

UCLA ECONOMIC LETTER

REAL ESTATE AND THE MACROECONOMY



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Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the UCLA Ziman Center for Real Estate and UCLA Anderson Forecast, summarizes the U.S. housing affordability crisis. It is presented as part of the [UCLA Anderson June 2018 Economic Outlook: Building New Homes in a Zoning-Constrained City](#).

The Best of Times and the Worst of Times for Housing

By [David Shulman](#)

The outlook for housing over the next few years depends upon where and how you live. If you are a homeowner in coastal California, the Pacific Northwest, parts of the coastal northeast and such fast growing cities of Denver, Nashville and Austin, you are sitting pretty and enjoying rapidly increasing house prices. On the other hand, if you are a potential middle-class home buyer or a struggling renter in those areas, you are facing a very personal affordability crisis. From the supply side, although housing starts remain significantly below the boom years of 2004-2006, well-capitalized homebuilders, apartment owners and construction workers find their products in great demand.

“Zoning constraints, along with high impact fees, severely burden the ability of builders to deliver housing anywhere near an affordable price range.”

The core issue is that housing starts have not fully recovered from their nadir of just under 600,000 units a year during 2009-2010. In 2017 housing starts amounted to 1.21 million units and we are forecasting moderate increases to 1.34 million and 1.40 in 2018 and 2019, respectively and a modest decline to 1.36 million units in 2020. Although starts more than doubled off their recession lows, the current and forecast levels remain below the 59-year average from 1959-2017 of 1.435 million units a year. Forget about the two million starts a year of past housing booms: The housing shortage is for real.

PRICES RISING

In response, prices are rising rapidly and have more than recovered from the housing crash of 10 years ago. The national Case-Shiller Home Price Index is up 47% from the low in February 2012. It is now 7% above the previous peak in 2006, and up 97% since 2000. However, by comparison, the gains since 2000 for such hot cities as Los Angeles, Seattle and Denver amount to 178%, 138% and 111%, respectively. Contrast that with the meager gain of 42% reported for Chicago and Atlanta. As we said at the outset, it depends where you live.

Consistent with the sluggishness in housing starts, the growth in existing homes sales remains tepid. In 2018 they are estimated to be 5.6 million units, well below the 7.0 million peak recorded in 2005. In part the slowdown is due to an older society aging in place and a change in retirement patterns where grandparents have been reluctant to move away from grandchildren. However, with less moving around, homeowners have chosen to invest in remodeling, engendering a boom in that sector.

POSITIVE VS. NEGATIVE DEMAND FUNDAMENTALS

By most conventional measures housing activity should be soaring. As noted above, we have witnessed a decade of under-building which has given rise to a huge pent-up demand. Employment growth has been strong and employee compensation is on the rise, and until very recently mortgage rates have been extraordinarily low. With delays in major lifestyle events (marriage and childbirth), net new household formations declined to 800,000 in 2017. Nevertheless, with the economy strengthening we forecast the pace to return to a more normal 1.2 million over the 2018-2020 time frame.

But there remain strong headwinds limiting the demand for housing. Affordability is a major issue in the metropolitan areas where job growth is booming. The median home price in Los Angeles as of March 2018 was \$585,000, while median household income in 2016 was only \$58,000. Simply put, the numbers do not work. Similarly rents remain high relative to income with approximately 50% of the nation's renters paying more than 30% of their income to keep a roof over their heads.

Further, the interest-rate environment, which had been extraordinarily friendly, is turning more hostile. The rate on the 30-year fixed rate mortgage has risen approximately 100 basis points since mid-2016 to 4.5% and is likely to approach 6% by 2020. That will be quite the headwind especially when we recognize that Fannie and Freddie are guaranteeing loans with down payments as low as 3% and allowing home buyer (total debt payment)/income ratios of up to 50%. Indeed in the second half of 2017 about 20% of Freddie and Fannie loans were to borrowers whose debt payment/income ratio exceeded 45%. Indeed, reminiscent of the prior boom, non-prime loans have emerged to finance consumers with low credit scores.

