SPECIAL REPORT

TD Economics

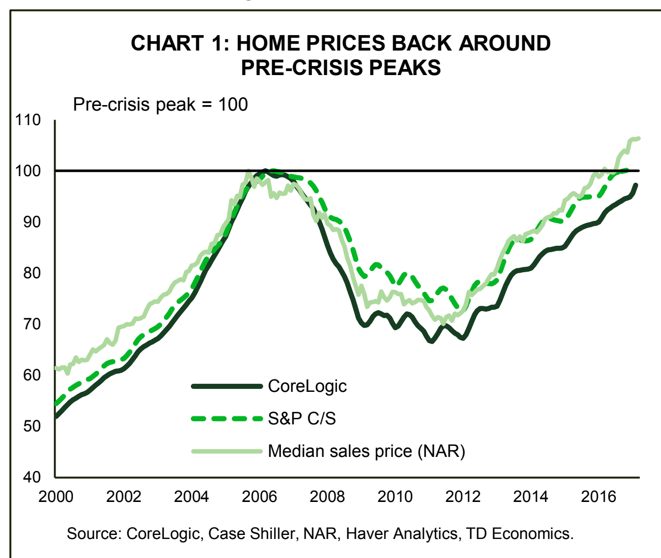
June 8, 2017

U.S. HOUSING RECOVERY STRONG ENOUGH TO WITHSTAND RISING PRICES AND RATES

Highlights

- Rebounding home prices and higher mortgage rates have recently led to an erosion of affordability across many American markets, throwing into question the sustainability of the housing recovery.
- While the decline in affordability may weigh on activity in the near-term, the metric remains favorable across many housing markets and should support housing demand going forward.
- Interest rates are expected to rise only gradually, with households likely able to withstand the incremental increases in borrowing costs as the labor market delivers continued job and income gains. Some improvement in the homeownership rate should also provide a gentle tailwind to demand, while a rebound of for-sale inventory should keep price growth in check.
- Activity is expected to maintain a modest upward trajectory, with existing home sales anticipated to rise by 3.4% this year and 2.6% in 2018 to nearly 5.8 million by the end of the forecast horizon. Price growth should remain strong, holding near 6% this year before decelerating to about 4% in 2018.
- Prices across the five major metros in the TD footprint (comprising of seventeen East Coast states and the District of Columbia) are expected to increase between 3% and 7%, with momentum being led by Boston and New York while D.C. and Philadelphia are likely to lag somewhat.

At this point U.S. home prices have effectively recovered all of their recessionary losses (Chart 1). Home valuations also rebounded fully across twenty-eight states and the District of Columbia, while eight more are likely to reach that threshold this year. Across the TD footprint, Boston is the only major market where prices are well above past peaks, while prices in New York are nearing that threshold. Home values in Philadelphia are within earshot of their past peaks, while Washington and Miami metropolitan areas remain well below their records.



Nationally, after five years of declines, prices have been increasing for just as long. Together with the recent rise in mortgage rates, the market has experienced an erosion of affordability. These trends aren't likely to reverse with the Fed widely expected to continue its interest hiking cycle while very-low inventory levels are likely to see price pressures intensify further. As such, it is not unreasonable to ask whether these dynamics have the potential to throw the housing recovery off track.

Overall, while declining affordability may weigh on activity in the near term, the metric remains favorable across many housing markets and should support demand for homes over the forecast horizon. Future rate hikes should be very gentle, ensuring that

