RESEARCH

Economic Watch

United States

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Economic Analysis

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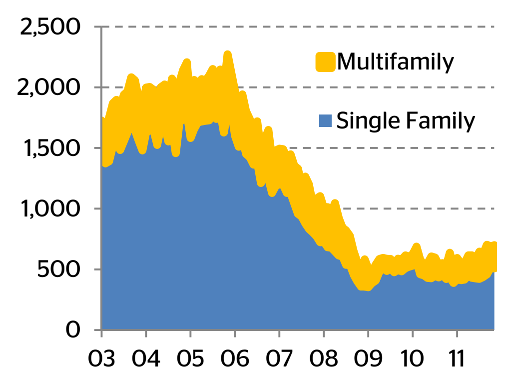
Housing Market Outlook: 2012

- **Rental demand surges, as home ownership declines**
- **Home prices will continue to slide across the U.S. due to the high inventory of distressed properties. Non-distressed property prices will remain under pressure**
- **Demand will improve in 2012, but remain low. Refinancing represents an opportunity for banks to increase market share**

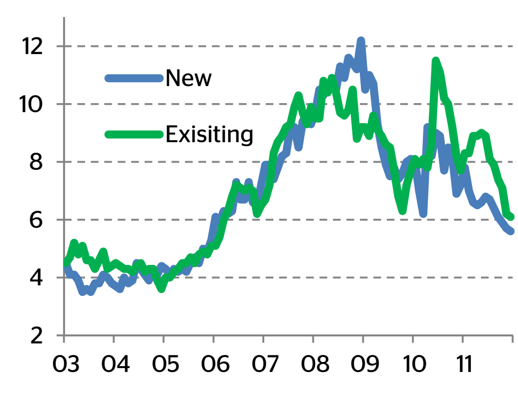
A hint of optimism has recently swept the housing market: existing home sales are trending higher, homebuilder confidence has ticked up, and historically low mortgage rates and a more precipitous drop in home prices relative to household incomes have boosted indexes of housing affordability to all time highs. Yet, many potential buyers and sellers remain on the sidelines: residential delinquency rates and foreclosures are stubbornly high, credit standards remain tight, unemployment is elevated, and national home price indexes continue to slide. Since its peak six years ago, the national average of home prices has fallen approximately 34%. Thus, many lenders, investors, buyers and sellers do not yet sense a rebound. We believe that the residential market will remain under stress in many areas throughout the country in 2012; however, opportunities are rising in growing markets for buyers to take advantage of record affordability, purchase investment properties and hedge rising rents.

Chart 1
Housing Starts, by Type
Thousands of Units, SAAR



Source: Census / BBVA Research

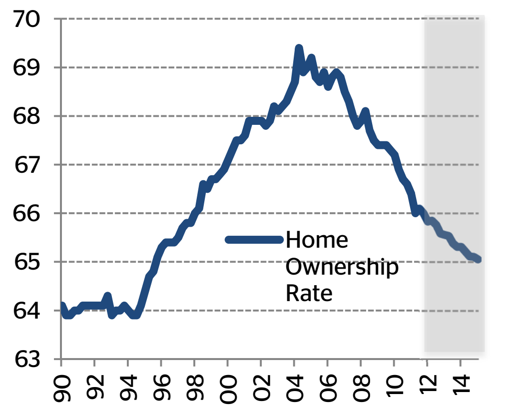
Chart 2
Months' Supply of Homes at Current Sales Rate
Months, Non-Seasonally Adjusted



Source: Census, National Association of Realtors / BBVA Research

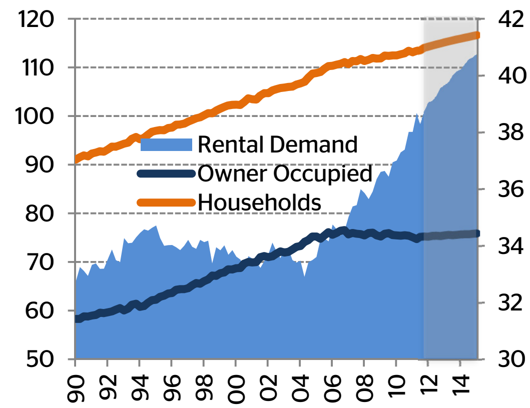
As a consequence of the decline in home prices, the subsequent rise in foreclosures, and tighter credit standards, many families are choosing – involuntarily or otherwise – to rent rather than buy. The homeownership rate continues to fall and our analysis projects a decline to 65% within 2-3 years. In a risk scenario, it could decline more rapidly to 64% - a level not seen since the early nineties. This trend indicates that rental demand will remain elevated over at least the next five years. Based on projections of the growth in households and the decline in the home ownership rate, the market will need nearly three million additional rental units by 2016.

