Observation

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TD Economics
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HIGHLIGHTS

- Since reaching a peak in early 2006, the U.S. housing market has spent the last five years in almost steady decline.
- With new construction at a minimum, a recovery in housing will depend primarily on reinvigorating demand and absorbing the current inventory of unsold existing and foreclosed homes.
- Three influences are likely to raise housing demand over the next several years: an increase in population growth; a return to more normal household formation behavior among young adults; and, an increasing number of independent households formed as the population ages.
- With home prices down more than 30% and realigned with long-run trends in income, improving labor market conditions will be the key that unlocks this latent demographic demand.
- As job growth accelerates, the number of new households will rise to 1.4 million annually. Initially this demand will be spent absorbing unsold existing homes, but over time it will become a driving force of new construction.
- From their current level of 549,000 (SAAR), housing starts should rise to 750,000 by the end of 2012, and by the end of 2013 should break over one million.

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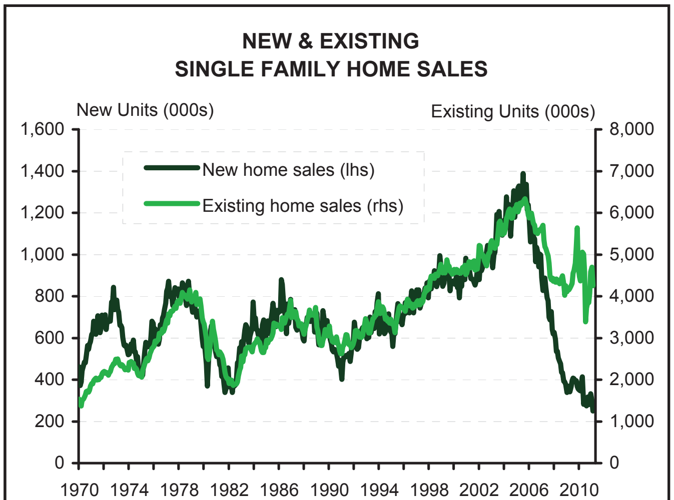
SETTING THE STAGE FOR A U.S. HOUSING RECOVERY

The U.S. housing market is in the dumps. With the decline in February, new single-family home sales reached an all-time low of just 250,000 units. Existing home sales have shown slightly more vigor, but are still not sufficient to bring down the month's supply of unsold homes. The fall in home sales has added to the misery of a housing market that is struggling to work through a considerable overhang of distressed sales. However, as the saying goes, it's always darkest before the dawn.

As with any other industry, the outlook for housing depends on the evolution of supply and demand. With new construction at a minimum, a recovery in housing will depend primarily on demand absorbing the current inventory of unsold homes.

Three influences are likely to raise housing demand over the next several years: an increase in population growth, as net migration moves back to pre-recession levels; a return to more normal household formation behavior among young adults, as the job market recovers; and, an increasing number of independent households formed, as the population ages. These three combined influences should lead the annual number of new households to almost quadruple from its current rock bottom level. With home prices down more than 30% and realigned with long-run trends in income, accelerating job growth will be the key that unlocks this latent demographic demand.

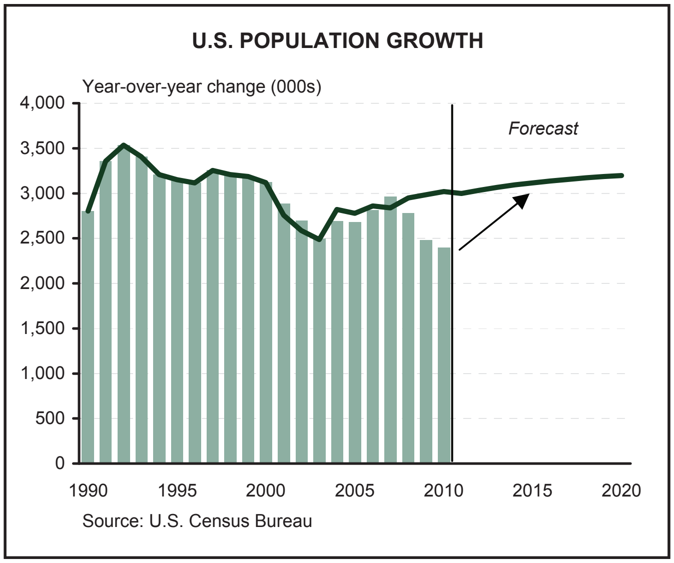


Source: National Association of Realtors, U.S. Census Bureau

More people, more houses?