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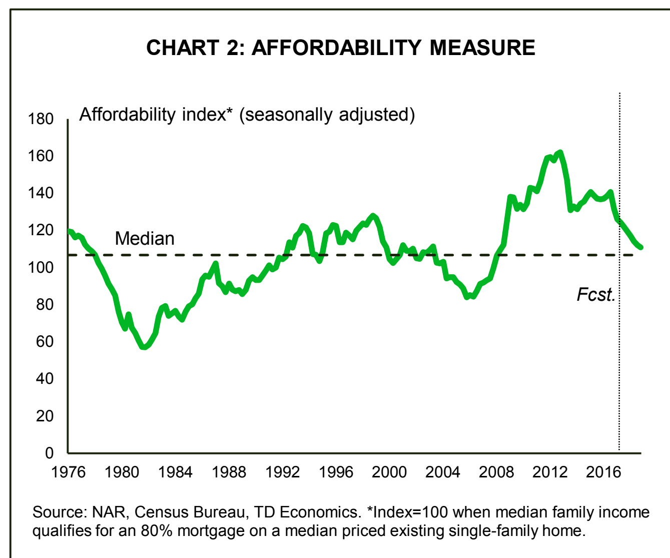


costs of homeownership rise only gradually. Affordability will further remain shored up by continued healing of the labor market which is poised to deliver job and income gains. Moreover, the improving labor market alongside elevated rents and favorable demographics should help lift the homeownership rate in the coming years. Lastly, over time the rising single family homebuilding should help soften price pressures as newly completed homes help increase inventories from their very low levels. All in all, we expect home sales to rise by 3.4% this year and 2.6% in 2018, while prices should increase by nearly 6% this year and 4% in 2018. Price growth over the 2017-18 period looks to be the fastest in Boston and New York, between 6% and 7%. Price growth in Washington and Miami won't be far behind, averaging 4% to 5%, over that time period, as affordability begins to weigh. Philadelphia's home prices should accelerate but still rise by a relatively modest 3% to 4% over the next two years, with strength in core metro counties offset by weakness in suburban New Jersey.

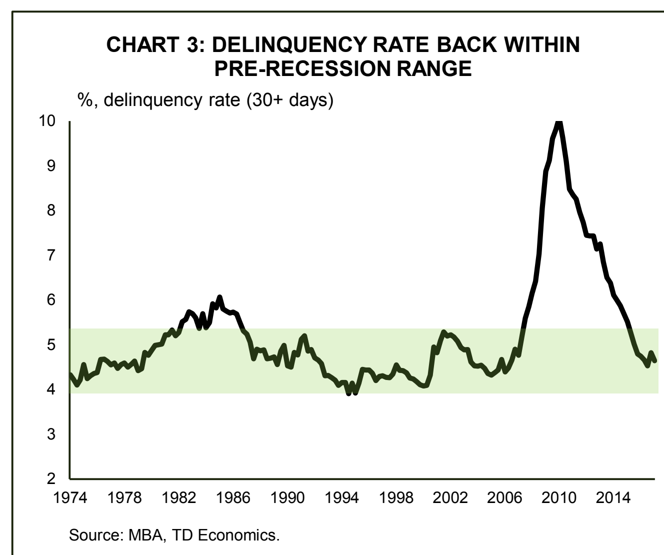
What's the fuss all about?

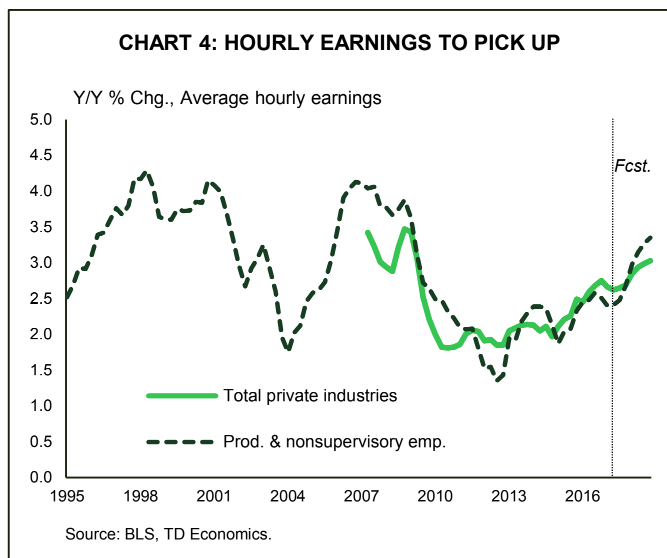
During the Great Recession, a combination of sharply lower home prices and a fall in borrowing rates made purchasing a home a lot more affordable for those with incomes who could access credit. During the recovery, home prices grew much faster than incomes, but affordability was supported by declining borrowing rates (Chart 2). In recent months however, home prices have accelerated to 7% per year in March, after rising by a relatively stable 5% during the previous two years. Strong demand amidst dwindling inventory levels appears to be behind the acceleration, and with inventories of existing homes near historical lows, price pressures are likely to persist for some time still. The heating up of price growth has also come alongside higher mortgage rates which have risen 75 basis points in the six months through March for a conventional 30-year mortgage, before giving up some gains alongside other long-term interest rates. Taken together, the deterioration in affordability has caused some sales volatility in the existing home market. But, despite some deterioration, affordability remains relatively healthy nationally and across most East Coast markets aside for Miami.

