February 10, 2014

Economics Group

Special Commentary

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Housing Chartbook: February 2014

Diminished Expectations for Housing in 2014

Surprisingly weak new home sales figures for December and downward revisions to the prior two months have lowered expectations for housing in 2014. Despite diminished expectations, we do not believe the underlying fundamentals of the housing recovery have suddenly taken a turn for the worse. We have long held that the housing recovery would be a long, difficult slog and now that investors appear to be backing away from the market, it has become abundantly clear how modestly the underlying fundamentals have actually improved. Sluggish job and income growth have weighed on household formation and encouraged a larger proportion of households to rent rather than buy a home. We see this trend gradually shifting as the economy moves to firmer ground, but the shift will be gradual and doubts will periodically resurface when bad weather or unsettling political events send chills throughout the economy.

December's disappointing new homes sales figures and the continuing slide in pending home sales is all the more disappointing because there has been so much positive anecdotal evidence that home sales and new home construction were set to improve. Home builder confidence has been gradually improving. The NAHB/Wells Fargo Home Builders' Index fell 1 point to 56 in January, as both the present and future sales indices fell slightly. The overall index, however, remains above its October and November level and improved over the course of the year. Many builders also reported rising order backlogs at the end of 2013 and are planning to increase land development in 2014. Confidence also seems to be gradually returning to the existing home market, despite the recent slide in pending home sales. With home prices rising nearly 12 percent over the past year, more homeowners now feel comfortable putting their homes on the market. Existing home inventories have risen from their historic lows, and homes are selling relatively quickly across much of the county.

Figure 1

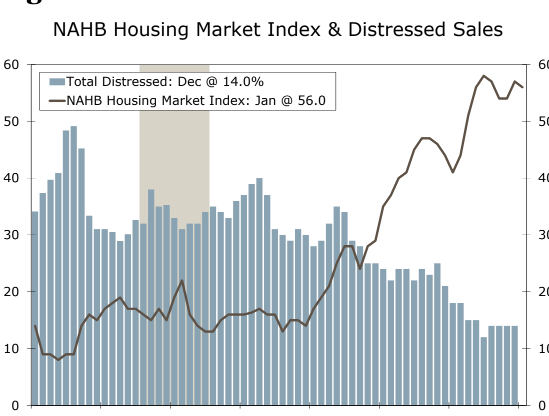
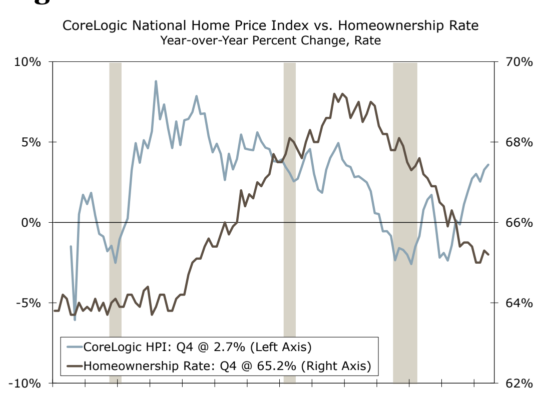


Figure 2



Source: NAR, CoreLogic, NAHB, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

Together we'll go far

Sluggish Household Formations Continue to Weigh on Housing Demand

The most recent data on residential vacancies and homeownership are reflective of the diminished expectations for housing in 2014. The total number occupied housing units increased by an incredibly modest 265,000 in 2013. Once again, all of the growth occurred in rental households, which grew by 315,000. The number of owner occupied homes fell by just under 50,000 during the year. The sluggish pace of household formations is likely due to the shaky recovery in employment and income. Nonfarm payrolls grew by an average of 182,000 jobs a month in 2013 and many of those jobs were in relatively low-paying industries, which weighed on wage and salary growth. We expect hiring to improve in 2014 and are currently looking for job gains to average around 195,000 per month this year. We also expect the quality of jobs to improve, with a larger proportion of new jobs created in higher paying industries.

The rental vacancy rate fell 0.5 percentage points over the past year and ended 2013 at 8.2 percent. The homeowner vacancy rate rose 0.2 percentage points over the past year to 2.1 percent, however, with the number of vacant homes for sale rising by 92,000 units. The drop in the rental vacancy rate reflects tightening rental markets across much of the country, with the biggest declines coming in the Northeast and Midwest. The West remains the tightest market, however, with a rental vacancy rate at just 6.3 percent. The drop in residential vacancy rates has lifted rents across the country and made homeownership relatively more attractive.

There is mounting evidence that the 9 year slide in the homeownership rate is nearing an end.

There is mounting evidence that the nine-year slide in the homeownership rate is nearing an end. The homeownership rate was unchanged in the fourth quarter at 65.1 percent on a seasonally-adjusted basis, which is where it has been for the past three quarters. The rate had peaked at 69.0 percent back in the fourth quarter of 2004.

We have slightly lowered our forecast for 2014 and 2015 to reflect the lower yearend home sales and new home construction figures. Sales of new homes are expected to rise 19.4 percent to 510,000 units in 2014, while sales of existing home rise 4.5 percent to 5.3 million units. With sales improving, new single-family starts should rise 19 percent in 2014 and by nearly 25 percent the following year. Overall housing starts are expected to rise nearly 16 percent to 1.07 million units in 2014 and another 14 percent to 1.22 million units the following year.

The gradual ramp up in new home construction will keep new home inventories relatively lean, which means new home prices will likely once again post gains well above their historic norm. We look for the median price of a new home to rise 4.6 percent in 2014 and look for median price of existing homes to rise 4.0 percent. In addition to tight inventories, new home prices are also being bolstered by rising construction costs and higher lot prices. Home price measures from Case-Shiller and CoreLogic will likely post somewhat larger gains but the pace of home price appreciation is expected to moderate in all measures, as more new and existing homes come on the market.

Figure 3

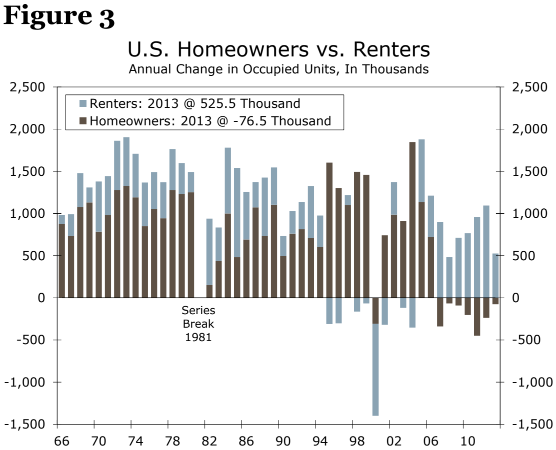
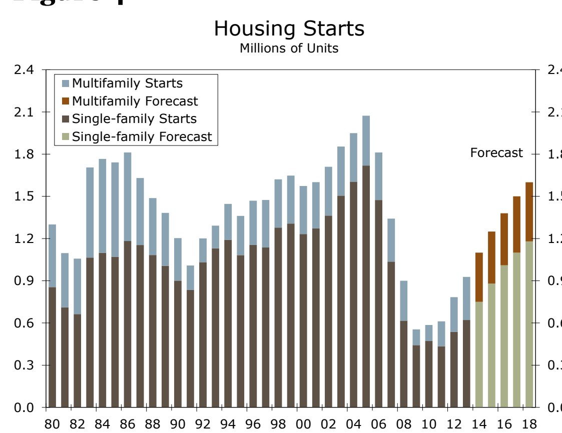


