Real Estate

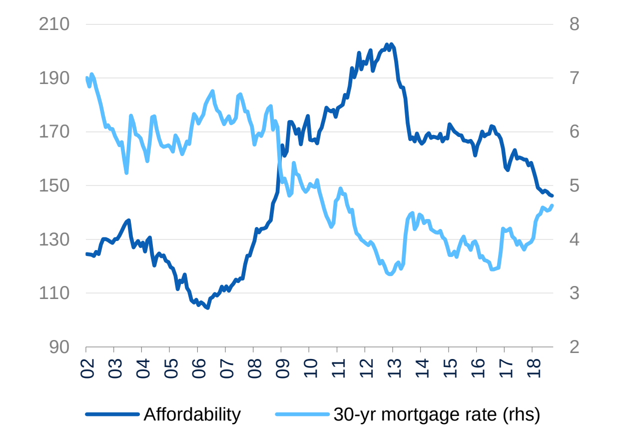
Housing outlook 2019

Filip Blazheski

- **Despite lower affordability, demographic trends will continue to support housing demand**
- **Home price appreciation will decline but remain above inflation in the short- to mid-term**
- **Tighter financial conditions will balance some of the regional disparities built up over the last decade**

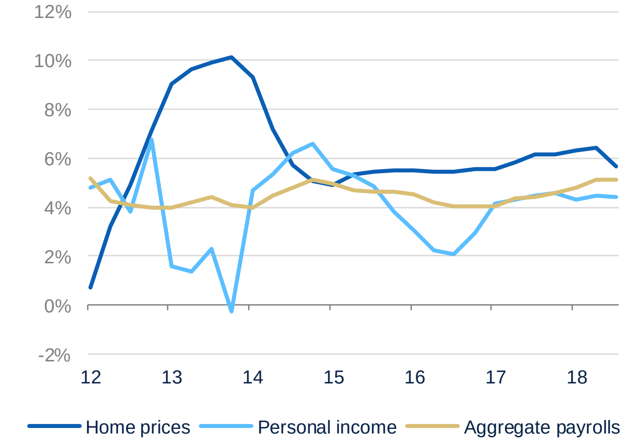
The housing market, which has been in a robust expansion mode since 2012, started weakening in the second half of 2018. Existing and new home sales declined, while new construction and home prices slowed down. This has come as a result of the sharp decline in affordability, which in turn was a result of higher mortgage rates (Figure 1). The lower level of affordability means that fewer buyers can afford to enter the housing market. Lower demand suppressed sales, which affected prices, which in turn impacted new construction. While interest rates bear most of the blame for the current slowdown, they come on the back of a six-year stretch of home prices outpacing income, sometimes to a significant degree (Figure 2). This outlook takes stock of the current state of the housing market and presents our outlook for 2019 and beyond in both the single-family and multifamily segments.

Figure 1. Housing affordability index and 30yr fixed mortgage rates (Index SA, median income = qualifying income and %)



Source: BBVA Research, FHLMC and NAR

Figure 2. Home prices and income (% YoY)



Source: CoreLogic, BEA, BLS

Interest rates and affordability

The 30-year fixed mortgage rate reached a high of 4.94% in mid-November – one percentage point higher compared to a year earlier. An increase of this magnitude translates to an 11% increase in monthly mortgage payments for a median-priced home of $260,000[1] – from $983 to $1,104. At an annual level, this represents an increase of $1,462, which is close to 2.4% of median household income.[2] The increase in interest rates would have particularly affected lower income earners in high-cost locations. Coupled with still solid home price appreciation, which is a result of a limited supply of homes for sale, higher interest rates have resulted in lower demand, which is likely to persist in the short to medium-term.

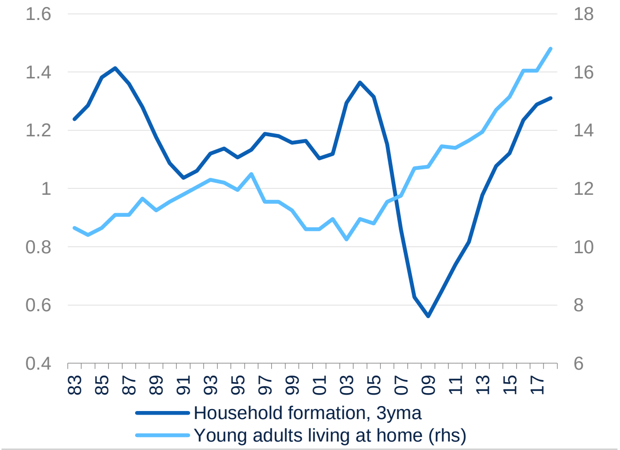
At year-end 2018, the 30-year fixed mortgage rate, which accounts for more than 70% of total outstanding residential mortgages, stood at around 4.5%. We expect this rate to stabilize around 5% in the short- to mid-term, meaning that more than one-half of the impact of interest rate increases has already been absorbed by the market.

