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HIGHLIGHTS

- After six long years, signs of life are emanating from Miami's housing market.
- While this is encouraging, Miami's housing recovery faces many challenges, including a huge decline in homeownership.
- By offering an attractive return on investment, the rental market is filling some of the void left by depressed homeownership.
- We expect rental demand to remain a silver lining in Miami's housing market for another two or three years as financial headwinds slow the recovery in homeownership.
- Unfortunately, a complete recovery remains some ways off since it requires homeowners to enter the fold.

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FOR RENT – MIAMI'S HOUSING MARKET

It is hard to overstate how devastating Miami's recent housing crisis has been. In recent years, home prices collapsed 50%, housing starts over 90% and the foreclosure rate rose more than 10 percentage points. Alone, real estate shrunk Miami's economy by more than 3% between 2006 and 2009.

After six long years, some signs of market stabilization have emerged. However, careful scrutiny reveals some curious trends. Homeownership, the traditional engine of housing growth, was mortally wounded during the crisis and shows few signs of recovering. In contrast, the rental market is becoming a major driver of renewed housing demand. Since rental demand actually strengthened during the crisis, rental rates have fared better than home prices. In turn, Miami's return on real estate investment is far more attractive today than in 2006. Property investors are taking notice, buying homes, and even engaging in some minor building. It appears Miami home sales, alongside a modest increase in prices has more to do with investor demand than homeownership.

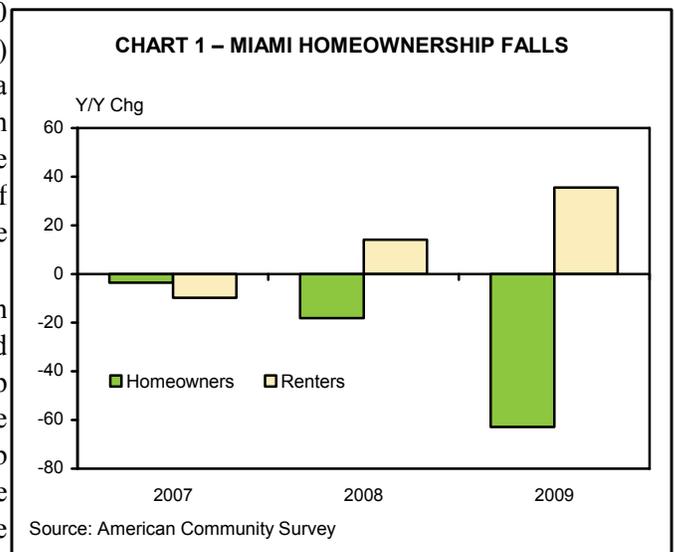
It seems likely that rental activity will remain a silver lining for Miami's housing market over the next two or three years. Many families will have no choice but to rent because financial headwinds remain a barrier to ownership. Unfortunately, while this may steady Miami's market for a time, a full recovery needs homeowners to enter the fold.

A Move from Owning to Renting

Miami suffered a massive set back in homeownership during the crash. Between 2006 and 2009, 84,500 families (a 6.2% decline) gave up on owning a home. This was a much larger decline than the experience in the rest of Florida (3.4%) and the nation (0.3%).

There are two main reasons Miami suffered such a massive slump in ownership during the crisis. First, severe job losses left many unable to make their mortgage payments, sadly leading

to the loss of ownership through foreclosure. Second, about 32% of Miami's homeowners owe more on their house than it's worth. Faced with such a disheartening circumstance, some households are choosing to strategically default on their mortgage debt (meaning the homeowner has the means to pay but opts not to, hurting their credit, but improving their balance sheet).



Three options face Miami's ex-homeowners: they can move in with friends or family, leave the city, or rent. Some opted for the first two choices. Between 2006 and 2009, Miami's average household size grew from 2.7 to over 2.8 people. Also, a rare decline in population during 2009 shows that many residents left the city in search of opportunities elsewhere.

