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Millennials Defy Stereotype

Special Issue on the Housing Market

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The financial crisis deferred and delayed but did not destroy millennials' plans to purchase homes. Most of the increase in homeownership during the last year was among first-time buyers.

Older millennials who are now in their mid-30s are doing particularly well; they graduated ahead of their younger siblings with fewer student loans and found better jobs after graduating. Some are even able to buy more expensive, larger homes where they may stay for longer than they would have in starter homes. They want backyards where their kids and dogs can play and good schools. They are even moving out to the suburbs. Sound familiar?

The websites of the government-sponsored enterprises (GSEs) - Fannie Mae, Freddie Mac and Ginnie Mae - are filled with tips for lenders on how they can help younger, more indebted, but also highly educated millennials qualify for secured loans. Nonbank mortgage issuers who fly below the radar of regulators are also back. So are a small cadre of lenders willing to issue nonconforming and subprime loans that will be sold to investors without the backing of the GSEs.

That debunks the widely held and overly-marketed notion that millennials would never buy homes. They were viewed as a new breed who were unwilling to commit and conform to traditional patterns of behavior, opting instead to live in urban cores

Housing outlook

	2016	2017	2018
Home sales*†			
Total	5941	6153	6276
Existing	5380	5536	5646
New	561	617	630
Home starts*			
Total	1177	1208	1309
Single	784	851	928
Multi	393	357	381
Pricies**			
Medium existing single	6.4	6.0	6.5
S&P case-shiller	5.1	5.9	7.5
FHFA	4.4	4.9	5.1

† Includes condos, coops, and single-family homes.
* Thousands of units
** Annualized growth rate

Year Starts Slowly

Real GDP is expected to slow to a 1.5% pace in the first quarter of 2018, almost half of the pace during the fourth quarter of 2017. The payback to the holiday season and fourth quarter surge has been greater than expected. Housing gains are tepid so far this year but we expect that to change. Investment in new equipment held up in the beginning of the year as government spending posted modest gains while the trade deficit widened fairly dramatically. At least a portion of the loss in trade, however, can be attributed to a one-time, one billion-dollar payment associated with the Olympics in South Korea.

Prospects for the second quarter are better with growth returning to close to 3%. Recent employment gains and what appears to be a firming in wages should give consumer spending a lift along with housing. Orders for new equipment remain solid although little appears to be in response to changes in the tax laws. Trade is the wild card along with escalating tensions in the Middle East. A shift in focus to Iran could push up oil prices and feed uncertainty in the future.

Powell Fed Primed for a June Hike

The Federal Reserve is expected to raise rates for a second time this year during the June meeting. The meeting in May will be used to set up the move. The forecast holds for at least three more rate hikes this year, barring further shifts in geopolitics.

> "There are concerns that rising prices are undermining mobility and employers' ability to hire workers in large urban areas."

within walking distance of their favorite coffee shops and mass transit. They did delay marriage and childbearing while renting for longer than other generations but did not give up on the "American Dream" of home ownership as many had predicted.

A poor economy, the housing bust and a surge in prices at the gas pump were behind those different choices early in the expansion. Many could not afford to commute from the suburbs when oil prices crossed the $100-per-barrel mark between 2011 and 2014. The percentage of young adults either staying home or returning to live with their parents also jumped in the wake of the financial crisis.

As that is now shifting, millennials are finally getting some of the respect they deserve; realtors are focusing on them in ways they hadn't in the past, viewing them as potential owners instead of perennial renters. Unfortunately, the tentacles of the crisis were long and threaten affordability in the hottest markets. Inventories of homes for sale continue to hover near record lows while rents in all but the most overbuilt of cities are rising.

Conversely older renters, some of whom bought and lost homes with subprime loans, are giving up on buying entirely. Many simply can't afford to buy, given the escalation in housing prices and post-crisis curbs on subprime lending.

This special edition of Economic Currents takes a closer look at the forecast for housing in 2018. Special attention will be placed on millennials and the impact their entrance into the ranks of homeowners will have on the housing market. Demand is expected to continue to outpace supply, which will push prices up even further and stretch the limits of affordability in the most popular markets. There are concerns that rising prices are undermining mobility and employers' ability to hire workers in large urban areas.

Relocation budgets, which were reduced along with training budgets since the end of the tech bubble in 2001 will have to be rethought. Employers who can help workers relocate will be able to attract more talent than those who don't. Some may even have to consider subsidies for mortgages and rents in the most expensive markets; wage differentials don't fully compensate for the cost differences. Some large employers have also started to move to less expensive secondary markets; their success in attracting talent has been mixed but may improve as the costs in the hottest markets become unbearable.

