The Apartment Boom Is Ending, Long Live the White Picket Fence

By Matt Topley

"I recommend that every man own the roof that sheltereth him and his," Arkad says. "Nor is it beyond the ability of any well-intentioned man to own his home." Arkad argues that "to own his own domicile and to have it a place he is proud to care for, putteth confidence in his heart and greater effort behind all his endeavors." -- "The Richest Man in Babylon"

KEY TAKEAWAYS

- There are nearly 90 million Millennials in the U.S. today. Don't stereotype them as debt- strapped city dwellers who will never seek the suburban dream.
- Many members of Gen Y have good incomes and are in the prime years for getting married, starting families and yes, buying suburban homes in good school districts. They just start a little later.
- Rents have never taken up a larger of the American worker's paycheck. Would you bet on this trend continuing?
- We believe strongly in real estate as a long-term investment, particularly in multifamily housing.
- Private real estate investment generates "alpha" in a tax-efficient manner and is an excellent source of income in a world of near-zero or even negative interest rates.

Introduction

Renter nation is a popular narrative sweeping America, as baby boomers trade down to rent, rather than own their homes, and as Gen Y (roughly 20-to-39-year-olds) never grows up to buy a house. It sounds good on paper, especially if you are selling multifamily apartments, but the facts tell a much different story. According to online real estate database Zillow, the rise in rental prices since 2005 is now running almost twice as high as the rise in incomes. As a result, rental cost as a share of personal income has hit a record high, vacancy rates have hit a 20-year low, and multifamily to single-family permits have hit a 30-year high. ***See charts that follow for more detail about these important statistics.***

Haven't we witnessed these unsustainable levels enough over the past 20 years to learn our lesson? Do you buy assets at their 30-year highs? Do you sell assets at their 20-year lows? Multifamily housing may not turn out to be a bubble due to our growing population, but that will not prevent the proverbial music from stopping on the financing and valuations for multifamily housing. It also may be earlier in the cycle than we think, as members of Gen Y tend to form families later in life than previous generations, and their shift to home ownership may push out to the 2020s.

Home ownership is the rock of American society—it anchors people to communities, solidifies families and forces savings. American title laws differ significantly from those of all other nations, and almost 75 percent of small businesses are financed from a home equity line. Yes, I know the math—renting and investing the difference produces a higher rate of return—but let me know when you find someone who followed that plan with success. According to the U.S. Census Bureau, there are approximately 86 million Millennials in the U.S. today, and they're in the prime years for getting married, starting families and buying their first homes. If you think I am just speculating about that statistic, let's take a closer look at the data.

Full disclosure: At Fortis, we believe strongly in real estate as an investment and in multifamily-housing as a ***great*** long-term investment. We think that private real estate investment generates "alpha" in a tax-efficient manner and that it's a good source of income in a world of near-zero or even negative interest rates. We do not think this asset class will result in a crashing bubble like biotech in 2015, technology in 2000 or housing in 2006. We are simply expressing a theory that the cycle is changing, as it has since the beginning of modern times. As the old saying goes, all real estate is local, so plenty of opportunity will exist for new real estate investments going forward.

Demographics

Millennials (aka Gen Y) are young adults born between 1981 and 2000, and they account for more than one-fourth (27.4 percent) of the U.S. population. They're a significantly larger cohort than their boomer parents' generation that drove the last housing boom. The conventional wisdom is that these young people will move to (or remain in) cities, never marry and be renters for their entire lives as they struggle to get out from under overwhelming student debt during their prime income-earning years. It seems like everyone is telling this story—except for Millennials themselves. It's true that there is a substantial increase in the preference for city living, especially among young people. But there is a limit to its expansion.

According to Trulia, the online real estate resource, 70 percent of all Americans (including 65 percent of 18-to-34-year-olds) view home ownership as part of their "American Dream," while student debt comes in at a distant No. 5 among Millennials' biggest obstacles to becoming homeowners. According to Demographic Intelligence (DI), Millennials are the most educated generation in U.S. history (thanks to the achievement of females in the group), and college-

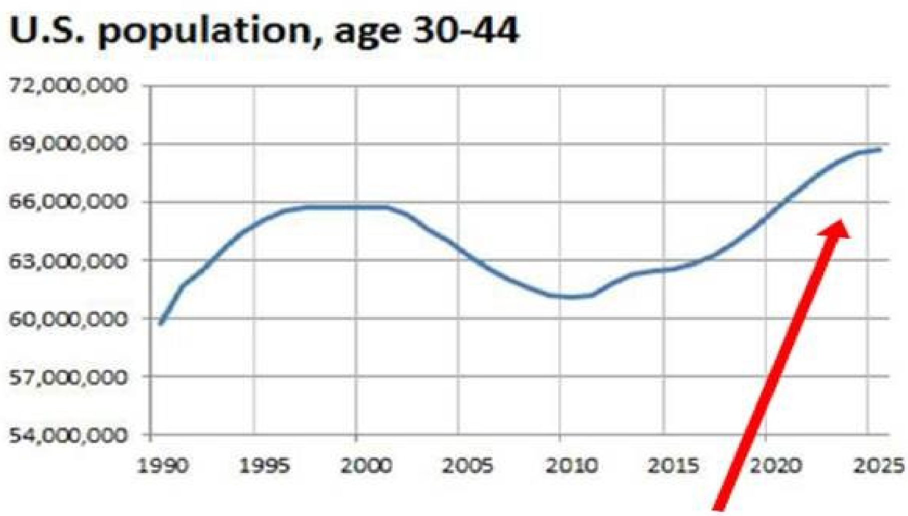
educated people are the demographic group most likely to buy homes. DI also finds that college-educated Millennials start getting married in big numbers at around age 25 or 26. Today, that age bracket is the bulge in a demographic tsunami.
Click HERE for related article.

