2 Housing Markets

Despite the most favorable mortgage rates in decades and two rounds of homebuyer tax credits, major housing market indicators stood at or near record lows in 2010. Construction was particularly depressed, with completions of new homes down some 18 percent from a year earlier to just 652,000 units. A rebound in single-family production and new home sales will depend largely on an upturn in household growth to reduce the severe inventory overhang. But with rental markets already tightening, multifamily starts may get a bounce.

GRIM CONSTRUCTION AND SALES REPORTS

The construction downturn has swept across the entire housing sector **(Figure 6)**. Single-family completions in 2010 sank to lows last seen in the midst of World War II, multifamily completions were down another 43 percent from the year earlier, and manufactured home placements hit their lowest levels since record-keeping began in 1974. Total starts held well below 1 million for the third consecutive year, distinguishing this cycle from past recoveries when construction rebounded quickly and strongly once annual starts dipped below that mark. Single-family starts did, however, stabilize near a 570,000 seasonally adjusted annual rate from the first quarter of 2009 to the end of 2010. The small increase in single-family permits and substantially larger 10.9 percent gain in multifamily permits last year suggest a bottom may have formed.

With such drastic cutbacks in construction activity, the inventory of new homes for sale is just 183,000 units—a level not posted since the mid-1960s when the number of US households was half what it is today. Even so, demand remains weak and the supply of new homes for sale was 7.3 months in March 2011, up from 7.1 months a year earlier and still well above the long-run average of 6.2 months. New home sales dropped another 14 percent in 2010 to a low of 323,000, marking the fifth consecutive year of double-digit declines. The downtrend continued in the first quarter of 2011 with sales running below a 300,000 annual rate.

Existing single-family home sales also fell in 2010, reversing gains in 2009 and surpassing the 2008 low despite another homebuyer tax credit last year. Based on Multiple Listing Service (MLS) data, the National Association of Realtors® (NAR) reports that existing single-family home sales dropped 5.7 percent to just 4.3 million. Estimates from CoreLogic, which include non-MLS sales, indicate roughly twice that decline.

According to NAR, first-timers accounted for 39 percent of homebuyers in 2010—essentially the same share reported in the American Housing Survey on average since 1977. But bolstered by the federal tax credit program ending in April 2010, the first-time buyer share hit 49 percent in that month before falling to 33 percent in December of last year and then to 29 percent in

FIGURE 6

The Housing Market Recovery Failed to Materialize in 2010

	2008	2009	2010	Percent Change 2007–8	Percent Change 2008–9	Percent Change 2009–10
Single-Family Home Sales						
New (Thousands)	485	375	323	-37.5	-22.7	-13.9
Existing (Millions)	4.35	4.57	4.31	-11.9	5.0	-5.7
Residential Construction						
Total Starts (Thousands)	906	554	587	-33.2	-38.8	5.9
Total Completions (Thousands)	1,120	794	652	-25.5	-29.1	-18.0
Median Single-Family Sales Price						
New (Dollars)	235,068	220,254	221,800	-9.8	-6.3	0.7
Existing (Dollars)	199,114	174,923	173,100	-13.1	-12.1	-1.0
Homeowner Balance Sheets						
Home Equity (Trillions of dollars)	7.06	6.85	6.30	-35.0	-3.0	-8.0
Mortgage Debt (Trillions of dollars)	10.63	10.51	10.07	-4.1	-1.1	-4.2
Construction Spending						
Residential Fixed Investment (Billions of dollars)	479	358	341	-27.6	-25.2	-4.9
Homeowner Improvements (Billions of dollars)	122	114	115	-16.8	-6.4	0.9

Note: All dollar values are in 2010 dollars, adjusted for inflation by the CPI-U for All Items.
Sources: US Census Bureau, New Residential Construction; National Association of Realtors®, Existing Home Sales; Federal Reserve Board, Flow of Funds; Bureau of Economic Analysis, National Income and Product Accounts.

January 2011. The homebuyer tax credit thus had a dramatic but short-lived impact, setting the stage for a sharp retreat in sales as soon as the program expired.

As the share of first-time buyers shrank, the share of cash buyers expanded from 19.8 percent in 2009 to 27.4 percent in 2010. With distressed sales and foreclosure auctions on the rise, cash purchases climbed steadily to a record-high share of 35 percent in March 2011. This trend indicates that many typical homebuyers remain on the sidelines, either unsure about the direction of home prices or unable to qualify for financing.

