# The Shifting Nature of U.S. Housing Demand

The U.S. housing market is growing again—but not as we knew it

Louise Keely, Bart van Ark,
Gad Levanon, and Jeremy Burbank

**May 2012**

## The Demand Institute

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**Our Homes Play a Vital Role in Our Lives.**

Some of us wake up each morning in a “charming and intimate” studio apartment (as a real estate agent might describe it) while others begin the day in a mansion. Either way, our homes are where we spend time with family and friends. We cook meals together, watch our favorite television shows, surf the Internet, and enjoy our hobbies. At night we can rest after a long day at work or school.

For many Americans their home is also their most valuable financial asset. But recently this has proved to be a rather volatile asset, and dramatic changes in home values have created stress for many Americans.

**The Shifting Nature of U.S. Housing Demand** is the first major publication from The Demand Institute. The trajectory of the housing market has now reached a true turning point. Based on our team’s analysis, the worst of the housing crash is over and a recovery has now started.

Yet this recovery will be very different from previous ones, with implications for leaders in most sectors. Where housing goes, the economy follows. Each time a house is sold many industries benefit as consumers arrange financing, launch renovations, and invest to improve the comfort and value of their homes.

In a world where 7 billion consumers will spend over $450 *trillion* on products and services over the next decade, many senior business and government leaders have told us that they would value more holistic perspectives that illuminate where consumer demand is heading. Our mission at The Demand Institute is to deliver this new knowledge. Future reports will tackle shifts in consumer demand spanning industries and continents across a wide range of strategic issues.

We hope you will find this report on the U.S. housing market to be timely, thought provoking, and valuable. As always, we welcome your feedback and ideas for future initiatives.

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# Executive Summary

**The worst is over for the U.S. housing market.** After six years of declining sales and falling prices that wiped $7 trillion from the value of housing assets, a turning point has been reached. The Demand Institute sees average prices rising by up to 1 percent in the second half of 2012 (in seasonally adjusted terms), marking the start of a housing recovery.

As the market revives, so will consumer spending: the business of building, buying, and selling homes generates enormous expenditure in a wide range of industries, including those associated with the transaction, those that produce goods and services for the home itself, and those that provide goods and services in the neighborhood around the home.

This housing recovery will be different in nature from previous recoveries because it will be shaped by new market conditions and expectations. This report explains those differences and the various ways in which they impact consumer demand.

- **This will be a two-stage recovery.** Seasonally adjusted average house prices will increase by up to 1 percent in the second half of 2012, rising to an annual rate of increase of 2.5 percent by 2014. Between 2015 and 2017, they will rise by 3 to 3.5 percent a year on average.

- **The recovery will be led by demand from buyers for rental properties**, rather than, as in previous cycles, demand from buyers acquiring properties for themselves. More than 50 percent of those planning to move in the next two years say they intend to rent.

- **Young people—who were particularly hard hit by the recession—and immigrants will lead the demand for rental properties.** Developers and investors will fulfill it, developers by building multifamily homes for rent (that is, buildings containing two or more units, such as apartment blocks or townhouses), and investors by buying foreclosed single-family properties for the same purpose.

- **Rental demand will help to clear the huge oversupply of existing homes for sale.** In 2011, some 14 percent of all housing units were vacant, while almost 13 percent of mortgages were in foreclosure or delinquent—increases of 12 and 129 percent respectively over 2005 levels. It will take two to three years for this oversupply to be cleared, and at that point home ownership rates will rise and return to historical levels. More than 70 percent of those planning to move three to five years from now say they intend to purchase their home.

- **The housing market recovery will not be uniform across the country.** Some states will see annual price gains of 5 percent or more. Others will not recover for many years. The deciding factors will include the level of foreclosed inventory and rates of unemployment.

- **There will also be vast differences within states.** Here, additional factors count, such as whether local amenities, including access to public transport, are within walking distance of homes. By examining seven factors that influence house prices at a local level, the report identifies four categories of cities and towns in which prices will behave differently (population share in parentheses):

    - Resilient Walkables (~15%)
    - Slow and Steady (~35%)
    - Damaged but Hopeful (~30%)
    - Weighed Down (~20%)

    We predict that each category will demonstrate a distinct pace and strength of price recovery. The Resilient Walkables are likely to lead the way with strong, early growth, while the Weighed Down will trail behind with slower and slighter price growth than the national average.

- **The average size of the American home will shrink.** Many baby boomers who delayed retirement for financial reasons during the recession will downsize. They will not be alone. The majority of Americans have seen little or no wage increase for several years, and many will scale back their housing aspirations. The size of an average new home is expected to continue to fall, reaching mid-1990s levels by 2015.

- **Consumer spending patterns will reflect the different nature of housing demand during this recovery**, in particular, the high demand for rental properties, for smaller homes, and for homes in vibrant communities close to local amenities. Industries including home remodeling, financial services, media, and retail will all experience shifts in demand and new growth opportunities.

  For example, people who rent their home tend to own fewer cars, so demand for neighborhood rental cars should rise. We also predict that the retail banking industry will introduce products and services to address the larger population of renters as well as the desire of many renters eventually to own their homes.

- **Despite the number of Americans who have been hurt financially by the housing crash, the desire to own a home remains strong.** We do not expect to see a long-term drop in ownership rates. Indeed, one survey has revealed that more than 80 percent of Americans recently thought buying a home remained the best long-term investment they could make.

Almost every consumer-facing industry will be affected by the housing recovery over the next six years. Business and government leaders should therefore seek to understand the nature of that recovery. In doing so they will be better able to anticipate how consumer demand will evolve, and to formulate business decisions.

# Turning the Corner

**The worst is over for most of the U.S. housing market.** Between 2006 and 2011, house prices fell by more than 30 percent, wiping $7 trillion from the value of housing assets and leaving many Americans with untenably high levels of mortgage debt relative to the value of their homes (Exhibit 1).

Consumer confidence has now rebounded from historical lows and sales of existing homes have started to rise slightly (Exhibit 2). As a result, The Demand Institute projects that seasonally adjusted average house prices will rise by up to 1 percent in the second half of 2012, and continue to strengthen to an annual rate of increase of 2.5 percent by 2014. From 2015 to 2017, we project annual average price rises will be between 3 and 3.5 percent (Exhibit 3).

**The worst is over.**

This housing recovery will be different from previous ones, however, reflecting the way in which the recession has forced many Americans to delay or scale back their dreams of home ownership. Indeed, the initial recovery in prices will be driven in large measure not by home ownership, but by demand for properties suitable for renting. Thereafter, as the economy improves, ownership rates will rise again, but there will be greater demand for smaller homes than hitherto, in line with consumers' constrained finances and heightened sense of caution.

This report describes these predicted trends in detail and examines their likely impact on consumer demand. The fall in housing wealth and the closing off of mortgage credit channels over the past six years may have led to an estimated decline in overall consumer spending during the period of $500 billion (commonly known as a wealth effect).[1] Separately, the drop in the volume of home purchases and in new household formation has affected consumer transactions and spending in a range of home-related industries.

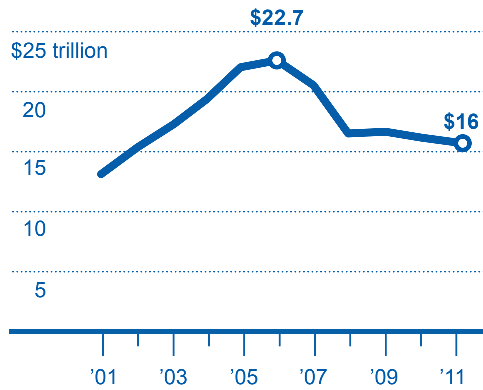
As an example of this transaction effect, in furniture, major appliances, floor coverings, and household tools alone, we estimate that U.S. consumer spending fell by $20 billion between 2007 and 2011 owing to the lower level of home sales. As house prices and sales recover, so will consumer spending. But the particular nature of this recovery means that the nature of consumer spending will alter too—an important consideration for companies in their efforts to align their investments in products and services in ways that will capture this nascent demand. All business leaders in every function, be it finance, product innovation, marketing, or any other, should, therefore, understand how housing demand is evolving, in order to grasp how it should shape their decisions.

Exhibit 1

# Housing Market has Weakened Consumer Balance Sheet

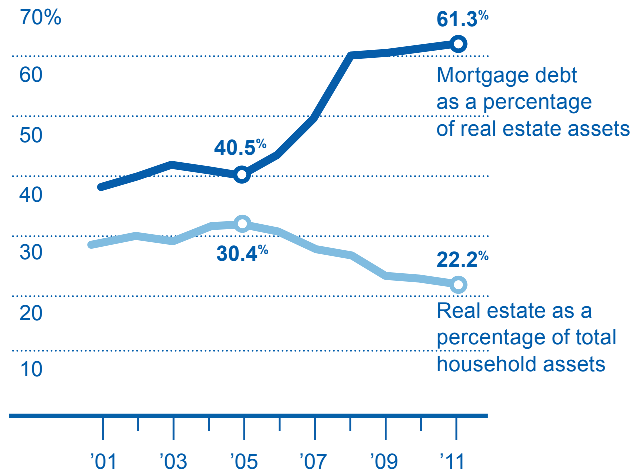
**Home values rose rapidly for half a decade, leaving owners flush with paper wealth. Then the bubble burst.**

