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Housing Update

Housing Stratification: Fewer Starter Homes, More Premium Homes

Starter homes are in short supply, and getting shorter.

By Adam Deermount

The bubble of the mid 2000s represented a major turning point for the US housing market. The entry level segment of the market experienced far more distress than other higher priced segments and was riddled with underwater borrowers and foreclosures. The initial market response was a plunge in pricing that drove ownership costs well below rental parity. In a functional market, this would have resulted in a great buying opportunity for aspiring home owners. However, high unemployment and low earnings during the Great Recession, coupled with a severely restrictive mortgage market meant that few were actually able to capitalize on the deep discount.

Prospective home buyers' loss of ability to buy presented an opportunity for investors. Large and small landlords began buying up entry level homes in record numbers with the intent to lease them out to those who could no longer save up a down payment or qualify for a mortgage. They purchased many tens of thousands of units, often at the court house steps using cash rather than individual mortgages.

At the same time that existing entry level homes were being taken out of the potential purchase pool by investors, rising construction costs – among other factors – made it very difficult for home builders to profitably construct entry level product. As such, they shifted much of their production to the high end where borrowers had substantially better means to save for a down payment, mortgage credit was generally more available and profit margins were substantially larger, serving to dry up entry level inventory even further.

Initially, the lack of new construction of entry level homes coupled with large scale investor purchases of existing homes helped stabilize the market by drying up excess supply and slowing or reversing the falling prices that had plagued many cities since 2008. While this initial elimination of so much distressed inventory was arguably a good thing, the long term consequences have not been.

Fast forward to the present day. On the surface, the inventory situation in the US appears to finally be turning the corner after years of extremely low supply have led to ever-increasing prices. Indeed, the supply of homes in the US increased by 3.3% in the 4th quarter of 2017. However, a closer look reveals that the increase is due to a large 13.3% increase in the supply of premium homes while the supply of starter homes continues to decline.

“Starter homes have become scarcer, pricier, smaller, older and more likely in need of some TLC” than they were six years ago, the real estate website Trulia reported Wednesday after analyzing housing stock across the country. Trulia began tracking prices and inventory in 2012.

*It's grim all over. American homes are at their least affordable in the report's history. **But the median listing price of available starter homes has risen 9.6 percent in the past year, easily beating out the trade-up and premium categories, while starter-home supply has fallen to a new low this quarter, Trulia reported.***

Perhaps the most striking finding is that the very buyers who are typically least able to plunk down a lot of money are confronted with the least affordable homes. **The share of income needed by those in the market for a premium home was 15 percent, and for a trade-up home 27 percent. For a starter it was 41 percent.**

Adding insult to injury, the homes aimed at first-time buyers are **less likely to be ready for human habitation than others, with fixer-uppers accounting for 11.2 percent of the category.** They're about nine years older than they were in 2012, and 2 percent smaller.

All of this begs the question: at what point is a starter home no longer a starter home? If prices continue to rise like this, eventually much of what is considered starter home inventory today will be re-classified as move up. Eventually, there isn't much left other than serious fixer-uppers, tiny homes or units in remote or highly undesirable areas. I've seen this happen up close in coastal Southern

California over the past 17+ years and the results aren't pretty. Unfortunately, as construction costs continue to rise, it's not going to become more economical to build new entry level homes anytime soon short of a major technological breakthrough. In addition, rising rates make it less likely that existing starter home owners will move or that landlords will sell parts of their portfolios, meaning that there is little to suspect that a change in this trend is on the horizon. Downward trending starter home supply appears to be the new normal – at least until the next recession.

Have a Safe and Blessed Easter Weekend

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