A Primer On The U.S. For-Sale Residential Market

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CoStar PORTFOLIO STRATEGY™

1 INTRODUCTION

The 10-year decline (2004–15) from the record level of U.S. homeownership has begun to reverse itself in the past several quarters. Residential sales volume is up, pricing has improved considerably from its depths after the recession, and inventory on the market is tight. Equally important, given the history of the subprime crisis and the Great Recession, residential mortgage lending standards today remain more conservative, attracting a pool of borrowers with higher credit quality.

This paper will provide an overview of both the dimensions of the residential mortgage market and cyclical factors leading to a renewed interest in homeownership. It's certain that the current upturn in homeownership won't revert to its previous frenzy—fueled by near-universal access to financing—but will rather maintain a much more reasonable pace, supported by more stringent financing standards.

2 CHARACTERISTICS OF THE RESIDENTIAL MORTGAGE MARKET

Historically, the ideal of the American Dream has included owning one's home; indeed, the development of the American suburb during the second half of the last century was synonymous with this aspiration. However, the last decade saw a pronounced drop in U.S. homeownership, as rapid price appreciation fueled by the ubiquitous availability of financing (regardless of credit history or employment), resulted in a near-meltdown in capital markets, ushering in the Great Recession. In turn, many lost their homes or became disillusioned by the idea of owning a home.

As the financial backdrop and regulatory environment have improved considerably since 2007–09, access to financing is now becoming somewhat less restrictive, leading to an improving rate of home sales and increasing values. Today, the total outstanding U.S. residential mortgage debt sits about 11% below the 2008 peak. (See *Exhibit 1*.) However, the U.S. mortgage market remains quite sizable compared to other fixed-income markets. Though short of the Treasury market by about $3 trillion (25%), it's roughly 15% larger than the corporate debt market, more than 1½ times the size of the municipal bond market, and nearly $9 trillion more than the entire CMBS[1] market. (See *Exhibit 2*.)

[1] CMBS stands for commercial mortgage-backed securities, which are fixed-income securities backed by commercial real estate loans

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Exhibit 1: Total U.S. Mortgage Liability

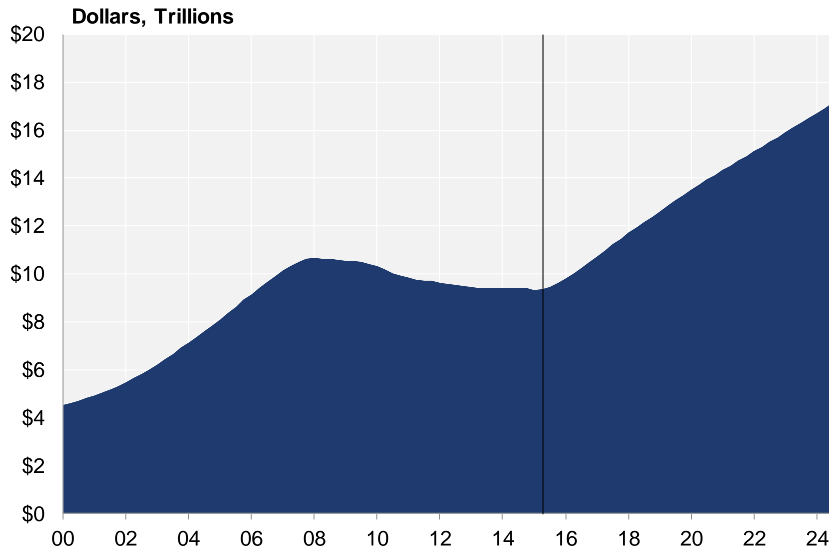
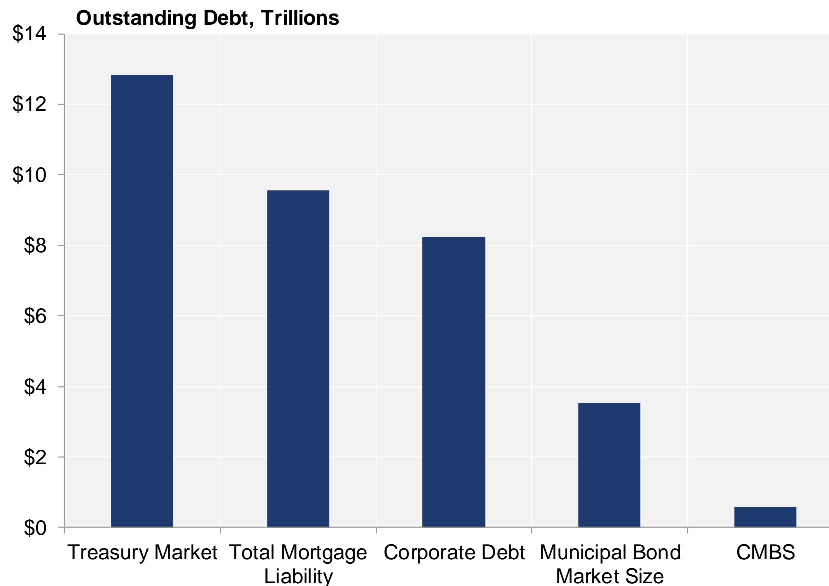


