Understanding the Significant Decline in Housing Affordability and What it Means for Rental Demand

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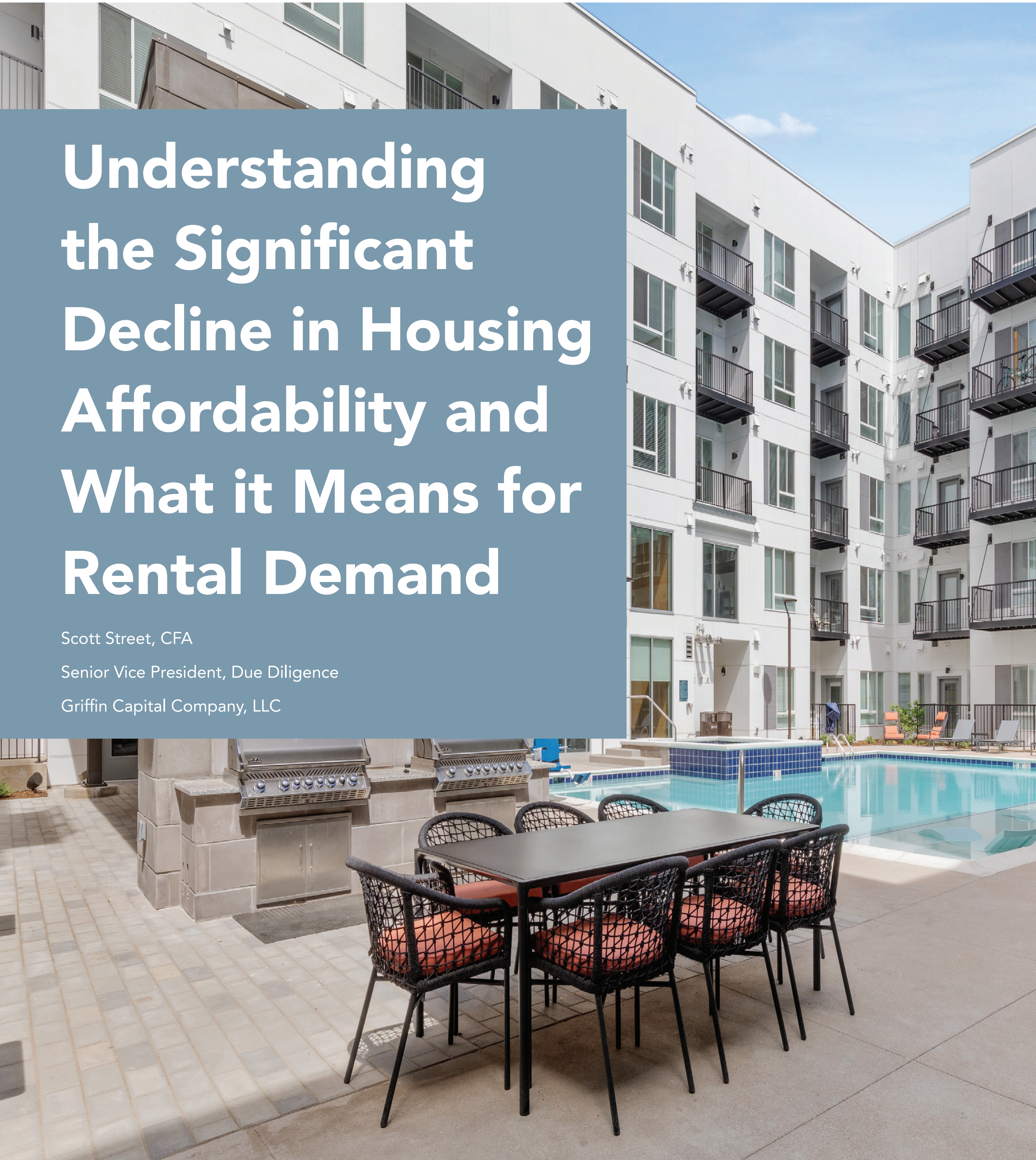


The American dream of homeownership has become increasingly further out of reach for a larger segment of the population fueling demand for alternative housing and creating a deeper pool of renters.