DI also notes that marriage rates recently ticked upward for the first time in two decades, driving the household formation bulge outward *(see "Potential for Future Household Formation" chart below)*. Home buyers aged 35 years and younger have become housing's largest segment, accounting for 35 percent of buyers. DI's Samuel Sturgeon, an expert in marriage and fertility trends, cites three important reasons Millennials will be buying homes in the next few years:

1. According to Trulia, Millennials are the most educated generation in U.S. history, and college-educated people buy homes.
2. College-educated Millennials start getting married at age 25 to 26 and beyond.
3. The two biggest age cohorts among Millennials, the bulge in the python, if you will, are now 24 and 25 years old.

Where are Millennials choosing to live? In March, the U.S. Census Bureau released its latest county-level population estimates and the trend is clear: Young adults, particularly those aged 30 to 44, are increasingly moving out of cities and into the surrounding suburbs.

The Potential for Future Household Formation: The Uptrend Is Starting



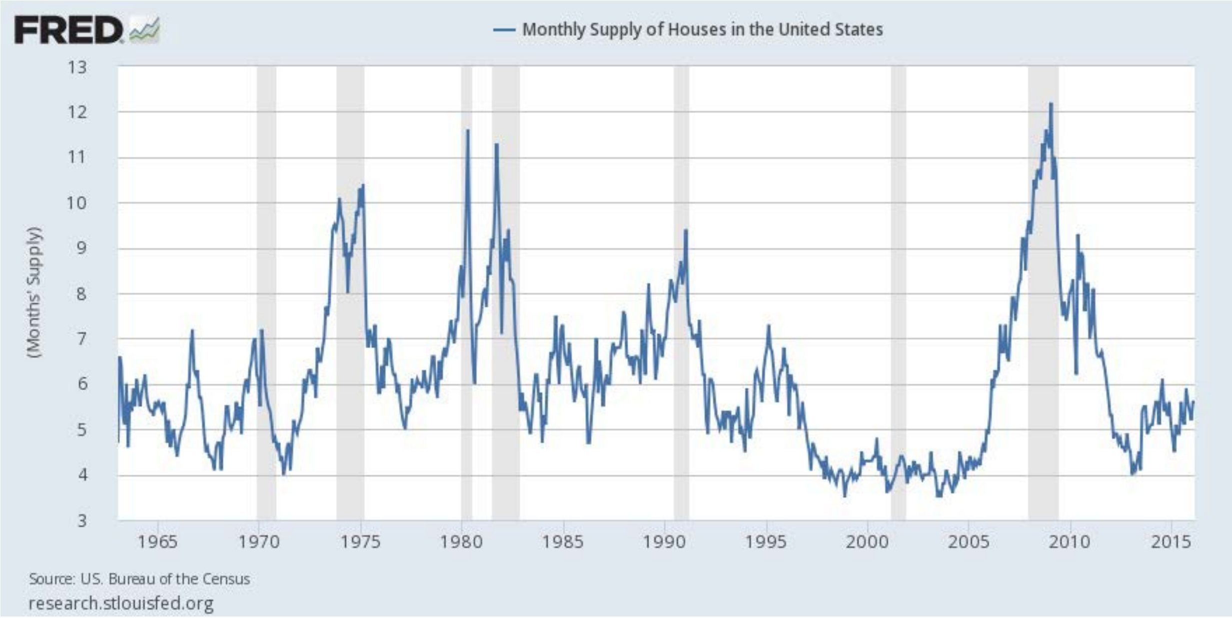
Source: Bureau of Labor Statistics, U.S. Census Bureau

According to DI forecasts, for births in the year 2015, almost three in five (59 percent) of children born to this generation will have married parents, but that share will ultimately rise to about 77 percent in the next 10 years. That means that over 25 percent of the entire U.S. population will get married and have children over the next decade.

Three in five children born to Millennials (59 percent) have parents who are married today, and 10 years from now, three in four children born to Millennials (77 percent) will have married parents.

Just as household formation will be hitting record highs in next five years, the monthly supply of houses for sale in the U.S. will fall back to the low end of the historical range. According to *Barron's* economics editor, Gene Epstein, a former chief economist for the New York Stock Exchange, [60 percent of households that become homeowners switch from apartments to detached homes].