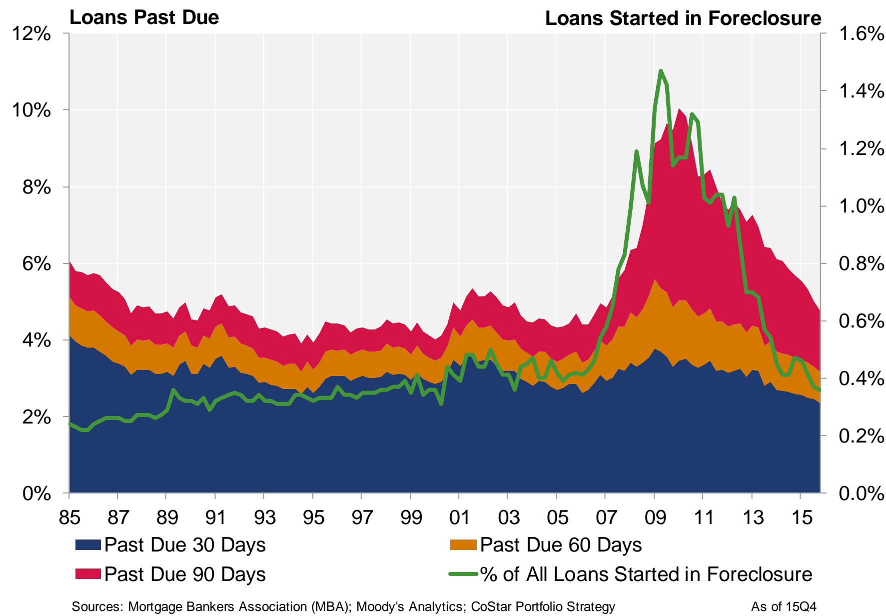
Exhibit 2: Mortgage Market Vs. Other Fixed-Income Markets



Looking forward, Moody's Analytics does predict that the residential mortgage market will begin growing again, driven by increasing home sales and construction. (See *Exhibit 1*.) This favorable outlook relies upon demographic trends that point to future homeownership, namely the sizable Millennial generation getting married and having children.

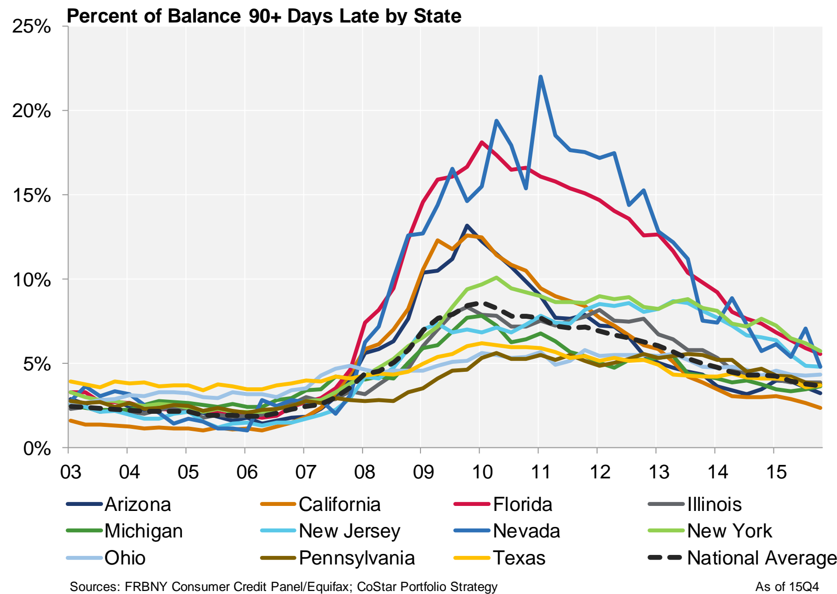
Along with this nascent improvement in the level of homeownership, the underlying fundamentals of the mortgage market have improved considerably. (See *Exhibit 3*.) Foreclosures once dominated for-sale listings, but as of 15Q4, the percentage of outstanding loans entering foreclosure dropped to under 0.4%, below even the lowest rate in the last cycle. Similarly, the percentage of loans more than 30 days past due is at its lowest level since 2007.

Exhibit 3: U.S Loans Past Due And Foreclosures Started



Breaking this down at a state level, U.S. fundamentals have improved across the board, as shown in *Exhibit 4*. Even in Nevada, where more than 22% of all mortgages were at least 90 days late in 2011, the statistics have improved dramatically, and delinquencies have fallen considerably, to below 5%.

Exhibit 4: Percent Of Balances More Than 90 Days Late



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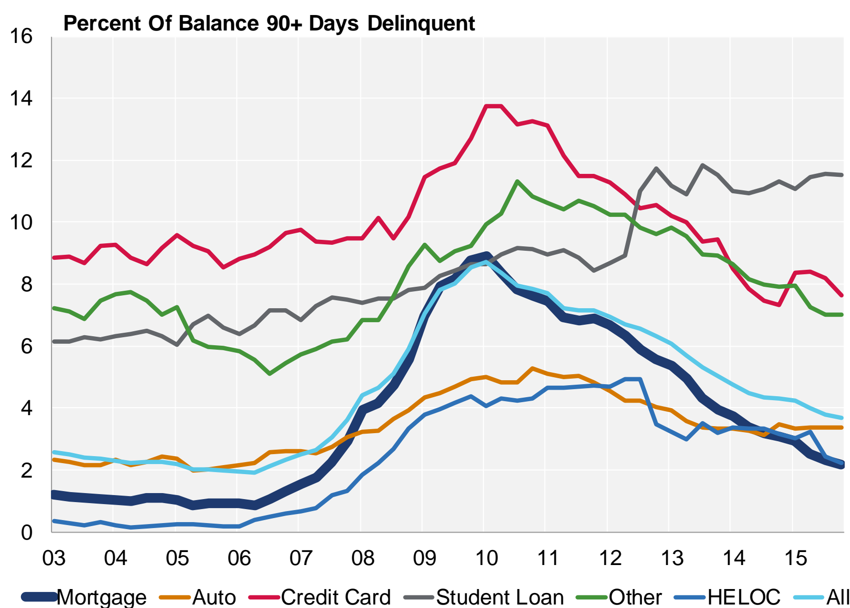
Compared to other common types of household debt, mortgage delinquencies have dropped markedly, to well below delinquent debt for credit cards and both student and auto loans. (See *Exhibit 5*.)

