OBSERVATION

TD Economics

February 5, 2013

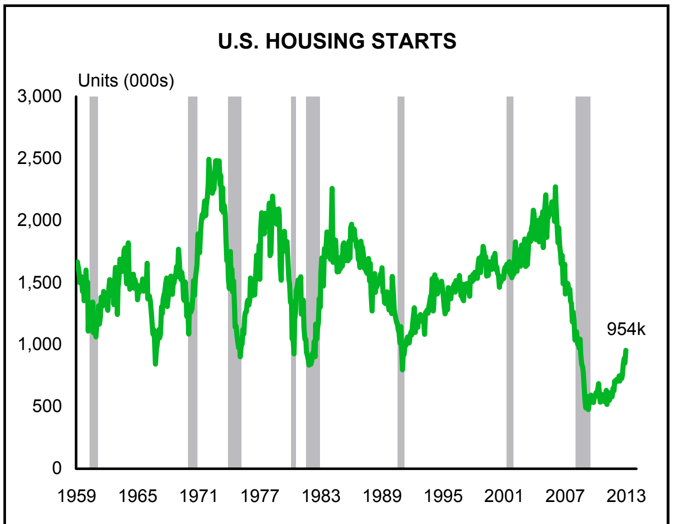
IS THE AMERICAN HOUSING REBOUND SUSTAINABLE?

Highlights

- 2012 was a very good year for the U.S. housing market. Home prices were up almost 8% and housing starts by close to 30%. The gains have prompted questions about whether the market has come too far too fast.
- An examination of long-term fundamentals suggests that housing still has considerable upside potential. Housing starts have only just surpassed the average trough experienced in previous housing cycles over the last fifty years; construction is still well under expected household formation; and, the improvement in housing affordability suggests little downside risk to home prices.
- The growth in construction has been led by multi-family units. In December, the level of multi-family starts surpassed the average over the last cycle running from 1995 to 2007. With continued pressure on the homeownership rate, rental demand is likely to remain strong and support continued gains in the multi-family sector.

Some of the most positive signals on the U.S. economy over the last year have come from the housing sector. Home prices are up almost 8% from a year ago, according to CoreLogic, and housing starts by almost 30%. However, given the persistence of a large amount of delinquent mortgages, the pace of the rebound in both prices and construction has raised questions about its sustainability. Can demand keep up to the increase in supply; or, is the market setting itself up for another price adjustment?

Exploring past housing cycles and the underlying drivers of demand and supply, the answer is clear: housing starts have barely surpassed the trough of previous cycles, construction is still well below demographic fundamentals, and home prices have returned to their longer run relationship with income. The growth in construction to-date is sustainable and is likely just the beginning of a multi-year recovery in residential investment and home prices.



Source: U.S. Census Bureau, TD Economics

Housing starts have only just surpassed past housing cycle troughs

Looking at a chart of U.S. housing starts, one thing is immediately apparent: housing exhibits strong cyclical behavior. Since 1959, there have been six major housing cycles in which a peak and trough can be clearly identified. Over these cycles, the peak in housing starts has averaged 2.1 million units (seasonally adjusted at annual rates), while the trough in housing starts has averaged 858k units.

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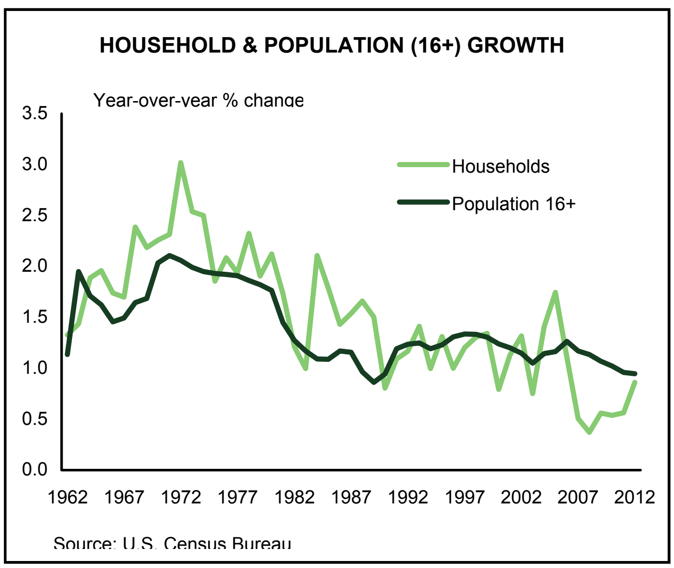
Historical U.S. Housing Cycles										
	Peak		Trough		Contraction*			Expansion**		
	Starts (000s)	Date (Month)	Starts (000s)	Date (Month)	Duration (Years)	% Change (Total)	% Change (Annual)	Duration (Years)	% Change (Total)	% Change (Annual)
	--	--	1,063	Dec-60						
	1,820	Feb-64	843	Oct-66	2.7	-53.7	-25.1	3.2	71.2	18.5
	1,769	Jan-69	1,085	Jan-70	1.0	-38.7	-38.7	2.3	109.8	38.9
	2,494	Jan-72	904	Feb-75	3.1	-63.8	-28.0	2.0	129.9	51.6
	2,197	Apr-78	837	Nov-81	3.6	-61.9	-23.6	3.2	143.0	32.4
	2,260	Feb-84	798	Jan-91	6.9	-64.7	-14.0	2.3	170.0	55.4
	2,273	Jan-06	478	Apr-09	3.2	-79.0	-38.1	15.0	184.8	7.2
Average	2,136		858		3.4	-60.3	-27.9	4.6	134.8	34.0
Current	954	Dec-12						3.7	99.6	20.7

