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Are Homebuilders Rising from the Dead?

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Homebuilders have suffered so severely and for so long that they have been given up for dead. Between 2006 and 2011, most major homebuilders saw their new home deliveries fall 70-80%. Besides the devastating impact on revenues, the housing depression forced homebuilders to write down or write off $billions worth of land, options and inventory. Pulte, D.R. Horton, and Lennar, which are the three largest homebuilders based on new home deliveries from 2006 through 2011, collectively lost about $10.5 billion during that period.

Over the past couple of years, there have been intermittent signs of stabilization in the housing markets, but none was sustained. Recent data once again indicate improvement. Should we trust this latest turn?

First, let's take a look at some evidence supporting a housing market turnaround. Existing home sales and their median price have been up every month on a year-over-year basis since early this year. New home sales are near two-year highs, with their median price achieving the highest level in more than 5 years. For-sale inventory is currently very lean in many parts of the country, and is way below normal levels. Homebuilders are getting more net new orders, delivering more homes and selling them at higher prices than a year ago. Below are related data for Pulte and Lennar, which are quite representative of the homebuilder industry as a whole.

Pulte	**Three months ended**	
	6/30/2011	**6/30/2012**
Net orders (units)	4,222	5,578
Net orders ($)	$1.12 billion	$1.61 billion
Homes delivered (units)	3,633	3,816
Average selling price ($)	$248,000	$268,000

Lennar	**Three months ended**	
	8/31/2011	**8/31/2012**
Net orders (units)	2,914	4,198
Net orders ($)	$0.73 billion	$1.15 billion
Homes delivered (units)	2,865	3,655
Average selling price ($)	$247,000	$258,000

So are these recent improvements once again a head-fake? Can we trust that the housing market has turned for good? While the market still has a long way back to full recovery, there are solid reasons to believe that this most recent turn will stick. We discuss why in the remainder of this article.

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Demographics

As reported in a 2011 study from the National Association of Home Builders, data from the Census Bureau's Housing Vacancy Survey indicated that the number of households has grown at an average annual rate of 1.5% since 1965, adding an average of 1.3 million new households per year. But this long-term trend was severely disrupted by the housing and financial crisis, which temporarily limited new household formation. According to the Census Bureau, during the period from spring 2007 to spring 2012:

- The number of shared households increased from 19.7 million to 22.3 million.
- The number of adults living in shared households increased from 61.7 million to 69.5 million.
- The percentage of young adults who lived in their parents' households grew from 11.8% to 14.2%.

According to a blog entry from Financial Times Alphaville (February 2012) and the May 2012 prepared remarks by the Director of the National Economic Council, Goldman Sachs economists have shown that the average annual growth in the number of households for the period 2002 to 2007 was ***1 to 1.3 million per year***, based on three different surveys from the Census Bureau. In contrast, the average annual growth in the number of households for the period 2008 to 2011 was down to ***600,000 to 700,000*** per year, or just about half of the 2002-2007 growth figures. Goldman Sachs economists further noted that population growth and aging would have warranted annual household formation of 1.3 to 1.4 million per year over the past few years. Delays in starting a new household can only last so long, and there are signs of regression towards more normal levels as we continue to recover from the Great Recession. In fact, a recent Census Bureau's report "Income, Poverty, and Health Insurance Coverage in the United States: 2011" (September 2012) stated that the total number of households as of March 2012 was about 1.2 million higher than a year ago.

In its 2010 study "The State of the Nation's Housing," the Joint Center for Housing Studies at Harvard University commented that a low-end estimate of household growth for 2010-2020 would be about 1.25 million per year and that this would support demand for about 1.7 million new housing units per year, on average, over the same period. The high-end estimate would be around 1.48 million new households per year, which would likely support an average of more than 1.9 million new housing units per year. This stands in sharp contrast against the currently depressed supply of new housing units, which languished at an annualized rate of only 750,000 units as of August 2012. The significant amount of household formations that was postponed during the Great Recession will be a major driver of housing demand in the coming years. Yes, the shadow inventory will alleviate some of the supply-demand imbalance, but that inventory has turned out to be less problematic than what was widely expected (as explained later in this article).

New Home Inventory is Limited

With a few exceptions, the number of new housing units available for sale has been hitting new record lows month after month since mid-2007. While building permits and housing starts have been slowly improving during the last few months, they remain at historically low levels and are only about one third of the volume from the peak of the bubble years. This can be seen in the table presented below, covering 2005 to 2011 and the first 8 months of 2012. To meet pent-up demand for housing, inventory will have to increase substantially from the current levels. Until we reach a better balance between supply and demand, new housing median prices are moving up in many parts of the country.