1: Assuming loan to value ratio of 80%
2: This calculation assumes median home prices remain unchanged, since the increase in home prices is to some degree offset by the increase in disposable income. In this way, the calculation allows us to only focus on the impact of higher interest rates.

Housing conditions

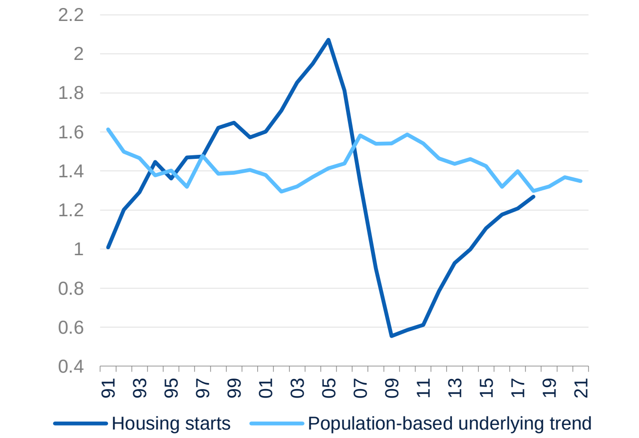
While demand will remain constrained by lower affordability, demographics will provide substantial support to housing. The Great Recession significantly suppressed household formation, resulting in a larger percentage of young adults living with their parents than ever before (Figure 3). Suppressed household formation went hand in hand with below-trend housing starts (Figure 4). While housing starts are slowly reaching their population-based trend level of 1.35-1.40 million, housing shortages that exist in a number of attractive locations will remain in place for the foreseeable future due to building restrictions and a lack of buildable lots, especially within favorable commute radii.

Figure 3: Household formation and share of young adults living at home (Million and %)



Source: BBVA Research, Census Bureau and Haver Analytics

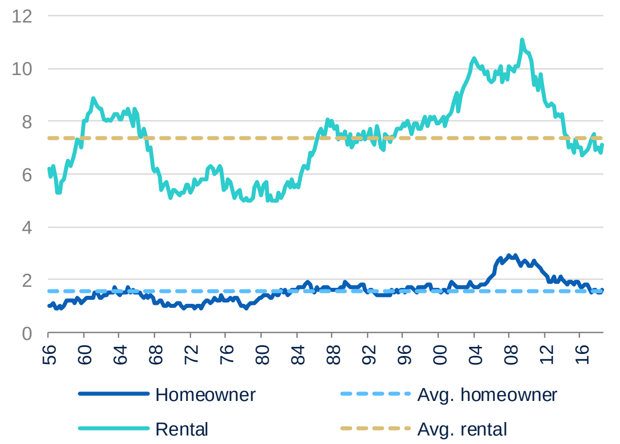
Figure 4: Housing starts (estimated for 2018) and population-based trend (Million)



Source: BBVA Research and Census Bureau

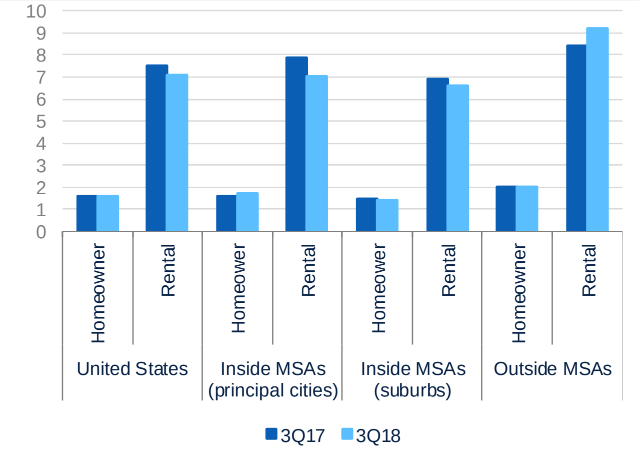
The national average vacancy rate (Figure 5) masks the pent up demand. Over the past 12 months, while vacancies have declined in metropolitan areas, they have increased in non-metropolitan areas (Figure 6), reflecting the higher availability of employment in urban centers. Within metropolitan statistical areas (MSAs), homeowner vacancies have increased inside central cities and decreased in the suburbs, reflecting the relative strength of demand for single-family homes by aging Millennials that are forming or growing their families. This suggests that while there might be some changes in preferences of Millennials relative to previous generations, the Great Recession had a significant effect on young adults' housing choices, which will eventually revert.