Monthly Supply of Housing Falling Back to Historical Lows as Age 30-44 Population Hits Highs

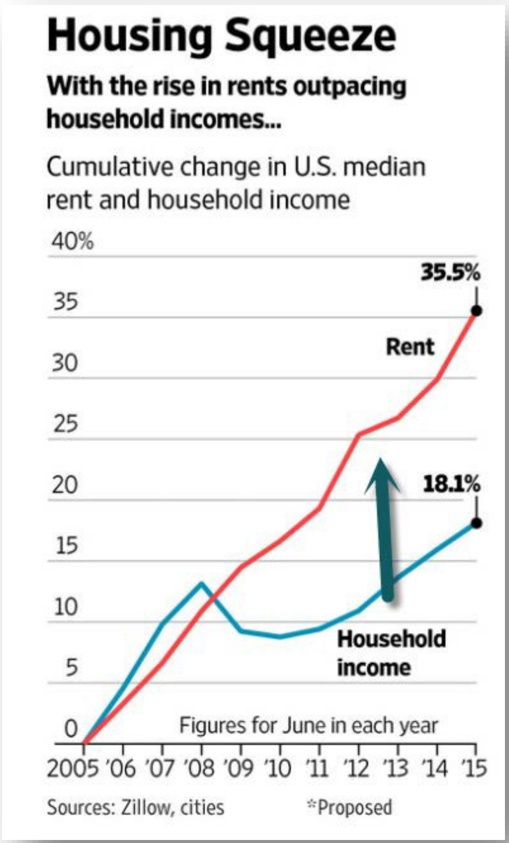


Current Economics Point to Unsustainable Gaps

The current economics of housing versus multifamily apartments in America is filled with unsustainable gaps. In my 20 years as an investment professional, I've noticed that big gaps in valuations tend to revert to the historical mean. Today in multifamily housing, we see some need for mean reversion in the following charts.

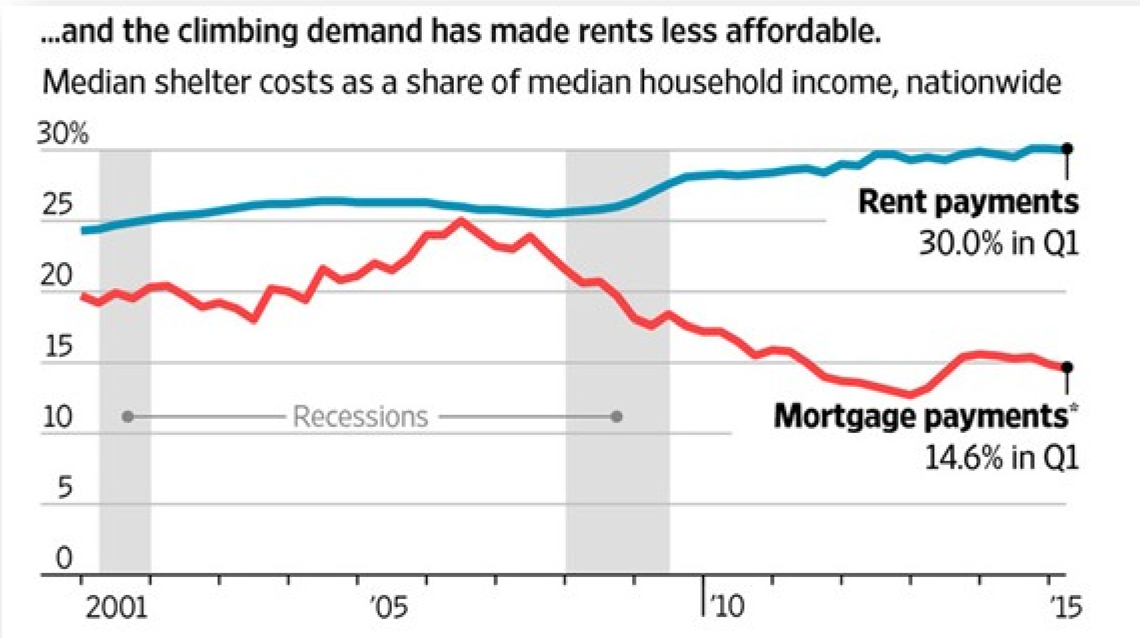
Unsustainable Gap #1—Can rents continue to climb at almost double household income?

More than one-quarter of Americans use at least half their monthly income for rent. A new report from Harvard University's Joint Center for Housing Studies and Enterprise Community Partners Inc. shows that for the 11.2 million households that rented their primary residences in 2013 (26.5 percent of the total), rent consumed more than half of their income. While that's a slight dip from the record high of 11.3 million rent-burdened households in 2011, this disturbing figure has risen by nearly 3 million people, or 60 percent, since 2000. In fact, about half of all renters are paying more than the recommended 30 percent of income toward their primary housing needs.