One of the reasons for lenders raising the debt/income ratio has been the explosive growth of student debt. Student loan debt has tripled from just under \$500 billion in 2006 to \$1.5 trillion in early 2018. Although this debt is not solely due to young people borrowing money for their educations, it will remain a ball and chain holding back the millennial generation from buying homes.

Although household formation remains strong, a major impetus for home purchases, especially single-family homes, is the birth of children. On that score the crude birthrate remains at multi-decade lows and is roughly half of what it was in 1960.

One last negative demand factor will be the recently passed tax reform which limits the deductibility of state and local taxes to \$10,000. In high tax states it is not unusual for upper-middle class tax payers to pay \$20,000 - \$30,000 a year in such taxes. As a result, one of the critical tax advantages, that being the ability to fully deduct property taxes, will be reduced. How this tax change will affect future demand remains to be seen, but it is certainly not a positive.

NEGATIVE SUPPLY FUNDAMENTALS

On the supply side, housing activity is plagued by excessive zoning constraints in the hot employment markets of the Pacific Coast and the Northeast. Although there have been attempts to relax those constraints in California and Massachusetts, local opposition to new developments, especially those of a higher density, remains fierce. Zoning constraints, along with high impact fees, severely burden the ability of builders to deliver housing anywhere near an affordable price range.

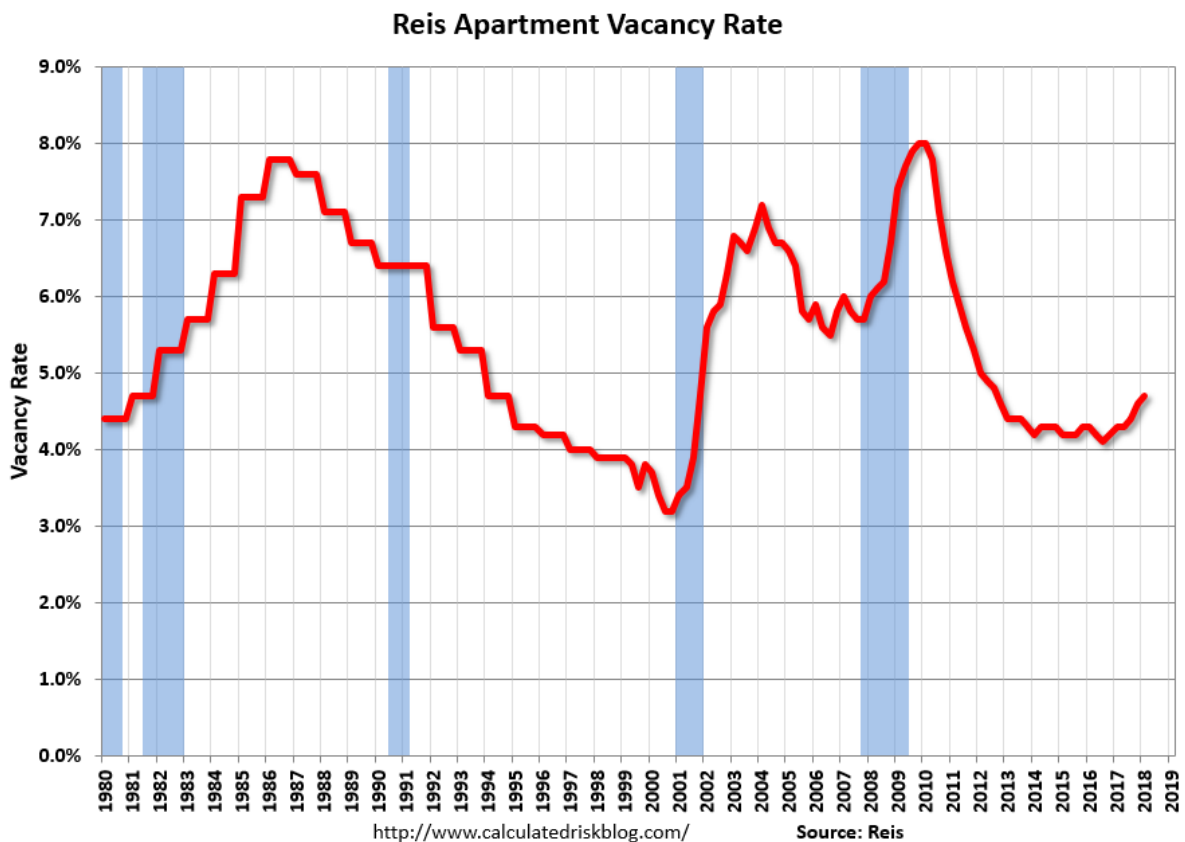
Further exacerbating the land situation, the market remains tight for construction labor and lumber prices have surged 50% partially in response to the Trump Administration's imposition of a 20% tariff on Canadian lumber in January 2018. That said, because housing remains in short supply, builders have been able to pass along cost increases to consumers evidenced by the strong gross margins reported by the publicly traded homebuilders. Indeed, the larger homebuilders have learned to profit from the tight zoning controls as regulation works to reduce competition.