Chart 3
Home Ownership Rate
%, Seasonally Adjusted



Source: Census and BBVA Research

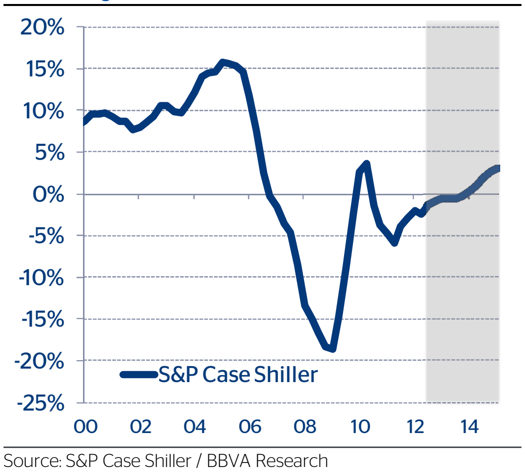
Chart 4
U.S. Households, Owner-Occupied and Implied Rental Demand, Millions



Source: Census and BBVA Research

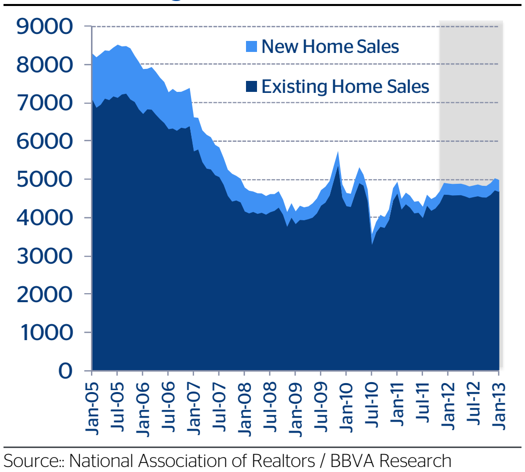
A declining homeownership rate underlies the low observed demand in the housing market. Nevertheless, the floor in housing sales and starts appears to have occurred last year, as we project these measures to continue their upward trend this year, although at a muted pace. The value of new single family housing construction is up on a year-over-year basis, and residential investment is finally making a positive – albeit small – contribution to GDP growth in early 2012. Lower new home inventories are supporting this construction activity: the months' supply of new homes reached around 6 months, and continues to tick downward as the sales rate rises. A return to about 4 months' supply is more consistent with a healthy new home market: a 23% annual average increase in the pace of new home sales combined with another 13% drop in new home inventory would return the months' supply figure to 4% by the end of the year.

