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Homebuilders have a big hill to climb but remain key to supply shortage

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Homebuilders have a big hill to climb in the new decade but play key role in helping solve the housing shortage and unlocking sales potential

Highlights

- In the millennial era of economic expansion (2012-2019), a total of 5.92 million single-family homes have been constructed. Over the same eight year period, 9.76 million new households have been formed.
- Despite a booming economy and healthy household formation, sustained levels of relative underbuilding and unfaltering demand since 2012 have left a sizable gap of 3.84 million new homes
- Single-family starts per 1000 households have grown from 4.6 in 2012 to 7.3 in 2019, taking the eight year average to an improved, yet disappointing 6.2 starts per 1,000 households, well below the two decade average.
- Homebuilder confidence has reached a two decade high at the end of 2019, with lower rates and robust economic growth providing a boost in the outlook for new construction.
- Demand for new homes remains insatiable, and even with an above average pace of construction, it would take home builders 4 to 5 years to solve the gap.
- A good fit of supply not just volume remains key, and if builders can deliver homes at adequate price points, absorption will continue to strengthen through the first half of the decade.

The roller coaster of homebuilding in the last two decades

Our [realtor.com housing forecast](#) predicts sales declines in 2020 not because of weak demand for homes but largely due to a supply misfit. [Prior research](#) on home ownership and tenureship has identified Baby Boomers and GenXers as key to freeing up properties and solving part of the shortage. Older groups are key to putting homes back on the market for desperate first time home buyers. However, the chances for this exchange of ownership to unfold fully in

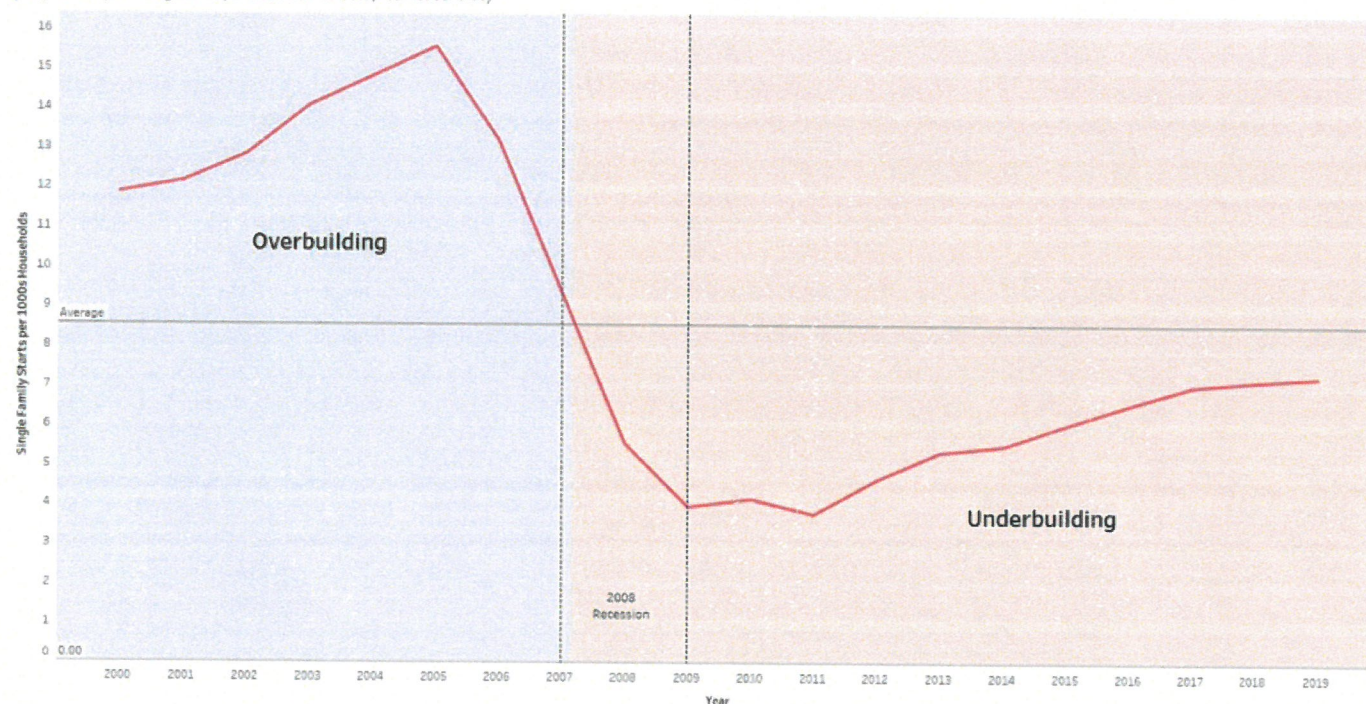
the short term are low at best. Other solutions to issues of inadequate supply remain hypothetical and hinge on significant changes to zoning and local policy. As the new decade in housing ramps up, the market has its eyes on builders to make bolder moves and capitalize on a hungry wait list of first time homebuyers.