Figure 4



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

National Housing Outlook

	2008	2009	2010	2011	2012	Forecast 2013	2014	2015
Real GDP, percent change	-0.3	-2.8	2.5	1.8	2.8	1.9	2.6	2.9
Nonfarm Employment, percent change	-0.6	-4.4	-0.7	1.2	1.7	1.6	1.6	1.7
Unemployment Rate	5.8	9.3	9.6	8.9	8.1	7.4	6.7	6.3
Home Construction								
Total Housing Starts, in thousands	905.5	553.9	586.9	608.8	780.6	923.4	1,100.0	1,250.0
Single-Family Starts, in thousands	622.0	445.0	471.1	430.5	535.3	617.9	750.0	880.0
Multifamily Starts, in thousands	283.5	108.9	115.8	178.3	245.3	305.5	340.0	370.0
Home Sales								
New Home Sales, Single-Family, in thousands	485.0	374.0	321.0	305.0	369.0	427.0	520.0	630.0
Total Existing Home Sales, in thousands	4,110.0	4,340.0	4,190.0	4,260.0	4,650.0	5,073.0	5,300.0	5,500.0
Existing Single-Family Home Sales, in thousands	3,660.0	3,870.0	3,708.0	3,787.0	4,127.0	4,470.0	4,670.0	4,850.0
Existing Condominium & Townhouse Sales, in thousands	450.0	464.0	474.0	477.0	528.0	603.0	630.0	650.0
Home Prices								
Median New Home, $ Thousands	232.1	216.7	221.8	227.2	245.2	265.8	272.5	279.5
Percent Change	-6.4	-6.6	2.4	2.4	7.9	8.4	2.5	2.6
Median Existing Home, $ Thousands	198.1	172.5	172.9	166.1	176.6	198.1	205.0	210.0
Percent Change	-9.5	-12.9	0.2	-3.9	6.3	12.2	3.5	2.4
FHFA (OFHEO) Home Price Index (Purch Only), Pct Chg	-7.8	-5.6	-3.0	-4.1	3.4	7.8	3.8	2.7
Case-Shiller C-10 Home Price Index, Percent Change	-16.7	-12.9	2.1	-3.5	0.3	12.2	8.1	3.3
Interest Rates - Annual Averages								
Prime Rate	4.88	3.25	3.25	3.25	3.25	3.25	3.25	3.44
Ten-Year Treasury Note	3.66	3.26	3.22	2.78	1.80	2.35	3.10	3.46
Conventional 30-Year Fixed Rate, Commitment Rate	6.04	5.04	4.69	4.46	3.66	3.98	4.80	5.05
One-Year ARM, Effective Rate, Commitment Rate	5.18	4.71	3.79	3.03	2.69	2.61	2.70	2.90

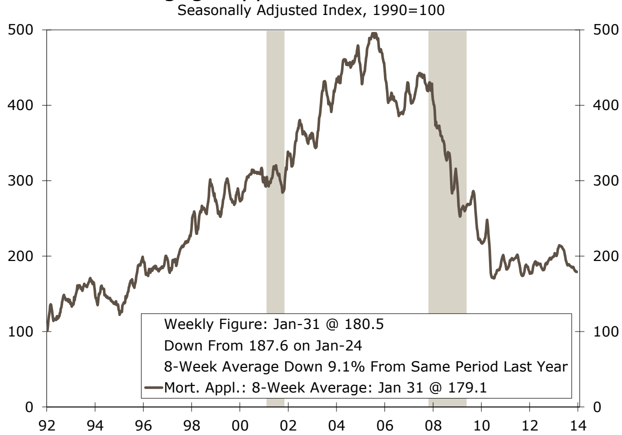
Forecast as of: February 10, 2014

Source: Federal Reserve Board, FHFA, MBA, NAR, S&P, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

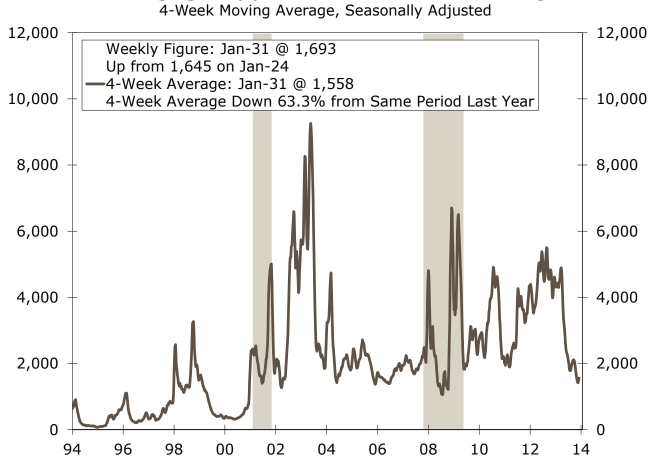
Mortgages

- Following a spike in mortgage rates, applications for mortgages to purchase a home fell 18.5 percent from their summer peak before rebounding over the past few weeks. The recent improvement provides a hint that the recent soft housing data may be due to unseasonably cold weather. The gain in purchase applications foreshadows a modest rebound in home sales.
- Rising mortgage rates over the balance of this year should not significantly impede affordability but will shift the mix of home sales toward smaller and less expensive homes.
- Refinance applications have also been weak in recent months and are down more than 70 percent from their mid-2012 peak.

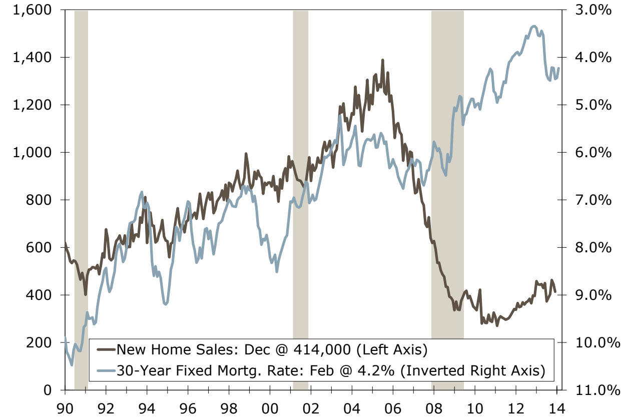
Mortgage Applications for Purchase
Seasonally Adjusted Index, 1990=100



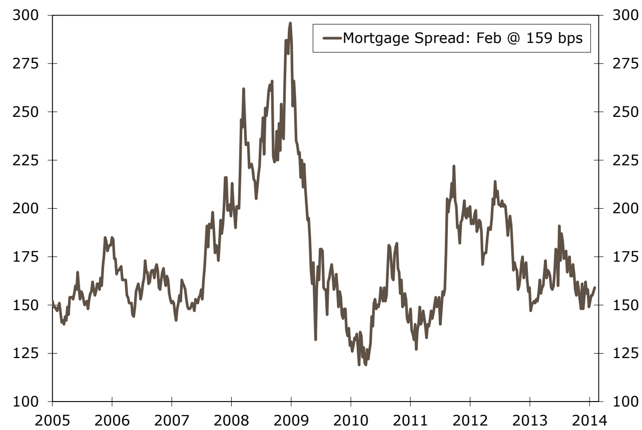
Mortgage Applications for Refinancing
4-Week Moving Average, Seasonally Adjusted