Chart 5
S&P Case Shiller National Home Price Index
YoY % Change



Source: S&P Case Shiller / BBVA Research

Chart 6
New and Existing Home Sales, SAAR Thousands

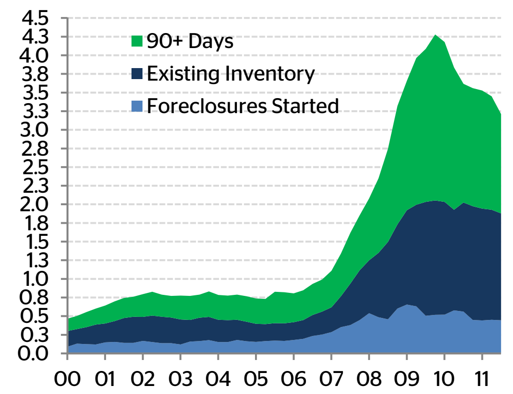


Source:: National Association of Realtors / BBVA Research

Prices will continue to slide, due to elevated levels of shadow inventory

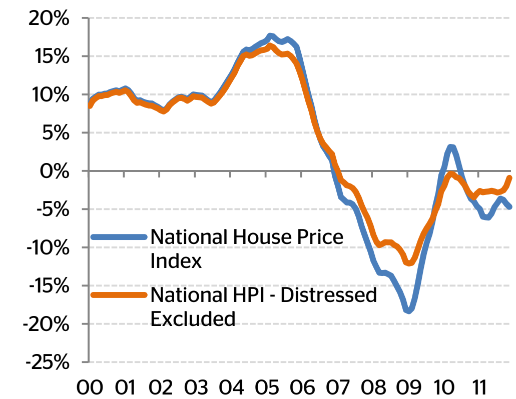
Despite the improvement in the pace of housing sales and new home construction, price indexes of existing homes will continue to decline throughout 2012 and possibly 2013. The pressures on home prices stem from a record high inventory of seriously delinquent mortgages and foreclosed properties that has only recently begun to trend downward. This shadow inventory consists of nearly four million homes: there are roughly 1.9 million homes that are in some stage of foreclosure, 1.3 million that are seriously delinquent (90+ days), and another 500,000-800,000 real-estate owned homes that have completed foreclosure. Foreclosures are attracting homebuyers and investors, as approximately 25% of total home sales are distressed properties (above 40% in California and Arizona). Because these properties sell for substantial discounts of 30% to 40%, aggregate home price indexes are projected to continue to fall. Nevertheless, prices of non-distressed properties are showing stability, but any price appreciation will be minimal – and certainly negative in real terms.

Chart 7
Inventory of Foreclosures and 90+ Day Delinquencies Million Units, End-of-Quarter



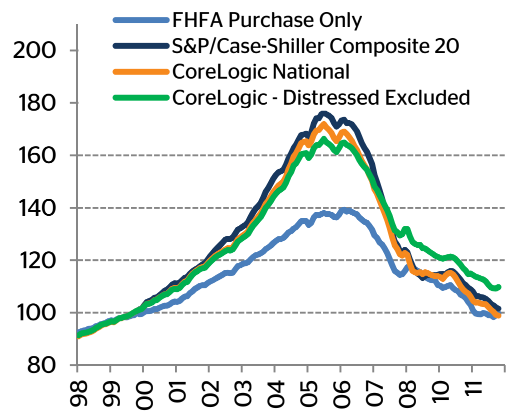
Source: MBA / Haver and BBVA Research

Chart 8
Core Logic Home Price Indexes
NSA, YoY % change



Source: Core Logic/ Haver and BBVA Research

Chart 9
Real Home Prices
January 2000=100, Deflated by CPI Less Shelter



Source: FHFA, S&P, CoreLogic, BLS / BBVA Research

A decade of real price appreciation has been erased

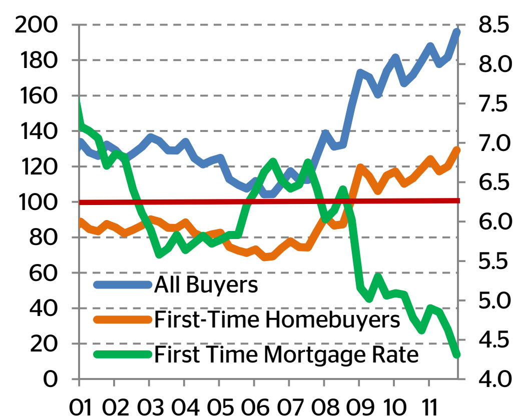
The real price appreciation of houses observed over the past decade has effectively been wiped out. Price indexes adjusted for inflation have returned to their 1998-1999 levels, and their continued slide combined with rising rents means that the rent-to-price ratio should reach its pre-2000 average of 5.25% in late 2012. Both of these signals are positive for a housing recovery in late 2012 and 2013: today's low mortgage rates and more favorable prices allow buyers to hedge inflation and rising rents. This reality is not lost on potential buyers: early Google trend indicators of homebuyer interest suggest an uptick in early 2012.

Record high affordability supports demand; tight credit may be an obstacle

The double-digit fall in home prices relative to household incomes combined with low mortgage rates has boosted housing affordability to previously unseen heights. Thus, the data suggests that more first-time homebuyers should be able to enter the market than ever before, provided that they can obtain credit.