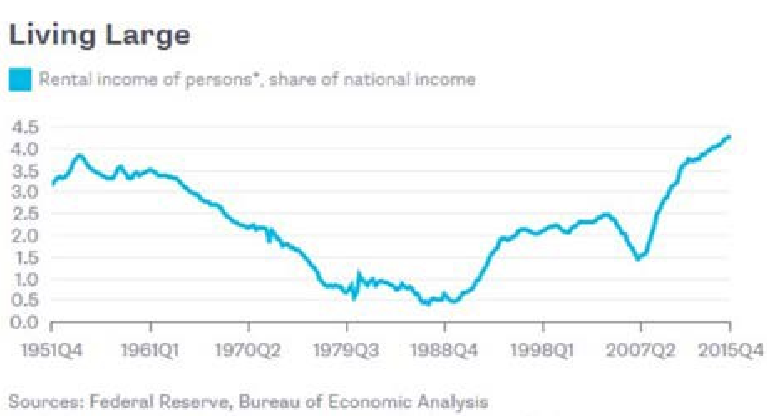
Unsustainable Gap #2—Can rent payments continue to run at twice the cost of mortgage payments?

Does renting versus buying as a financial strategy hold up when the median rent is twice as much as the median mortgage payment? It is easy to lay out the economic logic of renting versus buying when rents are low and you can invest the money you save (by not owning a home and paying interest and property taxes, etc.) in the stock market. But few people have the discipline to execute that strategy, and now the calculus is even tougher with exorbitant rents.



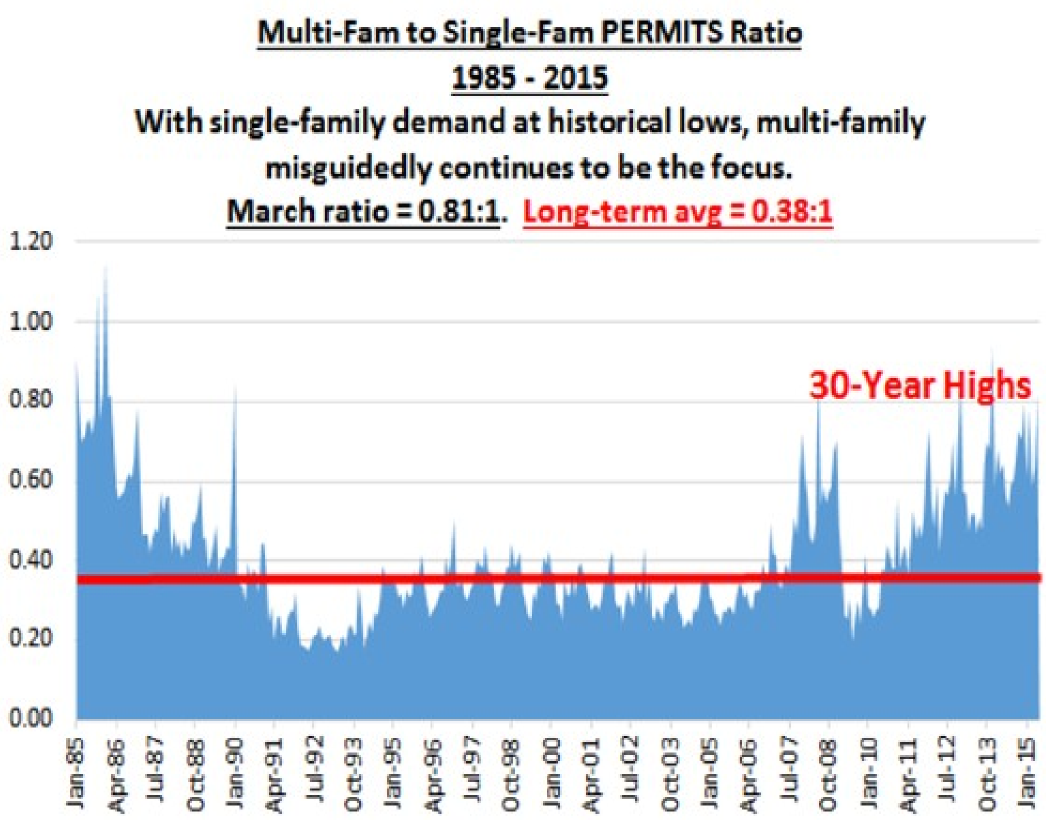
Source: "Rising Rents Outpace Wages in Wide Swaths of the U.S." Jeffrey Sparshott, The Wall Street Journal

To help answer that question, rental income as a share of national income just surpassed the previous high from 1951.



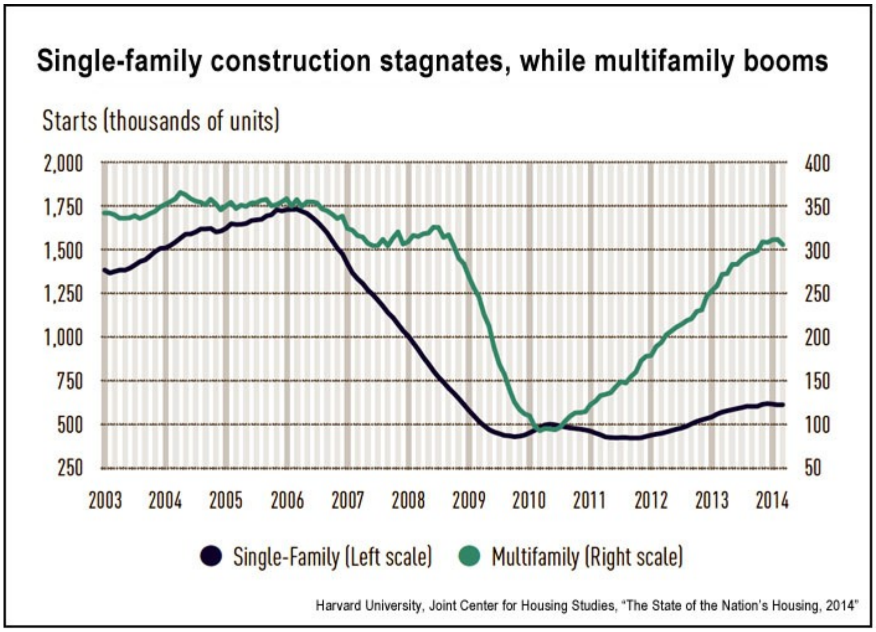
Unsustainable Gap #3—The ratio of multifamily to single-family building permits is at a 30-year high. Do you buy at the 30-year high?

