

THE BOOMER BOOST

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58

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IT HAS BEEN SAID THAT DEMOGRAPHY IS DESTINY. That is to say, significant changes in birth rates, longevity, immigration and other changes in the size and age structure of the population of a nation will reshape its society and determine its future. Nowadays some observers are saying demography is also destiny for the housing sector of the economy. *

FOR the United States, the big demographic force is the aging of the baby boom generation, those born between 1946 and 1964. This celebrated generation has garnered much press since the surprise jump in birth rates that occurred after World War II, when America entered a new age of peace and prosperity, * The boomer boost is not the only one for housing demand. Immigration is also an important demographic factor, but one that, at least for now, is secondary to the aging boomer phenomenon. * The first boomer-related housing boost came when the generation first grew up, formed households and started their own families. What is surprising to many is that the boomer boost is back. * In the last five years, aging boomers have driven up overall demand for housing. Even though the oldest boomer turns 59 this year and the youngest boomer turns 41-well past the age when most people buy their first home-boomers are expected to continue to drive up demand for housing for the next decade or two.

The reason aging boomers continue to drive up housing demand is that homeownership continues to increase with age. The homeownership rate for householders does not peak until somewhere between age 70 and 74-and may not peak then for the boomers. In every age group up to age 75, "there are still families trying to build on their savings to make the transition from renting to owning," says Frank Nothaft, chief economist for Freddie Mac.

While the net gains in overall homeownership rates are not big after age 50, the sheer numbers of boomers enhances the impact as boomers age into higher-ownership-rate age brackets. "This is a big demographic group-the biggest demographic group in [American] history," explains David Berson, chief economist for Fannie Mae. He estimates that baby boomers may account for 40 million of the 111 million households in America, or 36 percent of all households.

Getting it wrong

The boomer boost and the likelihood it will continue for a decade or more fly in the face of predictions by some analysts. Byron Wien, managing director and the senior investment strategist at Morgan Stanley, New York, suggested in January that during 2005 "higher interest rates will finally begin to have an impact on housing." He adds, "While the bubble only bursts at the high end on the two coasts and at resort locations, the price of an average home declines after years of increases. Housing stocks drop in a flat market."

Wien's forecast is not the first. "We've heard people try to sound the death knell of housing for more than two years," says economist David M. Jones, chairman of Investors Trust Co., Fort Myers, Florida, and, for many years, chairman and chief economist at Aubrey G. Lanston & Co. Inc., New York. "They have said that the surge in prices and demand is too good to be true, that it can't go on forever." Some, like Wien, have predicted that higher interest rates would bring the whole housing boom crashing down.

"But people are missing this point [about demography]. They keep thinking it's a bubble, that's it's all cyclical. They are just totally wrong," says Jones.

Jones explains that the astonishing run-up in house prices since 2000 is not entirely due to demographics. Indeed, much credit for rising prices should go to falling interest rates. Lower rates since 2000 have "leveraged the demographic effect," he says. He points out that even as interest rates have started back up, there remains fundamental strength in housing demand, despite some predictions of dire effects.

Interest rates, even after several hikes, still remain "by any measure, incredibly low," and still remain a leveraging factor to the demographic effect, according to Jones. Low short term rates have "spilled over into long-term rates," says Jones. The ??-year bond-the rate that tracks most mortgages-is still hardly more than 4 percent. Thirty-year mortgage rates remain "exceedingly attractive," Jones adds.

The little understood factor

To some extent, the drivers of current demand for housing are not fully appreciated. Indeed, few in the industry predicted the big gains in housing demand that have emerged in the past five years. Fewer still saw a big demographic driver to demand. "It's interesting that in an industry that depends so much on demographic factors, we know as little as we do," says

Doug Duncan, senior vice president and chief economist for the Mortgage Bankers Association (MBA).

Cambridge, Massachusetts-based Harvard University's Joint Center for Housing Studies noted the importance of boomers in pushing up housing demand in its State of the Nation's Housing: 2003 report. "Shifts in the age distribution of the population will favor higher spending on both remodeling of existing homes and purchases of new homes in the coming years," the report stated. "By 2010, older baby boomers will be in their peak wealth years and young boomers in the peak earning years of 45 to 54. Because of their sheer numbers and economic clout, the boomers will still be a major force in home-buying markets even though fewer of them will move over this decade."

