U.S. Municipal Housing 2019 Sector Outlook: Stable For Now

January 23, 2019

S&P Global Ratings' 2019 outlook for the U.S. public finance (USPF) housing sector is stable, with a few exceptions in certain subsectors. The outlook reflects stronger financial metrics, including asset growth, revenue diversification, and resilient strategy and management in most of the sector. We expect housing issuance volume to continue increasing this year as housing finance agencies (HFAs) expand their issuance of mortgage revenue bonds and more community development financial institutions (CDFIs) and public housing authorities (PHAs) enter the public markets. While S&P Global Ratings forecasts slower economic growth in 2019, last year ended with positive employment information. The combined strength of jobs, number of hours worked, and wages points to a strong income gain to end the year. Adding to that, the continued rise in the labor force participation rate of prime-age workers suggests that there is potentially more room to expand.

Note: We are publishing this article on Jan. 23, 2019, 33 days into a partial Federal government shutdown, which includes the Department of Housing and Urban Development (HUD). Much of the housing sector relies on HUD support. At this point, the sector's credit quality remains largely unaffected. However, if the shutdown were to continue into mid-to-late February and beyond, we would revisit this outlook. To date, January housing assistance payments for Section 8 projects and PHA funding have been provided and we expect these will be available for February. HUD's published contingency plan lacks clarity on the availability of funds and the expected implications from a prolonged shutdown.

PRIMARY CREDIT ANALYST

Marian Zucker
New York
(1) 212-438-2150
marian.zucker
@spglobal.com

SECONDARY CONTACT

Aulii T Limtiaco
San Francisco
(1) 415-371-5023
aulii.limtiaco
@spglobal.com

Risks And Opportunities

Risks	Opportunities
- Rising interest rates and continued home price appreciation, although slower, could continue to stress first time homebuyers - Higher labor and materials expenses increase construction costs, widening gaps in affordable rental housing development budgets - Federal funding and policy uncertainties linger as the government shutdown extends into its fifth week - Market volatility as the U.S. economy enters the 10th year of the second-longest expansion, with a slightly increased possibility of recession - Weak management and strategy in certain Section 8 and unenhanced affordable housing projects could jeopardize financial performance and cause further rating deterioration - CDFIs' decreasing capitalization ratios and increasing leverage ratios could lead to continued negative rating trends - Extreme weather events introduce event risk, particularly to issues supported by concentrated assets	- Stable-to-improving financial metrics (such as return on assets and net operating income) bolster the ability for most subsectors to withstand market changes - Demand for affordable rental and ownership housing continues to increase while the supply in most markets is decreasing--affirming the need for HFA, PHA, and CDFI involvement and existing multifamily housing developments - Rated PHAs and HFAs are diversifying their revenue sources while expanding the ways they serve their communities - CDFIs continue to make their mark in affordable housing and related community development by increasing bond issuance, using balance sheets and taking advantage of federal funding - Financial performance has improved for HFAs, with increased equity, profitability and flexibility, as well as lower delinquencies from both economic conditions and issuers' continued high reliance on government mortgage support and programs - Market conditions for bond-financed single-family mortgage lending programs are favorable

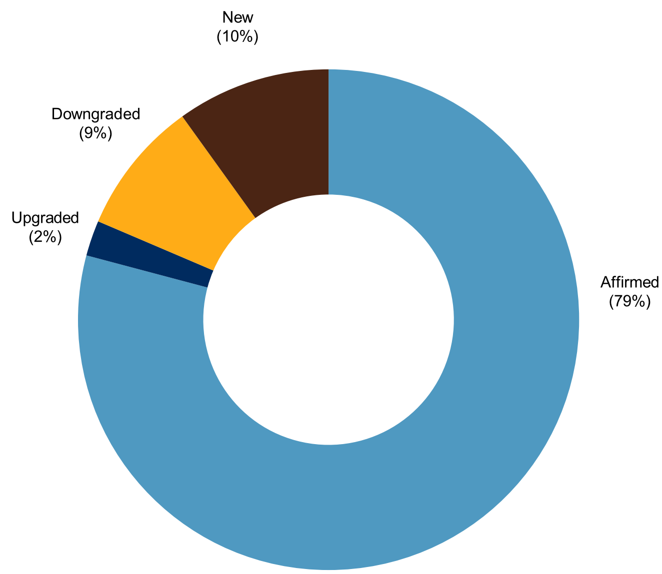
Credit Trends Vary By Subsector

Rated municipal housing issuers cover a broad range of credits, each of which play a role in financing, owning, or operating housing affordable primarily to low and moderate income households. The main subsectors include HFAs and their bond-financed loan pools, PHAs, CDFIs, and affordable housing projects (AHPs), which are single- or multi-rental property pools owned by an affordable housing sponsor.