After the 2008 housing bubble burst, the U.S. experienced a significant shortage of rental apartments, but now supply has achieved equilibrium with demand. Between 2008 and 2010, construction of multifamily units fell by as much as 70 percent from its trend growth rate over the past decade, due to lack of available of capital, both equity and debt. That imbalance has been corrected as multifamily permits have soared to a 30-year high.



Unsustainable Gap #4—Multifamily versus single-family construction affects school population.

Doesn't the structure of our public school system make this chart unsustainable? As mentioned earlier, Gen Y is the most highly educated generation in U.S. history. As young adults in this demographic group start to form households, schooling for their children will become paramount. This increases the demand for single-family homes in highly rated school districts as opposed to urban rentals. Even if young Gen Y households wanted to stay in urban environments, school capacity at private and magnet schools would be overwhelmed.



Unsustainable Gap #5—Rents have never taken up a larger share of the American paycheck. Would you bet on this going higher?

Rent as a percentage of household income has risen almost 28 percent since 2003, with a sharp, "hockey stick" increase since we came out of the 2007 housing crash. As more and more multifamily supply comes on the market, and as more young people buy homes, this trend line should revert to the historical mean of 25 percent.

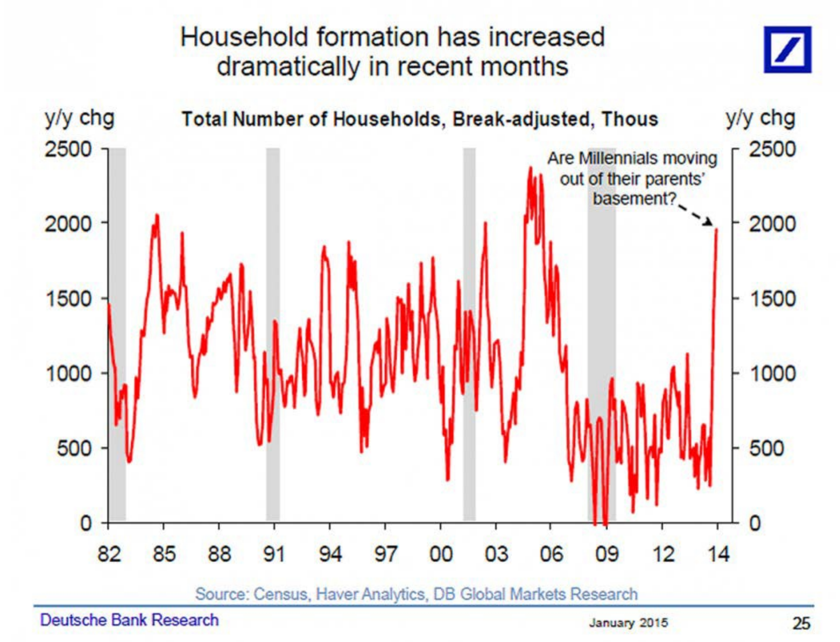
Millennial Balance Sheets—Myths, Lies and Marriage

Conventional wisdom is that young American people are drowning in debt, stuck in low-wage jobs and not planning on ever marrying to form households. But this argument is falling apart rapidly as Millennials increasingly look like their parents' generation when it comes to home ownership.