The Joint Center for Housing Studies also noted in 2003 that rising productivity in the 1990s has boosted income and wealth for all age groups. But boomers are expected to get a further boost when they inherit their parents' assets after most reach age 55 in the next decade.

The Homeownership Alliance cited demographic factors as a key to its 10-year forecast in a 64-page study last year titled America's Home Forecast: The Next Decade for Housing and Mortgage Finance.

While noting that homeownership rates rise with age, the Homeownership Alliance study did not comment on the potential of that effect to magnify demand.

The study was authored by five housing economists: Berson; Nothaft; David Lereah, chief economist for the National Association of Realtors (NAR), Washington, D.C.; Paul Merski, chief economist for the Independent Community Bankers of America (ICBA), Washington, D.C.; and David Seiders, chief economist for the National Association of Home Builders (NAHB), Washington, D.C.

The Homeownership Alliance report predicted that homeownership will rise above the recent record level of 69.2 percent (fourth-quarter 2004) and push past 70 percent in 2013. This will be helped by a surge in new household formations of 1.32 million to 1.63 million per year during the years 2004 to 2013. The report expects new household formations to keep housing prices rising 5 percent a year, provided there is no constraint in supply.

"Household growth, along with replacement requirements, second-home demand and changes in vacancies, will require average production of 1.85 [million] to 2.17 million new housing units per year," the Homeownership Alliance report forecast.

The Census numbers

One can get a good idea of the role that senior boomers can play by looking at primary data sources, particularly U.S. Census Bureau data that tracks

homeownership by the age of the householder, according to MBA's Duncan. In the census data, householders are segmented into age cohorts of five years (25 to 29, 30 to 34, 35 to 39, etc.).

Noting the patterns of rising rates of homeownership by age, Duncan contends that boomers are now and will for some time continue to be the largest demographic factor driving up demand. After boomer demand peaks, however, he expects rising demand from immigrants, minorities and echo boomers-the children of the baby boom generation, born between 1977 and 1994-to fill the slack.

The latest Census Bureau survey for which data is available-the third quarter of 2004-reports that homeownership rates peak at 84.5 percent for householders aged 70 to 74 years old. This is only slightly higher than the 84 percent ownership rate for those aged 65 to 69, but more than seven percentage points higher than 77.8 percent J homeownership rates for those aged 50 to 54, for example.

"This means that even the oldest baby boomers are at least 11 years away from peak homeownership," notes Fannie Mae's Berson.

One of the reasons that housing industry leaders may not have been able to foresee how boomers could boost demand is that in the past, homeownership peaked at an earlier age and began to decline earlier and more sharply. In 1982, for example, the peak age for homeownership was ages 60 to 64-a full 10 years younger than it is today.

In 1982, the homeownership rate was 80.1 percent for those aged 60 to 64, falling to 77.9 percent for those aged 65 to 69 and 75.2 percent for those 70 to 74. Contrast that with a third-quarter 2004 homeownership rate of 84.5 percent today for those aged 70 to 74. That's nearly a 10 percentage point gain for that age bracket.

Indeed, if one looks at the age groups tracked by the Census Bureau, the homeownership rates were close to those of 1982 for people aged 25 to 64. Yet for those age 25 and under, and those age 65 and older, the more recent homeownership rates are significantly higher.

Looking to the future, one can take the homeownership rates seen in current data and see how the aging of boomers will affect overall housing demand. Not only will baby boomers have higher ownership rates between ages 65 and 75-as revealed by current homeownership patterns-but there will be many more people in those age brackets, which will magnify the impact of aging boomers.

Improvements in medicine and overall health are likely to push the age of peak ownership up further over the next 20 years. "Each generation has been healthier than the previous," notes Berson. "Peak ownership [in the future] may be at age 74 or 75"-higher than the estimated peak age of 70 assumed for seniors today.

Nothaft identifies good health among seniors as a key reason for rising housing demand. "What's causing longevity is a healthier lifestyle and diet, even a healthier childhood [that produces benefits later in life], plus better medications for senior citizens," he says. "This increases the probability they will be healthy enough to be homeowners longer in life."