Exhibit 5: Percentage Of Balance 90+ Days Late By Loan Type[2]

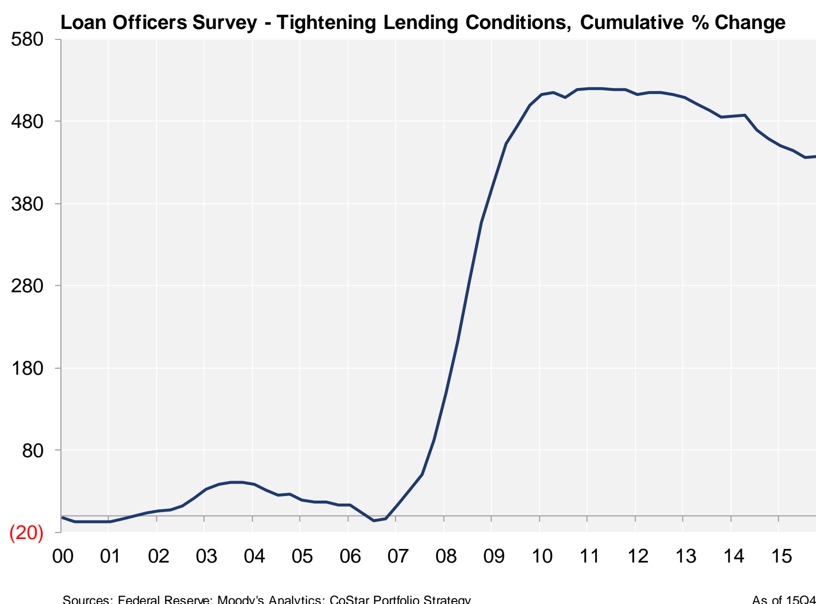


In fact, compared to other types of typical household debt, mortgage delinquencies have had the biggest drop (for 90-days-plus overdue), falling more than 670 basis points[3] since 2010. In comparison, delinquencies on credit card debt dropped just over 600 basis points during the same period, while overall measures of household debt performance improved by 500 basis points. (See *Exhibit 5*.)

Such a marked improvement in residential mortgage performance is directly attributable to a pronounced tightening of lending conditions. Senior mortgage officers are surveyed quarterly by the Federal Reserve Board, to determine how credit standards have changed over the past three months. After the housing bust, credit availability was slim to none, underscoring just how restrictive lenders became. While more loan officers now report that their banks are loosening lending conditions, gone are the days when applicants had to simply pass a breath test to get a mortgage. (See *Exhibit 6*.) The resulting constriction in residential lending standards, along with governmental initiatives, contributed to the marked decline in delinquencies observed today.

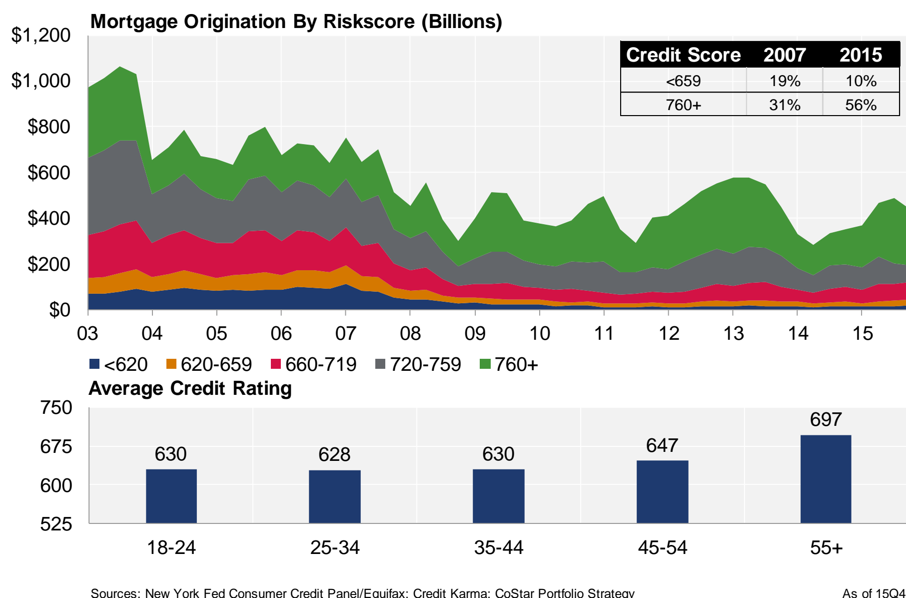
[2] HELOC stands for home equity line of credit which is akin to a second mortgage
[3] Basis points are a unit a measure of percentages and are equal to 1/100th of 1% (a 1% change would be equal to a 100 basis point change)

