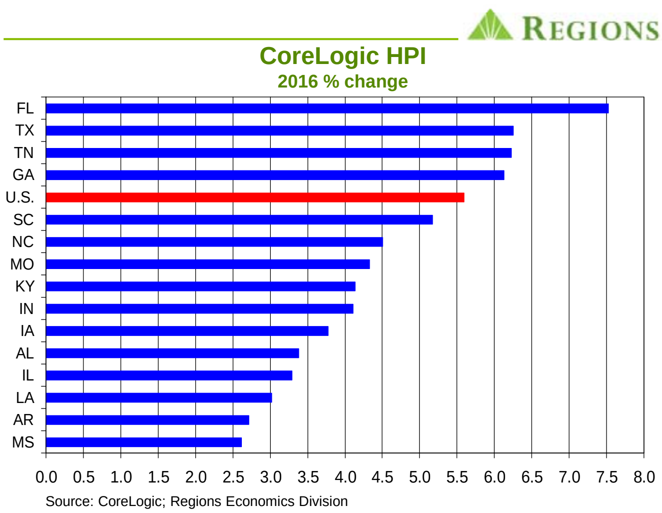
ECONOMIC UPDATE
REGIONS
February 2017

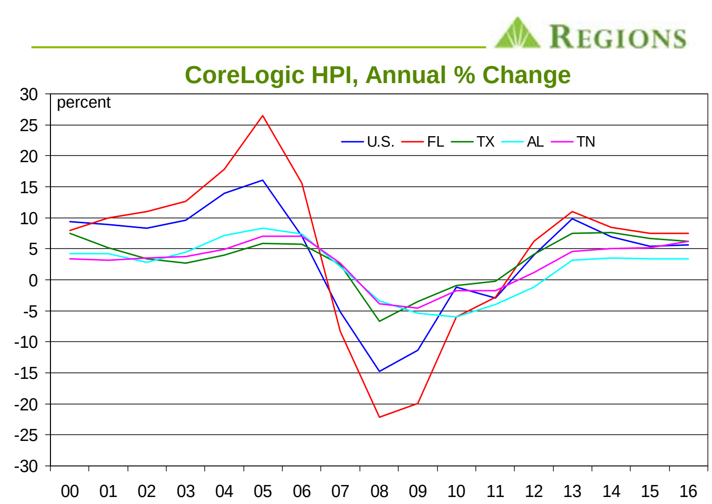
Housing Market Update: Regions Footprint

With the year-end 2016 housing market data now rolling in, we thought this would be a good time to summarize some of the main trends in housing market conditions across the Regions footprint. As is the case with the broader economy, the recovery in the housing market can best be described with three words – slow and uneven. This is true nationally and within the Regions footprint. And, as is also the case with the broader economy, one of the main questions facing the housing market is whether the pace of recovery will pick up materially in 2017, particularly with potentially significant changes in fiscal, regulatory, and trade policy looming on the horizon. While we see any such acceleration in the pace of economic, and housing market, activity more of a 2018 story than a 2017 story, that very much depends on what we get and when we get it, i.e., the specific policy changes we get and when those changes actually emerge from the legislative process. For now, though, we think it worth taking a closer look at our starting point in housing markets across the Regions footprint.



On an annual average basis, house prices rose by 5.6 percent for the U.S. as a whole in 2016 as measured by the CoreLogic House Price Index (HPI). This was a slightly above the 5.4 percent growth logged in 2015. Four states within the Regions footprint saw house price appreciation top the national average in 2016, with Florida posting a 7.5 percent increase in the CoreLogic HPI, followed by Texas (up 6.3 percent), Tennessee (up 6.2 percent), and Georgia (up 6.1 percent). Florida also saw a 7.5 percent in the CoreLogic HPI in 2015. At the other end of the spectrum, Mississippi saw house price appreciation of just 2.6 percent in 2016, with Arkansas posting a 2.7 percent increase and Louisiana a 3.0 percent increase.

