



## Executive Summary

With employment growth strengthening, consumer spending up, and rental markets tightening, some of the ingredients for a housing recovery were taking shape in early 2011. Yet in the first quarter of the year, new home sales plumbed record lows, existing sales remained in a slump, and home prices slid. Tight underwriting requirements, on top of uncertainty about the direction of home prices, continue to dampen homebuying activity. The weakness of demand is slowing the absorption of vacant properties for sale, hindering the recovery.

### THE ROCKY ROAD TO RECOVERY

As in past downturns, renewed job growth and stronger consumer confidence are needed to spark the housing recovery. Through 2010, however, conditions in few states showed signs of improvement (**Figure 1**). Unemployment rates are still hovering near 9 percent and confidence remains relatively low. In addition, the persistent decline in home prices, the ongoing foreclosure crisis, the large shares of underwater homeowners, and tight lending standards are all holding back homebuyer demand.

Conditions in the rental and owner markets have begun to diverge. Even with the net shift of 1.4 million single-family homes to rentals in 2007–9 (nearly double the number in 2005–7), rental vacancy rates have fallen and given a lift to rents and property values. But on the homeowner side, vacancy rates have edged down little from the 2008 peak despite draconian cuts in new construction, and the number of vacant homes held off the market continues to climb. Moreover, new home sales set another record low in February 2011 as prices fell both nationally and in most states.

With an unusually large number of households leaving homeownership and an unusually small number of renter households buying homes, the national homeownership rate dipped below 67 percent in 2010, down from 69 percent in 2004. Given that the foreclosure wave is still cresting and would-be buyers are waiting for prices to firm, homeownership could continue to decline in 2011. The farther the homeownership rate falls, the longer it will take to work through the excess inventory of homes for-sale and held off market (**Figure 2**).

At this point, a more normal rate of household growth is needed to hasten the absorption of excess supply. But even though the echo boomers (born 1986 and later)—the largest generation ever to reach their 20s—are entering their peak household formation years, household growth flagged during the late 2000s as more young adults delayed setting out on their own and growth in foreign-born households came to a halt. While estimates vary widely, the Current Population Survey indicates that household growth averaged about 500,000 per year in 2007–10. This is not only less than half the 1.2 million annual pace averaged in

2000–7, but also lower than that averaged in the 1990s when the smaller baby-bust generation entered the housing market.

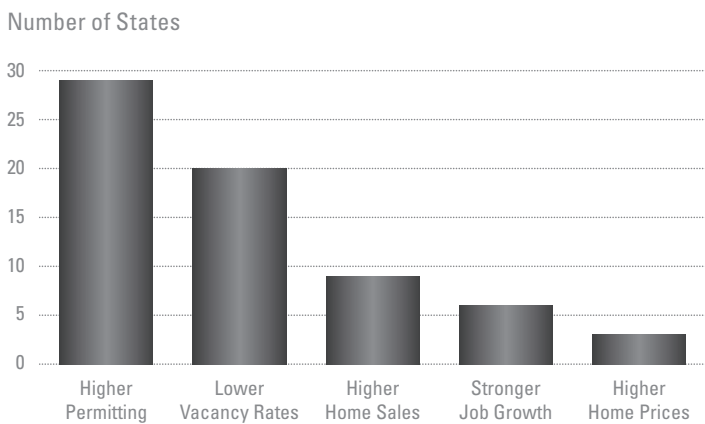
### UNCERTAINTY IN THE HOMEOWNER MARKET

It is unclear how strongly attitudes toward homeownership have become more negative. According to a Fannie Mae survey, the share of renters believing that buying a home is a safe investment is sharply lower than in 2003, and even fell over the course of 2010. This is not surprising given the plunge in home prices over the past five years as well as the dramatic increase in owners that have lost all their home equity. Even so, some 74 percent of renters still agreed, as of the first quarter of 2011, that owning a home makes more financial sense than renting, as did 87 percent of the overall US population. And when asked if now is a good time to buy, the shares of both renters and owners responding yes were similar to the shares in 2003. Most Americans thus still prefer to own their homes and perceive that today’s lower home prices and low mortgage interest rates provide a buying opportunity.

First-time buyers are key to a strong recovery in the homeowner market. The potential for first-timers to drive growth is clear from the lift in both home sales and prices that came with the expiration of the tax credit programs in 2009 and 2010 (Figure 3). Many of these would-be homeowners were locked out at the top of the market and were then scared away as both home prices and employment plummeted. The question now is whether, without the incentive provided by the tax credits, first-timers have the will to buy.