But how much do home builders need to ramp up, and realistically, how fast can they ramp up? Analyzing housing starts data for the last two decades with household formation as a backdrop reveals homebuilders have both a big hill to climb and a big mountain of opportunity.

Since 2001, 17.6 million single family homes have been built while 20.2 million households have been formed. In simple terms, this equates to a cumulative supply shortage of 2.6 million units. This pace of building over the two decades also equates to an average of 8.5 homes per 1000 households, or roughly one home built per 1.15 households formed. But the trend over the years has been anything but consistent. The last 20 years have also seen nearly two full economic cycles unfold, and the recent economic expansion has been characterized by a home supply shortage. To fully understand the impact of uneven home building activity over the last two decades on the housing market in the 2020s, it's important to dissect each of the key periods and further quantify the current gap.

Pace of New Home Construction in the Last Two Decades

(Single Family Housing Starts per 1000 Owner Occupied Households)

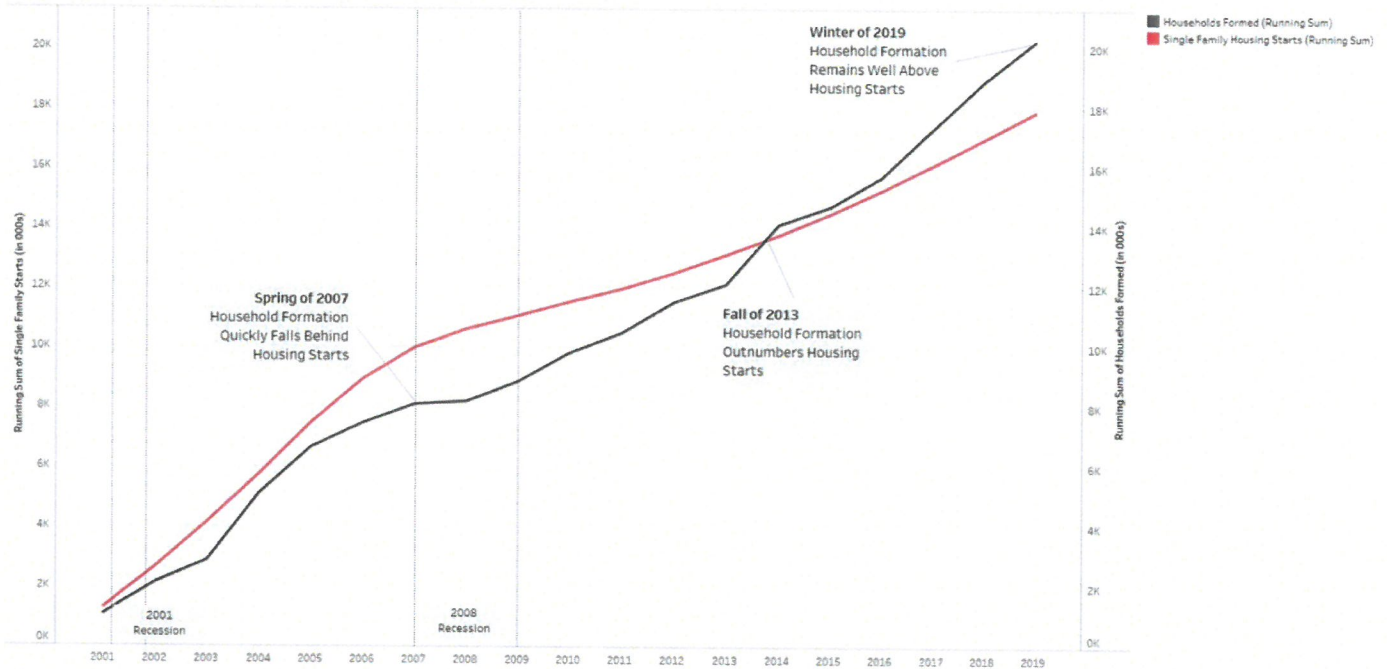


2001-2005: a boom in new home construction

Balanced levels of home construction are elusive. Home building is inherently a cost-heavy and time-intensive process, and one with considerable lag. Home builders take time to adjust to demand and buyers take time to adjust to what gets built. At the start of the millennium, and over the five year period between 2001 and 2005, a total of 7.5 million single family homes were constructed. During the same timeframe, about 6.4 million new households were formed, amounting to roughly only one home built per 0.9 households formed. While the pace of home building had been just slightly outpacing household growth, it had been doing so consistently. The issue became compounded by the already problematic levels of over-construction in the late 1990s and the quickly escalating shaky economic fundamentals and speculation in the early 2000s. New home output grew rapidly, with home builders increasingly confident with what seemed to be unfaltering demand going into the middle of the decade.

By 2005, single family housing starts relative to population had peaked at over 15.5 new homes built per 1000 households. That pulled the five year average up to 13.9 starts per 1000 households. Correspondingly, the home builder confidence index (NAHB's Housing Market Index HMI) had also risen quickly and peaked at 72 in June 2005. This move away from equilibrium set the stage for the subsequent economic crash.

