SPECIAL REPORT

TD Economics

February 16, 2016

U.S. HOUSING & RENOVATION OUTLOOK: BUILDING MOMENTUM

Highlights

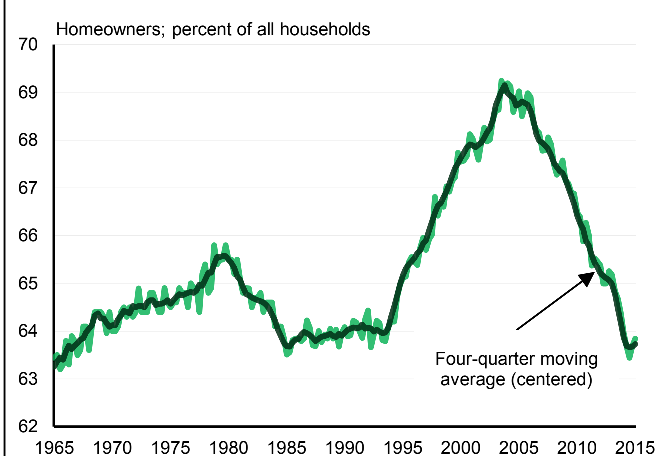
- Seven years into economic recovery and the housing market is still in the early stages of its own rebound from the Great Recession. While some metrics such as existing home sales and prices have moved close to normal, others, such as the level of new home sales, overall housing construction and the homeownership rate are still well below.
- The housing market should improve further over the next year. Supported by ongoing income and job growth, affordability will remain favorable and the housing market will be able to withstand the very modest pace of rate hikes anticipated from the Federal Reserve.
- After falling by nearly six percentage points over the past decade, the homeownership rate is expected to push higher over the next several years, giving support to home sales, especially from first time buyers.
- Existing home sales are expected to grow 6.0% over the next year and new home sales by over 12%. Home prices will move higher as well, growing by 5.0%. Across major East Coast markets covered in this report, including New York, Philadelphia, Boston and Miami, we expect Miami to see the fastest growth across housing metrics.

There were bumps along the way, but 2015 was another solid year for the U.S. housing market. Existing home sales rose 6.5%, while new home sales were up an even greater 13.7%. Home prices also continued to recover, rising by 6.2% according to the Core Logic price index. On the construction side of things, housing starts rose to over 1.1 million units, the highest level since 2007, and homebuilder confidence pushed higher. Still, there were some soft spots. The homeownership rate fell to a fifty-year low before edging up in the second half of the year (Chart 1). Meanwhile, a lack of inventory in the resale market appeared constrain the pace of sales.

The housing market should improve further over the next year. While the Federal Reserve has begun to take interest rates higher, the rate of future increases will be very gradual. As job and income prospects continue to improve, affordability should remain favorable and help move the market in favor of new homebuyers. On net, the housing market remains under supplied relative to demographic fundamentals. Low levels of inventories should be met with rising construction and greater new home sales. Low commodity prices should also help to make new home purchases an affordable option.

For the renovation market, activity tends to follow home sales. The rise in sales to date in addition to further improvements over the next year will imply continued growth in renovation and home improvement activity. With ongoing home price increases,

