ECONOMIC OUTLOOK
REGIONS
May 2017

It's A Seller's Market – Has Anyone Told The Sellers?

For the most part, Q1 2017 was a quarter to forget, at least in terms of the economic data. The final indignity came in the form of the BEA's initial estimate of Q1 GDP, which showed annualized real GDP growth of just 0.7 percent. A quarter to forget, indeed. There are a number of factors that combined to wreak havoc on the Q1 data, including a winter that was atypically mild through February before changing course in March. Last month's *Outlook* discussed some of the ways in which the weather and a few other atypical factors impacted the Q1 data. We have often noted the underlying health of the U.S. economy is neither as poor as the Q1 GDP data suggest nor as robust the Q2 data will likely imply.

One notable exception to the generally soft Q1 economic data was the housing market, specifically sales of new and existing homes that generally came in ahead of expectations. March was a particularly strong month for new and existing home sales. This was captured in the "headline" sales, numbers, i.e., seasonally adjusted annualized rates, as sales are commonly reported. For instance, at an annual rate of 621,000 units, new home sales matched July 2016 as the highest monthly sales rate since January 2008, while the annual sales rate of 5.710 million units was the highest monthly sales rate for existing homes since February 2007.

But, as our regular readers know, we put little stock in the headline numbers on the housing market data releases and instead focus on the trends in the not seasonally adjusted data. This is, at least to us, where the real strength of March home sales is most evident. In March, there were 58,000 new homes sold, which marks the strongest month for new home sales since August 2007. Not seasonally adjusted existing home sales rise each year in the month of March, but the 456,000 existing homes sold this March reflect a 44.8 percent increase from February, the largest increase for the month of March in the life of the existing home sales data which date back to 1999 in their current incarnation.

As with much of the economic data, however, the Q1 data on home sales were clouded by a host of factors that make it difficult to assess the underlying trends. It helps here to recall that new home sales are booked at the signing of the sales contract, while existing homes are booked at closing, which typically falls 45-60 days after the signing of the sales contract. So, strong existing home sales in March reflected, to a large extent, sales contracts signed between late-January and late-February, and one factor that could have motivated buyers to act was rising concern over affordability. In other words, rapid price appreciation over the past several months and what, at the time these sales contracts would have been signed, were fears that mortgage rates would go even higher in subsequent months likely motivated at least some buyers to act sooner than they otherwise would have.

Concerns about the course of mortgage interest rates along with what was atypically mild winter weather likely led to there being more activity in the new homes market sooner in the year than would otherwise have been the case. It also helps to note that new home sales can be booked at any stage of construction, i.e., before ground has been broken, during construction, or after the unit has been completed. Sales of units on which construction had not yet begun have accounted for an atypically high share of new home sales over the past several months, which means builders constrained by shortages of labor and/or materials have still been able to book sales and contend with the construction backlogs at a later time.

As we've noted several times in our write-ups of the monthly housing market data, we think the demand side of the housing market remains quite healthy. Ongoing job and income growth, rising household net worth, still favorable mortgage interest rates, elevated consumer confidence, and a sustained period of rapid rent growth that has further skewed the math in favor of buying have combined to fuel steady growth in the demand for homes. These factors help account for strong home sales during Q1.

Conversely, however, we have for some time expressed concerns over the supply side of the market, for both existing homes and new homes, which have been reflected in our below-consensus forecasts for single family construction and sales. Solid Q1 home sales notwithstanding, our view has not changed. This leads us to believe that, rather than solid Q1 sales indicating the housing market has shifted into a higher gear, at least some of Q1's sales came at the expense of sales in later quarters. Coming months will answer this question more definitively, but at present it is hard to see much relief on the supply side of the market.

One way to illustrate our point is to look at inventories of homes for sale. Our discussion will be limited to inventories of single family homes for sale and we use the not seasonally adjusted data for both new and existing homes to come up with a total count. One advantage of using the not seasonally adjusted data is that there are clear seasonal patterns in inventories. For instance, listings of existing homes for sale typically begin to rise in March of any given year, ahead of the traditional spring selling season, then begin to drift lower over the back half of the year.