Figure 5: Housing vacancy rates (%)



Source: BBVA Research and Census Bureau

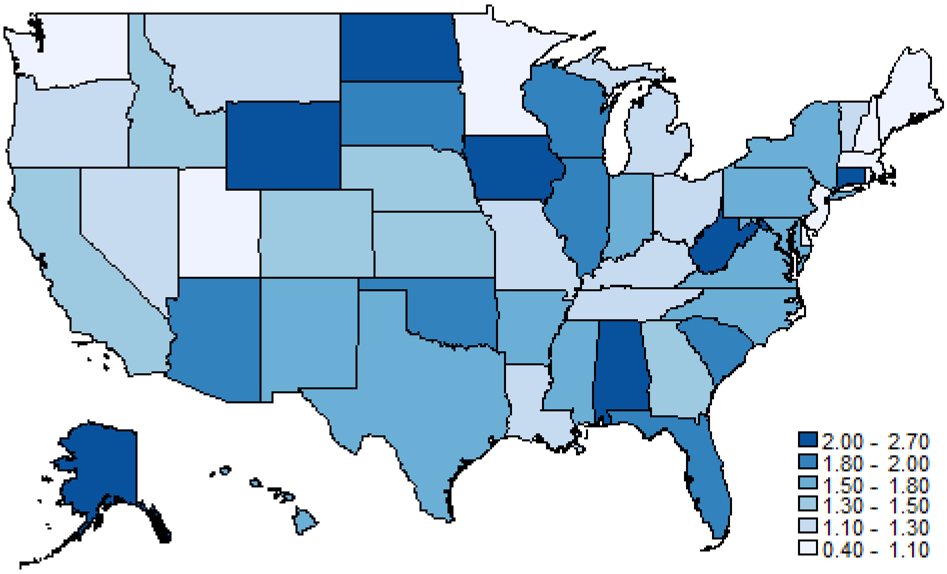
Figure 6: Vacancy levels (Million)



Source: BBVA Research and Census Bureau

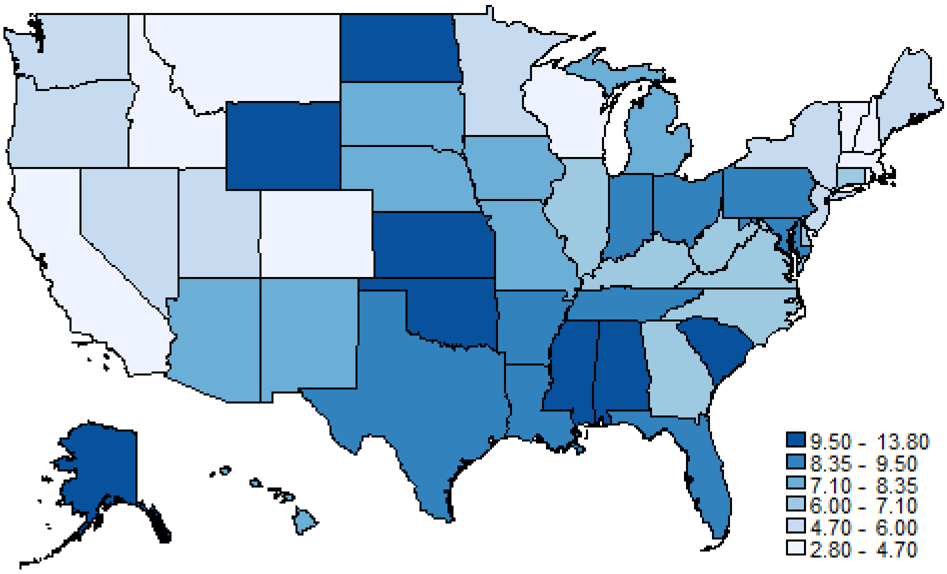
Vacancy rates also vary by state, with Alaska and West Virginia having the highest homeowner vacancy rates (Figure 7), and North Dakota and Oklahoma having the highest rental vacancy rates (Figure 8). All of these states have been impacted by the downturn in the energy industry in 2014-2016. On the other hand, the states with the lowest vacancy rates tend to be in the West and New England. Additionally, Minnesota, New Jersey, Kentucky, and Georgia also have relatively tight housing markets.

Figure 7: Homeowner vacancy rates (%)



Source: BBVA Research and Census Bureau

Figure 8: Rental vacancy rates (%)



Source: BBVA Research and Census Bureau

Vacancies by MSA confirm the underlying fundamental trends. The MSAs with low vacancy rates (Table 1 and Table 2) are characterized by solid economies, especially employment generation. Moreover, most of the MSAs with low homeowner vacancy rates also exhibit relatively affordable housing markets and have enjoyed significant improvements in the housing sector over the last several years (Figure 9). For instance, homeowner vacancy in Nashville, TN declined from close to 4% in the first half of 2015 to 0.6% by mid-2018, while homeowner vacancy in Greensboro, NC declined from 2.8 to 0.8% in the same period. These developments suggest an ongoing regional rebalancing of the housing market away from high-cost coastal areas to locations that recovered somewhat later in the aftermath of the Great Recession.

In regards to rental vacancy rates, the tightest markets are in high-cost MSAs such as Boston, Denver, and San Jose, although there have been significant improvements in some lower-cost areas such as Cincinnati and Buffalo (Figure 10). The multifamily markets in these locations have benefited from not experiencing a high degree of new construction of apartments in the first half of the 2010s. That said, many traditionally industrial mid-size MSAs such as Toledo and Albany are still struggling with high and increasing rental vacancy rates, likely as a result of their difficulty to attract enough young residents, which are more likely to rent than own. Among the MSAs with high rental vacancies, Oklahoma City and Houston have experienced a significant increase in construction over the last few years and have been affected by the slowdown in the oil and gas industry.