Despite exposure to the same economic cycles, housing subsectors have produced varying results. The past 10 years of economic growth and low interest rates provided the environment for the municipal housing sector to stabilize balance sheets, restructure debt profiles, fund reserves, build financial and operational resilience, and expand into new products and markets. The results have led to new rated entities, as well as stable-to-positive ratings for the majority of the sector. However, AHP trends have been negative, because property performance deterioration and management and strategy deficiencies led to multiple downgrades. Across the entire housing sector in 2018, 79% of credit actions were affirmations, 10% were new, 9% were downgrades and 2% were upgrades (see chart 1). The downgrades and negative outlooks are predominately in the AHP subsector.

Chart 1

Housing Rating Actions In 2018



Rating And Outlook Distribution: Mostly Stable

In our view, the housing sector is on generally sound footing: 88% of issues have stable outlooks, 10% have negative outlooks, and the remaining 2% have positive ones (see chart 2). Similar to the rating changes, the negative outlooks are mainly in the AHP subsector.

Housing credit quality remains strong and highly rated, despite some concentrated subsector negative rating trends. Most housing credits are 'AA' (see chart 3). HFAs recovering from the financial crisis have moved into higher ratings, and a downward trend in AHP transactions caused the noticeable increase in non-investment grade ratings.

Chart 2

U.S. Municipal Housing Sector 2018 Outlook Distribution

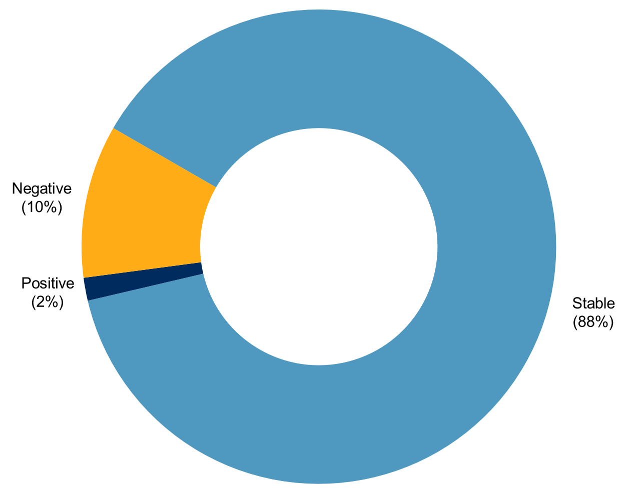
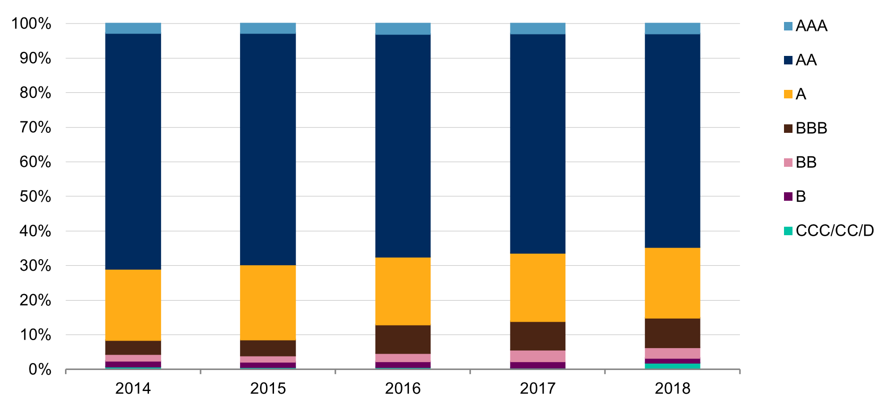


