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MORGAN STANLEY RESEARCH

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Global

Housing Market Insights

A Rentership Society

The combination of falling home prices, limited mortgage credit, continued liquidations, and better rental options is fundamentally changing the way Americans live. We believe this change is only beginning, and is moving the country towards becoming a Rentership Society.

Excluding delinquent borrowers, the homeownership rate, which officially stands at 66.4%, would instead be 59.7%. As rental households increase and owner-occupied households remain constrained by tight mortgage credit and distressed liquidations, the official homeownership rate should fall.

The demand for shelter is growing, but the lack of mortgage credit will drive this demand to the rental market at the expense of the owner-occupied market. As household formations grow and distressed liquidations continue, the demand for both multi-family and single-family rental units will likely increase.

Multi-family vacancies are already falling and rents are rising across the country, including in some of the hardest hit regions. Low levels of construction have limited supply, resulting in a booming market for multi-family rentals.

Each distressed single-family liquidation creates a potential renter household, as well as a potential single-family rental unit. The better match of single-family properties for these involuntary owner-turned-renters should drive demand for single-family rentals.

Housing Market Insights

A Rentership Society

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In all of our publications to date, we have focused almost exclusively on owner-occupied housing – for decades, the ultimate goal for US households and seemingly forever upheld as the American Dream. Over the past few years, however, we have watched as that dream has become more of a nightmare for the 30% of mortgage borrowers (almost 20% of all homeowners) no longer willing or able to make their loan payments or who no longer have any equity in their homes as property values have plummeted. It's hasn't been much easier for the other 80% of homeowners either, with tight mortgage credit, high unemployment and negative wealth effects limiting the pool of potential homebuyers while a massive backlog of liquidations continues to put downward pressure on home prices. With the homeownership rate already in decline, we think it's safe to say that the ownership society is suffering.

At the same time, another much more positive trend in US housing has been playing out. Over the past two years, the sometimes overlooked and often maligned US rental housing market has begun a solid recovery. Indeed, rental vacancy rates have fallen faster than they ever have, and rents are rising across the country – even in some of the hardest hit areas of the housing and economic downturn. Driven by a once again increasing household formation rate, positive job creation and a surge of distressed homeowners forced to move to rental housing, demand for rental units is booming. Coupled with almost non-existent building and long development cycles, excess rental housing supply may be worked off in less than a year.[1] In addition to the benefit to the multi-family sector, distressed homes selling well below replacement costs are also allowing the market for single-family rentals (historically about 50% of all rental housing) to grow.

In this report, we dig deeper into these underlying trends and changes in the market for shelter. We come to the following conclusions:

- The combination of falling home prices, limited mortgage credit, continued liquidations, and better rental options is fundamentally changing the way Americans live. We believe this change is at least semi-permanent, and is moving the country towards becoming a Rentership Society.
- Excluding delinquent borrowers, the homeownership rate, which officially stands at 66.4%, would instead be 59.7%. As rental households increase and owner-occupied households remain constrained by tight mortgage credit and distressed liquidations, the official homeownership rate should fall.
- The demand for shelter is growing, but the lack of mortgage credit will drive this demand to the rental market at the expense of the owner-occupied market. As household formations grow and distressed liquidations continue, the demand for both multi-family and single-family rental units will likely increase.
- Multi-family vacancies are already falling and rents are rising across the country, including in some of the hardest hit regions. Low levels of construction have limited supply, resulting in a booming market for multi-family rentals.
- Each distressed single-family liquidation creates a potential renter household, as well as a potential single-family rental unit. The better match of single-family properties for these involuntary owner-turned-renters should drive demand for single-family rentals.

Gimme Shelter

To best understand the fundamental changes occurring in the US housing market, we believe it makes the most sense to start at the top. Taking a step back from our usual focus on the owner-occupied market, we instead examine the **total market for shelter** – regardless of whether that shelter is owned or rented.

