

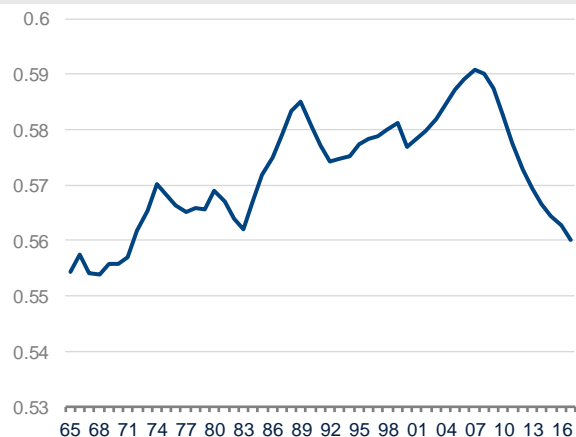
6. Housing market: is history repeating itself?

Although the U.S. housing market has been in recovery mode since 2011, it has not reached full normalization. While a decade ago the challenge was a meltdown in home prices as a result of overbuilding, speculation, and easy underwriting standards, the sector now exhibits a suboptimal level of new construction and tight inventory of existing homes for sale, which results in elevated home prices across important metropolitan areas (MSAs). In this article we analyze current trends and provide our outlook for the residential sector for the next two years.

Housing demand and supply

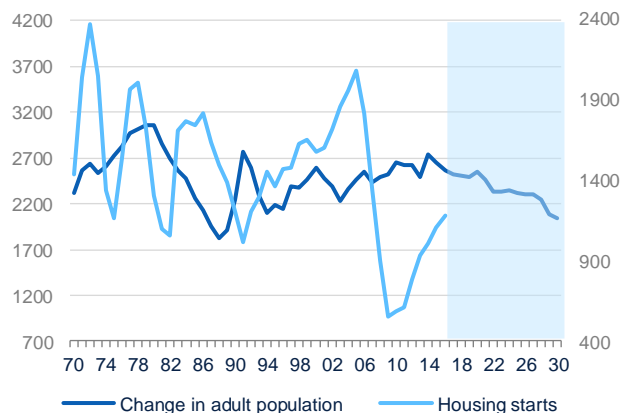
The most important driver of housing demand is population growth. The increase in adult population during the last decade and the low level of new construction, have facilitated the absorption of most excess inventory, particularly in economically attractive MSAs. Figure 6.1 shows the ratio of housing units per adult, which has declined since 2007 and stands at its lowest level in 45 years. While housing starts have increased significantly since bottoming out in 2009, they remain below demand and will stay as such over the next one to two years (Figure 6.2).

Figure 6.1. Housing units per resident, 20+ years old (Units)



Source: BBVA Research and Census Bureau

Figure 6.2. Population growth and housing supply (Thousands)

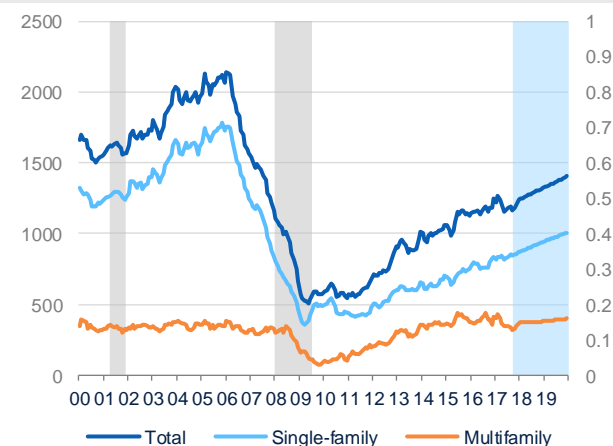


Source: BBVA Research and Census Bureau

Housing starts can be divided into single-family and multifamily. Since last March, total units have had difficulty to maintain an upward trend, mostly due to lower multifamily, which are the smaller component. Meanwhile, although single-family housing starts have not been able to compensate fully for the retreat in multifamily construction, they have increased 9% YoY during the first nine months in 2017. The retreat in multifamily construction has been particularly strong in the third quarter (Figure 6.3), but this is likely transitory and will be offset in the coming months, as evidenced by the stronger trend in multifamily construction permits that tend to lead housing starts. Nonetheless, the share of multifamily housing starts is still expected to decrease gradually due to demographic factors. For example, Millennials will demand more single-family