FIGURE 1

### Few States Showed Signs of Housing Market Recovery in 2010



Notes: Changes in all measures except permits are from 2009:4 to 2010:4. Permits are measured year over year from 2009 to 2010. Vacancy rates are for owner units. Stronger job growth is defined as at least a 1% increase. Source: JCHS tabulations of US Census Bureau, Housing Vacancy Survey and New Residential Construction; National Association of Realtors®, Existing Home Sales; Bureau of Labor Statistics, Total Nonfarm Employment; and Federal Housing Finance Agency, Purchase-Only House Price Index.

While many households aspire to homeownership, underwriting standards may stand in their way. Low-downpayment loans, a common means of entry for many moderate-income homebuyers, are largely unavailable outside of FHA-insured mortgage programs. Even there, though, the Obama Administration has tightened requirements and raised costs. Many lenders originating low-downpayment loans have also imposed higher credit score screens than FHA. If the proposed 20-percent down requirement for qualified residential mortgages passes, low-downpayment lending without a federal guarantee may remain sharply curtailed.

The combination of higher income, downpayment, and credit score requirements in today’s broader mortgage market will prevent many borrowers from getting the loans today that they would have qualified for in the 1990s before the housing boom and bust. While a return to more stringent standards was clearly warranted, there is concern that overly rigid guidelines may unnecessarily restrict access of low- and moderate-income households to the benefits of homeownership. Indeed, regulators have signaled in their initial proposals that they are inclined to take a conservative approach to defining risky loans. Over the longer term, it is unclear how the impending reform of the housing finance system, including changes in the role played by Fannie Mae and Freddie Mac, will influence the cost and availability of mortgage loans.

### RENTAL REBOUND

After years of stagnation, growth in the number of renter households accelerated in the second half of the 2000s. While estimates vary, the Housing Vacancy Survey indicates that the number of renters swelled by 3.9 million from 2004 to 2010. Nevertheless, rental vacancy rates rose and rents stalled through 2009 as new additions to the supply and conversions of existing homes to rentals exceeded demand. The tide turned in 2010 as the rental vacancy rate fell from 10.6 percent in the first quarter to 9.4 percent in the last, the lowest quarterly rate posted since 2003. Just under one-third of the 64 markets surveyed by MPF Research reported vacancy rates below 5 percent at the end of last year, and more than half reported rates under 6 percent. Only a year earlier, vacancy rates in just one-fifth of these markets were below 6 percent.

With vacancy rates down, the pressure on rents has mounted. MPF Research found that nominal rents for professionally managed apartments were up 2.3 percent last year, recovering some of the ground lost in 2009. The rental rebound has reached most metropolitan markets, with the notable exception of areas with an excess supply of for-sale units. Indeed, of the metros covered, only Las Vegas, Fort Myers, and Tucson reported further rent declines in 2010.

If employment growth, especially among young adults, continues to pick up and homeownership rates continue to slide, renter household growth should remain strong. This would increase pressure on vacancy rates and rents, spurring an increase in

multifamily construction—assuming that acquisition, construction, and development financing is available. Since it will take some time before any additional supply comes on line, rental markets are likely to remain tight at least in the short term. In any case, with most new construction that does occur focused

at the high end of the market, the affordability challenges for low-income renters are likely to intensify.

### SHIFTS IN DEMAND

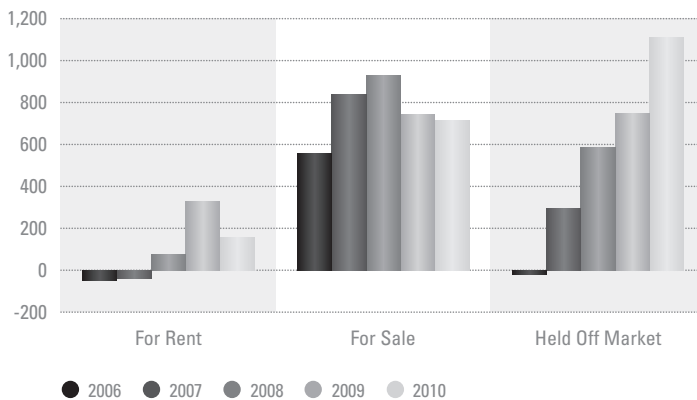
Questions about changes in homebuying attitudes, access to mortgage credit, immigration trends, and household formation rates among young adults shroud the short-term outlook for housing demand. Certain demographic trends, however, make some aspects of the longer-term picture clearer. In particular, the aging of the baby boomers (born 1946–65) is projected to drive up the number of households over age 65 by some 8.7 million by 2020—a 35 percent increase from 2010 (Figure 4). Immigration has little impact on these projections because few people emigrate at these ages. The growing share of older households will provide important ballast for the owner market, offsetting in part the lower homeownership rates among younger households.