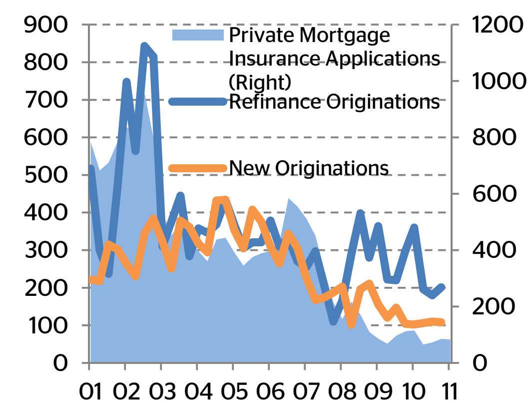
Lenders have certainly tightened credit standards for first-time homebuyers, and loan approvals should continue to rise as the unemployment rate declines and the perceived risk of job losses drops. Mortgage applications, however, remain very low, indicating that in spite of record affordability, many potential buyers are choosing to rent rather than buy. Possible reasons for low demand include further expectations of price declines, an insufficient job history, a lack of savings for a down payment and over-extended consumer credit. The deleverage process is continuing for many households as they restore their balance sheets, and because income growth trailed consumption growth in late 2011, the pace of consumption is now moderating.

Chart 10
Affordability Indexes and Mortgage Rate
Index, 100=Highly Affordable; Mortgage Rate, % (Right)



Source: National Association of Realtors / BBVA Research

Chart 11
Mortgage Originations and Applications
Originations, Billions USD; Applications, Thousands



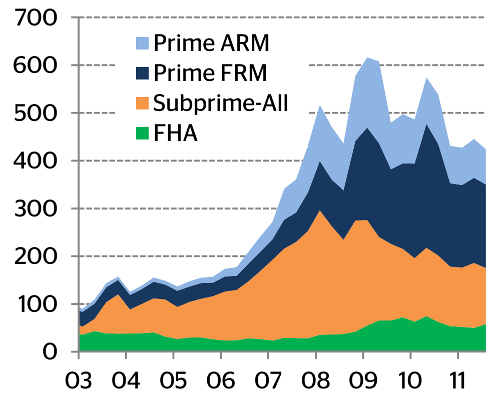
Source:: Mortgage Bankers Association / BBVA Research

Residential asset quality continues to improve slowly on bank balance sheets, but high foreclosures remain a concern for many lenders

Tighter credit standards are likely to persist for some time, as residential delinquency rates have remained persistently high, and the flow of prime fixed-rate foreclosures has not eased significantly. Thus, it ill behooves banks, Fannie Mae and Freddie Mac to ease credit standards to accommodate more buyers. We project the delinquency rate to continue declining throughout 2012, but it will remain above 8% through 2014.

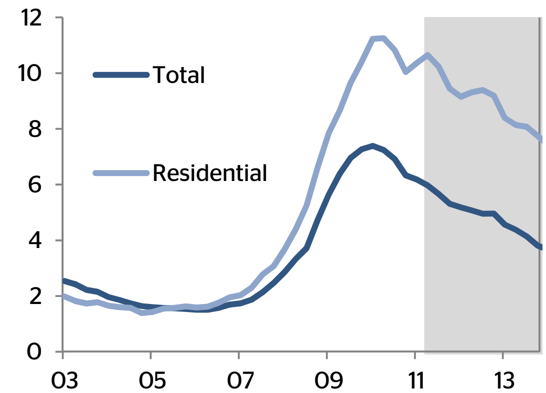
Furthermore, lenders are rightly concerned about additional foreclosures, as approximately 25% of borrowers (around 12 million mortgages) owe more than their home is worth and 8.6 million are current on their payments. Of the remaining 3.4 million that are behind on their payments, approximately 1.3 million are seriously delinquent. The risk of further home price declines and additional job losses place borrowers with negative equity at the margin of default.

