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Economics Group

Special Commentary

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Five Critical Questions for Housing in 2017

Following another year of modest gains in home sales and new single-family home construction, the new year brings forth considerable promise and genuine concerns. Stronger job and income growth has clearly bolstered consumer confidence, nudging more potential buyers into the housing market. With for-sale inventories incredibly lean across much of the country and construction restrained by land development costs and an onerous zoning approval process, home prices have continued to firm at a pace well ahead of wage and salary growth. Rising mortgage rates are set to compound the sting of higher prices, particularly for first-time homebuyers struggling to save the necessary down payment for a home. The apartment market also appears to be at a crossroads, with a surge in completions leading to outright declines in asking rents in some of the largest and fastest-growing apartment markets.

Rising mortgage rates are set to compound the sting of higher prices.

Most forecasts anticipate another year of modest recovery. Sales of new and existing homes are expected to rise modestly, and new home construction should post similar gains relative to this past year (Figure 1). The latest NAHB/Wells Fargo Housing Market Index survey supports this scenario, with buyer traffic increasing solidly and sales gaining momentum heading into 2017 (Figure 2). Continued job gains, low unemployment and rising consumer confidence also bode well for housing demand.

As we begin a new year, that will likely see a unique set of risks and rewards, we address what we believe to be the five most important questions for the housing market in 2017.

- How will higher mortgage rates impact home sales?
- Will home prices continue to outpace inflation and wages?
- Will the homeownership rate rise from its recent lows?
- Will first-time homebuyers return to the housing market?
- Has the apartment market topped out?

Figure 1

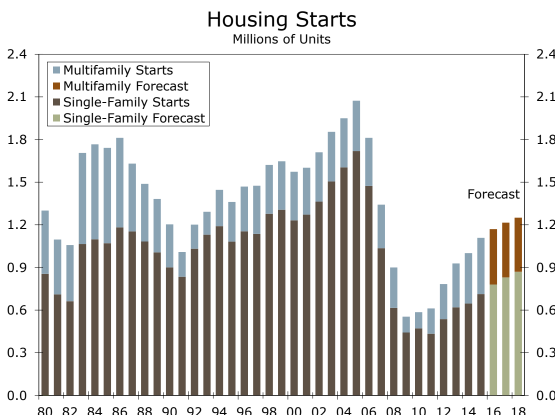
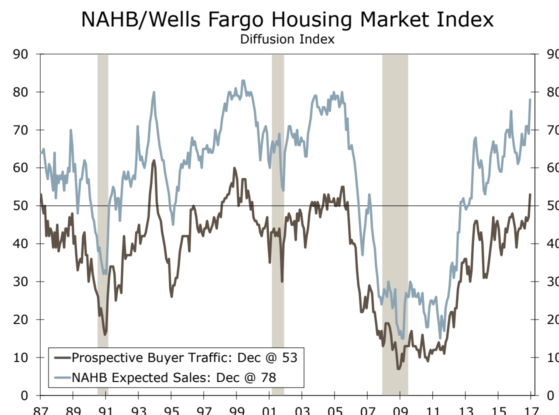


Figure 2



Source: U.S. Department of Commerce, NAHB and Wells Fargo Securities

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

How Will Higher Mortgage Rates Impact Home Sales?

Mortgage rates have continued to follow U.S. Treasury yields higher in the wake of the U.S. presidential election.

Changes in the political climate raise the first, and perhaps most critical, question for housing in 2017—how will higher mortgage rates impact home sales? Mortgage rates have continued to follow U.S. Treasury yields higher in the wake of the U.S. presidential election, eliciting questions about the future course of interest rates, and, if sustained, the subsequent effect on home sales and housing affordability. The interest rate on the conventional 30-year fixed rate mortgage has risen roughly 75 basis points since the election, and stood at an average of 4.32 percent for the week ended December 28 (Figure 3). This marks the highest weekly average since April 2014, according to data from Freddie Mac. If these interest rate levels persist, a 75 basis-point increase adds roughly $80 to the monthly principal and interest payment for the typical homebuyer, all else equal. This scenario creates a troubling dilemma for potential homebuyers—will they lock in a mortgage ahead of further anticipated interest rate increases, wait for a pull-back on softer economic reports, or remain in the rental market?

While mortgage rates are widely expected to remain low on a historical basis, a rising interest rate environment will clearly create some roadblocks. Home sales are more interest rate sensitive today than they have been in the past due to the combination of persistently sluggish wage and salary growth, rising home prices and more stringent mortgage qualification requirements. Lower interest rates have helped offset some of these drags, but even when rates moved broadly lower, as global rates tumbled following the Brexit vote, relatively few buyers rushed into the market. Now that rates are climbing, consumers will be hard pressed to maintain their buying power.