Real estate assets held by U.S. households



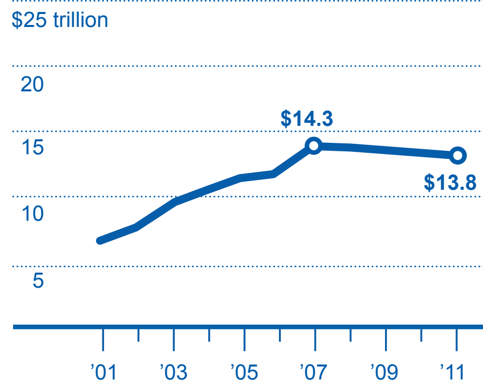

**As homes lost value, mortgage debt ate into the household balance sheet.**

Effect of real estate crash on U.S. households




**Saddled with heavy debt, consumers closed their wallets and began the long, slow process of deleveraging.**

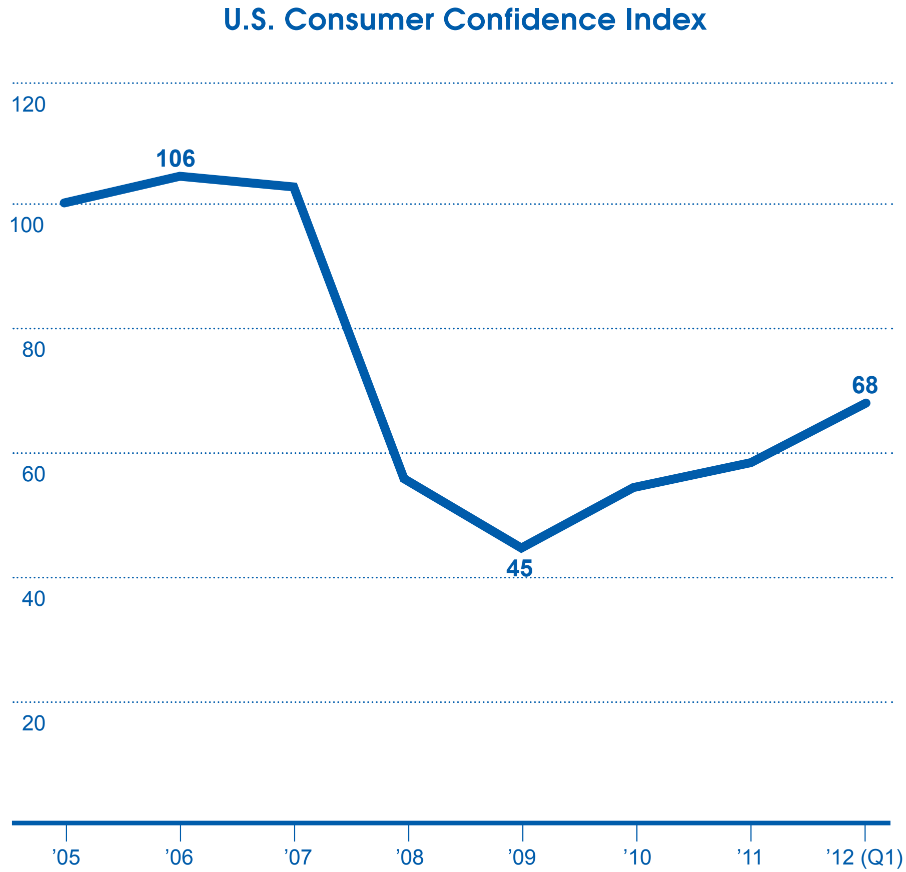
Total U.S. household debt




Source: The Demand Institute; U.S. Federal Reserve Flow of Funds (2001–2011)

Exhibit 2

# U.S. Consumer Confidence Rebounding

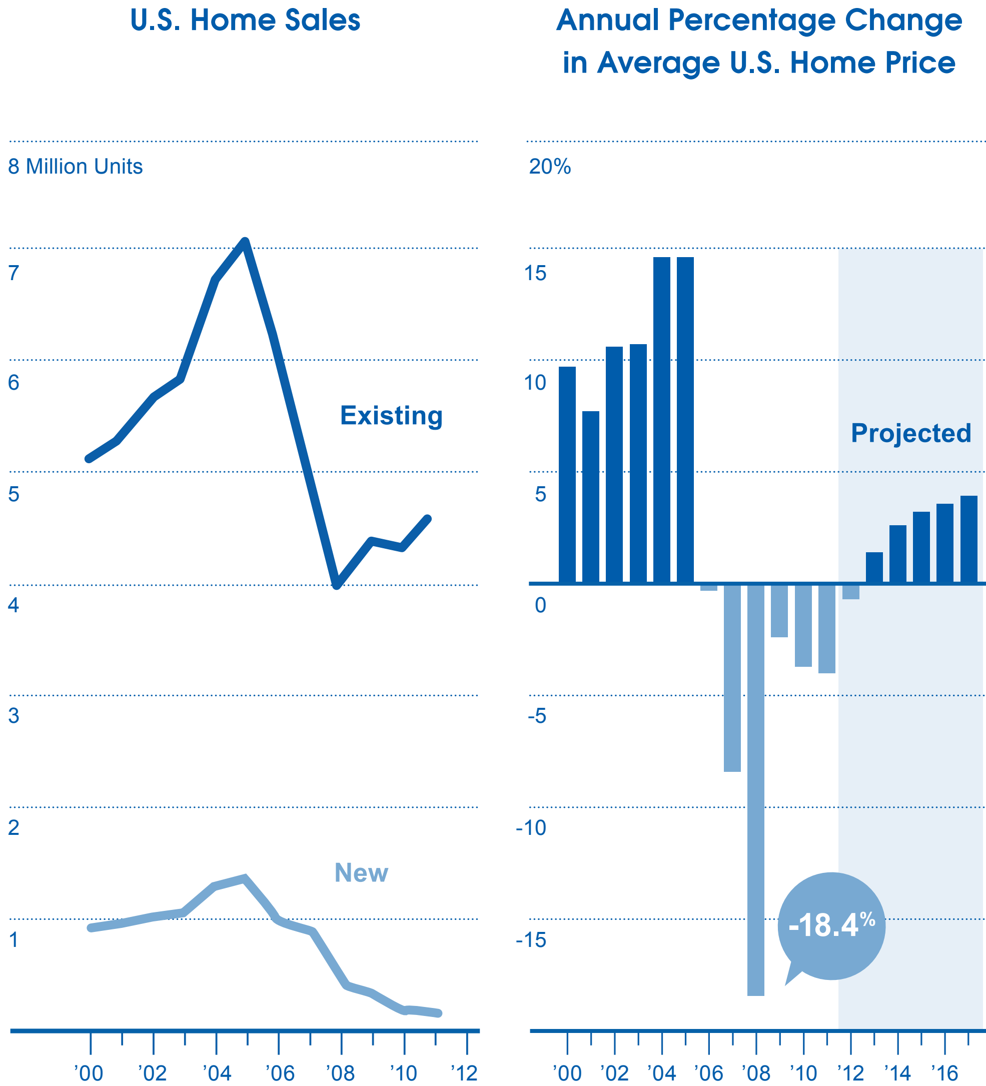



Note: 1985 Consumer Confidence Index began at 100.

Source: The Conference Board's Consumer Confidence Index® (annual average)

Exhibit 3

## Home Sales Leveling Out, Price Declines Ending




Source: Existing home sales from National Association of Realtors

New home sales from U.S. Census Bureau, Department of Commerce

Note: 2001–2011 data is fourth quarter, seasonally adjusted

Source: The Demand Institute; Case-Shiller Composite – National Index (through 2011). Forecasts through 2016 from Zillow Home Expectations Survey, March 2012

# Rental Demand Leads the Way

**A housing market recovery typically is equated with an increase in housing starts, marking developers' expectation of imminent demand.** Whether a housing recovery will drive a broader economic recovery or vice versa is a matter of debate. Either way, housing starts have in the past played a significant role in economic revival, such is the industry's impact on employment and on a range of related industries including furniture manufacturing, electrical appliances manufacturing, and landscaping, to name but three.

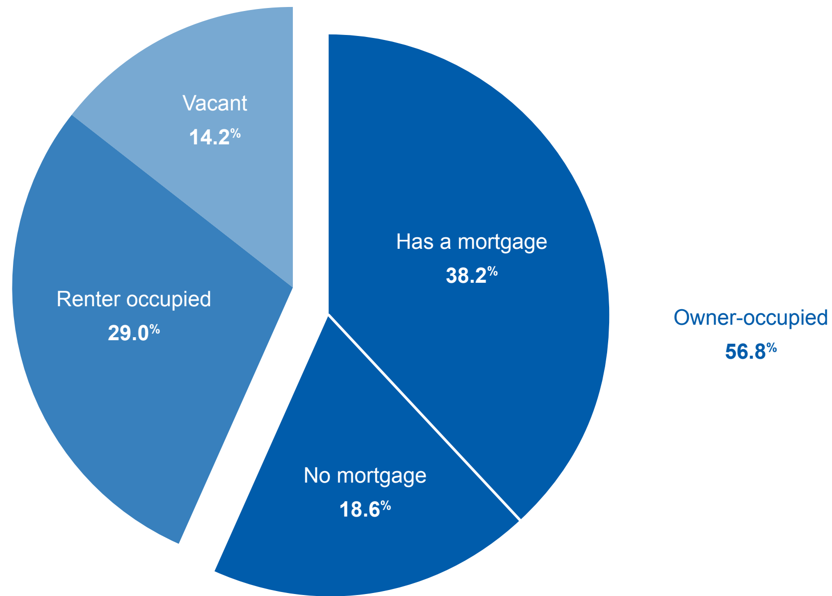
Residential investment historically accounts for only about 5 percent of U.S. GDP, but it has accounted for as much as 16 percent of GDP growth during previous periods of economic recovery.[2] This time around, housing starts have not been a driver of the economy's growing strength. Construction accounted for only 1.5 percent of total GDP growth[3] between the end of the recession in the second quarter of 2009 and the first quarter of 2012. That is because there is still a massive oversupply of housing for sale. In 2011, some 14 percent of all housing units were vacant, and almost 13 percent of all mortgages were in foreclosure or delinquent—increases of 12 and 129 percent respectively over 2005 rates (Exhibit 4).