CHART 1: U.S. HOMEOWNERSHIP RATE



Source: U.S. Census Bureau, TD Economics

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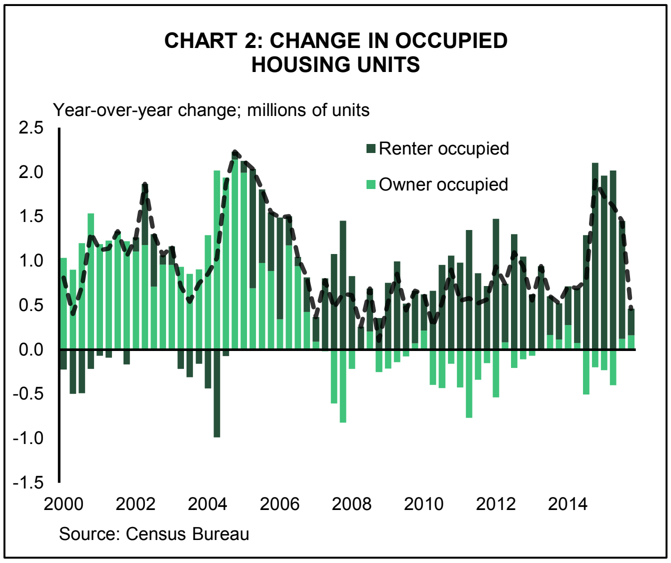


homeowners will see ongoing progress in home equity, which should facilitate investment in home improvement. These dynamics will be more than sufficient to handle the very modest pace of interest rate hikes expected from the Federal Reserve.

Homeownership is set to rebound

Since hitting a trough in February 2010, the U.S. economy has created 13.6 million new jobs. This rate of job creation has brought the unemployment rate down from a peak of 10.0% to just 4.9% in January of this year. Surprisingly perhaps, over this same period there has been absolutely no growth in the number of home-owning households. In fact, since reaching a peak in 2006 (at the height of the housing bubble), the total number of owner households has fallen by 1.4 million (Chart 2). As a result, the homeownership rate has plunged nearly six percentage points.

This rapid turn in homeownership reflects the destructive nature of the foreclosure crisis. Over 9 million mortgage borrowers were foreclosed on or suffered a major credit event between 2006 and 2014 according to estimates by the National Association of Realtors. Not only have the majority of these households moved from owning their home to renting, but many continue to have a blemished credit rating that still impinges on their ability to return to homeownership.

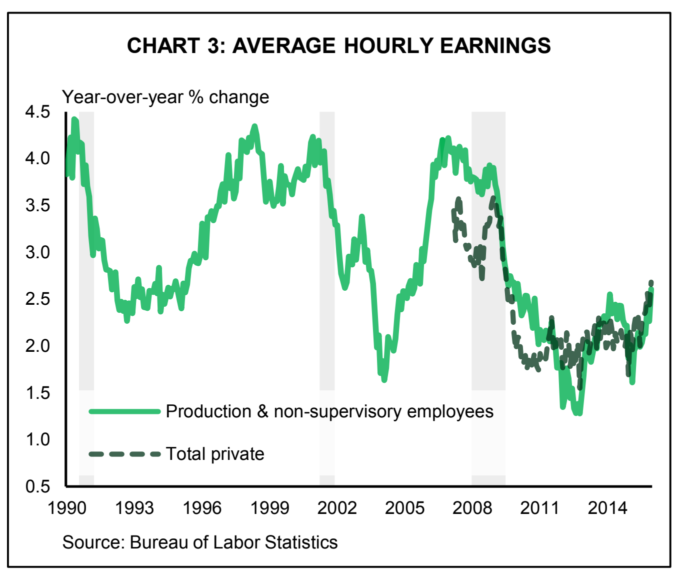
In addition to the decline in homeownership, the rate of household formation has also slowed. Over the past 40 years, America has added about 1.2 million households per year. Yet over the past five or so years, the rate of household growth has fallen almost in half to just 600k to 800k a year (depending on which survey you consult). Many households have doubled up or, in the case of many young people, moved back in with parents. Indeed, the share of 25 to 34 year-olds that live at home with their parents has risen by about five percent over the past five years.