Chart 12
New Foreclosures, By Borrower and Loan Type
Quarterly, Thousands of Units; ARM=Adjustable; FRM=Fixed



Source: Mortgage Bankers Association / BBVA Research

Chart 13
Total Loan and Residential Delinquency Rates



Source: Federal Reserve / BBVA Research

Federal government efforts are centered on stemming the flow of foreclosures; aid and incentives to homeowners and lenders will expand

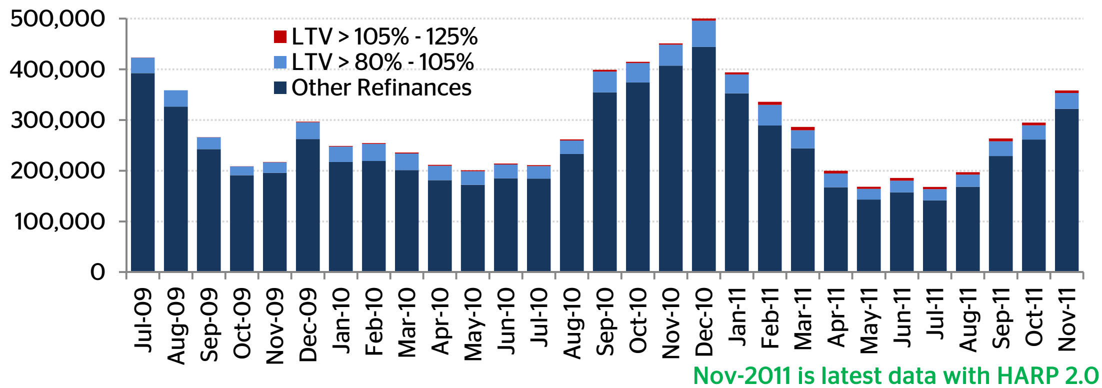
The Federal Reserve believes that the transmission channel of its loose monetary policy to the housing market is not working effectively because sales and mortgage originations remain low. The Federal Reserve released a whitepaper in January outlining the pros and cons of policies that the Administration can pursue to aid homeowners. The policy sketches ranged from mortgage modification programs to a wide-scale rental conversion program of government and bank-owned real-estate. In line with their analysis, the current Administration is attempting to expand homeowner assistance programs such as the Home Affordable Refinance Program (HARP) to encourage refinancing activity and the Home Affordable Mortgage Program (HAMP) to incentivize private lenders to modify mortgages and reduce principal balances.

Refinancing activity has picked up due to the expanded scope of the programs, and in the latest proposed expansion of HARP, the program will include investors and borrowers whose loan-to-value ratios (LTVs) exceed 80%. Thus, borrowers with LTVs in excess of 100% may be able to benefit from a combination of refinancing and principal reduction so that they are building equity.

An additional announcement has attracted investor interest in recent weeks: the FHA has approved Fannie Mae's real-estate owned (REO) to rental program, and Freddie Mac is similarly developing a program to allow investors to buy their REO properties in bulk and convert them into rental units. Investors are attracted to the steep purchase discounts of these foreclosed homes: the rental units may generate positive returns due to rising rents and the eventual sale of the property at a higher price. The two federal Government Sponsored Entities (GSEs) and the FHA own an estimated 215,000 distressed properties that they need to sell. Based on the projected demand for rental properties over the next several years, such a program could help ease rising rents by boosting supply and satisfying the new demand.

This rental conversion program, however, will only have a positive effect if people still want to live in the areas with the highest number of foreclosures. Many of these areas are saddled with high unemployment, and slow job growth limits opportunities for residents. During the housing boom, the flow of residential investment into new construction stimulated the local economies by boosting tax revenue and spending. Today, some of these communities are struggling with declining property tax revenue and an outflow of residents.

Chart 14
Fannie and Freddie Total Refinancing (Number of Loans), by Loan-to-Value Ratio (LTV)



Source: FHFA / Haver, BBVA Research

High refinancing activity presents an opportunity for banks; but the direct economic impact of refinancing will be minimal

Due to exceptionally low mortgage rates, many borrowers are finding it sensible to refinance their existing mortgages to lower their monthly payments. The total volume of refinance originations has been higher than that of new mortgages throughout the past four years, as both rates and sales plummeted. Nevertheless, some borrowers are unable to refinance – either they have loan to value ratios that are too high (perhaps negative equity), or the upfront transaction costs make refinancing not worthwhile. Thus, the federal government has proposed to further expand the Home Affordable Refinance Program (HARP) by allowing residential investors to refinance and eliminating the out-of-pocket costs of refinancing for borrowers. These changes will certainly spur further activity and could be a boon for lenders to collect fees and capture market share.