Rates to rise but only gradually

The recent spike in mortgage rates has been rapid, and was largely related to the heightened expectations for pro-growth policies. But, while the unemployment rate is nearing the Fed target, the lack of inflationary pressures will motivate the Fed to continue only a very gradual hiking cycle. With two more rate hikes in the cards for this year, three more in 2018, and the likely beginning of the unwinding of the Fed balance sheet, the rate on a conventional 30-year mortgage is likely to rise above 5% by the end of 2018. Still, rates are expected remain lower than they were pre-recession and accommodative by historical standards. Moreover, the rise going forward should be more incremental, with increases of 10 to 20 basis points per quarter. Such a scenario would lift monthly mortgage costs on a median-priced home by between $10 and $25 each quarter – an increase that should be manageable given the expected income growth.

The other element that has in the past restrained housing market activity is credit availability. After the significant tightening in lending standards that occurred during the





crisis, loan officers have had little reason to tighten further as credit quality has improved substantially since then. For instance, FICO scores averaged 700 in April – the highest point since 2005. Meanwhile, the share of consumers likely to get approved for a mortgage has increased with those deemed riskiest (scores below 600) accounting for 20% of credit scores – down from 25.5% in 2010. Moreover, data from the Senior Loan Officer survey suggest that loan officers have on net continued to loosen credit standards consistently for three years now. As the share of delinquent mortgages is already within the pre-recession range of between 4% and 5% (Chart 3), and with mortgage rates inching higher, banks are unlikely to tighten credit conditions anytime soon.

Labor market to support housing market

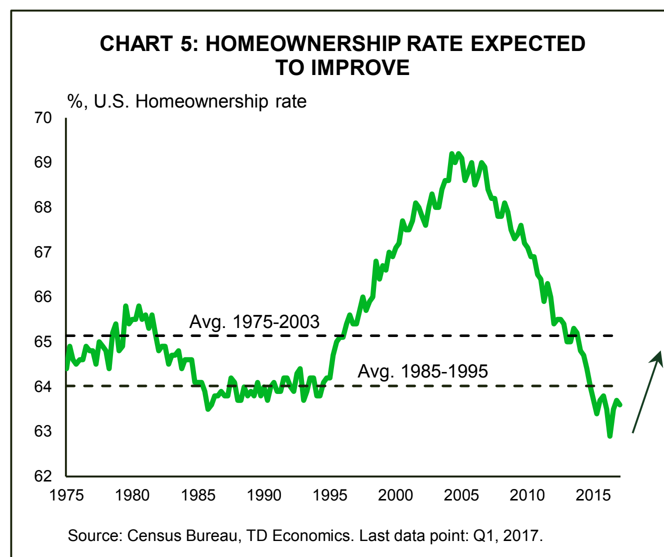
Activity in the housing market will also be supported by continued improvement in the labor market. Continued job gains should keep the unemployment rate low, with the official measure already sitting at a healthy 4.3%, while alternative measures of labor underutilization tell a similar tale. Moreover, the share of the population that's employed has improved, having risen by around two percentage points since the recession to 60% presently. Americans also feel more confident about looking for new opportunities and switching jobs, with the quits rate near the same level as prior to the recession.