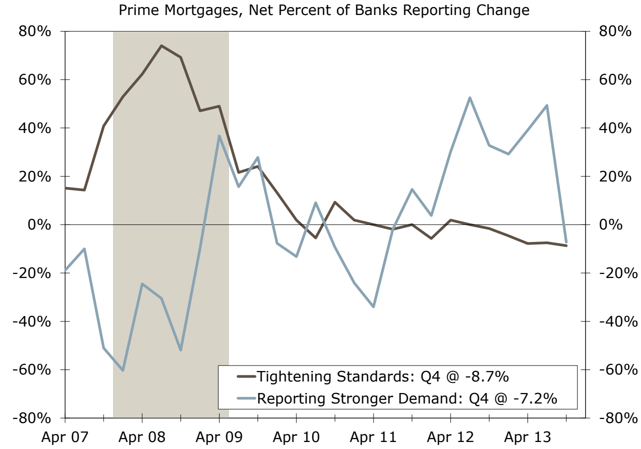
New Home Sales vs. 30-Year Mortgage Rate
Thousands; SAARFHLMC Conventional Fixed Rate Mortgage



Conventional Mortgage to 10-Year Treasury Spread
Basis Points



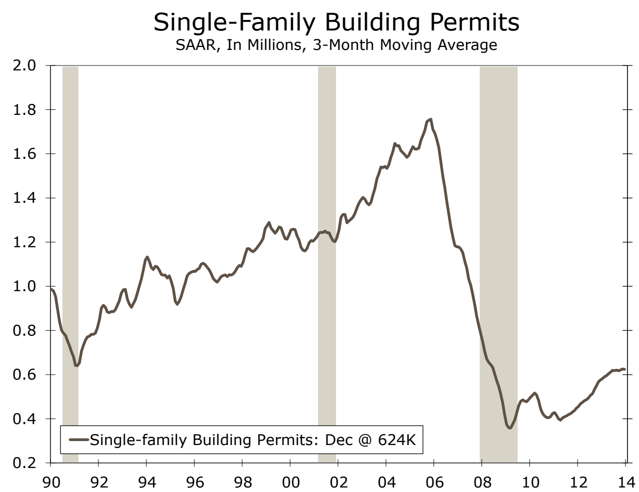
Residential Loan Standards and Demand
Prime Mortgages, Net Percent of Banks Reporting Change

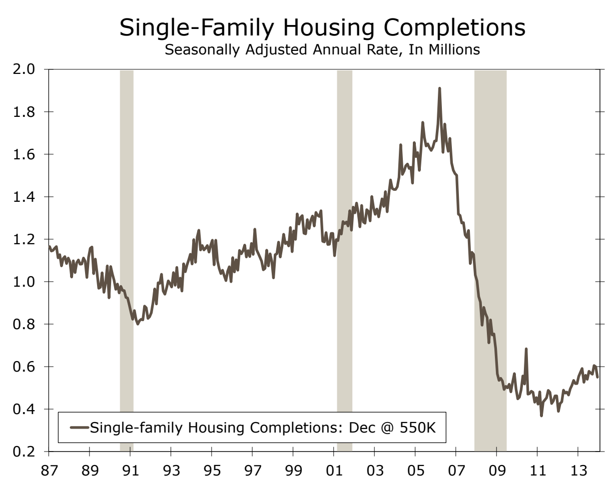


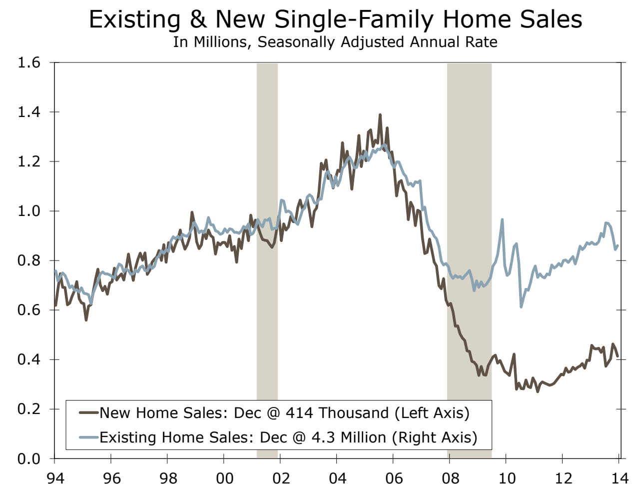
Source: Mortgage Bankers Association, FHLMC, U.S. Department of Commerce, Federal Reserve and Wells Fargo Securities, LLC

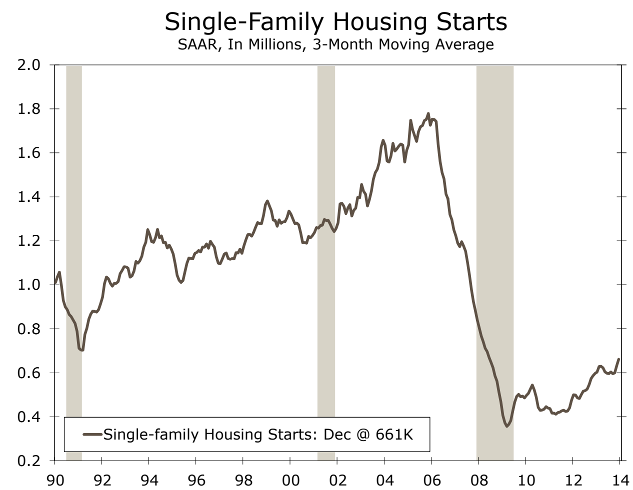
Single-Family Construction

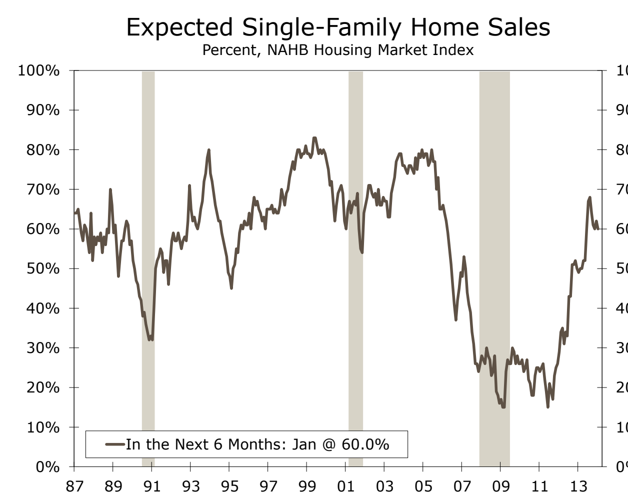
- Following two straight monthly gains, single-family starts dropped 7 percent in December. Although swings in the monthly data are expected during the seasonally slow winter months, non-seasonally adjusted figures plummeted more than 17 percent in December.
- We suspect the dip in starts is weather-related, which suggests construction activity may remain soft through January and February.
- The more forward-looking single-family permits data have also been disappointing. Single-family permits were down 4.8 percent in December and have risen just 4.5 percent over last year.