The majority of baby boomers are likely to age in place since most people do not relocate in the years leading up to or after retirement. Still, fully one in three heads of households aged 65–74 in 2007 reported having moved in the previous 10 years, many to smaller homes. If the older baby boomers match this mobility rate, some 3.8 million would downsize their homes over the coming decade, lifting the demand for smaller units. Their sheer numbers also mean that the baby boomers will have a major impact on the housing markets of preferred retirement destinations, which so far have been the non-metropolitan areas in the South and West. Meanwhile, the number of pre-boomer households over age 75 will also grow rapidly over the

FIGURE 2

### Excess Vacancies Remain Abnormally High, Especially for Units Held Off Market

Excess Vacant Units (Thousands)



Notes: Excess vacancies are measured by comparing current levels with those obtained by applying average vacancy rates from past periods of stability. For sale and held off market vacancies use rates from 1999–2001; for rent vacancies use rates from 2003–7. Held off market units include units intended for occasional use, occupied by someone with a usual residence elsewhere (URE), and all other year-round units not for rent or for sale but vacant for reasons other than the above.

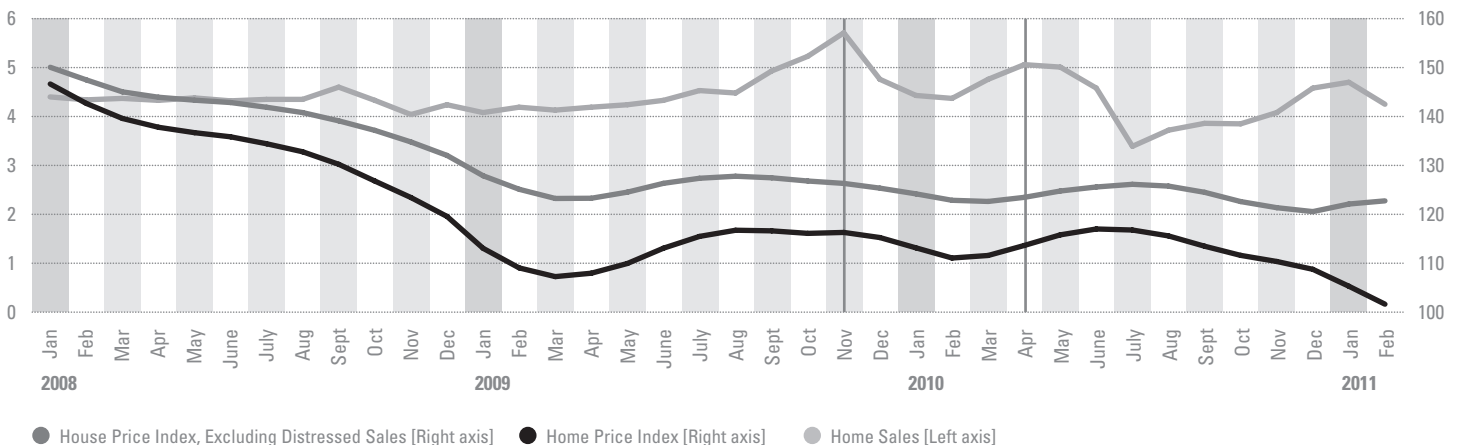
Source: JCHS tabulations of US Census Bureau, Housing Vacancy Surveys.

FIGURE 3

### Expiration of the Homebuyer Tax Credits Boosted Sales and Prices in 2009 and Early 2010

Existing Single-Family Home Sales (Millions)

Single-Family Home Prices (Index)



● House Price Index, Excluding Distressed Sales [Right axis] ● Home Price Index [Right axis] ● Home Sales [Left axis]

Notes: Vertical lines denote expiration dates of homebuyer tax credit programs. Existing home sales are at seasonally adjusted annual rates.

Sources: National Association of Realtors®; CoreLogic.

next 10 years and spur demand for housing developments that offer both independent and assisted living.

The massive echo-boomer generation will have an important but less predictable impact on housing markets. The household headship rates of young adults were sliding even before the Great Recession hit, and the downturn accelerated that decline. It is unclear how much, if at all, headship rates among echo-boomer adults will recover as they age and the economy improves. It is also unclear if net immigration will make up for the declines that occurred after the economic crisis. Even so, there is reason to believe that the echo-boomer generation will be large enough to boost the number of young adult households in 2010–20 and in turn the demand for starter apartments and single-family homes. Indeed, assuming headship rates revert to their 2007–9 average and that immigration is just half what the Census Bureau now projects, the number of households under age 35 will grow to nearly 26.5 million in the next decade.