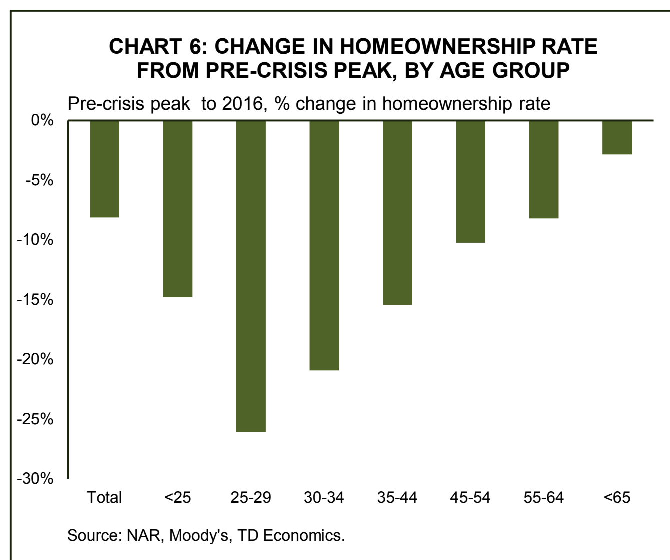
Just as the tight inventory levels are pressuring up home prices, a shortage of qualified labor is pressuring up wages (Chart 4). After averaging roughly 2.1% from 2009-2014, hourly wage growth has risen to around 2.5% recently, helping offset some of the rising housing costs. The low unemployment rate and elevated job openings should motivate firms to raise worker compensation to attract employees. This is already evident among small and medium-sized enterprises which make up the vast majority of the private labor force, with the share of firms planning to increase worker compensation near pre-crisis peak levels. Ultimately, the expected addition of another 3.3 million jobs over 2017-18, and improved wage growth of around 3% during the same period, should equate to robust income growth and provide a solid foundation for housing demand.

Homeownership a tailwind, but no quick turnaround

Sales should also be supported by some improvement in homeownership. The lack of a rebound in homeownership rate remains a disappointing aspect of the housing recovery. The rate peaked in the mid-2000s at around 69%, supported by lax lending standards and self-reinforcing price expectations. During the crisis, many Americans defaulted on their mortgages and the homeownership rate began to fall accordingly. But the decline continued even as the American economy recovered, with the homeownership rate hitting a historical-low of 62.9% in mid-2016.

Slower household formation helped contribute to this decline well into the recovery. While a part of the decline was related to a continuation of long-running trends of delaying marriage and forming households among young adults, the financial difficulties following the crisis further prevented many individuals from forming households, with many moving back in with family to help reduce expenses. In addition, blemished credit histories, stricter lending stan-





dards and uncertainty regarding housing as an investment motivated most of the households that formed during the recovery toward renting, while home-owning households remained flat.

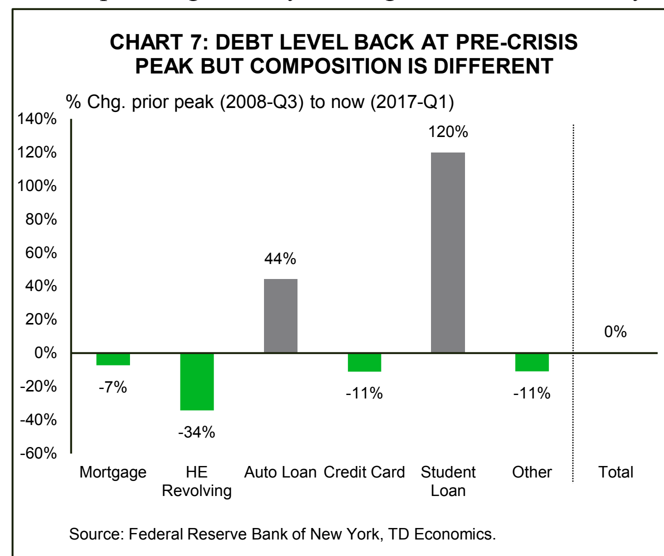
Young Americans in particular, being at the start of their careers and having little established credit histories, were hardest-hit (Chart 6). In 2005, only 26% of young adults aged 18 to 34 were living at home, but by 2015 that figure rose to a third – a total of 24 million individuals. Rising rent costs and surging student debt also put homeownership out of reach by making it harder to save for down payments. Student debt, in fact, has been growing at the fastest pace among all other types of debt on an aggregate basis (Chart 7). It is worth pointing out that although overall debt levels are now back to their pre-crisis peak – with student debt being the main thrust behind this advance – when stacked against income, the ratio is still much lower than prior to the crisis.

