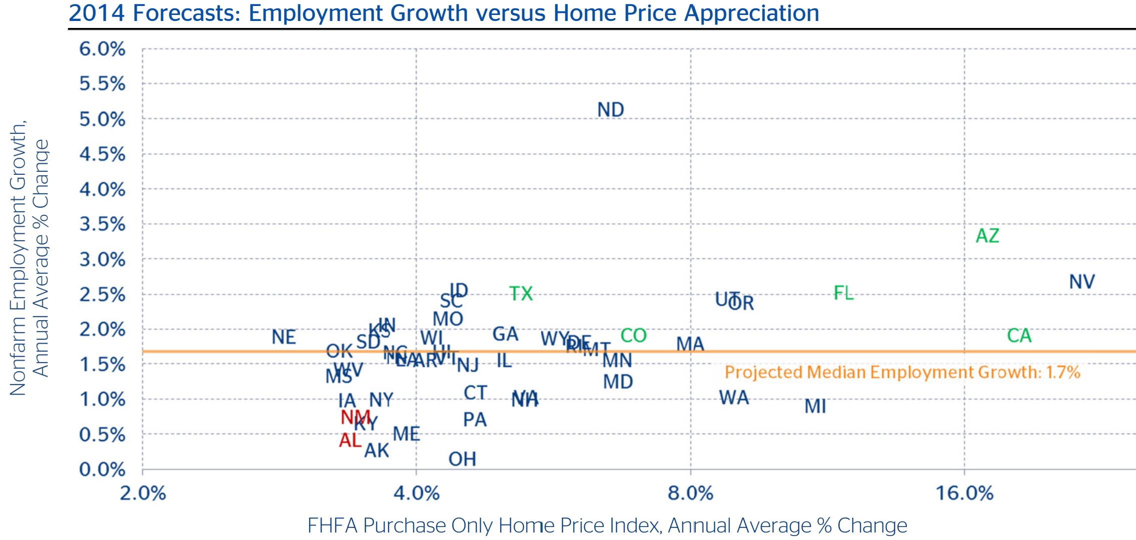
Home equity lending continues to decline as all types of lenders have shied away, but with the rebound in home prices and homeowner equity, 2014 looks to be an attractive time for lenders to re-enter this market. For mid-career professionals, recent homebuyers and current homeowners, home equity loans may be attractive to fund remodeling and upgrades.

In this environment, commercial banks will have to focus on construction lending, home equity loans and new purchase originations to grow their mortgage portfolios. Although refinance activity provided substantial fee income to commercial banks and allowed them to capture market share from other types of lenders during the past two years, refinancing has declined to less than 50% of mortgage originations from a high of nearly 80% at the end of 2012. Although the government-backed HARP program was extended through December 2015, higher mortgage rates reduce the benefit of refinancing.

The Central Tenet of Real Estate: It's All About Location

Driving the increase in national price indexes, some of the hardest-hit housing markets of California, Arizona, Nevada, and Florida saw a sharp rebound in prices last year. In California and Arizona, a rapid decline of foreclosure inventory and relatively strong job growth fueled both investor and homebuyer demand and pushed prices up more than 20% in some metropolitan markets.

Chart 11
2014 Forecasts: Employment Growth versus Home Price Appreciation



Source: BBVA Research

Furthermore, burgeoning energy and technology industries spurred hiring and housing demand in select regional markets. For example, Texas, Colorado and North Dakota housing prices all rose substantially as job growth surged in these states. Inventory is exceptionally tight in some of these "hot" housing markets – well below 3 months at the current sales rate. For example, the Texas A&M Real Estate Center estimates that the months' supply stands at 2.1 in Dallas and 2.7 in Houston.

Across states, the relationship between state-level job growth and home price appreciation was clearly positive last year, and that trend will continue. States with favorable employment outlooks will also see some of the largest increases in home prices next year as purchase demand will be relatively stronger. Nevertheless, home price appreciation will ease in California and Arizona, as the rapid growth in 2013 was due largely to a rebound from the low prices reached during the height of the housing crisis. Florida's price appreciation looks to strengthen in 2014 as the inventory of foreclosed homes declines, and investor demand remains elevated.

North Dakota is projected to post the strongest employment growth next year along with solid home price appreciation, while Utah and Oregon are projected to post above average growth in employment and housing prices. Washington and Michigan will see above average gains in home prices; however, their employment growth will pull back in 2014.