Table 1: Homeowner vacancy rates, largest MSAs (%)

Lowest 15		Highest 15	
Grand Rapids	0.2	Charleston	3.9
Minneapolis	0.5	Sarasota	2.9
Salt Lake City	0.5	Pittsburgh	2.9
San Antonio	0.6	Cape Coral	2.8
Cleveland	0.6	Hartford	2.8
San Diego	0.6	Toledo	2.7
Nashville	0.6	Rochester	2.7
Omaha	0.7	Tulsa	2.6
San Jose	0.7	Tampa	2.6
Las Vegas	0.7	Richmond	2.4
Greensboro	0.8	Orlando	2.3
Raleigh	0.8	Houston	2.2
Seattle	0.8	Bridgeport	2.0
Atlanta	0.8	Oklahoma City	1.9
Detroit	0.9	Knoxville	1.9

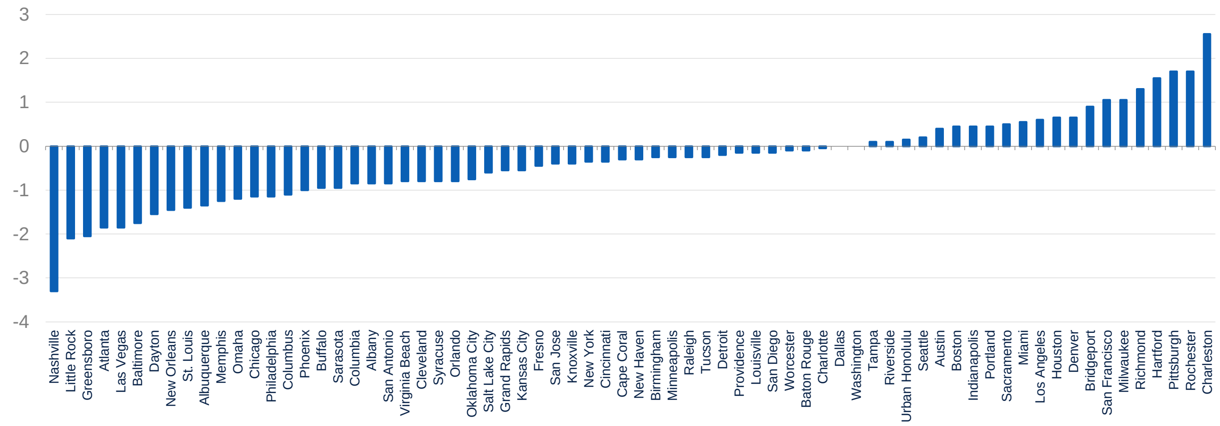
Source: BBVA Research and Census Bureau

Table 2: Rental vacancy rates, largest MSAs (%)

Lowest 15		Highest 15	
Fresno	2.0	Charleston	17.6
Worcester	2.3	Toledo	15.5
Denver	3.2	Oklahoma City	13.5
Boston	3.6	Dayton	13.5
Cincinnati	3.6	Birmingham	12.6
Cape Coral	3.7	Tulsa	11.2
San Jose	3.7	Albany	11.0
Allentown	3.9	Little Rock	10.8
Los Angeles	4.0	Memphis	10.4
Grand Rapids	4.4	Tampa	10.4
Sacramento	4.4	Greensboro	10.3
San Diego	4.4	Columbia	10.2
Syracuse	4.5	Baltimore	10.2
Minneapolis	4.6	New Orleans	10.1
Providence	4.6	Houston	9.4

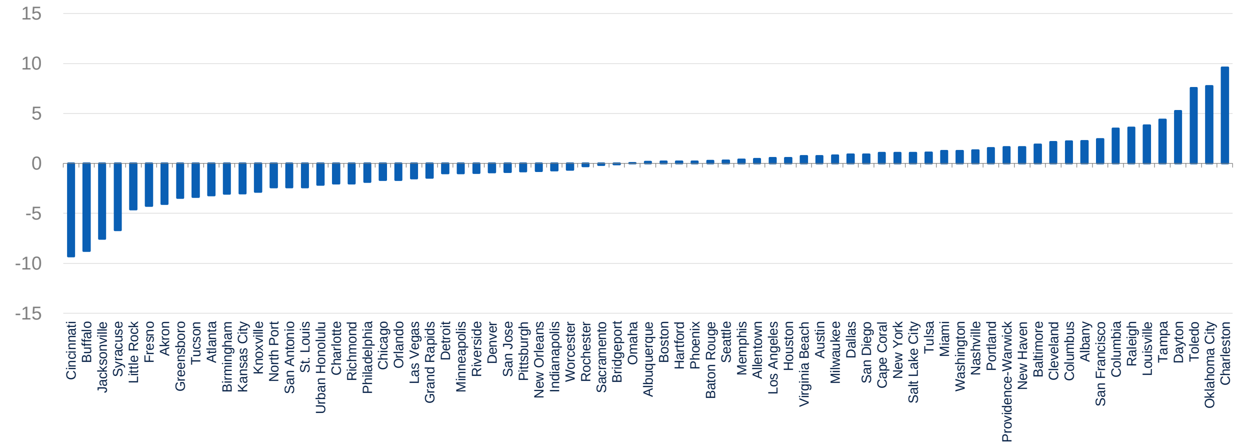
Source: BBVA Research and Census Bureau

Figure 9: Homeowner vacancy rates, largest MSAs, change 1H2015 – mid-2018 (percentage points)