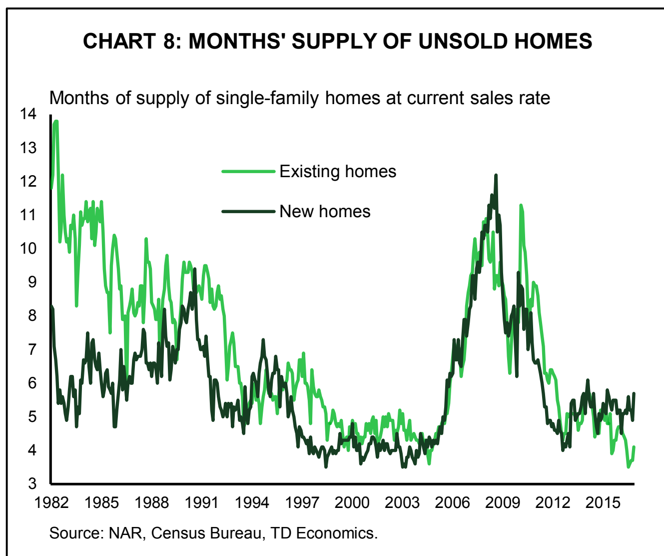
While a quick turnaround in the homeownership rate is not likely, there has been some improvement lately and prospects for continued progress remain positive. Blemished credit histories are likely to exert less of a drag the further we move away from the recession. As negative events – such as bankruptcies which typically stay on record for seven to ten years – continue to fall off credit histories, consumers will not only have more access to credit but at lower rates too. Household formation has also improved in recent years, with the trend likely to continue as Millennials enter the prime age for forming a family. Moreover, years of rapidly rising rents have made homeownership more attractive for some, as have rising expectations for continued home price appreciation. There is already some evidence that Millennials or Generation Y-ers are becoming more traditional in their buying habits. The recently released TD Bank 2017 Mortgage Service Index found that Millennials all over the country are flocking to purchase new homes, especially single family homes, with 90% saying that now is a good time to buy, while more than half plan to do so within the next year. This narrative is corroborated by a recent report from the National Association of Realtors (NAR) which points to an increase in the share of Millenials buying in single family homes in suburban locations. Moreover, attitudes toward homeownership have also improved, with the vast majority (82%) of recently surveyed buyers agreeing that owning a home is a good financial investment. Meanwhile, job security that comes along with a tight labor market should also promote homeownership. Overall, the moderate improvement is expected to be an added tailwind for housing demand.

Activity to maintain modest upward momentum

The sustainability of the housing recovery will also be contingent on supply. At present, the housing market remains undersupplied with the inventory of existing homes for sale, at just 4.1 months' of current sales, hindering activity and driving up prices (Chart 8). Reasons for the dearth of inventory stem from the presence of underwater mortgages as well as the fact that single family construction has been running well below historical norms for several years.

The dearth of inventory and rising price growth will encourage both more listings as well as homebuilding. The latter is reflected in builder confidence, with the NAHB housing index remaining near historical highs. In this vein, we anticipate single family housing starts to rise 8% this year





and 12% next year. This trend lines up with the expected improvement in the homeownership rate, with anecdotal evidence suggesting that builders are increasingly catering to millennials and other first-time home buyers by focusing on properties at the lower end of the price range.