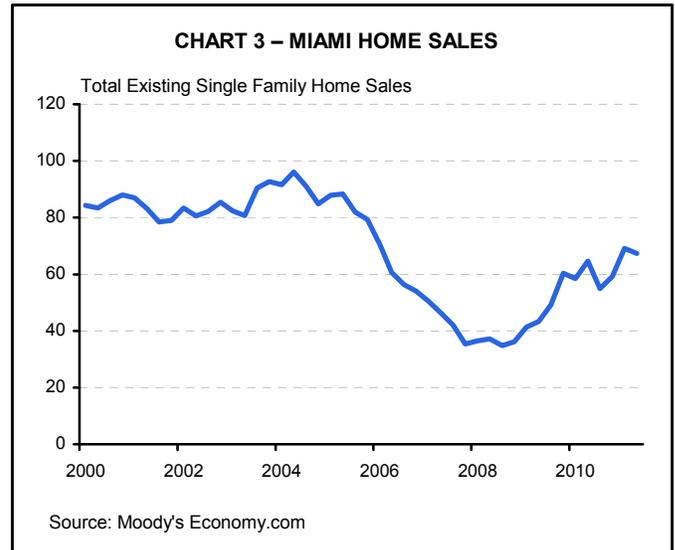
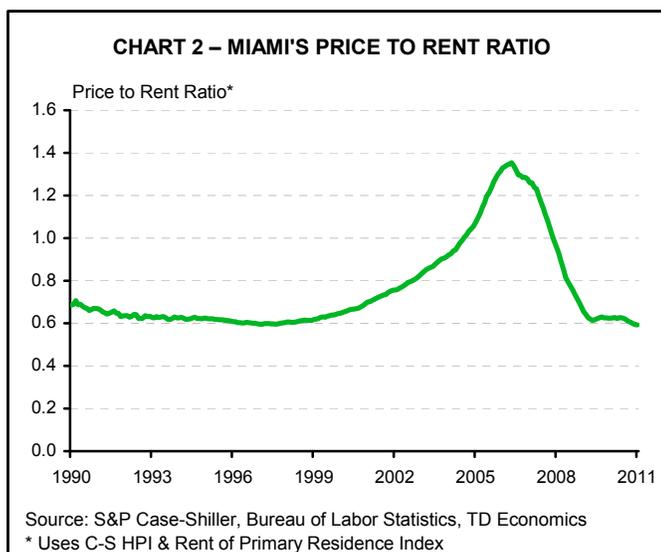
However, many ex-homeowners tried option number three – renting. Between 2006 and 2009, when the number of new households in Miami turned negative, the number of renters grew by 39,786 (or 6.1%), a faster than average pace.

Renters to the Rescue

Miami's rental market has slowly been filling the void left by depressed ownership. The return on rental investment is attracting investors, improving sales and even stimulating some minor building. This transition has been in the works for a few years, but we think Miami's rental market will continue gaining share in the years ahead.

Stable rental demand has improved investor returns. According to the Bureau of Labor Statistics, Miami rental prices only fell by 2.5% during the crisis and have risen modestly since. Without 40,000 new renters between 2006 and 2009, rents would have fallen much further. This matters, since rents are cash flows for investors. With home prices down 50% and rents essentially unchanged, the cash flow from a dollar invested in a Miami home is the highest it has been since 1997.

As expected, these vastly improved returns are attracting investors. For instance, Delavaco Properties LP, an investment firm, plans to spend \$70 million on homes in South Florida by the end of 2012, fix them up and rent them out¹.



Foreign investors are swooping in too. Reports suggest that as many as 20% of Florida home sales (likely higher in Miami) are to foreigners, who purchase homes for vacation and rental purposes².

The influx of domestic and foreign investors is driving up sales. Moody's Economy.com estimates that during Q2 2011, single-family home sales in Miami were back at 2006 levels. This is up 4.1% from a year ago when sales were artificially buoyed by a temporary tax credit. With ownership still so low, homeowners cannot account for these sales.

Early signs of rental investment are also showing up in what little new building is underway in South Florida. Multifamily units (favored by renters) have seen slightly more building momentum than single-family (favored by homeowners) since the start of 2010.

Rental Market to Retain Vitality for Another 2-3 Years

This revival in the rental market looks likely to last for a few more years. New household formation will lay the foundation for ongoing rental demand. As job growth improves in the coming years, many Miamians who moved in with friends and family will regain the means to form an independent household. Also, Miami's population – a key source of new households – grew by 1.3% in 2010. This growth rate may slow in the coming years, but it is important that Miami is no longer shrinking as it did in 2009.

Of course, if Miami's new households become homeowners, it won't help the rental market. However, financial duress will temper the recovery in Miami's homeownership rate for at least two or three years. After defaulting or missing a loan payment, access to credit can be restricted for two to seven years. Since about 20% of Miami's mortgage holders are behind on their home payments, as many as 174K

potential future homebuyers (or about 14% of homeowners) may be shut out of the buyer’s market for at least two years. This number would be higher if you consider those who have already defaulted and forfeited their property. As a result, a larger than average share of new households may have little choice but to rent.

These financial headwinds also mean that Miami’s rental market should play a larger role in the city’s recovery than in the rest of Florida or the nation. According to the most recent Federal Reserve data, the three counties that make up the greater Miami metro area – Dade, Broward, and Palm Beach – have the highest delinquency rates in Florida, and are roughly four times greater than the national average.