Chart 3

U.S. Municipal Housing Sector Rating Distribution

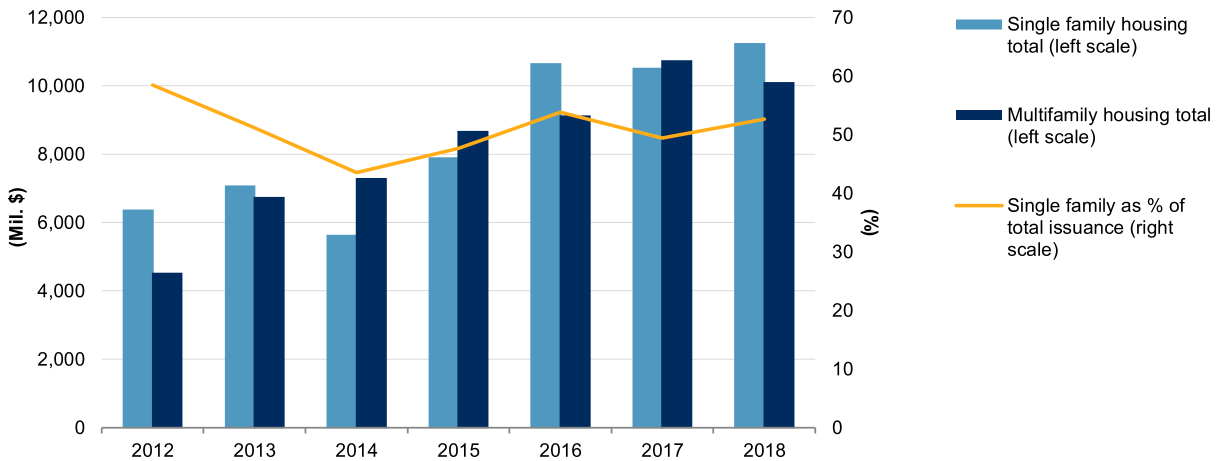


Housing Bond Issuance

Municipal housing bond issuance increased slightly in 2018, exceeding $21 billion. Single family bonds constituted a slightly larger portion of issuance than multifamily bonds, increasing to 53% in 2018 from 49% in 2017 (see charts 4 and 5).

Chart 4

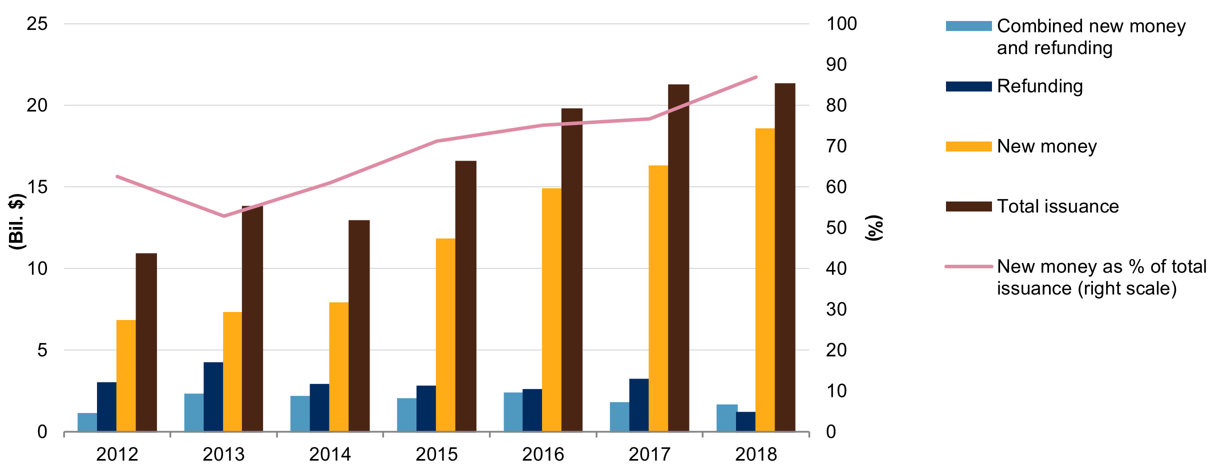
Single And Multifamily Bond Issuance



Source: Thomson Reuters.

Chart 5

Bond Issuance By Type



Source: Thomson Reuters.

Interestingly, although the Tax Cuts and Jobs Act of 2017 did not impose new limits on refunding rules for housing bonds, the amount of refunding bonds issued in 2018, at $1.2 billion, was down considerably from the $3.2 billion in 2017, and the $2.6 billion in 2016.

Economic Outlook

In our economic forecast (see table), we saw the peak of the U.S. economic cycle in 2018, spurred by the tax bill's short-term effects. S&P Global Ratings' economists forecast GDP growth to slow to 2.3% from 2.9% in 2018 and unemployment to drop to 3.6%. We have increased our projections of the likelihood of a recession over the next 12 months to 15%-20%,up from 10%-15% a few months ago, primarily due to equity market volatility and trade tensions. We also expect two more 25-basis-point Federal Reserve rate hikes by year-end, which would bring the benchmark federal funds rate to 3.0%, up from near zero about 10 years ago. Our economists forecast 10-year Treasury yields to reach 3.4% by year-end and conventional mortgage rates to be over 5%.

We have increased our projections of the likelihood of a recession over the next 12 months to 15%-20%.