House prices nationally and in the individual states (and metro areas, for that matter) have followed similar trends over the past several years, though obviously the magnitude of changes varies greatly. After hitting a cyclical peak, in 2005 nationally, house prices fell sharply during the downturn and continued to decline in each year through 2011 nationally and in most states. One reason house prices continued to decline for some time after the end of the recession in mid-2009 is that homes sold through foreclosure, short sales, or out of REO inventories or, what are generally referred to as "distress" sales, acted as weights on house prices, as distress sales typically take place at a significant discount compared to non-distress sales. With distress sales as a share of total home sales peaking in 2011, house prices turned a corner in 2012 and posted their most rapid post-recession increases in 2013. In subsequent years the pace of house price appreciation has settled in to a more moderate pace in the U.S. as a whole and in many states. The chart to the right shows the annual percentage change in the CoreLogic HPI for the U.S. and a few of the states in the Regions footprint. In addition to illustrating the patterns discussed above, the chart is a useful reminder that most of the states in the footprint avoided the drastic swings seen nationally and in states such as Florida within the footprint and Arizona, California, and Nevada outside of the footprint.



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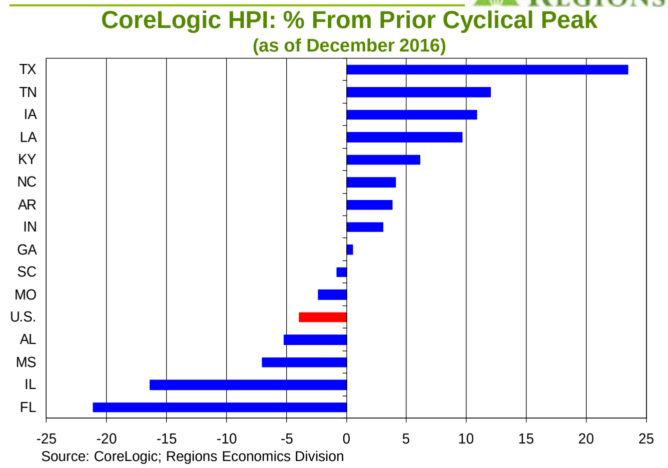
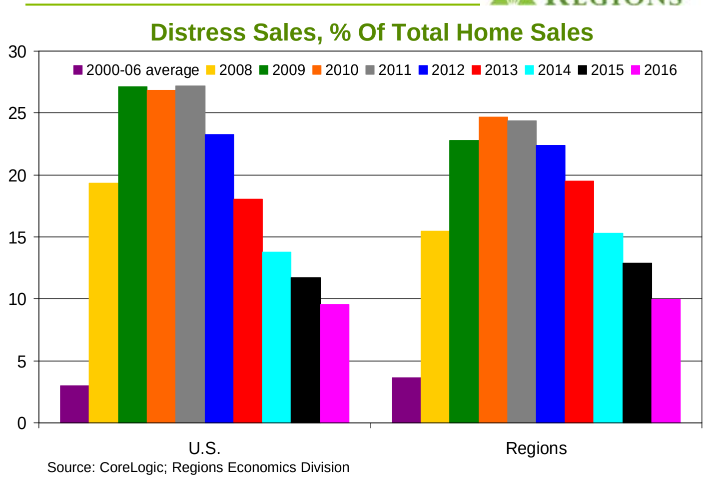
Without in any way endorsing it as a meaningful guidepost, we do realize that the pre-recession peak in the CoreLogic HPI is a common reference point for many people in assessing conditions in the housing market. For states such as Florida, and to a lesser extent Illinois, in which the credit-fueled growth in house prices became largely disconnected from housing market fundamentals in the pre-crisis years, our view is the pre-recession peak in house prices is not the proper comparison for current day house prices. It may be more meaningful in other states that, while not avoiding credit-fueled boosts to house prices, didn't experience them to nearly the same degree. Obviously each individual is free to draw their own conclusions on this point, but in any event at year-end 2016 the CoreLogic HPI for the U.S. as a whole stood 3.9 percent below its pre-recession peak, as seen in the chart to the side.