Exhibit 6: Tightening Mortgage Lending Conditions



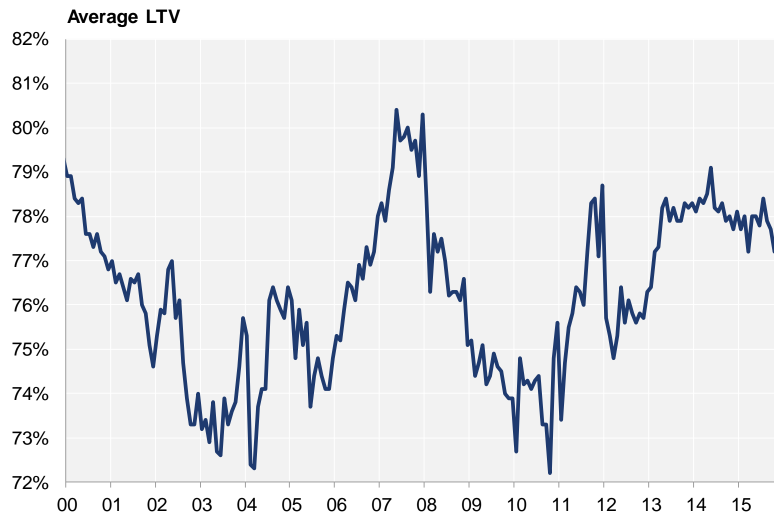
A look at another important commonly used industry measure, FICO scores, underscores the notion that access to the residential mortgage market is increasingly restricted to the most creditworthy applicants. (See *Exhibit 7*.) Indeed, given generally higher average credit ratings among older cohorts, it's not implausible that mortgage commitments are now routinely going to those with more established careers and savings. High levels of student debt rank among the key reasons why members of the large Millennial generation, who tend to have lower credit scores, are not fully embracing homeownership at this point in their burgeoning careers.

Exhibit 7: Mortgage Origination By Riskscore



Finally, compared to the last housing cycle, loan-to-value (LTV)[4] ratios today are still below the previous high point in 2007. (See *Exhibit 8*.) Even in the wake of a previously announced easing of down payment standards by the GSEs[5], LTVs remain a comfortable 280 basis points under their last cyclical peak.

Exhibit 8: U.S. Average LTVs

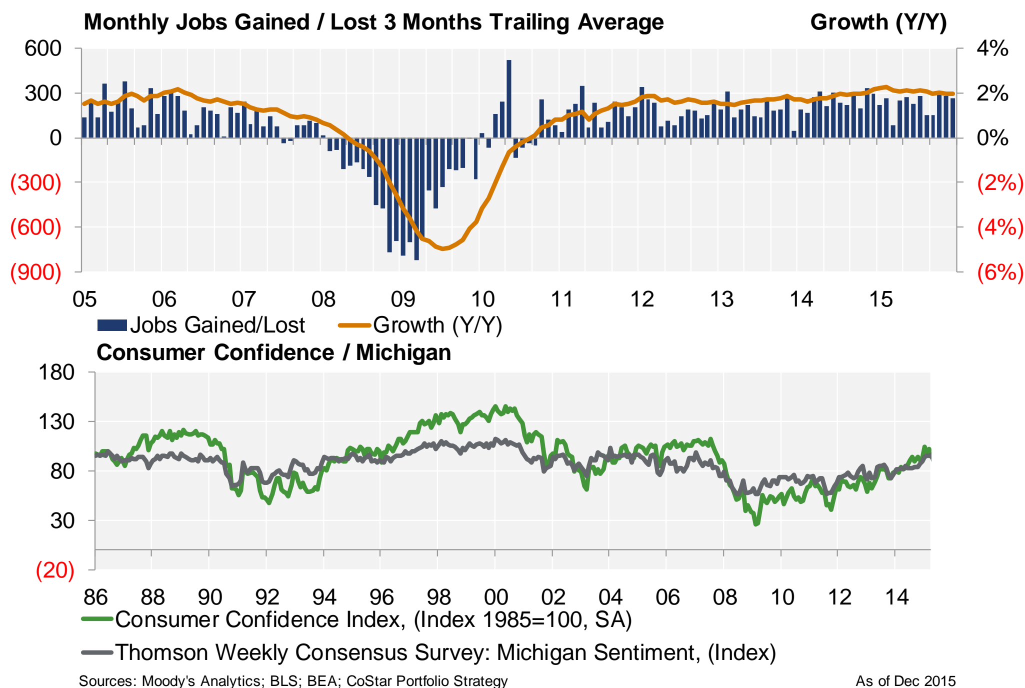


3 STATE AND OUTLOOK FOR THE FOR-SALE RESIDENTIAL MARKET

Despite its marked improvement, the U.S. single-family housing market is still working to fit comfortably into its new post-Great Recession skin. As the slow but steady economic gains of this cycle have progressed, for-sale single-family construction has remained muted in the face of an exploding for-rent multifamily environment. At the same time, an exceptionally tight market has spurred healthy pricing gains, while total supply on the market remains near a multi-decade low. In its current state, the market is best described as stable, given the lack of construction and permitting activity. However, despite a pronounced lack of supply growth, it is important to note that the single-family housing market is in a far healthier position moving forward than it was during the prior cycle and should be able to weather any economic downturn without fundamentals completely unwinding. Furthermore, with growing confidence in the sector, new construction should pick up somewhat.