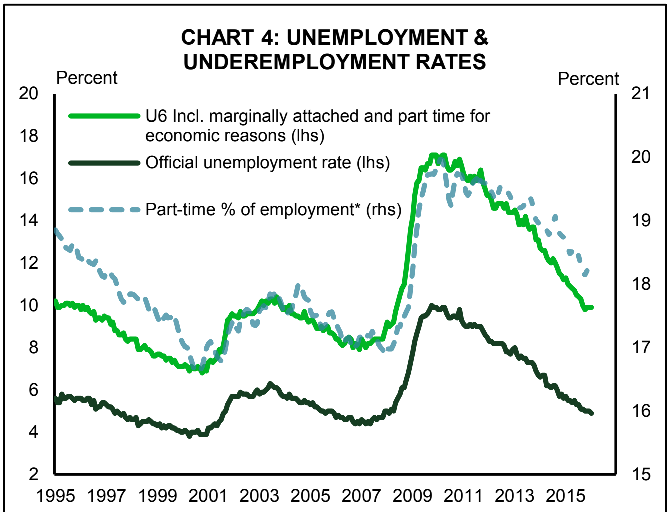
Of the households that have been created, all of them have been renters. The growth in the number of renters has outpaced growth in the number of rental properties, resulting in the rental vacancy rate falling to its lowest level in nearly 30 years. Unsurprisingly, rent growth has accelerated. Nationally, rents have risen by 3.7% over the past year according to the consumer price index. Depending on which home price metric is used, this is either on par or just under the pace of home price growth.

The good news is that the further away we move from the financial crisis, the more likely households are to return to homeownership. After hitting a trough of 63.5% in the second quarter of 2015, the homeownership rate ticked up in the final two quarters of 2015. This trend is expected to continue. The fundamentals in favor of homeownership include accelerated income growth and low borrowing costs, which will combine to support affordability metrics, as well as improving credit availability. Let's consider each of these in turn.

Income growth to remain on strong footing

First, in terms of incomes, there are already signs that wage growth has escaped its relatively slow trajectory through the first several years of economic recovery. Average hourly earnings were up 2.5% from a year earlier in January and have moved steadily higher through the past year (Chart 3). With the fall in energy prices pushing inflation to zero percent, these wage gains are translating into strong gains in





*Three-month moving average. Source: Bureau of Labor Statistics.

real purchasing power. Aggregate real personal disposable income has been growing by over 3.0% for the past fifteen months – the longest streak in over fifteen years.

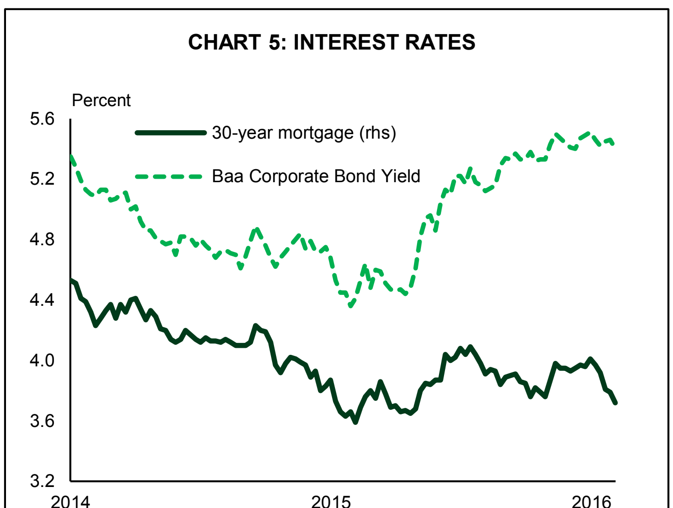
Incomes are likely to continue to move higher over the next year. With the unemployment rate pushing to new lows and the job opening rate near all-time highs, companies are likely to have to offer higher wages in order to continue to attract candidates. Supported by faster wage growth, real disposable income is likely to maintain its streak of above 3.0% growth over the next year. This provides a strong foundation for housing demand.