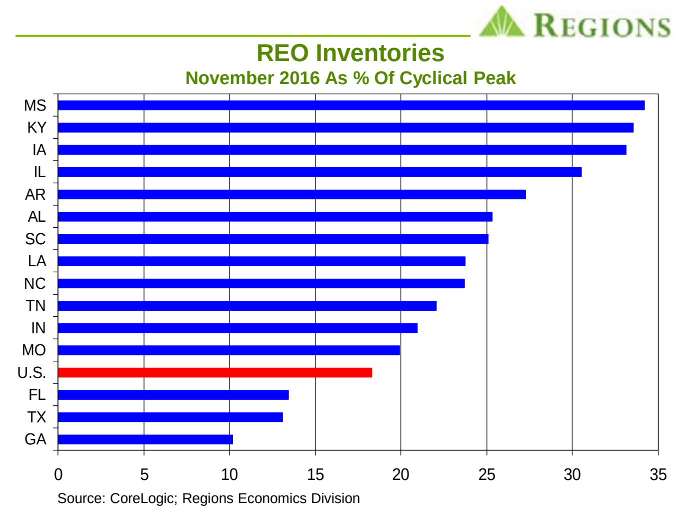
Nine states in the Regions footprint have seen the CoreLogic HPI surpass the pre-recession peak, led by Texas, where the HPI stood 23.5 percent higher as of year-end 2016. Georgia barely made the cut – it was not until November 2016 that the state's HPI surpassed the pre-recession peak and December's increase in the HPI left it 0.5 percent above that prior peak. For the most part, those states in which the CoreLogic HPI is the furthest above the pre-recession peak are the states that saw the less pronounced run-ups prior to the downturn and, as such, experienced less severe peak-to-trough declines in their HPI. Conversely, at year-end 2016 the CoreLogic HPI for Florida was still 21.1 percent below its pre-recession peak with the HPI for Illinois still 16.4 percent below the pre-recession peak. To put this in some perspective, however, since hitting a trough in February 2011, the CoreLogic HPI for Florida has risen by 57.2 percent, easily the largest trough-to-current increase in the Regions footprint and topping the 44.3 percent increase in the HPI for the U.S. as a whole since it hit a trough in March 2011.



As noted above, distress sales have had a significant impact on the behavior of house prices over the current cycle. While the impact of distress sales has clearly lessened over the past few years, it has not completely dissipated. The chart to the side shows distress sales as a share of total home sales over the past several years compared to the pre-crisis average for both the U.S. and the Regions footprint. Between 2009 and 2011, distress sales accounted for 27.1 percent of all home sales in the U.S. and 23.9 percent of all home sales in the Regions footprint. Note, however, that these shares vary dramatically across the individual states in the footprint. For instance, in Florida distress sales accounted for 36.7 percent of all home sales from 2009 through 2011, while in Georgia the share was 33.6 percent. Conversely, in Mississippi (10.1 percent), Iowa (10.6 percent), and Louisiana (11.9 percent) distress sales accounted for a significantly smaller share of total home sales over the 2009 through 2011 period.

Nationally and in each state in the Regions footprint, however, distress sales still accounted for a significantly above-average share of home sales in 2016, when using the average over the 2000-2006 period as the benchmark (note that the CoreLogic data on home sales by type only run back to 2000). Data from the Mortgage Bankers Association, for which we regularly provide quarterly summaries, show foreclosure inventories remain elevated relative to pre-crisis norms, yet mortgage delinquency rates and foreclosure starts are at or below pre-crisis norms. Or, another way to think about is that "inflows" into the foreclosure pipeline have returned to what could be considered "normal" rates, but "outflows" from the foreclosure pipeline continue at a rate which, while having picked up since the depths of the crisis, nonetheless remains slower than normal. In some states, such as Florida, the judicial process that governs foreclosures is a big factor in this, but there are other factors at play.

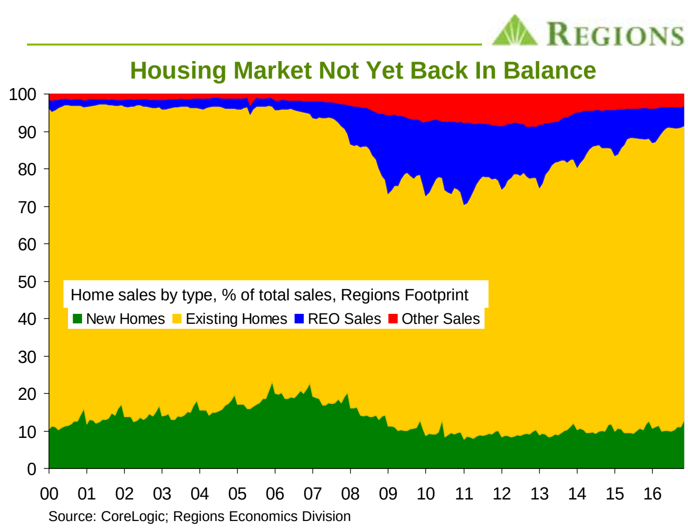
One way to look at this issue utilizing the data from CoreLogic is to look at current REO inventories as a percentage of their cyclical peak, which gives us a sense of the speed at which these distress inventories have cleared across individual states. The results may at first seem surprising but, upon further review, they are more understandable. For instance, current REO inventories in Georgia are only 10.2



percent of the cyclical peak, while Texas (13.1 percent) and Florida (13.4 percent) are both also well below the U.S. average (18.3 percent) on this metric, as seen in the chart to the side. At the other end of the scale, current REO inventories in Illinois, Iowa, Kentucky, and Mississippi stand at better than 30 percent of their cyclical peak. In other words, even though Florida and Georgia had much bigger backlogs of distress to clear, they have made far more progress than states with lighter distress backlogs to clear.