Source: BBVA Research and Census Bureau

Figure 10: Rental vacancy rates, largest MSAs, change 1H2015 – mid-2018 (percentage points)

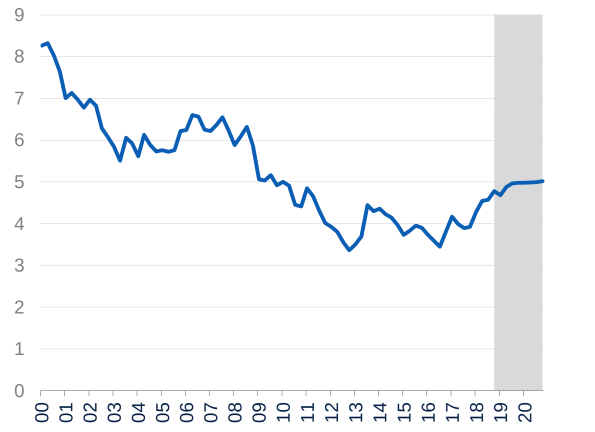


Source: BBVA Research and Census Bureau

New construction

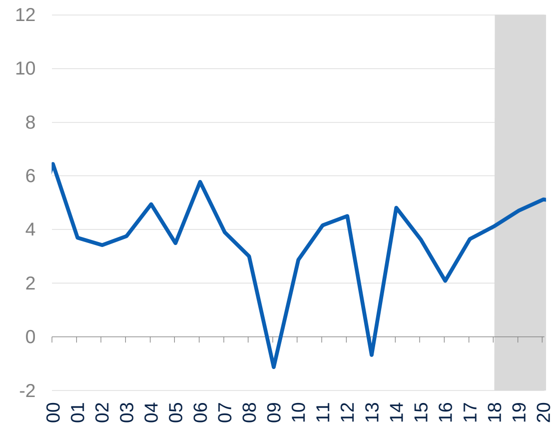
With homeowner vacancies at and rental vacancies below their historical average, and significant pent up demand and housing shortages in multiple locations across the country, residential construction will remain expanding in line with the overall strength of the economy. A slowdown in the increase in mortgage interest rates (Figure 11) and solid income growth due to labor market tightness will contribute to a continuing increase in demand that will also incentivize construction activity (Figure 12).

Figure 11: 30yr mortgage interest rates (%)



Source: BBVA Research and FHLMC

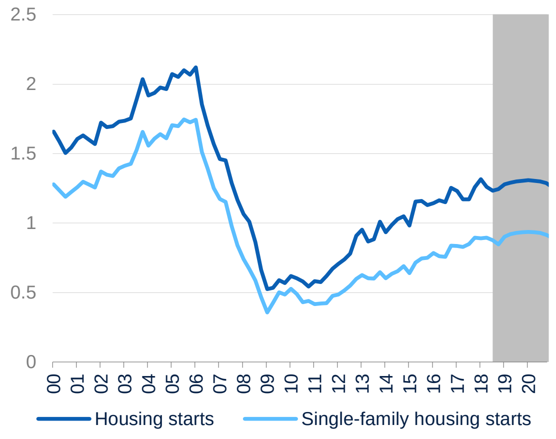
Figure 12: Personal disposable income per capita (YoY%)



Source: BBVA Research, Census Bureau and BEA

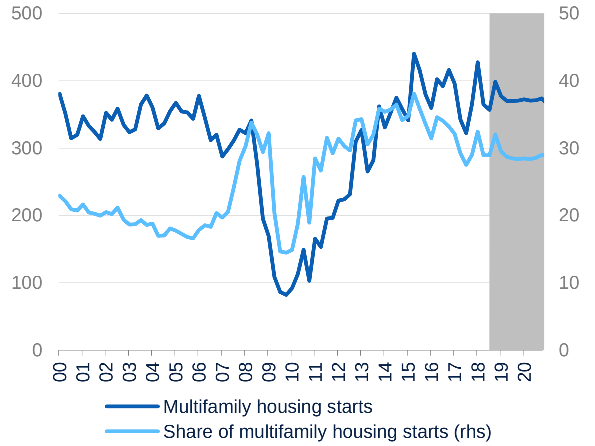
We expect housing starts to increase to 1.3 million from the current level of 1.27 million, and remain around that level through the end of 2020 (Figure 13). This forecast assumes that the economy remains in expansion mode but implies a much smaller annual gain compared to the post-crisis period. While single-family construction is expected to continue increasing slowly, multifamily construction is expected to stabilize at the current levels (Figure 14). Single-family housing demand will be supported by the aging of Millennials that are forming families and are willing to relocate away from markets that have become unaffordable due to price increases over the preceding period. Multifamily housing starts will remain close to their current level because the MSAs where rental vacancies have decreased recently are relatively small and thus require less new construction in absolute terms in the short-term to address the increase in demand, compared to the earlier period. Over the long-run, multifamily housing demand will be supported by demand in urban centers and a lack of affordable single-family options in some locations, as well as the attractiveness of this type of housing for residents in their late 70s or older.

