

# UCLA ECONOMIC LETTER

## REAL ESTATE AND THE MACROECONOMY

*A partnership between the UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast sponsored by the Ziman Center's UCLA Rosalinde and Arthur Gilbert Program in Real Estate, Finance and Urban Economics*

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Monthly condensed analyses of crucial real estate and economic issues offered by the 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, analyzes the ongoing lengthy recovery of the housing market.

## The Housing Market Continues Its Long, Slow Ascent

By *David Shulman*

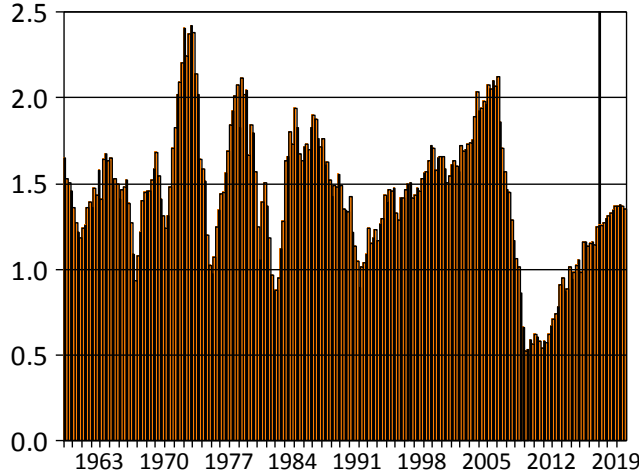
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In this most unusual of housing cycles, housing starts continue to slowly grind higher as they have since the cyclical bottom in 2009, a long seven years ago. (See Figure 1) Further the recovery remains so tepid that starts remain well below prior peaks and are at what used to be characterized as recession levels. In contrast, prior cycles exhibited very sharp rebounds that approached or surpassed the prior cyclical peak. Although the recovery hasn't been complete it has certainly been lengthy by historical standards.

*“With retail challenged by online shopping, there are fewer places for real-estate investors to go. Much of their money will find its way into apartments.”*

**Figure 1. Housing Starts, 1959Q1 – 2019Q4F**

(Millions of Units, Annualized Data)



Sources: U.S Bureau of the Census and UCLA Anderson Forecast

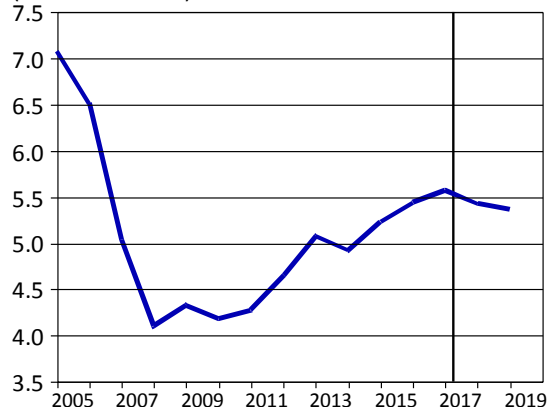
Although we marked up our forecast from last quarter to 1.27 million units in 2017 and 1.34 million units and 1.37 million units in 2018 and 2019, respectively; **that level of activity remains below the 1.4-1.5 million units per year we estimate to be consistent with long-run demand.** The upgrade is the result of the apparent resilience of the housing market to the recent 50 - 75 basis point increase in mortgage rates and lowering our view on the future course of interest rates. The latter is based on our belief that there will be less fiscal stimulus coming from tax reductions that we previously anticipated. Nevertheless it appears that after an extended period of over-building in the first decade of this century we continue to be in an extended period of under building.

What makes the under building so puzzling is that it is occurring against a backdrop of modest economic and employment growth and a sustained period of very low mortgage interest rates. Going forward we are forecasting that real GDP will be growing at a 2.4% pace over the next three years, roughly consistent with the recent past. **Although not as strong as employment growth, household formations averaged about 1.2 million per year from 2012-2017 and are forecast to accelerate to about 1.5 million in 2018 and 2019 still well above housing starts.**

However, house prices have rebounded significantly since their nadir in 2012 -- up 44% and just 5% below the prior peak in 2006. It is therefore no surprise that with limited additions to supply and slowly increasing demand that house prices would make a meaningful recovery. The supply situation is being exacerbated by a growing tendency of existing homeowners to stay put thereby limiting the supply on the market for entry-level homebuyers.<sup>1</sup> As a result, existing home sales remain well below the prior peak of seven million units in 2005 compared to about 5.5 million units this year. (See Figure 2) While homeowners are staying put, they are being active in remodeling their homes resulting in a boom in building materials and gardening equipment sales.

**Figure 2. Existing Home Sales, 2005 – 2019, Annual Data**

(Millions of Units)



Sources: Nation Association of Realtors and UCLA Anderson Forecast

There are many explanations for the long, slow recovery in housing starts. They range from much tighter credit standards compared to the earlier boom, slow income growth, the “hollowing out” of the middle class and the unwillingness of the millennial generation to make long-term commitments. For example the fertility rate which has been in long-term decline since the early 1960s, declined from 2.12 children per woman at the start of the great recession in 2007 to 1.84 in 2015. Of course this decline in fertility has been offset in part by immigration. Another factor in the decline in homeownership has been the development of national single-family home rental businesses that cater to those households who seek a suburban lifestyle, but do not have the ability to purchase a home.