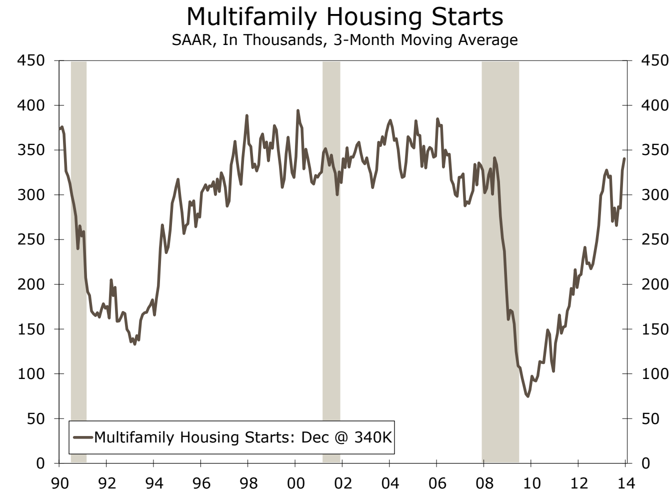


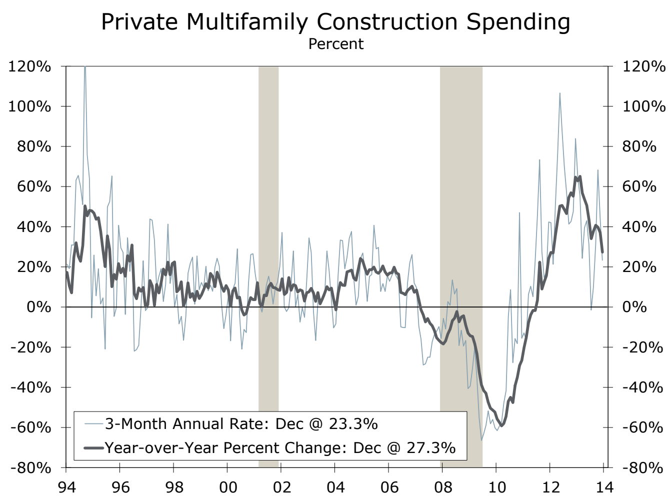


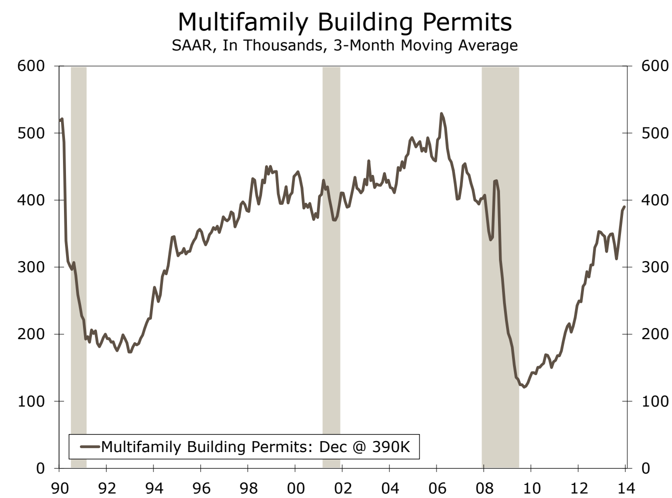
Source: U.S. Dept. of Commerce, National Association of Realtors, NAHB and Wells Fargo Securities, LLC

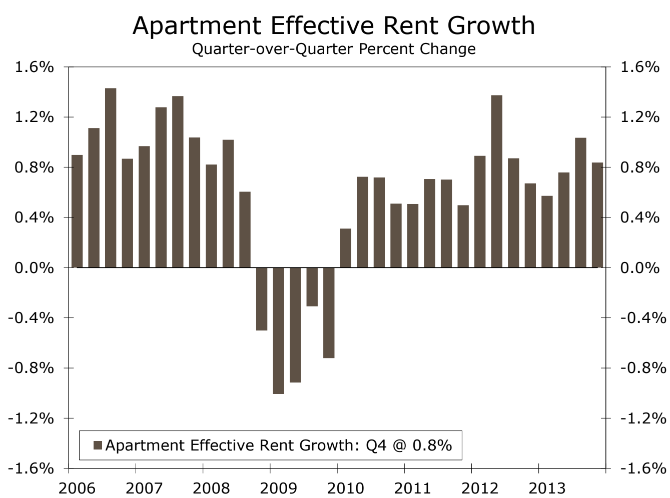
Multifamily Construction

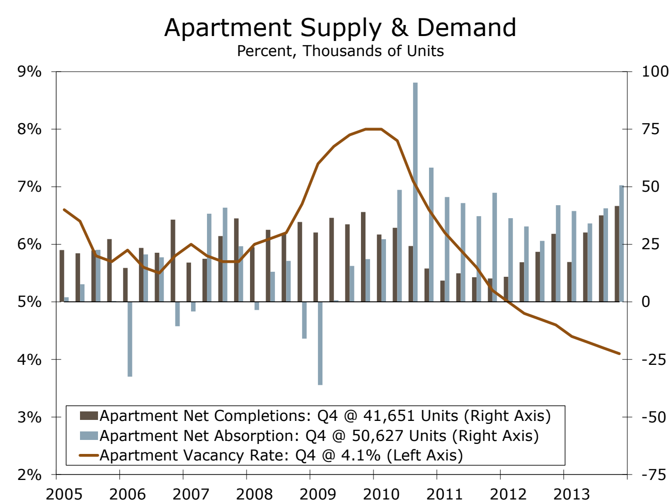
- Despite summer slowdown, multifamily starts are running nearly 25 percent ahead of last year's pace, reaching the highest level in seven years in 2013. Multifamily construction accounts for a third of total housing starts and is expected to continue to grow this year, albeit at a more modest pace.
- Multifamily starts are expected to rise only modestly in coming years as the supply of newly completed units begins to run ahead of demand and sluggish income gains limit rent growth. Even with the dynamics shifting, the apartment market appears set for several years of gains.