[4] LTV stands for the loan-to-value ratio. It represents the proportion of the loan relative to the value of the asset.
[5] GSE stands for government-sponsored enterprise. In this case Fannie Mae and Freddie Mac.

Exhibit 9: Monthly Job Growth And Consumer Confidence Indices[6]



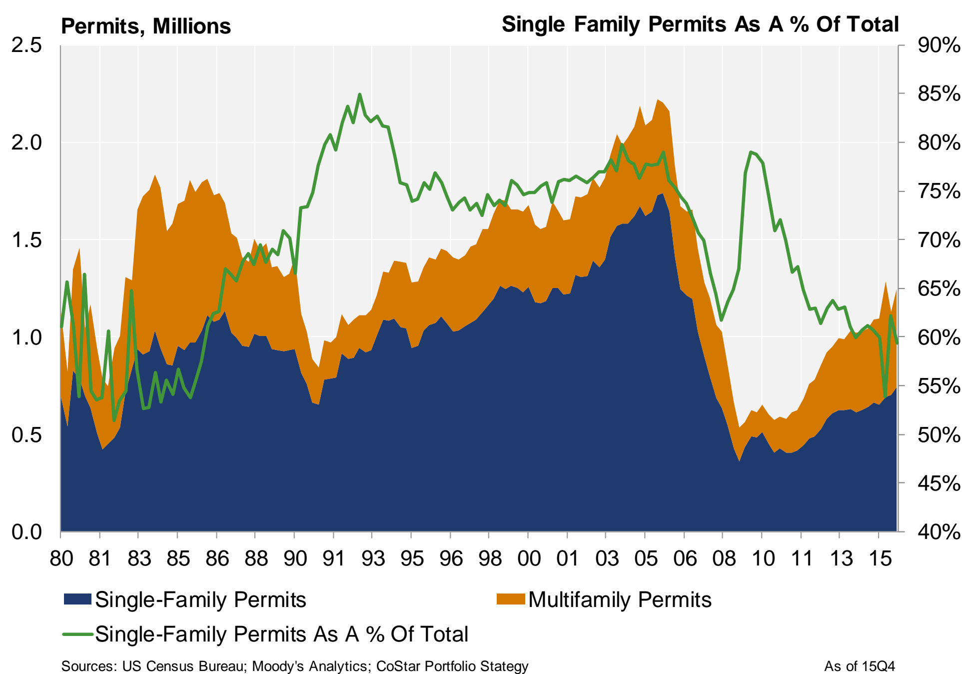
While this economic cycle has been anything but flashy, both employment and output continue to demonstrate measured, consistent growth. (See *Exhibit 9*.) Indeed, recent job gains (2014–15) equate to the healthy pace last seen during 1998–99. Moreover, as total U.S. employment levels surpassed the previous cyclical peak in mid-2014, wage growth has improved, while consumer confidence continues to trend upwards as well. (See *Exhibit 9*.)

Outside of economic gains, the biggest boon to the for-sale, single-family market has been a historical dearth of new supply. Total single- family permitting between 2010 and 2015 averaged a meager 550,000 permits, versus nearly 980,000 between 1986 and 2015. While permitting has been trending upward in recent months, as of December 2015 total issuance is still more than 250,000 below this long-term average. In fact, prior to the Great Recession, one would need to go back as far as 1995 to observe a similar dip below one million permits. Going beyond structural supply-side changes in the sector, changing demand factors have also proven to be a primary driver of market tightness. For example, between 2005–14, households renting single-family detached homes increased by over 3.3 million, per the U.S. Census.

Equally important, during this cycle developers have shown a demonstrable preference for multifamily construction. As the green line in *Exhibit 10* demonstrates, total single-family permits sit at levels last seen in the 1980s.