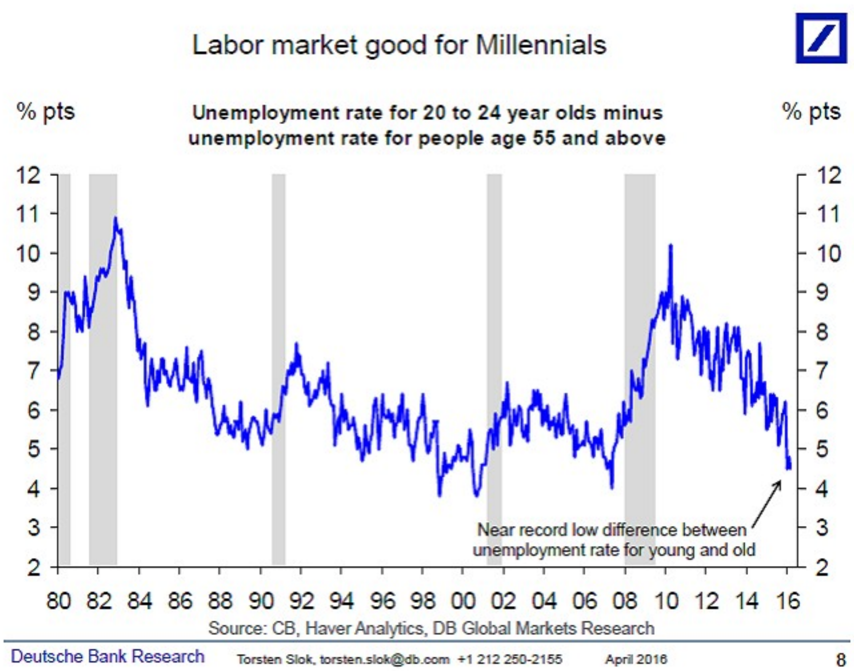
Among the research that confirms this is a study released this year by the Urban Land Institute, historically hostile to suburbs, which found that some 80 percent of current Millennial homeowners live in single-family houses and that 70 percent of the entire generation expects to be living in single-family houses by 2020. Renowned geographer and author Joel Kotkin has more about America's booming suburbs and exurbs.

We are now seeing a sharp increase in household formation, which experts say is currently increasing at a rate above 1.5 million annually. They say that we are building around 1.5 million homes per year and 250,000 homes are torn down per year, so we are facing another unsustainable gap.

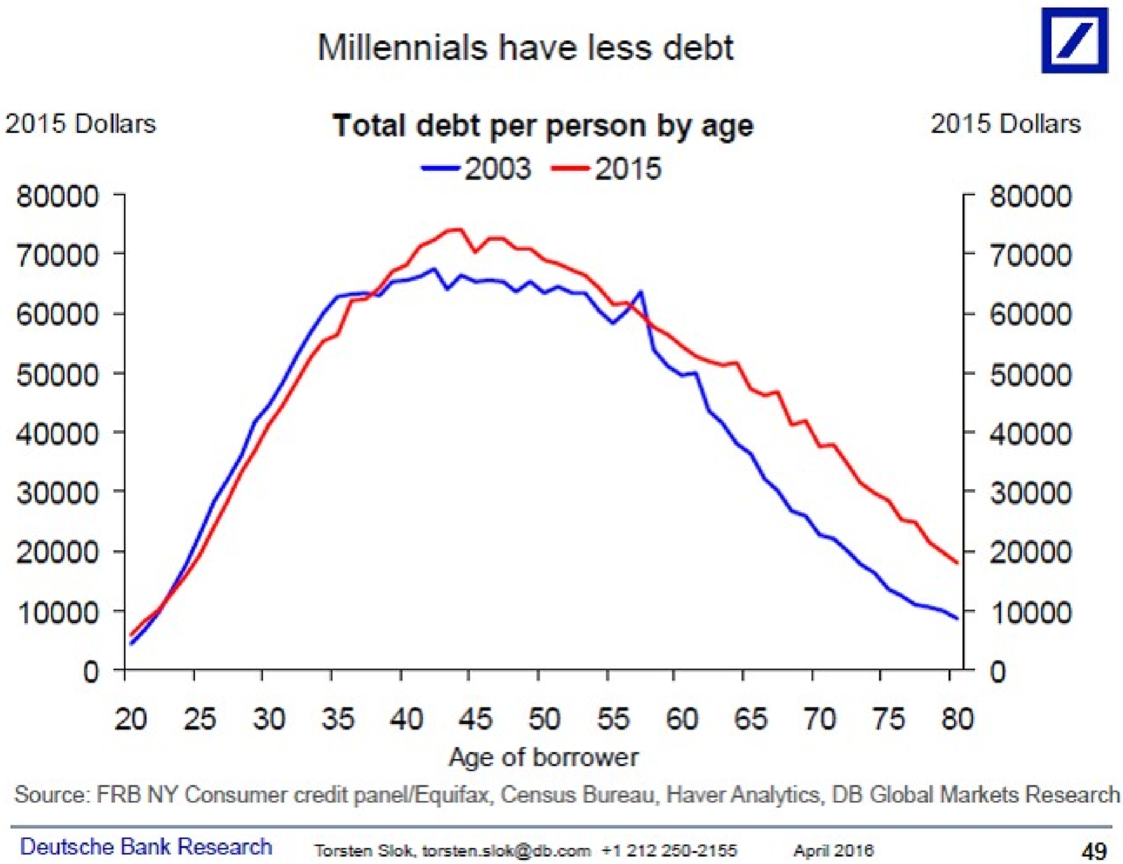
DI predicts that ultimately about 60 percent of the children of Millennials will be born to married parents, up from 45 percent today. We are about to experience a lot of Millennial marriages and a lot of Millennial married births, challenging the stereotype that Gen Y is averse to marriage and having children.



At Fortis, our view is that the myth about the lack of jobs for college-educated Millennials is unfounded, especially with an unemployment rate dipping below 5 percent for young people. Research from CB, Haver Analytics and Deutsche Bank indicates that there are now only 1.5 job seekers for each open position—that's down from nearly seven job seekers per open position after the global financial crisis.