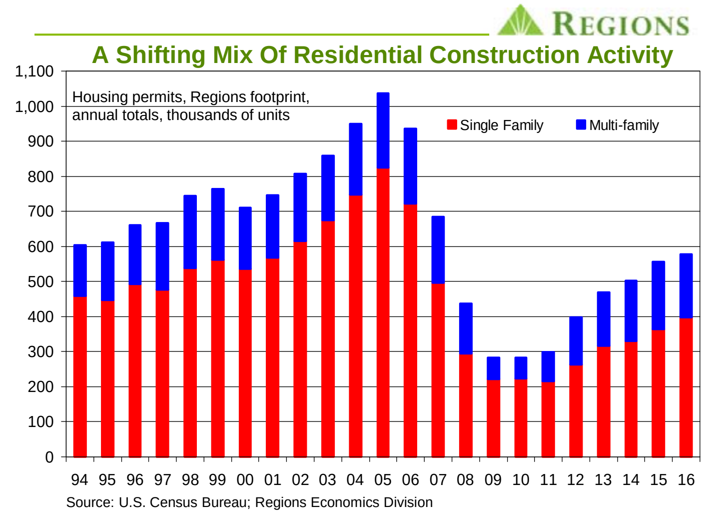
There are a few factors that can help account for this. First, with Florida, Georgia, and Texas boasting, along with the Carolinas, the fastest population growth in the footprint, it follows that there is faster growth in the demand for housing and, as such, a greater impetus for distress inventories to clear. Moreover, it is reasonable to think that in these markets with stronger demand side fundamentals, sellers of distress properties may not have to discount the properties as steeply in order to facilitate sales as sellers in markets with weaker demand side fundamentals. Along these lines, investors and other institutional buyers will have been more drawn to these markets to acquire homes at a discount to either flip or to put them on the rental market. As we discussed in our July 2016 *Housing Market Update*, the sizeable pool of distress single family homes in this cycle gave rise to single family REITs, and these REITs will have concentrated on larger metro areas with stronger housing demand. Conversely, those areas in with less favorable demographic profiles, and less favorable economic conditions in general, have attracted little or no interest from investors or institutional buyers, thus facilitating less clearance of distress inventories.

Still, it is a valid question as to whether distress inventories will ever return to levels that, prior to the downturn, would have been considered as normal. In other words, are distress inventories now structurally higher than was the case prior to the downturn, even in states such as Florida and Georgia where thriving economies and healthy demographic trends fuel steadily rising demand for housing. One line of thinking is that the current inventory of distress homes consists of either less desirable properties or properties in less desirable locations. One characteristic of the housing frenzy was construction taking place in distant suburbs further away from urban cores than had been seen in prior cycles – think “drive until you can buy.” To the extent this was the case, if homes in these distant suburbs ended up in distress it could be harder to now move them given their less desirable location. They will not be as attractive as single family rentals and it could also be that holders of these distress properties are not willing to discount them as steeply as prospective buyers would demand to make up for the location of the property.



At present, we simply do not have the answers for these questions, and time will of course tell. What we do know, however, is that what remain above-average distress inventories are a sign that the housing market remains out of balance. The chart to the side is basically a time series version of the chart on the prior page that showed annual averages, but the point is the same – distress sales continue to account for an above-average share of total home sales. This is the case both in the Regions footprint, as shown in this chart, and nationally. That distress accounts for an above-average share of sales indicates that distress inventories are being worked down, even if at a slow rate, though this does not rule out the possibility that distress inventories will be structurally higher going forward than was the case in the past.