Nevertheless, despite all of the negatives, the homeownership rate has begun to rise after a long six percentage point decline that began in 2004. We anticipate that the homeownership rate will level off somewhat above its current level of 64.2%. The demand fundamentals have, at least recently, overcome the supply impediments for ownership housing.

THE BOOM CONTINUES IN MULTI-FAMILY HOUSING

The demand for multi-family housing continues to be strong as millennials (less so recently) and empty nesters seek a more urban lifestyle. In response, multi-family housing starts have approximated 350,000 - 400,000 units a year for the past several years. We forecast that starts, which amounted to 357,000 units in 2017, will average 407,000 units/year over the 2018 -2020 time period. However, because much of the construction has been at the high end of the market, the vacancy rate has recently increased from 4.5% to 4.8% in the first quarter. (See below)

Apartment Vacancy Rate, 1980 – 2018Q1, Percent



Source: REIS via CalculatedRisk.com

The decline in vacancy rates has brought higher rents, with rent growth approximating 3.5% -4.0% a year since 2015. In fact, from 2010 to 2018Q1 the cumulative increase in rents has amounted to 27%, well above the increase in the overall consumer price index of 15% and the 19% in employee compensation. It is no wonder that renters feel stressed. As of 2016 roughly half of all renters were paying in excess of 30% of their incomes on rent and that in turn has engendered new calls for such self-defeating policies as rent control.

Nevertheless, despite rising interest rates, real estate investors remain enamored with investing in rental apartments. It appears that these investors are willing to look through what they perceive to be temporary softness in the high end apartment market. We would note that the publicly traded apartment REITs are reporting rent increases well below that reported by the consumer price index. Why? The REITs apartment assets are concentrated at the high end of the market. Despite this, investor demand is sustained by default because retail real estate looks challenged and the industrial property market remains way too hot. Apartment investing remains one of the few games in town for real estate investors. Thus the supply of rental apartments will keep coming.

CONCLUSION

In terms of prices, the housing market is booming, especially on both coasts and selected cities in the interior. But in terms of housing activity, the market is muddling through with very mediocre levels of housing starts and home sales. Despite easier mortgage terms, consumers are being held back by high prices in areas where job growth has been strong. Meanwhile, lower-income renters are struggling with high rent burdens where rents have risen well above the overall price index and income growth. The pricing problem is aggravated by strict zoning controls that limit increases in supply. In contrast, multi-family housing is benefitting from higher rents, and despite growing vacancy rates at the high end of the market, investor demand is keeping construction activity strong. As we said at the outset, your view on the housing market depends on where you live and whether you are an owner or a renter.