Second-home ownership gaining

Another potential baby boomer effect is an increase in ownership of second homes. People tend to become second-home buyers after age 50 or 55, according to Nothaft. As more baby boomers move into this age bracket, they are likely to drive up ownership of second homes.

Demand for second homes has been rising steadily. Over the past decade the number of second homes has increased by an average of more than 100,000 a year, pushing up their share of total housing stock from 5 percent to 5.5 percent, according to the Census Bureau's Housing Vacancy Survey. The Homeownership Alliance contends that rising wealth among older Americans improves the odds that boomers will become second-home owners.

Inflation-adjusted wealth among all families, for example, rose from a median of \$61,300 to \$86,100 in the period between 1992 and 2001, according to the Federal Reserve's Survey of Consumer Finances, which is conducted every three years. (Data from the 2001 survey was released in 2003; data from a survey done in 2004 will not be released until 2006.)

The Homeownership Alliance study, however, found that despite favorable conditions for higher second-home ownership, the potential fell short of expectations. Even so, the study forecasts that the ownership of second homes will rise by 125,000 a year over the next 10 years.

The report explains: "In the decade ahead, demographics will continue to be favorable, but demand for second homes will depend on incomes, the performance of the stock market and other investments, and the cost of housing finance. It will also depend on social trends and fashions. It could benefit from a continuation of the current unpopularity of foreign travel and from the possibility that aging baby boomers will choose to become semi-retired, rather than either retiring or continuing full-time work."

MBA's Duncan suggests that homeownership is rising among the youngest age cohort because wealthy boomers are able to help their children become homeowners at an earlier age than they did. Indeed, homeownership among those under age 25 rose from 19.3 percent in 1982 to 25.4 percent in 2004—a fairly hefty jump. Rates also rose slightly for those aged 25 to 29, from 38.6 percent in 1982 to 39.9 percent in 2004.

Immigration will push up demand

The continuing strong flow of immigrants into the United States will also push up demand. In 2000 there were an estimated 33.1 million foreign-born

people living in the United States, of whom 31.1 million were counted in the U.S. Census. This population included 21.6 million legal immigrants, 1.8 million applicants for legal status, 1.2 million temporary migrants and an estimated 8.5 million illegal immigrants, according to a Census Bureau working paper by Kevin M. Deardorf and Lisa M. Blumerman.

Since 1990, immigration levels have been high-and rising. From an average of 1 million a year in the 1990s, immigration rose to 1.3 million per year after 2000. The largest number of immigrants can be found in the population group aged 15 to 34. Immigrants have swelled the ranks of young age groups as the baby bust (those born between 1965 and 1976) has aged, filling in a shortfall in demand created by the baby bust, according to Fannie Mae's Berson. That impact is expected to continue. The Census Bureau's current projection for the coming decade is for 893,000 immigrants per year, an expected level of migration that many observers consider to be low.

The impact of newly arrived immigrants on homeownership at first lowers the average homeownership rate. Then, as a given immigration cohort remains in the United States and ages, this dampening effect on the average disappears. This happens because homeownership rates for these immigrants eventually reach and sometimes exceed the national average.

"When someone immigrates to the United States, they don't show up and generally buy a house right away," explains Nothaft. Immigrants typically rent initially, then learn the customs in America, its financial system and its language, and then they learn about potential neighborhoods where they would like to live.

Immigrant homeownership rates overall, for example, are about half that of the native-born population, according to Nothaft. Homeownership rates, in fact, have been temporarily dampened below what they would otherwise have been absent high levels of immigration, he adds.

Over a period of 12 to 20 years, however, the rate of homeownership rises to rates equal to the average for the United States, Nothaft says. This means that the significant surge in immigration that occurred in the 1980s is now having an impact on housing demand. In the next decade, an even bigger surge in immigration in the 1990s and the early 2000s will push up demand, Berson says, as homeownership rates among these groups begin to rise to the national average.