Figure 13: Housing starts (Million)



Source: BBVA Research and Census Bureau

Figure 14: Multifamily housing starts (Thousands and %)



Source: BBVA Research and Census Bureau

Existing home sales

Existing home sales peaked in 2017 and were on a downward trend for most of 2018, as a result of both lower supply and demand. On the supply side, rising mortgage interest rates have made relocation less attractive, since homeowners changing homes are forced to replace a lower interest rate loan with a higher interest rate one. This has dis-incentivized listing properties for sale. Moreover, the extended period of suppressed new construction in the wake of the Great Recession, resulted in fewer recently built houses available for resale by their first owners compared to earlier periods. On the demand side, lower affordability has led to lower willingness to purchase a home.

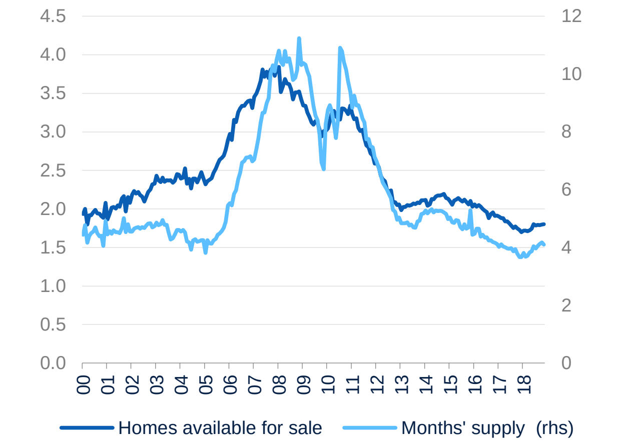
The adjustments in both supply and demand, while resulting in some increase in the number of homes on the market and months' supply (Figure 15), have nevertheless still left the market very tight. In November 2018, the supply of existing homes for sale stood at 4.1 months, whereas a balanced market is considered to have six months' supply. Among large metro areas, demand is strongest relative to supply in Oakland and Tacoma, with 1.7 months' supply of homes for sale, while supply is highest relative to demand in Naples and Miami with 9.4 and 9.1 months, respectively[3].

Since tight market conditions in the existing homes market will remain in place, and construction will increase only slightly, we expect existing home sales to remain close to their current levels, with a gradual downward trend (Figure 16). The supply of existing homes for sale will remain suppressed as long as housing construction does not increase in a meaningful way or Baby Boomer homeowners start downsizing. Baby Boomers, the second largest generational cohort, have still not reached the mid- to late-70s, an age when householders start to downsize in larger numbers. This lack of supply will continue to support price appreciation, which will help keep demand in check.

An additional factor that could affect the market going forward is the greater degree of caution on the side of potential buyers, which are likely to be wary of the dangers of buying at the top of the cycle, which proved detrimental for homeowners that purchased homes during 2005-2007. While positive over the long-run and contributing to sustainable conditions in the market, this degree of caution could further increase the ongoing weakness in home sales in the coming period.

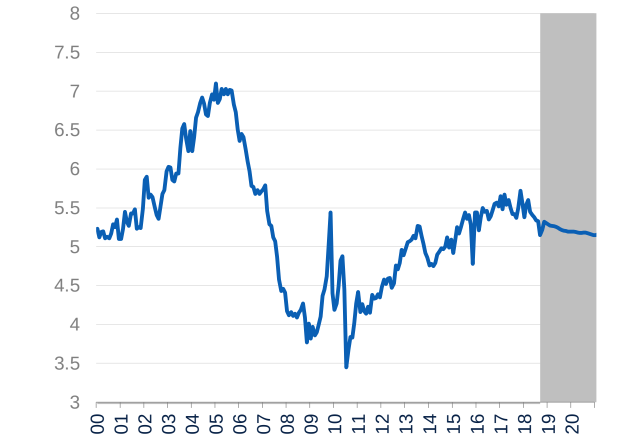
3: See Redfin https://www.redfin.com/blog/data-center

Figure 15: Homes available for sale and months' supply, seasonally adjusted (Million and months)



Source: BBVA Research and NAR

Figure 16: Existing home sales (Million)