The only segment of the home building sector now showing clear signs of recovery is multifamily housing (Exhibit 5). Multifamily housing starts have increased significantly, and according to the National Association of Homebuilders, are driven by developers seeking to rent out these properties. Developers started 178,200 new multifamily units in 2011—a 54 percent increase over 2010, although still well shy of the over 370,000 units averaged each year from 1980 to 2007.[4]

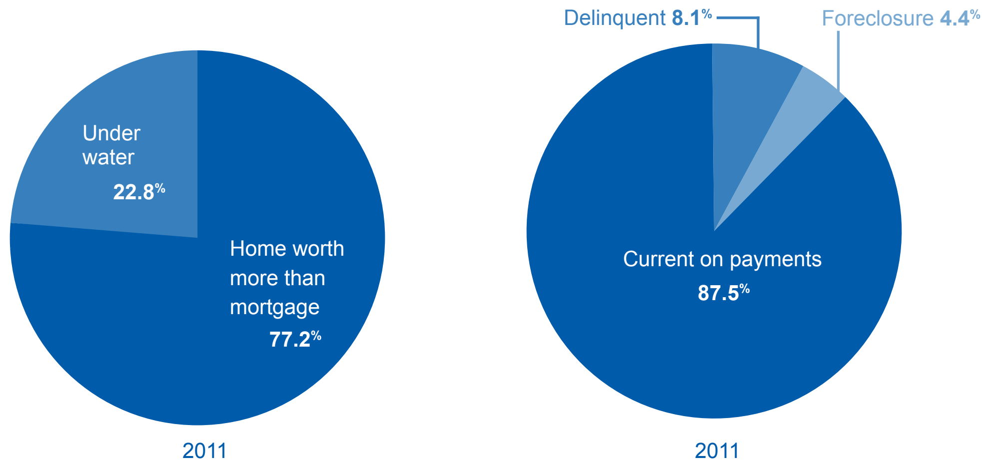
Exhibit 4

## 13 Out of 100 Homes with Mortgages in Risky Financial Position

### All Housing




### All Housing with Mortgages (Including Occupied and Vacant)




Notes: Vacant: Includes year-round and seasonal vacancies

Mortgages: Includes mortgages, contract to purchase, or similar debt

Mortgage status of owner-occupied units in 2010

Sources: The Demand Institute; Occupancy / Vacancy: U.S. Census Housing Vacancies and Home Ownership Survey, Series H-111

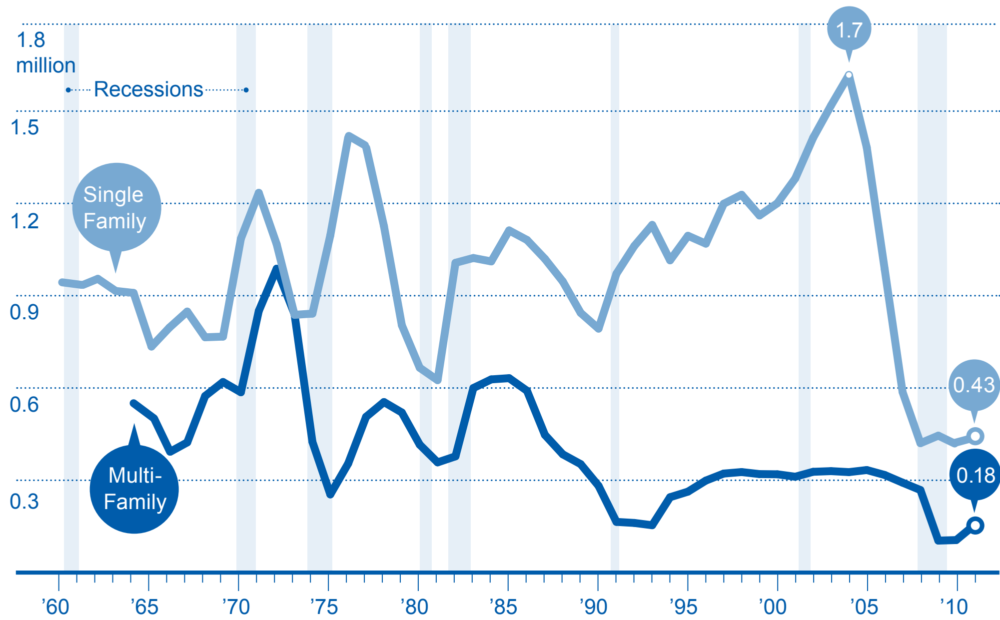
Mortgage Status: U.S. Census American Community Survey, Table B25081

Delinquency Status: Mortgage Bankers Association; Underwater: CoreLogic Negative Equity Report, Q4 2011

Exhibit 5

# Home Starts Not Linked with Current Economic Recovery

## Annual Housing Starts




Source: U.S. Census Residential Construction Survey, 1960–2011; National Bureau of Economic Research

In addition, investors attracted by high yields are buying up single-family properties that can generate rental income. As seen in Exhibit 6, the median asking rent in the United States increased by 19 percent between the peak of the housing market in 2005 and the first quarter of 2012. According to Trulia, the online real estate listing site, and others, in most cities it is now more expensive to rent than to buy.[5] But demand for rental properties ensures rents are not about to fall. That demand comes from several quarters.

First, many of those who left the housing market because they defaulted on loans will have no choice but to remain in the rental market until their finances improve, in terms both of rebuilding savings and restoring their ability to borrow.

**Consumers are now renting for multiple reasons.**

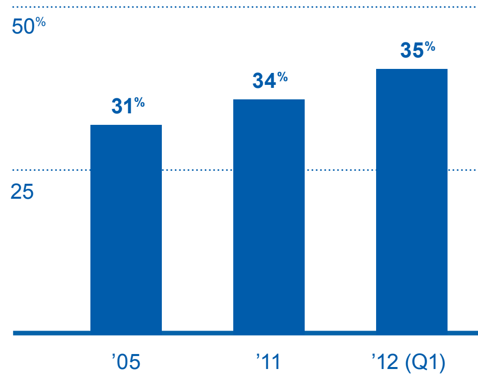
Second, there will be strong demand from young adults. Eighteen to 34-year-olds will account for 43 percent of all current heads of households moving during the next two years, the single largest age group. More than half of these young movers expect to rent when they next move.[6] This age group was particularly hard-hit by the recession. The unemployment rate for 20 to 24-year-olds in March 2012 was 13.2 percent, compared with 6.8 percent for those over 25. Moreover, an analysis of census data carried out by the Pew Research Center reveals that Americans under the age of 35 had a net worth in 2009 that was 68 percent below that of their peers in 1984. It is thus not surprising that home ownership rates among young Americans have fallen by more than those for any other age group, as shown in Exhibit 7, and that a large number are not yet ready to buy, even as the economy recovers.

## Exhibit 6

# Rental Demand is Leading the Way

**The share and volume of rented homes has increased...**

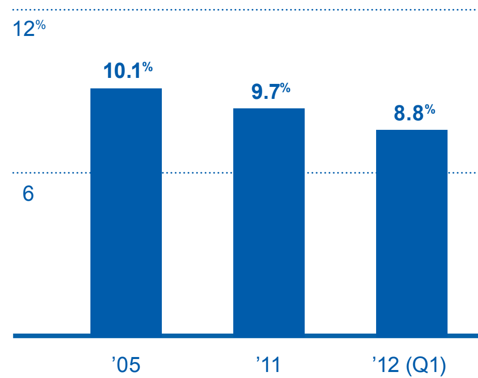
Occupied rental units as share of total occupied U.S. housing units




**Rented units (millions):** **34.1** **38.4** **39.5**

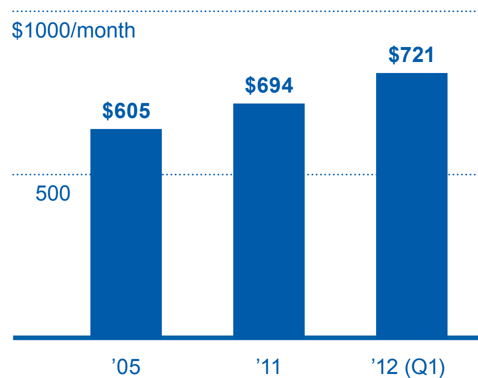
**... and rental vacancy rates have dropped...**

Rental vacancy rates




**...while rental prices have increased**

Median asking rent

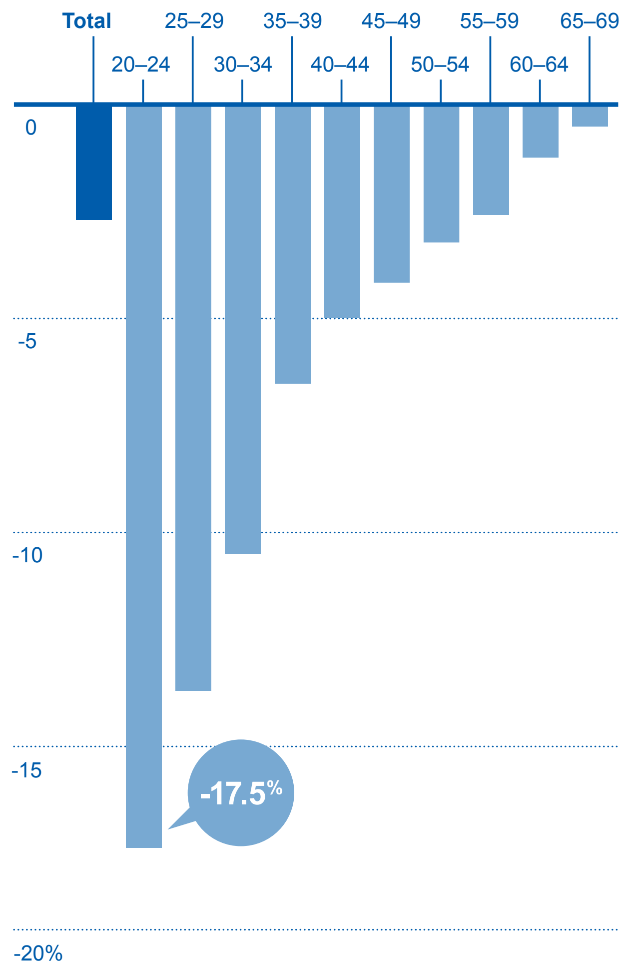



Note: U.S. 2005 and 2011 are annual figures except for vacancy rates which are first quarter of each year; 2012 is for the first quarter