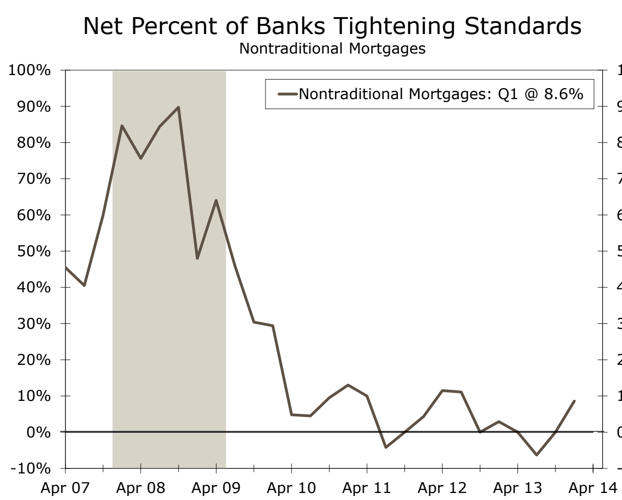


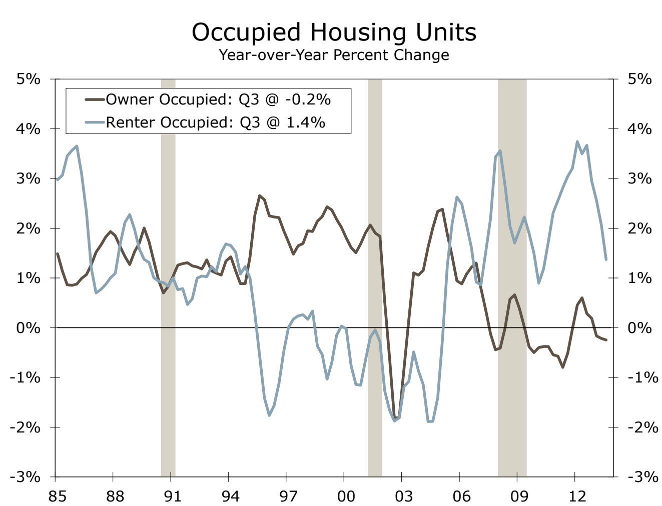


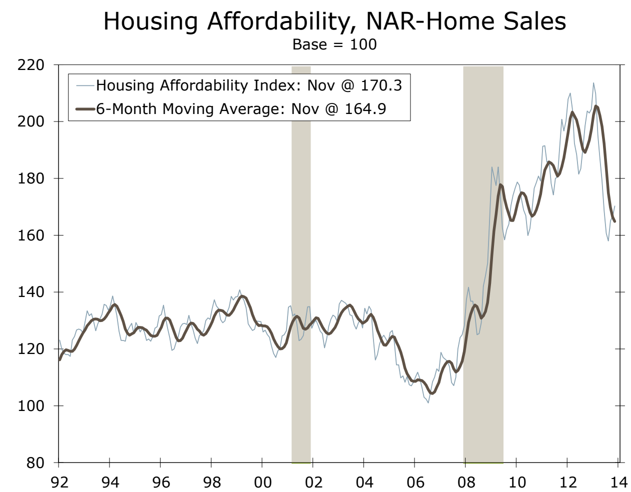
Source: U.S. Dept. of Commerce, REIS Inc. and Wells Fargo Securities, LLC

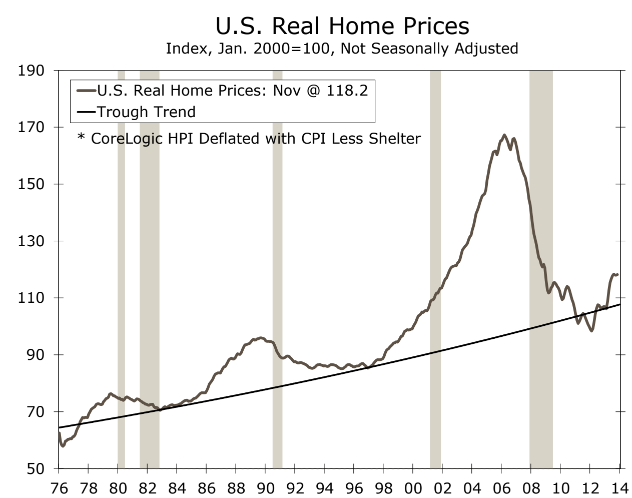
Buying Conditions

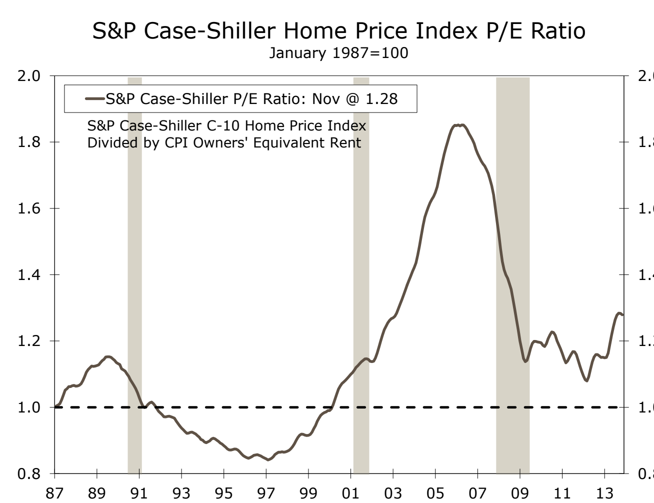
- With the Fed winding down its unprecedented asset purchase program, many are concerned that rising long-term rates could derail the housing recovery. With the summer spike in mortgage rates and rise in home prices, housing affordability has edged lower over the past year. First-time home buyers, which now account for an exceptionally small portion of sales, are particularly sensitive to rising mortgage rates.
- Tight lending conditions and investors paying all-cash for properties have played the largest role in keeping first-time home buyers on the sidelines. According to the latest Senior Loan Officer Survey, few banks reported any change in lending standards or demand.









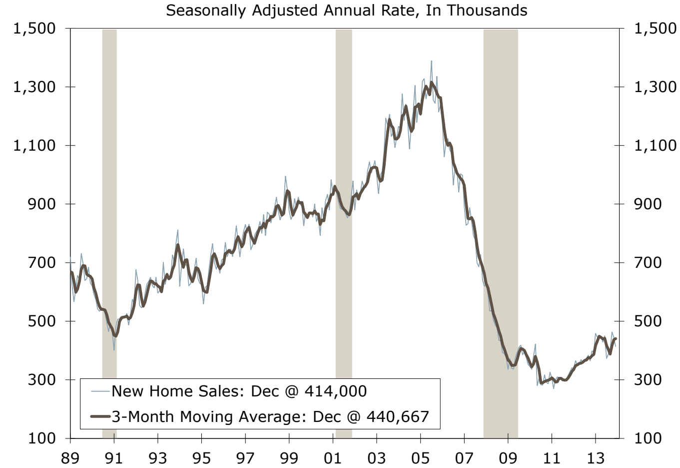


Source: CoreLogic, S&P, Federal Reserve, NAR, U.S. Dept. of Labor, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

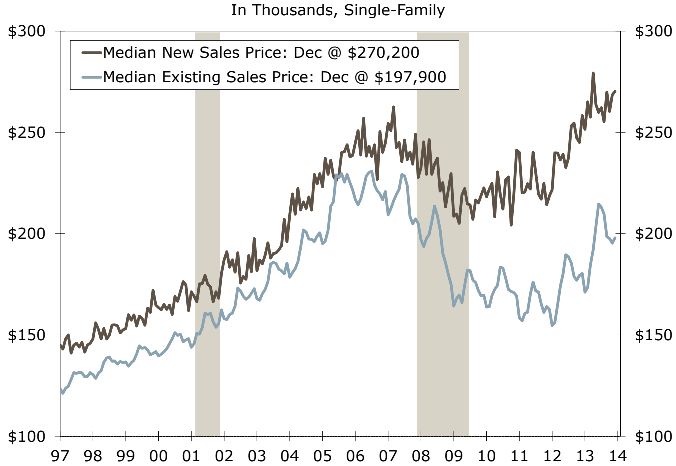
New Home Sales

- Reflecting unseasonably cold weather, new-home sales dropped more than expected in December to a 414,000-unit pace and sales for the previous three months were revised lower. The weaker new home sales data are at odds with improving builder sentiment.
- Although inventories remain exceptionally tight, they are 15 percent higher than one year ago. Completions may have been slowed by unseasonably wet weather. Units "not started" and "under construction" have seen a meaningful increase over the past year.
- Sales of new homes below $150,000 rose in December, but activity in this segment has been a weak spot during the past year.