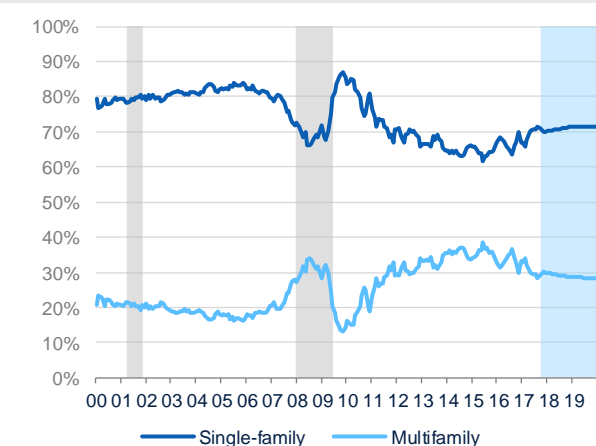
housing units as they enter into their 30s (median age of first-time homebuyer in 2016 was 32)¹⁰, form families, and require more space (Figure 6.4). As a result, total housing starts are projected to reach 1.4 million units SAAR in 4Q19, 17% higher than their current level.

Figure 6.3. Housing starts
(Thousand units, SAAR, 3mma)



Source: BBVA Research and Census Bureau

Figure 6.4. Share of single-family and multifamily housing starts (%)



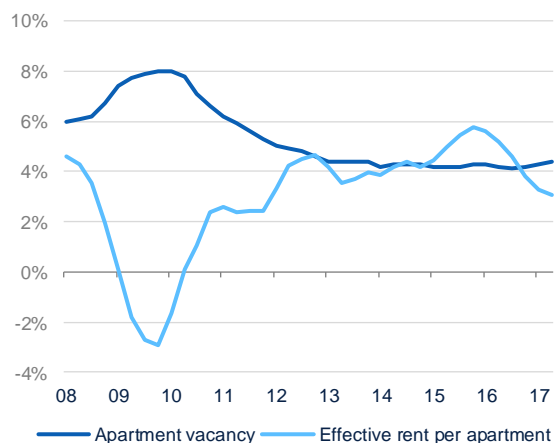
Source: BBVA Research and Census Bureau

Apartment market conditions

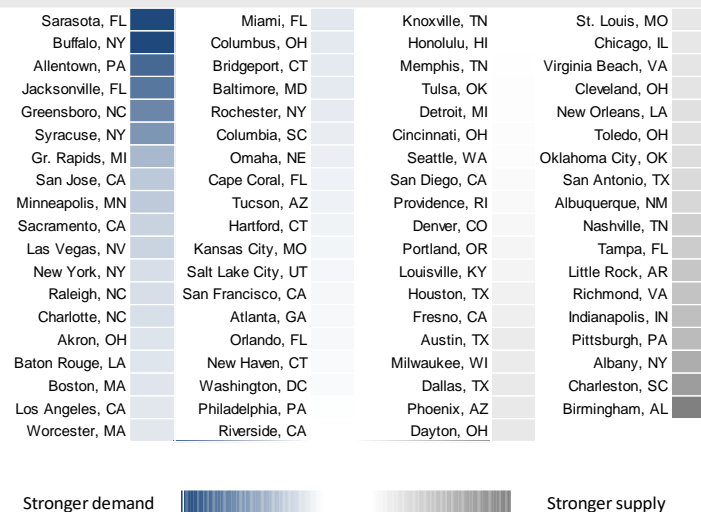
The slowdown multifamily housing starts in 2016, and especially in 2017, will cause lower apartment completions, which will help stabilize rent growth and vacancy rates (Figure 6.5). Notwithstanding, relative to 2012-2016, we expect rents to increase at a slower pace and vacancy rates to edge up modestly.