As of June 30, 2022, the median sale price for homes in the U.S. had grown 36.5% over the previous two years reaching a record high of $440,300, which represents a 111% increase over the prior cycle low of $208,400 in Q1-2009 and a 71% increase over the pre-Global Financial Crisis ("GFC") high of $257,400 in Q1-2007.[1] Putting further pressure on the ability for first time home buyers to enter the market, is the fact that wages have not grown at nearly the same pace. According to the NAHB/Wells Fargo Housing Opportunity Index, only 56.9% of homes are considered affordable to those earning the median income in their area, a dramatic fall from 78.8% as of March 31, 2012. This dynamic is even more exaggerated in many locales such as Los Angeles, the most unaffordable city in the country, where only 8.3% of homes are considered affordable. For those that cannot afford to own a home, renting is often the best option.

The increased demand for rental housing due to housing affordability challenges, changes in demographics and other factors has catalyzed rents to rise significantly, though not nearly at the rate of home prices. Nationally, rents grew 15.5% year over year as of March 31, 2022. Within certain high-growth markets such as Tampa, Phoenix and Austin, multifamily rents rose even more dramatically, growing 27.6%, 25.6% and 23.9%, respectively.[2] Whether by choice or necessity more and more Americans are choosing to rent instead of own, as evidenced by the homeownership rate which has steadily declined over the past two decades to 65.4%[3].

For those focused on the housing market, the question is whether the rapid decline in housing affordability and increased propensity to rent is simply transitory in nature, or something more persistent, that will have a lasting impact both on housing policy and investment activity. To answer this question, one needs to examine a variety of factors that are impacting housing dynamics.

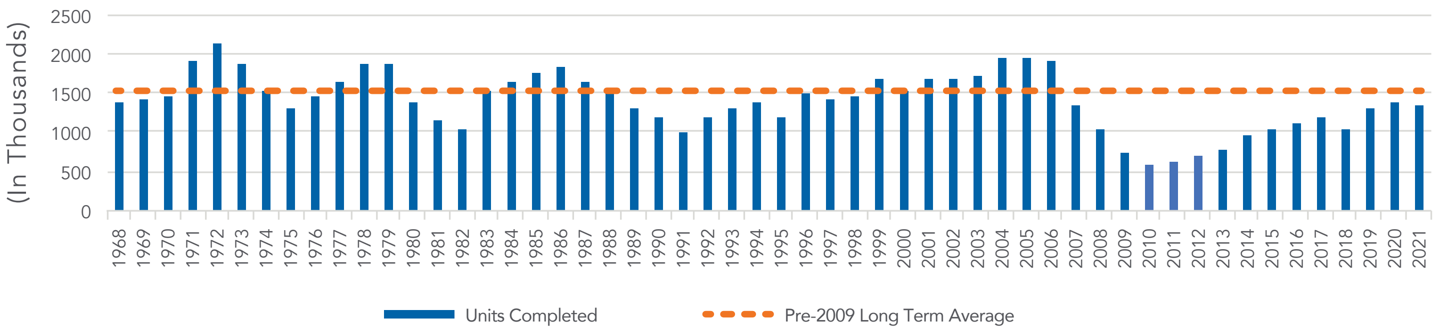
Supply

According to Freddie Mac, the U.S. had a housing shortage of 3.8 million homes as of 2020.[4] In the single-family market, this shortfall is evident not only in the price of homes but also the median number of days properties are on the market, which stood at 96 days at the beginning of 2017 and has since fallen dramatically to 32 days at the end of June 2022.[5] In the rental market, the shortfall can be seen by vacancy rates, which went from a high of 7.0% in 2009 to 2.3% in the first quarter of 2022.[6]

1. U.S. Census Bureau and U.S. Department of Housing and Urban Development, Median Sales Price of Houses Sold for the United States [MSPUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MSPUS, July 26, 2022.
2. CBRE U.S. Multifamily Q1 2022 report
3. U.S. Census Bureau, Homeownership Rate in the United States [RSAHORUSQ156S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/RSAHORUSQ156S, July 5, 2022
4. https://www.freddiemac.com/research/insight/20210507-housing-supply
5. Realtor.com, Housing Inventory: Median Days on Market in the United States [MEDDAYONMARUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MEDDAYONMARUS, July 5, 2022
6. CBRE Research. "Multifamily Market Fundamentals Strengthen in Q1. https://www.cbre.com/insights/figures/q1-2022-us-multifamily-figures.