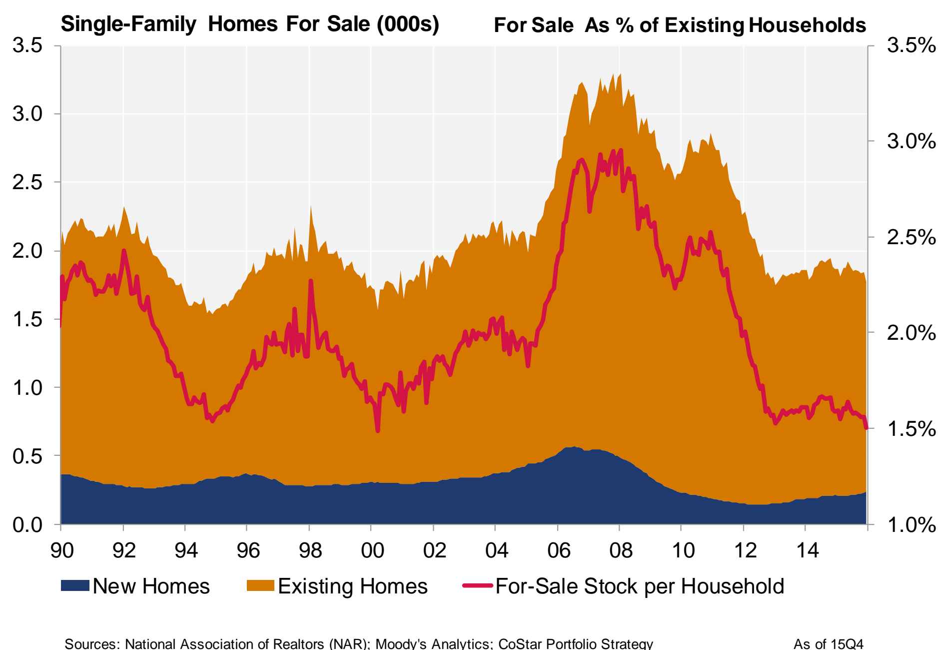
[6] SA stands for seasonally adjusted

Exhibit 10: Permitting By Housing Type



In turn, the lack of new home construction has created a market where total single-family homes for sale equate to levels last seen in 1990 and 2000. (See *Exhibit 11*.) At the same time (1990–2015), the U.S. has added nearly 25 million households. In other words, the number of homes for sale as a percentage of total U.S. households has held at or near multi-decade lows since 2013, with no signs of a dramatic increase in inventory on the near-term horizon.

Exhibit 11: U.S. Single-Family Inventory Available For Sale



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Finally, as previously noted, for-sale housing production has waned in the wake of a dramatic shift towards rental housing. Multiple barriers to entry (e.g. stricter lending standards, student debt) prevent Millennials from joining the homeownership pool, while Gen Xers and Baby Boomers also have displayed a preference for the rental market. In turn, the U.S. homeownership rate fell to its lowest level since the early '90s, coming in at 63.8% in 15Q4, 540 basis points below the 2004 peak. However, over the past two quarters, that rate has ticked up 40 basis points. Most importantly, this is the first time that the homeownership rate has risen in back-to-back quarters since 2009. (See *Exhibit 12*.)

Exhibit 12: U.S. Homeownership Rate

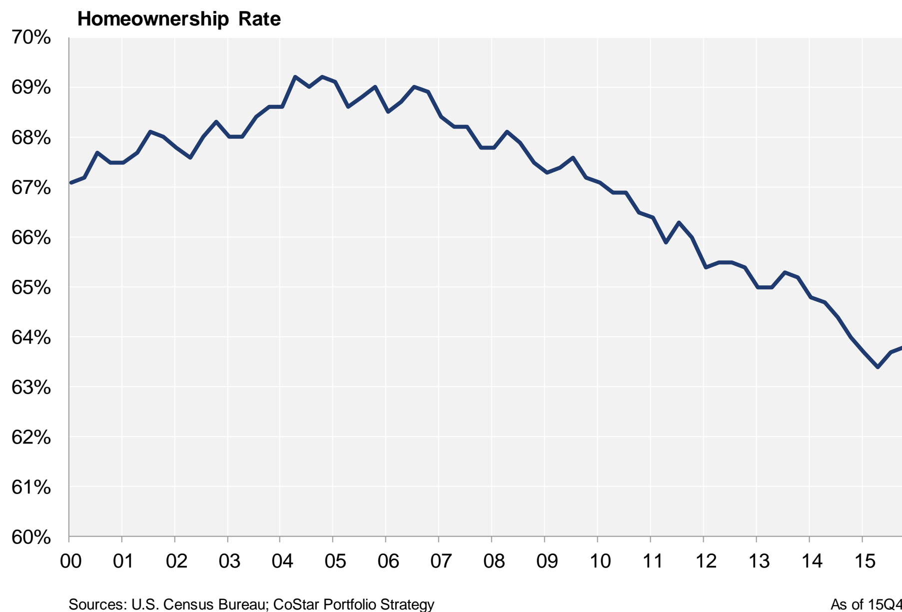
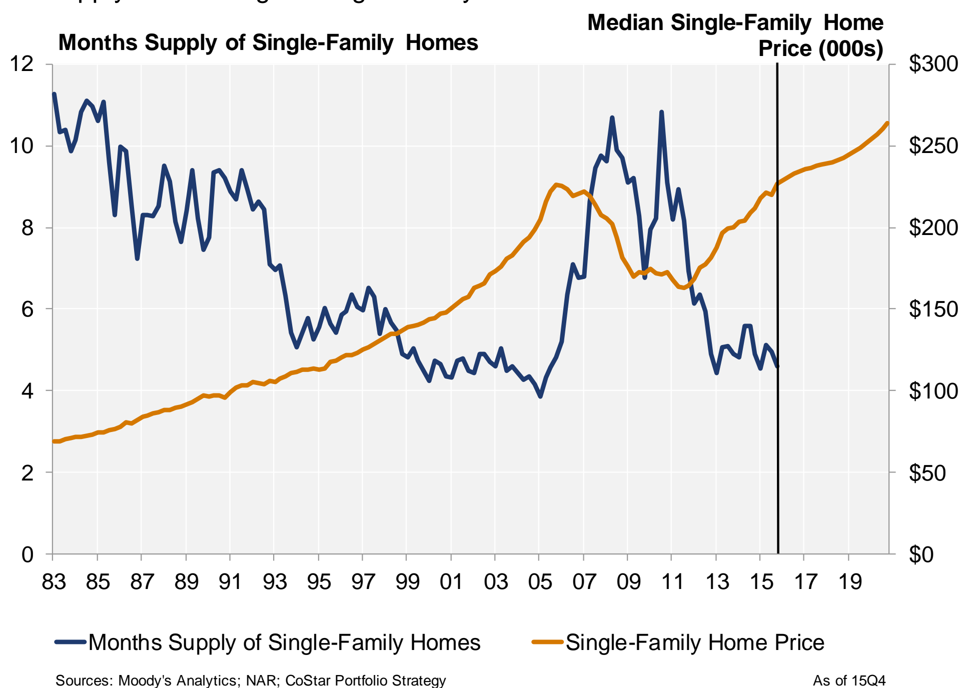