Consumers had more alternatives available to them when mortgage rates jumped suddenly in the past. Buyers could switch to an adjustable rate mortgage or simply purchase a less expensive home. Both avenues are less viable today, however. At today's low rates, there are simply less savings available from switching to an adjustable rate. Moreover, with rates expected to climb, borrowers would be taking on more risk. Finding an affordable home is also more difficult, as investors have scooped up a large portion of the lower-priced existing home inventory and converted them to rentals, while builders have had a tough time delivering lower-priced homes due to higher land development and construction costs.

Rising mortgage rates will create some additional challenges for the housing market.

While rising mortgage rates will create some additional challenges for the housing market, we still expect home sales to grind modestly higher. After all, interest rates are rising largely due to prospects for stronger economic growth and higher inflation expectations in the medium-term. Wages and salaries are growing a bit more rapidly and consumer confidence has risen to the highest levels in more than 15 years. Against this backdrop, we see new home sales rising 8.0 percent in 2017 and a further 4.9 percent in 2018. New home sales will benefit from a steady rise in completions, which have benefited from mild weather across much of the country. We look for existing home sales to rise 2.2 percent in 2017, following an anticipated 3.6 percent gain in 2016.

Figure 3

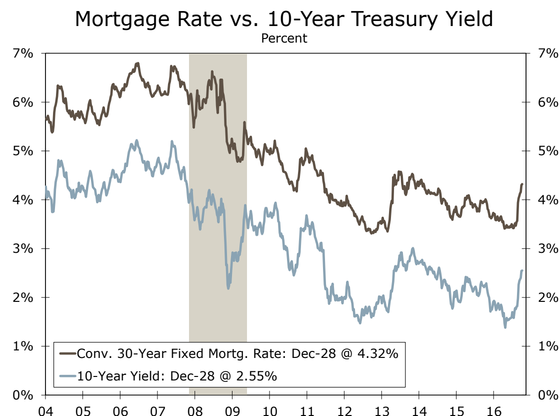
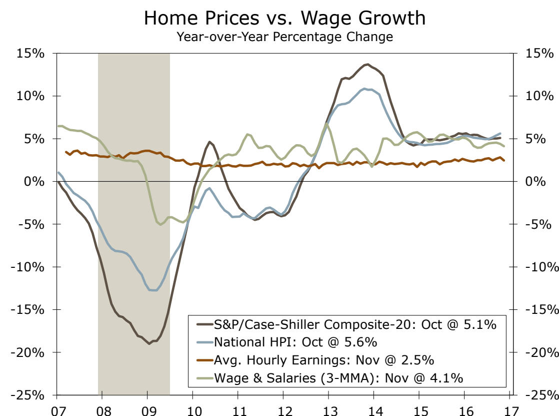


Figure 4



Source: FHLMC, Federal Reserve Board, S&P, U.S. Dept. of Commerce and Wells Fargo Securities

Will Home Prices Continue to Outpace Inflation and Wages?

Home price appreciation moderated throughout much of 2016, and we expect price gains to decelerate further in 2017. We estimate that the S&P CoreLogic Case-Shiller 10-City Home Price Index rose 4.5 percent in 2016, while the 20-City Index rose 5.0 percent. Much of the moderation in home prices has been in higher-priced gateway markets on the East Coast, most notably New York and Miami, where prices had risen substantially in earlier years, largely on the strength of overseas buying. Slower global economic growth, particularly in Europe and Latin America, combined with the stronger U.S. dollar has curbed foreign buying along much of the East Coast. The impact has been less dramatic in the West, with price gains slowing a touch in San Francisco and Los Angeles, but surging ahead in Seattle, Portland and Denver.

Home price appreciation moderated throughout much of 2016, and we expect price gains to decelerate further in 2017.

Some of the moderation in home prices reflects a shift in buyer preferences back toward the suburbs. Urban infill locations had accounted for a larger proportion of sales early on in the recovery process, which drove prices sharply higher. With more homes being built in the suburbs, we anticipate the median price of a new home rose just 3.8 percent in 2016, marking the smallest gain in five years. This trend is apparent in large, rapidly growing Sun Belt markets, such as Houston, Dallas, Atlanta, Phoenix and Orlando. Migration trends are also helping to moderate prices, as more consumers are moving to lower-priced markets in Florida, Texas, Arizona, Georgia and the Carolinas. We look for home price appreciation to moderate further in 2017. Prices should still rise roughly 4.5 percent year over year, however, which will likely outpace inflation and wage growth.