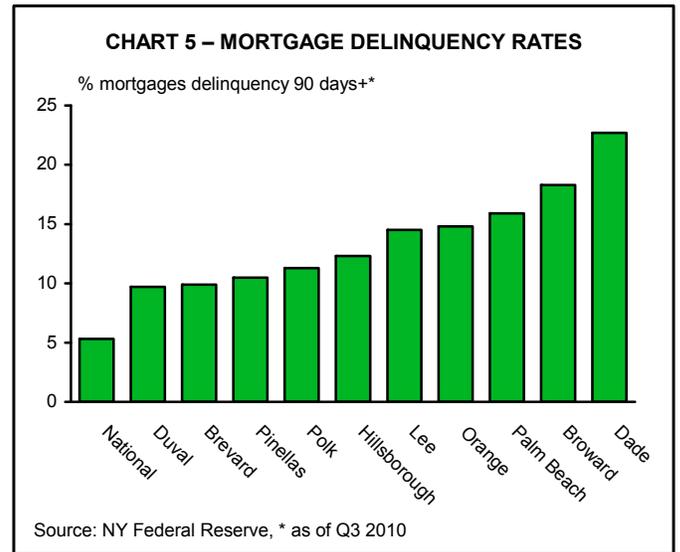
A Healthy Market Needs Homeowners

Miami’s rental market will continue to flourish, but housing’s vitality ultimately rests with homeowners. For one, for every renter in Miami there are nearly two homeowners. As long as two thirds of the market is languishing, resale activity will be slow and the market will remain hobbled.

Another reason owners are so important is that they tend to demand a different type of house than renters. Almost 73% of Miami’s owners live in single-family detached houses, compared to only 25% of renters. This means that price, construction and sales growth from rental activity will be slow to reach homeowners.

Finally, it is widely believed that ownership brings many indirect advantages not offered by renting. Homeowners are generally more engaged in the upkeep of their homes and neighborhoods. Over time, this supports higher home prices.

In two or three years, South Florida’s ownership rate should gradually start restoring some of its former luster. As



Miami’s credit problems become less acute, more prospective owners will be able to take on home loans. This option should prove attractive, since falling prices have vastly improved housing affordability. Also nudging families towards ownership will be the higher rental prices stemming from an outperforming rental market.

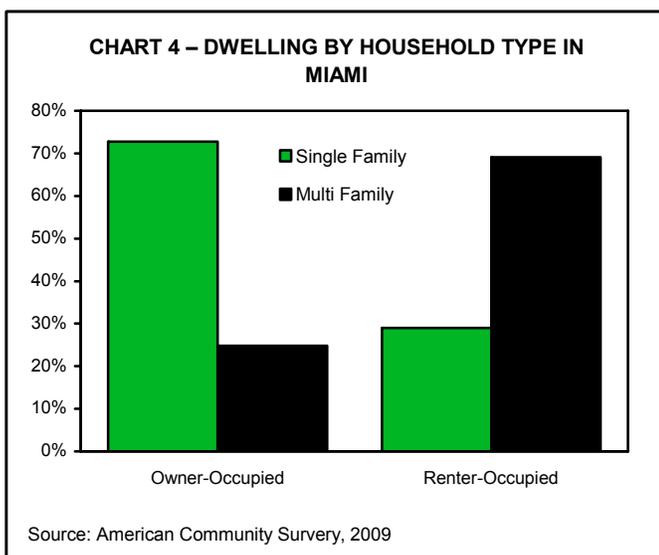
While we believe the ownership rate will start to improve in a couple of years time, we must highlight the enormous uncertainty that exists. It is too early to tell if attitudes towards ownership have changed permanently, or what the future has in store for the mortgage insurers Fannie Mae and Freddie Mac? While a recalibration in ownership rates may affect the importance of homeowners, they will have to play a key role in recovery.

Conclusion

After six years, Miami’s housing market appears to be entering a new phase. Sales are rising and home prices are inching up. With a huge glut of homes in foreclosure and a jobless rate above 9%, however, the path to recovery remains foreboding. One notable challenge facing Miami’s housing recovery is lackluster homeownership.

Rental activity should continue to fill some of this ownership void due to an attractive return on investment. Yet the unfortunate reality remains that homeowners are the largest source of demand and must play a central role in order for a healthy and sustained recovery.

1. <http://www.bloomberg.com/news/2011-03-29/cash-paying-vultures-feast-on-u-s-housing-as-mortgages-dry-up.html> Retrieved September 6, 2011.
2. <http://finance.fortune.cnn.com/2011/08/17/foreign-buyers-housing/> Retrieved September 6, 2011.





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