The chart on the following page shows the historical series on inventories of single family homes for sale, new and existing, as well as the familiar months supply metric, i.e., how many months of inventories there are at current sales rates. As can be seen in the chart, inventories of single family homes for sale are notably lean, both in terms of the absolute number of homes for sale and the months supply, which as of March stood at 3.95 months. Note that in a balanced market, months supply would be around 6.0 months. A slightly faster pace of single family construction and the further paring down of distress inventories has led to a shift in the

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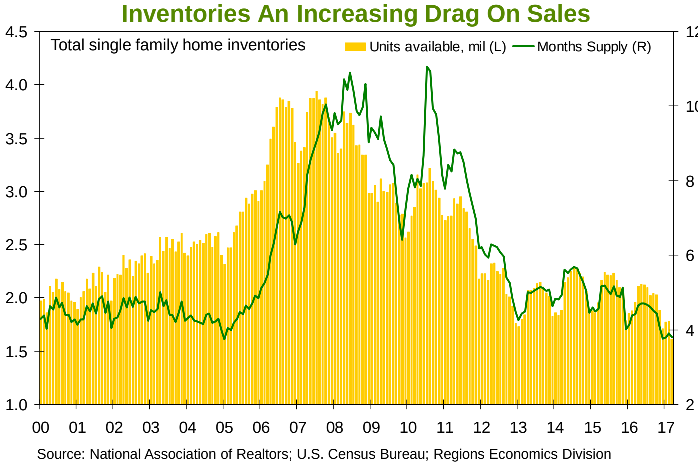
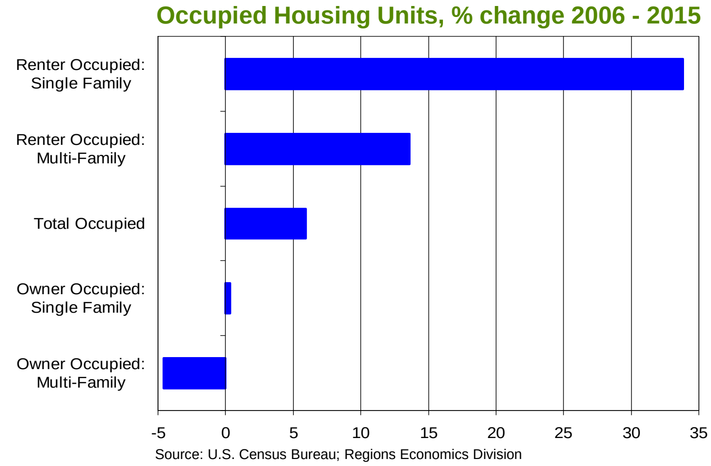
composition of inventories, with new homes accounting for just over 14 percent of the total over the past several months. This is up from a low of around 6 percent in 2011 and is in line with the share seen before the housing market boom/bust prior to the 2007-09 recession. Still, while the mix of inventories may not look out of alignment, the reality is that the level of inventories remains notably low.



The seasonal pattern in inventories we noted earlier is clearly visible in the above chart. The seasonal top in inventories for 2017 is shaping up to be well shy of that seen in 2016, which in turn was shy of that seen in 2015. In other words, the present lean level of inventories isn't something that just happened overnight, instead, it's been in the works for several years now – keep in mind that in the earlier phases of the present expansion, a steady and significant flow of distress properties helped prop up inventories. At the peak, distress sales accounted for around 30 percent of all home sales, according to data from CoreLogic. In a normal market, that share would be right at 3.0 percent, and in recent months has been hovering around 6.0 percent.

Clearly, then, the diminished flow of distress properties is a key contributor to the low inventories of single family homes for sale. There is, however, another way in which distress properties have played a part, one that is perhaps not fully appreciated but is something we touched on in one of our periodic housing market updates (July 2016). The past several years have seen the rise of REITs focused on single family rental homes; these REITs were active buyers of large blocks of distress properties they ultimately placed on the rental market. While for many the term "rental housing" conjures up images of rental apartments, the reality is that over the past several years single family homes have become an increasingly important part of the rental housing market.

In our July update, we noted the steady increase in the share of the stock of occupied rental housing units accounted for by single family homes. Our source here, the American Community Survey (ACS), gives us detailed annual data on the composition of the housing stock, though the history is short (the ACS data starts in 2006) and the data come with a substantial lag, so the 2015 data are the latest available. In 2006, single family rental units accounted for 31.1 percent of the occupied rental housing stock, but for 2013 through 2015 that share averaged 35 percent. If that doesn't sound like a material difference, keep in mind that there were over 43.7 million occupied rental housing units as of the 2015 ACS data, so the increase in the single family share from 31 to 35 percent translates into a significant number of single family units being renter, as opposed to owner, occupied.