The table lays out a summary of our 2018 housing forecast:

- Sales of existing homes are expected to approach a 5.7 million unit annualized rate, the strongest pace in the expansion but still 20% below the peak in 2005. Condo sales are expected to pick up faster than single-family home sales because of the shortfall in inventories.
- New home sales are forecast to reach 630,000, still only half of the peak level in 2005.
- Housing starts are expected to rise to 1.3 million units in 2018 with a small rebound in the multifamily housing market adding to gains in the single-family market. The volume of construction in the housing market is likely to remain nearly 60% below the 2005 level and well below demand.
- Home prices will accelerate between 5 and 7.5%, depending on the measure, and set new highs in 2018.
- Underlying Fundamentals

In many ways, 2018 represents a tipping point for the housing market:

- Our forecast shows real GDP growth reaching 2.7%, the fastest pace since the onset of the expansion;
- We expect unemployment to fall to the lowest level since the late 1960s;
- Labor shortages are intensifying;
- Wages are poised to accelerate across skill levels;
- Credit will ease further for mortgages despite a predicted uptick in mortgage rates.
- First-time home buyers are back in force.

Homeownership will rise slightly but remain well below the unsustainable highs of the housing market bubble. The real concern is prices stretching the limits of affordability, especially for low-wage workers forced to move to the farthest suburbs and become what one affordable home developer worries is a "new class of the suburban poor."

> "The volume of construction in the housing market is likely to remain nearly 60% below the 2005 level and well below demand."

Home Sales

Existing home sales are expected to continue to edge modestly higher in 2018. Tight supplies are the primary constraint. Much of the existing inventory deteriorated during the early years of the crisis, which has left current homeowners with older homes in need of more repairs compared to previous housing market cycles.

A recent study by Zillow underscores the costs associated with selling a house. Rising values have increased closing costs, which represent a percentage of the sales price, while older homes need more repairs before they are ready to list for sale. Zillow estimates that sellers need to come up with more than $18,000 for closing costs and repairs to on a house valued at just over $240,000. This comes as a shock, as many sellers are first-time sellers and have not had to deal with the transaction, let alone prep costs associated with selling a home.

Those costs, coupled with the higher prices of trade-up homes, have prompted older homeowners - mostly baby boomers - to renovate instead of attempting to sell and trade up. The few homes that do make it to market often need a long list of repairs. We didn't invest in our homes when values were falling; that has left the few houses that are on the market far from move-in ready.

Hurricanes, fires and floods in late 2017 and early 2018 further damaged properties and stretched the availability of contractors who were already scarce. Shortages of wallboard following the floods in Houston forced many major producers to reroute supplies from other parts of the country. Some took a blow on margins when more of the wallboard was routed to building supply stores, instead of builders, where pricing is more competitive. That reduced supplies and limited resources for upgrades and repairs on older homes for first-time buyers elsewhere.

An overhang of student debt is exacerbating the problems but not in the way most assume. The level of debt is less the problem than the kind of debt. Defaults by the poorest borrowers, who took on debt to attend for-profit schools, remain the highest. The next highest levels are among African Americans from less affluent families. A recent study by Brookings shows they are five times as likely to default as their white counterparts, even when the white students drop out. African American students are less likely than their white counterparts to get help from their families in servicing their debt.

The increased burden that student debt places on those families who are able to help their children may have a secondary effect. It may be one of many reasons that baby boomers are not selling. They would be more reluctant to trade up and take on the additional mortgage expense associated with doing so if they are servicing their child's student debt.

Housing Construction

Housing starts are forecast to rise 9% percent to 1.3 million units in 2018. Single-family housing starts are also expected to rise 9% to reach 928,000 this year. That's good, but not good enough to prompt materials producers to expand their capacity much. Materials producers I have spoken with are waiting to see single-family housing starts stabilize at a one million unit pace before they reopen and retool idled plants. They tell me they can't justify the costs of opening plants - some of which have been closed since 2006 - until demand hits that threshold on a sustained basis. It is worth noting that the producers who weathered the crisis suffered major losses. Almost all materials producers, from the lumber to wallboard industry, were forced to sell off their inventories below cost in the wake of the bust in housing construction,

Escalating land, materials and labor costs are all raising the costs of construction and preventing builders from moving downstream to build less expensive homes. Tariffs on lumber are another problem as they have added to costs. Multifamily and commercial builders say they are concerned about how steel tariffs will affect their costs.

