November 07, 2018

Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Home Sales Remain Soft

Home Sales Are Slowing but the Apartment Market Is Catching a Second Wind

The economy does not simply grow or contract but rather is constantly evolving. This evolution is readily apparent when gauging the housing market. Sales of both new and existing homes have been weakening for the past six months and home price appreciation has finally broken from its earlier breakneck pace, even in many of the nation's hottest housing markets. Inventories remain tight but are now growing again, and bidding wars are far less common. Buyers now have a little more negotiating power—something that used to be the norm. We term the current environment as a soft sellers' market, as sellers remain in a stronger position than buyers due to the continued lack of supply in desirable markets. Buyers are a little more hesitant, however, due to higher mortgage rates and the impact of tax reform on higher priced homes.

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The persistent slowdown in home sales over the past six months was initially thought to be a supply problem. Inventories of existing homes had been trending lower for more than three years before leveling off around the middle of this year. With fewer homes for sale, existing home sales were destined to fall and have done so. Sales of existing homes through the first nine months of 2018 are running 2.1% below their year-ago pace. New home sales have fared better, as construction has consistently run below the sum of household growth and replacement needs, creating pent-up demand. New home sales through September are running 3.6% ahead of their year-ago pace, although sales have clearly lost momentum more recently. First-time buyers are increasingly struggling with affordability, and higher mortgage rates are discouraging many potential buyers.

With demand cooling, inventories have begun to increase and price appreciation has moderated. Inventories of existing homes have risen modestly over the past three months. Reports out of California note even larger gains but mostly off of extraordinarily low levels, leading to large percentage increases. Inventories remain lean from a historical perspective and buyers still have few homes to choose from in the most desirable markets. While prices are rising less rapidly, prices are still rising faster than wages, and higher interest rates are giving buyers pause.

Figure 1

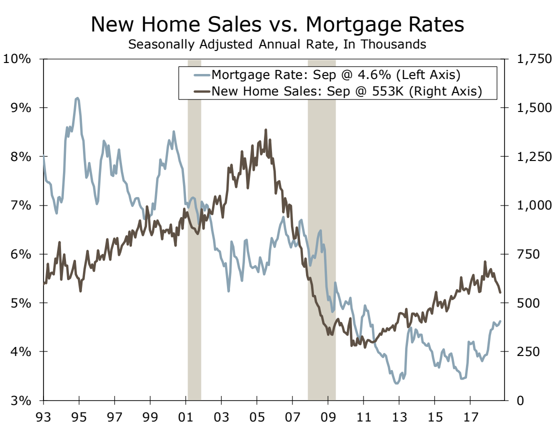
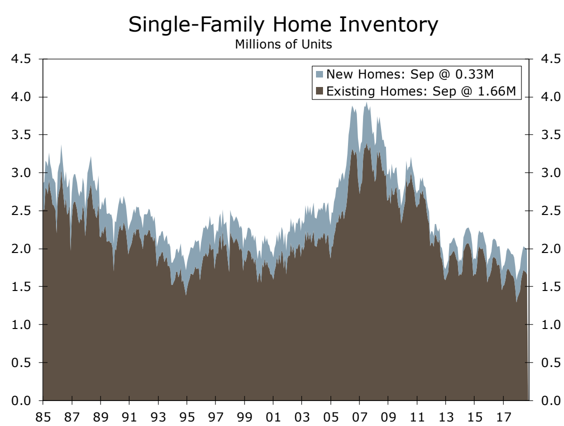


Figure 2



Source: Fannie Mae, National Association of Realtors and Wells Fargo Securities

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The Softening For-Sale Market Has Been Good for Apartment Owners

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The magnitude and speed at which home sales have weakened is surprising, following just a three-quarter of a percentage point rise in mortgage rates. We suspect the problem is a lack of affordable product in the markets where potential home buyers would like to live. This helps explain why sales turned down well ahead of this fall's rise in mortgage rates. The lack of inventory in desirable markets is a function of how highly concentrated economic growth has been in this cycle. Two industries, technology and energy, have accounted for a disproportionate share of job growth. While job gains have broadened more recently, a larger proportion of the high-paying, creative industry jobs are being added in submarkets closer to the central business district. By contrast, job growth in suburban markets has been slower to recover and wage gains have lagged for many occupations that are at greater risk of automation and outsourcing.

The rapid growth in higher value-added positions closer in to many major cities has fueled a housing crunch that has sent home values and rents soaring in many rapidly growing markets. The lack of developable lots closer in to the city has fueled growth of in-fill developments and tear-downs, which have often removed more affordable homes from the market. The resulting battles over gentrification have also led to some political blowback, which has stymied development in some areas. Growth is also creeping back out toward the suburbs, particularly those that are developing their own urban cores. What has largely been missing, however, has been the push to develop exurban areas, where land has historically been less expensive. Such development has remained elusive, as higher development costs have largely offset any savings in raw land costs.

The same trends impacting home sales are evident in the rental market. Demand remains strong for amenity-rich apartments located near the city center or in the metro area's second or third largest employment centers. Demand for apartments further out in the suburbs has taken longer to recover but has been doing better more recently, reflecting stronger job growth and an acceleration in wage gains. The suburbs have generally seen less development, so the improvement in demand has pulled vacancy rates lower and pushed rents higher. New suburban development remains elusive, however, and most new projects continue to cluster around pricier submarkets closer to the central business district.

We have further reduced our forecasts for home sales and new home construction following the recent string of weaker housing reports and downward revisions to previous data.