Housing market to withstand gradual Fed tightening

Other necessary conditions for growth in the housing market are credit availability and affordability. In terms of availability, the news is generally good. After tightening considerably during the housing collapse, the Senior Loan Officer survey from the Federal Reserve shows a net majority of loan officers loosening mortgage standards. This should not be a surprise. Mortgage credit quality has improved substantially since the housing crash and recession. Delinquency rates on mortgages issued since 2010 onward are of much better quality than earlier vintages. While updated regulations from the Consumer Finance Protection Bureau appeared to slow the pace of home sales at the end of last year, this effect is likely to fade as familiarity with the changes increases.

The other concern for borrowers is the cost of debt. On the surface the fact that the Federal Reserve has begun a tightening cycle may give some potential borrowers pause before considering making the plunge into homeownership. However, two things are important that make this less of constraint than it may seem at first blush. The first is that this rate hiking cycle will be different from every one that has come before it. In the past, once the Fed began raising rates they tended to continue doing so in quarter-percentage-point increments at every consecutive meeting, raising rates as much as eight times in a single year (or a total of 2.0 percentage points). This time, the rate of increase is likely to considerably slower. We anticipate just two increases in the federal funds rate in 2016 and two more in 2017. That would bring the fed funds rate to a still accommodative range of 0.75% to 1.0% by the end of this year and 1.25% to 1.5% by the end of 2017.

The second important point is that fixed-rate products are priced not off the fed funds rate, but on longer-term government bond yields. Despite the Fed's first rate increase in December, longer-term government bond yields have actually fallen to start this year. As a result, the 30-year mortgage rate is currently 30 basis points lower than it was at the end of December (Chart 5). We anticipate that longer-term bond yields will begin to rise over the next year as current fears in financial markets surrounding the global economy subside, but like the increase in the federal funds rate, this is likely to be a very gradual process. Over the next six months we anticipate mortgage rates will rise by less than 20 basis points (or 0.2 percentage points), leaving them lower than their level at the start of this year. For the median priced home with a 30-year mortgage, an increase in 20 basis points on the mortgage rate amounts to an additional $25 dollars a month mortgage payment. Given the outlook for income growth, the housing market should easily be able to sustain such a gradual rise.



Source: Federal Reserve Board

Renovation activity to follow home sales higher

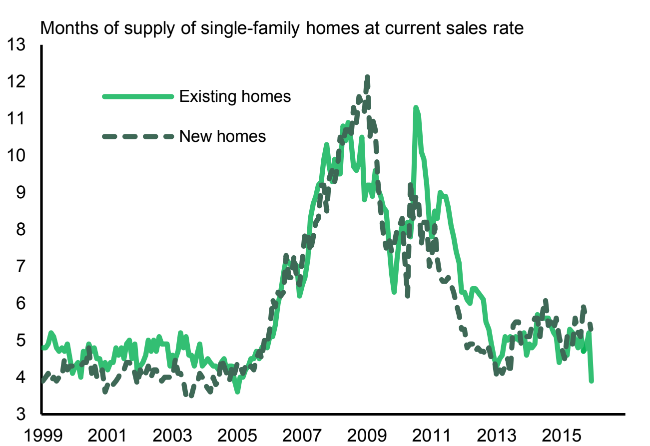
Putting it all together, we expect to see continued growth in both existing and new home sales over the course of 2016. For existing home sales, we anticipate an increase of 6.0% in 2016, down slightly from 6.5% in 2015. Still, this will bring the total level of existing home sales to 5.6 million, the highest in a decade.

As they have over the past four years, new single-family home sales should continue to outperform existing sales. We expect growth in new home sales of 12.5% in 2016, bringing sales to 560 thousand, the highest level since 2007 (but still well under the over 1 million pace set during the housing boom years between 2003 and 2006).

The outperformance in new home sales reflects a number of phenomena. For one, new home sales fell much further than existing sales, plunging over 80% peak to trough, compared to the 50% decline in existing home sales. From such a low base there is simply more room for improvement in the new market. For two, existing home sales appear to be more constrained by the level of supply in the market. The inventory of existing homes available for sale fell 4% through 2015 (December to December), despite the rise in sales. As a result, the "months' supply" of homes at the current sales rate – a typical inventory metric – fell to 4.4 months, the lowest level in over a decade (Chart 6). New home sales may also be constrained by the availability of land and labor, but so far these appear to be less binding than in the existing market. The month's supply of new homes ended 2015 slightly higher than a year earlier, suggesting that there is already more inventory available.