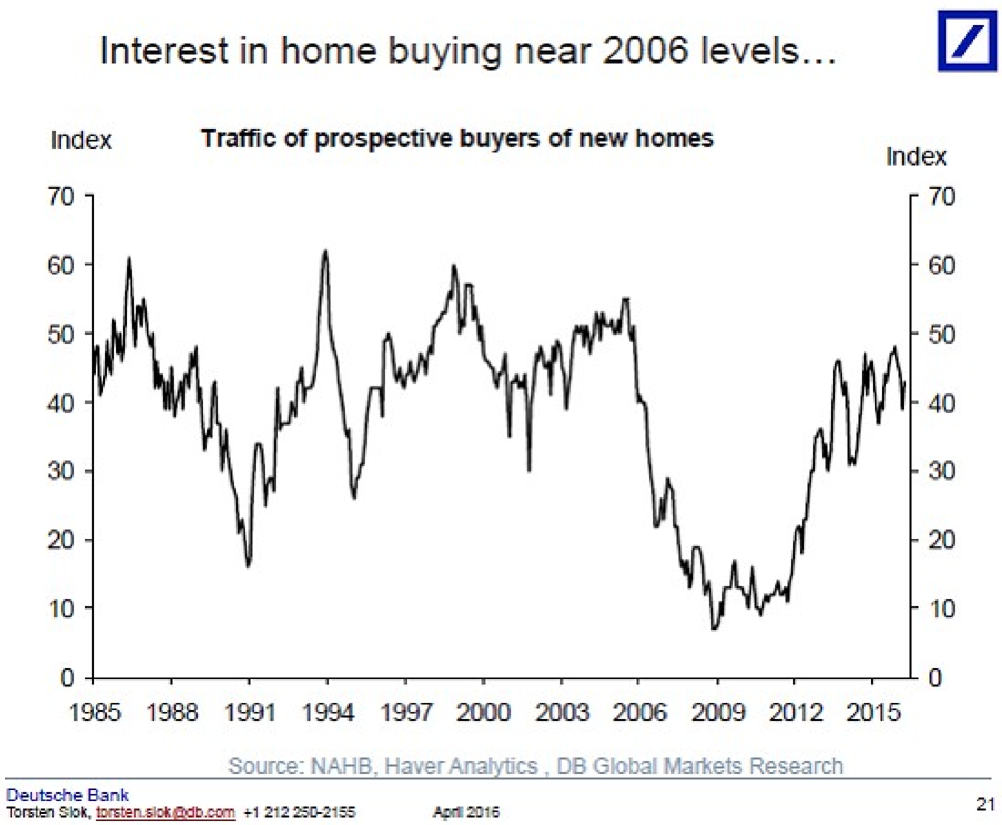


It is an urban myth that the young generation today is more in debt; it is the older generations that have higher debt levels (see chart below). The reason is that since 2009, it has been difficult for Millennials to get a loan. As a result, 25-to-35 year-olds today have less debt than they did in 2003.



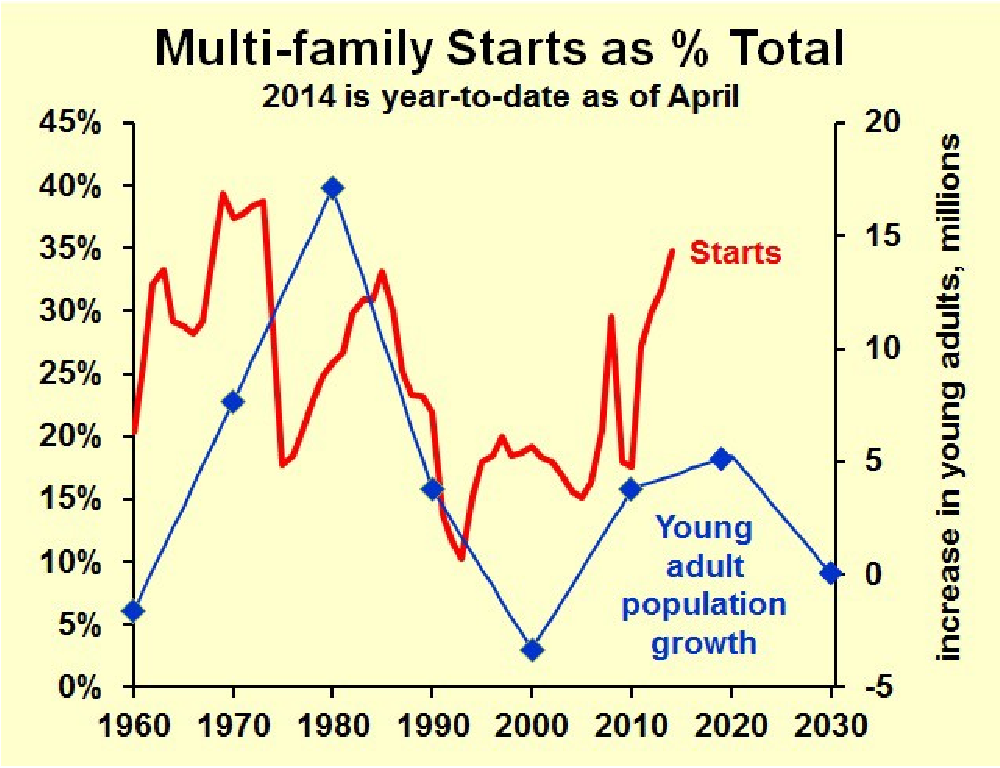
The final myth is that Millennials don’t want to own, but young adults’ interest in home buying is back to 2006 levels just as Gen Y hits prime ownership age. University of Southern California urban planning professor Dowell Myers is among the doubters about urban paradise. He ventured to say that cities have reached “peak Millennial” population growth and that it can only go down from this level, because as the largest cohort just turned 25, there will simply be fewer of them. Meyers also said that we are about to embark on the children of Gen X baby bust.