That being said, the balance of apartment demand vs. supply varies significantly by MSA. The markets that have the most favorable environment for landlords –low and declining vacancy rates– are generally in Florida, California, and certain pockets of the Mid-Atlantic and the Midwest (Figure 6.6). In great part, this reflects supply constraints, a large retirement population, and a large share of prime age apartment renters, which tend to be residents between 20 and 29 years-old. With the exception of Florida, which is a popular retirement destination, the MSAs that are experiencing strong apartment demand have higher than average or increasing share of prime age renters due to stronger relative attractiveness (Figures 6.7 and 6.8).

10: NAR. 2016 Profile of Home Buyers and Sellers. <https://www.nar.realtor/sites/default/files/reports/2016/2016-profile-of-home-buyers-and-sellers-10-31-2016.pdf>

Figure 6.5. Apartment vacancies and rents (% and %YoY)


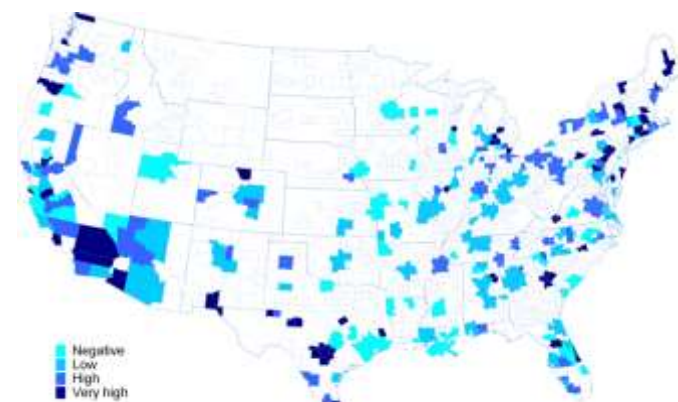
Source: BBVA Research and REIS

Figure 6.6. Rental apartment market by MSA, 75 largest, 2Q17 (relative balance of demand vs. supply)


Source: BBVA Research

Figure 6.7. Share of population of age 20-29, 2015


Source: BBVA Research and Census Bureau

Figure 6.8. Increase in the share of population of age 20-29 in total, 2010-2015


Source: BBVA Research and Census Bureau

Single-family market conditions

The MSAs with a large share of population in their 20s are also expected to provide opportunities to the single-family segment. Particularly if population growth remains strong, home prices remain affordable for first-time homebuyers, and economic attractiveness does not diminish. Given the aging of population and the decline in geographic mobility over time, remaining attractive to younger residents has become an even more determinant for long-term success. In 2016, only 5%

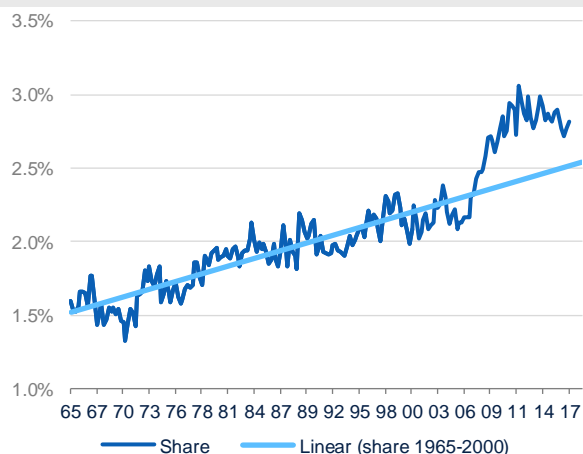
of total residents moved to a different county, state or abroad. This rate was 9% and 10% for residents aged 20-24 and 25-29, respectively.¹¹ For MSAs, ensuring net positive inflow of young residents will alleviate the challenges from population ageing and support residential investment.

Housing starts are inversely related with vacancies, particularly with vacant units held off market for reasons other than occasional use. These units are generally associated with locations with low or negative population growth due to low economic attractiveness and are different from homes vacant for sale, for rent, for seasonal use or temporarily occupied by people with residence elsewhere. The share of vacant units held off market for reasons other than occasional use has increased significantly at the national level after the subprime mortgage boom mostly due to previous overbuilding. It remains elevated since the Great Recession (Figure 6.9), but is geographically relatively concentrated.