*Contraction = peak-to-trough. **Expansion = previous trough to peak. Source: Census Bureau

The table above contains data on housing cycles over the past 50 years. The most recent trough of 478k units, reached in April 2009, is the clear outlier in this series. Since then, housing starts have doubled, reaching 954k in December 2012. The current level of starts has only just surpassed the average trough of previous cycles and it is still below the troughs reached in 1960 and 1970. With the perspective of history, the current level of housing construction remains low.

Population growth supports 1.3 million new U.S. households per year

While housing exhibits cyclical behavior, the trend that it cycles around is determined by growth in the number of households. Household formation, in turn, is determined by growth in the adult population and changes in the propensity of adults to form households. Both of these factors were negatively impacted by the Great Recession and as a result, household formation growth decelerated and contributed to the decline in construction investment (see chart, bottom left).



However, the creation of households rebounded in 2012 to over 1 million and a further increase is anticipated over the next several years. The prior deceleration in household growth was caused in large part by the drop in employment during the recession, especially among younger cohorts. During the recession and ensuing bad labor market, youths were more inclined to remain at home rather than forming their own households.

Fortunately, the return to positive job growth has led the employment rate and the rate of household formation to rebound. For 25-34 year-olds, the employment rate rebounded by more than a full percentage point to 74.9% in 2012 from 73.8% in 2011. Likewise, the number of households headed by 24-34 year-olds increased in the year. This trend is likely to continue to improve as employment growth accelerates over the next two years.

Which states have the most upside potential?

Housing construction declined in all parts of the country, but some states were hit worse than others. In Florida, housing starts fell by over 90% from peak-to-trough. Focusing our analysis on states in TD's footprint, the South Atlantic appears to have the largest gap between expected household growth and the current level of construction. With a current level of construction that is more than 60% below expected household growth, Florida and Georgia, in particular, appear to have considerable upside potential over the next several years. Housing construction in the Northeast and Middle Atlantic are also below demographic trends, but the gaps are relatively smaller (see table below).

Demographics & Housing Construction			
	Hh growth	Housing Starts	
	Ann	2012	
	Avg. 13-15 (000s)	(000s)	% from demo-graphics
National	**1,325**	**780**	**-41.1**
East Coast	**511**	**271.7**	**-46.8**
Maine	4.5	3.2	-28.4
New Hampshire	5.0	2.5	-50.5
Vermont	2.0	1.3	-34.4
Massachusetts	21.0	10.2	-51.7
Rhode Island	2.0	0.8	-60.9
Connecticut	5.5	4.7	-14.9
New England	**40**	**22.6**	**-43.4**
New York	38.0	21.3	-43.9
New Jersey	16.5	15.9	-3.3
Pennsylvania	22.5	17.9	-20.3
Middle Atlantic	**77.5**	**55.2**	**-28.8**
Delaware	4.5	3.8	-14.8
Maryland	21.5	14.5	-32.5
West Virginia	3.0	2.5	-17.5
Virginia	43.0	25.6	-40.4
North Carolina	52.0	44.2	-15.0
South Carolina	26.5	18.5	-30.1
Georgia	63.5	23.1	-63.7
Florida	174.0	58.4	-66.4
Washington D.C	4.0	3.2	-19.4
South Atlantic	**393.5**	**193.9**	**-50.7**

Source: Census Bureau, Moody's Economy.com, TD Economics

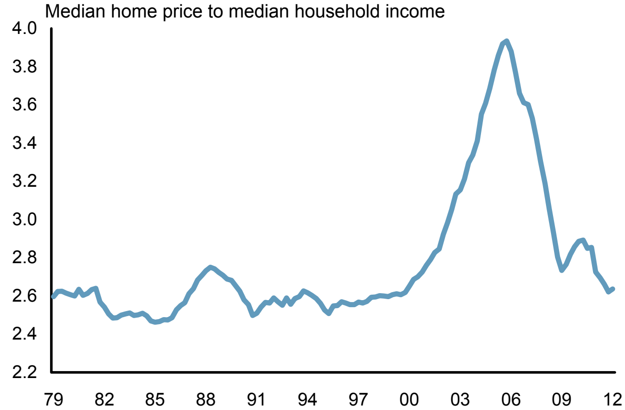
With the adult population increasing by 2.4 million annually, a conservative estimate for household growth is 1.3 million per year. Housing starts are still 30% below this level, suggesting continued scope for further increases.