PRICES UNDER PRESSURE

After strengthening slightly at mid-year, home prices ratcheted down again, ending 2010 down 4.1 percent. Trends were remarkably similar nationwide. Indeed, home prices in nearly three-quarters of the 384 metro areas and divisions covered by the FHFA index fell in the fourth quarter of last year, with 47 metros posting drops of more than 5 percent. The Case-Shiller index, which reports on fewer markets but is not similarly restricted to sales of homes with conventional mortgages, indicates that prices in 18 of 20 large metros were down year over year in January 2011, with prices in 11 metros surpassing previous cyclical lows. Still, the brief rise in home prices when the second homebuyer tax credit expired suggests that underlying demand remains strong, although potential buyers feel little urgency to act without an incentive. The weakness in house prices was evident not only in areas hit hard by the foreclosure crisis, such as Phoenix and Atlanta, but also in markets where prices had been firming. For example, Minneapolis and Dallas posted significant price drops in 2010 after prior-year gains **(Table W-7)**. The only metros reporting higher prices last year were Washington, DC (up 2.3 percent) and San Diego (up 1.7 percent).

While prices for low-end homes made especially large gains during the housing boom, they have now dropped much more sharply than those for high-end properties **(Figure 7)**. In Atlanta, for example, prices of high-end homes were down 23 percent from the peak to December 2010, but those for low-end homes plunged a staggering 50 percent. In the last year, prices at the low end of these markets typically fell three times more than those at the high end.

According to CoreLogic, the latest round of declines pushed overall home prices back to levels last seen in early 2003. With so many years of price appreciation lost, millions of Americans own homes worth less than their mortgages. These underwater homeowners are often unable to move because their choices are so unpalatable: pay off the balance of the loan that the sale price does not cover, negotiate a short sale or deed in lieu of foreclosure, or relinquish the house to foreclosure. The large number of owners thus stuck in place inhibits trade-up demand, putting even more downward pressure on prices.

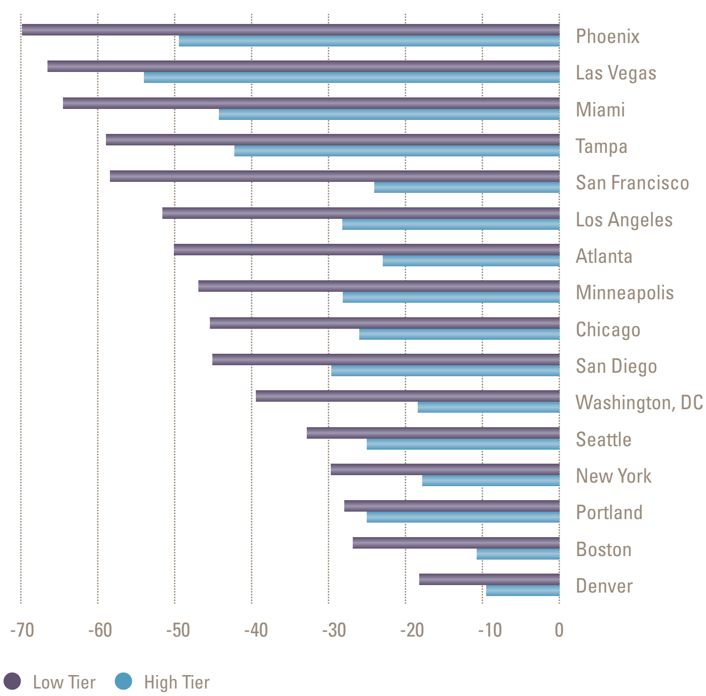
Progress in relieving this problem has been slow. Based on about 85 percent of US mortgages, CoreLogic estimates indicate that the number of homeowners with negative equity edged down from 11.3 million in 2009 to 11.1 million at the end of 2010. Of these underwater owners, nearly 5 million (about 10 percent of all owners with mortgages) have loans of at least 125 percent of home value. In hard-hit Florida and Arizona, about 30 percent of homeowners with mortgages are severely underwater. In Nevada, the share is nearly 50 percent and mortgage debt overall has reached 118 percent of the aggregate value of homes in the state.