Overall homeownership rates of immigrants and others have also been helped by "a sea change in credit underwriting," according to Berson. Econometric research in the early 1990s led to credit scoring and a revolution in underwriting. Since then, lenders have tended to see a borrower's credit history as the most important factor in determining the likelihood that he or she will repay a loan. Other factors, such as loan-to-value (LTV) ratio, were considered secondary to one's credit history.

Automated underwriting and automated home appraisals have reduced the cost of originating a mortgage and, thus, made mortgages more affordable, according to Nothaft. He points out that Freddie Mac's Loan Prospector® underwriting technology, for example, improves the ability of lenders to underwrite and understand risk in a mortgage application file. In addition, there are new loan products that, for example, allow borrowers to buy a home with a down payment of only 3 percent.

Similar changes in underwriting have occurred throughout the industry and have "brought into ownership a whole population that had not previously qualified," says Berson, "including people with lower wealth and people with lower income."

In the future, minorities are expected to be a growing share of new households and, thus, to the extent automated underwriting and new products target minorities, this will boost demand for homes. In its State of the Nation's Housing: 2003 report, the Joint Center for Housing Studies predicted that household growth—the primary driver of housing demand—will exceed 12 million between 2000 and 2010. While the center predicted that immigrants would represent one-fourth of new households, it forecast that minorities as a group will represent two-thirds, or 8 million of that total. The report noted minorities represented 32 percent of first-time homebuyers in 2001, and 43 percent of all renters.

The naysayers

Of course, not everyone believes the fundamentals of the housing market portend steady and growing demand. Anthony Downs, a real estate economics expert with The Brookings Institution, Washington, D.C., last fall told Californians they might want to consider cashing in on their gains. Home prices in California have soared 123 percent in five years, Downs told his audience. "Sell whatever you don't want to keep forever. No one knows where the market peak is, but this must be close to it," Downs told the University of California at Berkeley's Fisher Center for Real Estate and Urban Economies' Real Estate & Economics Symposium in San Francisco.

Stephen Roach, chief economist for Morgan Stanley, contends that Americans are saving less because they view the run-up in home equity and other assets as a proxy for long-term saving. Roach is worried that the paltry saving rate in the United States is contributing to a growing accounts deficit with the rest of the world that could lead to a lower dollar and higher interest rates (and a wet blanket for the housing sector.)

Most housing economists are not buying the idea of a bubble in real estate prices or an imminent decline in housing prices, given the underlying demand being generated by demographic factors.

"In the last 50 years home values have trebled," says Nothaft. "The last sustained drop in home values [during the Great Depression came during a period of extended 25 percent unemployment." Nothaft contends that it

would take another major calamity on the scale of the Great Depression before national home prices would drop. This, of course, does not mean prices will not fall in some parts of the country or that prices will continue to rise as rapidly as they have. "It's unrealistic for housing prices to rise 10 percent or more" annually in the coming years, Nothaft says.

Even so, high mortgage debt still poses some challenges to the storyline that boomers will continue to drive up demand. To what extent will boomers sell their homes to reduce debt in retirement so they can maintain living standards? That may depend in part on how well they have saved for retirement. To the extent boomers have not saved for retirement, they may not be able to stay in their homes in retirement and, thus, would be more likely to sell. However, only if they subsequently rent instead of buying a less expensive home or apartment would they decrease overall demand for homeownership.

According to Craig Copeland, a senior research associate at the Employee Benefit Research Institute (EBRI), Washington, D.C., government data reveals that current retirees have not been forced to sell. "They have stayed in their homes," he says, helped in part by lower interest rates. Even so, Copeland says, "I can see that going forward, that could be an issue."

That is so because people have traded up to more expensive housing in their 50s, and some have increased their mortgage debt in the process. Others have bought second homes, raising their overall debt burden.

A 2003 EBRI study co-authored by Copeland predicted that American retirees will have at least \$45 billion less in retirement income in 2030 than what they will need to cover basic expenditures and any expense associated with an episode of care in a nursing home or from home health-care providers. By 2040, that shortfall will be \$400 billion.

This suggests that while a significant number of boomers are extraordinarily well-prepared for retirement, many others are not. This latter group will face challenges over time that might include selling their home and finding less expensive housing in order to meet basic expenses. The EBRI study concluded many boomers now working could avoid the shortfall by saving an additional 5 percent of compensation during their working years.

