

Economic *SYNOPSIS*

short essays and reports on the economic issues of the day



2013 ■ Number 2

Rent or Buy?

Silvio Contessi, *Economist*

Li Li, *Research Associate*

The residential real estate market showed additional signs of improvement in 2012, though the recovery has been quite different for single-family compared with multifamily markets. Between 2009:Q2 and 2012:Q3, the average year-over-year growth rate of house prices was about 0.78 percent,¹ while the average year-over-year growth rate of asking rent for apartments was 5 percent (see the first chart). In the short term, homeownership and renting can be considered two sides of the same coin in the sense that the demand for rental units increases automatically as the homeownership rate declines and vice versa. The homeownership rate declined from 67.4 percent to 65.5 percent during the recovery period and is now closer to the historical average of the 1980s and 1990s. Meanwhile, the rental vacancy rate declined from 10.6 percent to 8.6 percent.

In this adjustment process from home buying to renting, multifamily rental activity has been the bright spot in the housing market: As one realtor in the Eighth Federal Reserve District recently said, “Yesterday’s buyer is today’s tenant.” According to real estate agents, waiting lists for rental units have become common. As the demand for multi-unit structures expands, supply also adjusts, as evidenced by the different growth rates in building permits during the recovery: Between 2009:Q2 and 2012:Q3, multifamily permits increased by roughly 138 percent, while single-family permits increased by only 20 percent.

What explains this narrowing of the gap between the demand and supply of apartments? First, difficulty in obtaining financing has become an important barrier for potential homeowners. Despite historically low mortgage interest rates and a high Housing Affordability Index, many prospective home buyers are being rejected by mortgage providers because of stricter post-crisis underwriting standards and larger required down payments.² According to several realtors, applicants with slight blemishes on their credit records are being refused mortgages even if they meet income requirements.

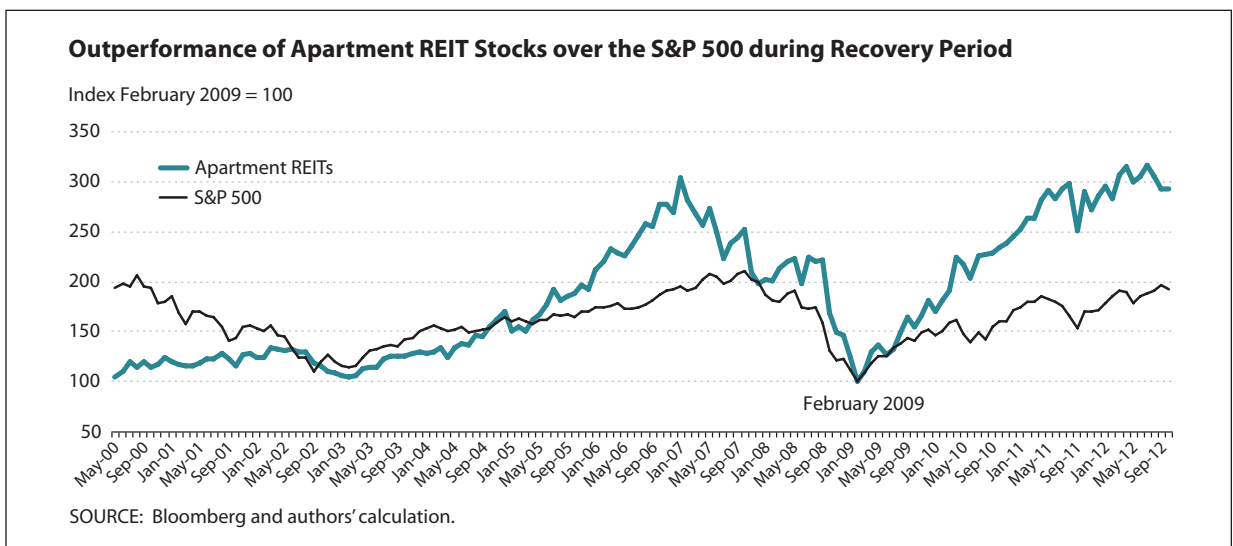
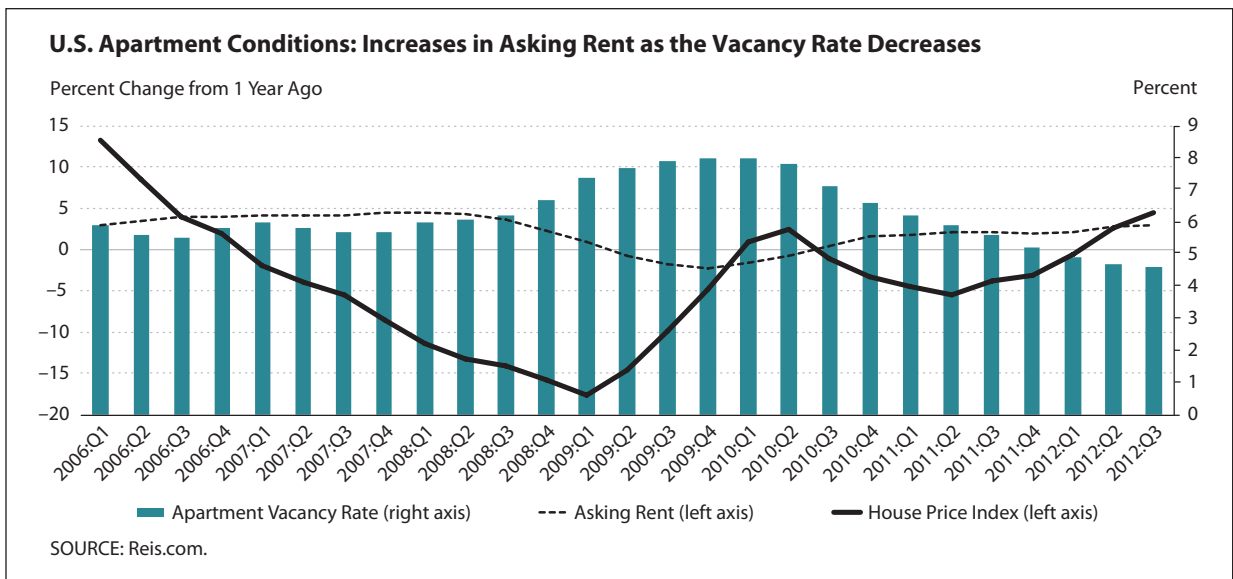
Second, potential first-time buyers face competition from investors in the housing market who can pay cash up front. Private investors, such as real estate investment trusts (REITs), public and private pension funds, and venture capitalists, are again very active in the housing market. Such investors pool