Multifamily starts on the other hand, have remained elevated for some time, with limited room for growth. Much of the post-recession building in the multifamily segment has been in the rental market, with purpose built rentals starts making up as much as 95% of all multifamily starts in the first quarter of 2017. The significant amount of units still in the pipeline, along with signs pointing to a rising rental vacancy rate and slowing rent price pressures, point to slower growth ahead for homebuilding in this segment, which should peak this year before moderating in 2018.

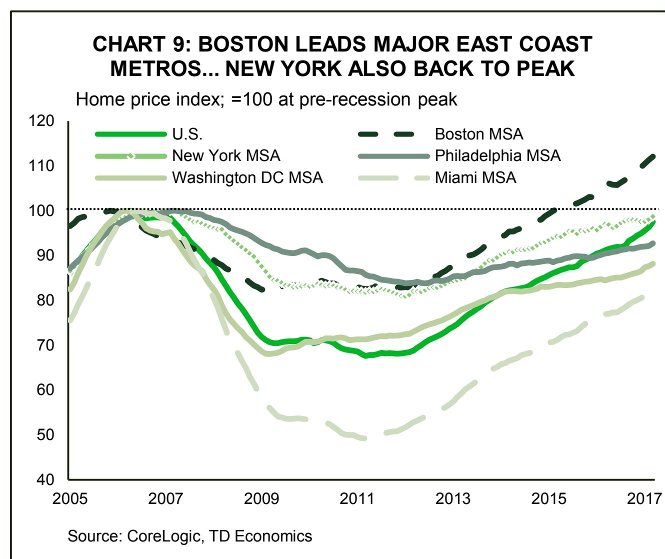
Builders will face hurdles such as a shortage of labor, limited availability of undeveloped lots in desired locations and an increase in input costs such as lumber. The rising costs will largely be passed on to consumers, further increasing the already-elevated new home prices and spilling over into the resale market. As such, we expect home price growth to average near 6% this year. Eventually the increased supply of homes in the market will help bring some balance, but we expect this to be more of a factor next year with price growth averaging 4% in 2018.

With the newly completed inventory likely to be absorbed quickly, we expect new home sales to continue to lead the way, much like they have done over the past few years, with activity up 7.5% this year and 6.3% in 2018. As some existing homeowners upgrade to new properties with the trend being supported by a declining share of underwater mortgages, this will help unlock sales potential on the existing home front where activity is expected to advance at a more moderate pace of 3.6% this year and 2.4% in 2018.

Recovery to proceed, but performance will vary

The discussion above has focused on national trends, but housing is very much a regional story, with significant differences in affordability, demographics, economic growth, and market conditions. For instance, many markets have seen very little price appreciation since the recovery, including Connecticut, West Virginia, Pennsylvania, and New Jersey within the TD footprint. While the relatively low prices offer a buffer to absorb higher interest rates, many of these states face weaker demographic and economic prospects which dampens the outlook. On the other hand, the D.C, Florida, New York and Massachusetts housing prices have seen more significant price appreciation since the trough, leaving them more vulnerable to interest rate shocks related to degraded affordability. Still, these regions typically have better growth prospects which should support continued demand for housing despite the higher prices.

In **Boston**, house prices only declined half as much as they did nationally and have already rebounded 10% above their previous peak (Chart 9). The housing market was supported by healthy economic growth, with Boston's knowledge-based economy seeing a less pronounced downturn and a relatively brisk recovery. The metro economy is about 13% larger than during the previous peak while the jobless rate has recently touched 3%, leading to strengthening wage gains. The low inventories will lead to some robust price gains, of between 6% and 7% in the near-term while



