



HOUSING MARKETS

Housing markets showed some signs of recovery in 2009. The question now is whether the large overhang of vacant units—combined with high unemployment and record foreclosures—will allow a robust and sustained upturn. As job growth resumes, however, household growth should pick up and help spur increased new construction and sales. With the economy, existing sales, and consumer confidence already turning around, home improvement spending should soon follow suit.

PLUMBING THE DEPTHS

With demand for new homes reaching record lows, production slowed to a crawl last year. In fact, fewer homes were started in 2009 than in any year since World War II. Even with a weak rebound in the second half of the year, starts of single-family homes were down 28 percent from 2008 and stood below 500,000 units for the first time since recordkeeping began in 1959. Manufactured home placements fell by an even greater 34 percent, while multifamily starts plummeted by a whopping 62 percent from an already low level.

Permitting for new housing was also off sharply, suggesting that starts will remain below normal levels for some time. Census Bureau estimates show that permits totaled just 583,000 in 2009, compared with 2.16 million at the 2005 peak and an annual average of 1.32 million in the 1990s (**Table A-2**). Again, this is the first time in recorded history that annual permits have numbered less than 900,000. Even after a sizable 31 percent jump from the March 2009 trough to March 2010, the pace of permitting remained in the low 600,000s through April of this year.

The sharp cutback in permits extended across the nation, with 57 of the 100 largest metropolitan areas posting record lows last year. In fully 89 percent of these metros, permitting activity in 2009 was at less than half the average annual pace in the 1990s (**Figure 6**).

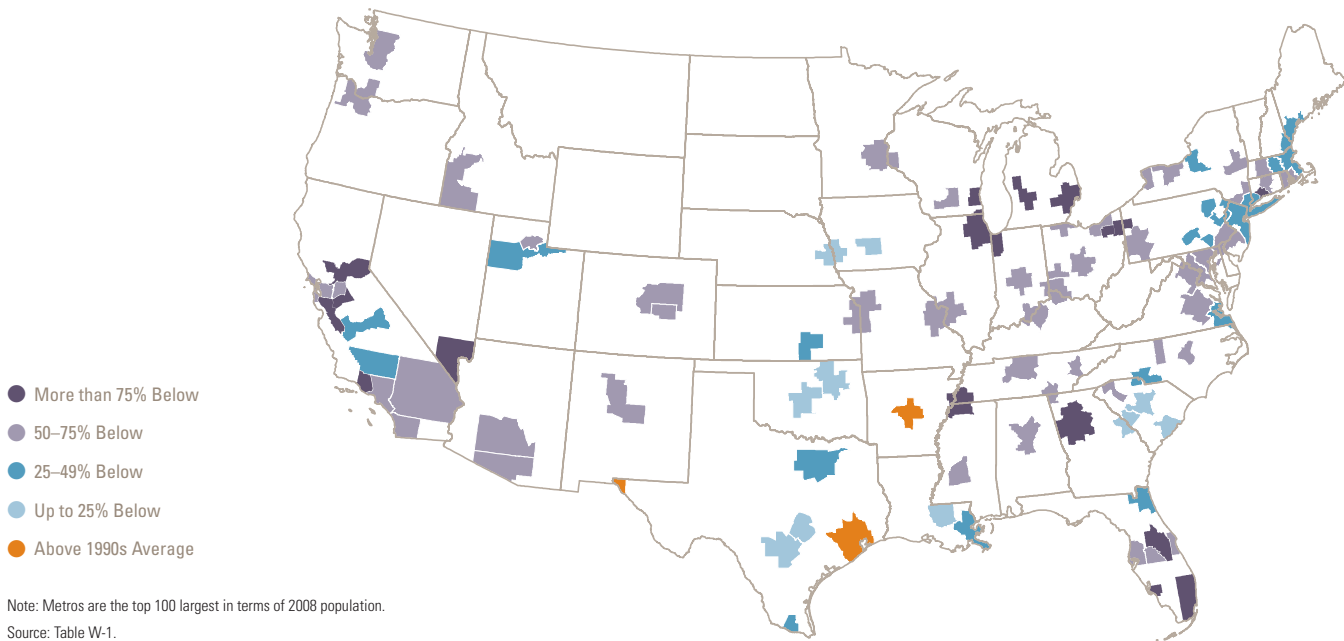
PROMISING SIGNS

Even in the midst of crushing job losses and a severe recession, both new and existing home sales managed to stage comebacks in the middle of 2009. Although home sales lost some ground late in 2009 and early 2010, housing markets may have turned a corner.