The MSAs that are burdened with surplus inventory and deficit demand are predominantly clustered in the eastern part of the Midwest, parts of the Mid-Atlantic such as western Pennsylvania, and the South, excluding Texas and Florida. On the opposite side of the spectrum are MSAs with very low level of vacancies due to high demand for housing, geographical constraints, or regulatory restrictions. They are most often located in the western part of the country, the western part of the Midwest, as well as parts of the East Coast, Florida and Texas (Figure 6.10).

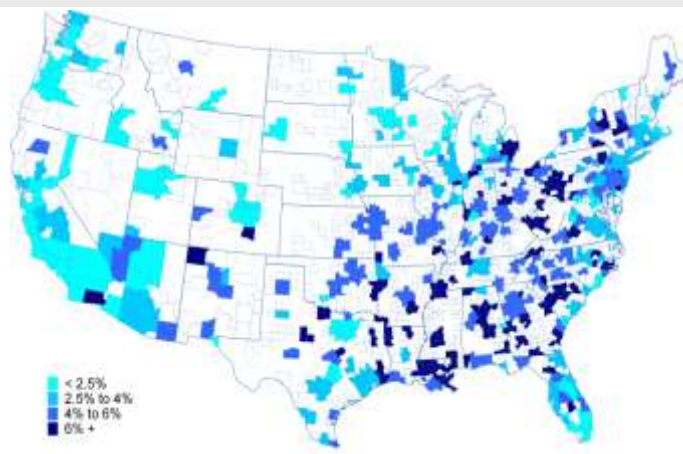
The MSAs that are poised to benefit the most from new construction are characterized by solid to high economic attractiveness, elastic housing supply, and low inventory of vacant units. Single family housing starts are expected to increase 7.3% in 2018 and 6.3% in 2019.

Figure 6.9. Share of vacant units held off market for reasons other than occasional use (%)



Source: BBVA Research and Census Bureau

Figure 6.10. Share of vacant units held off market for reasons other than occasional use, 2016



Source: BBVA Research and Census Bureau

11: See 2016 Census Bureau data: <https://www.census.gov/newsroom/blogs/random-samplings/2017/01/mover-rate.html>

Existing home sales

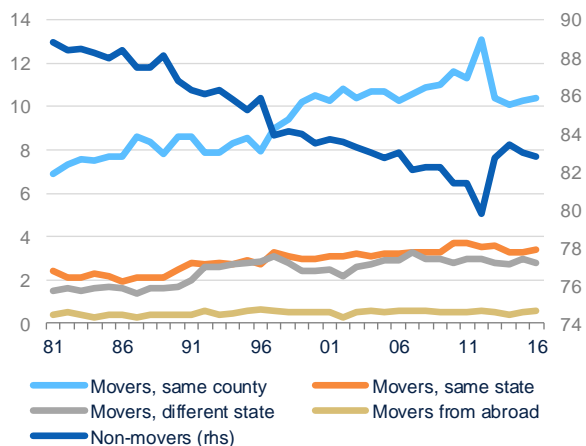
Years of suboptimal construction and supportive monetary policy, which has allowed homeowners to lock in low interest rates, as well as lower population mobility (Figure 6.11), has resulted in a historically low supply of existing homes for sale (Figure 6.12). Seasonally adjusted months' supply of homes for sale currently stands at four months; two months below the level usually considered indicative of a balanced market. The market for existing homes is particularly tight in attractive markets of the West Coast (Figure 6.13). These trends are likely to persist until more new construction reaches the secondary market.

This has been a slow process because the second largest generation cohort – the Baby Boomers – are still not old enough to start selling their homes and downsizing in larger numbers. Although the oldest Baby Boomers are turning 71, half of the Baby Boomers are below 61. The age at which seniors downsize and start to move into multifamily units at a faster pace has been pushed to 75, in line with healthier lifestyles and increasing longevity.¹²

With Baby Boomers staying put and lack of supply, some MSAs face the risk of ageing Millennials (especially older ones) moving to locations that offer more affordable housing in order to raise families, assuming they can find career opportunities. The impact is unlikely to damage the most attractive MSAs. Likewise, it could benefit some of the hardest hit MSAs in the past decade such as Detroit, Cleveland and Baltimore, as long as they can become a magnet for Millennials.