Source: The Demand Institute; U.S. Census Bureau Housing Vacancy Survey

Exhibit 7

# Recent Home Ownership Decline Concentrated




Source: U.S. Census Bureau American Community Survey, 2006–2010

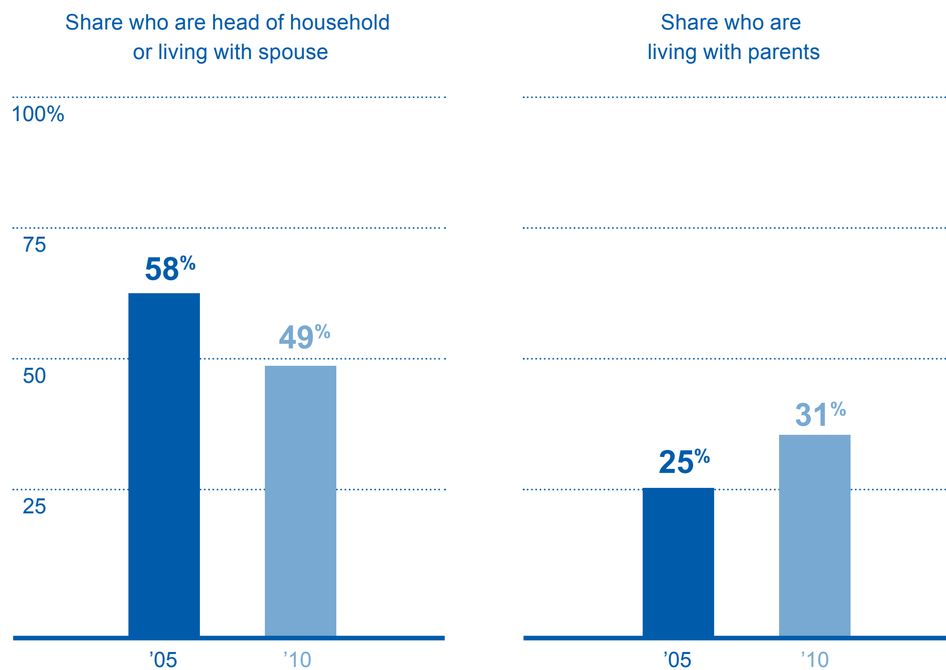
Many members of this age group, constrained by the weak economy and uncertain employment prospects, delayed moving out of the family home (Exhibit 8). We project that “doubled-up households”[7] will continue to account for just over one in five of all households over the next five years. Financial reasons are the commonest cause of doubling up, cited in half of all situations. But the prevalence of adult children living with their parents will decline from almost 60 percent of doubled-up households today to about 40 percent in 2017.[8] Assuming that unemployment among young adults declines as the economy recovers, young adults will venture out to form their own households. But our research suggests that those who are ready now to strike out on their own will be more likely to rent than to buy.

Third, new immigrants will be searching for homes to rent. Net immigration into the United States averaged 1.3 million people a year between 2005 and 2007. But in 2008, more people left the recession-bound country than arrived. Immigration rebounded in 2010 as job prospects improved, and the U.S. Census Bureau now expects net immigration to reach 1.2 million to 1.6 million a year by 2017, contributing substantially to growth in the number of households and rental demand.[9]

It is this demand for rental properties that will help drive the initial phase of the housing market recovery, during which the current oversupply of existing homes will gradually clear. In the second phase, from 2015 to 2017, increases in GDP growth, employment, and consumer credit availability will pave the way for more house sales.

Exhibit 8

# Young Adults Postponed Forming New Households




Source: U.S. Census Bureau, American Community Survey, 2005–2010

# A Recovery of Two Phases

**The recovery will unfold differently in different geographies.** The sidebar, "An Inconsistent Pattern of Recovery," describes these differences.

Improvement in the housing market will coincide with improvement in the overall economy, and will depend on the strength of growth in employment and incomes, on regulation,[10] and on monetary policy. For example, if there is no uptick in economic growth later in 2012 to its potential rate of 2.5 percent, the housing recovery will be delayed. But regulatory reforms, such as the replacement of Freddie Mac and Fannie Mae, or shorter-term changes to hasten the pace of foreclosures and relieve debt burdens, could quicken it. Indeed, some have argued that the lack of reform of housing finance policy to date is detrimental to the overall economy. Tax policy changes that make home ownership more or less favorable would also influence the nature of demand, while significantly higher interest rates could restrain it. The pace of house price growth predicted in this report assumes inflation growth will not lead to dramatically tighter monetary policy. With these caveats, we predict two distinct recovery phases.

## Phase One

**Satisfying rental demand and clearing out oversupply, 2012 to 2014**

We predict that seasonally adjusted average house prices will grow by just under 1 percent in the second half of 2012. In 2013, growth will increase to about 1.5 percent over the year, rising to 2.5 percent a year in 2014.

As discussed, new rental demand, particularly from young people and immigrants, will help to drive the overall housing market, as developers build multifamily homes and investors buy single-family properties for rent.

During this period, the stock of vacant and foreclosed homes will hold home construction and house price growth back from their historical levels. But the pace of sales of these homes will start to pick up this year as banks, real estate agents, lawyers, policy makers, and homeowners have come to realize that the market will not recover while over-supplied, and that lower prices will have to be accepted. We predict that it will take two to three years to clear the oversupply of homes.

## Phase Two

**Return to ownership and rising home values, 2015 to 2017**

We expect house prices to increase by an annual 3 to 3.5 percent between 2015 and 2017. Improved economic conditions, and in particular lower unemployment,[11] will encourage more people to buy again. So will historically low home-ownership costs, even though house prices and interest rates are likely to rise during the period. Importantly, by the start of 2015, there will no longer be an oversupply of existing properties.

Currently, 11 percent of homeowners say they would like to sell their home but their home is not on the market. The commonest reason cited, by half of these homeowners, is that they would not be able to get the price they want.[12] We predict that once price growth has risen to the 3 percent forecast for 2015, these homeowners will start to return to the market and the volume of sales of existing homes will increase.

Given that homeowners are voluntarily holding back today, they will re-enter the market cautiously and in an orderly fashion, and the potential likelihood of a flood of inventory that could reverse price increases will be avoided.

Credit conditions will also ease by 2015, and we expect the criteria for loan qualifications and the amounts required for down-payments on mortgages to be similar to those seen in the mid-1990s. The Federal Reserve Bank's survey of senior loan officers indicates that credit conditions, while still tight, are already starting to loosen slightly. Moreover, the monthly household debt-service ratio—that is, the ratio of monthly debt obligations to disposable income—is down to levels last seen in the mid-1990s, while consumer credit is again starting to expand.[13] It may take a few years before access to mortgage credit opens to many households, but by 2015 we expect further progress to have been made in deleveraging and building up credit worthiness among households.

This means that while many immigrants and young adults setting up house for the first time will still rent—a crash in demand for rented properties is unlikely—many householders who are currently renting will buy a property.[14] Indeed, 73 percent of those planning to move in three to five years say they intend to buy.[15] In addition, those who already own property will seek to upgrade, given their improved finances.

# An Inconsistent Pattern of Recovery

**The U.S. housing market recovery will not be uniform across the country.** While prices will rise by 3 to 3.5 percent a year on average between 2015 and 2017, some regions could see rises of 5 percent or more by 2015. Elsewhere, prices could remain flat or even continue to fall over the next three years.

State-level unemployment rates, the proportion of foreclosure inventory relative to total inventory, and the extent of recent price declines are all indicators of how quickly any state's housing market will recover. Exhibit S1 shows how foreclosures are concentrated in ten states, for example. The higher these variables, the slower the expected recovery. Hence, north central states including the Dakotas, Montana, and Nebraska, as well as Virginia, are poised to begin recovery. Florida, Nevada, New Jersey, and Illinois are among states that will make slower progress (Exhibit S2).

But the pace and extent of recovery will also differ significantly within states. City and town unemployment rates, for example, can vary from the state average.

In addition, a trend toward accessible locations, reflecting householders' preference for living in areas where they can walk to local stores and other amenities, makes certain urban areas more attractive than the suburbs and rural areas. We therefore, looked at likely house price trends at the city level by examining seven variables.

1. **Population size:** an indicator of the availability and variety of local amenities
2. **Walkability and access to public transport** (using Walk Score data)
3. **Severity of recent decline in house prices:** an indicator of the fragility of the market (using Zillow house price data)
4. **Current affordability relative to the national average.** Prices might have fallen sharply, for example, but still be relatively high if they started out high
5. **Unemployment at the Metropolitan Statistical Area level**
6. **Proportion of foreclosure inventory relative to total inventory at the state level**
7. **Judiciousness of state foreclosure policy.** Some state regulations make foreclosure clearance more difficult

From this analysis, four segments of the population emerge, with their recovery patterns summarized in Exhibit S3.

**Resilient Walkables**
About 15 percent of the population lives in this segment, which comprises populous urban or semi-urban communities well served by local amenities. House prices here fell by less than the national average between 2006 and 2011, in some cases by much less. The same is true of local employment. Examples include Boston and some of its closer suburbs, such as Brookline and Cambridge; Philadelphia; some suburbs of Washington, D.C., such as Rockville, MD and Herndon, VA; and Denver, CO and some of its suburbs. These localities will be the first to recover. We expect house prices here to rise by an average of 3 percent in 2013, and by up to 5 percent a year between 2014 and 2017.

**Slow and Steady**

About 35 percent of the population lives in this segment. These localities have seen double-digit house price falls since the market peaked, although the declines are still less than the national average. Property here is now affordable relative to the national average, there is not a particularly high proportion of foreclosure inventory, and the state foreclosure process is not particularly restrictive. Walkability and local unemployment are average. Examples include Gaithersburg, MD; Charlotte, NC; and Dallas and Fort Worth, TX. We predict that these areas will recover more quickly than the national average, with annual price increases reaching 3 percent in 2014, and similar gains accruing in the following three years.