MBA's Duncan acknowledges that boomers have more debt than previous generations. "My educated guess is that the average boomer couple will have owned more homes, leveraged themselves upward, managed more debt and expanded more debt" than previous generations, he says. He thinks that worries about too much debt held by boomers may be "a little bit overblown." The trend reflects more the economic logic of carrying the higher debt levels than the failure to discipline spending on the part of borrowers, Duncan says. For example, he suggests that some of the higher debt reflects the ownership of a second home.

Boomer seniors want luxury

The aging of the baby boom industry is well understood by home builders, according to Jack L. Haynes, executive vice president of the National Builder Division of Countrywide Home Loans Inc., Calabasas, California, which was rated the No. 1 lender for new-home purchase loans during the first half of 2004, according to Mortgage Banking's Marketrac feature.

"Home builders are keenly aware that many of the buyers of houses are coming from the baby boom generation," says Haynes. The older members of the baby boom generation are already looking to buy their "final home" or possibly a second home, he says. The younger half of the boomers, on the other hand, are move-up buyers.

Countrywide co-authored a study of older Americans in 2003 with the National Association of Home Builders. "Probably the most striking aspect of the initial results of this study is that many homebuyers aged 50-plus are not simply cashing out the equity they built up in the home they raised their children in and downsizing into a less-expensive house or apartment," says Haynes. Instead, they are building a more lavish house than they owned previously. This is partly because many of them "are coming to purchase a new home with a fair amount of cash," he says.

The desire for a lavish retirement lifestyle is strikingly different from past generations, which tended to pare back on living expenses during retirement. A new approach to retirement is typical for a generation that has tended to redefine each stage of life as they lived through it—an approach first celebrated in the press in the 1980s, when the term "yuppie" was born to signify young, upwardly mobile professionals.

Notes Haynes: "Baby boomers continue to rewrite the rules of consumer behavior at every stage of life, and home builders and mortgage lenders need to be prepared to meet their changing demands."

With greater wealth and a desire to enjoy a richer lifestyle, a significant number of boomers do not want to spare on amenities in a new retirement home. Typically, explains Haynes, boomer seniors looking to buy a new home want a one-story house, which raises costs over a two-story house with comparable square footage, says Haynes. Boomers may ask for a three-car garage. The third bay, explains Haynes, is typically for a golf cart. Often senior boomers want a stereo system installed throughout the house, an exercise room and a media room.

Haynes also sees a pick-up in demand for housing by immigrants and echo boomers. "I'm not seeing any decline in demand in the future. In actuality I'd say there is an increase in demand," Haynes says, although he agrees that higher interest rates could eventually put a dent in demand.

Not all seniors are moving to the most popular retirement areas along the West Coast and southeast coast, Gulf Coast and the southern tier of states in the southwest. Some are staying put in the towns and cities where they lived during their working lives. And some are staying near where they worked but

moving to new retirement communities. This latter approach still ends up boosting demand for new housing, according to Haynes.

Why not a decline in demand?

One important trend-the rising age of peak homeownership-makes the aging of the baby boomers starkly different from that of earlier generations. This alone makes for an opposite outcome on housing demand than might have otherwise occurred. As noted earlier, a comparison of data from 1982 and 2004 shows sharply different homeownership patterns.

In 1982 homeownership peaked at 80.1 percent for householders aged 60 to 64, and fell to 75.2 percent for those 10 years older (70 to 74). If those trends were still in place today, the impact of the baby boomers might be very different. It would mean housing demand could drop by five percentage points for boomers as they pass from age 65 to age 75. This would occur for older boomers during the years 2009 to 2019. Such a decline would mute the impact of rising homeownership for the younger half of the boomers over that same period. Eventually these patterns would produce a decline in demand.

In 1989, when data showed a lower age for peak homeownership, two economists-Gregory N. Mankiw and David N. Weil-predicted a decline of 47 percent in the price of housing by 2007 in a scholarly article ("The Baby Boom, the Baby Bust, and the Housing Market," *Regional Science and Urban Economics* 19 [1989].) Clearly the authors failed to anticipate the new pattern in homeownership. Indeed, they "did not factor in the fact that homeownership rates rise with age," says Nothaft. Mankiw did not respond to several queries for comments.