Existing home sales remained below 5.4 million SAAR for the second month in a row in September 2017. In part, Hurricanes Harvey in Texas and Irma in Florida delayed sales in 3Q17. Going forward, we expect a rebound in 4Q17 and an annual average of 5.54 million in 2017; 1.2% higher than in 2016. Sales are expected to increase to 5.65 million in 2018 (Figure 6.14). Over the mid-term, existing home sales expressed as a share of the entire housing stock, will remain around 4%, which is close to their historical average but significantly lower than in the early 2000s. This is consistent with an environment characterized by low migration, gradually rising interest rates and a large majority of Baby Boomers that continue to own their homes.

12: See for example Rappaport, J. (2015). Millennials, Baby Boomers, and Rebounding Multifamily Home Construction, Federal Bank of Kansas City. <https://goo.gl/pejo2W>

Figure 6.11. Geographic mobility (%)


Source: BBVA Research and Census Bureau

Figure 6.12. Supply of existing homes for sale (% and months, seasonally adjusted)


Source: BBVA Research, NAR and Census Bureau

Figure 6.13. Supply of existing homes for sale by MSA, September 2017 (months at current sales rate)


Source: BBVA Research and Redfin

Figure 6.14. Existing home sales (million, SAAR)

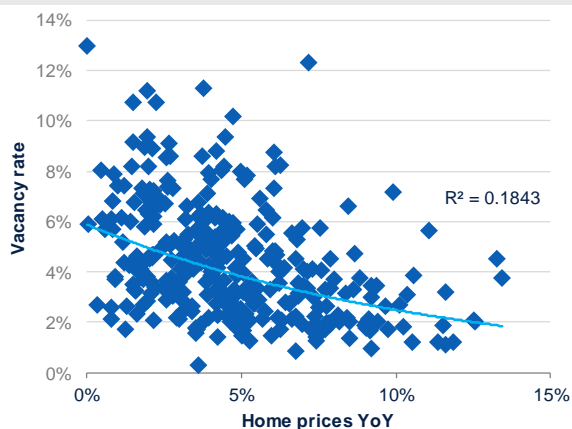

Source: BBVA Research and NAR

Home price misalignment

After a period of stable growth, generally between 5% and 5.6% YoY during May 2015-April 2017, the CoreLogic home price index started accelerating in late spring, reaching a level of 7% YoY in August. Strong price appreciation is driven by a low supply of houses in attractive locations (Figure 6.15). We expect home prices to continue increasing at a solid pace nationwide (Figure 6.16). We anticipate home price appreciation to gradually slow towards the end of 2018, supported by increasing new construction.

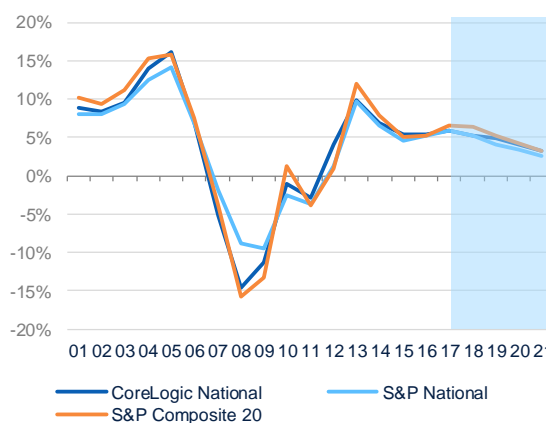
The strong increase in home prices begs the question of whether home prices are getting misaligned from fundamentals. This question is particularly important from a banking perspective, since housing booms and busts can be particularly damaging to financial stability and the economy, and lead to banking distress.