Single-Family Housing Starts vs Households Formed 2001-2019

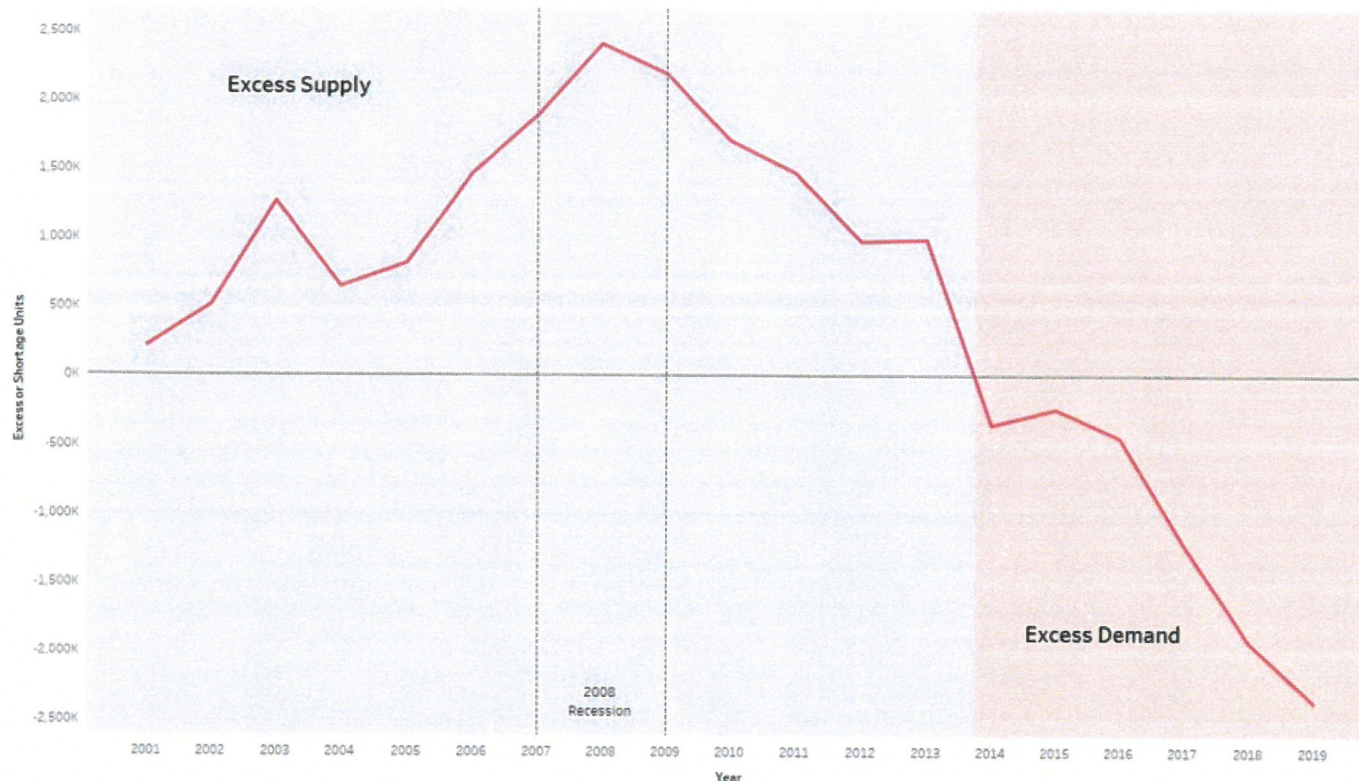


2006-2008: builders face reality check during the financial crash

As the 2008 financial crisis kicked into gear, momentum in home construction quickly turned into a visible excess of supply. Even as homebuilders scaled back, household growth kept dramatically coming short of expectations. In the trough of the recession (2006-2008), the cumulative impact of years of overbuilding became more apparent. During the three year period, a total of 3.1 million single family homes were constructed, yet only 1.54 million new households were formed. That roughly translated into just one home built per 0.5 households formed. The overall stock of new homes had improved quickly but under weak fundamentals and vanishing buyer demand. During this period, housing starts relative to population shifted brusquely, with single-family starts per 1000 households moving down from 13.2 in 2006 to 5.6 in 2008, taking the three year average to 9.3. Fittingly, home builder confidence had also dropped sharply, with NAHB's Housing Market Index HMI sinking to 8 at the end of the period in January 2009.

Cumulative Excess/Shortage of New Home Supply Since 2001

(Running Sum of Single-Family Housing Starts - Running Sum of Households Formed)



2009-2011: builders hold back post crash

In the years following the financial crisis, home builder sentiment remained overly cautious, severely restricting the amount of permits, starts and completions. During the three year period (2009-2011), a mere 1.35 million single family homes were constructed, yet 2.28 million new households were formed. That translated to roughly one home built per 1.7 households formed. The pace of construction fell well below equilibrium and well below the decade average. During this period, housing starts relative to population remained historically low, with single-family starts per 1,000 households averaging a mere 4.0 over the three year period. Consistently, home builder confidence remained unignited and well below historical averages, with NAHB's Housing Market Index HMI remaining below 22 and failing to jump notably throughout the three year period.

2012-2019: builders cautiously throttle output during early recovery and housing boom