Nevertheless, it's helpful to consider what Mankiw and Weil found and why. The two economists predicted that housing demand would grow more slowly in the 1990s and the first decade of the 21st century than in any time since the end of World War II.

The deflation in asset prices would be the mirror image of the run-up in housing values that occurred in the 1970s when baby boomers were forming households and first driving up the price of real estate. During the 1970s the real price of housing rose between 19 percent and 32 percent. Mankiw and Weil examined the U.S. Census Bureau data to analyze what factors drove up prices. They found that having more children does not drive up housing prices. Thus, during their childhood years in the 1950s and 1960s, baby boomers had no effect on the housing market.

Looking at the housing and demographic data for the 1970s and 1980s, the authors found the impact of the baby boom generation on demand for housing begins at age 20 and continues to rise to age 30. After 40, boomers, they wrote, would be expected to reduce demand for housing by about 1 percent a year. (The oldest boomer was 43 in 1989.) "This decline is probably attributable to the fact that, because of productivity gains, older

cohorts have lower lifetime income than younger cohorts, and therefore demand less housing," Mankiw and Weil wrote.

The authors, of course, could not have anticipated the big surge in productivity that came in the late 1990s and continues into the first half of this decade, boosting income and wealth for workers-especially those who benefit from the advances associated with information technology.

Mankiw and Weil found that 22 percent of the 50 percent gain in the real value of housing between 1970 and 1980 can be attributed to gains in real disposable income, reflecting gains in productivity. They attributed much of the rest of the gains in prices to the fact that demand outstripped supply.

Mankiw and Weil believed in 1989 that the baby bust generation would have the opposite effect of the baby boom generation and drive down the real value of housing. The authors cautioned, however, about the perils of forecasting, noting, "We cannot be confident about precisely what effects this slow growth [in housing demand] will have." Even if only half the amount predicted occurred, it would still be "one of the major economic events of the next two decades."

In 1995 Craig Swan, then a visiting economist at the Federal Reserve Bank of Minneapolis, faulted the methodology used by Mankiw and Weil in a scholarly article ("Demography and the Demand for Housing: A Reinterpretation of the Mankiw-Weil Demand Variable," *Regional Science and Urban Economics* 25 [1995]).

Swan found the authors' demand variable did not take into account all the factors that affect housing demand and, thus, they performed their analysis without all the significant variables in the mix. In particular, Swan notes, they failed to include such factors as real income, relative prices and real interest rates. More important, Swan faulted them for failing to include a factor to capture the potential effect of rising building costs on housing prices.

In his own work, Swan had already found the historic data suggesting that when the costs of home construction go up, it tends to restrict the supply of housing. This, in turn, drives up the cost of housing. Swan argued that any forecast on housing demand needs to take into account costs that affect supply, such as shifts in lumber prices, construction wage rates and productivity gains, along with environmental and building regulations. One should also factor in land prices, something that Mankiw and Weil did not do, Swan wrote. In such areas as California and the Northeast, the cost of land is driving up the cost of housing, Swan noted in 1995. That effect has become magnified in the last five years.

There may be some potential soft spots to the demographic impact of boomers, according to Duncan. He thinks that at some point a lot of boomers who now own second homes may sell their primary home and take the profits to pay off debt they will have on the second home, which will then

become their primary home. Does this potential consolidation of two properties into one main residence "soften" the market?, Duncan questions. He is not sure, but thinks that housing market players should keep an eye on this potential development.

For now, however, there is consensus-at least among housing economists-on three key points. First, a later peak in homeownership will magnify the impact of the boomers aging on housing demand. Second, rising wealth from higher incomes due to higher productivity allows a large share of boomers to move up in retirement, reversing the historical pattern. Finally, the sheer magnitude of the boomer population will exaggerate all effects.

It appears, then, that the aging of the boomers - all other things being equal-will be an ongoing accelerator on housing demand and house prices. This accelerating effect is likely to continue for at least 10 years, and possibly 20. No complete analysis of the outlook for the housing sector should ignore this critical factor. MB

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