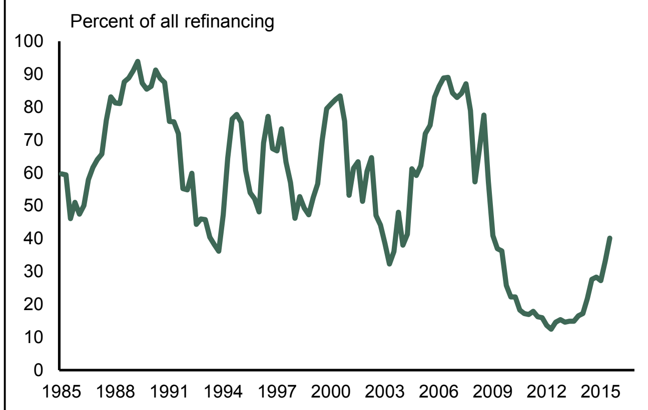
With demand rising amid a relatively low level of supply, home prices will continue to march higher. Nationally, we expect home price growth of around 5.0% in 2016. As more supply comes is added to the market, we expect price growth to decelerate marginally, moving closer in line with income growth around 4.0% annually.

CHART 6: MONTHS' SUPPLY OF UNSOLD HOMES



Source: National Association of Realtors, Census Bureau.

CHART 7: MORTGAGE REFINANCING WITH 5% HIGHER LOAN AMOUNT



Source: Freddie Mac

The outlook for renovation activity is tied firmly to the outlook for home sales and prices. Improvement activity is more correlated with existing home sales than new home sales since buyers tend to make renovations following the purchase of an existing home. Investment in residential improvement rose 5.5% in 2015 and appears likely to accelerate to around 9.0% in 2016.

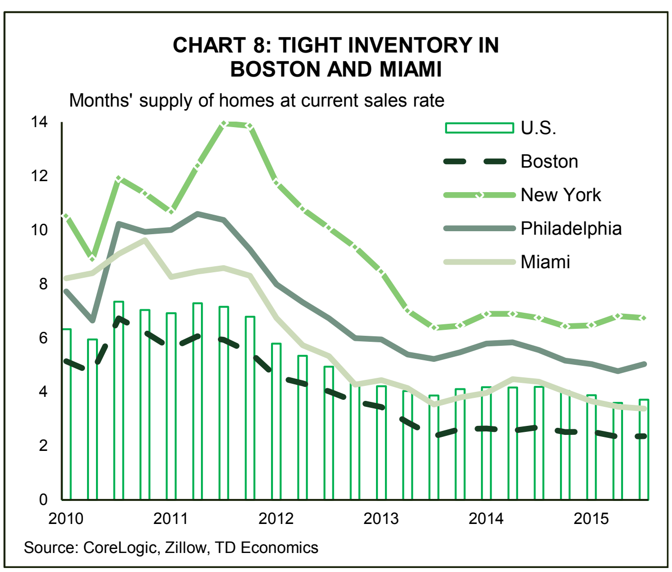
Another reason for optimism about the outlook for renovation activity is the fact that the rise in home prices has brought millions of homeowners out of negative equity positions. At its peak in the first quarter of 2012, the percent of homeowners of single-family homes with mortgages who owe more than the value of their home rose to 31.4% according to data by Zillow. This has since fallen to just 13.4% of homeowners. With home prices expected to continue to rise over the next several years, this number will continue to improve.