So how did we get to this crisis-level inflection point? Between 1968 and 2008, the U.S. delivered an average of 1.5 million new housing units per year.[7] That number stayed relatively consistent during that time peaking in the run up to the GFC at 2.25 million. The spike in foreclosures that occurred during the GFC caused existing homes to flood the market. The median home price sank to $208,400 in the first quarter of 2009[8] and, as a result, the cost to develop new homes often exceeded the price of existing properties, eliminating any profit developers could generate. This caused average annual new deliveries between 2010 and 2012 to sink to 617,000 units, a nearly 60% decline from the previous historical average. As home prices bottomed and again began to rise, so too did development activity. However, the distress of the GFC reduced the availability of construction financing, tightened credit standards and led to a more cautious outlook from developers and lenders who had suffered heavy losses during the recession. As a result, deliveries between 2013 and 2021 averaged only 1.1 million, or roughly 380,000 per year less than the pre-GFC long-term average.

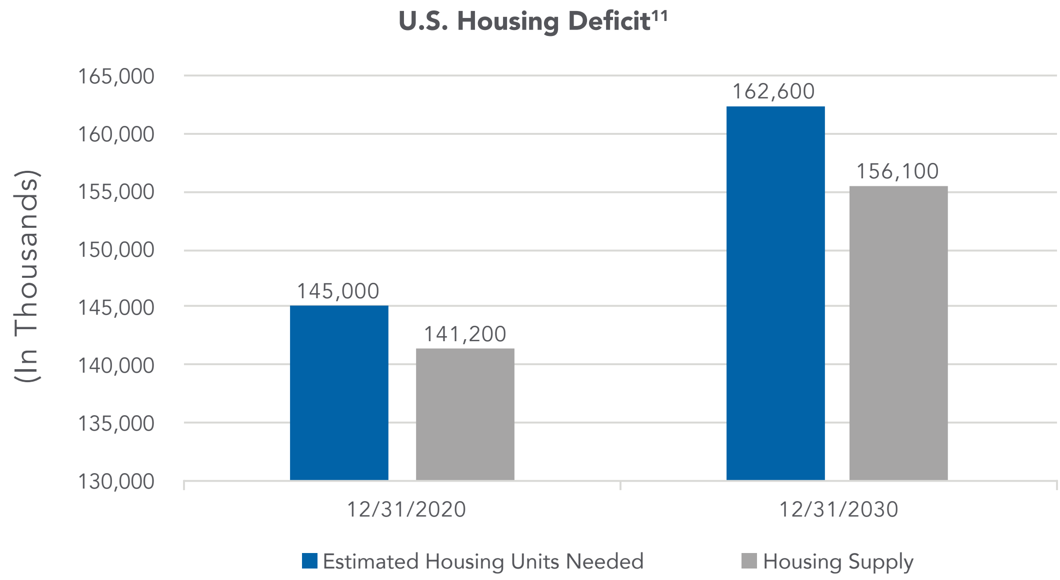
U.S. Privately-Owned Housing Completions



Source: U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Privately-Owned Housing Units Completed: Total Units [COMPUTSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/COMPUTSA, July 5, 2022.