The above chart illustrates our point on the increased prominence of single family homes in the rental housing market. Over the 2006-15 period, the number of occupied single family homes increased by 33.8 percent, compared to a 13.6 percent increase in occupied multi-family housing units. Conversely, thanks to an only trivial increase in owner occupied single family units and a decline in owner occupied multi-family units (i.e., condos), the number of owner occupied housing units actually declined over this time frame. In and of itself, that will probably surprise no one, but the composition of the change in occupied rental housing market might. And, to be sure, there are base effects in play here, i.e., the starting point for occupied single family rental units was much lower than that for occupied multi-family rental units, but, still, the shift is noteworthy.

This is by no means to say that all of these single family homes that have been shifted to the rental market would have been transacted in the for-sale segment of the housing market had they remained owner occupied, but it is reasonable to assume at least some share of them would have been. This goes to our point that the number of single family homes available for sale has been held down by the rise of single family REITs. One point we made in our earliest discussion of this point is whether, and when, we might see single family REITs begin to divest themselves of part or all of these rental units, i.e., put them up for sale.

Thus far, there are no indications such a move is at hand, which is not at all surprising. After all, high occupancy rates and solid rent growth combined with rapid house price appreciation mean these single family REITS are enjoying the best of both worlds, i.e., healthy cash flows along with capital appreciation. Still, should they get to the point that they do decide to begin unwinding their holdings, it could bring some relief on the supply side of the for-sale market, but this would likely be fairly concentrated in a relatively small number of markets. As such, we don't look to this as a source of meaningful relief for lean inventories.

In addition to a significant shift of single family homes to the rental market, there are other factors that have helped hold down the number of existing single family homes for sale. One factor is equity, either negative equity or only marginally positive equity positions for current homeowners. Those in such a position are generally unable to sell their home, at least not without writing a check to make up for the lack of equity, and this has been a drag on home sales over the past several years. To be sure, this drag is abating in light of what has been robust house price appreciation. At the peak in 2011, per data from CoreLogic, just over 25 percent of all mortgaged households were in a negative equity position; that share has since fallen steadily and as of December 2016 stood at 6.2 percent (or, 3.165 million loans).

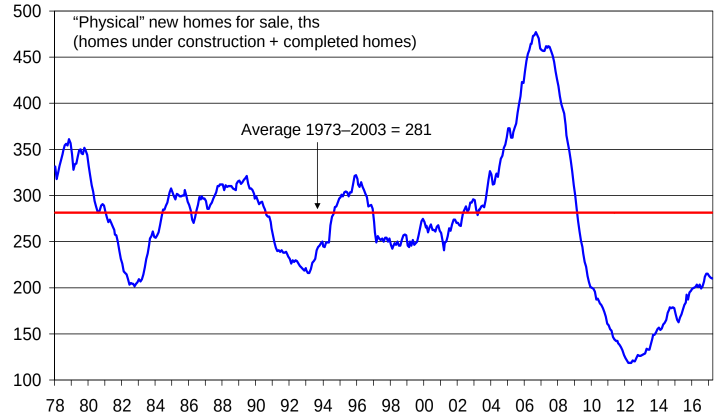
What we don't know, however, is what constitutes "normal" for this metric, as the data only begin in 2009. What we also do not know is the number of those who have only marginal equity, i.e., positive but only marginally so, which acts as a constraint on selling a home. While it is reasonable to conclude that what has been rapid house price appreciation over the past several months has freed up more homeowners with unfavorable equity positions, it is also likely that this effect has been concentrated amongst a group of larger metropolitan areas, which mirrors patterns in house price appreciation. In the aggregate, as of Q4 2016 owners' equity in residential real estate stood at 57.8 percent of the value of that real estate, still below normal but up considerably from the cyclical trough of 36.0 percent in Q2 2009 (data are from the Federal Reserve's *Flow of Funds* release). On the whole, then, improving equity positions should be an increasing positive for existing home sales over coming quarters.