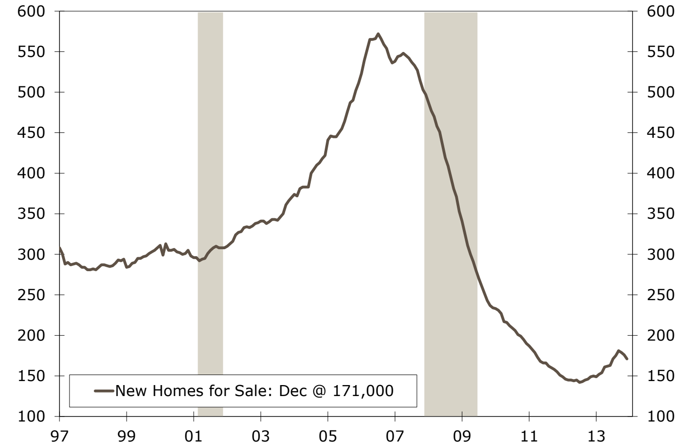
New Home Sales
Seasonally Adjusted Annual Rate, In Thousands



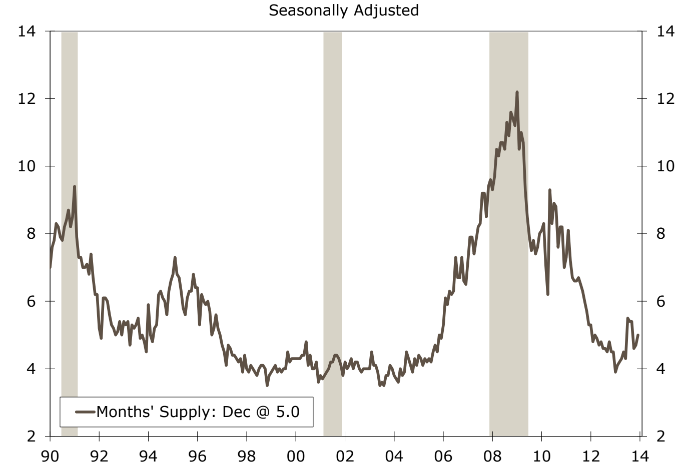
Median New & Existing Home Sale Prices
In Thousands, Single-Family



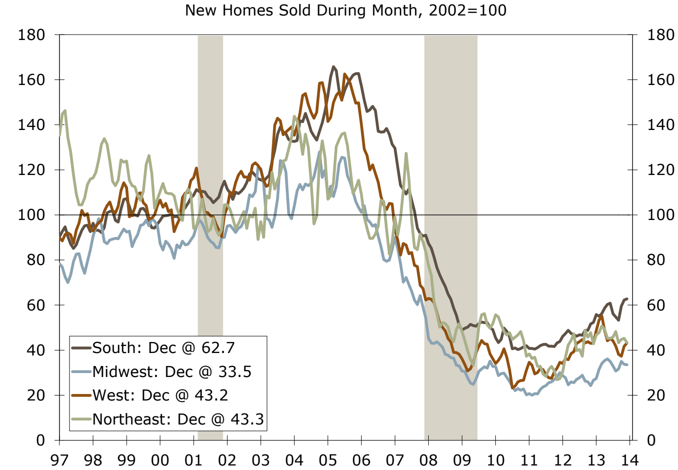
Inventory of New Homes for Sale
New Homes for Sale at End of Month, In Thousands



Months' Supply of New Homes
Seasonally Adjusted



New Home Sales
New Homes Sold During Month, 2002=100

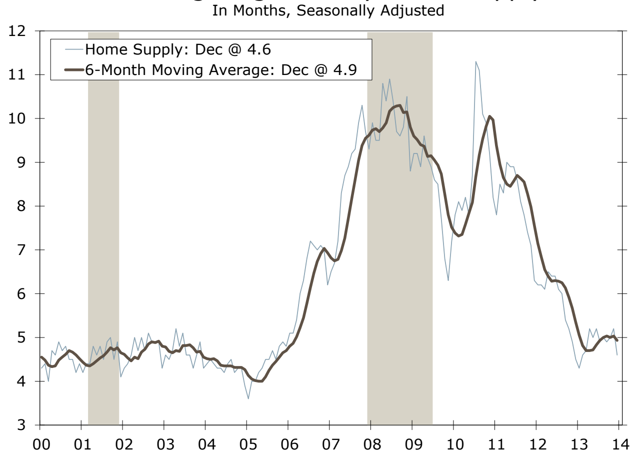


Source: U.S. Department of Commerce, National Association of Realtors and Wells Fargo Securities, LLC

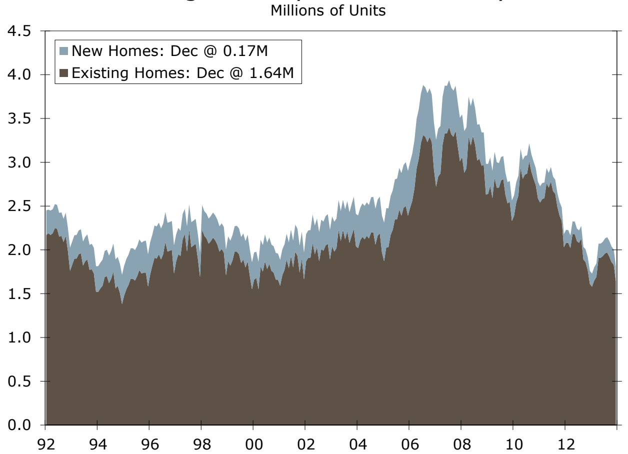
Existing Home Sales

- Existing home sales rebounded in December to a 4.87 million-unit pace. Over the last year, all-cash transactions have played a large role in overall sales activity. Although this activity has helped fuel the housing recovery by clearing up foreclosures and short sales, the spike in prices for lower priced homes has pushed many potential first-time home buyers to the sidelines. Investor purchases have shown signs of pulling back more recently, however.
- Listed inventories fell to 1.86 million units, but we are in the seasonally slow period of the year. We will get a better idea of the pace of activity this spring, when the bulk of for-sale inventory tends to come on the market.