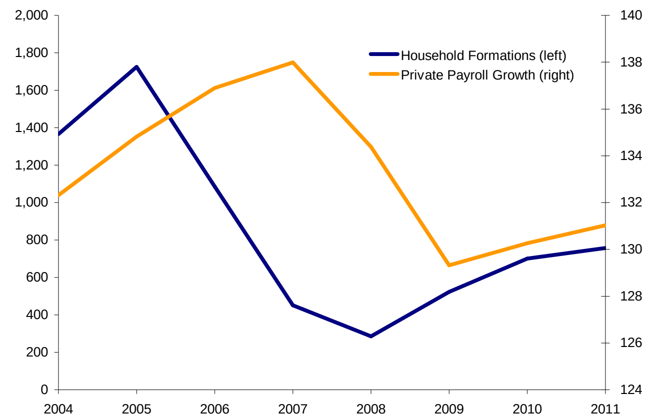
At this level, the underlying fundamentals are increasingly positive. Starting on the demand side, the main driver for shelter demand is household formations. These formations are driven by macroeconomic factors including job growth and immigration, but basically tie closely to overall economic performance. Historically, during recessions, the household formation rate falls below the long-term average of roughly 1.3MM, as individuals voluntarily, or are forced to, put off life

[1] Joint Center for Housing Studies of Harvard University, "America's Rental Housing", April 26, 2011

decisions that might otherwise be made under better economic circumstances. These decisions may include having children, getting a divorce, moving out of their parents' homes, etc. Consequently, as the economy emerges from recession and begins to grow again, the household formation rate typically rises above the long-term average as pent-up demand for shelter finally makes its way into the market.

Exhibit 1

Household Formations Driving Demand for Shelter[1]

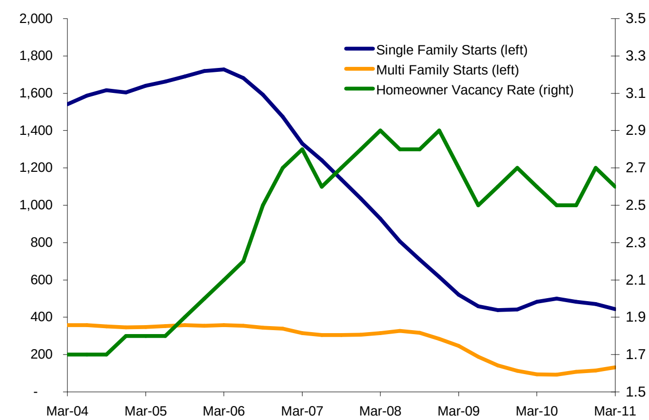


1. 2011 estimate is based on Q1 data only
Source: US Census, BLS, Morgan Stanley Research

In Exhibit 1, we can see this pattern occurring since 2004. We also see that after running well below the long-term average during the Great Recession, the household formation rate is beginning to improve. Not surprisingly, it is highly correlated to the rate of job growth.

Exhibit 2

Vacancy Rates Improving with Low Construction



Source: US Census, Morgan Stanley Research

At the same time that demand for shelter in the country is increasing, the supply of shelter is increasingly being absorbed – even when taking into account the shadow inventory of distressed homes. Some sectors of housing are benefiting more than others in this absorption, but for now, we focus only on the overall picture. There, we observe that both the estimates of single-family and multi-family excess units are beginning to decline. This decline is helped in part by a very low level of construction activity over the past several years since the housing downturn began, and is further aided by the lack of construction today. Exhibit 2 presents these dynamics in chart form.

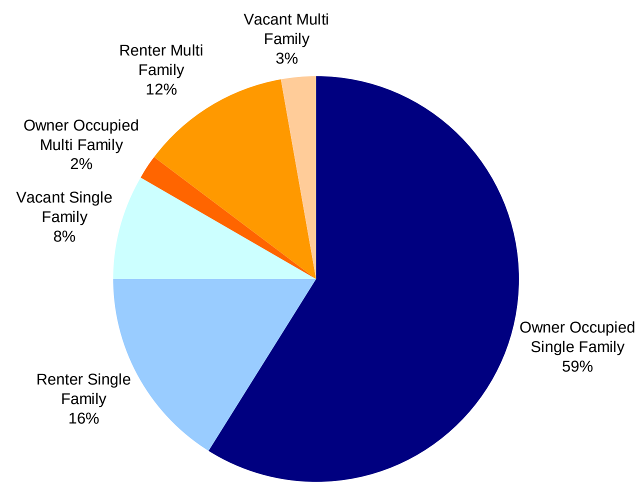
At this point, we would like to point out that some analysts believe that the only reasonable conclusion from this macro data is that housing starts must rise, and quickly, to prevent a shortage of housing in the near future. While we might agree that we may be headed toward a shortage of **total housing units** in the longer term, we believe that a very important distinction must be made between what is happening with owner-occupied and rental housing.