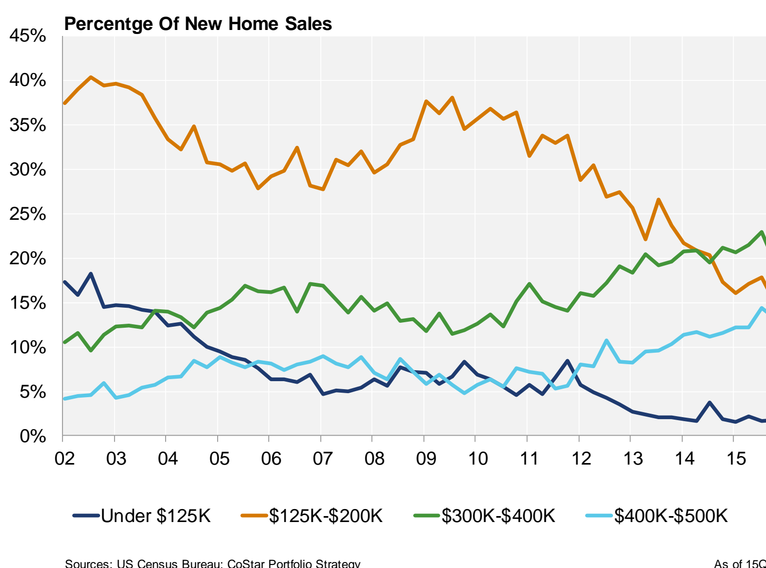
Exhibit 13: U.S. Supply And Pricing Of Single-Family Homes



Despite the historic rate at which buyers have vacated the for-sale market, largely for multifamily rental units, the overall tightness of the for-sale single-family market has shifted its dynamics dramatically in favor of sellers. (See *Exhibit 13*.) Pricing has aggressively bounced back since the recession, and according to the National Association of Realtors, home prices are now in line with their prior peak. With inventory on the market remaining tight, prices should continue to rise over the next five years, according to Moody's Analytics. (See *Exhibit 13*.)

To a large degree, this increase in pricing has also resulted from developers adapting to the changing demand pool by building move-up product for households—nicer, larger homes, rather than starter homes. (See *Exhibit 14*.) The biggest growth in share of new home sales has been in the $300,000–$400,000 and $400,000–$500,000 categories, which have grown by 2.4% and 4.4%, respectively, since their 2006–07 peak. Conversely, both the under-$125,000 and $125,000–$200,000 tranches have seen their shares shrink dramatically, by 7.7% and 18.3%, respectively, since their last cycle peak.

Exhibit 14: Percentage Of New Home Sales By Sale Price



Even with rising prices for single-family homes, wage growth in recent years, along with highly favorable mortgage rates, has actually fostered an environment wherein U.S. median household income is now 65% above requisite levels necessary to qualify for a mortgage (80% LTV of a median-priced home). (See *Exhibit 15*.) Essentially, white-collar salaries are rising faster than home price inflation. Since those most likely to be able to afford the more expensive homes built during this cycle are also less likely to have the credit and debt burdens keeping them out of the homeownership pool, demand-side dynamics, from a pure affordability standpoint, remain relatively strong.

Exhibit 15: Housing Affordability Index Vs. Mortgage Rates[7]

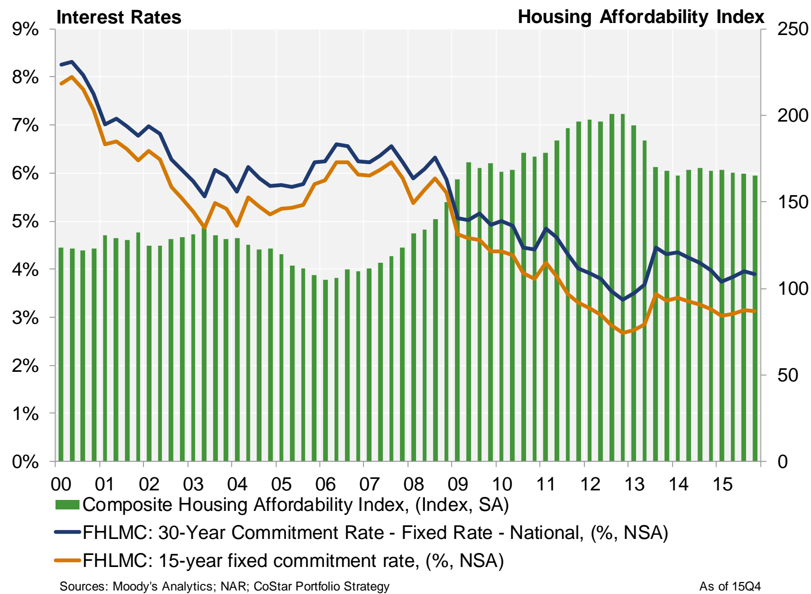
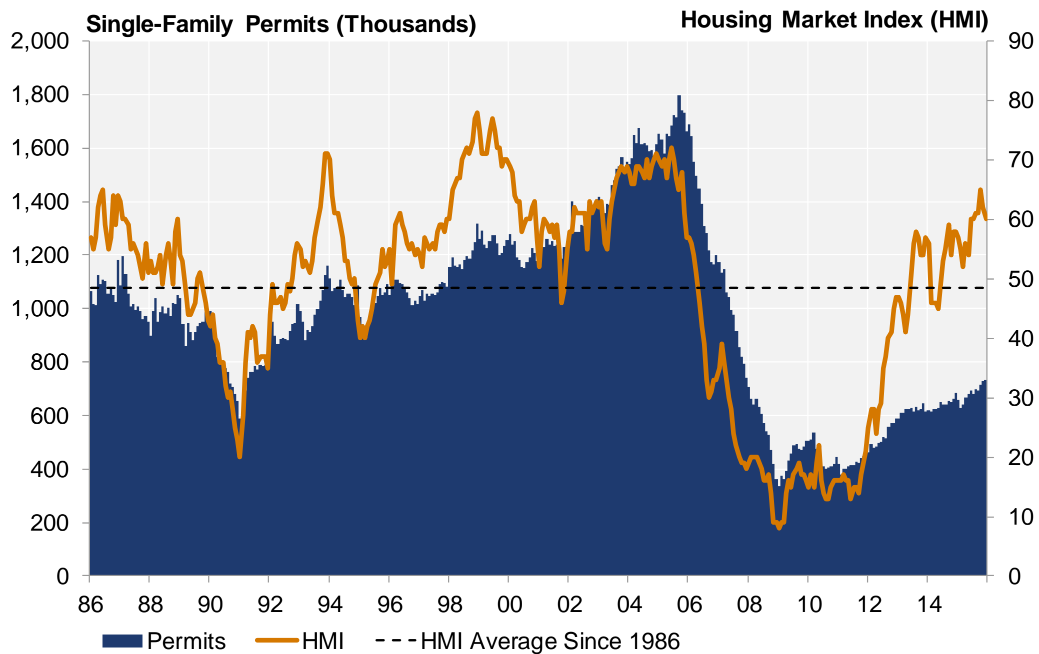