Home prices have moved back in line with income

In addition to the rebound in construction, home prices have steadily risen over the last year. At first glance, the increase in home prices may seem counterintuitive. After all, inventories of foreclosures are over four times their historic average. However, the rise in prices has been accompanied by a consistent reduction in foreclosures – from 4.6% of mortgages in the fourth quarter of 2010 to 4.1% in the third quarter of 2012.

The seeming contradiction between elevated foreclosures and rising home prices is explained in part by a decreasing flow of distressed properties – either foreclosures or short sales – onto the market.[1] Distressed sales as a share of all

U.S. HOME PRICE TO INCOME RATIO



Source: National Association of Realtors, U.S. Census Bureau, Moody's Economy.com

sales have fallen from an average of 30.4% in 2011 to 26.1% in 2012 (year-to-date to October) according to CoreLogic. At the same time, the composition of distressed sales has shifted away from foreclosures in favor of short sales, which typically sell at a smaller discount.

Progress in clearing foreclosures is particularly evident in the states that were worst hit by the crisis. In Nevada, for example, foreclosure inventories rose from 0.8% of mortgages in 2006 to 10.4% in 2010. As a result, at the beginning of 2011, distressed sales made up 65% of all sales in the state. However, over the last two years, foreclosure inventories have been nearly cut in half and distressed sales have fallen to 31% of the market. Home prices in Nevada were up 14% year over year in November.

The same pattern that has occurred in Nevada is evident to a lesser extent in Florida. While foreclosure inventories have taken longer to come down, they have shown progress – falling from a peak of 14.5% in the third quarter of 2011 to 13% in the third quarter of 2012. Similarly, distressed sales remain a significant portion of the market, but have fallen from 30%-35% to around 25%. And, home prices in Florida are up 7.9% from year-ago levels as of November, in line with the national average.

A second related point is that the total inventory of homes for sale has fallen dramatically over the last several years. In absolute terms, the inventory of existing homes has fallen 48% from a peak of 3.8 million in January 2008 to just over 2.0 million in December 2012. Just as important, the months' supply of inventory – how long it would take to clear the market entirely, given the current rate of sales – is just 4.4 months, down from a peak of 12.1 months in July

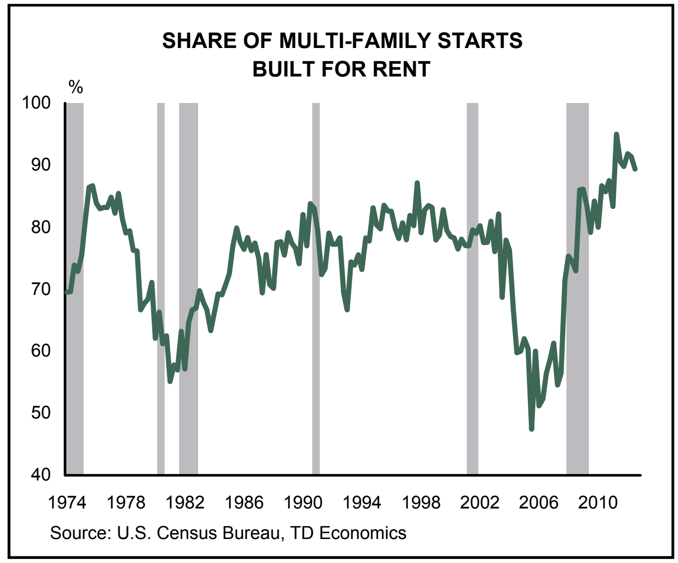
2010. The reduction in supply of existing homes is in large part the result of the reduction in supply of new housing. The inventory of existing homes for sale follows the inventory of new homes with a lag of approximately 18 months.

Finally, and perhaps most importantly, the turnaround in home prices has reflected a resurgence in demand supported by rising housing affordability. Home prices fell 32% across the U.S. between 2006 and 2011. This brought the level of home prices back in line with their historical relationship with income. Between 1979 and 1999, median home prices averaged 2.6 times median annual income and remained within a narrow range of 2.5 to 2.7 times over the whole period. However, beginning in 2000, home price growth started to outpace median income. By the peak of the housing bubble, in the final quarter of 2005, home prices had risen to four times median income. With the decline in home prices that has occurred since 2006, the price-to-income ratio fell back to 2.6 times income in 2012 - exactly in line with its long-run average.