Troubled loans, short sales, and foreclosure auctions will continue to stifle home prices and slow the rate at which homeowners escape their negative equity positions. According to NAR, distressed sales of existing homes increased to 40 percent in March 2011, up from 35 percent a year earlier. Including distressed sales, the decline in existing home prices December 2009 to December 2010, as measured by CoreLogic, rises from 3.1 percent to 4.5 percent. At last measure in February, inclusion of distressed sales turns annual price appreciation in 15 states from positive to negative. Overall, Zillow.com estimates suggest that the share of homes sold for less than their purchase prices climbed from 25.4 percent in 2009 to 30.7 percent in 2010.

FIGURE 7

Prices at the Low End of the Market Have Fallen More than at the High End

Decline in Home Prices, Peak to December 2010 (Percent)



Note: The high (low) tier includes the top (bottom) third of all homes, ranked by initial sales price.
Source: Table A-8.

THE INVENTORY OVERHANG

Rental vacancy rates improved significantly last year, dropping steadily to 9.4 percent in the fourth quarter. This was the lowest quarterly rate posted since 2003 and well below the 10.7 percent rate a year earlier. The largest vacancy rate decline was for large multifamily buildings with 10 or more rental units.

Meanwhile, the 2010 vacancy rate for for-sale homes was 2.6 percent, unchanged from 2009. Single-family vacancies actually dipped slightly while those for condo and co-op units rose significantly. The largest increase was for units in buildings with 10 or more units, where vacancy rates climbed 1.4 percentage points to 10.0 percent. The inventory overhang from the housing boom was still evident in both rental and for-sale markets, with vacancy rates for units built in 2000 or later well above those for older units.

While there is no definitive way to determine how much excess inventory exists, one common approach is to start with "normal" vacancy rates, that is, from the pre-boom years when rents and house prices were more stable. Average vacancy rates from 2003 to 2007 for rental units, and from 1999 to 2001 for all other types of units, provide a fair approximation of normal. Comparing these rates against those in 2010, the excess inventory amounts to approximately 700,000 for-sale homes and 160,000 rentals.

But these estimates do not include units held off market in preparation for sale or rent, a category that covers many unoccupied homes in some stage of foreclosure. Vacancy rates for this category are abnormally high and rising. Indeed, excess vacant units of this type numbered 1.1 million in 2010. Add to that about 700,000 excess seasonal homes (another category that may include vacant units that owners are waiting to put up for sale when conditions improve), and the excess housing inventory could total as much as 2.6 million units.

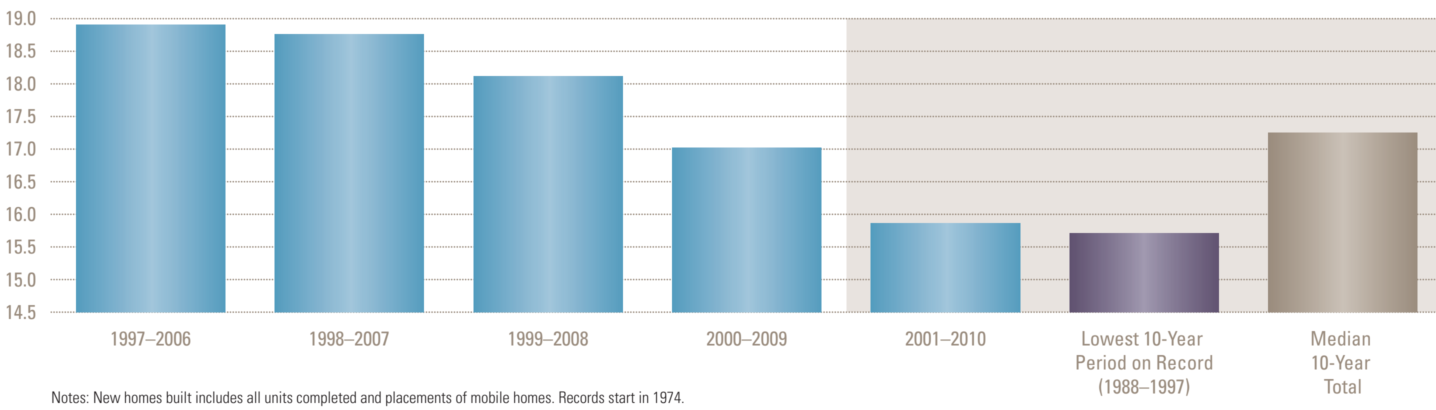
Working off the inventory overhang appears to be a demand-side problem. The post-2006 cutback in housing production has been so severe that completions and placements in the past 10 years—a period that includes one of the largest housing bubbles in the nation's history—barely exceed the lowest level of any 10-year period in records that began in 1974 **(Figure 8)**. And with weakness continuing, 2002–11 will likely set a new low for production.