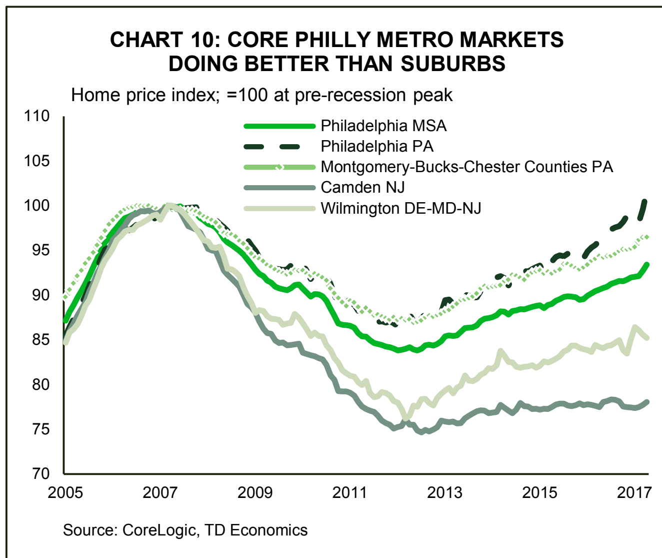


CHART 10: CORE PHILLY METRO MARKETS DOING BETTER THAN SUBURBS

Source: CoreLogic, TD Economics

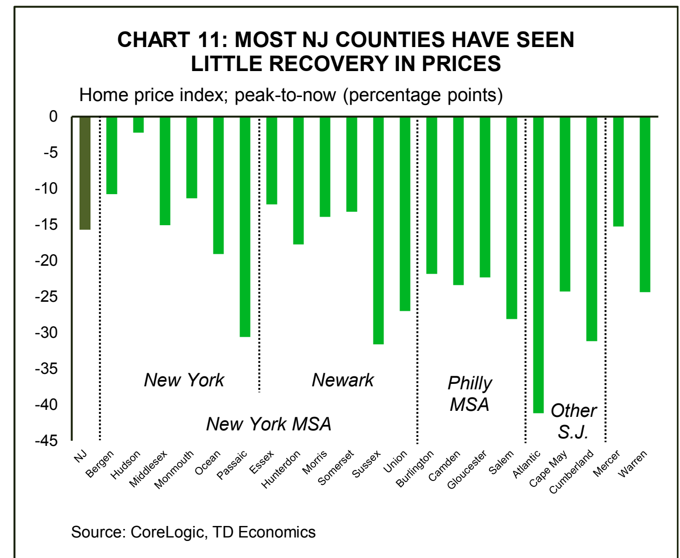


CHART 11: MOST NJ COUNTIES HAVE SEEN LITTLE RECOVERY IN PRICES

Source: CoreLogic, TD Economics

affordability will by shored up by continued income gains. But, price growth should begin to moderate as previously started housing units are completed and begin to reach the market, shoring up the for-sale inventory.

Philadelphia's housing market has experienced very mild price growth during the recovery, averaging just 3% in the last four years as suburban portions of the metro weighed on the aggregate metro prices (Chart 10). Still, prices are nearing pre-recession peaks, particularly in the core metro markets, given the very mild correction during the downturn. This dynamic has largely mirrored the economy, which barely contracted during the downturn, but has trailed behind the national since. The improvement in the jobless rate has also trailed the nation, but quickened recently as weaker demographics weigh on the labor force growth. Going forward, housing should continue to improve with price growth likely to accelerate somewhat on a dearth of inventory in core Philadelphia counties. However, weaker demographics and a still elevated foreclosure pipeline – particularly in the South Jersey counties – should keep price growth constrained to 3% to 4% going forward.

The weakness in suburban North Jersey and Long Island counties has also kept the prices in the **New York** metro from rebounding fully. But, while Long Island has seen a surge in demand leading to strong price gains in recent months, the same cannot be said of New Jersey where home prices remain nearly 20% below their past peaks. Hudson is the only county in New Jersey where home prices have largely recovered (Chart 11), owing to its proximity and transit links to New York City where values have surged. Strength has now shifted to nearby Essex where prices are rising at double-digit rates. But, values in most other suburban Jersey markets are soft. On the other hand, core New York City boroughs, supported by investors who shored up the market during the downturn and helped spur an early recovery, are reaching new records. Prices in Brooklyn, Manhattan, and Queens, are some 50%, 25%, and 10% higher (Chart 12), respectively, than prior to the downturn, with demand pushing out to more distant counties. As such, while pull-back in luxury demand from investors and eroding affordability is likely to weigh on the highest priced counties, the metro overall should benefit from strong demand related to improved prospects for the financial industry and already low unemployment of just 4%.