The states that experienced the worst decline in home prices have also seen the biggest rebounds over the last year. In Nevada home prices fell by nearly 60%, while in Florida they fell 50%. Relative to their relationship with income, both of these states appear to have moved from overvalued to undervalued. Rather than signaling an overheating, the pace of home price growth over the last year is evidence of a market that overshot on the downside and is now returning to fundamentals.

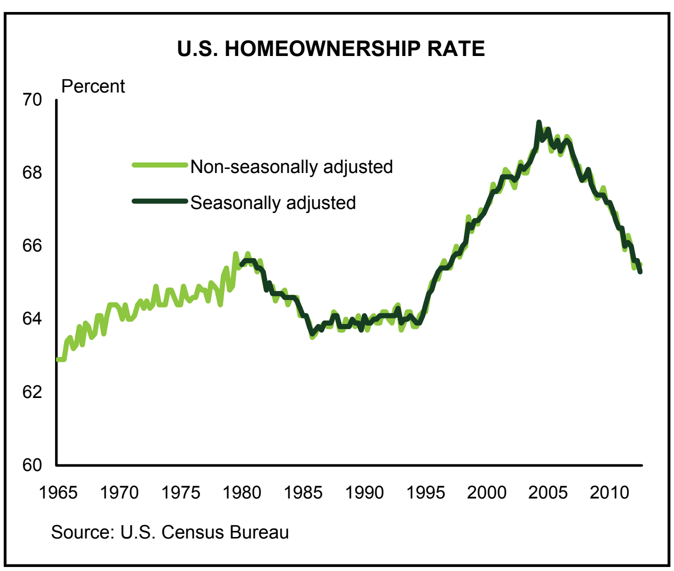
How much can multi-family contribute?

While all segments of construction have rebounded,



multi-family construction has taken flight. From its trough of just 57k units, multifamily starts have increased more than five-fold to 338k (SAAR). In fact, unlike single-family construction, which is still well below its pre-recession level, at 338k units, multi-family starts have surpassed the average of 33k experienced over the previous housing cycle running from 1995 through 2007.

The rise in multi-family construction is due mainly to downward pressures on homeownership from weak economic and credit conditions that have pushed many new households into the rental market. From a peak of 69.4% in the second quarter of 2004, the U.S. homeownership rate has fallen 4.1 percentage points to 65.3%. The drop is even more precipitous among younger households. From a peak of 58% in 2004, the homeownership rate of 30 to 34 year olds fell by over eleven percentage points to 46.9% in the third quarter of 2012.



The decline in homeownership supports multi-family construction because the sector is now almost entirely weighted towards rental properties. Over 90% of the multi-family homes started in 2012 were built for rent. This is in contrast to the late stages of the housing boom, when the share shifted heavily in favor of multi-family units built for sale (i.e. condos).

Supported by job growth, the homeownership rate will eventually rebound. However, in the near term it is likely to face considerable headwinds. As long as the foreclosure rate is above historic levels, there will remain a pipeline of households transitioning out of ownership and into renting. At the same time, consumer credit scores will take time to heal. At the peak of the housing crisis in 2010, one in six mortgages were past-due on their payments. This blemish on many households' credit histories will limit their access to credit over the next few years.

Another factor that will weigh on homeownership is the rise in student debt. Student debt has been one of the fastest growing segments of consumer credit, up 28% over the last year. The significant debt levels of people graduating from college and university may delay the transition to homeownership among younger households.

Assuming the homeownership rate remains relatively close to its current level, with 1.3 million new households, 450k of them are likely to be renters. This should support an ongoing rise in the level of multi-family construction.

Bottom Line

The behavior of the housing market is responding as one would expect from the evolution of both supply and demand. On the supply side, foreclosures and inventories are exerting less of a drag, while rising new home construction is still below the needs of household formation. On the demand side, affordability has improved dramatically and credit conditions have improved. Tighter supply and increased demand is lifting prices and sales. Meanwhile, demand from the rental market remains strong for multi-units.

These forces become even more apparent when looking at the performance of home prices across the country. The states that have been the best performers over the last year have been those that declined the furthest during the downturn – states like Arizona, Nevada, and Florida.

The bottom line is that the rebound in construction, while swift, still leaves the level of activity around 30% short of demographic fundamentals. Taking into account the need to replace depreciated housing stock, the true figure is closer to 40%. At the same time, while home price growth may slow from its current rate of 7% as more distressed inventories come on the market, the massive improvement in housing affordability means that further price decreases are unlikely. All told, 2012 was likely just the beginning of a multi-year rise in the U.S. housing market.

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Endnotes

1. A short sale occurs when a borrower and lender agree to sell a home (usually at a price less than the value of the mortgage) instead of going through the foreclosure process.