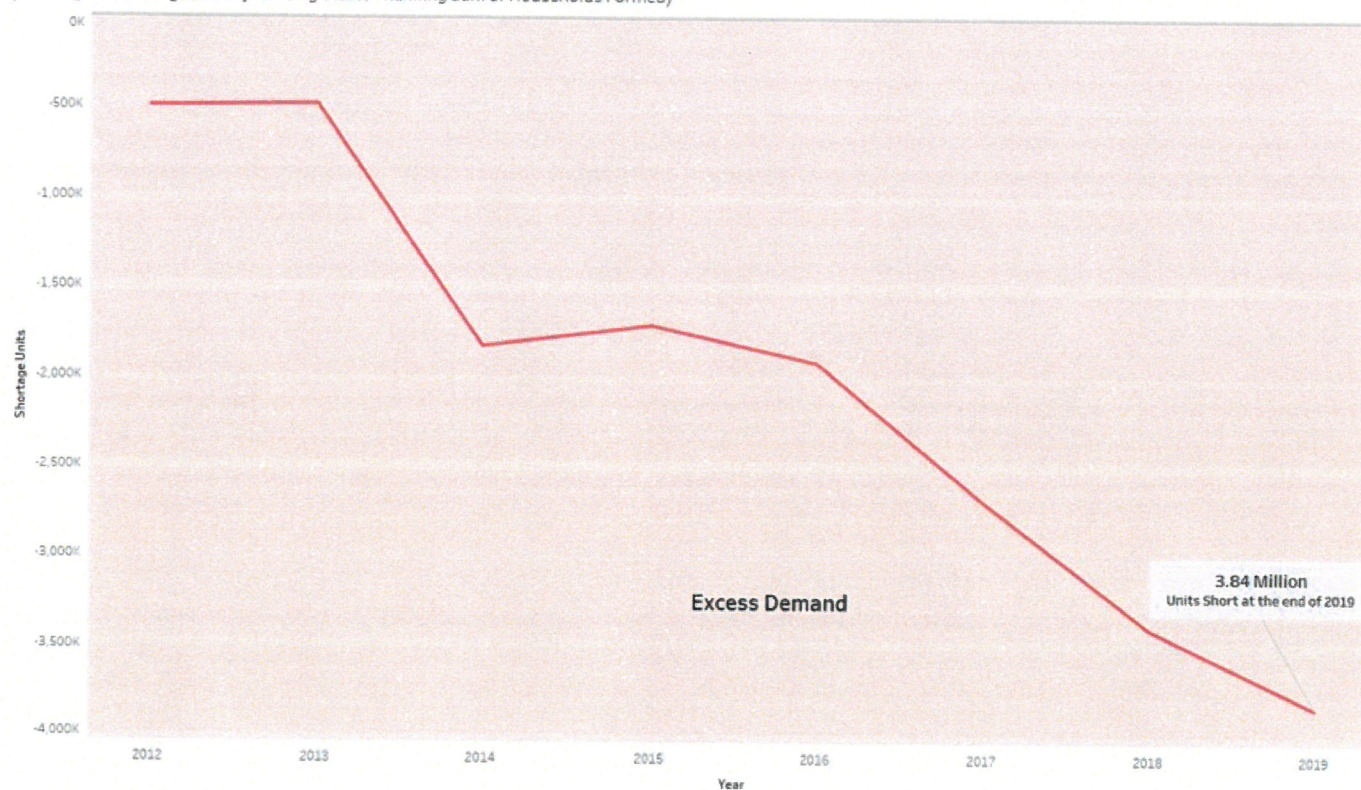
The first and oldest millennial cohort turned 31 in 2012, marking the eventful entrance of the largest generation in history into the housing market. Effectively, millennials as a group have only known a depleted housing market with few options, especially as it relates to new homes. In the millennial era of economic expansion (2012-2019), a total of 5.9 million single-family homes have been constructed. Over the same eight year period, 9.8 million new households have been formed. That translates into only one home built per 1.7 households formed, well below the two-decade average and matches the levels seen in the years post-crash. In an ideal balanced market that ratio should gravitate around one, with one new home built for every new household formed.

During this period of economic growth, the pace of housing starts relative to population has improved steadily but at a crawling pace. Single-family starts per 1000 households have grown from 4.6 in 2012 to 7.3 in 2019, taking the

eight year average to an improved, yet disappointing 6.2 starts per 1,000 households. Home builder confidence has recovered fully, with NAHB's Housing Market Index HMI rising up 55 points from 21 in January 2011 to 76 in December 2019, marking a two decade high. Crucially, since 2016, robust and growing home builder confidence has failed to translate into strong home building output. As an example, 2017 and 2018 reached the same levels of confidence seen in 2003 and 2004, but the pace of home building (starts per 1,000 households) was virtually half. Effectively, sustained levels of relative underbuilding and unflinching demand in the last eight years have left a sizable gap of 3.84 million new homes. On paper, this is how many new units should have been built and offered to homebuyers since 2012.