Exhibit 16: U.S. National Association Of Homebuilders Index And Single-Family Permits



As market conditions have continued to tighten and affordability concerns have been focused in the multifamily sector, confidence in the single-family industry has started to inch up in a meaningful way.

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[7] NSA stands for not seasonally adjusted

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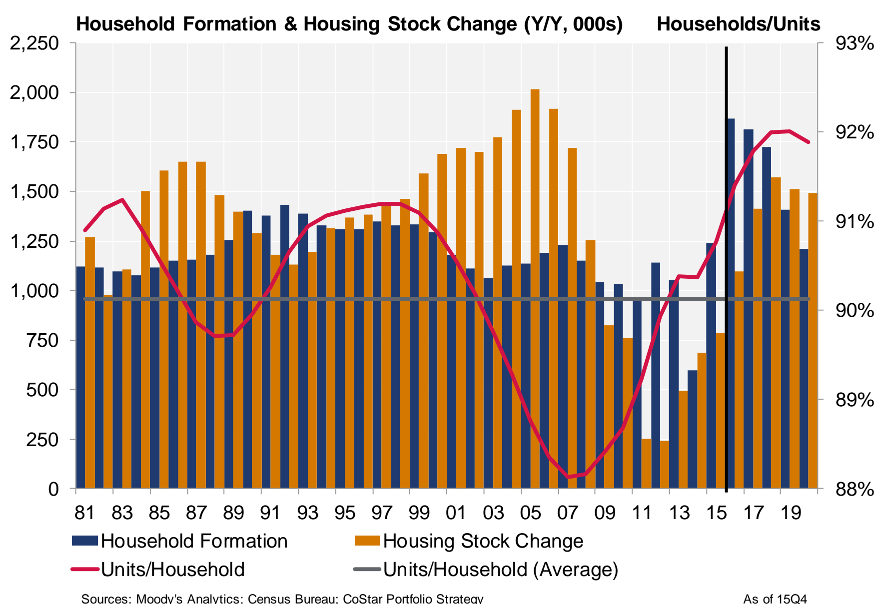
HMI, the National Association of Homebuilders' Housing Market Index, has finally surged past its prerecession low and continues to show positive momentum. (See *Exhibit 16*.) The survey-driven index asks responders to rate market conditions for new single-family home sales and single-family home sales six months into the future. As the index has ticked up above the historical average, permitting has followed suit, increasing 7% over the past year, and nearly 120% since the HMI trough in 2009. Should this growing confidence translate to increased developer activity, particularly for building starter homes, upward movement in the sector is expected to follow.

4 CONCLUSION

The fundamentals of the single-family market have markedly improved. The U.S economic expansion continues—job growth remains steady, which has improved consumer confidence and should translate into greater demand for single-family homes. As homebuilders have largely sat on the sidelines throughout this recovery—with only 240,000 new homes on the market versus 570,000 during the last cycle's peak—the supply of new housing units for sale has dramatically failed to keep up with a faster rate of household formation. (See *Exhibit 17*.)

Exhibit 17: U.S. Households Vs. Housing Stock



This recovery has been characterized by a lack of supply (the orange bars), while household formation (demand) remains strong. Dividing households by number of units gets a housing "occupancy," which comes out to roughly 90.8%, slightly above the historical average. And over the next few years, household formation is poised to continue outpacing housing construction, leading to even tighter conditions in the for-sale market. In turn, this state of affairs should put further upward pressure on home prices, as the underlying fundamentals of the for-sale housing market and mortgage market remain strong.

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