The Owner / Renter Divide

Before we go into the details of the owner-occupied vs. rental discussion, we need to clarify some definitions that are too often confused.

Exhibit 3

Breaking Out the US Market for Shelter[1]



1. Single family includes buildings up to 4 units and manufactured housing
Source: US Census, Morgan Stanley Research

First, the terms “multi-family” and “rental” are often used interchangeably, but in reality they are not the same thing. While multi-family units can be rental units, they can also be condos or townhomes that are owner-occupied. At the same time, not all rental units are multi-family units. In fact, perhaps surprisingly, nearly 50% of all rental units are not what most people would consider to be “multi-family”. Based on an analysis of US Census data, we estimate that roughly 50% of rental units are single family – defined as traditional single family, manufactured housing, and buildings with fewer than 5 units. Conversely, the owner-occupied market is usually thought of as the single-family home market, even though that market includes units in multi-family buildings. Therefore, we believe it is much more relevant to discuss rental vs. owner-occupied units when breaking out how Americans live, and then further distinguishing the rental side between multi-family and single-family units. Exhibit 3 shows the various components of the US market for shelter.

Now that we’ve covered the macro trends in the market for shelter, and clarified how we define the components of that market, we are ready to evaluate those components to determine the future direction of US housing.

Rude Awakening

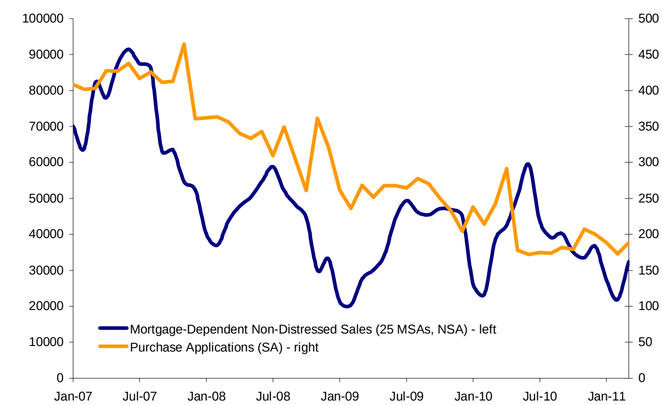
Owning your own home has been the crux of the American Dream for the greater part of the past century. The belief that homeownership is a right, not a privilege, for Americans led to ever more aggressive public and private policies to promote such ownership. From increasingly risky mortgage origination, to mortgage interest deductions, to tax-free capital gains, to policies designed to ever expand the universe of potential home buyers, the American Dream became more accessible to a larger share of the population. The peak of this dream likely occurred in the middle of the last decade when the phrase **“ownership society”** was coined, and the homeownership rate hit nearly 70%. And then it all came crashing down.

In the aftermath of the housing collapse (or perhaps in the middle of it, depending on your view), homeownership is finally being viewed in a different light. The previous assumptions that housing is a good investment, or that home prices can only go up, or that all Americans should be able to buy a home, are being seriously challenged. While we have written extensively about these issues, there are four key points that we believe are driving the fundamental changes in the market for owner-occupied housing:

1. The lack of mortgage credit availability due to tightened lending standards and lower consumer qualifications is severely hindering home buying. In Exhibit 4, we show the low levels of mortgage applications for purchase and mortgage-dependent home purchases.

Exhibit 4

Mortgage Activity Remains Low



Source: Mortgage Bankers Association, DataQuick, Morgan Stanley Research

2. Falling home prices are affecting the desirability of homeownership by keeping potential buyers on the sidelines, either temporarily or permanently. In Exhibit 5, we summarize some of the recent survey work on the desire to be a homeowner.