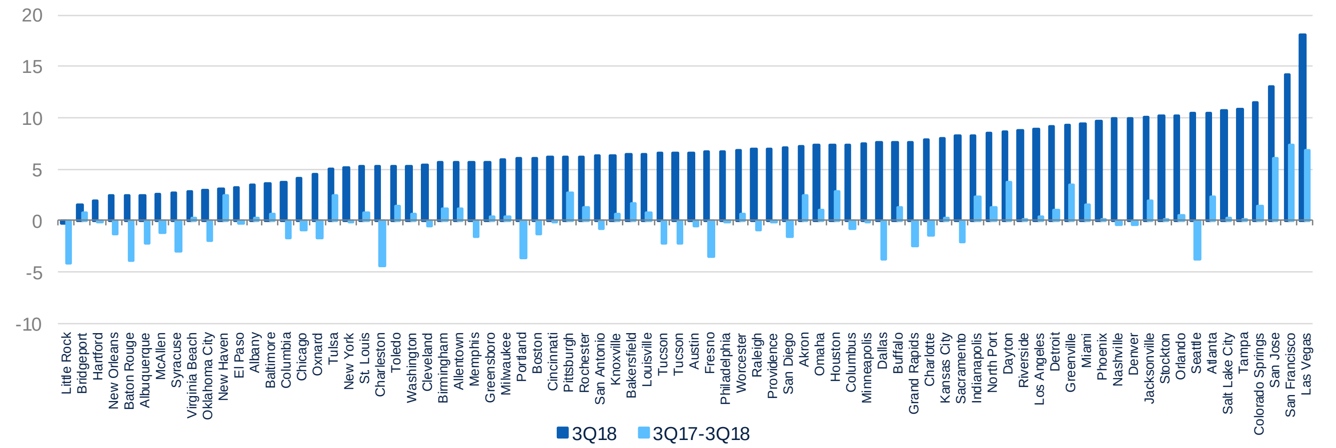
Source: BBVA Research and NAR

Home prices

Like all other housing indicators, home price appreciation has slowed relative to the first half of 2018. Whereas the CoreLogic home price index ran at 6.6% YoY rate in March and April, its rate of growth slowed to 5.1% by November, the lowest in three and a half years. Nevertheless, in inflation-adjusted terms, home prices are still increasing at a rate of 3.2% YoY, higher than the average of this measure since 1977, which stands at 2.2%.

Price appreciation in 3Q18 was strongest in Las Vegas, where home prices increased at a nominal rate of 18% YoY, according to the Federal Housing Finance Agency. Out of the eighty largest MSAs, price appreciation stood below 5% in only sixteen, generally smaller MSAs (Figure 17). Also, compared to a year earlier, price appreciation has increased in the majority of locations, implying that while price appreciation might be slowing, it is still strong and even accelerating in MSAs that have a combination of attractive economic fundamentals, home prices that are affordable relative to incomes and/or tight housing markets. This affirms the view that while lower affordability is likely to contain some of the pace of price appreciation going forward, home price growth is still likely to remain solid. Based on this, we expect home prices to increase by 4.9% in 2019 and 4.2% in 2020, compared to 5.9% in 2018 (Figure 18), with the rate of appreciation slowing further after that, but remaining above the rate of inflation.

Figure 17: Home prices, 80 largest MSAs (% YoY and percentage points change in growth YoY)

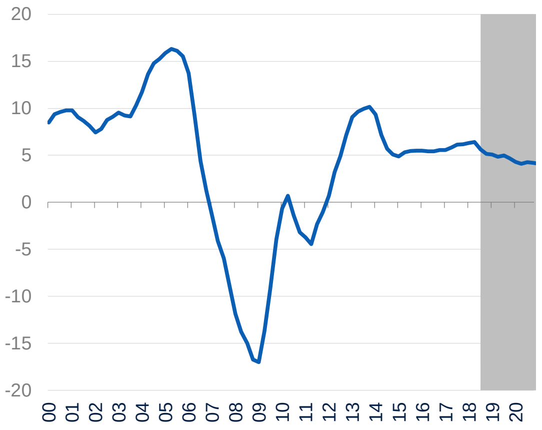


Source: BBVA Research and FHFA

Home price misalignment

The extended period of home price growth after the Great Recession, combined with the exceptional attractiveness of certain metro areas and limits to building growth, has led to home prices diverging from their fundamentals in some regions. Our analysis indicates that there is a high correlation between the degree of home price misalignment before and after the Great Recession (Figure 19). That said, the level of misalignment currently is much lower than in the previous cycle. We also find that the levels of misalignment in the most positively misaligned metro areas (where prices are above fundamentals) and the most negatively misaligned ones (where prices are below fundamentals) have started to decrease in absolute terms (Figure 20). This regional rebalancing is positive and will contribute to the sustainability of the housing market in the long run. We expect this trend to continue in 2019. The rebalancing will be driven by a combination of changes in affordability, demographics and local economic developments. These trends will favor the housing markets of affordable mid- to large-size metropolitan areas that are able to take advantage of the secular economic trends, especially as they relate to the knowledge economy, and attract young residents that are forming or already have young families. The outlook for smaller metro and rural areas is less positive, which implies a need to develop strategies for coping with stagnant or declining population levels.