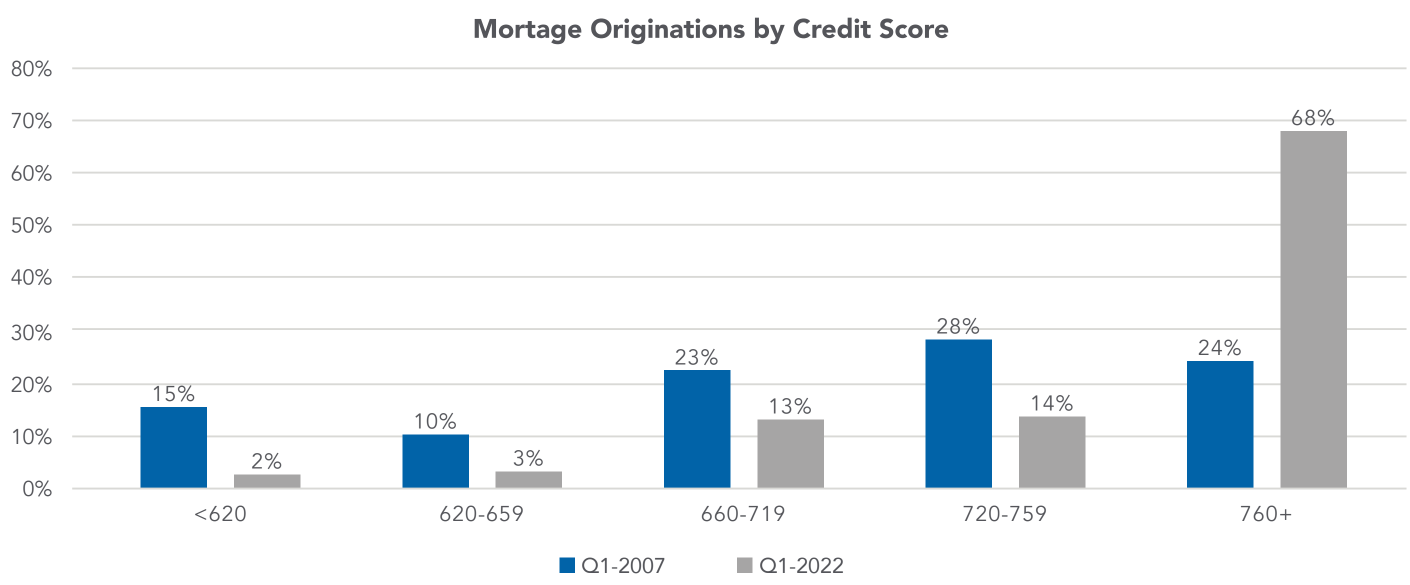
Additional development is needed to overcome the shortfall but as is the case when trying to overcome any deficit, a return to historical levels alone will not be sufficient to get back to equilibrium. The U.S. Census projects that by 2030, the U.S. population will increase to 355.1 million.[9] As of the end of 2021, the total U.S. housing supply stood at 142.6 million units. Based on the current average household size of 2.51 people[10] and Freddie Mac's target vacancy rate of 13%, which they believe is the level needed to maintain a well-functioning housing market that requires some vacant properties for sale and for rent, this means that roughly 20 million additional housing units are needed to keep pace with population growth. If the U.S. only produces the pre-2009 long-term average of 1.5 million units per year, this will result in a shortfall of approximately 6.5 million units.

7. U.S. Census Bureau and U.S. Department of Housing and Urban Development, New Privately-Owned Housing Units Completed: Total Units [COMPUTSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/COMPUTSA, July 5, 2022
8. U.S. Census Bureau and U.S. Department of Housing and Urban Development, Median Sales Price of Houses Sold for the United States [MSPUS], retrieved from FRED, Federal Reserve Bank of St. Louis
9. U.S. Census Bureau, Population Division: Washington, DC Projected Population Size and Births, Deaths, and Migration: Main Projections Series for the United States, 2017-2060
10. U.S. Census Bureau, Current Population Survey, March and Annual Social and Economic Supplements



Tightening Financial Conditions

In addition to the significant supply shortfall, tighter underwriting standards have also had a significant impact on would be home buyers. The securitization boom of the early 2000s and the role that the easy credit environment of that era played in the financial crisis that followed resulted in a reaction from regulators and lenders that has tightened the availability of credit, making it more difficult for homebuyers to access credit markets and consequently shrinking the pool of those able to qualify for home loans. In the first quarter of 2007, 15% of mortgage originations were to borrowers with a credit score of less than 620 and only 24% were to borrowers with a credit score of 760 or higher. However, in the first quarter of 2022, only 2% of originations were to borrowers with a credit score of less than 620 and 68% were to those with scores of 760 or higher.