Even under these conservative immigration assumptions, minorities will account for seven out of ten of the 11.8 million net new households in 2010–20. Hispanics alone will contribute nearly 40 percent of the increase. By 2020, minorities are expected to make up a third of all US households. But with their lower average incomes and wealth than whites, more of these households will have to stretch to afford housing. And with their lower homeownership rates, the rising number of minority households will place downward pressure on the national homeownership rate. Impending decisions about underwriting standards—especially downpayment requirements and credit score cutoffs—will thus have an especially

important impact on the ability of tomorrow’s minority households to buy homes.

### MOUNTING HOUSING CHALLENGES

The Great Recession exacerbated the affordability challenges that had been building for a half-century. At last measure in 2009, 19.4 million households paid more than half their incomes for housing, including 9.3 million owners and 10.1 million renters. While low-income households are most likely to have such severe burdens, cost pressures have moved up the income scale (**Figure 5**). Households earning between \$45,000 and \$60,000 saw the biggest increase in the share paying more than 30 percent of their incomes for housing, up 7.9 percentage points since 2001. Among those earning less than \$15,000, the share rose by only 2.9 percentage points—primarily because nearly 80 percent of these households were already housing-cost burdened in 2001.

In addition to longstanding and worsening affordability challenges, the housing crash and ensuing economic downturn drained household wealth, ruined the credit standing of many borrowers, and devastated communities with widespread foreclosures. The collapse of house prices has left nearly 15 percent of homeowners with properties worth less than their mortgages and eroded the equity of most others. Overall, the amount of real home equity fell from \$14.9 trillion at its peak in the first quarter of 2006 to \$6.3 trillion at the end of 2010—well below the \$10.1 trillion in outstanding mortgage debt. This has reduced the amount that owners can cash out if they sell, as well as the amount they can borrow to finance spending and investment.

Meanwhile, the foreclosure crisis continues. As of March 2011, the Lender Processing Services (LPS) reports that about 2.0 million home loans were at least 90 days delinquent. Another 2.2 million properties were still in the foreclosure pipeline, with 67 percent of owners having made no payments in more than a year, and 31 percent having made no payments in two years. The crisis is especially acute in pockets across the country. Indeed, just 5 percent of census tracts accounted for more than a third of all homes lost to foreclosure since 2008. It will take years for these neighborhoods—which are disproportionately minority—to recover from this calamity. As policymakers tackle the regulation and redesign of the mortgage market, it will be important to keep sight of the needs of these hard-hit communities.

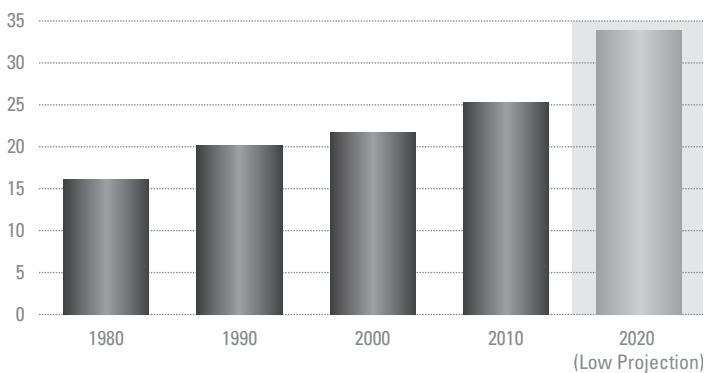
### THE OUTLOOK

So far, housing has not played its traditional role of helping the economy recover from a recession. Weak job growth, high unemployment, slumping home prices, and subdued consumer confidence have all hampered a rebound in residential investment. The strength of the housing recovery, when it does occur, will rest on how fully employment bounces back. The first four months of 2011 brought promising news on the jobs front, with

FIGURE 4

### As the Baby Boomers Age, the Number of Seniors Will Increase Dramatically in the Next Decade

Households Headed by Persons Aged 65 and Older (Millions)