Cumulative Shortage of New Home Supply Since 2012

(Running Sum of Single-Family Housing Starts - Running Sum of Households Formed)



2020 and beyond: builders' big hill to climb is also a big mountain of opportunity

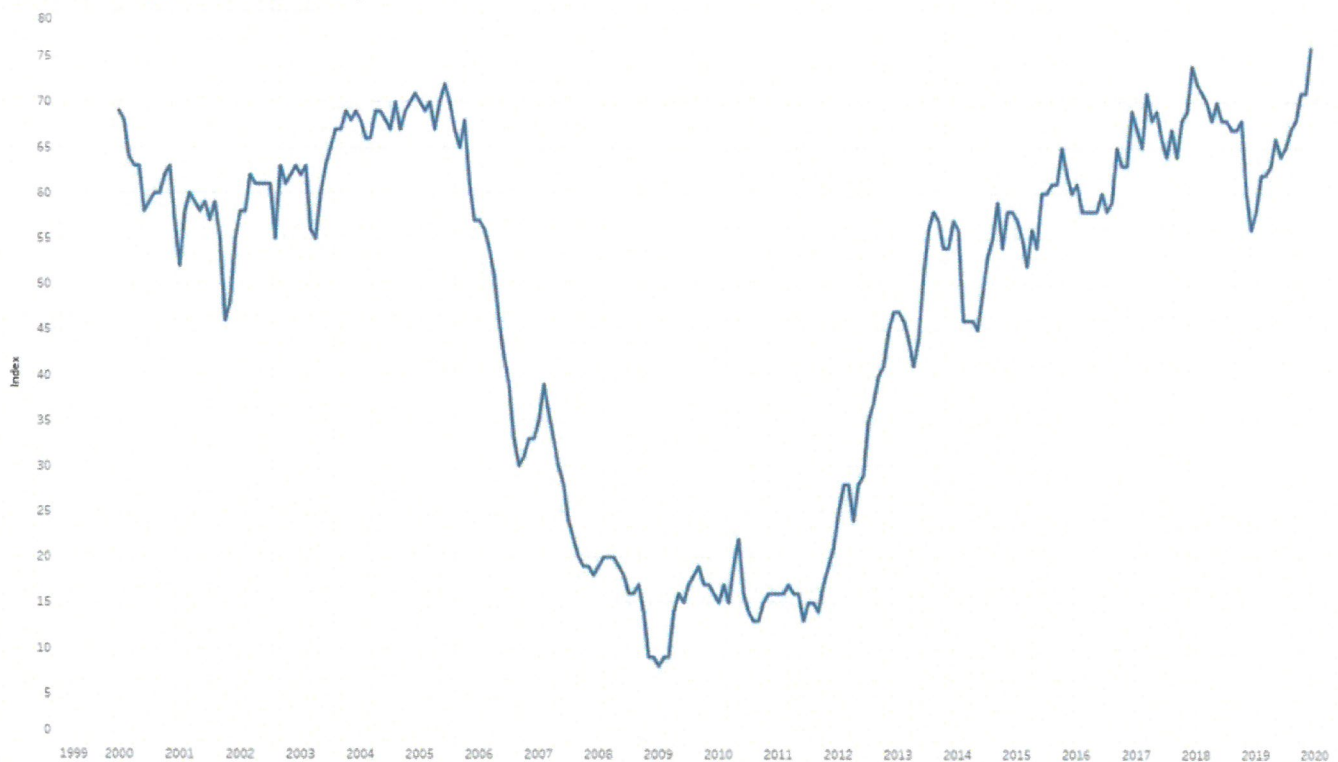
Despite improvements to new home production levels and lower target price points, overly cautious and margin focused builders have failed to quench buyer demand in recent years. While the pace of household formation should moderate in 2020 as economic output and household growth slow down, builders have untapped buyer potential to realize. The demographics and economic fundamentals should continue to underpin home builder confidence. Large populations of renters and well qualified potential buyers with strong incomes are waiting in the wings. If the economy avoids a full-on recession and rates remain low, the window for builders remains open.

Accordingly, with **builder confidence** reaching a two decade high at the end of 2019, it's very possible we'll see home builders increasingly ramp up on production. However, even throttling to an aggressive pace of two single-family starts per household formed, or 12.5 starts per 1000 households, it could take the market 4 to 5 years to get out of undersupply and back to equilibrium. That is assuming all other economic factors remain the same. Under a more conservative scenario, if the levels of construction keep up with household formation on a one to one ratio, the gap could easily remain large well into the end of the decade, leaving unrealized potential on the table. Timing is what

makes the balance so tricky. On average, builders need buyers to enjoy 2-3 years of solid income streams for a downpayment as well as confidence in their financial stability 2-3 years down the road. Barring a large scale event such as a full-on trade war, the likelihood of a full-on recession in the next few years remains low, so this may be the right time for builders to make a move.