**Damaged but Hopeful**

About 30 percent of the population lives in this segment, which largely consists of localities in states with a high proportion of foreclosure inventory, more restrictive foreclosure processes, and medium to high levels of unemployment. Price drops here were around the national average. Recovery will be slower than the national average, with prices reaching 3 percent annual growth a year later than the national average, in 2016. But these localities tend to be highly walkable, and we predict that from 2017 onward, growth will exceed the national average. Examples include Chicago and its more walkable suburbs; San Diego, CA; and Stamford, CT.

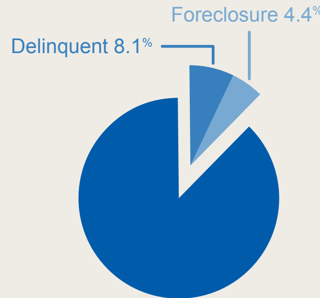
**Weighed Down**

About 20 percent of the population lives in this segment, which will see the slowest rate of recovery. Price drops have been higher than the national average and there is a large proportion of foreclosure inventory. These localities also suffer from higher than average unemployment, are more sparsely populated, and have low walkability. The fact that housing is relatively cheap compared to the national average will not greatly assist recovery. Indeed, long-term prospects are most uncertain. We do not expect price rises to reach the national average even by 2017. Examples of cities and towns in this segment include some of the outer suburbs of Chicago, some of the smaller suburbs of major metropolitan areas in Florida, such as Tampa and Orlando, some of the smaller suburbs of Tucson and Phoenix in Arizona, and some cities in Nevada that are not in the Las Vegas or Reno metropolitan areas.

### Exhibit S1

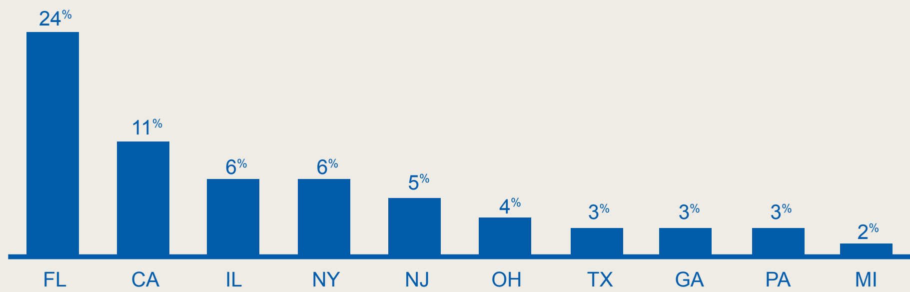
## "At Risk" Properties Concentrated in 10 States

### Share of Mortgages at Risk



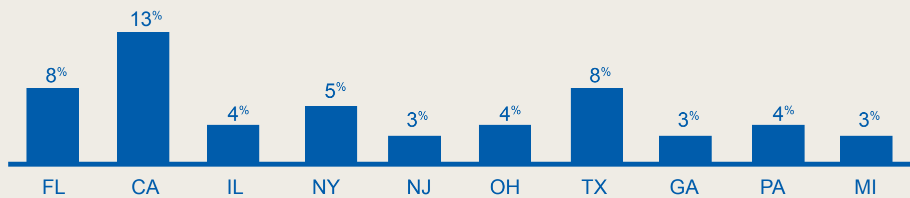

Nearly 13% of U.S. mortgages are at risk

### Share of Foreclosed Homes




2/3 of homes in foreclosure are in 10 States

### Share of Homes with Delinquent Mortgages




Over 1/2 of delinquent homes are in the same 10 states

Source: The Demand Institute; Mortgage Bankers Association

Exhibit S2

# States Differ in Foreclosures, Unemployment, And House Prices

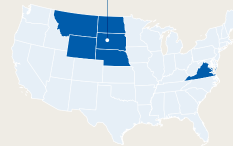
| | Map of U.S. foreclosures<br>Share of total housing inventory in foreclosure | Price average changes |
|---|---|---|

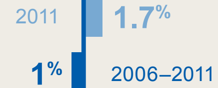
**Lower unemployment**

**The 13 states that had unemployment rates under 7%...**

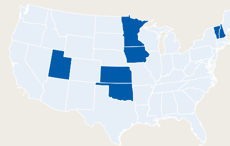
Less Than 2%

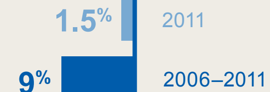
ND 1.09%






2–4%

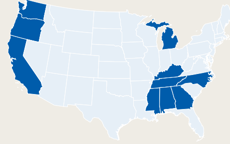


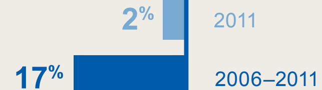



**Higher unemployment**

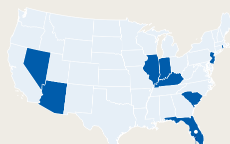
**The 18 states that had unemployment rates over 9% in 2011...**

2–4%






4% or More

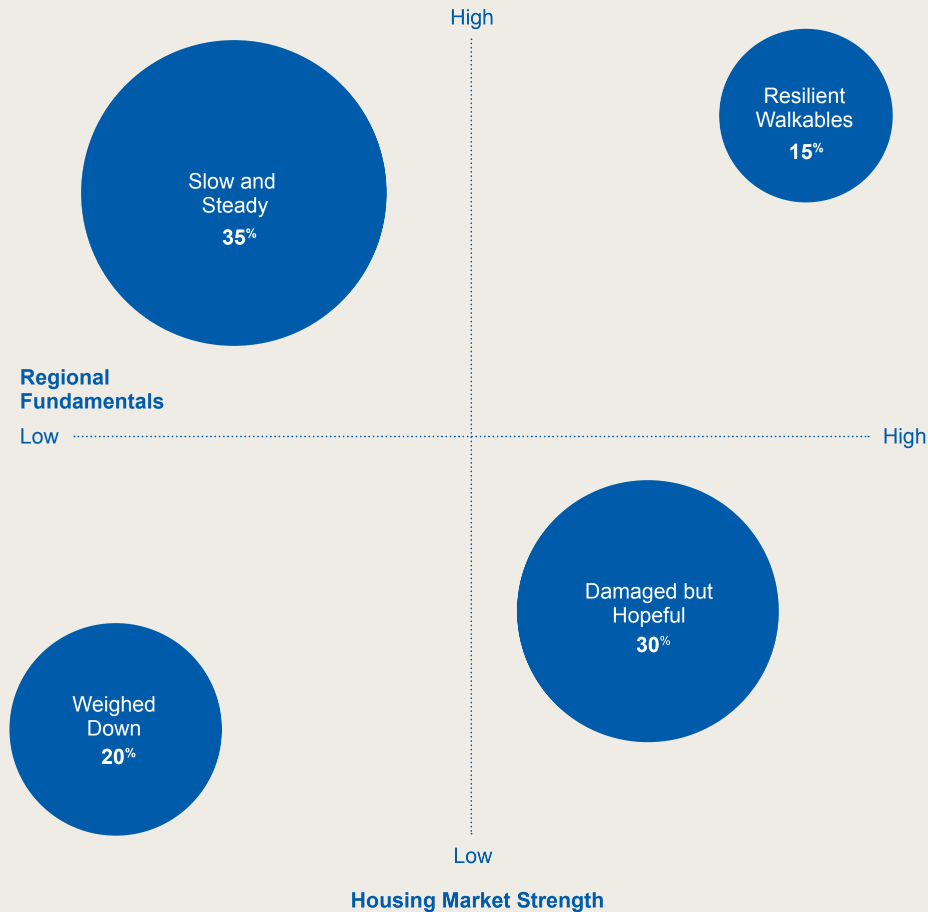


FL 14.4%

Source: The Demand Institute; Bureau of Labor Statistics; Mortgage Bankers Association; FHFA

## Exhibit S3

# An Inconsistant Pattern of Recovery




Note: Housing market strength based on distressed property prevalence and historical price declines. Regional fundamentals based on labor market dynamics and accessibility. Bubble size and percent indicates share of population in that segment.

Source: The Demand Institute

# A Remodeled American Housing Dream

**It appears then that Americans' desire to own their homes has survived the financial distress of the recession.** We do not expect to see a long-term drop in ownership rates. One survey showed that more than 80 percent of Americans still feel buying a home is the best long-term investment they can make.[16]

Americans' aspirations are still closely linked to property ownership. Prior to the market crash, more people moved for aspirational reasons such as wanting to own instead of rent, wanting a nicer home, or wanting to live in a better neighborhood, than for purely practical reasons, according to U.S. Census mobility data. Those aspirations, which peaked during the housing bubble, evaporated as the economy slid into recession.

Rental demand today reflects these economic realities. Most Americans who move over the next two years will do so for practical reasons, be they job or budget-related (Exhibit 9). But there is evidence that renters and existing homeowners alike who plan to move in the next three to five years will again do so for aspirational reasons.[17] Hence, the return to home ownership.

## Downsizing, Polarization, and Accessibility

Although demand for new and existing homes will rise, consumer demographics as well as altered preferences will change the nature of that demand. Consumers will reduce their expectations and houses will be smaller, neighborhoods will be increasingly segregated economically, resulting in polarization, and demand will be high in areas well served with amenities that are within walking distance and that have a sense of community. Sprawling, featureless suburbs will be less attractive.

### Downsizing

Demand for smaller homes will be driven partly by the many baby boomers who delayed retirement because of financial concerns during the recession.[18] When they do eventually retire, many will not move. But those who do are likely to downsize.[19]

This will be part of a more general trend toward downsizing. The average size of new homes fell between 2007 and 2010 back to 2004 levels, and for the period from 2010 to 2015 it is expected to fall by another 10 percent, to reach mid-1990s levels (Exhibit 10). This downsizing is in line with a growing income gap in the United States. The number of middle-class households and their share of total income earned is shrinking. A minority of households has become richer, but most find themselves poorer and many, therefore, will want smaller homes.