We have further reduced our forecasts for home sales and new home construction following the recent string of weaker housing reports and downward revisions to previous data. We still see new home sales increasing over the forecast period but now look for just 5.6% growth in 2019 and 5.3% growth in 2020. Much of that increase will come from more affordable homes in the South and West, which will restrain new home price appreciation. With little inventory, new home construction will continue to gradually edge higher. Apartment development is now expected to remain stronger for a little longer. There are a great deal of projects in the pipeline and a large number of proposed projects that have not yet moved forward. Demand for well located projects should remain strong, but vacancy rates will likely rise as job growth moderates in 2019 and 2020.

Figure 3

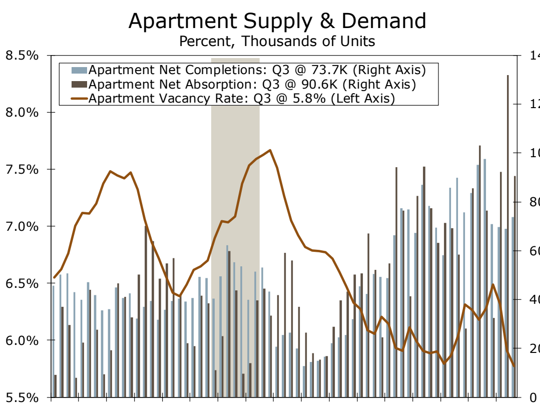
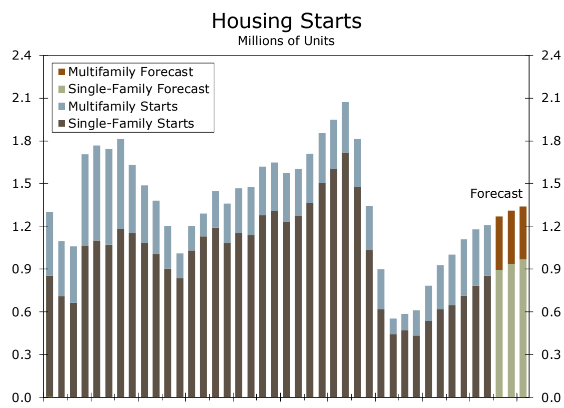


Figure 4



Source: CoStar, Inc., U.S. Department of Commerce and Wells Fargo Securities

National Housing Outlook

								Forecast		
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP, Percent Change	1.6	2.2	1.8	2.5	2.9	1.6	2.2	2.9	2.7	2.2
Residential Investment, Percent Change	-0.1	13.0	12.4	3.9	10.1	6.5	3.3	-0.1	0.6	2.4
Nonfarm Payroll Change (Avg. Monthly)	174	179	192	250	226	195	182	207	165	120
Unemployment Rate	8.9	8.1	7.4	6.2	5.3	4.9	4.4	3.9	3.6	3.3
Home Construction										
Total Housing Starts, in Thousands	608.8	780.6	924.9	1,003.3	1,111.8	1,173.7	1,202.9	1,270.0	1,310.0	1,340.0
Single-Family Starts, in Thousands	430.5	535.3	617.7	647.9	714.5	781.5	848.9	895.0	935.0	970.0
Multifamily Starts, in Thousands	178.3	245.3	307.2	355.4	397.3	392.2	354.0	375.0	375.0	370.0
Home Sales										
New Home Sales, Single-Family, in Thousands	305.0	369.0	429.0	437.0	501.0	561.0	613.0	630.0	665.0	700.0
Total Existing Home Sales, in Thousands	4,260.0	4,660.0	5,090.0	4,940.0	5,250.0	5,450.0	5,510.0	5,430.0	5,465.0	5,495.0
Existing Single-Family Home Sales, in Thousands	3,787.0	4,128.0	4,484.0	4,344.0	4,646.0	4,838.0	4,892.0	4,820.0	4,850.0	4,875.0
Existing Condominium & Co-op, in Thousands	477.0	528.0	603.0	591.0	608.0	614.0	619.0	610.0	615.0	620.0
Home Prices										
Median New Home, $ Thousands	227.2	245.2	268.9	288.5	294.2	307.8	323.1	326.2	333.7	341.5
Percent Change	4.8	7.9	9.7	7.3	2.0	4.6	5.0	1.0	2.3	2.3
Median Existing Home, $ Thousands	166.1	176.8	197.1	208.3	222.4	233.8	247.2	259.2	271.2	282.0
Percent Change	-3.7	6.4	11.5	5.7	6.8	5.1	5.7	4.9	4.6	4.0
FHFA Purchase Only Index, Percent Change	-4.2	2.9	7.1	5.1	5.4	6.0	6.7	6.4	6.0	5.6
S&P Case-Shiller C-10 Home Price Index, Percent Change	-3.5	0.3	11.7	7.9	4.6	4.5	5.3	5.4	5.1	4.8
Interest Rates - Annual Averages										
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.27	0.52	1.13	2.13	3.06	3.19
Prime Rate	3.25	3.25	3.25	3.25	3.27	3.52	4.13	5.13	6.06	6.19
10-Year Treasury Note	2.78	1.80	2.35	2.54	2.14	1.84	2.33	2.99	3.59	3.63
Conventional 30-Year Fixed Rate, Commitment Rate	4.46	3.66	3.98	4.17	3.85	3.65	3.99	4.63	5.19	5.23

Forecast as of: November 7, 2018

Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, FRB, FHFA, FHLMC, National Association of Realtors, S&P, Wells Fargo Securities

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