The rebound in demand was aided by falling home prices, the federal tax credit for first-time homebuyers, and Federal Reserve purchases of mortgage-backed securities to keep interest rates

Permitting Activity Last Year Was Just a Fraction of 1990s Levels

Housing Permits in 2009 Relative to 1990s Annual Average



low. Depending on the measure used, the peak-to-trough drop in monthly home prices was anywhere from 13 percent to 32 percent. In many markets, prices fell by half or more—erasing the record runups earlier in the decade. Meanwhile, the federal tax credit for first-time buyers, initially set to expire in fall 2009, was renewed, expanded to include repeat homebuyers, and extended to contracts signed by the end of April 2010. Finally, interest rates on 30-year fixed mortgages averaged only 5.04 percent in 2009 and 5.00 percent in the first quarter of 2010.

As a result, the first-time homebuyer share of sales soared to 45 percent in 2009 as households previously boxed out of the market jumped at the dramatically lower prices. Bargain hunters buying up troubled properties largely drove the gains in existing home sales last year. The National Association of Realtors® estimated that the share of existing home sales that were distressed in 2009 averaged 36 percent per month, topping out at fully 49 percent in March.

RISKS TO THE RECOVERY

After following a classic pattern of improving exactly two quarters before growth in real gross domestic product (GDP) turns up—and within two to three quarters of renewed employment growth—new home sales sputtered in the final quarter of 2009 and the first quarter of 2010.

Despite strong new home sales gains in March and April 2010, the durability of the housing recovery is still at risk. In addition to the expiration of the homebuyer tax credit program, which may have temporarily jacked up home sales, the market faces threats from the severe overhang of vacant units, still high unemployment, and record numbers of owners with homes worth less than the amount owed on their mortgages.

Demand has been so weak that vacancies hit record levels despite draconian production cuts. The number of vacancies exploded from 2006 through 2008 before growth slowed in 2009. For-sale vacancies finally eased last year, perhaps aided by the first-time homebuyer tax credit. But increases in for-rent vacancies more than offset the reduction, suggesting that some owners may have shifted their empty for-sale units to the rental market. Worse, the surge in foreclosures pushed the number of excess vacant homes in the “held off market” category some 745,000 units above normal levels, rivaling the total number of excess vacant units that are for sale and for rent (**Figure 7**).

On the for-sale side, vacancy rates for single-family homes edged down 0.2 percentage point in 2009 while those for multifamily units slipped 0.3 percentage point. This improvement may be only temporary, however, as banks continue to put foreclosed homes back on the market. On the for-rent side,

vacancy rates increased slightly for single-family homes but climbed sharply for buildings with 10 or more apartments.

The stubbornly high and rising overall vacancy rate—even with production near 60-year lows—reflects the fact that household growth has been running well below what would be expected in normal economic times. While there is some evidence that doubling up in shared quarters has been on the increase, the main explanation for the weakness of demand appears to be lower net immigration.

High unemployment is not helping either. The limited historical data available suggest that employment growth is critical to new home sales in the first two years of housing market recoveries. But the sheer numbers of job losses and of discouraged workers who have exited the labor force make this cycle much worse in depth and duration than the last several. When employment was hammered in previous downturns, job growth rebounded strongly. Most economists, however, consider a large bounceback unlikely in 2010. If job growth

does surprise on the upside, home sales and construction could see a more robust recovery.

SAGGING HOME PRICES

The overhang of vacant units pushed home prices down again in 2009. While all major price measures showed declines, the most inclusive indices—such as the NAR, S&P/Case-Shiller, and First American CoreLogic—registered the largest drops. Indeed, the declines in these indices (which include sub-prime mortgages and very high-balance mortgages) are more than double those in the narrower Federal Housing Finance Agency (FHFA) or Conventional Mortgage Home Price Index (CMHPI). That the fall in the FHFA index accelerated in December 2009 suggests that rising delinquencies among prime mortgages are increasing the number of distressed sales and putting added pressure on home values.

Nominal price declines are especially noteworthy. Between October 2005 and March 2010, the NAR median house price plunged 26 percent. The only other time in the past 40 years that this measure has fallen was from November 1989 to December 1990, when the dip was just 2 percent. In the past year alone, nominal house prices in the narrower CMHPI index were off by more than 5 percent in 42 of the 81 metropolitan areas and divisions (52 percent) with consistent price histories back to 1975. Until 2009, only five metros (6 percent) had ever posted nominal declines greater than 5 percent in single year.