According to the Current Population Survey, the source that comes closest to matching the 2010 Census count, average annual household growth slowed by more than 400,000

FIGURE 8

Despite the Mid-Decade Surge, Home Construction in the 2000s Was Lower than in Nearly Every 10-Year Period Since 1974

New Homes Built (Millions)



Notes: New homes built includes all units completed and placements of mobile homes. Records start in 1974.
Source: JCHS tabulations of US Census Bureau, New Residential Construction data.

between 2001–5 and 2005–10. As a result, 2 million fewer households were formed in the last five years than if the pace in the first half of the 2000s had continued. Such depressed levels of household formation have kept excess vacancies high despite the sharp correction in construction.

While it is difficult to gauge how close the market is to balance, the longer-term outlook is positive. Based simply on the aging of the current US population and average headship rates by age and race/ethnicity in 2007–9, household growth should hit 1.0 million per year over the coming decade. Additional demand will come from immigration, the need to replace existing homes, and demand for second homes. All told, baseline demand for new housing is likely to total at least 16 million units over the next ten years, although construction levels could be lower given the need to work off the current excess supply.

STATE-LEVEL CONDITIONS

Permitting levels, home sales and prices, vacancy rates, and employment growth all help to gauge conditions in specific housing markets. While most states saw improvement in at least one of these indicators in 2010, just 19 experienced broad gains. Permitting was the most widely improving indicator, although just 29 states posted increases in this measure, and total permits remained near historical lows. Homeowner vacancy rates also ended 2010 lower in 20 states, reflecting the significant number of owned units converted to rentals or taken off the market.

The direction of home prices was the most common negative factor. As measured by the FHFA purchase-only price index, home prices in just three states ended the year higher than they began. Washington, DC, was the only market to register positively on four of the five indicators, although Washington State, North Dakota, and Hawaii posted improvements in three. Eight states saw no turnaround in housing market indicators in 2010.

Employment growth is perhaps the most important metric because it is a leading indicator of housing demand. While nonfarm employment is still well below pre-recession levels in all but three states, the number of states registering job gains jumped from 2 in the first quarter of 2010 to 44 in the first quarter of 2011. Based on recent growth rates, though, returning to pre-recession employment levels will take more than five years on average.

Job gains in the once-hottest homebuilding markets are especially modest. At the height of the housing boom in 2005, just four states—Florida, California, Georgia, and North Carolina—accounted for more than 30 percent of US permits and had job growth rates that were 50 percent above the national average. Since 2008, however, employment gains in these states have lagged. In fact, Florida, Georgia, and North Carolina are three of just eight states where nonfarm employment fell last year.

HOUSING AND THE ECONOMY

Rather than leading the recovery as in past cycles, homebuilding was a damper on GDP growth in 2010 **(Figure 9)**. Spending was volatile during the year, but the 0.75 percentage-point drop in residential fixed investment (RFI) in the third quarter was the biggest drag on growth since the worst of the housing bust. In 2010 as a whole, RFI fell another 0.2 percentage point to just

2.3 percent of GDP—the smallest share since 1945. In stark contrast, RFI as a share of economic output averaged 4.2 percent in the 1980s and 1990s, reaching as high as 6.1 percent at the market peak in 2005.

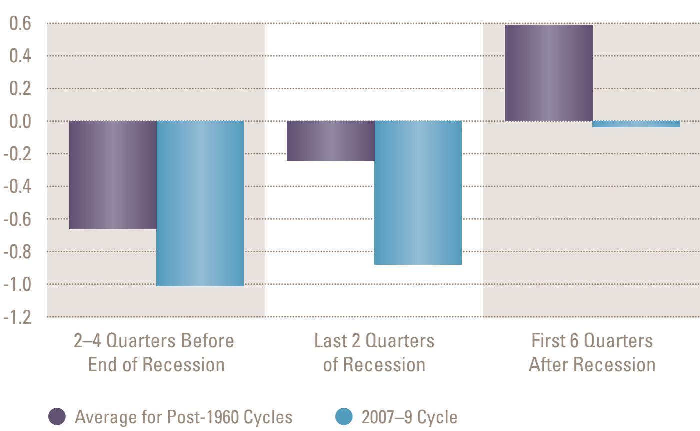
In addition to homebuilding, the housing sector adds directly to the economy through consumption of housing services, including rent paid by tenants, homeowners' imputed rent, rental management services, residential utilities, and furniture purchases. This spending is less volatile than construction and, when combined with RFI, makes up a much larger part of the economy. In 2010, the total housing share of GDP was 17.1 percent, down from a high of 20.7 percent in 2005 and below the 18.3 percent averaged in the 1980s and 1990s.