Will the Homeownership Rate Rise from Its Recent Lows?

Perhaps no other single indicator captures the travails of the housing market better than the homeownership rate. During the housing boom, homeownership surged as new mortgage products opened homeownership to buyers previously unable to purchase a home. The innovations in the mortgage market proved too ambitious, however, and homeownership tumbled once home prices began to slide and the economy succumbed to the Great Recession (Figure 5). Homeownership continued to decline during the ensuing recovery, as sluggish job and income growth and tighter mortgage underwriting standards kept many buyers on the sidelines.

In recent quarters, the homeownership rate has shown some encouraging signs of stabilization. Household formation has picked up and, after hitting an all-time low of 62.9 percent in the second quarter, the homeownership rate rose 0.6 percentage points to 63.5 percent in the third quarter. The improvement in household formation is noteworthy in that the number of homeowners rose by the largest amount in just over a decade (Figure 6). While one good quarter does not signal a trend, the gain comes at a time when consumer confidence has improved and worries about job security have subsided. We look for household formations to strengthen further and expect the homeownership rate to rise by half a percentage point over the course of the year.

We look for household formations to strengthen further in 2017.

Figure 5

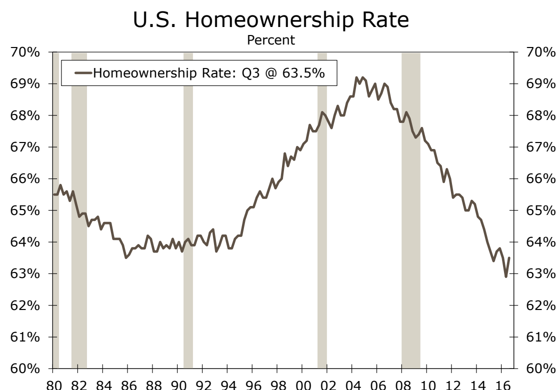
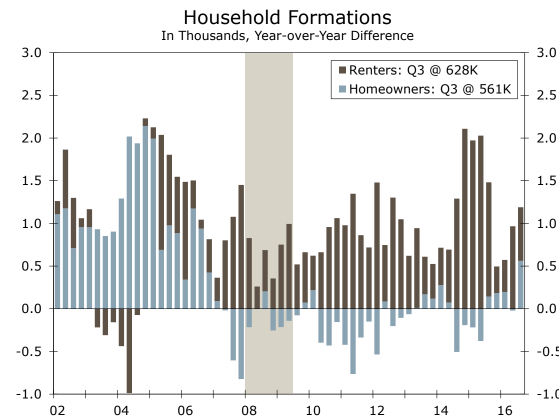


Figure 6



Source: U.S. Department of Commerce and Wells Fargo Securities

Will First-Time Homebuyers Return to the Housing Market?

The absence of first-time homebuyers continues to be a key roadblock to a more robust housing recovery. Overall demographics continue to favor increased homeownership, as the number of persons reaching the point in their lives that they tend to form families and buy a home is increasing. A rising share of potential buyers also feel more confident about their employment and income prospects, and a broader selection of homes is now within the price range of many would-be buyers. Affordability is still more challenging for younger buyers today than it has been for previous generations, particularly given the more stringent requirements on down payments and income verification.

Many hurdles have kept young adults from entering the housing market.

The homeownership rate among adults under the age of 35 sunk to 35.2 percent from a peak of 43.1 percent in 2004, as first-time homebuyers continue to represent a historically small share of home sales. First-time homebuyers accounted for 35 percent of all homebuyers in 2016, up from a near three-decade low of 32 percent recorded in 2015, according to data from the National Association of Realtors (Figure 7). While the improvement is encouraging, the share remains a good bit lower than the long-term average of 40 percent. The lower share of first-time homebuyers does not come as a surprise, as many hurdles have kept young adults from entering the housing market. Increasing rents and debt burdens have impeded young adults' ability to save for a down payment and shortages of for-sale inventories, particularly for starter homes, has left few affordable housing options to choose from. As a result, a larger share of young adults either continues to rent, remain in school or live with their parents (Figure 8).