We don't have the usual adjustment in supply to meet growing demand from first-time millennial buyers even when they are willing to pay up. One estimate from the Urban Institute that was presented at the National Association for Business Economics annual policy conference in late February suggested that the shortfall in new single-family home construction could be in excess of 300,000 units.

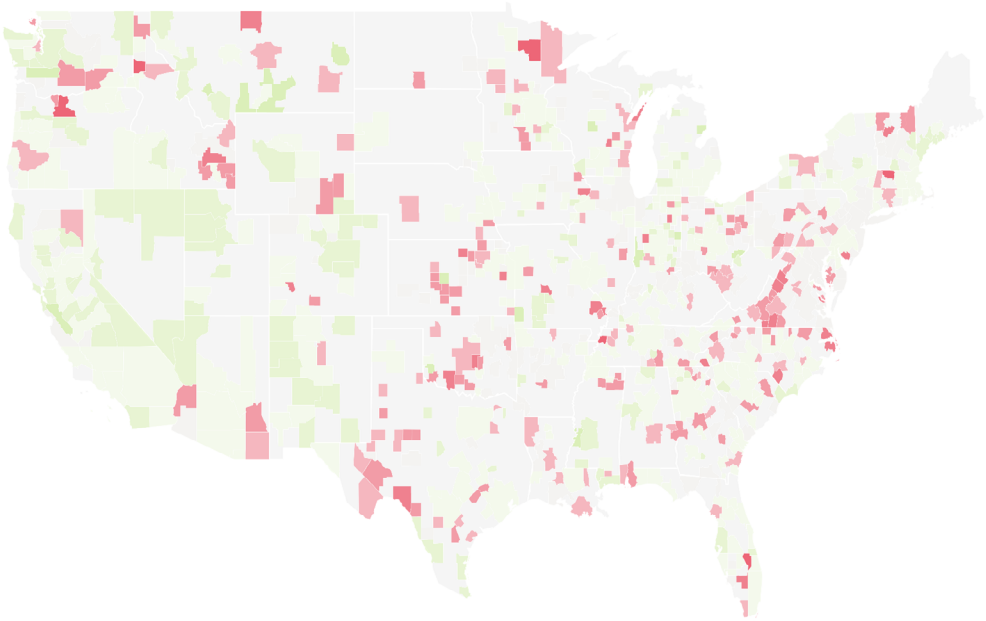
The quality of manufactured housing is improving and may eventually offer an alternative to those looking for affordable housing. The problem is scale. There are very few producers of manufactured housing. None have the necessary scale to move the needle enough to meet demand.

California has begun to ease the permitting process, which should make it a bit easier for developers to build less expensive, more affordable homes. The number of permits rose after a package of new laws passed late last year. Escalating land-use costs, however, is a national problem. Even the South where, historically, the most affordable new housing has been constructed is facing rising land-use costs. Employers and builders have told me about escalating construction costs; affordability is limiting mobility and getting workers to where the jobs are.

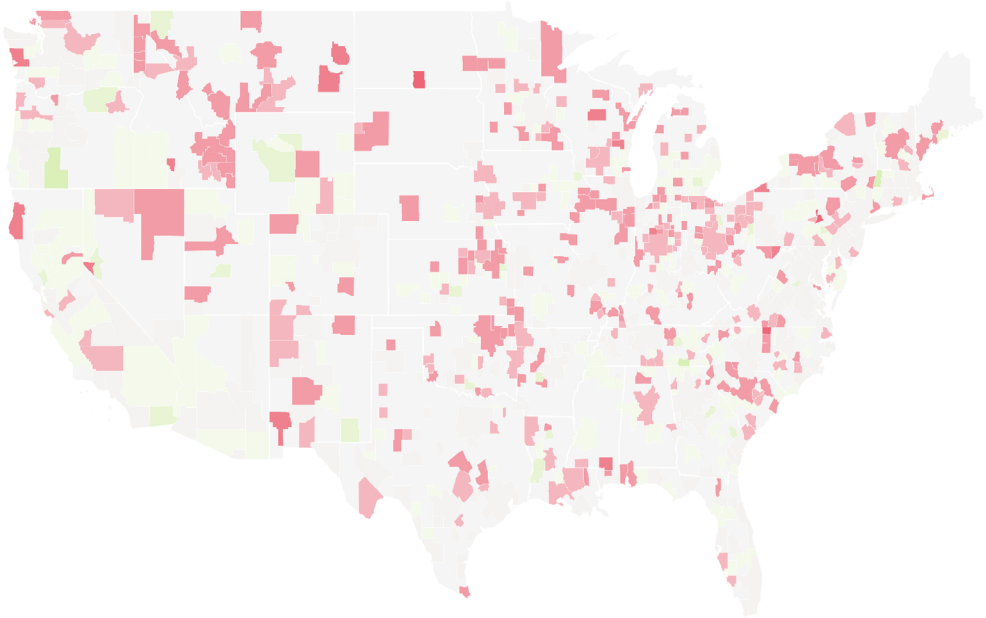
The multifamily market is a different animal; it is now overbuilt in some secondary markets such as Denver. Landlords are offering incentives, including a month or more free. Posted rents rarely decline, which makes actual rents harder to track. A posted drop in rents could violate a developer's loan covenants. (See the map for the hottest and coolest rental markets.) The greatest acceleration in rents over the last year occurred in Boston, Los Angeles and Minneapolis; the largest deceleration was in Seattle, Charlotte and Baltimore. Seattle and Charlotte, however, are fundamentally much stronger markets than Baltimore.