Exhibit 5

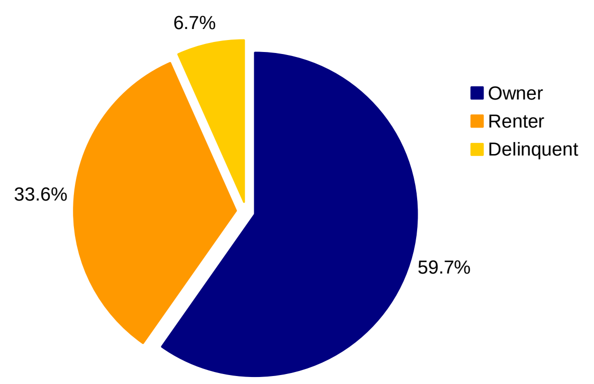
Americans Have Concerns About Homeownership

Percentage of …	%	Survey Company	Release Date
Adults who believe a housing recovery is unlikely until 2014 or beyond	54%	Trulia / RealtyTrac	May-11
Renters who never plan to own	28%	Trulia	Feb-11
Renters who plan to buy, but not in next 2 years	69%	Trulia	Feb-11
Americans who think home prices will fall or remain flat over the next year	65%	Fannie Mae	May-11
Renters who believe that homeownership requires making a financial sacrifice	81%	Fannie Mae	May-11
Americans who think homeownership is a safe investment (in 2003)	83%	Fannie Mae	May-11
Americans who think homeownership is a safe investment (in 2011)	66%	Fannie Mae	May-11

Source: Trulia, RealtyTrac, Fannie Mae

3. The high rates of mortgage delinquency, foreclosure and liquidations are turning homeowners into renters, lowering the homeownership rate and increasing the demand for rental units. In Exhibit 6, we show what the current homeownership rate would be if we excluded currently delinquent borrowers.

Exhibit 6
Homeownership Rate Excluding Delinquencies



Source: US Census, Morgan Stanley Research

4. For the first time in recent history, the government is no longer promoting homeownership for all Americans, leading to the reconsideration of housing-related public policy. In Exhibit 7, we highlight some recent policy quotations from the US Treasury.

Exhibit 7
Quotes from the GSE Whitepaper

Treasury Quote
"In the past, the government's financial and tax policies encouraged housing purchases and real estate investment over other sectors of our economy, and ultimately left taxpayers responsible for much of the risk incurred by a poorly supervised housing finance market."
"The Administration believes that we must continue to take the necessary steps to ensure that Americans have access to an adequate range of affordable housing options. This does not mean our goal is for all Americans to be homeowners."

Source: US Treasury

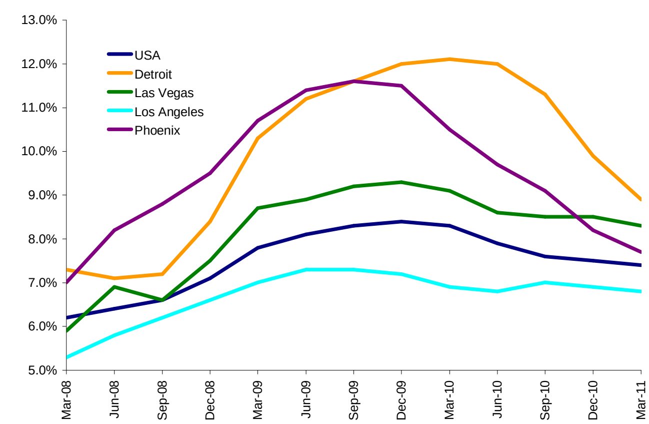
Each of these points can have a profound impact on the future of US housing, and the balance in the market for shelter, but taken together they are forcibly moving the country away from being an ownership society.

Not Throwing Your Money Away

While both the owner-occupied and rental markets suffered during the recession, their respective paths have diverged more recently. As the owner-occupied market continues to get hit by the combination of factors mentioned above, the rental market has come storming back. Often maligned historically as a product on which you "throw your money away," rentals have become a much more valued shelter option – we believe both because of the shift in sentiment that we discussed, and also because of the necessity of renting for those losing their homes in distress.