Refinancing and mortgage modification programs aim to boost economic activity on two fronts. First, program proponents allege that lowering monthly payments will help the marginal borrower avoid default and subsequent foreclosure. The evidence that refinancing will prevent foreclosures, however, is mixed, as the savings from refinancing cannot fully replace the income from a lost job. Second, by lowering monthly debt obligations, refinancing frees up household income and allows consumers to spend more in the market, thus boosting economic activity. The extent of this boost from first and second-round effects, however, is minimal.

Clearly, a new home purchase loan that puts $250,000 into the market has a more substantial impact than a refinancing effort that saves a homeowner $100-$300 per month. At the peak of the housing boom in 2005, our estimates suggest that lenders were injecting as much as $300 billion annually into the economy for the purchases of new homes as both the prices and sales of new homes shot upward. In 1995, prior to the boom, lenders were injecting slightly less than $100 billion annually. Thus, the cumulative direct effect of rising sales and prices was a boost to economic activity of around $1 Trillion between 1997 and 2007. Given that much of this money was being reinvested in the housing market for new construction and thus creating jobs, the second-round effects were substantial and produced a sharp rise in economic output and asset values.

Even a refinancing effort that could reach all of the 12 million underwater borrowers and save each household $3000 per year would only reduce their collective debt service by $36 billion per year – far less than the $200 billion surplus that lenders were injecting into the economy each year during the height of the boom.

In summary, while federally-supported refinancing, mortgage modification and REO conversion programs will help to reduce homeowner debt burdens and ease the inventory of distressed properties, they will have a minimal effect on near-term economic growth. A reduction of distressed inventory, due to rental conversions and fewer foreclosures, however, could help the transition to the equilibrium in the housing market.

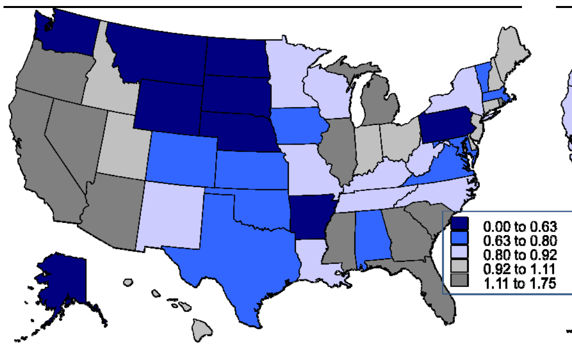
Across the U.S., substantial regional variation in market fundamentals will determine the pace of housing sales and new residential investment

Although home prices have slid in all markets throughout the U.S. during the last four years, the bust was the most severe in Arizona, California, Florida and Nevada. Recent indicators suggest that housing activity is picking up in Arizona and California: delinquencies declined steadily in 2011 and construction employment has remained positive on a year-over-year basis during the majority of last year. Although the rate of new foreclosures remains high – in excess of 1%- it is exhibiting a downward trend. The inventory of foreclosures has been steadily declining in these states also, boosted by investor demand and short sales.

Nevada is now beginning to follow California and Arizona's improvement; however, the percentage of total loans in foreclosure is double that of those states. Nevertheless, the improvement in these states stands in stark contrast to Florida's housing situation that is the worst in the nation.

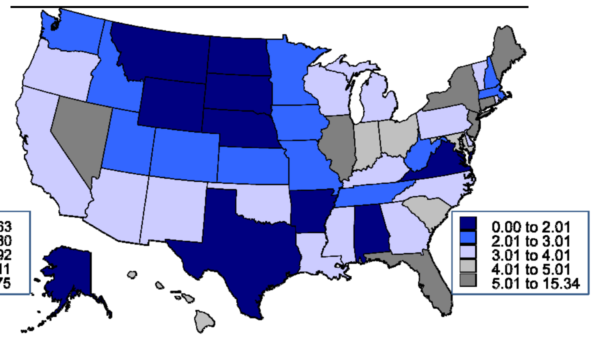
While inventories of foreclosures declined in many states in 2011, they actually rose over the year in Florida, and remain above 14% of total loans - double the rate of Nevada's inventory. Thus, in local markets, inventories of existing homes may be well above 16-24 months' supply if we include these foreclosures. To the extent that an inefficient foreclosure process has hampered the market's improvement, measures to speed completion of the foreclosure process, transition properties into real-estate owned inventory and connect buyers or investors are the only remedy to bring down the levels of distressed properties.

