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U.S. HOUSING UPDATE—MIND THE GAP

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KEY TAKEAWAYS

Housing prices have breached the record prices set 10 years ago; however, home affordability is much higher than it was at that time.

The housing market has changed greatly in 10 years, with a much higher proportion of renters.

The millennial generation has just entered its prime home buying years.

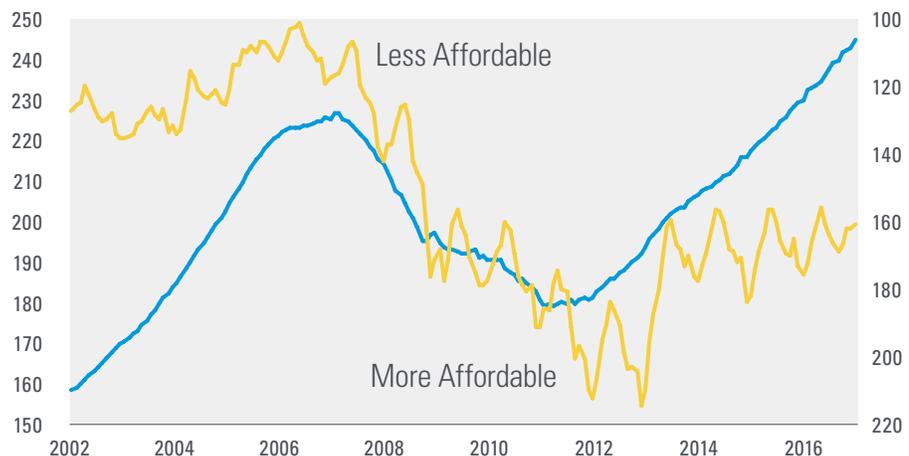
Housing prices hit what was then an all-time high ten years ago; the bursting of the housing bubble was arguably the primary cause of what we would come to call “The Great Recession.” Housing prices surpassed the levels reached a decade ago in November of 2015, and have continued to move higher since. Yet, the market is very different today as the portion of households renting has increased even though, thanks to low mortgage rates, home affordability is still reasonable. Two major factors may boost home prices going forward, the impact of the slowdown in new home sales, which has reduced supply, and the fact that the first wave of the millennial generation has entered its prime home buying years.

HOME SWEET HOME

Housing is an incredibly important part of the U.S. economy, accounting for approximately 15% of gross domestic product (GDP) if you include the money spent on construction, maintenance, and rent—including owner-imputed rent, essentially the rent you would pay to live in the home that you own. Home equity also accounts for approximately 15% of the average household’s net worth. It is easy to see how a change in housing values affects consumer behavior and economic data. In turn, home values can be very sensitive to changes in mortgage rates.

1 HOUSING PRICES HIT ALL-TIME HIGHS, BUT AFFORDABILITY REMAINS HIGH RELATIVE TO HISTORICAL LEVELS

- FHFA House Price Index: Purchase Only (Left Scale)
- Housing Affordability (Right Scale, Inverted)



Source: LPL Research, Haver Analytics, National Association of Realtors 05/12/17

Performance is historical and no guarantee of future results.

Housing Affordability is the ability of a household with a median income to afford the payments on a median-priced home at current mortgage rates.

The FHFA House Price Index is a broad measure of the movement of single-family house prices.

The Federal Housing Finance Agency (FHFA) House Price Index peaked in March 2007 (peak in May 2007 was representative of non-seasonally adjusted basis) just prior to the Great Recession which began in January 2008. Although the current market is reaching new highs, we seem very far from another housing bubble. First, housing affordability is relatively high, much higher than it was at the 2007 housing price peak [Figure 1]. Affordability, defined as the ability of a household with a median income to afford the payments on a median-priced home at current mortgage rates, has declined from peak levels. Even though home prices have increased, affordability levels are still high relative to the long-term average due to low mortgage rates. The opposite was true in 2007.

BUILDING: MORE DEMAND THAN SUPPLY

To keep supply and demand in balance, the number of homes (housing stock) should increase roughly in line with the number of households being formed. Both household formation (which determines demand for housing) and homebuilding itself suffered due to the Great Recession. However, since 2007, the number of households has increased by 7.3%, while housing stock has only increased by 6% over the same period.