But (and, really, you just knew there was one of those coming), just as improving equity positions should help free up a greater number of homes for potential re-sale, rising mortgage interest rates could have the opposite effect. While we don't necessarily know of a way to quantify this, it is more than plausible to think that those who either took out a new mortgage or refinanced an existing mortgage during the era of sub-four percent mortgage interest rates, basically from late-2014 through late-2016 (two years constitutes an "era," right?) would be very hesitant to trade homes and, in the process, commit to a higher mortgage rate.

It is true that, thus far, increases in mortgage interest rates have been fairly modest, but nonetheless rates are likely to rise further over coming quarters, which will only increase the number of those "locked in" to a sub-four percent mortgage. Moreover, to the extent we do continue to see robust house price appreciation, that would make the hurdle even harder to clear for those with ultra-low mortgage interest rates considering trading homes.

As for inventories of new homes, we have seen nothing in the data to make us change what has for some time now been our baseline forecast of only gradual growth in construction and sales of new single family homes. The list of reasons is by now familiar to our regular readers, but the short version is constraints on the supplies of buildable lots, labor, and materials, tougher financing conditions for many homebuilders, and what in many markets have become lengthier and costlier entitlement processes. Moreover, an often underappreciated constraint on the supply of new homes is that there are simply fewer builders than there used to be. During the downturn, larger national builders had the financial wherewithal to survive, but many mid-sized and small builders did not. While some of the smaller builders have returned, their contribution to overall inventories is, in most cases, negligible. That many of the mid-sized regional builders won't be coming back has left a meaningful, and at least thus far lasting, gap in new construction.

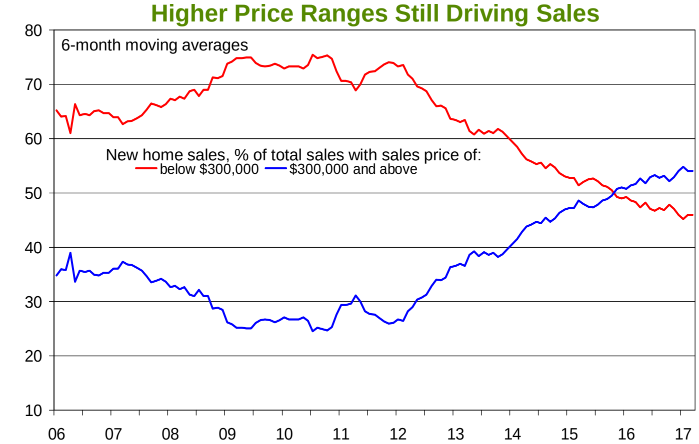
New Home Inventories Nowhere Near Normal Levels



Source: U.S. Census Bureau; Regions Economics Division

The above chart illustrates how far below normal new home inventories are. While there has been a significant bounce off of the cyclical trough, our view is that further progress will come at only a gradual pace, and indeed the level of physical inventories of new homes (i.e., either completed homes or those in some stage of construction) has basically not budged over the past six months.