According to the broad S&P/Case-Shiller index, prices for low-end homes in most metropolitan areas registered the largest drops (Figure 8). On average, the declines at the low end of the market were more than 50 percent greater than those at the high end. This disproportionate loss of housing wealth has added to the pressures on low-income homeowners faced with job losses and heavy debt loads.

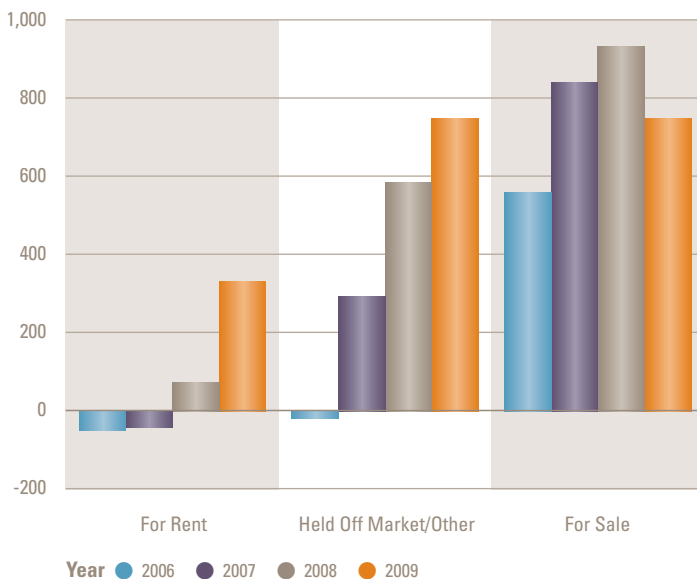
When nominal prices are rising, owners who get into trouble making payments or need to move can simply sell their homes for a nominal gain and pay off their mortgages. But when nominal prices fall, owners whose homes are worth less than their mortgages cannot sell at a gain. This impedes repeat sales and increases the likelihood of defaults. According to First American CoreLogic, roughly one-quarter of American homeowners with mortgages were underwater in the first quarter of 2010. Some 40 percent of these 11.2 million distressed owners are located in California and Florida. Nevada has the highest incidence of the problem, affecting 70 percent of homeowners with mortgages.

At the same time, though, steep price declines also bring critical improvements in first-time homebuyer affordability

FIGURE 7

Excess Rental Vacancies and Units Held Off Market Increased Again in 2009, Offsetting the Drop in For-Sale Vacancies

Estimated Excess Vacant Units (Thousands)



Notes: Excess vacancies for for-sale units and units held off the market are estimated against 1999–2001 levels; those for rental units are measured against 2003–7 levels. Held off market/other comprises occasional use, usual residence elsewhere, and other units. Estimates do not include units rented or sold and not yet occupied.

Source: JCHS tabulations of the US Census Bureau, Housing Vacancy Survey.

that will help to fuel recovery. Nationwide, the median sales price dropped from 4.7 times the median household income in 2005 to 3.4 times in 2009. When combined with low interest rates, this puts mortgage payments on the median priced home closer to median gross rents than at anytime since 1980 (**Table A-1**). Among the 92 metropolitan areas consistently covered by NAR since 1989, price-to-income ratios in 21 are now below their long-run averages—some significantly so. For example, the ratios in Lansing, Cleveland, and Cape Coral are some 18–23 percent lower than long-run levels.

During the start of the spring buying season in March, median house prices as well as prices on homes with prime mortgages were headed higher. The closely watched (unadjusted) S&P/Case-Shiller index, however, showed another month of declines in most of the 20 metropolitan areas tracked. If prices soften after expiration of the homebuyer tax credit, some urgency to buy will be lost. But if prices firm, they could encourage would-be buyers on the sidelines to jump in before a stronger upturn.

Median prices for existing single-family homes in most areas with widespread foreclosures—particularly Florida, the Midwest, and the Southeast—were still falling in the first quarter of 2010. Prices in some of California’s largest metros, however, did post measurable rebounds. Albeit an imperfect

guide, history suggests that home prices move up only gradually after severe declines, even when foreclosures are less of a problem than they are today.

REMODELING MARKETS

While the drop in new construction spending has been off the charts, the cutback in remodeling activity is in line with previous downturns (**Figure 9**). Real homeowner improvement spending in 2009 fell 25 percent from its 2006 peak—about a third as large as the drop in new residential construction.