According to U.S. Census Bureau data released in 2014, among Millennials in their early 20s, 721,000 moved out of the cities, compared with 554,000 who moved in. A 2015 survey by the National Association of Home Builders found that 66 percent of Gen Y prefer to live in the suburbs, 24 percent want rural and 10 percent want to live in the city. The survey showed that 81 percent want three or more bedrooms in their home.



The Young Adult Population Growth Is Ending

The blue line in the chart shows the net increase in 20-to-34 year-olds in the decade leading up to the data point. Demographics isn't everything, but it appears to be something.



Source: [Bill Connerly, Forbes 2014]

Conclusion

"Millennials are settling down and having kids later, but based on surveys and what we see, they will be a home-owning generation."

Douglas C. Yearly, Jr., Chief Executive Officer and Director of Toll Bros.

In the U.S., after breaking ground on apartment buildings in 2015 at the fastest pace in 25 years, rent prices are finally starting to falter. For the first time in two years, rents in Manhattan actually got cheaper and landlords are offering incentives to tenants. In the first quarter of 2016, the national vacancy rate rose for the third quarter in a row. Most alarming, demand for new apartments was about half the typical level. The number of occupied new apartments across the country climbed by just over 20,000 units in the first quarter, compared with the five-year average of about 40,000 for the quarter.

The fact that Millennials are not currently becoming homeowners is due not to a lack of desire, but to economic challenges. As Millennials move into their early 30s, salaries are increasing, households are forming, highly educated women lead dual-income families and Millennials' average FICO scores are at all-time highs. Millennials have already jumped from making up 28 percent of first-time home buyers two years ago to 35 percent today. According to research firm Digital Risk, 70 percent of 18-to-34 year-olds are interested in buying a home within the next five years.

Even though we expect a supply/demand imbalance in housing, our firm does not expect the pricing acceleration of the last bubble. The baby boomer housing bull market brought the historic implosion of interest rates, plus the birth of the two-income household. Due to our country's lack of inflation-adjusted income growth over recent decades, falling mortgage rates, as opposed to rising incomes, have accounted for the entire 70 percent rise in home prices over the past 15 years.

As former President Franklin Delano Roosevelt once said, "A nation of homeowners is unconquerable." There are some proven tangible homeownership results, such as lower crime rates, higher participation in civic affairs and better household health. More important are the psychological benefits of pride, confidence, commitment and social attachment to a community. The Millennial generation will create their unique historical American story that will differ from that of previous demographic groups, but housing will not be the ultimate differentiator. In this category, Gen Y will look much like their parents and their grandparents.

About the Author

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Matt has a unique, global perspective on investing that he gained from nearly two decades on the trading desk and from studying abroad. While doing his graduate work, he had the opportunity to explore the world, studying in Shanghai, Beijing, Toronto and Prague. Matt's desire to make a positive difference, both in his clients' lives and in the community, is evident both in and outside the office. In his free time, Matt is dedicated to many charitable organizations, devoting time and expertise, with a focus on helping inner-city schools and first-generation college students.

Matt sits on the Fortis Executive Committee and serves as Chair of the Fortis Investment Committee, overseeing the delivery of investment advice and strategy for our clients. A voracious reader and compassionate educator, he has the ability to interpret complex technical financial information and simplify it for the benefit of each of his clients. Matt directs the content of our Fortis INSIGHTS blog, an extension of a daily industry research newsletter he authors, helping our clients and teammates stay informed about market trends.

Matt holds a Bachelor of Arts from Holy Family University, an MBA from LaSalle University and a Master of Arts in Organizational Leadership from the University of Pennsylvania. He serves on the Board and is Chairman of the Endowment Committee for BLOCS and Holy Family University.

When asked what makes the Fortis investment philosophy stand apart from other wealth management firms, Matt shared:

"Our goal is to provide clients with an unbiased roadmap for investing, minimizing emotional influences and focusing on the factors that they — and we, together — can control."

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As a true family office, our mission is to enhance our client's return on life. We help our clients achieve what is important to them by bringing clarity to financial decisions and by helping them articulate and achieve their life goals.

Focusing on more than just investable assets, we view our families from a global perspective and understand their entire financial world. This approach positions Fortis to add significant, measurable value in the areas of accounting, tax, estate planning, wealth management and philanthropy.

Managing wealth is easier with a team of experienced, knowledgeable, independent professionals. Fortis has earned the role of an entrusted advisor and is a valued resource for all family financial decisions.

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