Rising rents in the hottest markets and millennials' desire to buy instead of rent have fueled demand for condos. This, coupled with the push to continue to build in the most expensive markets, suggests a moderate rebound for multifamily starts this year.

Housing trends
Housing prices (owner-ccupied)



Rents



Dark red areas are experiencing relatively great, negative growth while dark green areas are experiencing relatively greater, positive growth. Growth rates are annualized and drawn from February, 2018 observations. The observational units are a mix of Census Business Statistical Areas (i.e. "metro areas") and counties (for cases where the county is not in a metro area). Areas that lack data are in light grey. The house prices are based on the Zillow Home Value Index. The rental prices are based on the Zillow Rental Index.

Source: Zillow and authors' calculations.

> "Price is the ultimate equalizer in economics. Either higher home prices will prompt a lot more construction or…housing could become unaffordable and force more would-be home buyers to drop out"

Home Prices

Home prices are expected to rise between 5 and 7.5 percent depending on the measure. The map provides a sense of where the fastest and slowest appreciating markets are located. The markets with the highest demand, on the East and West Coasts, have been the most stable in recent years.

We may see some small shifts due to recent changes in tax laws and the near elimination of state and local tax deductions. The largest effect is not necessarily in the expensive markets, where less affluent homeowners will be forced to move; there are still plenty of wealthy buyers to take their places. The larger effect will be on home prices where the less affluent move; those home values will rise even faster than they otherwise would have.

Improving incomes, tight supplies and the ongoing push from older millennials to buy and settle down will keep prices rising in 2018. Easier credit will help dampen the drag from higher mortgage rates and keep demand from first-time buyers elevated. The return of subprime lenders is still too small to make much of a difference, especially in the top markets. We should keep a watch on how fast those lenders are expanding into second-tier markets and more distant suburbs where many low-wage workers are giving up on ownership and renting instead; this trend creates a different set of problems for home values in those areas.

The only offset is a recent drop in investment by China, which halved in the U.S. last year. So far, however, those losses have not shown up in weaker real estate values, at least not in the housing market. The impact of a loss in Chinese investment in the broader real estate market could be more pronounced over time.

Bottom Line

I recently asked a group of CEOs how they thought the average tenure of young workers had changed over the years. They were unanimous in their responses; they all firmly believe that tenure among millennials is significantly lower than that of other generations. The actual data on the tenure of 25-34 year olds tells a different story; tenure among that age group was a stable 2.8 years from 1983 to 2015. Higher turnover rates in recent years were driven more by the fact that millennials dominate the labor force in numbers, rather than a change in their behavior relative to earlier generations. In fact, the tenure of workers in their 20s actually went up during the height of the crisis when jobs were scarce.

I raise this point because it underscores how misunderstood and mischaracterized millennials have become as a generation. They have intensified the trends seen among baby boomers rather than reversed them. Marriage and childbearing were deferred as they achieved high levels of education, most notably among women, focused on getting their careers on track and saved for down payments. The financial crisis and increase in student debt appear to have exacerbated those trends; they did not, however, change the fundamental desire to own a home.

The challenge will be to meet the demand with increased supply, which has proven more difficult in the wake of the crisis. Price is the ultimate equalizer in economics; either higher home prices will prompt a lot more construction or, given the hurdles to new construction, housing could become unaffordable and force more would-be home buyers to drop out of the market. Historically, rising mortgage rates were the primary factor curbing demand; soon, rising prices could exacerbate those effects. It is useful to remember that housing corrects before other sectors of the economy when we are heading into a recession; we are not there yet.