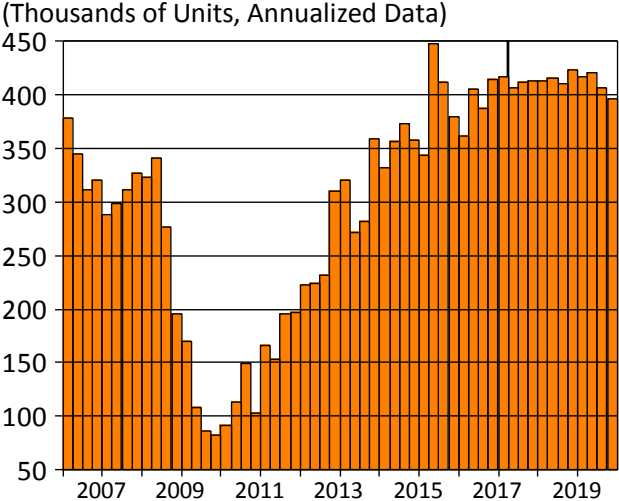
**Perhaps more insidious are the use of regressive zoning and environmental regulations that reduce the overall supply of housing.** This is especially true in the growing, employment-rich coastal cities where high demand and restricted supply are making housing ever more unaffordable for households earning the median income for their region. It is here where the demand for housing remains unsated.

All of these factors have led to a dramatic decline in the homeownership rate from 69.4% in 2004 to the recent low of 63.2% in 2016. It has since modestly rebounded to 63.6%. We have been forecasting the bottom for this series for the past several years to no avail. However we now believe that homeownership rate has stabilized and will increase modestly from here.

### MULTI-FAMILY HOUSING BOOMS

The flip side in the decline in the homeownership rate has been a boom in rental housing. **Multi-family housing starts, after crashing during the great recession to 112,000 units in 2009 has surged to 392,000 last year.<sup>2</sup>** We are forecasting multi-family starts to run at about a 400, 000-unit annual rate over the next three years. (See Figure 3) Although there have been signs of over-building high-end units in New York and San Francisco, we still believe that starts will remain at an elevated level as developers shift their focus from high-rise urban to more affordable mid-rise suburban product. **Apartment developers have, at long last, realized that there is a limited market for \$3,500/month one-bedroom apartments.**

**Figure 3. Multi-Family Housing Starts, 2006 -2019F**



**Sources: U.S. Department of the Census and UCLA Anderson Forecast**

Several factors underpin the multi-family boom: households locked out of the single-family market for credit and income reasons; the preference of millennials for a more urban lifestyle; and the delay of marriage and child-bearing just to name a few. There has also been an increase in multi-family demand among the very wealthy for urban condominiums and among international buyers seeking EB-5 Visas or a safe haven for their money. Thus in Manhattan, San Francisco and Miami, for example, it is not surprising to see the several floors of unlit apartments at night.

As a result, apartment vacancy rates have collapsed from 8% at the worst of the recession in 2010 to 4.1% in 2016, but bounced to 4.3% in this year's first quarter. It is notable that vacancies rose in the face of strong demand, indicating that supply is now outpacing demand. A casual look at the rates indicates that apartment vacancy has bottomed, and with continued high levels of new construction vacancy is on the rise.

The market tightness has had its impact on rents. As measured by the Consumer Price Index, rents have recently been rising at a 4% rate, twice the 2% per year increase in the overall price level. For the first time in a while we are now witnessing the official rent index run higher than what the public apartment real estate investment trusts (REITs) are reporting. For example such national apartment owners as EquityResidential, AvalonBay Communities, Camden Property Trust and Mid-America Apartment Communities reported year-over-year-rent increases of 2.6%, 3.1%, 2.9% and 2.9%, respectively.

So why are the official data so much higher than the private data reported by the REITs? The answer is twofold. First, REITs operate in the higher-end of the market where most of the new supply is coming on; second, the official data is over-weighted towards rent-controlled apartments whose rents are not marked to market as often. Thus the official data tends to lag the spot market data reported by the REITs on the way up and on the way down.

But this gives rise to an obvious question. Why are you still forecasting a robust construction market for multi-family housing? The answer here is also twofold. There is a real demand for affordable condominium units that will be met in the suburbs and two there remains a boatload of money still around to invest in real estate. **With retail real estate challenged by the continued onslaught of online shopping, there are fewer places for real-estate investors to go. Much of their money will find its way into apartments.** Although it might not be realized, institutional investors are projecting pro forma internal rates of return for Class A apartment buildings of 6-6.5% for a 10 year time horizon, still well above investment grade corporate bonds.

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<sup>1</sup> Dougherty, Connor, "A New Normal for Real Estate as Owners Choose to Stay Put." The New York Times, May 15, 2017, p.1

<sup>2</sup> Our definition of multi-family starts include two or more units in contrast to the standard industry definition of five or more units.