### Polarization

The long-term trend of growing income inequality in American society is contributing to polarization of neighborhoods by income. It is already estimated that the proportion of families living in middle-income neighborhoods in metropolitan areas fell from 65 percent in 1970 to 44 percent in 2007, while the proportions living in affluent or poor neighborhoods both increased.[20] This decline in middle-income neighborhoods is partly a result of there being less mixing of income levels within individual areas. The trend is likely to intensify as widening income inequality begins to affect the middle class, which has experienced slow wage growth over the past decade, and especially since the last recession. Polarization of neighborhoods by income will lead to a distribution of housing that reflects growing income inequality. Housing stock within neighborhoods will become more homogenous, and there will be a growing number of modest homes and a smaller number of neighborhoods with finer homes.

### Accessibility

Demand will increase for houses in communities that offer convenient access to amenities and services. Over the course of decades, many U.S. cities declined as middle- and upper-income families left for the

suburbs. In the 1990s and 2000s, some, such as Boston, Seattle, New York, and San Francisco, experienced a renewal as young professionals and other well-heeled individuals flocked to areas rich in jobs, entertainment, and culture. The phenomenon was not limited to large city centers. Some suburbs, such as Kentlands, Maryland; Reston, Virginia; and Evanston, Illinois offer these environments too. These communities emphasize a mix of residential and commercial developments with nearby services and amenities. Services include easy access to public transportation, a significant advantage as traffic pressure in major metropolitan areas worsens owing to limited investment in road infrastructure.

This trend is reflected in house prices. An analysis of prices in almost 1,700 U.S. cities showed a relationship with a city's walk score—that is, its "walkability" in terms of how far local amenities and services were from residential areas. Prices have grown more strongly in "walkable" cities since 2000.[21]

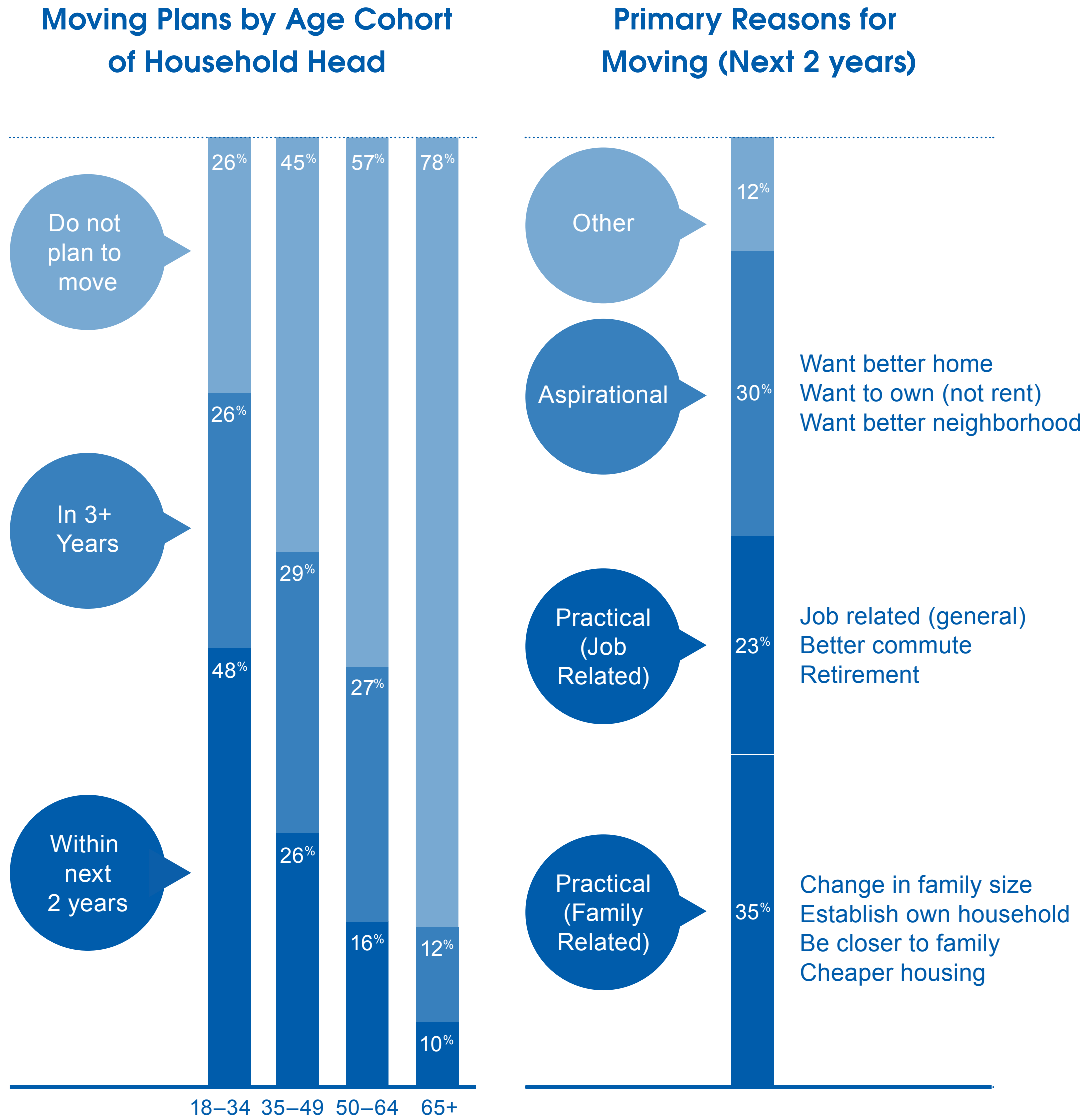
At the same time, our research suggests a countertrend, in that many Americans—particularly those planning to purchase—will move even farther from the city to suburbs where housing is more affordable. Price appreciation in many suburban areas will be weak. In fact, recent research shows that almost half of those living in poverty are now in the suburbs, suggesting that the suburbs face challenges once thought the preserve of urban and rural areas. Broadly, the center of economic gravity will continue to tilt away from the suburbs and back toward urban areas.

The beginnings of these trends are already apparent. Over the course of the next five years they will take hold, increasingly influencing the nature of housing demand and consumer spending in adjacent industries up to 2017 and beyond.

It is to the effect on adjacent industries of changes in the housing market that we now turn.

## Exhibit 9

# Many Americans Planning a Move Within 6 Years

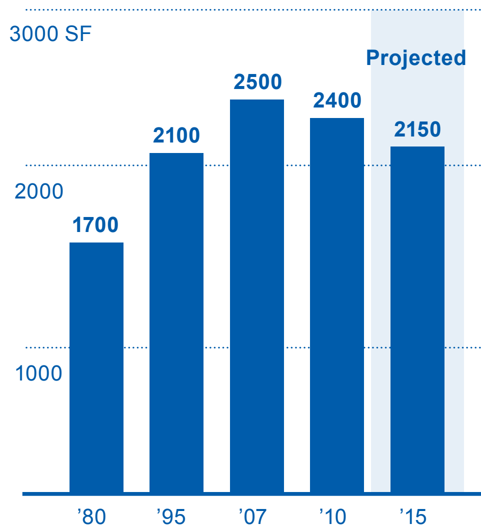



Source: The Demand Institute; The Conference Board (consumer survey conducted December 2011; N=2,632)

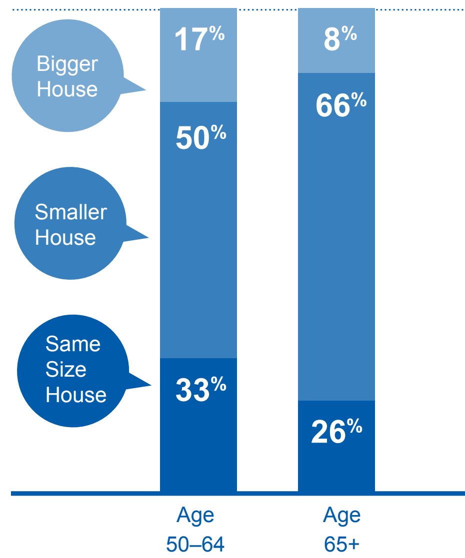
Exhibit 10

## Average New Home Size Projected to Decline

### Average New Home Size




### Older Americans' Intentions Among Those Planning to Move




Source: The Demand Institute; U.S. Census Bureau; National Association of Homebuilders; The Conference Board (consumer survey conducted December 2011; N=2,632)

# The Impact on Adjacent Consumer Industries

**Traditionally, consumer spending is affected by the housing industry in two ways, via the wealth effect and the transaction effect.**

The wealth effect occurs through the accumulation or loss of wealth resulting from house price movements. It is estimated that, on average, every $100 change in housing wealth leads to a $7 change in overall consumer spending. This impact on consumer spending is estimated to be greater than that of other financial assets.[22]

The transaction effect occurs through the business of building, buying, selling, and renting homes, and the consumer spending these activities generate in other industries. As described in the first section of this report, a fall or rise in housing-related consumer spending affects a wide range of industries, including those associated with the transaction, those that produce goods and services for the home itself, and those that provide goods and services in the surrounding neighborhood. In addition, shifts in the nature of housing demand alter the type of demand in adjacent categories.[23]

Because of the slow growth in house prices during this recovery, the wealth effect will have little or no impact on spending. Neither will the sale of new, single-family homes help drive the performance of other industries to any great extent in the near term given that single-family construction is unlikely to return to historical levels for several years. But rental demand will, through the transaction effect.

The rental boom has two features that are significant in terms of consumer spending. First, the spending patterns of landlords and renters tend to differ from those of homeowners. Second, the characteristics of renters themselves have changed. A higher proportion have been homeowners than used to be the case. Many might be preparing to purchase again. And some are renters-by-necessity who have not much cash and restricted access to credit.

As a result, we expect these renters' spending patterns to vary from those of earlier renters. For example, those who have owned a home in the past might need to store goods that they cannot fit into their rental home. Thus, they will spend money on storage facilities. Others, who cannot afford to buy furnishings, will have to rent them. Spending will also be influenced by the type of dwelling rented; those who rent single-family homes may spend differently from those in an apartment.