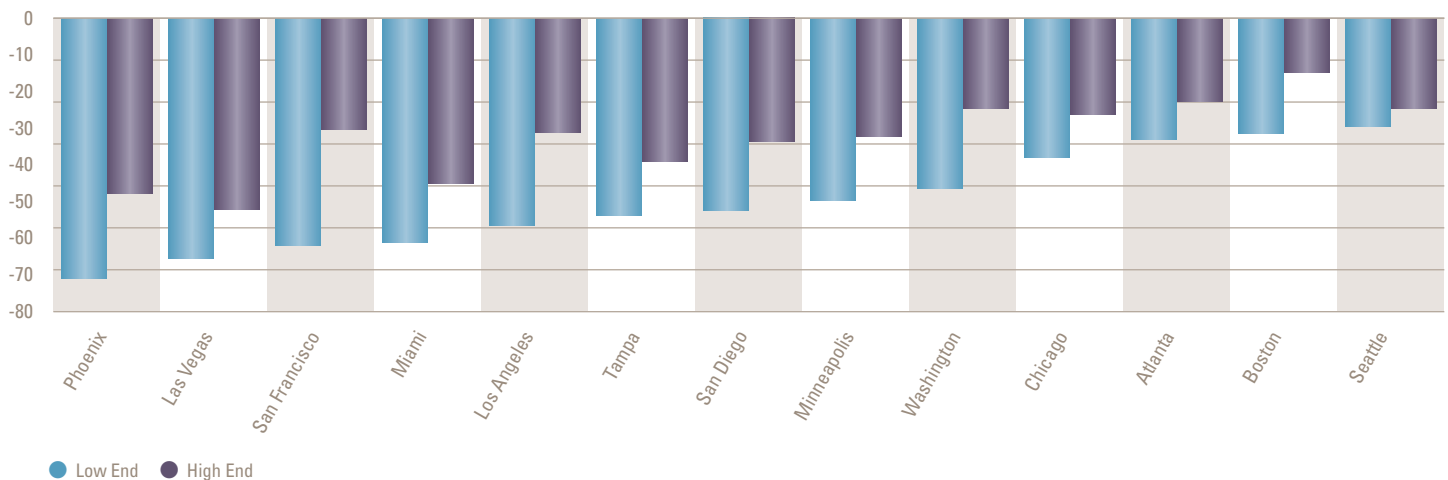
Remodeling generally holds up better during recessions than new construction because owners have little choice but to replace certain worn-out systems in their homes. The continuing dominance of higher-income owners in the market may have also served to limit the cutback in remodeling expenditures. In 2007, the top 5 percent of spenders accounted for fully 47 percent of all home improvement spending, up from 45 percent in 2001. This may have prevented a larger slide in the remodeling market both because higher-income households have been less affected by unemployment and house price declines, and because they have readier access to credit.

Federal stimulus spending and tax incentives have supported improvement spending as well. The federal government dis-

FIGURE 8

House Prices Have Tumbled Much More at the Low than at the High End of the Market

Peak-to-Trough House Price Decline (Percent)

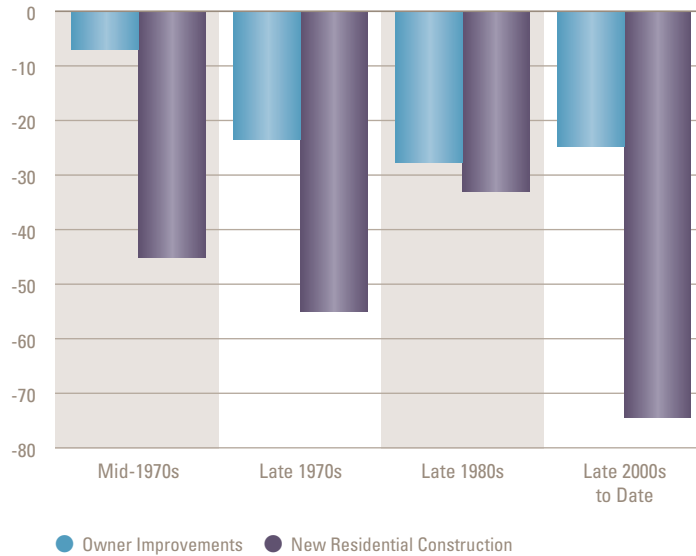


Notes: Values shown are monthly through March 2010. Low (high) end represents the bottom (top) third of the market based on previous purchase price. Source: S&P/Case-Shiller Tiered House Price Indices.