Source: New York Fed Consumer Credit Panel/Equifax

11. https://www.freddiemac.com/research/insight/20210507-housing-supply

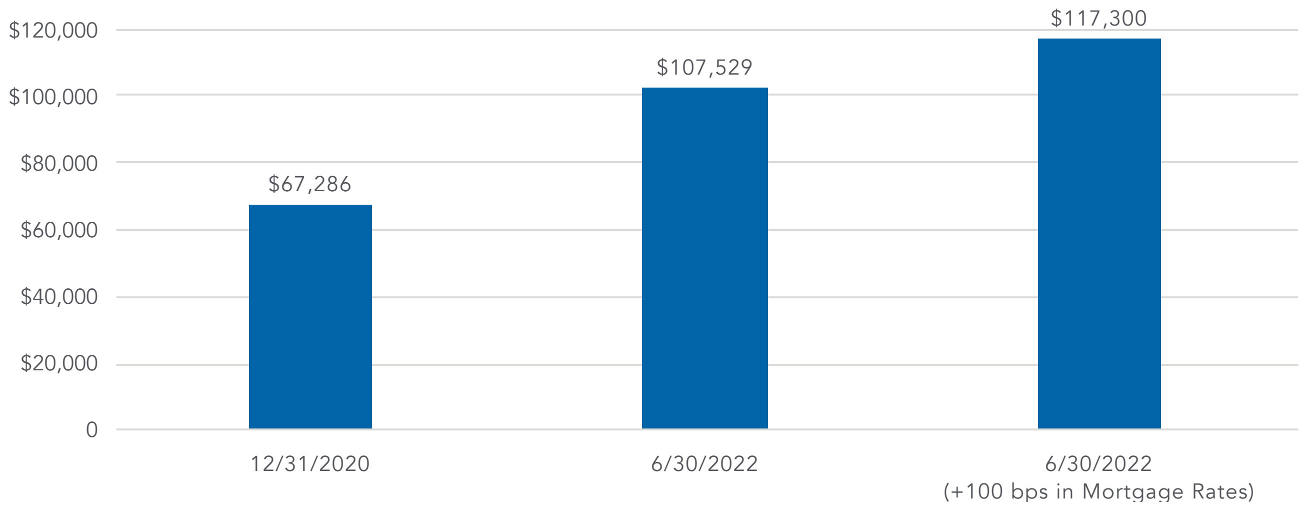
Credit requirements weren't the only factor that became more onerous after the GFC, down payment requirements increased as well. In 2006 and 2007, it was easy to obtain a mortgage without putting any money down. Today, the minimum down payment is generally 3.5% for an FHA loan and 5% for most conventional loans. Any down payment less than 20% of the purchase price typically requires private mortgage insurance ("PMI"), which can increase the monthly cost of a mortgage significantly. For those that want to avoid PMI, the amount of money required as a down payment to purchase a home at the median sale price has more than doubled from $41,680 as of March 31, 2009 to $88,060 as of June 30, 2022 given the significant rise in home values. A recent survey by Northwestern Mutual found that the average personal savings, excluding funds earmarked for retirement, only totaled $62,086, far short of the amount needed to afford a down payment at current values.[12] The situation is even more dire for younger cohorts, with 63% of millennials indicating that they had no money for a down payment on a house and only 15% indicating that they had $10,000 or more saved as of February 2021.[13]

Higher home prices translate to larger mortgages which require higher mortgage payments. Just as tighter lending requirements and larger down payments have slashed the number of prospective home buyers, so too has higher monthly mortgage payments. The combination of larger mortgages, and rising interest rates, is creating additional pressure on the prospective home buyer and existing homeowner.