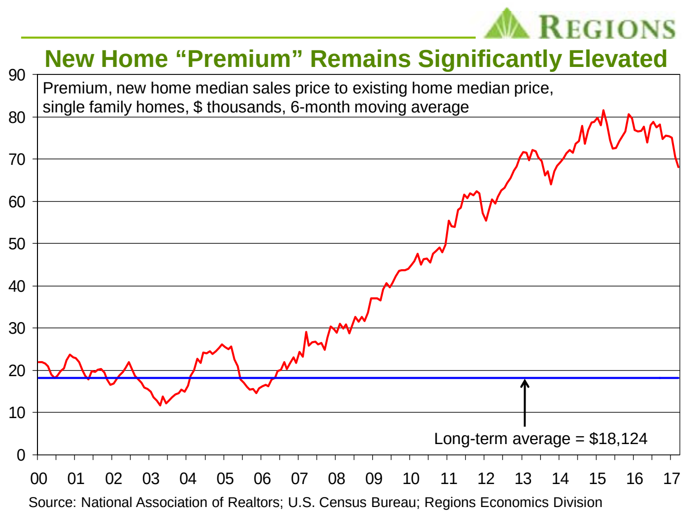
Higher Price Ranges Still Driving Sales



Source: U.S. Census Bureau; Regions Economics Division

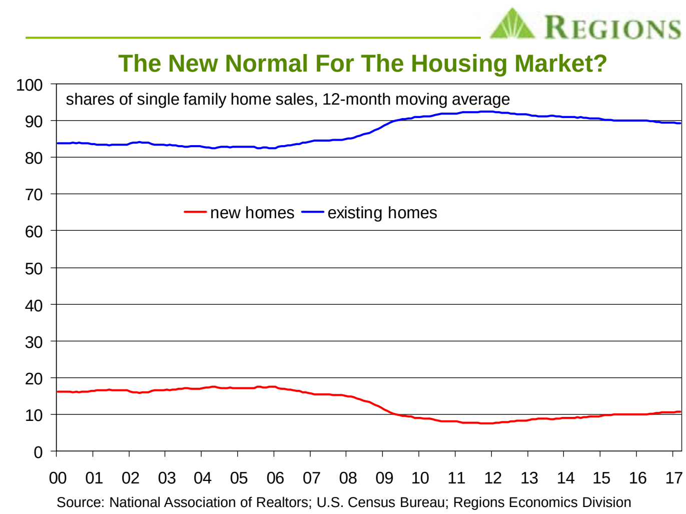
This isn't necessarily to say that builders are in dire straits due to atypically low levels of construction. As we've noted, builders are making up for in margin what they've been missing out on in volume. In other words, as seen in the above chart, builders have increasingly concentrated their efforts in the higher price ranges, which has been a perfectly logical response to market conditions. In the early phases of the housing market recovery, stringent mortgage underwriting standards significantly limited the pool of potential buyers to those on the upper end of the credit spectrum, which in many cases meant on the upper end of the income spectrum, who were willing and able to purchase higher priced homes. While the availability of mortgage credit has increased, there is still sufficient demand at the higher price points, thanks in part to how low mortgage interest rates have been. In addition, higher entitlement costs are, for the most part, passed along to buyers in the form of higher sales prices, which simply reinforces the trend toward building higher priced homes. It is worth noting that, should the U.S. actually impose tariffs of up to 20 percent on lumber imported from Canada, this would have the same effect, i.e., higher lumber prices would be passed along to homebuyers. This would put new homes out of reach, in terms of affordability, for more prospective buyers, particularly were it to occur in conjunction with higher mortgage interest rates.

What remains to be seen is whether builders shift their focus more towards the lower price ranges than they have thus far done. One issue, however, is that in markets in which entitlement costs are more burdensome it would seem that there is a limit to how low builders can go on selling prices, or, perhaps more accurately, how low they are willing to go given what would be pressure on profit margins. One alternative is for builders to concentrate more in the outlying portions of larger metro areas to avoid these high costs.



As it is, there is an extraordinarily large gap between median sales prices of new and existing single family homes, as seen in the above chart. The significant increase in this gap in the early phases of the housing market recovery was mainly driven by distress properties coming on the market and selling at significant discounts, which weighed on median sales prices of existing homes. By the time distress inventories had cleared to a notable degree, builders had shifted their focus towards the higher price ranges, which sustained a further increase in the new home "premium." That the premium has begun to narrow, even though new home prices remain elevated, reflects what has been robust price appreciation for existing homes over the past several months. As a side note, the long-term average is the average differential from January 1984 through December 2006.

If our assessment of housing market conditions, including the extent to which inventories of homes for sale are likely to increase over coming months, is correct, further narrowing of the new home premium will be driven more by rising prices for existing homes than by lower prices for new homes. One thing we have been a bit surprised by is that robust price appreciation has not drawn more inventory on to the existing homes market. While there has been some such movement, it seems to have been somewhat limited thus far, even given our prior points about negative equity and current homeowners being "locked in" to low mortgage interest rates. It could be that a prolonged period of robust price appreciation will indeed draw more supply on to the market, but by that point affordability will have become a bigger issue, particularly to the extent we see further increases in mortgage interest rates.



The above chart shows how the balance in the housing market has yet to recover from the distortions that developed prior to and in the wake of the 2007-09 recession. To reiterate a point made earlier, builders are building fewer houses than would normally be the case, but thus far they've been making up for lower volumes with higher margins. There is, however, a limit as to how much longer this can continue. On a more macro level, it is worth noting that new residential construction has a bigger impact on overall economic growth than is the case for existing home sales. Indeed, the only portion of the sale of an existing home that appears in the GDP data is the broker's commission on the sale, so one implication of the shortfall of new single family homes is that residential construction has made smaller contributions to overall GDP growth than would have been the case in a more typical cycle. While multi-family construction has made a contribution to overall GDP growth, the reality is that a new single family housing unit makes a bigger contribution than a new multi-family housing unit.