Bottom Line

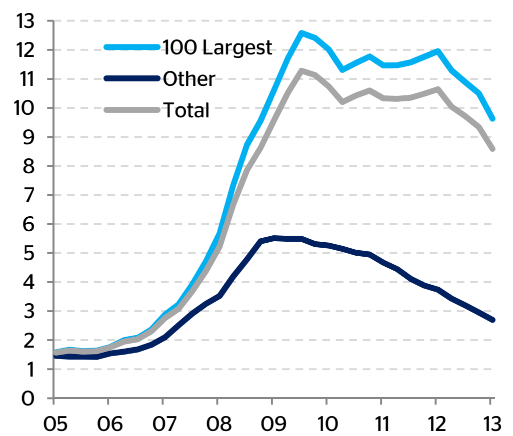
Overall, 2014 is a positive year for the residential market as economic growth, job creation and household formation will all pick up in a low interest rate environment. The pace of home sales and new home construction will gradually increase along upward trends, and home prices will continue to rise, although at a softer pace than 2013. Single and multi-family construction activity will continue to increase to satisfy demand, as new homes will continue to sell quickly after they are finished and rental demand remains elevated. Asset quality at commercial banks continues to improve, and banks will have to shift from refinancing activity to originating new mortgages in a highly competitive environment.

Although consumer de-leveraging activity appears to have bottomed, the volume of new mortgage purchase originations is expected to remain low. Demand from first-time homebuyers remains below trend, as home prices are rising faster than their incomes. On the other side of the market, older homeowners and late-career professionals are more confident in the housing market, as they are increasingly looking to sell their current homes and purchase new homes. Low interest rates and a recovery of home prices remain favorable for homeowners to borrow against their real estate equity to fund remodeling projects.

Across the U.S., there is much regional heterogeneity in affordability, home price appreciation and growth prospects as we head into 2014. Markets with appreciable job growth are expected to experience the greatest price appreciation as the housing supply remains exceptionally tight.

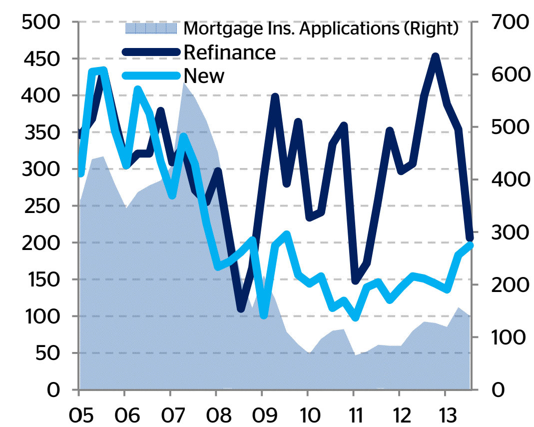
Key Mortgage Market Indicators

Chart 12
Loan Delinquency Rates, Residential Real Estate Commercial Banks, Quarterly, SA,%



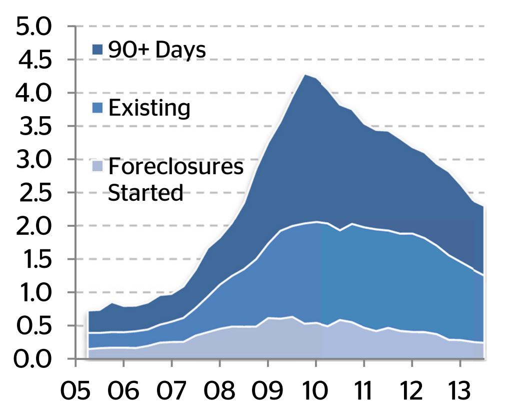
Source: Federal Reserve / Haver, BBVA Research

Chart 13
Mortgage Originations and Applications
Originations, Billions USD; Applications, Thousands



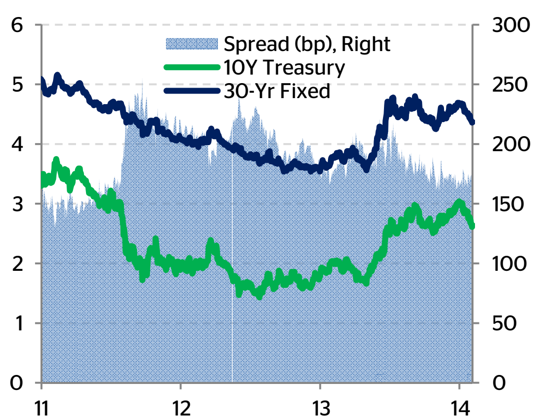
Source: National Assoc. of Realtors / Haver

Chart 14
Inventory of Foreclosures and 90-Day+ Delinquencies
Million Units, Quarterly Data, Through 1Q13