Demographic factors play an important role in housing demand in the long run. While an increase in the population does not guarantee an increase in households, if the population is growing faster than the number of households, the number of people per household must be increasing as well. As we will discuss later on, the recession caused an increase in the average size of households, but we doubt this is sustainable. Before we get there, let's first consider how many more people, and in particular, how many more adults there are likely to be in the U.S. over the next decade.

Forecasts for population growth are based on assumptions about future fertility rates, age specific death rates, and the number of people who will enter the country net of those who will leave. In 2008, the U.S. Census Bureau projected that between



2010 and 2020, the U.S. resident population would grow by 3.1 million people annually. This forecast was based on an assumption that net-migration would average just under 1.4 million annually over this period.

The most recent estimates for U.S. population indicate that net-migration has come in below this rate over the last two years. In 2008 and 2009 (the last year for which data is available) net-migration is estimated to have averaged 860,000, causing the U.S. resident population to rise by 2.7 million annually. Deteriorating labor market conditions are the main culprit for the slowdown in net-migration. According to the *2009 Yearbook of Immigration Statistics*, the number of skilled persons obtaining certifications for employment-based permanent residence fell from 85,000 in 2007 to 48,900 in 2008 and further to 40,400 in 2009. Estimates of undocumented immigrants by the Department of Homeland Security suggest that this population has also fallen in recent years, reflecting a response to fewer job opportunities in the U.S.

As job opportunities in the U.S. increase and the jobless rate moves down, net-migration will likely rise and provide greater support to population growth. The Congressional Budget Office (CBO) predicts that by 2015 total net migration flows will rise to 2.3 million. The CBO's estimates incorporate the "likely dampening effect of the recession on immigrant flows and the likelihood that those flows will increase sharply as the economy recovers."[1]

The CBO's estimate falls on the high side of the 1.4 million net-migrants per year expected by the Census Bureau. In addition to their baseline projection, the Census Bureau also has low and high net-migration projections. At the low end, net-migration is assumed to average 1.2 million annually, while at the high end it reaches 1.7 million. If net-migration comes in at the low end of the scale, this would lead to population growth of over 2.8 million annually over the next decade. If at the high end, the population would grow by 3.4 million annually.

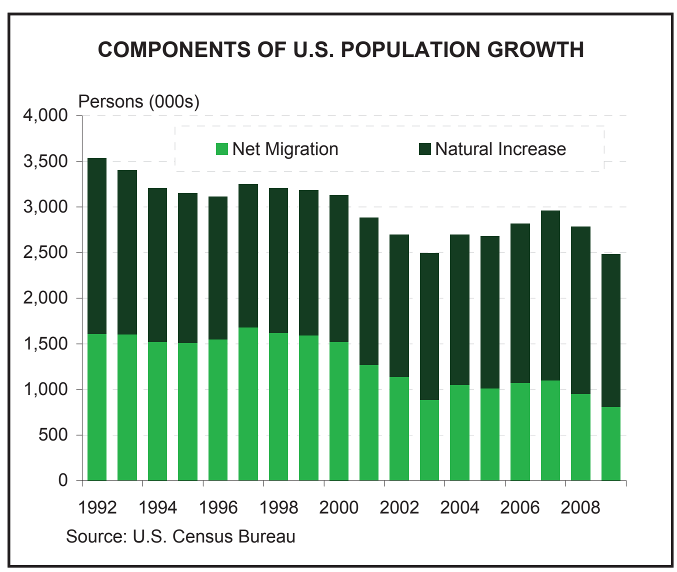
All told, even with conservative assumptions on net-migration, population growth is likely to accelerate from the pace set over the last two years. Given the age structure of the population, assuming the U.S. Census Bureau's projection of growth of 3.0 million annually implies growth in the adult population of around 2.5 million per year.