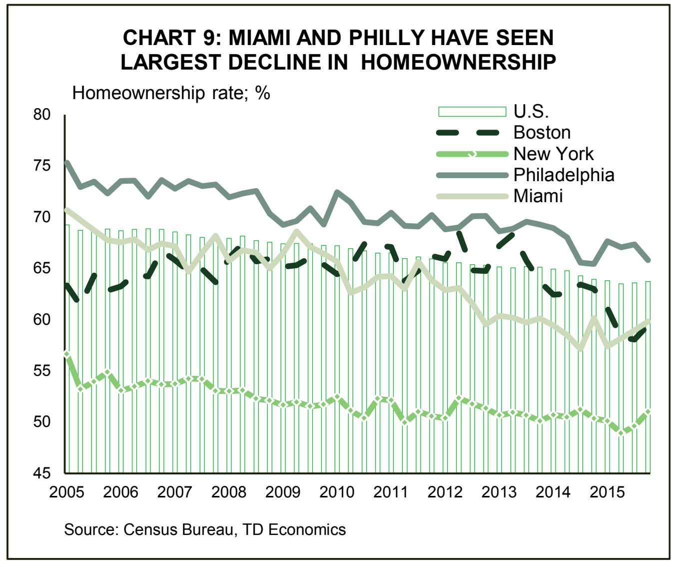
In fact there are signs that homeowners may be cautiously dipping into their new found home equity in order to finance purchases or investments in their home. According to Freddie Mac, the percentage of mortgage refinancing resulting in a higher loan amount has been moving steadily upward over the past several years (Chart 7). This is corroborated by estimates of home equity withdrawal that appear to have turned up over the last year. Now, it's important to note that this is far removed from the excesses of mortgage equity withdrawal during the housing boom that left many households more vulnerable to falling home prices, but does suggest a growing confidence among households in the ongoing housing recovery.

All regions to participate in recovery, with Miami leading major East Coast markets

The trends that are set to drive the housing recovery nationally (rising homeownership, income gains, low borrowing costs, and improved credit) will be felt across most regional markets. But, performance will vary depending on underlying fundamentals, which often differ substantially from market to market. These fundamentals will increasingly come into focus as demand from investors, which in recent years lifted markets from Boston to West Palm, begins to wane as prices recover. Investment across gateway markets, including New York and Miami, which tend to attract significant international inflows, may be pressured further still in light of the lofty greenback and lukewarm global growth.

Looking across major East Coast markets including Boston, New York, Philadelphia, and Miami, the fundamentals remain healthy. From an economic growth perspective, Miami looks set to outperform, with real GDP growth projected to average nearly 4% this year and next – partly reflecting the strong cyclical upturn and robust population growth. Boston's knowledge-based industries should also deliver a strong showing of about 3% over the 2016/17 period, while New York's vibrant economy is set to also outpace the national at about 2.5% during that time. Philly's





economy is expected to lag, with growth likely to average just above the 1.0% mark over the coming years, given its less-cyclical nature and subdued demographics. These trends will be mirrored in employment and income gains, which should enable more potential first-time homeowners to join the club and enable current owners to move up.

Homeownership rate has even more upside potential across East Coast markets

Homeownership rate dynamics also suggest there is considerable scope for improvement regionally, with the major East Coast metros seeing more severe declines in the share of owner-occupied households than the 5.8 percentage point experienced nationally. Here, the Miami metro also appears to be primed for the strongest comeback, with homeownership rates dropping by 13.8 pp through the trough, while Philly, Boston and New York experienced declines between 10 and 7 percentage points.

The surge in renter-households that accompanied falling homeownership rates have led to a surge in demand for apartments, leading to rapid rent growth with rent ten to twenty percent higher than prior to the recession. These increases in rents are significantly higher than those of existing home prices and have made homeownership a more appealing proposition in many markets.