Prior to the downturn, sales of new homes accounted for 15.5 percent of all home sales in the Regions footprint (13.8 percent nationally) but, post-crisis, that share is much lower. As we have frequently noted in our write-ups of the monthly new home sales reports, builders have been constrained by shortages of buildable lots, labor, and materials, while what has become a more costly and burdensome entitlement process means that in many markets new homes are priced at the higher ends of the price scale. For builders, what is lost in volume is made up for in margin, but for buyers this means fewer choices and higher prices, with prospective first-time buyers priced out of many markets. Patterns in housing permits across the Regions footprint mimic those seen nationally – single family permit issuance rising but



at a slow pace, and this is expected to remain the case. This illustrates our point that new single family construction is likely to account for a below-average share of home sales over coming quarters. Non-distress existing homes accounted for 81 percent of all home sales in the Regions footprint prior to the downturn (83.2 percent nationally), but post-crisis have accounted for just over 73 percent of sales in the footprint and only a slightly higher share nationally. One constraint on non-distress existing home sales that has become increasingly binding is lack of inventory, which is in part a reflection of the homes snapped up by single family REITs and placed on the rental market.

Distress sales have helped fill in the shortfalls left by existing and new home sales, but there is a limit as to how long this will remain the case. As distress inventories are pared down further and further, at least the inventories of distress homes that are truly in play as viable purchases, something will have to adjust in order to clear the market, and there are basically only two choices – prices or quantities. Given the supply constraints in the new homes segment of the market, which we do not think will go away quickly, that leaves existing homes as the primary market clearing mechanism on the supply side of the market. It is possible single family REITs will at some point wish to cash in on what will have in most markets been significant price appreciation since they purchased these homes, but absent that it seems there simply won't be adequate capacity for response on the supply side of the market. It is also possible that, with sufficient price appreciation, many current owners could be inclined to list their homes and trade-up, but it is likely that many of these prospective sellers will be deterred if it means trading up into a higher mortgage interest rate.

Another possible source of relief on the supply side is that the price appreciation seen over the past few years has led to a significant reduction in homeowners in negative equity positions. Lack of history – the CoreLogic data on negative equity begin only in 2009 – makes it harder to put the data in the proper perspective, but we do know that the share of homeowners in negative equity positions is significantly lower than the peak share seen in 2010 and 2011. As of September 2016 (the latest data point), 6.3 percent of homeowners nationally were in a negative equity position, but in three states in the Regions footprint – Florida, Illinois, Mississippi – more than ten percent of homeowners were in a negative equity position and in Louisiana that share was just below 10 percent. It is also worth recalling that simply being "above water" is a necessary but not sufficient condition to make a sale financially feasible; the reality is a seller must be some distance above water in order to cover all of the costs of selling their home. Our point here is that while having fewer homeowners in a negative equity position is clearly a positive, it is likely the case that the reduction in negative equity positions does not, at least at present, translate into as much supply capacity as may seem to be the case on the surface.

That basically leaves price as the primary mechanism by which the housing market clears, which raises concerns of its own. For instance, recent years have seen growth in house prices and growth in household incomes become increasingly misaligned. While low mortgage rates have been a buffer between the two by holding down monthly mortgage payments even as prices have risen rapidly, that buffer becomes thinner and thinner as mortgage rise, as they are expected to over coming quarters. To be sure, further improvement in labor market conditions should help support income growth and the prospect of lower individual tax rates would mean even firmer growth in disposable personal income. The question then becomes whether faster income growth will be sufficient to fully offset both higher house prices and higher mortgage interest rates. We have regularly stated our view that the demand side of the housing market is quite healthy, but nonetheless see continued rapid house price appreciation and higher mortgage rates as downside risks.

Finally, as this piece was intended as a discussion of broader trends rather than a dive through the data, we've kept our discussion on a state level. We do provide housing market data – house price appreciation, mortgage delinquency rates, housing permits – on the metro area level in our monthly data updates. So, for now, we'll simply note that in the group of in-footprint metro areas we track in our monthly data updates, 12 of the 20 metro areas with the fastest house price appreciation in 2016 were in the state of Florida. By the same token, 16 of the 20 markets for which the year-end value of the CoreLogic HPI was the furthest below the pre-recession peak were in the state of Florida while Texas metro areas dominate the list of markets in which the HPI is furthest above the prior peak. This goes to our earlier point that the relationship between current house prices and the prior cyclical peak is not necessarily a useful framework from which to assess current housing market conditions. There are many pockets of the Regions footprint – markets in Florida, Georgia, the Carolinas, Tennessee, and Texas – in which supply simply isn't keeping pace with growth in demand, resulting in rapid house price appreciation and raising at least some question as to how sustainable this dynamic is.

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