Now, to go from population growth to housing demand, we must consider the decisions of different age groups in the population to form households and how they are impacted by economic conditions.

Economic factors behind household formations

Prior to adulthood, most people live at home with their parents, but once a person is in their mid-20's there's a good chance that they will leave their parents home to form their own household. By dividing the number of households headed by people of different ages by their population, we get an estimate of the propensity for individuals in each age group to form independent households – a concept commonly referred to as the headship rate. At an aggregate level, the headship rate (households per population) is simply the inverse of the average size of households. When the headship rate falls, average household size increases.

As shown in the chart (next page), headship rates rise steadily with age. For 25-29 year olds there are just under 43 independent households per 100 people; by 45-54 this rises to 55.6 and by 65-74 there are just under 62 households for



every 100 people. While headship rates move around on a year-to-year basis, the pattern of headship rates rising with age has remained relatively unchanged.

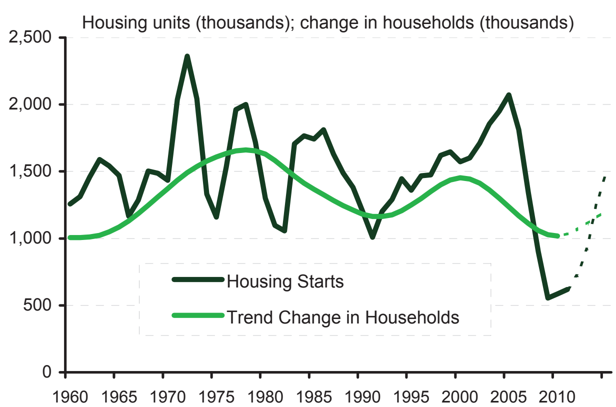
In addition to social factors, age specific headship rates are dependent on economic conditions, and, in particular conditions in the job market. Between 2007 and 2010, a net 4.1 million jobs were lost by Americans between 16 and 35 years of age. As employment fell, young people that had previously formed their own household doubled up or moved back in to the family home. As a result, despite an increase in the young adult population of over 2.4 million, the number of households headed by individuals under the age of 35 fell by over 600,000 over the three year period. The outright decrease in the number of young households was a prime reason for the decline in household formations from 1.6 million in 2007 to just 356,000 in 2010.

Once again, conditions in the job market are a key driver of household formations, particularly in influencing the decision of younger individuals. Fortunately, job growth appears to have turned a corner. Private payroll growth in the first quarter of 2011was the fastest since the end of the recession. Over the remainder of this year, we expect the U.S. economy to add an additional two million jobs. As job growth improves, so too will household formations among young people. With annual growth of close to 500,000 in adults below 35, this should lead to close to 200,000 households formed annually by this age group over the next ten years.

An aging population will also support household formations

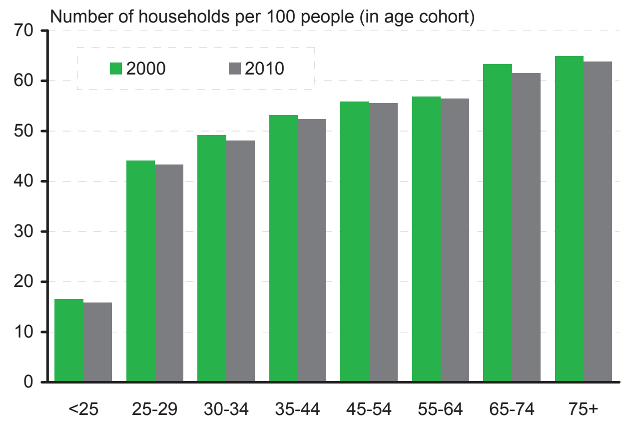
This brings us to the final factor important to household