**The home-buying transaction triggers a wide range of consumer spending.**

The underlying structural changes we have described—downsizing, polarization, and accessibility—will also shape consumer spending through the transaction effect. Almost every consumer-facing industry will feel this effect as consumers adapt to new economic circumstances that will change where they live, the types of homes they choose, who lives with them, what they put in their homes, and even how they spend time outside their homes. The following sections suggest how rental demand and the trends that are reshaping housing demand in other ways will play out in various industries.

### New Housing Development

Development of new rental units will be an important source of home building growth. The revenues of large rental developers such as Avalon Bay and Equity Trust are as high or higher now than they were at the peak of the housing boom, with many focusing their portfolios on the upper end of the market. Although high-income households are most likely to own, there is still a segment of that market that will rent due to life-stage or lifestyle preferences, or that has delayed taking on ownership during the housing crash.

The growth of these rental developers contrasts with the declining revenues of builders of single-family homes that target the ownership market. As the market recovers, these builders will have to contend with demand for smaller—and cheaper—homes, although some are already responding to the changing nature of demand. Builders such as KB Home, Lennar, and Toll Brothers now offer

"home-within-a-home" models that include a second, self-contained unit with its own entrance, bathroom, and kitchenette that can accommodate parents, adult children, or tenants.

As construction of single-family homes recovers, we anticipate that it will reflect polarization trends. A larger share of homes are likely to be both smaller and to have more modest finishes than homes built during the housing boom.

### Home remodeling

The remodeling sector suffered less than the homebuilding sector during the recession. Its revenues fell by 16 percent between 2006 and 2011,[24] compared with a 55 percent decline in revenues for the total residential construction sector.[25] Recently one part of the remodeling sector has started to recover. The largest home-improvement retailers, The Home Depot and Lowes, saw revenue growth in 2010 and 2011.[26] Sherwin-Williams, the largest U.S. paint retailer, reported gains too, citing a 9.1 percent increase in Paint Store Group sales during the fourth quarter of 2011.

The sector will also outperform construction as the economy recovers. It will benefit from the abundance of foreclosed homes that are being purchased by investors to rent out and are in need of repair. Landlords, unlike homeowners, will not be able to postpone these repairs for long. In addition, older people who choose not to move will need to have their homes adapted, as will those who choose to accommodate several generations under the same roof. A recent Bank of America Merrill Lynch report confirms that "renovation spending is on a decisive uptrend, which is likely to persist."

### Retail Banking, Asset Management, and Insurance

Financial services will experience growing demand from the rental market, giving it the opportunity to offer new products and services for renters. Those who rent and can afford to do so are likely to seek investment vehicles for their savings other than property. Retail banks could enter partnerships with other investment firms to offer real estate investment trusts, or offer new accounts that record on-time rental payments and monthly savings to help renters qualify for home purchase in the future.

Banks could also offer “lease-to-own” programs to renters who have defaulted on home loans but would like to own property again. For homeowners who rent out the home they own and rent somewhere else to live themselves—a fairly common occurrence among those who have to move but do not want to sell at current prices—products and services that help them to collect and pay rent, utilities, and property taxes on two or more properties could prove popular.

In personal and casualty (P&C) insurance, there will be demand for renters' insurance, which is cheaper than homeowners' insurance. Opportunities might also arise for P&C insurers to introduce products for renters that cover alternative investments such as art, jewelry, and vehicles, and liability insurance that is bundled with renters' insurance. On the commercial side, landlords will need insurance for their rental properties, compensating insurance companies that serve both commercial and P&C markets for loss of homeowners' insurance premiums.

**We project significant growth for consumer durables.**

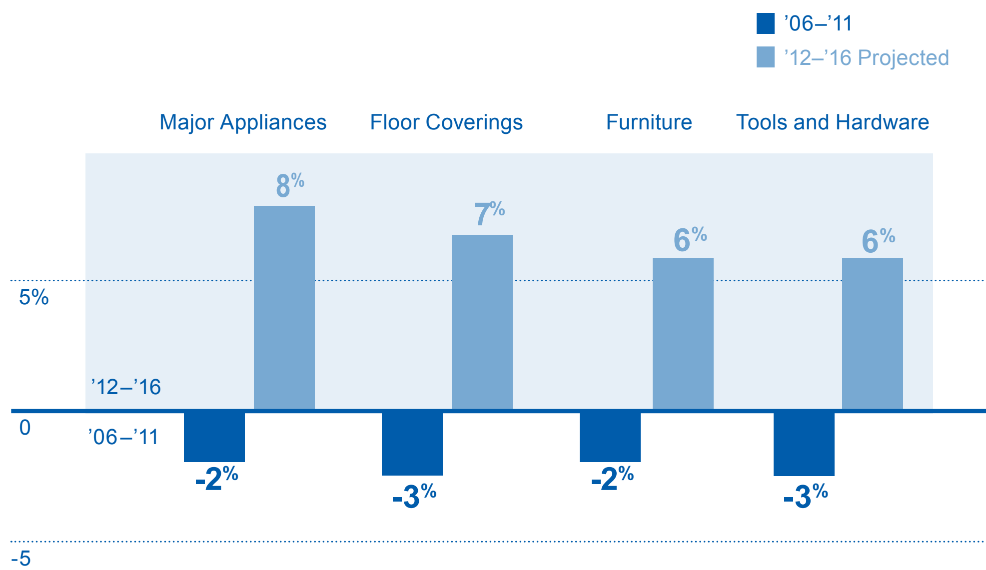
### Home Fixtures, Furnishings, and Appliances

The decline in the housing market has taken its toll on these sectors, with spending falling by 5, 10, 11, and 20 percent on furniture, tools, large appliances, and floor coverings respectively between 2006 and 2011. We project the rebound in sales of new and existing homes over the next five years will contribute to up to 6 percent annual growth in spending on furniture, 6 percent on tools, 8 percent on large appliances, and 7 percent on floor coverings (Exhibit 11).[27] This growth will be felt by manufacturers globally, including companies such as LG and Markor Furniture that manufacture in South Korea and China and sell in the United States.

## Exhibit 11

# Adjacent Industries to Benefit from Housing Recovery

### Annual Percentage Drop In Consumer Spending During Housing Crash and Potential Increase Through 2016




Source: The Demand Institute; BEA National Accounts; U.S. Census Bureau; National Association of Realtors

Value-oriented brands are likely to see the greatest growth. In the short term, this trend will be driven by landlords and renters who want to spend less on fixtures and furnishings than homeowners. In the longer term, the rise in income inequality will reinforce demand for value-oriented goods, even among homeowners. And in line with demand for smaller homes, we also expect to see strong growth in sales of furniture and appliances designed for comfort and practicality in smaller spaces.

Spending on small durable goods, including small appliances and decorative items, bucked the trend during the recession by continuing to grow, albeit more slowly (Exhibit 12). Such products help consumers, be they renters or homeowners, to improve their living environment relatively cheaply. In 2011, retailers in this sector, such as Bed Bath & Beyond, Williams-Sonoma, and Pier 1 Imports, increased their sales by between 6 and 12 percent. Strong growth is expected to continue.[28]

**Media, Entertainment, and Telecommunications**

Many companies in media-related and telecommunications industries seemed immune to the housing market turmoil. Apple, for example, experienced a net income surge from $3.5 billion in 2007 to $25.9 billion in 2011.[29] And despite the monthly expense of cable television subscriptions, television viewing is at record levels, according to Nielsen research. The average person still watches more than 150 hours of television a month and television remains the most popular screen, although consumers are increasing the variety of devices they use to view video.

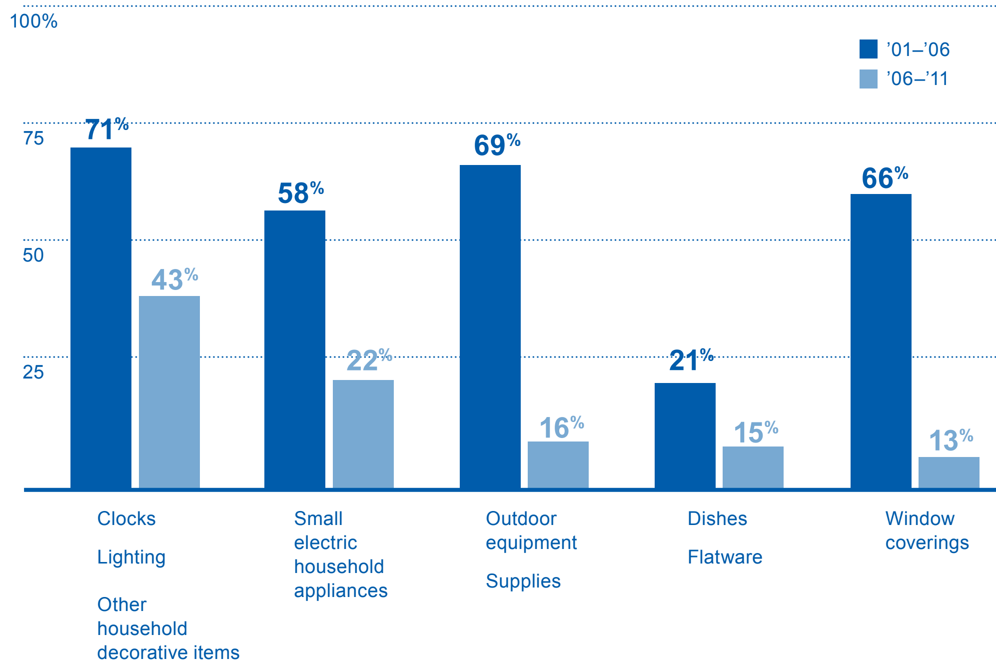
While we do not anticipate an uptick in media consumption due to the strengthening of the housing market, the fact that more people will rent and have smaller homes could influence the devices they use. For renters in temporary accommodation, portable devices might be preferred, while those living in smaller homes might require smaller screens and integrated devices. Furniture manufacturer IKEA already produces a furniture range with a built-in television and home entertainment system. And soundbars are an increasingly popular alternative for rooms that cannot accommodate a full surround-sound system.