FIGURE 9

Remodeling Cycles Are Less Severe than Homebuilding Cycles

Peak-to-Trough Change in Real Annual Value Put in Place (Percent)



Notes: Values are adjusted for inflation by the CPI-U for All Items. New residential construction includes private production of both single-family and multifamily structures. Declines in owner improvements and construction occur over slightly different periods. Source: US Census Bureau, Construction Spending Statistics.

tributed \$5 billion to states to provide low-income owners with free weatherization of their homes. While small in comparison with the more than \$100 billion spent by homeowners on improvements, these programs were still a plus for remodeling last year. Perhaps more important, federal tax incentives encouraged owners to upgrade the energy efficiency of their homes. The share of professional remodelers reporting they had worked on projects linked to the energy-efficiency tax credits thus increased from 39 percent in 2009 to 53 percent in early 2010.

HOUSING AND THE ECONOMY

With the exception of the 2001 recession, housing construction typically leads the nation both into and out of recessions. In that year, unusually sharp and rapid interest rate reductions engineered by the Federal Reserve kept housing relatively strong both before and after the downturn.

After dragging down the economy for 14 straight quarters, residential fixed investment finally supported growth in the second half of 2009. As a share of GDP, residential investment bottomed out at 2.4 percent in the second quarter of 2009 and averaged 2.5 percent for the year—its lowest level since 1945. In total, real residential fixed investment dropped 53.7 percent from 2005 to 2009 (Figure 10).

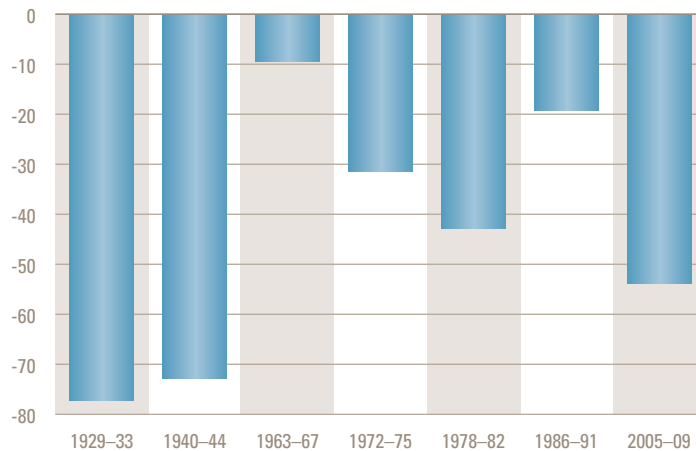
Falling home prices also helped to dampen economic growth. Moody's Economy.com estimates that spending cutbacks by homeowners reeling from both the loss of housing wealth and reduced capacity to tap into home equity shaved 0.8 of a percentage point from GDP growth in 2009. Indeed, Freddie Mac reports that even though overall refinancing activity increased 75 percent last year, cash-out refinances were increasingly rare. The annual volume of home equity cashed out at refinancing of prime, first-lien conventional mortgages declined by another 25 percent to \$70.8 billion in 2009—about one-fifth of the 2006 peak level. This pushed cash-out refinance volumes below 2001 levels in nominal terms. Meanwhile, the share of cash-in refinances (borrowers paying down debt when they refinanced) climbed from about 10 percent in 2006 to 36 percent by the fourth quarter of 2009.

Further gains in manufacturing, a continuing strong rebound in consumer spending, or a more robust recovery in housing markets and home prices will likely be necessary to keep the economy growing. During this cycle, employment nationwide declined by 8.4 million while the residential construction sector alone lost 1.3 million jobs. In areas that had relied heavily on homebuilding to fuel growth—such as Florida, Arizona, and Nevada—a bounceback in construction may be necessary for a job recovery to take hold.

FIGURE 10

Residential Fixed Investment Has Posted Its Largest Drop Since the 1940s

Change in Real Spending (Percent)

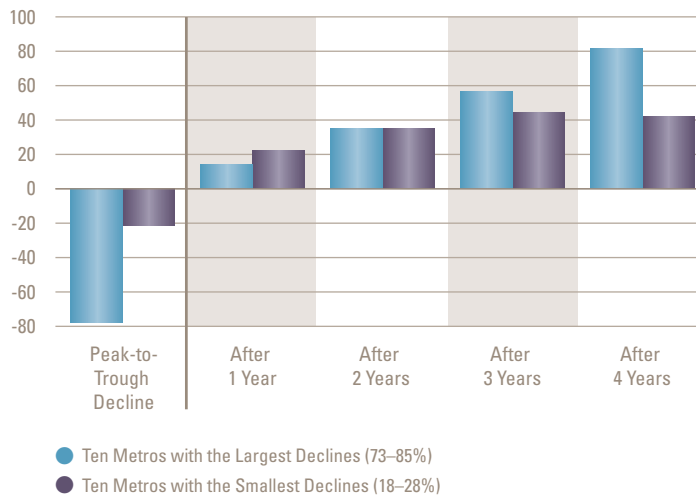


Note: Changes in 1929-33 and 1940-44 are in chained 1937 dollars; 1963-67, 1972-75 and 1978-82 in chained 1972 dollars; 1986-91 in chained 1987 dollars; and 2005-9 in chained 2005 dollars. Source: US Bureau of Economic Analysis, National Income and Product Accounts.