Despite persistent headwinds, some improvements are taking place. One of the most encouraging trends for housing demand is that Millennials are getting older. The leading edge of the Millennial generation are beginning to reach an age at which major lifetime events such as marriage, purchasing a home and having a child are more likely to occur. The homeownership rate for persons aged 35 to 44 was 58.4 percent in the third quarter of 2016, which is a significant 23.2 percentage points higher than the rate for those under 35. Job growth also remains solid, and the unemployment rate is trending near levels consistent with full employment. As the labor market tightens, wages and salaries are rising more rapidly and workers are feeling more secure about employment prospects, which should encourage more people to put down roots and buy a home.

We expect first-time homebuyers to become modestly more prevalent in 2017.

We expect first-time homebuyers to become modestly more prevalent in 2017. After focusing more on infill opportunities earlier in the cycle, builders are increasingly finding ways to profitably deliver more homes to first-time buyers. Gains will remain modest relative to past cycles, but we expect first-time buyers to become more active in the South and West, particularly in markets like Denver, Dallas, Phoenix, Atlanta, Nashville and Charlotte, which have been magnets for Millennials. Gains should also be evident in higher-cost markets along the West Coast, many of which have been working diligently to find ways for developers to bring more affordable housing options to the market.

Figure 7

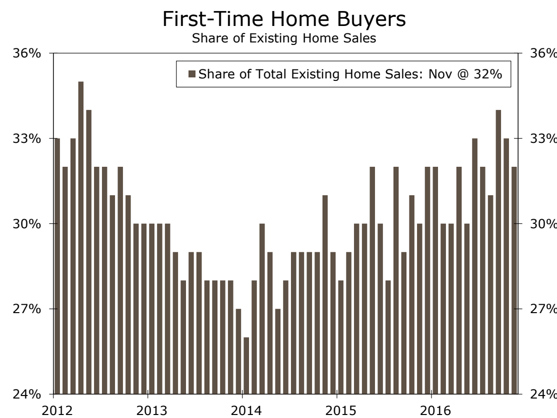
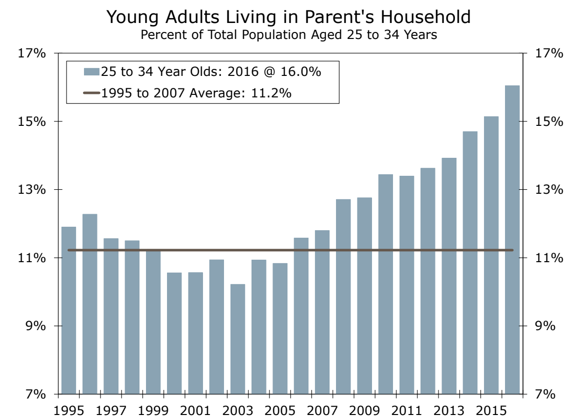


Figure 8



Source: National Association of Realtors, U.S. Dept. of Commerce and Wells Fargo Securities

Has the Apartment Market Topped Out?

The flip side of the lack of first-time homebuyers and declining homeownership rate has been an exceptionally strong apartment market. Demand for apartments has been remarkably strong over the past five years, leading to a building boom throughout much of the country. A larger proportion of new construction has been for higher-end units, many of which have been built in and around the urban core of major metropolitan areas. The development wave of higher-priced units has pushed rents substantially higher in many markets across the United States. Nationwide, effective rent growth rose 3.9 percent year over year in the third quarter, according to Reis (Figure 9). Investors have also bought and renovated many older apartment complexes that are relatively close to key employment centers, resulting in higher effective rents. Suburban apartment development has tended to lag, however, as land prices have often been too expensive to provide the returns that luxury units close to key city centers offered.

The apartment market now appears to be at an inflection point. According to data from Reis, apartment completions have outpaced absorption in nine of the past 10 quarters, but both remain incredibly strong (Figure 10). As a result, the apartment vacancy rate has risen just 0.2 percentage points since bottoming at 4.2 percent in 2014 and stood at 4.4 percent in the third quarter. The onslaught of new construction has been highly concentrated in a handful of cities around the country, however, and many markets are reaching the point that apartment owners are resorting to incentives to lease apartments. In kind, in recent quarters, asking rents have fallen in several key markets, including San Francisco and New York. We expect these trends to continue in 2017. We look for apartment vacancy rates to rise back above 5 percent in 2017 and for rent growth to slow further. Apartment construction will likely decline, although increased apartment building in many suburban locations will help limit the overall drop.

Apartment completions have outpaced absorption in nine of the past 10 quarters.