Figure 6.15. Share of vacant units held off market for reasons other than occasional use vs. home prices, 2016



Source: BBVA Research and Redfin

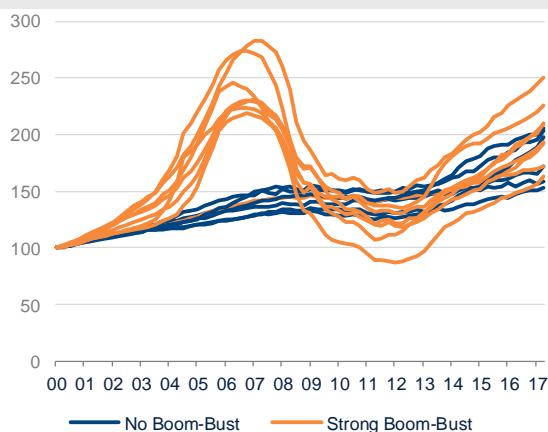
Figure 6.16. Home prices indices (YoY)



Source: BBVA Research, CoreLogic and S&P

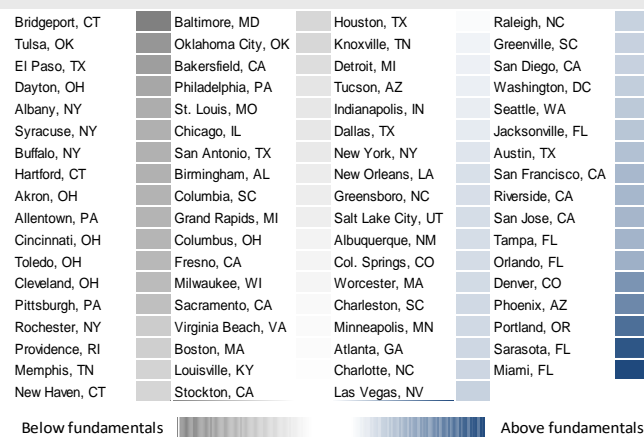
In general, there are some MSA that are prone to boom-bust cycles. These places tend to exhibit regulatory restrictions or geographical constraints that fuel home price appreciation at a faster pace than national average. Rising prices in turn generate speculation, which further fuels higher prices that eventually produces an asset bubble (Figure 6.17). This is exactly what happened in some locations during the 2000s.

Figure 6.17. Home prices in two groups of MSAs



Source: BBVA Research and FHFA

Figure 6.18. Home prices vs. fundamentals in major MSAs (BBVA Research HPI Misalignment Index)



Source: BBVA Research

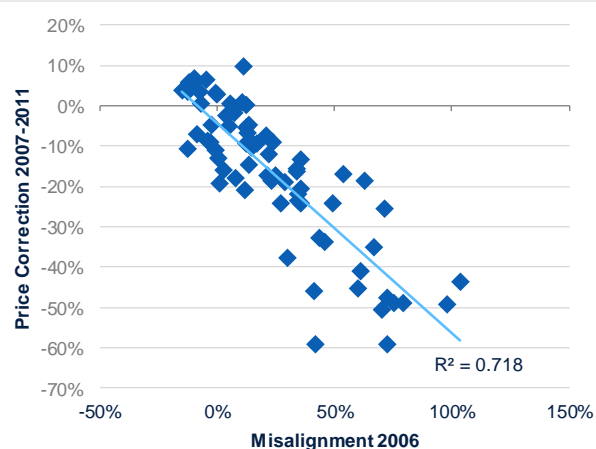
According to our analysis, despite the healthier footing of the housing market compared to a decade ago, risk is building up. The BBVA Research HPI Misalignment Index indicates potential for higher risk levels in certain locations (Figure 6.18), many of which had elevated home prices before the Great Recession (Figure 6.19). Since misalignment levels in 2006 are highly correlated with the level of price correction in 2007-2011 (Figure 6.20), the current degree of high misalignment in some markets generates concerns.

Figure 6.19. Misalignment in 2016 vs. 2006 (%)



Source: BBVA Research

Figure 6.20. Misalignment in 2006 vs. correction 2007-2011 (%)



Source: BBVA Research

However, one feature that differentiates the current situation from the previous cycle is that there is significantly less speculation and credit is tighter, thus not fueling high leverage positions. While the previous boom-bust cycle was based on easy credit, this time around the appreciation seems to be driven by significantly suppressed supply. The combination of high home prices in some parts of the country could help the relative competitiveness of locations that have more affordable markets, but these locations nevertheless would need strong economic fundamentals in place that attract new population, especially aged 20-40. Public policy can play a significant role in catalyzing faster development of until now overlooked MSAs, which would not only benefit them, but also the places that are currently highly attractive but cannot accommodate new residents by building out at a faster pace.

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