Chart 15
New Foreclosures, 4Q11 by Quintile
% of Total Loans



Source: Mortgage Bankers Association / BBVA Research

Chart 16
Foreclosure Rate (Inventory), 4Q11 by Quintile
% of Total Loans



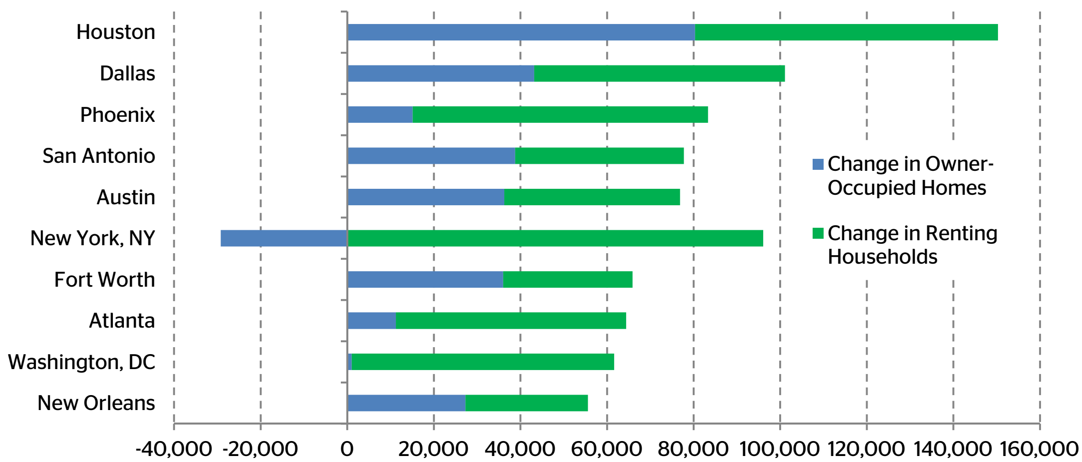
Source: Mortgage Bankers Association / BBVA Research

High oil prices support energy production and exploration: housing demand surging in North Dakota

As the initial declines in these markets spread to the center of the country, however, rising energy prices and strengthening global demand supported a wave of new investment in U.S. energy exploration and production. Much of this activity has been concentrated in the center of the country: from Texas and Louisiana up to North Dakota and Idaho. The mining and support activities sectors have led employment gains in these states, and thus they have seen an influx of new residents. North Dakota's economic output is expanding rapidly, and as a consequence, construction employment is up over 20% on the year and residential investment is surging ahead.

This structural change is evident in the table below: between 2007 and 2010, five of the top 10 markets that saw an increase in the total number of households are in Texas. In contrast to New York City which saw a decrease in owner-occupied households and a transition to renters, owner-occupied households grew in these Texas metropolitan areas. Thus, in select markets where job growth is occurring, a home purchase looks attractive given today's low borrowing costs.

Chart 17
Change in Households, by Ownership Type: 2007-2010
Top Metro Areas ordered by Total Change in Households