Housing-related activities also affect GDP indirectly. Falling home sales reduce the multipliers associated with the spending of income derived from these transactions. Housing wealth effects—generated by strong house price appreciation—also contribute indirectly to GDP by spurring expenditures on consumer goods and services, often financed with home equity. With the current weakness in house prices, however, the volume of cash-out refinancings (resulting in measurably higher mortgage balances) hit a 10-year low even though refinancing overall accounted for two-thirds of the estimated $1.6 trillion in mortgage originations last year. According to Freddie Mac, just 18 percent of conventional mortgage refinancings took cash out while a third put cash in (reinvesting equity to reduce outstanding debt). The trend toward cash-in refinancing strengthened over the year, reaching 44 percent of all refinances in the fourth quarter—the highest share since 1985. Many of these cash-in refinancings were no doubt by necessity so that borrowers could take advantage of historically low mortgage rates.

FIGURE 9

Unlike in Previous Cycles, Residential Construction Has Been a Drag on the Economic Recovery

Contribution of Residential Fixed Investment to Real GDP Growth (Percentage point)



Source: JCHS tabulations of US Bureau of Economic Analysis, National Income and Product Accounts.

INVESTMENT IN EXISTING HOMES

Even at the height of the homebuilding boom, expenditures on maintenance and improvement of existing homes accounted for about a quarter of total residential fixed investment. That share has since risen to nearly 45 percent. In 2010, real homeowner improvement spending was down 26.7 percent from its peak—a substantial decline, although much more modest than the 76.4 percent drop in new residential construction spending.

Like other segments of the housing market, homeowner improvement activity has yet to stage a strong rebound, with real spending last year up just 0.9 percent from 2009. One reason is the slowdown in home sales, a primary driver of marginal changes in remodeling expenditures. The Joint Center for Housing Studies estimates that owners spend 2.5 times more on improvements in the first two years after buying homes than the annual average outlay of $2,500. After the initial two years of ownership, however, spending drops precipitously **(Figure 10)**.

The small increase in spending last year does, however, suggest that more owners are choosing to remodel than to move. The government stimulus package, combined with their own desire to save money, has supported owners' efforts to increase the efficiency of their homes. And with the added benefit of tax credits, energy-efficiency improvements have become a growth market for remodeling contractors. Indeed, a JCHS survey indicates that the share of remodelers that reported completing energy-efficiency or sustainability-related projects in the previous year increased from 84 percent in early 2009 to 97 percent in early 2011.

The need to address the deferred maintenance of properties that have gone through the long foreclosure process may also help to boost remodeling spending. The Home Improvement Research Institute reports that buyers of distressed homes spend an average of 14 percent more on improvements within the first year of ownership than buyers of non-distressed homes.

PIVOTAL FEDERAL SUPPORTS

With Fannie Mae and Freddie Mac under conservatorship, reliance on federal mortgage guarantees has escalated. Inside Mortgage Finance reports that the government owned or guaranteed close to 90 percent of mortgage originations in 2010. FHA has become the primary lender to borrowers with downpayments of less than 20 percent, lifting its share of mortgage originations to nearly 20 percent last year. USDA Section 502 guarantees for mortgages to low- and moderate-income households in rural areas have also increased significantly.

In the secondary markets, GSE and agency mortgage-backed securities (MBS) accounted for 96 percent of issuances last year. Moreover, from January 2009 through March 2010, the US Treasury not only bought $1.25 trillion of these MBS, but also invested $175 billion in GSE debt securities.

As the government attempts to extricate itself from this pivotal role, many private issuers of mortgage securities remain on the sidelines. While this may reflect caution about accepting credit risk while housing prices are still falling and employment growth is sluggish, it may also signal that the large government footprint has left little room for private lending. Accordingly, the GSEs and FHA raised the costs of their guarantees in early 2011 to shore up their balance sheets and to test the waters for reentry of private capital without government guarantees. The Obama Administration intends to continue this course to allow private investors to regain market share. The longer-run federal role in mortgage markets is unclear. The Administration has outlined three broad options for restructuring government mortgage guarantees, none of which call for the continued existence of Fannie Mae and Freddie Mac. However, rolling back public sector support too quickly could severely shock the housing market.