Figure 9

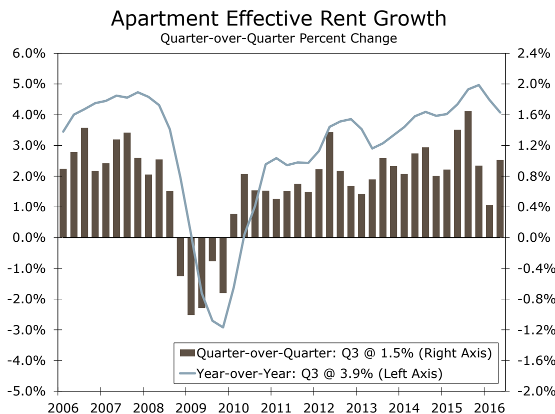
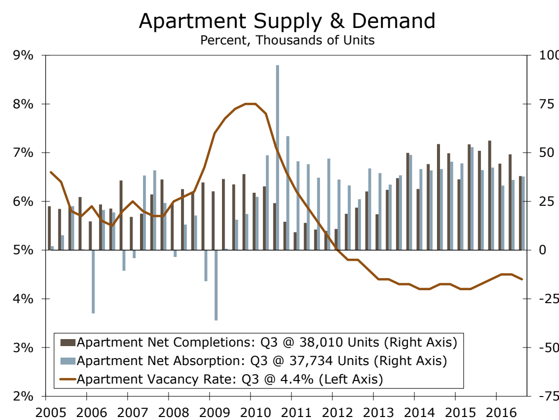


Figure 10



Source: Reis, Inc. and Wells Fargo Securities

National Housing Outlook

							Forecast		
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP, Percent Change	2.5	1.6	2.2	1.7	2.4	2.6	1.6	2.2	2.2
Residential Investment, Percent Change	-2.5	0.5	13.5	11.9	3.5	11.7	4.9	3.8	4.8
Nonfarm Employment, Percent Change	-0.7	1.2	1.7	1.6	1.9	2.1	1.7	1.4	1.2
Unemployment Rate	9.6	8.9	8.1	7.4	6.2	5.3	4.9	4.7	4.5
Home Construction									
Total Housing Starts, in Thousands	586.9	608.8	780.6	924.9	1,003.3	1,111.8	1,170.0	1,220.0	1,240.0
Single-Family Starts, in Thousands	471.1	430.5	535.3	617.7	647.9	714.5	780.0	840.0	870.0
Multifamily Starts, in Thousands	115.8	178.3	245.3	307.2	355.4	397.3	390.0	380.0	370.0
Home Sales									
New Home Sales, Single-Family, in Thousands	322.0	305.0	369.0	429.0	437.0	501.0	565.0	610.0	640.0
Total Existing Home Sales, in Thousands	4,190.0	4,260.0	4,660.0	5,090.0	4,940.0	5,250.0	5,440.0	5,560.0	5,660.0
Existing Single-Family Home Sales, in Thousands	3,708.0	3,787.0	4,128.0	4,484.0	4,344.0	4,646.0	4,820.0	4,930.0	5,030.0
Existing Condominium & Townhouse Sales, in Thousands	474.0	477.0	528.0	603.0	591.0	608.0	620.0	630.0	630.0
Home Prices									
Median New Home, $ Thousands	221.8	227.2	245.2	268.9	282.8	296.4	307.8	317.0	326.5
Percent Change	2.4	2.4	7.9	9.7	5.2	4.8	3.8	3.0	3.0
Median Existing Home, $ Thousands	172.9	166.1	176.8	197.1	208.3	222.4	232.4	242.5	253.0
Percent Change	0.2	-3.9	6.4	11.5	5.7	6.8	4.5	4.3	4.3
FHFA Purchase Only Index, Percent Change	-3.0	-4.1	3.1	7.3	5.4	5.6	5.5	4.8	4.4
S&P Case-Shiller C-10 Home Price Index, Percent Change	2.1	-3.5	0.3	11.7	7.9	4.6	4.5	4.4	4.2
Interest Rates - Annual Averages									
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.27	0.56	1.00	1.50
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.27	3.56	4.00	4.50
Ten-Year Treasury Note	3.22	2.78	1.80	2.35	2.54	2.14	1.82	2.50	2.66
Conventional 30-Year Fixed Rate, Commitment Rate	4.69	4.46	3.66	3.98	4.17	3.85	3.71	4.16	4.28
One-Year ARM, Effective Rate, Commitment Rate	3.79	3.03	2.69	2.61	2.44	2.53	2.70	2.90	3.00

Forecast as of: January 4, 2017

Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, FRB, FHFA, FHLMC, National Association of Realtors, S&P, Wells Fargo Securities

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