Game consoles—already in 45 percent of U.S. households[30]—could become a household staple for those without space for a home theater, giving access to the internet, streamed content, DVDs, and games. Consumers will increasingly spend money on broadband rather than cable television as a result. But watching video via the internet or on mobile devices has not replaced the television and will not do so in the near term.

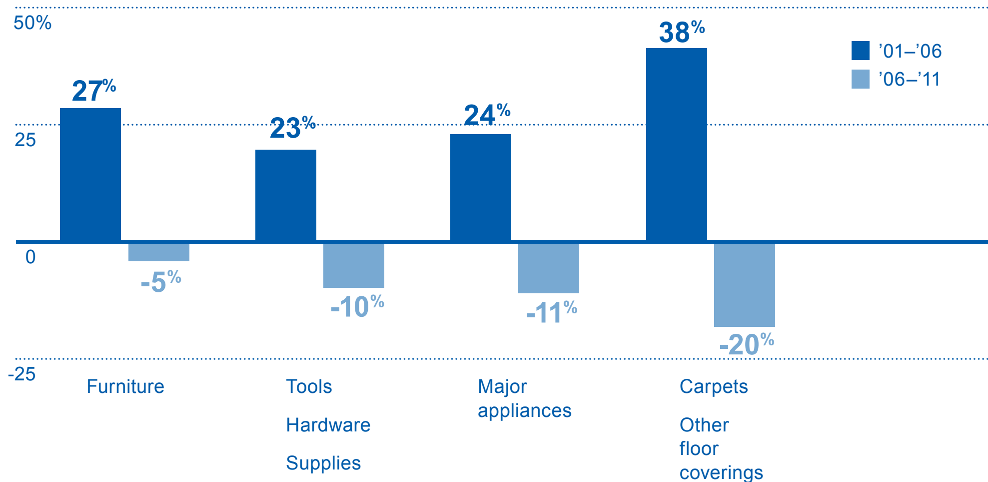
### Exhibit 12

## Small Durables Fared Well During Housing Crisis

### Small Household Durables Consumer Spending Percent Changes




### Large Household Durables Consumer Spending Percent Changes




Source: The Demand Institute; Bureau of Economic Analysis, 2012 (March 1 release)

Outside the home, group discounts from online companies such as Groupon and Living Social, offering daily deals concentrated on local experiences, have already emerged from the resurgence of people's interest in their communities. In the new housing world, these groups might offer renters or downsizers experiences beyond the home that they might not have tried otherwise.

### Non-durable Packaged Goods and Retail

The trend toward smaller homes (less storage) and accessibility (easily reached stores) is likely to lead to the purchase of smaller sizes of packaged goods. This will mean lower spending per shopping trip, and more frequent trips. Indeed, Americans might move toward the norms of Europeans and Asians, for whom stock-up shopping trips have never caught on to the same extent because they live in smaller, more "walkable," and public transport-accessible homes.

Several large retailers are already reinforcing this behavior by building more small-format stores, while online retailers will benefit from consumers moving away from stock-up trips and instead, shopping just in time and for smaller-pack sizes. Retailers might also provide facilities for hobbies, such as woodworking and crafts, that smaller homes would struggle to accommodate, and even shared gardening space.

### Adjacent Rental Markets

An increase in rented properties will raise demand for rented appliances and furniture from those who are short of cash and access to credit. Revenues for Aaron's Inc., which leases furniture, electronics, and appliances, have risen by 65 percent since 2006, and those for rival Rent-A-Center by 18 percent.[31] Rent-A-Center has even begun testing rent-to-own offerings sold at kiosks in a handful of Best Buy stores, reflecting the constraints on many consumers.[32] Even as households move from home rental back toward ownership, increasing income inequality will sustain demand for these kinds of rental services.

Renters have fewer cars, partly because on average they earn less and may not be able to afford a car. But they also often have to pay separately for parking, or have limited access to parking space, or both. From 2000 to 2010, the average number of cars per household, regardless of the size of household or whether it was rented or owned, stayed constant.[33] The median home-owning household, however, had one more car than the median rental household. In addition,

Americans are driving less, and that is especially true of young adults; between 2001 and 2009, 16 to 34-year-olds reduced the number of miles they drove by 23 percent. Thus, as demand for rented housing rises, we expect to see a corresponding increase in demand for private vehicle rentals. Accessibility will strengthen this demand over the longer term as the trend diminishes the need to own a car. Zipcar, one of the larger car-sharing service companies targeted at local and short-term needs, faces intense competition but still expanded its membership from 140,000 to 673,000 between 2007 and 2011, and its revenues from $58 million to $242 million.[34]

Like other rental markets, the self-storage business has been relatively resilient through the housing decline. For people who used to own a home or who want to own in the near future, renting off-site storage enables them to keep items they cannot accommodate in their rental home. As sales of existing homes increase, so will demand for self-storage as part of the activity of moving.

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The double-digit increases in U.S. housing prices over the first half of the past decade proved unsustainable. But the freefall is over. The point has been reached where housing prices will start to climb, albeit at single-digit rates in most markets over the next five years.

That is good news for Americans who want to invest in building a home for themselves and their families. While short-term profits will be rare, the evidence suggests that housing remains a sound long–term investment.

Nevertheless, consumers are adapting to new economic circumstances that will change how and where they choose to live. And where there is shifting demand, there are opportunities for new business. It is a shift with which consumer-facing companies should familiarize themselves.

## Notes

**1.** The estimated drop in spending from a wealth effect compares with a $300 billion drop in consumer spending during the most recent U.S. recession (fourth quarter 2007 to first quarter 2009).

**2.** The period of recovery is defined as the first 11 quarters after the end of a recession.

**3.** Bureau of Economic Analysis, December 13, 2011.

**4.** New Residential Construction Survey, annual data, U.S. Census Bureau.

**5.** Trulia uses the widely accepted metric of median house price over median rental price. If the ratio is below 15, then it is considered less expensive to buy for those staying in a home for five years or more.

**6.** Asked of respondents to The Conference Board's Consumer Confidence Survey, December 2011.

**7.** We define doubled-up households as those with two or more adults (18 years or older) who are not spouses or partners. These adults could be family, including parent and child, friends, or roommates.

**8.** Asked of respondents to The Conference Board's Consumer Confidence Survey, April 2012.

**9.** U.S. Census Bureau projections, 2009.

**10.** The IMF has recently called for regulatory changes in the United States to address the level of household debt and to assist households with their debt burden. See remarks by Christine Lagarde, IMF/CFP Policy Roundtable on the Future of Financial Regulation, April 17, 2012.

**11.** Unemployment could fall to 6 percent by 2015 but there could be further to go. The natural rate of unemployment could be increasing but might not be as high as 6 percent.

**12.** Homeowners under 50, with shorter tenure in their homes, are also more than twice as likely as homeowners over 50 to cite getting less than they paid if they were to sell (44 percent vs 20 percent) or to cite being unable to pay the mortgage off if they sold (41 percent vs 13 percent). Older and middle-income homeowners are more likely than others to be holding back from selling now. Asked of respondents to The Conference Board's Consumer Confidence Survey, April 2012.

**13.** Federal Reserve Board.

**14.** The level of demand for rental units can be sustained, even as the rate of ownership rises, owing to the formation of new households. The number of households will continue to grow, and many new households will rent before buying, including immigrants and young adults, as discussed.

**15.** Asked of respondents to The Conference Board's Consumer Confidence Survey, December 2011.

**16.** Pew Research.

**17.** Asked of respondents to The Conference Board's Consumer Confidence Survey, December 2011.

**18.** More than two-thirds of older Americans who lost their jobs and substantial wealth said they would have to delay retirement.

**19.** Asked of respondents to The Conference Board's Consumer Confidence Survey, December 2011.

**20.** See report: "Growth in the Residential Segregation of Families by Income, 1970–2009".

**21.** The Demand Institute analysis of Walk Score data and Zillow home price data.

**22.** Estimates vary. For example, see "How Large is the Housing Wealth Effect? A New Approach," C. Carroll, M. Otsuka, and J. Slacalek, *Journal of Money, Credit and Banking,* February 2011. There is debate over the influence of housing wealth on consumption. Using the established wealth effect estimates, the impact on consumption of housing wealth's decline from 2006 to 2011 was about $100 billion a year. Some studies have found, however, that the housing wealth effect exists only in countries with well-developed credit markets for housing, suggesting that if credit were restricted, that the wealth effect would be eliminated. After all, many consumers' spending decisions are more influenced by their monthly income than their illiquid wealth. In any case, with the prospect of much slower house price growth and tightened credit standards, it is our view that the housing wealth effect will not play a significant role in the upcoming housing recovery.

**23.** While we focus here on the effects of housing on consumption, any change in housing construction obviously affects supplier industries to the housing sector. For example, an analysis from the industry-by-industry Input-Output tables by the Bureau of Economic Analysis shows that for every dollar produced in construction, the aggregate economy produces about $1.95 economy wide. Energy suppliers, metal and mineral products, and technical services such as design and engineering all contribute. The real estate sector, which includes rental activity, also generates production by the financial industry.

The additional jobs created in these industries in turn create purchasing power that adds to the economy's recovery.

**24.** Including commercial spending on rented properties.

**25.** Bureau of Economic Analysis National Accounts, March 30, 2012 release.

**26.** Yahoo! Finance.

**27.** These projections are built from regression-based estimates of consumer spending growth in each industry, assuming 2.5 percent annual GDP growth and a return to the 1995 to 2004 averages for the number of sales of existing homes and new single homes completed, by the fourth quarter of 2016. The increase in number of sales and completions accounts for the 26 to 38 percent of the total consumer spending growth across each of the four industries.

**28.** Yahoo! Finance.

**29.** Apple 2011 Annual Report.

**30.** Nielsen.

**31.** Standard and Poor's Capital IQ.

**32.** Rent-to-own enables consumers to lease a product, with an option to purchase the product at the end of the lease.

**33.** U.S. Census Bureau American Community Survey.

**34.** Annual Report 2011, Zipcar.

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