Housing Units Authorized by Building Permits,
Housing Units Started, and New Houses For Sale
(units in thousands)

Year	Permits	Starts	For sale
2005	2,155.3	2,068.3	515
2006	1,838.9	1,800.9	537
2007	1,398.4	1,355.0	496
2008	905.4	905.5	352
2009	583.0	554.0	232
2010	604.6	586.9	188
2011	624.1	608.8	150

Seasonally adjusted (annualized)

Year	Month	Permits	Starts	For sale
2012	Jan	684	720	149
2012	Feb	707	718	146
2012	Mar	769	706	145
2012	Apr	723	747	145
2012	May	784	706	144
2012	Jun	760	754	144
2012	Jul	811	733	141
2012	Aug	803	750	141

Historically High Affordability

In the first quarter of this year, a measure of housing affordability from the National Association of Realtors (NAR) reached a record high of 205.9. A value of 100 means that a family earning the national median income has 100% of the income necessary to qualify for a mortgage on a median-priced property at the current mortgage rates. The most recent monthly reading was 182, which is still very high compared to the past few decades.

In a September 2012 press release covering its "Summer 2012 Rent vs. Buy Report," Trulia reported that buying a home is on average 45% cheaper than renting in all of the 100 largest U.S. metropolitan areas, assuming a 30-year fixed mortgage rate at 3.5%, itemized deductions at the 25% federal tax bracket, and a 7-year ownership horizon. Even though affordability varies by location, buying is still cheaper than renting by a sizable 24% in the metropolitan area with the lowest affordability.

Historically Low Mortgage Rates

Low mortgage rates contribute to historically high housing affordability. At the time of this article, Freddie Mac reported that the average rate on a 30-year fixed mortgage just fell to an all-time record low of 3.49% and the average rate on a 15-year fixed mortgage dropped to a new record low of 2.77%. The rate declines were at least partly a reaction to the Fed's recent "QE3" announcement.

The historically low mortgage rates continue to attract consumers to refinancing and purchase mortgage loans. According to the Fed's survey in April which covered about 60 large domestic banks and 24 branches and agencies of foreign banks, demand for prime residential mortgage loans strengthened moderately in the first quarter of this year. In the July survey, a relatively large portion of the banks reported having experienced stronger demand for prime mortgage loans over the second quarter. Despite continued strict underwriting standards, more mortgages are being approved by lenders. For instance, Wells Fargo, which is the largest mortgage lender in the country, reported that its mortgage originations for the second quarter of this year were $131 billion, more than double from a year ago. Further, tough underwriting standards do not affect real estate investors who typically pay all-cash. This type of buyers accounted for 18% of existing home buyers in August, according to the NAR.

Existing Home Inventory is Limited

Despite apocalyptic predictions, the shadow inventory does not appear to have impaired the housing market recovery to the extreme extent that was widely expected. In its August report, the NAR said that while inventories of existing homes are broadly balanced, the markets in the western region of the country and Florida are experiencing inventory shortages. There is substantial anecdotal evidence that potential home buyers are looking at new homes, after being frustrated by the lack of existing home inventory and the hassle of buying foreclosed homes.

Existing home inventory is lower than expected for several reasons. For one, investors (as opposed to owners/occupants) are buying foreclosed homes in bulk to turn them into rentals and take advantage of a very strong rental market. According to the Businessweek article "Private Equity Bets Billions on Foreclosures" dated July 26, 2012, major institutional investors including Colony Capital, Blackstone Group, Kohlberg Kravis Roberts, and Och-Ziff Capital Management plan to spend at least $7.2 billion to buy foreclosed single-family homes. In the article "Boost for Foreclosure Market" dated September 16, 2012, the Wall Street Journal reported that Colony Capital owns about 3,600 homes and hopes to reach 10,000 by next spring. Waypoint Real Estate Group, another major investor in the single-family real estate market with more than 2,200 homes, plans to build the portfolio up to 11,000 units by the end of next year. Recently, Waypoint successfully obtained debt-financing from Citigroup to help expand its portfolio. Further availability of such financing would help speed up the process of absorbing this shadow inventory.

Another reason for the lean existing home inventory is that banks have been slow to release REOs into the market. Daren Blomquist, Vice President of RealtyTrac, wrote for the RealtyTrac News Room on July 13, 2012 that the company estimates only 15% of REOs are being listed for sale. Further, RealtyTrac reports that pre-foreclosure sales (typically short sales) increased to a 3-year high in the first quarter of this year; such sales mean the related properties are not taken in as REOs. Short sales, which are facilitated by lenders' willingness to write down loan balances, can be priced to move. Finally, there are homeowners who can afford to continue paying their mortgages, but are tempted to default because of negative equity in their homes. As housing prices rebound and negative equity turns positive in some cases, a portion of these homeowners might decide to save their homes.

Buyer Psychology

People who can afford to buy would naturally be hesitant to buy if they think they can get a house more cheaply tomorrow. But once prices stabilize and turn (as they seem to have done in many parts of the country), potential buyers will start worrying about "missing the train" and rush to buy. This can turn a downward spiral into an upward spiral as increasing demand pushes up prices, drawing even more anxious buyers into the market and boosting prices. As just one particularly notable example, the number of San Francisco homes sold in August rose year-over-year by 14.2%, with their median price rising year-over-year by 10.8%, according to DataQuick. Earlier this year, a local brokerage in the Bay Area, Pacific Union, blogged about receiving 27 bids for one home, and that more than two-thirds of the homes it sold in first quarter of this year saw multiple bids.

Although hurdles remain, the odds are good that the recent turn in the housing market will stick. Homebuilders are likely to enjoy good growth in the next few years, as the cycle finally turns up.