financial resources to invest in housing, anticipating price increases that may generate hefty profits from “buy now and sell later” strategies. One indicator of the success of this strategy is the roughly 216 percent increase in the stock price of apartment REITs from February 2009 to July 2012 compared with the 88 percent increase in the S&P 500 during the same period (see the second chart).³ Because the stock market performance of REITs is comparable to the conditions during the real estate “bubble” years, many analysts wonder whether multifamily REITs are experiencing a bubble.

**As one realtor in the
Eighth Federal Reserve District
recently said, “Yesterday’s buyer
is today’s tenant.”**

Third, although homeownership rates are falling for all age groups, renting has become more appealing to the younger generations that would have been eager home buyers before the crisis. In part, this shift toward renting is a response to lifestyle changes as younger, more-educated households highly value their mobility and flexibility and are discouraged by the responsibilities, costs, and especially risks associated with homeownership; this, in turn, results in greater willingness to pay rent than to own equivalent properties. In part, younger generations have been disturbed by the labor market outcomes of the Great Recession, including the difficulty in finding jobs that match their skills—if they can find jobs at all—which results in a more cautious approach to homeownership.

While the multifamily rental segment of the real estate market is sending positive signals, it is also raising some concerns. In particular, the target home size of “move-up” home buyers is shrinking.⁴ Traditionally, the bulk of the real estate market has consisted of first-time buyers and repeat buyers, regardless of whether they are moving up, across, or down with regard to home size. Before the crisis, first-time buyers could easily and relatively quickly move up and acquire pricier homes. The current residential market, however, is characterized by a significant presence of investors, fewer first-time



buyers, and guarded move-up buyers.⁵ More generally, traditional buyers have much less room to maneuver because of difficulties in securing mortgages either through first mortgages or refinancing. As a result, either by choice or by force, many households are currently paying higher average rents than mortgage payments, a fact that may be contributing to limited consumer spending in other goods and services.

As builders adjust the supply and homeownership returns to historical average levels, thereby stabilizing the demand for rental units, the increase in rents is likely to decelerate and reduce the current euphoria in the multifamily markets. ■

Notes

¹ In this article, home prices are measured by the CoreLogic Home Price Index that includes distressed sales.

² The composite Housing Affordability Index is published monthly by the National Association of Realtors. The index equals 100 when the median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home. A rising index indicates more buyers can afford to enter the market.

³ The selected apartment REITs consist of 15 publicly traded U.S. companies. Their stock tickers are ACC, AIV, AEC, AVB, BRE, CPT, EDR, EQR, ESS, HME, MRTI, MAA, PPS, RPL, and UDR. The average stock price of the apartment REITs is weighted by market capitalization.

⁴ A “move-up” home buyer is a property owner who has owned a residential property and is looking to purchase a larger home.

⁵ See Said, Carolyn. “Repeat Home Buyers a Rare Breed.” *San Francisco Chronicle*, August 30, 2012; www.sfgate.com/realestate/article/Repeat-home-buyers-a-rare-breed-3829628.php.

Posted on January 11, 2013

Views expressed do not necessarily reflect official positions of the Federal Reserve System.