What has filled that gap and allowed supply to meet demand? Renting. The percentage of households not owning its primary dwelling has risen almost 5%, from 31.6% to 36.4% from 2007 to 2017 [Figure 2]. You can see that the number of houses lived in by their primary owners has barely moved, however, the number of homes occupied by renters has increased by 23.5%. A recent survey conducted by online real estate company Zillow suggested that in the major real estate markets, the 20% down payment requirement for home ownership, a requirement that was frequently ignored during the housing bubble, was a major impediment to home ownership. In many real estate markets, such as the technology hubs in the San Francisco Bay area, 20% of the average home price can be greater than the average annual salary.

In the five years previous to 2007, there was a clear trend of overbuilding [Figure 3]. Not surprisingly, home building collapsed during the Great Recession, with permits for new home construction, which had been averaging around 1.5 million homes per year, falling below 350,000 in 2009. Though home construction has rebounded from this absolute low, permits still remain below 900,000.

A number of reasons have been offered as to why this is so. As we have shown above, it is not a lack of demand caused by the relatively low level

2 GROWTH IN HOUSING STOCK HAS LAGGED HOUSEHOLD FORMATION SINCE 2007

| | Total Housing Units | Occupied Housing Units (Households) | Owner Occupied | Renter Occupied |
|--------------|---------------------|-------------------------------------|----------------|-----------------|
| Q1 2007 | 128,439,000 | 110,715,000 | 75,683,000 | 35,031,000 |
| Q1 2017 | 136,090,000 | 118,800,000 | 75,556,000 | 43,244,000 |
| % Difference | 6.0% | 7.3% | -0.2% | 23.4% |

Source: LPL Research, U.S. Census 05/12/17

of household formation. The main reason seems to be the inability of would-be buyers to come up with the down payment. Other reasons may be:

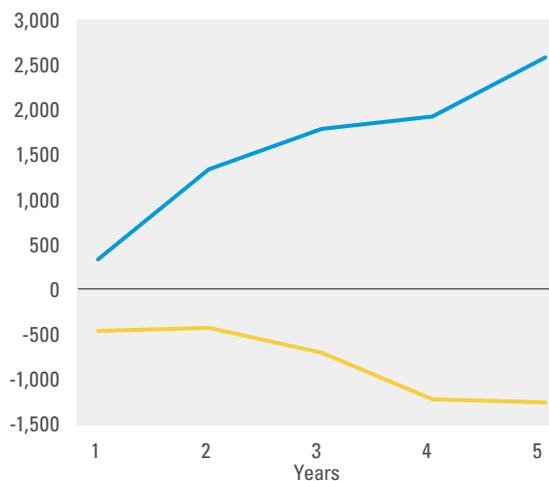
- Lack of available lending; even though interest rates are low, it may be difficult for builders to obtain financing for new homes,
- Shortage of available land, especially in the centers of major metropolitan areas,
- Increased land use and building regulations, mostly at the state and local level,
- Difficulty finding workers, as many people left the construction industry during the Great Recession.

So even as the economy recovered and exceeded pre-recession levels, housing construction did not.

3 OVERBUILDING — A TREND NOT PRESENT TODAY — EMERGED FIVE YEARS BEFORE THE GREAT RECESSION

Cumulative Difference Between Growth in Housing Stock and Household Formation (Thousands)

● 2002-2006 ● 2012-2016



Source: LPL Research, U.S. Census 05/12/17

THE NEXT GENERATION MOVES IN

The other factor that is about to hit the housing market is that the next demographic wave, the millennials, is about to enter its peak housing consumption years. Historically, the age at which a person buys his or her first home is 31. The millennial generation, roughly defined as people born between 1982 and 2000, is just entering this age group. It does appear that this group is waiting a few more years before their first home purchase. However, there are more than 80 million people in this demographic group, and despite the popular perception of millennials living in their parents' basements, the reality is that eventually they will require housing.

CONCLUSION

Housing prices hit their pre-Great Recession peak just over 10 years ago, and then declined 20% on average (and much more in some places). Nationally, prices recovered to pre-recession levels in November of 2015 and have continued higher since. Though housing prices remain at all-time highs, there are few signs of another housing bubble. Growth in households has exceeded growth in housing stock since 2007, and affordability remains above long-term averages (aided by low interest rates). These signs, among others, indicate that even though housing prices are seeing gains, the housing market is not experiencing the same excesses that contributed to the crash in 2008. ■

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Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

DEFINITIONS

The Federal Housing Finance Agency (FHFA) House Price Index (HPI) is a broad measure of the movement of single-family house prices. The HPI is a weighted, repeat-sales index, meaning that it measures average price changes in repeat sales or refinancings on the same properties. This information is obtained by reviewing repeat mortgage transactions on single-family properties whose mortgages have been purchased or securitized by Fannie Mae or Freddie Mac since January 1975.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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