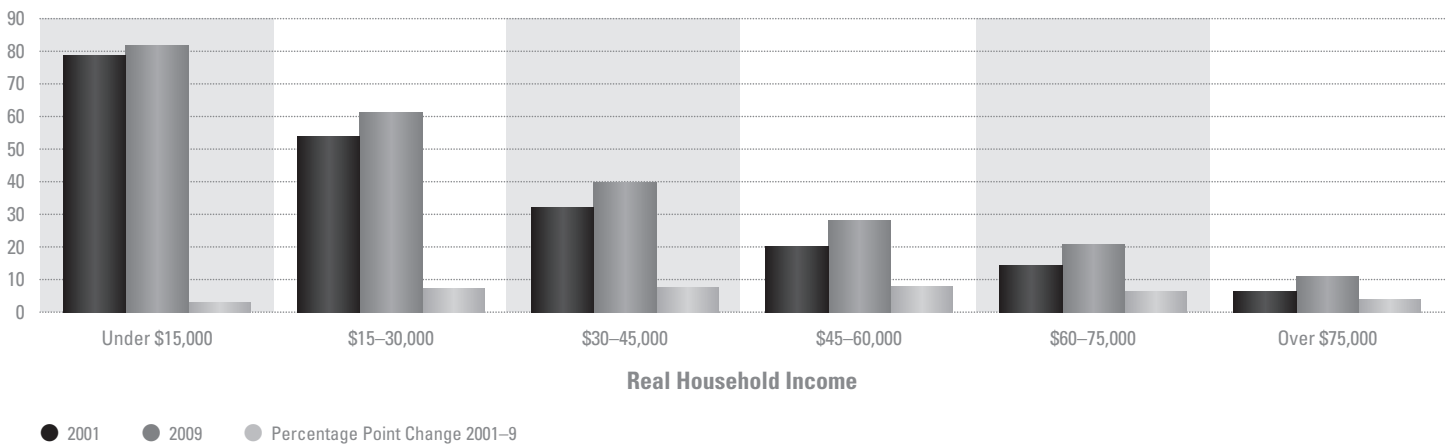


Notes: Senior households are those headed by a person aged 65 or older. JCHS low projection assumes that immigration in 2010–20 is half that in the US Census Bureau’s 2008 middle-series (preferred) population projection. Sources: JCHS tabulations of US Census Bureau, Current Population Surveys; JCHS 2010 household growth projections.

FIGURE 5

## Affordability Problems Are Creeping Up the Income Scale

Share of Households with Cost Burdens (Percent)



Notes: Cost-burdened households spend more than 30 percent of pre-tax income for housing. Income ranges are in 2009 dollars, adjusted for inflation by the CPI-U for All Items. Source: JCHS tabulations of US Census Bureau, 2001 and 2009 American Community Surveys.

payrolls expanding by nearly 200,000 per month on average. If these advances continue and energy prices settle down, a sustainable recovery could at last be developing.

Local housing markets will revive at different rates, in proportion to the depths they hit during the recession, the amount of overbuilding that occurred, and the speed at which job growth resumes. As of February 2011, 21 states were within 5 percent of their previous peak employment levels while most others were 5-7 percent below previous peaks. At the recent pace of growth, however, regaining the jobs lost during the recession will take at least five years in most areas. Many of the states with the farthest to go—Nevada, Florida, Georgia, Arizona, and California—are those that claimed the largest share of homebuilding activity during the boom. With recovery in these states likely to lag, national construction volumes will remain lackluster until employment growth in these markets strengthens.

Most critical to a housing recovery is a pickup in household growth. The severity of the Great Recession depressed immigration as well as headship rates among both young and middle-aged households. Indeed, an improving economy may allow more people who have delayed living on their own to form additional households and, as a result, temporarily boost household growth above the baseline trend. However, high unemployment rates—on top of the long-term increase in rental affordability problems—may have lowered the trend itself. To match the 1.12 million annual rate averaged in the 2000s, household formation rates must return to their 2007-9 average, and net immigration must reach at least half of Census Bureau projections.

In the near term, rental markets are likely to lead the housing recovery. The owner-occupied market continues to face headwinds, with servicing problems causing long delays in resolving the backlog of foreclosures. In addition, tighter underwriting requirements are preventing many potential first-time buyers from qualifying for mortgages. On the foreclosure front, the good news is that the share of home loans delinquent by at least three months dropped from 5.6 percent in early 2010 to 3.8 percent in March—a sign of light at the end of the tunnel. And once consumers perceive that a floor has formed under house prices, their reentry into the market could quickly burn through the lean inventory of unsold new homes and slim down the excess supply of existing homes on the market.

A number of major policy debates are under way that could add even more uncertainty to the housing outlook. Implementation of the Financial Reform Act and decisions about what form government mortgage guarantees are to take will have a profound impact on the future cost and availability of mortgage credit. What seems certain is that federal programs aimed at relieving rental affordability problems and revitalizing distressed neighborhoods will be on the table, along with other domestic spending programs as the government attempts to address fiscal imbalances. Thus, the pressure to curb spending on housing is mounting just as rental affordability problems are escalating.