If nothing else, it will be interesting over coming quarters to watch how these inventory constraints are resolved against a backdrop of rising mortgage rates and rapidly rising prices of existing homes. Should affordability be sufficiently impacted, what are now inventory shortfalls could easily turn into inventory overhangs, which would imply an adjustment in selling prices. By no means are we implying price declines on the order of those seen during the last cycle, but at the least it would be reasonable to expect significantly slower rates of price appreciation. Again, coming quarters will reveal how this will play out, but what seems clear is that the present dynamic – limited inventories, robust price appreciation, and rising mortgage rates – cannot be sustained indefinitely. The question is what gives first, supply or demand.

ECONOMIC OUTLOOK

REGIONS

May 2017

Q4 '16 (a)	Q1 '17 (p)	Q2 '17 (f)	Q3 '17 (f)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)		2015 (a)	2016 (a)	2017 (f)	2018 (f)
2.1	0.7	3.5	2.4	2.4	2.6	2.3	2.2	Real GDP[1]	2.6	1.6	2.2	2.4
3.5	0.3	3.0	2.8	2.6	2.7	2.5	2.4	Real Personal Consumption[1]	3.2	2.7	2.4	2.6
								Business Fixed Investment:				
1.7	6.1	2.8	2.8	2.8	3.1	3.5	3.5	Equipment, Software, & IP[1]	4.0	0.0	2.8	3.1
-1.9	22.1	-2.1	1.2	1.7	2.9	2.9	3.1	Structures[1]	-4.4	-2.9	6.0	2.2
9.6	13.7	6.3	4.3	8.0	9.3	6.6	4.8	Residential Fixed Investment[1]	11.7	4.9	6.2	6.9
0.2	-1.7	2.2	0.9	0.9	0.8	0.9	0.9	Government Expenditures[1]	1.8	0.8	0.2	1.0
-605.0	-602.8	-607.5	-617.8	-626.7	-636.3	-646.6	-655.5	Net Exports[2]	-540.0	-563.0	-613.7	-650.3
1.248	1.253	1.230	1.246	1.293	1.316	1.333	1.353	Housing Starts, millions of units[3]	1.108	1.176	1.255	1.345
18.0	17.2	16.9	16.7	16.8	16.7	16.6	16.5	Vehicle Sales, millions of units[3]	17.4	17.5	16.9	16.6
4.7	4.7	4.5	4.5	4.5	4.4	4.4	4.4	Unemployment Rate, %[4]	5.3	4.9	4.6	4.4
1.6	1.6	1.6	1.4	1.3	1.3	1.2	1.2	Non-Farm Employment[5]	2.1	1.8	1.5	1.2
1.6	2.0	1.9	2.0	1.9	1.9	2.0	2.1	GDP Price Index[5]	1.1	1.3	2.0	2.0
1.4	2.0	1.9	2.1	2.0	2.0	2.1	2.1	PCE Deflator[5]	0.3	1.1	2.0	2.1
1.8	2.6	2.5	2.6	2.4	2.3	2.3	2.3	Consumer Price Index[5]	0.1	1.3	2.5	2.3
1.7	1.7	1.8	1.9	2.1	2.1	2.1	2.2	Core PCE Deflator[5]	1.4	1.7	1.9	2.2
2.2	2.2	2.1	2.2	2.2	2.2	2.3	2.4	Core Consumer Price Index[5]	1.8	2.2	2.2	2.4
0.42	0.68	0.93	1.16	1.38	1.42	1.67	1.88	Fed Funds Target Rate, %[4]	0.14	0.39	1.03	1.72
2.13	2.45	2.35	2.45	2.50	2.60	2.70	2.80	10-Year Treasury Note Yield, %[4]	2.14	1.84	2.44	2.75
3.84	4.17	4.07	4.10	4.21	4.34	4.46	4.58	30-Year Fixed Mortgage, %[4]	3.85	3.65	4.14	4.51
-2.4	-2.6	-2.7	-2.9	-3.0	-3.0	-3.2	-3.3	Current Account, % of GDP	-2.6	-2.6	-2.8	-3.2

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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