FIGURE 11

In the Previous Cycle, Markets with Sharper Construction Cuts Did Not Recover More Strongly Until Year Three

Median Annual Change in Single-Family Permits, Late 1980s to Early 1990s (Percent)



Note: Data include the 50 largest homebuilding markets, as ranked by permits issued in 1986, posting greater than 10% declines in permits.
Source: JCHS tabulations of US Census Bureau, New Residential Construction.

THE OUTLOOK

Entering 2010, it appears that unusually low demand for new homes—rather than a large oversupply of housing—is holding back residential construction. In fact, the deep cuts in homebuilding have likely brought long-run supply and demand closer to balance. But the depressed state of demand is keeping vacancy rates for for-rent and for-sale homes on the market stubbornly high. Meanwhile, vacancy rates for units held off market coming off foreclosures are still climbing.

After previous recessions, robust employment growth has been necessary for housing starts to stage a comeback. Interest rate changes can help or hurt, but generally have to be large to make a substantial difference. Moreover, the amount by which homebuilding falls at the local level has little to do with how quickly it revives. As the experience of 1986–92 shows, the rising tide lifted all metropolitan markets at about the same pace until several years out (**Figure 11**).

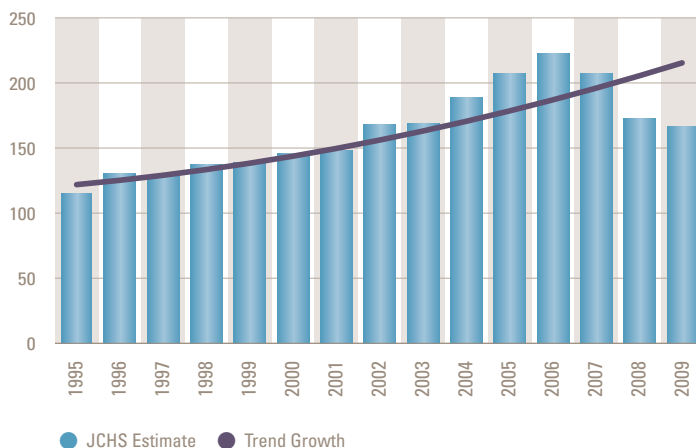
Unusually weak demand has also undercut home improvement spending. While average homeowner remodeling expenditures did show a sharp uptick in 2000–6, it now appears that the amount by which remodeling demand is currently below trend has made up for the amount by which it was above trend earlier in the decade (**Figure 12**). Owners tend to spend more on remodeling right after purchasing homes, and their expenditures are sensitive to interest rates if the improvement projects require financing. The Leading Indicator of Remodeling Activity for the first quarter of 2010 thus points to a rebound that should extend throughout the year, largely as a result of the pickup in existing home sales and the decline in interest rates.

In the longer term, both homebuilding and remodeling activity should increase dramatically. Demographic forces will lift household growth over the coming decade regardless of whether immigration is suppressed or the echo boomers delay forming independent households (**Table A-5**). Thus, even under a low-immigration scenario and assuming headship rates hold constant at 2008 levels, overall housing demand—including for second homes and replacement of older housing lost from the stock—should support more than 17 million new home completions and manufactured home placements between 2010 and 2020.

FIGURE 12

After Several Years of Strong Growth, Remodeling Spending Has Now Fallen Well Below Trend

Owner Improvement Expenditures (Billions of 2008 dollars)



Notes: The JCHS estimate is the 2005 American Housing Survey total owner improvements indexed by the annual level of owner improvements as reported by the US Census C-30 series. Trend growth for 2005–9 is calculated by applying the 1995–2000 growth in owner improvements by age, household type, and minority status in the AHS to JCHS household projections. Values are adjusted for inflation by the CPI-U for All Items.
Sources: JCHS tabulations of US Census Bureau, American Housing Survey; JCHS 2009 household projections.