Figure 18: CoreLogic home price index (%YoY)

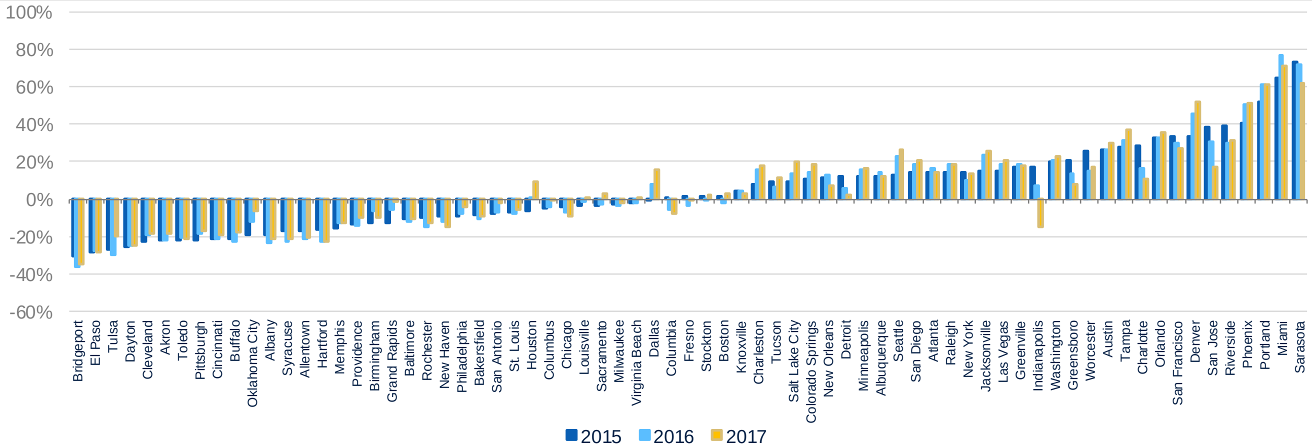


Source: BBVA Research and CoreLogic

Figure 19: BBVA Home Price Misalignment Index (% misalignment from fundamentals)

Source: BBVA Research

Figure 20: BBVA Home Price Misalignment Index (% misalignment from fundamentals)



Source: BBVA Research

Bottom line

Housing market activity slowed in the second half of 2018 in response to higher mortgage rates. Still, home price appreciation remains solid at 5.1% YoY. Home prices are driven by a suboptimal supply of both new and existing homes for sale. The suboptimal supply of new homes has been a feature of the housing market since the Great Recession. Because of structural issues, new construction is going to increase only somewhat going forward. Existing homes supply will remain low due to higher interest rates, which dis-incentivize relocation of homeowners. Demographics will continue to drive demand, with Millennials aging and forming families and thus searching for single-family homes in suburban areas, while Baby Boomers have still not started downsizing at a significant degree. The attractiveness of large coastal knowledge-intensive metro areas will remain, but the lack of affordable housing will drive some residents to smaller metro areas away from the coasts. Demand for apartments in attractive areas will remain strong, driven by the strength of the local economies and lack of affordable ownership options. Mid-size metro areas that can attract young families are likely to benefit from the rebalancing in the housing market in the wake of lower affordability. However, small metro areas and rural regions will continue to struggle to attract residents. In all, while affordability will remain an issue, demographic trends will continue to support housing demand. While home price appreciation will slow, it will remain solid. Tighter financial conditions will help rebalance some of the regional disparities built up over the last decade.

Forecasts

Table 3. Housing market forecasts

	2015	2016	2017	2018 (f)	2019 (f)
Building permits (Million)	1.18	1.21	1.29	1.32	1.35
Housing starts (Million)	1.11	1.18	1.21	1.26	1.29
New home sales (Thousand)	503	560	616	627	636
Existing home sales (Million)	5.23	5.44	5.54	5.37	5.24
CoreLogic home price index (% YoY)	5.3%	5.5%	5.9%	5.9%	4.9%
Median home price ($)	220	232	246	257	268
Affordability (Index 100=Median income qualifies for median price)	168.0	168.5	159.3	147.9	142.0
30Y mortgage rate (%)	3.9	3.6	4.0	4.5	4.9

(f): forecast
Source: BBVA Research

DISCLAIMER

This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) BBVA Research U.S. on behalf of itself and its affiliated companies (each BBVA Group Company) for distribution in the United States and the rest of the world and is provided for information purposes only. Within the US, BBVA operates primarily through its subsidiary Compass Bank. The information, opinions, estimates and forecasts contained herein refer to the specific date and are subject to changes without notice due to market fluctuations. The information, opinions, estimates and forecasts contained in this document have been gathered or obtained from public sources, believed to be correct by the Company concerning their accuracy, completeness, and/or correctness. This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.