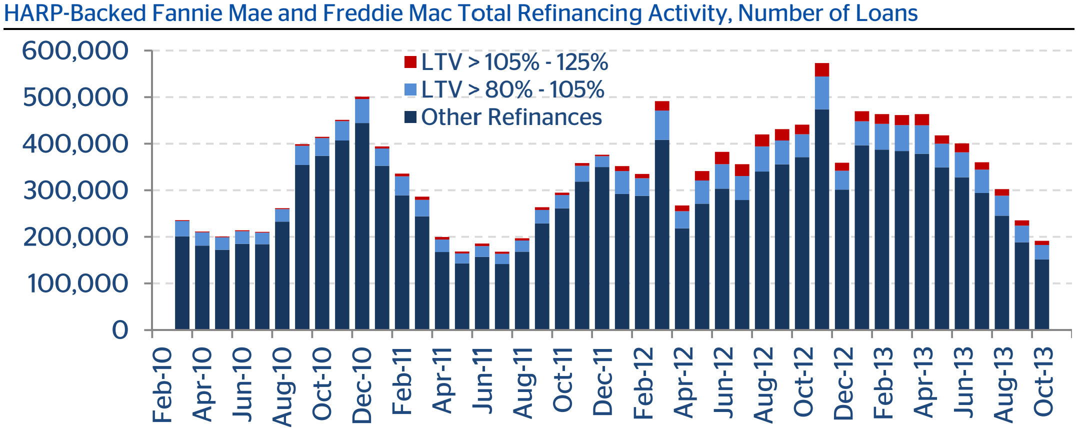
Source: BBVA Research & MBA / Haver

Chart 15
10-Year Treasury Yield and Mortgage Rate (%)
Difference on right in basis points (bp)



Source: Federal Reserve, WSJ / BBVA Research

Chart 16
HARP-Backed Fannie Mae and Freddie Mac Total Refinancing Activity, Number of Loans



Source: Freddie Mac and Fannie Mae / Haver Analytics and BBVA Research

Key Mortgage Market Indicators

Mortgage Market Indicator	Units	Obs. Mo.	Current	Prior Mo.	6-Mo. Ago
Core Logic Home Prices	YoY% Change	Dec	11.2%	11.5%	11.2%
Excluding Distressed	YoY% Change	Dec	10.0%	10.0%	9.4%
Existing Home Sales		Dec	4870	4820	5060
Northeast	Thousands	Dec	640	650	630
Midwest	of Units,	Dec	1110	1160	1210
South	SAAR	Dec	2030	1970	2010
West		Dec	1090	1040	1210
Existing Months of Supply		Dec	4.6	5.1	5.1
New Home Sales		Dec	414	445	450
Northeast	Thousands	Dec	21	33	35
Midwest	of Units,	Dec	60	51	56
South	SAAR	Dec	230	248	241
West		Dec	103	113	118
New Months of Supply		Dec	5.0	4.7	4.3
Affordability Index, Seasonally Adjusted		Nov	167	163	186
Refinance Share, %		Dec	51	56	68
Mortgage Rate (Conventional)	%	Jan	4.43	4.46	4.37
10-Yr Treasury (CM)	%	Jan	2.86	2.90	2.58
Spread	bp	Jan	157	156	179