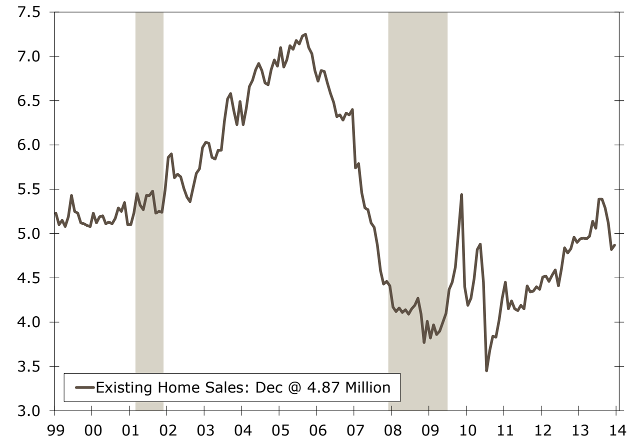
Existing Single-Family Home Supply
In Months, Seasonally Adjusted



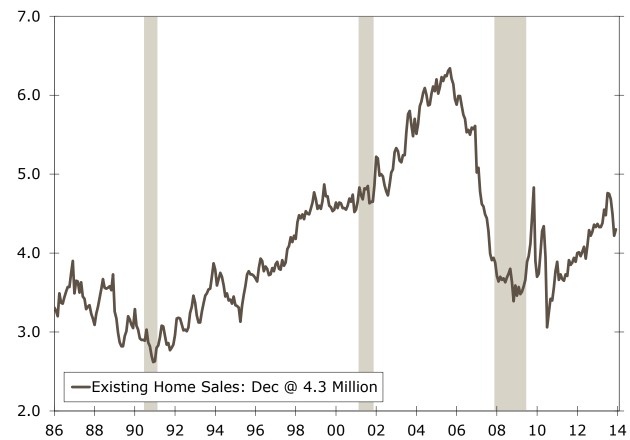
Single-Family Home Inventory
Millions of Units



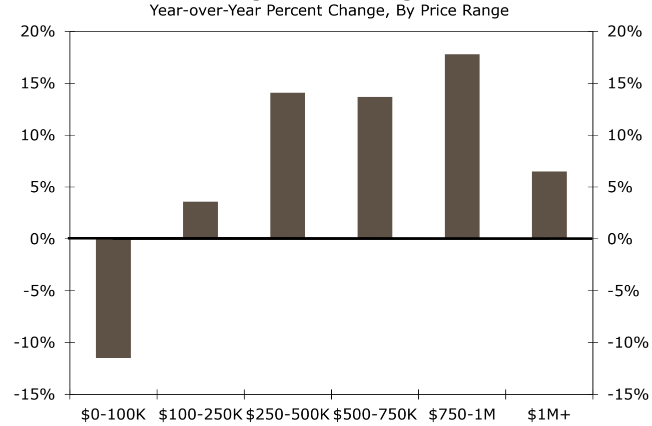
Existing Home Resales
Seasonally Adjusted Annual Rate - In Millions



Existing Single-Family Home Resales
Seasonally Adjusted Annual Rate - In Millions



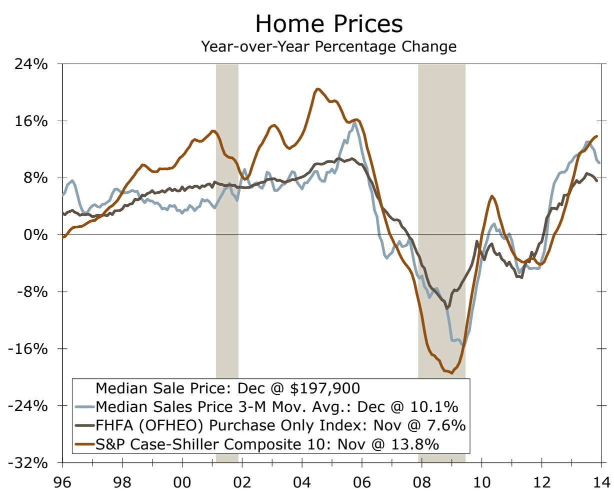
Percent Change in Existing-Home Sales
Year-over-Year Percent Change, By Price Range

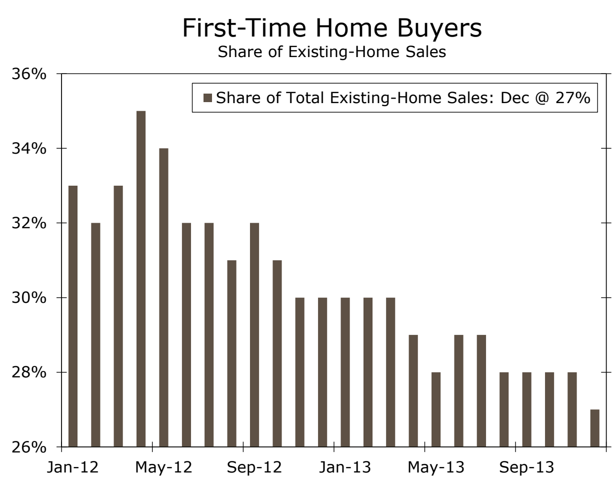


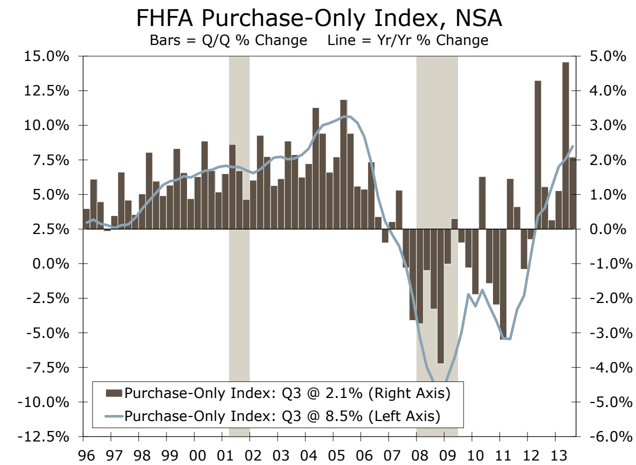
Source: National Association of Realtors, U.S. Department of Commerce, CoreLogic and Wells Fargo Securities, LLC