We believe most HFAs, PHAs, and CDFIs can absorb this gradual increase in rates, given the limited amount of unhedged floating rate debt on their respective balance sheets and their ability to adjust lending rates (where relevant) to support their borrowing costs. In addition, as with 2018, the Fed's efforts to normalize monetary policy and end quantitative easing have helped HFAs regain their typical borrowing rate advantage, stimulating growth in balance-sheet assets and sustainable revenue streams.

U.S. Economic Outlook

	2016	2017	2018f	2019f	2020f	2021f
Real GDP (y-o-y % change)	1.6	2.2	2.9	2.3	1.8	1.7
Residential construction (y-o-y % change)	6.5	3.3	0	0.5	1.7	2.5
Unemployment rate (%)	4.9	4.4	3.9	3.6	3.7	3.9
Target Federal Reserve fed funds rate (%)	0.50-0.75	1.25 -1.5	2.25-2.50	3.00-3.25	3.00-3.25	2.75-3.00
10-year Treasury note yield (%)	1.8	2.3	2.9	3.4	3.6	3.7
Mortgage rate (30-year conventional, %)	3.6	4	4.5	5.2	5.6	5.9
Housing starts (mil.)	1.2	1.2	1.3	1.3	1.3	1.4

Source: S&P Global Ratings. y-o-y--Year-over-year. f--Forecast.

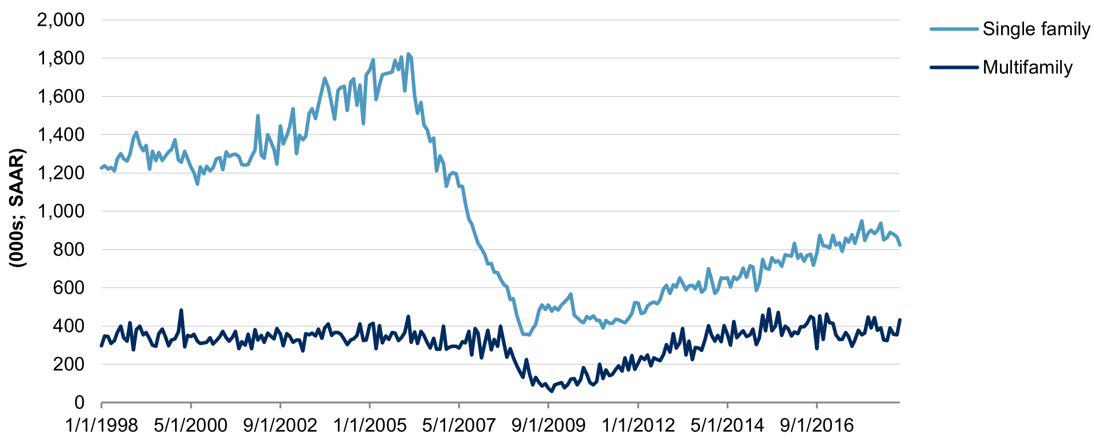
Annual housing starts continue to rise modestly; November 2018 starts rose to 1.25 million according to the Commerce Department, up from 1.2 million in November 2017 (see chart 6). Sales of new and existing homes peaked in 2017 and began to slow in 2018. Part of this slowdown is attributable to the continued increase in housing prices. The S&P Case Shiller Home Price index has climbed steadily since 2012, although it has flattened recently (see chart 7). According to David M. Blitzer, managing director and chairman of the Index Committee at S&P Dow Jones Indices, "The combination of higher mortgage rates and higher home prices rising faster than incomes and wages means fewer people can afford to buy a house....Home prices are up 54%, or 40% excluding inflation, since they bottomed in 2012. Reduced affordability is slowing sales of both new and existing single family homes."

Homeownership rates in the U.S. have also increased to 64.4% in third-quarter 2018 from the low of 62.9% in second-quarter 2016, as reported by the Federal Reserve Bank of St. Louis. Millennials, defined by the Pew Research Center as those born from 1981-2000 will begin to turn 38 in 2019, six years above the average age of 32 for first time homebuyers. The Pew Research Center also projects that, in 2019, millennials will overtake baby boomers as the largest cohort of the population representing a huge wave of households moving into the rental and housing market over the next 13 years. Even with the recent uptick in wages, affordability challenges remain and

HFA's down-payment assistance programs should be attractive for millennials.