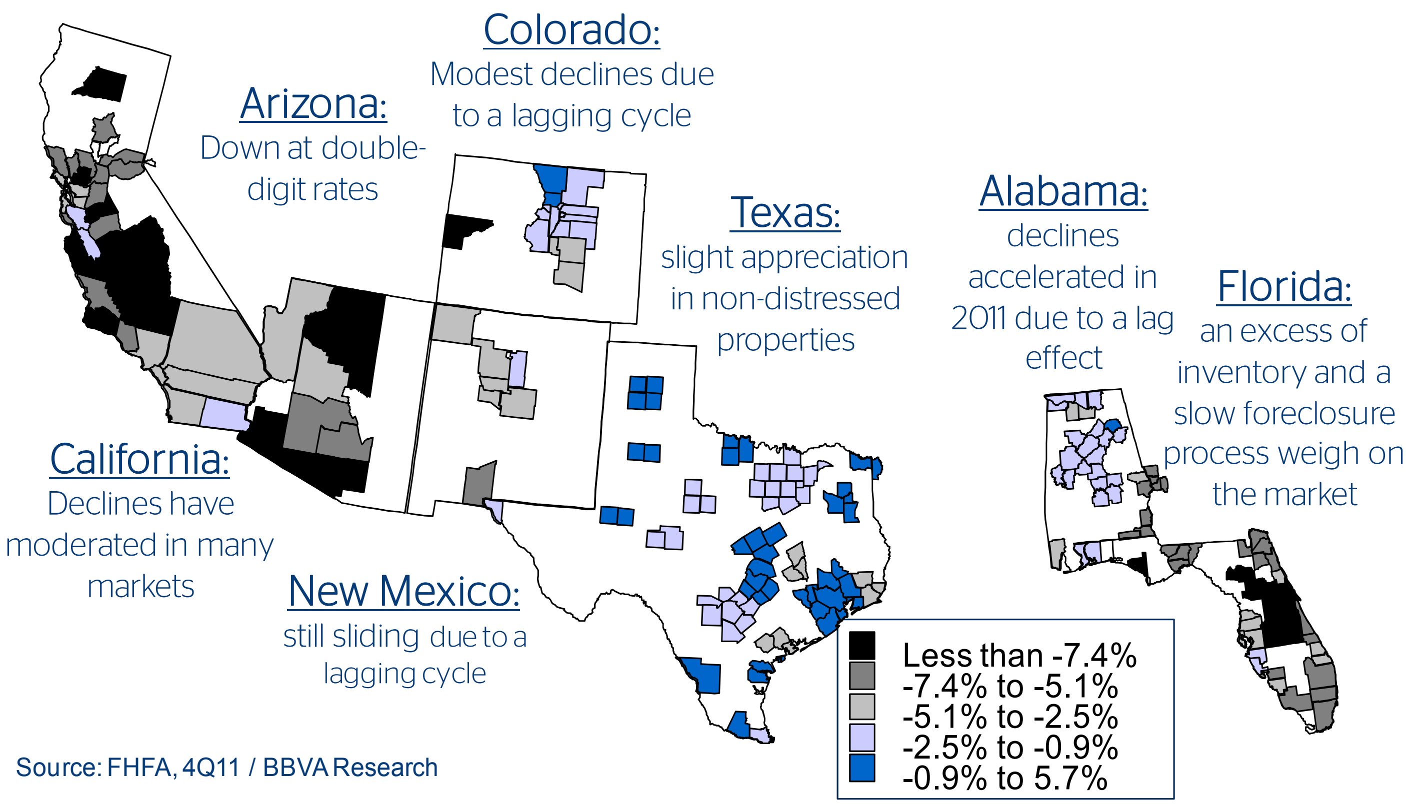
Source: Census and BBVA Research

Bottom Line

Recent data suggest that the housing market will improve in 2012 and lower new home inventories indicate that new residential construction projects will make a positive contribution to economic growth this year. While the floor in sales and housing starts appears to have been reached in 2011, national price indexes will see further declines in 2012 due to the overhang of foreclosed properties and the inventory of existing homes. Although the months' supply of existing homes has declined to around 6 months, adding the nearly 4 million shadow inventory to the total homes for sale puts the months' supply in excess of 17 months at the current sales rate. The prospect of further foreclosures will weigh on the market during at least the next two years, but the regional impact will vary. Curtailing the flow of foreclosures is a key target of policymakers. The federal government is focused on aiding struggling homeowners, and borrower and lender incentives to refinance or modify mortgages are expected to increase. The high demand for refinancing combined with these incentives may be an excellent opportunity for lenders to open dialogs with existing clients, gain market share and attract new customers.

Although housing fundamentals are still poor in many local markets, there are pockets of metropolitan areas that are experiencing rapid growth and demand for housing in these areas is relatively strong. Rising energy prices and exponentially increasing energy demand in emerging markets are supporting jobs and new residential investment in key energy producing states throughout the U.S. such as North Dakota, Texas, Louisiana, Idaho, Colorado, Wyoming and Pennsylvania – among others. At the same time, record high affordability is a positive message for potential homebuyers, and rent-to-price ratios are projected to return to their pre-2000 average by late 2012 because rents are rising and prices will continue to slide. Thus, a home purchase today in a growing metropolitan area looks attractive for qualified buyers.

BBVA Compass Sunbelt Region Metropolitan Area Home Prices
FHFA All Transactions Index, Year-Over-Year % Change, by Quintile, 4Q11



Source: FHFA, 4Q11 / BBVA Research