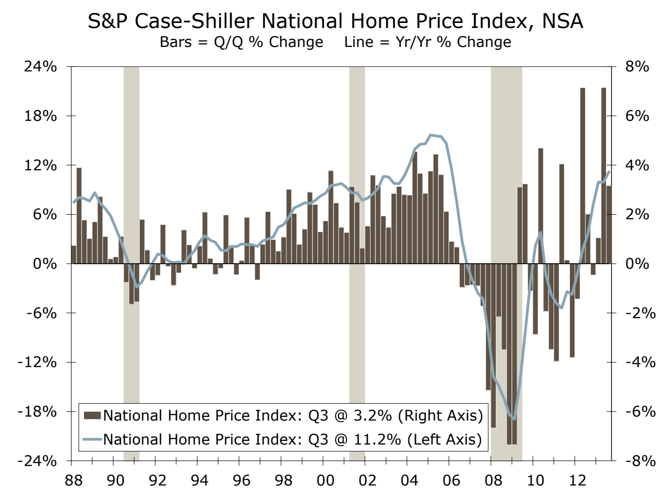
Home Prices

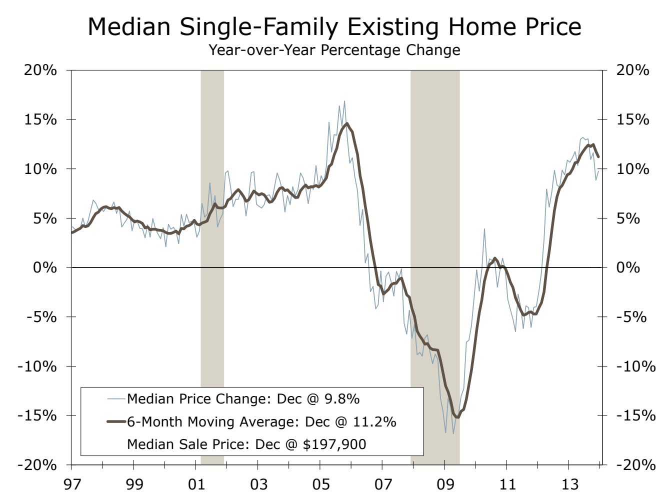
- Home price appreciation has begun to moderate due to stronger year-over-year comparison as well as some softening in investor demand. An influx of investors concentrated in the parts of the housing market where prices overshot the most, further exaggerated the turnaround in prices and give the impression that the housing recovery is stronger than it actually is. The underlying fundamentals, such as job growth, income growth and household formations, have improved much more modestly.
- With investors pulling back and monetary policy set to become progressively less supportive of housing, we expect price appreciation to decelerate to the mid- to low-single digit range.







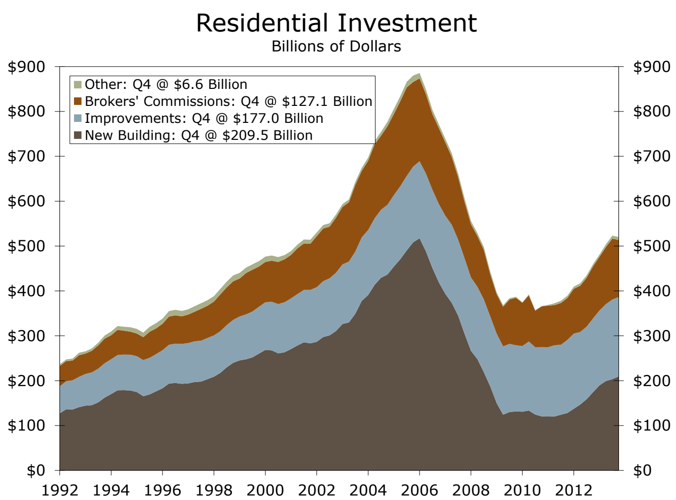


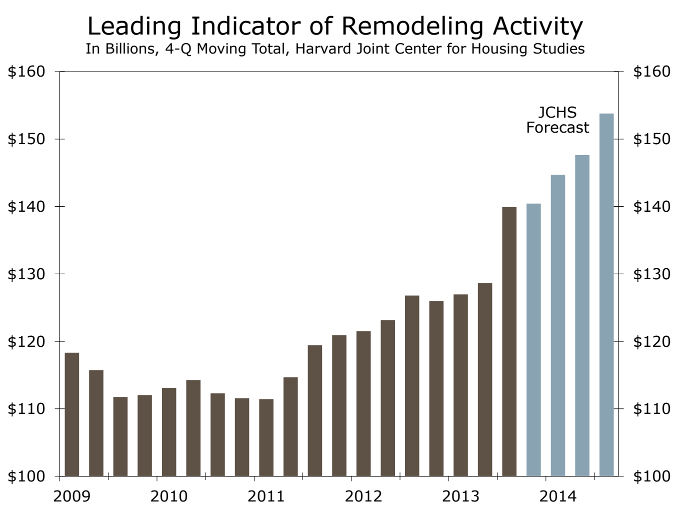


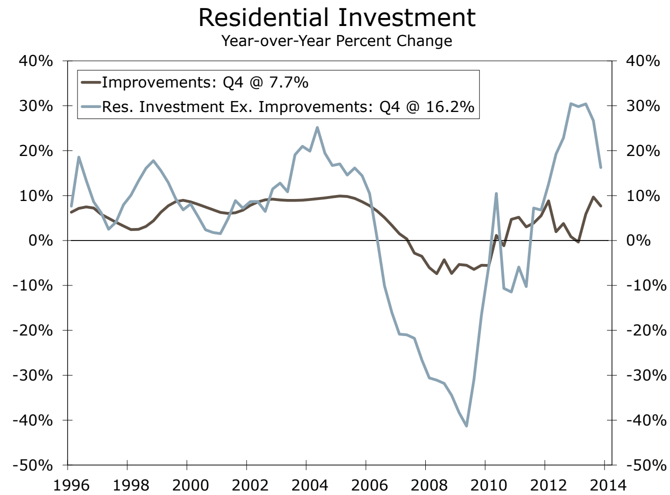
Source: CoreLogic, NAR, S&P, FHFA, U.S. Department of Commerce and Wells Fargo Securities, LLC

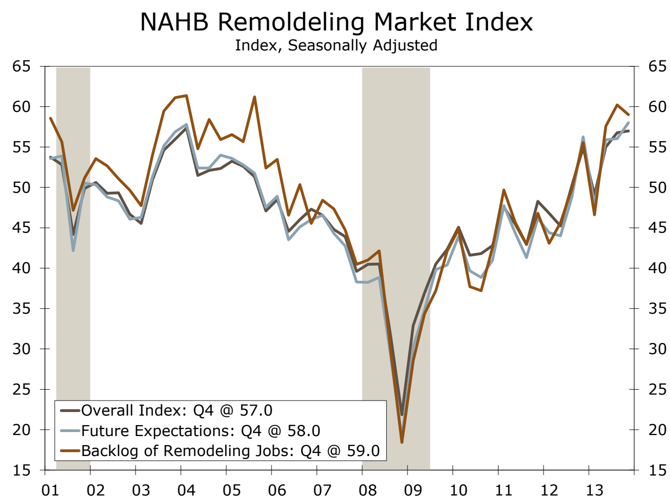
Renovation and Remodeling

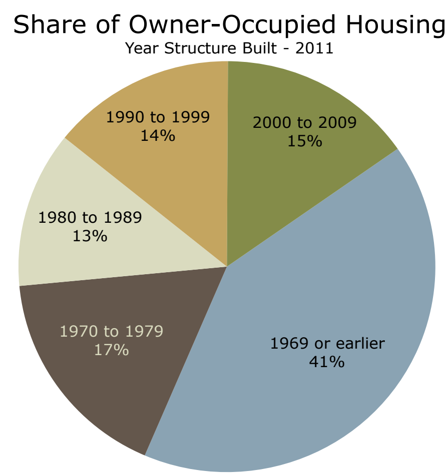
- The share of owner-occupied homes built more than four decades ago now represent more than 40 percent of total housing stock. Older housing units could bode well for remodeling activity and new construction in the years ahead. Spending on residential improvements accounted for nearly 40 percent of total residential outlays in 2012. Part of the increase reflects investors upgrading formerly distressed properties.
- Rising home prices has also helped fuel spending on improvements, as homeowners benefitted from rising home equity. The NAHB Remodeling Market Index recently hit its highest level since early 2004.











Source: Joint Center for Housing Studies, U.S. Department of Commerce, NAHB and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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