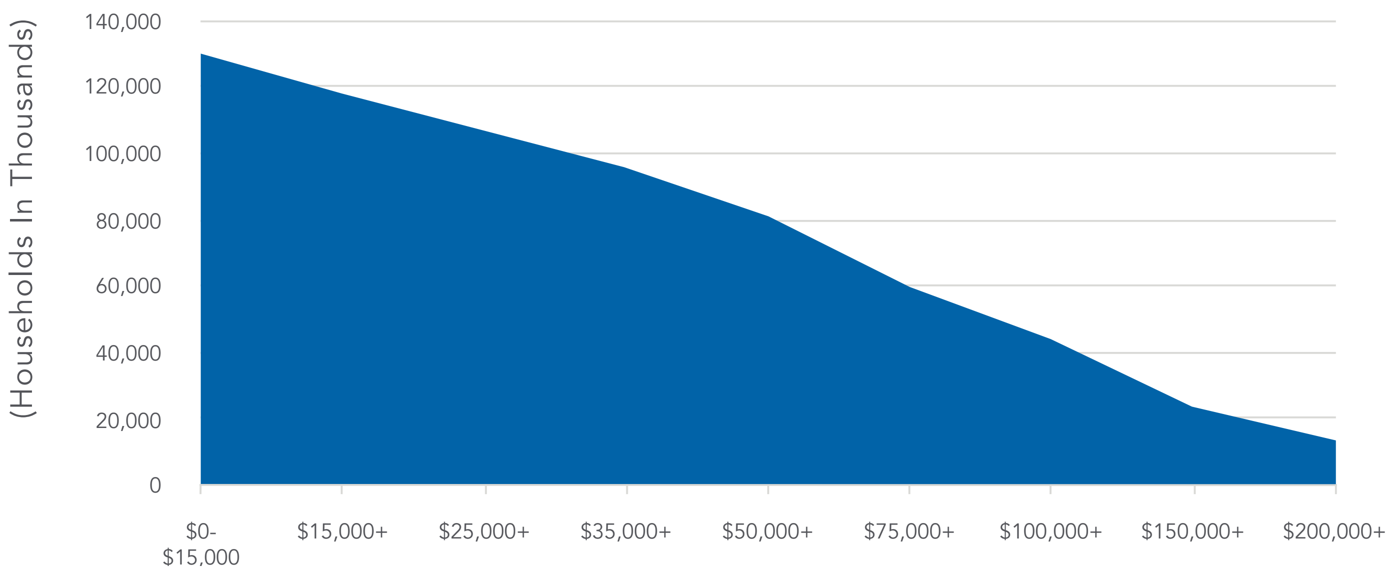
At the end of 2020, 30-year mortgage rates hit an all-time low of 2.67%, which helped to offset the rise in the average loan amount for many borrowers and helped push home values higher.[14] Rates have since risen 287 basis points to 5.7% as of June 30, 2022, and, as a function of that rate movement, the monthly mortgage payment on a 30-year loan with 20% down at today's median home price is 60% higher than it was only a year and a half ago. Based on a mortgage debt-to-income ratio of 28%, the estimated amount of income required to purchase a home today is $107,529 vs. $67,286 at the end of 2020. Comparing that to the median household income of $67,521 at the end of 2020, one would conclude that most Americans do not have the income needed to afford a home. The current rise in inflation also presents the risk that interest rates could rise further and puts pressure on potential home buyers' cash flow. Should the 30-year mortgage rate rise an additional 100 basis points in the future to 6.7%, the income required to purchase a home would rise to $117,300, resulting in millions of additional households being unable to afford a home.

12. Northwestern Mutual Life Insurance Company, 2022 Planning & Progress Study
13. Apartment List Renter Survey, February 9, 2021
14. Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US, July 26, 2022

Annual Income Required to Qualify for a Home Mortgage[15]



Number of U.S. Households by Income Tier



Source: U.S. Census Bureau, Current Population Survey, 1968 to 2021 Annual Social and Economic Supplements (CPS ASEC).

15. Assumes property taxes equal to 0.79% of the property value, property insurance premiums of $175 per month and a mortgage debt-to-income ratio of 28%

Conclusion

Chronic supply issues that are the product of decades of underproduction, changing population demographics, elevated home values, limited wage inflation and tighter credit conditions have led to systemic housing issues that are unlikely to be resolved in the near-term. These dynamics are creating a deeper renter pool and secular demand for alternative housing. While this demand has pushed rents higher, the cost to rent continues to be far less than the all-in cost of homeownership. The increased propensity to rent can be expected to continue and is likely to result in predictably strong rent growth for years to come. New development in both the single-family and multifamily sectors is desperately needed to address these housing shortfalls and affordability challenges and provide the necessary shelter for American families.

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