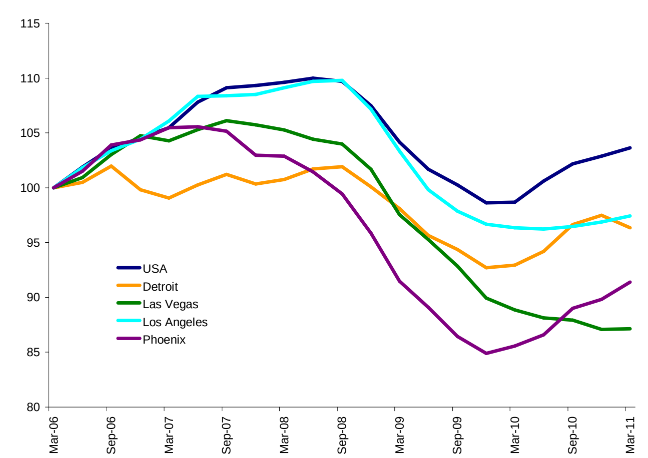
Here again we make the distinction between multi-family and single-family rentals and note that the vast majority of rental data comes from the multi-family side – mostly because it is institutional and widely reported. Sources such as PPR, REIS or CBRE provide data such as average rents and vacancy rates for multi-family rentals, but single-family rentals are a much more fragmented and non-transparent market, generally owned by individuals – at least for now.

Exhibit 8
Multi-Family Vacancies Are Falling



Source: PPR, Morgan Stanley Research

Exhibit 9
Multi-Family Rents Are Rising



Source: PPR, Morgan Stanley Research

But what we do know from multi-family rental data is that the market is booming. Vacancy rates were falling at a record pace before slowing recently, and rents have been rising across the country – even in the hardest hit housing markets. In Exhibits 8 and 9, we show some of these trends across the country and for some select MSAs that have seen the greatest amount of home price depreciation.

What we find most notable is that in every one of the 25 MSAs we track, it is actually cheaper on a monthly basis to buy a distressed home than to rent (it is still generally cheaper to rent than to buy a non-distressed home). In our report from April (see *Housing Market Insights: Distressed vs. Non-Distressed*, April 25, 2011), we showed that cap rates for distressed properties are in the double digits.

The big question is, why would households be willing to pay these high rents when they could instead buy the home for much less on a monthly basis? We believe the answers to that question are the main drivers in the fundamental changes we see in how Americans live, and they are the same ones that we identified above for why owner-occupied housing remains weak. Namely, lack of mortgage credit availability, continued home price declines, high numbers of displaced distressed homeowners, and a change in government sentiment are forcing Americans to rent, regardless of whether it makes more sense, or if it is even more desirable, to buy.

Furthermore, the relationship between multi-family and single-family rentals is changing. As short sales, foreclosures and liquidations occur on single-family homes, the households coming out of those homes and looking for shelter are a better fit for single-family rentals than multi-family. These households are typically in suburban areas, have families, and have already been living in a single-family home. For these reasons, combined with the fact that distressed prices are creating a growing investment opportunity in providing single-family rental housing, we believe that as rental demand increases, single-family rentals will grow strongly.

A Rentership Society

We have established our views on the overall market for shelter (positive), the market for owner-occupied housing (negative), and the market for rentals (positive). We have also identified the four major factors we believe are driving the move away from owner-occupied housing and toward rental housing. Now, we address timing.

Much of what we've discussed has actually happened before. These types of moves between owner-occupied and rental housing occur as a result of market dynamics. In fact, the interplay between these markets is pretty much constant. When it becomes too expensive to own, more people will rent. And when it becomes too expense to rent, more people will buy. But for these markets to continuously oscillate around an equilibrium, certain market conditions must exist, such as access to credit, and reasonably stable wealth and credit profiles.

It is our view that these required market conditions will not return for several years. In fact, some of the conditions that we identified may get worse for owner-occupied housing. Specifically, GSE reform, Dodd-Frank securitization rules, mortgage interest deduction reform, continued home price declines and a long workout period for distressed homes, will likely make it **harder** to buy an owner-occupied home. As such, we believe that the US will become a Rentership Society, in which the homeownership rate will keep falling, the homerentership rate will conversely rise, and the rental market will dominate the investment landscape in housing for years to come.

Throughout the housing bubble, the homeownership rate increased from 66% to 69%. During this period, significant and numerous opportunities were created from housing finance to securitization to homebuilding to mortgage servicing. The initial collapse of the housing bubble then led to one of the greatest trades in US housing history – shorting the subprime market. As we move into the next stage of this cycle, what opportunities will emerge if the homeownership rate moves in the opposite direction by three times the magnitude? ***That*** is the sixty billion dollar question.

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