HOUSING STARTS & HOUSEHOLD FORMATIONS



*Hodrick-Prescott Filter. Source: U.S. Census Bureau, TD Economics

U.S. HEADSHIP RATES BY AGE COHORT



Source: U.S. Census Bureau

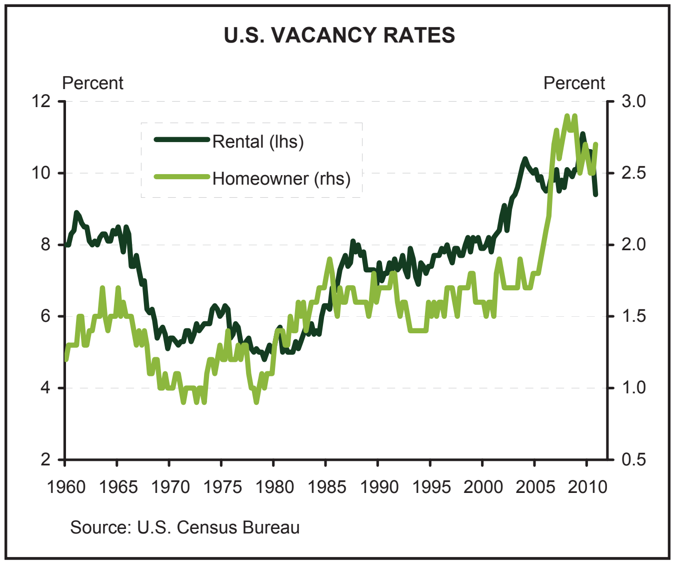
growth – the age structure of the population. If there is one thing we can be relatively sure of with respect to the future it is that someone who is 25 today will be 26 next year. Due to the increase in fertility rates following the Second World War, the United States has a bulge in the population's age distribution. The baby-boomers – people born between 1945 and 1964 – are currently making their way up the age distribution. Over the next decade, this will result in a greater share of population growth coming from the older segment of the population. During this period, the percent of the population that is over 55 is expected to rise by four percentage points from 25% to 29%.

The movement of people into older age groups – where they have a higher propensity to head a household – will tend to increase the total number of households formed in the United States. Combined with population growth and a rebound in the number of younger households, this should lead the annual average number of new households to rise to 1.4 million annually from its current level of 350,000.

Bottom Line

An important factor behind the slow recovery in housing has been the impact of the recession on housing demand. The rise in the unemployment rate has contributed to a slowing in the pace of population growth. And, with the sharp drop in jobs for young people, many formerly independent households have been erased as young people have moved back into their parental home. However, home prices are now down more than 30% and interest rates are at remarkably low levels. As such, a resurgent job market appears to be the final missing ingredient necessary to unlock this pent-up demographic demand.

From its current level of 300,000, household formations are expected to rise to 1.4 million over the next several years. This new demand will be key to absorbing excess inventory in the housing market. In the near-term many of these households may end up renting. In fact, there are already signs that this is occurring. The rental vacancy rate has fallen from a peak of 11.1% to 9.4% in the final quarter of 2010. However, the decline in rental vacancies will pull up rental values and over time will improve the relative attractiveness of homeownership where prices are still falling. A tripling in the underlying pace of household formations will go a long way to absorb the substantial inventory of unsold and foreclosed homes. And, as housing vacancies begin to decline, the need for new construction will begin to rise. From their current level of 549,000 (SAAR), housing starts should rise to 750,000 by the end of 2012, and by the end of 2013 should break over one million.



Endnotes

1 Congressional Budget Office. CBO's Labor Force Projections Through 2021 (March 2011). Washington, DC. Retrieved from: http://www.cbo.gov/ftpdocs/120xx/doc12052/03-22-LaborForceProjections.pdf