Regulations being developed under the Financial Reform Act, including creation of the Consumer Financial Protection Bureau, will also fundamentally reshape the mortgage market. Among the proposed changes are prohibitions on some of the riskiest types of loans and imposition of different risk retention and liability requirements on the basis of specific loan terms. Other regulations will affect reporting rules and capital requirements for mortgage lenders, as well as loan-level disclosures of securitized pools. These efforts to bolster the safety and soundness of the mortgage system have, however, raised concerns that the changes will unduly raise the costs of credit and reduce access for borrowers with limited wealth.

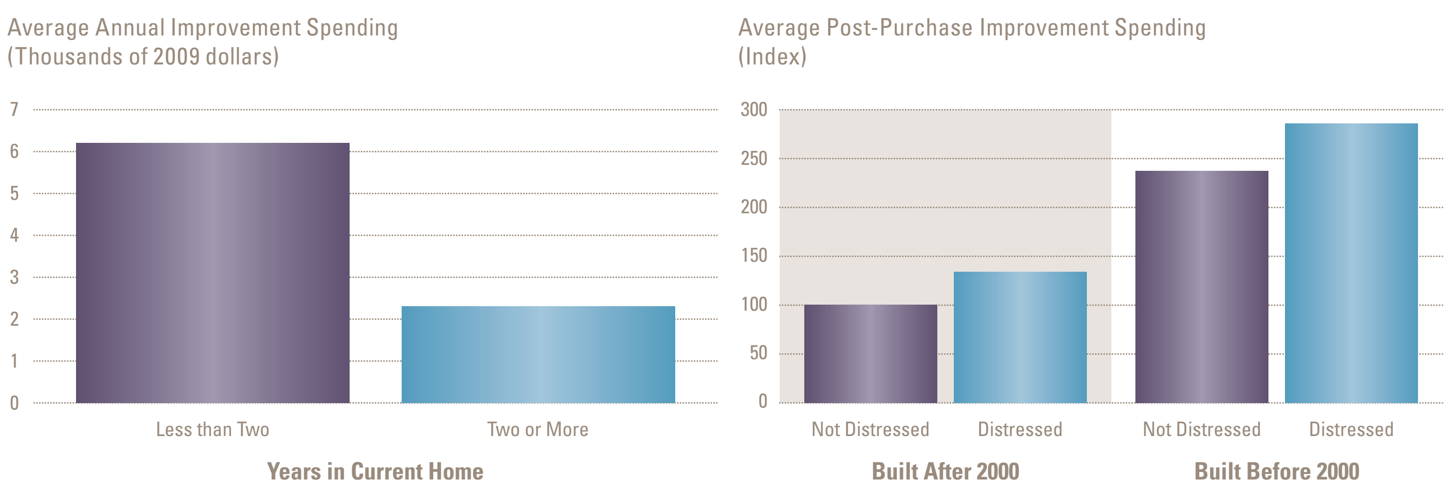
THE OUTLOOK

Despite the severe cutback in homebuilding, the sharp slowdown in household growth has kept vacancy rates high. Absorption of the excess supply has been slowed by the weakness of the economic recovery, which has yet to stimulate a large enough rebound in employment to spur housing demand. In the meantime, more than 11 million homeowners remain stuck in homes worth less than their mortgages, 2.0 million are severely delinquent on their payments, and 2.2 million are in the foreclosure process. With distressed sales continuing to push down prices, many would-be homebuyers are waiting for even better deals.

On the brighter side, low interest rates and weak prices have made homeownership more affordable than in decades. Several strong months of private sector job growth in early 2011 provide encouraging signs of a housing market rebound. With inventories of new homes at historic lows, a turnaround in demand could quickly result in tighter markets. Over the longer term, the number of younger households is set to rise sharply, supporting growth in the population that fuels growth in both new renters and first-time buyers. The path of the economy and evolution of the mortgage market will determine when and if this increased demand materializes.

FIGURE 10

Homeowners Spend the Most on Improvements Within Two Years of Buying, Especially If the Property Is Distressed



Note: Distressed properties include those bought from a financial institution, purchased as a short sale, or with loans that were either delinquent or in the foreclosure process.
Source: JCHS tabulations of US Census Bureau, 1995–2009 American Housing Surveys; and Home Improvement Research Institute, 2010 Recent Home Buyers Survey.