Home Builder Confidence back to Two-Decade High

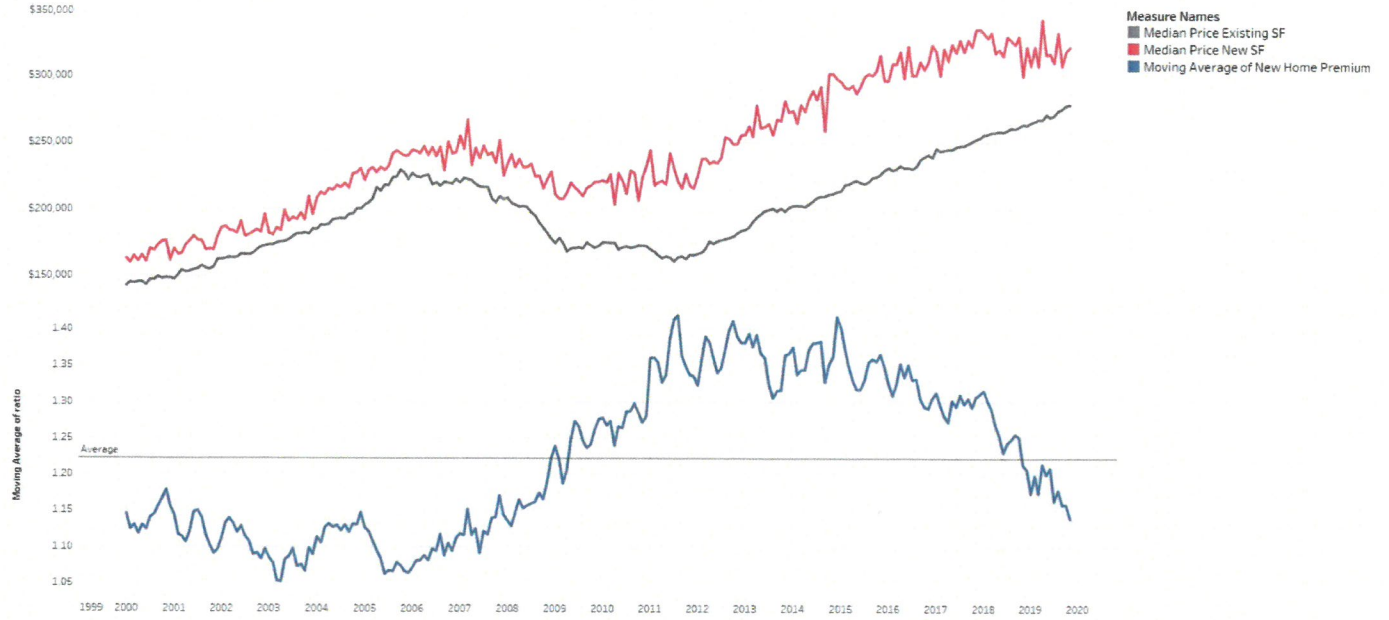
NAHB's Housing Market Index HMI (2000-2019)



But solving the home supply puzzle is evidently not just a game of volume. Supply quality, both in price and size, is just as crucial. Builders can't build homes for a market that doesn't exist. Luckily, the last few years have given them good mileage in the mechanics of buyer elasticity. The price gap between newly built and existing homes has been closing slowly in recent years, for the good. In the last two decades, the ratio averaged 1.22, with new homes priced 22% higher than existing homes on average. During the 20 year period, the new home premium varied wildly, bottoming out at just 5% in April 2003 and peaking at 42% in August 2011. At the end of 2019, the premium dropped to 16%, but it's only been under the two decade average for less than a year.

New Home Premium Reverting back to 'Normal' Early-2000s levels

Existing vs new home median sale prices (2000-2019)



In 2020 and beyond, builders have the capacity and confidence to address home buyer demand, but they also have reasons to remain cautious, maximize profits and avoid overbuilding. If they can manage to balance both forces carefully in the new economic cycle, homebuilders could be one of the bright spots for housing in the new decade.

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