The **D.C.** metro experienced a correction similar to that of the nation. The early recovery was supported by relatively

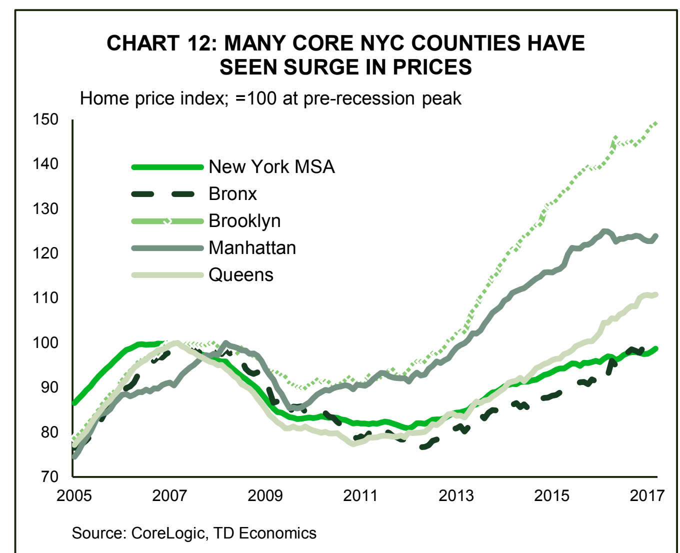


CHART 12: MANY CORE NYC COUNTIES HAVE SEEN SURGE IN PRICES

Source: CoreLogic, TD Economics

robust economic growth owing to significant federal government stimulus in the aftermath of the recession. However, momentum petered out in 2013 following the sequestration-related economic weakness. Growth effectively stalled during the 2012-16 period with weak job growth keeping the jobless rate elevated. Unemployment has trended lower more recently, but at 3.7% it remains well above the previous lows of 3%. Improving federal spending and economic growth should lead to stronger demand for housing, with prices likely to accelerate to nearly 5% this year amidst declining inventory of existing home sales, after years of sub-inflation growth.

The **Miami** metro has suffered the most severe downturn of the main East Coast metros, with homes losing half of their value through the recession. However, about two-thirds of the losses have since been recouped. Investors were a key support during the early recovery, but have pulled back since as prices rebounded. Still, rising demand from traditional homebuyers has been offsetting this trend. The economy only regained its pre-recession peak in 2015, but had much ground to make up given the 11% contraction and legacies of the credit overhang which delayed the recovery until 2012. GDP has grown by an average of 3.5% since with the ensuing job gains reducing joblessness from 11% to below 5% in the metro area. The improvement has spurred a strengthening in wage growth which should help support demand amidst rising interest rates and price gains. Still, the eroded affordability will begin to weigh on price growth, which should decelerate closer to income growth going forward.

Bottom line

Rebounding home prices and increasing mortgage rates have led to an erosion of affordability, raising questions as to the sustainability of the American housing recovery. Our analysis suggests that while deteriorating affordability may weigh on activity somewhat, the metric is poised to remain favorable across many housing markets and should support housing demand over the coming years.

Looking ahead, interest rates are expected to rise much more gently, with households likely able to withstand the incremental increases in borrowing costs thanks to a solid labor market poised to deliver continued job and income gains. Some improvement in the homeownership rate is also expected to provide a gentle tailwind to housing demand, while a rebound of for-sale inventory should keep price growth in check.

All in all, activity is expected to maintain a modest upward trajectory, with sales tilted toward the bigger single-family segment. As is the nature of the housing market, performances will vary by region, but most major metros in the TD footprint are expected to trend toward their fundamentally-supported pace of gains related to affordability.

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