Strong home price growth has cut into affordability, but low borrowing costs are an offset

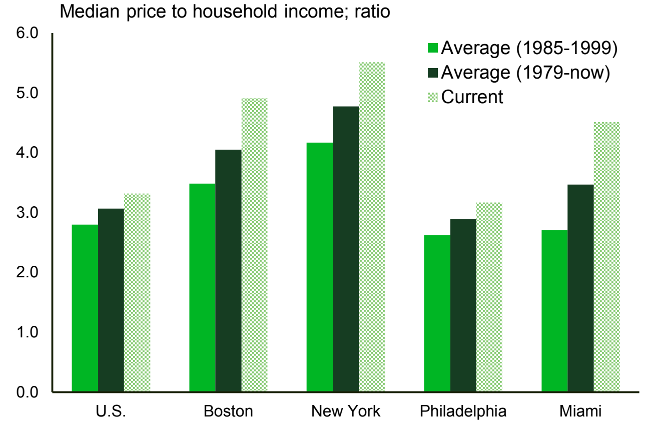
As is the case with many other indicators, the hardest hit markets have seen the most rapid rebound in home prices. Northeastern markets have generally not fallen as much as many hardest-hit regions. Home values in Philly were the least hardest-hit, with the central and other Pennsylvania counties especially stable. In light of this, as well as the significant weakness in New Jersey and Delaware portions of the metro, price gains since the recovery began have averaged a meagre 2%-3%. They have risen a more robust 5%-6% in New York and Boston, where declines in prices were also less severe than nationally. On the other hand, the hardest hit Miami, have experienced the strongest rebounds thus far, with prices up about 10% on average.

The strong run-up in prices relative to income has significant implications as far as future housing activity is concerned since it can impinge on affordability, making it harder for first time homebuyers to enter the market. The ratio of the median home price to household income has nationally already surpassed its long-term average by about 0.25 percentage points. Philly's price-to-income metric also suffered a similar deterioration, as subdued price growth still outpaced the weak income gains. But, the metrics are more stretched in the remaining metros, with price-to-income 75 higher than historical in New York and Boston, and a full percentage point in Miami.

Affordability metrics look far more favorable when interest rates are taken into consideration, with the ultra-low environment shielding homeowners' disposable income. In fact, the share of payments going to mortgage expenses remains between 5% and 7% below their historical averages across the four metros. Affordability should remain good in light of the muted mortgage rate increases expected over the coming quarters, provided that home price gains decelerate more in line with household incomes.

This is precisely what we are expecting. Home prices have been on a tear in recent years as an improving economy, low borrowing costs and increasingly limited inventory all helped valuations recover. The cyclical boost related to the first two factors should begin to diminish in the near-term, but inventory shortages continue to pose challenges, particularly in the Boston and Miami markets, where inventory is only 2.4 and 3.4 months' worth of sales at current pace. This is largely related to the two legacies of the downturn: a severe underbuilding in recent years as well as a still significant share of negative equity mortgages. Rising home construction should help alleviate the former, with construction back to pre-recession levels in Boston and New York, and at 2/3rd the pace in Philly – all more vigorous rebounds than the national, which remains at just over half its 2005 pace. On the other hand, supply of homes for sale across these markets, and Miami's in particular, should also get a helping hand from continued price gains, which should help unlock some inventory previously held off the market by owners who owed more on their homes than they are worth.

CHART 10: PRICE GROWTH HAS OUTPACED INCOME, BUT LOW RATES HELP AFFORDABILITY



Source: Zillow, TD Economics

All these factors should combine to make for continued recovery in existing and new home sales and in turn drive renovation activity across the metro markets. Given the strongest cyclical factors and robust fundamentals the Miami market is expected to lead activity, with existing home sales projected to rise by 8% to 140,000 annually in 2016. The New York and Boston markets should see improvement in line with the national one, with transactions up about 6% to 160,000 and 67,000, respectively. Philadelphia will also experience an increase in sales activity, but given the more lackluster fundamentals, these will be more subdued, with a 4% gain leading to 76,000 homes changing hands across the metro.