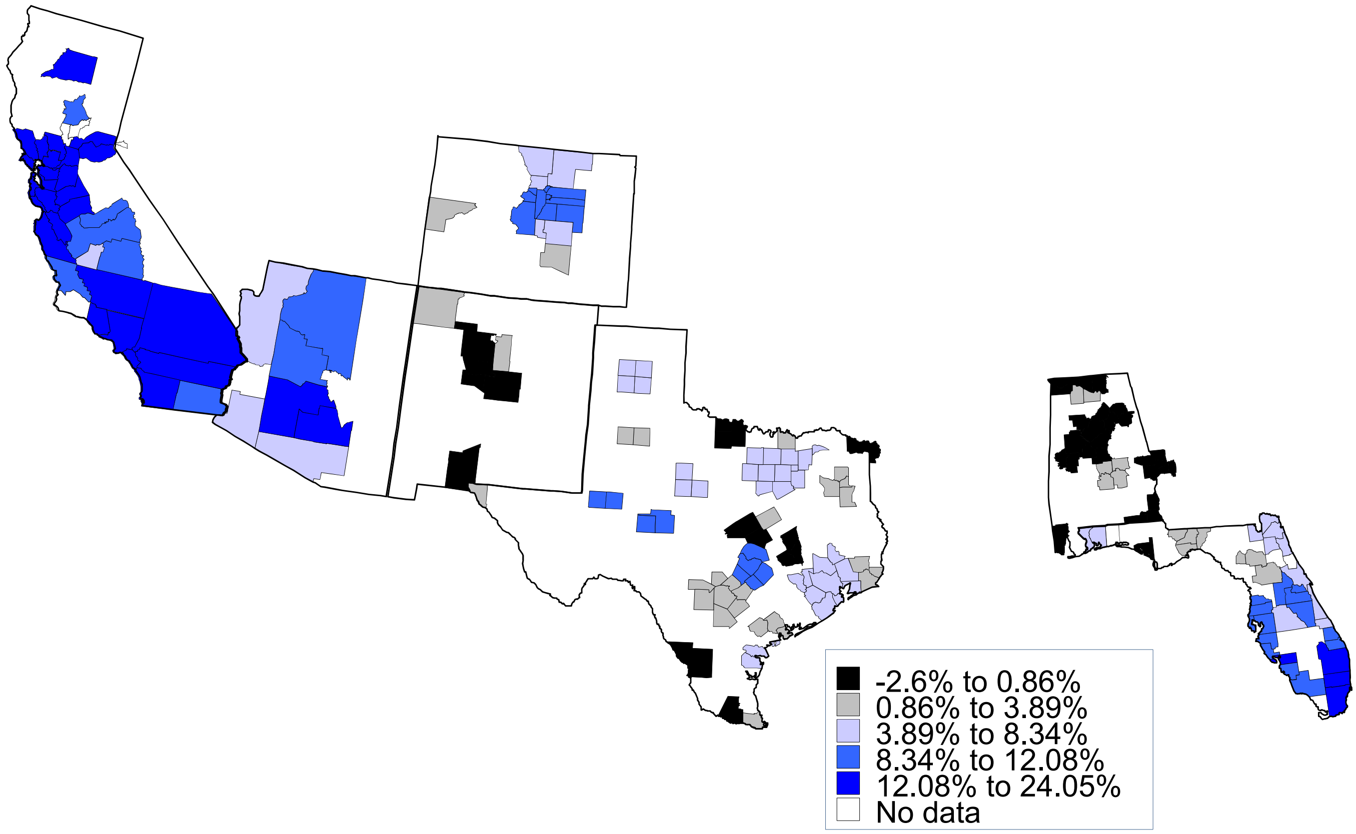
Asset Quality Metrics		Obs. Qtr.	Current	Prior Qtr.	4-Qtrs Ago
Res. Loan Delinquency Rate - Top 100 Banks	%	Q3-13	9.6	10.5	12.0
Foreclosures Started, Per Qtr	Thousands	Q3-13	249	260	376
Forclosure Inventory	Thousands	Q3-13	1256	1355	1700
Mortgages Past Due (30 Days-		Q3-13	6.4	7.0	7.4
Alabama		Q3-13	8.8	9.4	9.7
Arizona	% of	Q3-13	4.6	5.1	6.1
California	Mortgages	Q3-13	5.0	5.4	6.4
Colorado	Serviced,	Q3-13	4.4	4.7	4.9
Florida	MBA	Q3-13	6.6	7.1	7.7
New Mexico		Q3-13	5.5	5.8	6.1
Texas		Q3-13	7.1	7.6	7.9

Labor Market	AL	AZ	CA	CO	FL	NM	TX	US
Employment Growth (Y-o-Y % Change)								
Dec-13	0.6%	2.0%	1.6%	1.9%	2.6%	0.4%	2.3%	1.6%
Nov-13	0.2%	1.9%	1.6%	1.9%	2.5%	0.2%	2.4%	1.7%
Dec-12	0.6%	2.4%	2.4%	2.5%	1.9%	0.6%	3.2%	1.7%
Empl. Change, YTD, Thousands	10.4	49.3	235.7	43.9	192.9	3.2	252.4	2186.0
Unemployment Rate (SA, %)								
Dec-13	6.1	7.6	8.3	6.2	6.2	6.4	6.0	6.7
Nov-13	6.2	7.8	8.5	6.5	6.4	6.4	6.1	7.0
Dec-12	6.4	8.2	8.7	6.8	6.7	6.6	6.2	7.2

Sources: Core Logic, NAR, Census, Mortgage Bankers Association, Freddie Mac Primary Mortgage Market Survey, Federal Reserve, BLS / Haver Analytics and BBVA Research

Metro Area Housing Prices: Across the Sunbelt

Year-over-Year % Change, by Quintile, 3Q13
FHFA All Transactions Index (Includes Appraisals)



S&P/Case Shiller Metro Area Home Price Indexes				
YoY% Change	Nov-13	Prior Mo.	6-Mo. Ago	1-Year Ago
Phoenix	16.8%	18.1%	20.5%	23.0%
Denver	8.9%	9.5%	9.7%	7.8%
Los Angeles	21.7%	22.1%	19.1%	7.8%
San Diego	18.7%	19.7%	17.3%	8.1%
San Francisco	23.3%	24.6%	24.4%	12.8%
Miami	16.5%	15.8%	14.2%	10.1%
Tampa	15.8%	15.2%	10.9%	6.9%
Dallas	10.0%	9.7%	7.6%	5.9%

Source: S&P/Case Shiller / Haver Analytics and BBVA Research