Economic forecast — April 2018

	2017	2018	2019	2017:4	2018:1	2018:2	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National outlook												
Chain-weight GDP[1]	2.3	2.7	2.9	2.9	1.5	2.9	3.4	3.2	2.9	2.6	2.48	2.33
Personal consumption	2.8	2.5	2.6	4.0	1.2	2.8	2.7	2.6	2.4	2.7	2.71	2.62
Business fixed investment	4.7	5.8	6.1	6.8	5.1	5.1	6.5	6.7	6.7	5.7	5.4	5.03
Residential investment	1.8	1.4	2.6	12.8	-4.6	5.6	2.2	2.0	1.5	2.1	3.88	4.67
Inventory investment	15.2	63.3	78.3	15.6	59.8	53.4	67.5	72.3	79.5	81.1	77.73	74.79
Net exports	-621.8	-712.4	-764.8	-653.9	-688.3	-708.2	-717.3	-726.0	-739.7	-755.3	-773.12	-790.93
Exports	3.4	4.2	6.3	7.0	1.4	4.6	6.8	6.8	6.0	6.2	6.67	6.78
Imports	4.0	6.5	6.6	14.1	7.4	4.9	6.4	6.3	6.4	6.8	7.41	7.44
Government expenditures	0.1	1.8	2.0	3.0	0.9	2.3	2.6	3.2	2.3	1.3	0.82	0.31
Federal	0.2	3.1	3.1	3.2	0.9	2.3	5.1	5.7	3.6	1.2	0.26	-0.64
State and local	0.1	1.1	1.3	2.9	0.8	0.6	1.2	1.7	1.6	1.3	1.16	0.89
Final sales	2.4	2.4	2.8	3.4	0.5	3.0	3.0	3.1	2.7	2.6	2.56	2.4
Inflation												
GDP deflator	1.8	2.1	2.5	2.3	2.3	1.5	2.3	2.3	2.6	2.6	2.56	2.66
CPI	2.1	2.3	1.7	3.3	3.6	1.2	1.9	1.1	1.2	2.1	2.17	3.14
Core CPI	1.8	2.3	2.4	2.2	3.0	2.3	2.4	2.3	2.3	2.4	2.46	2.53
Special indicators												
Corporate profits[2]	2.7	3.0	5.0	2.7	2.3	2.9	1.1	3.0	6.8	6.9	5.64	5
Disposable personal income	1.2	2.5	3.8	1.1	3.8	2.3	3.3	3.9	5.6	3.2	2.97	2.51
Housing starts (mil.)	1.2	1.3	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.4	1.36	1.37
Civilian unemployment rate	4.4	4.0	3.7	4.1	4.1	4.0	3.9	3.8	3.6	3.6	3.68	3.7
Total nonfarm payrolls (thous.)[3]	2176.7	2707.9	2071.0	556.3	673.6	599.8	688.5	746.1	709.8	568.4	402.48	390.37
Vehicle sales												
Automobile sales (mil.)	6.3	5.6	5.4	6.3	5.7	5.7	5.6	5.5	5.5	5.4	5.4	5.4
Domestic	4.5	4.1	3.9	4.6	4.1	4.1	4.0	4.0	4.0	3.9	3.9	3.9
Imports	1.7	1.6	1.5	1.7	1.6	1.6	1.6	1.5	1.5	1.5	1.5	1.5
Lt. trucks (mil.)	10.9	11.3	10.5	11.5	11.5	11.3	11.2	11.0	10.7	10.6	10.5	10.2
Domestic	9.0	9.1	8.6	9.4	9.3	9.2	9.1	8.9	8.7	8.6	8.6	8.3
Imports	1.9	2.1	2.0	2.1	2.2	2.1	2.1	2.1	2.0	2.0	1.9	1.9
Combined auto/Lt.truck	17.1	16.9	16.6	17.8	17.2	17.0	16.8	16.5	16.2	16.0	15.9	15.6
Heavy truck sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Total vehicles (mil.)	17.5	17.4	16.4	18.2	17.7	17.5	17.3	17.0	16.7	16.5	16.3	16
Interest rate/yields												
Federal funds	1.0	1.8	2.6	1.2	1.4	1.7	1.9	2.1	2.3	2.6	2.73	2.75
10-year treasury note	2.3	3.0	3.5	2.4	2.8	2.9	3.1	3.3	3.4	3.5	3.53	3.57
Corporate bond BAA	4.4	4.8	5.3	4.3	4.5	4.7	4.9	5.1	5.2	5.3	5.41	5.47
Exchange rates												
Euro/Dollar	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.21	1.21
Dollar/Yen	112.1	105.8	101.1	112.9	109.7	109.1	108.1	107.2	106.2	105.0	103.96	102.94

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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