Chart 6

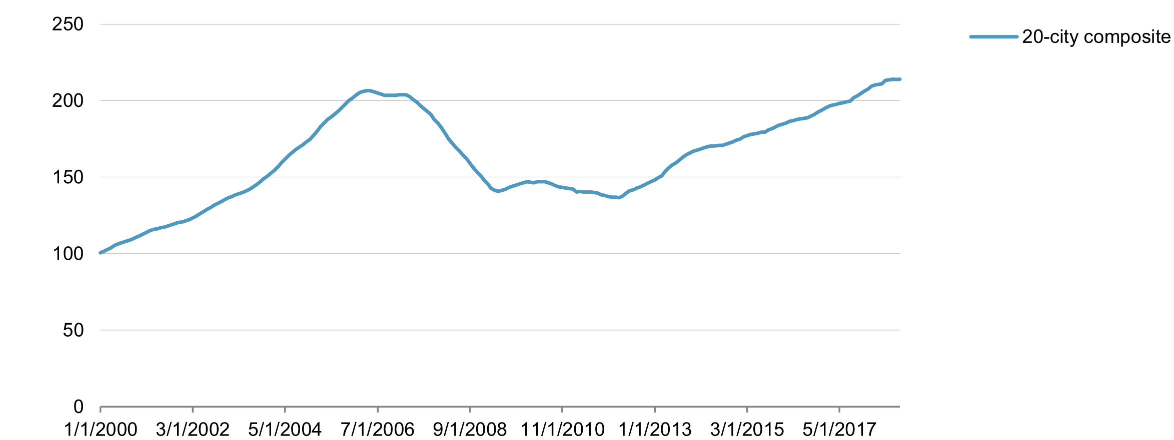
New Privately Owned Housing Starts, 1998-2018



Source: U.S. Census Bureau, New Residential Construction. SAAR--Seasonally adjusted annual rates.

Chart 7

S&P/Case-Shiller Home Price Index



Source: S&P/Case-Shiller.

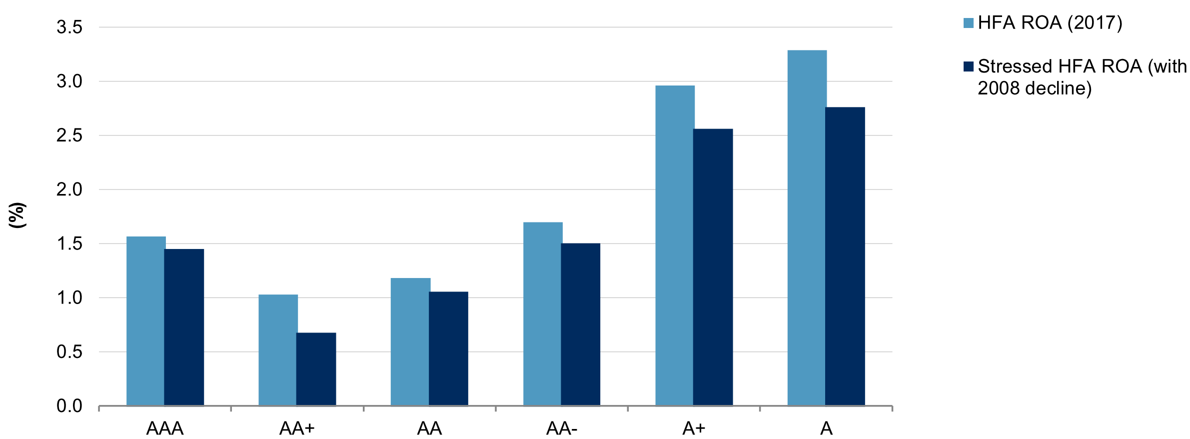
Have HFAs Become More Resilient Ahead Of Any Recession?

HFAs have effectively reversed the negative effects of the Great Recession a decade ago. While their trend of improved financial ratios hit the five-year mark in fiscal 2017, the question remains if they can avoid or withstand shocks--whether from environmental, social, or governance (ESG) factors, or another economic downturn.

Over the past 10 years, HFAs built economic resilience by diversifying revenues, varying program funding sources, and reducing exposure to counterparties. Despite HFA asset bases declining from pre-recession levels, profitability has largely improved and equity has far exceeded historical levels. The 2008 downturn significantly affected HFA profitability ratios, with the largest return on assets (ROA) decline at 35 basis points. Since then, HFAs have increased profitability, generating revenue from a variety of sources beyond interest income, including sales of mortgage-backed securities (MBS), and loan servicing fees. HFA ROA ratios at today's levels could seemingly absorb a hit similar to what they experienced in 2008, and not skip a beat (see chart 8). The lowest stressed ROA--at 0.67% for the 'AA+' category--would still fare better than that for the category five years ago. This is primarily due to the flexibility HFAs have built into their lending programs, by diversifying products and funding sources.

Chart 8

Housing Finance Agency Return On Assets

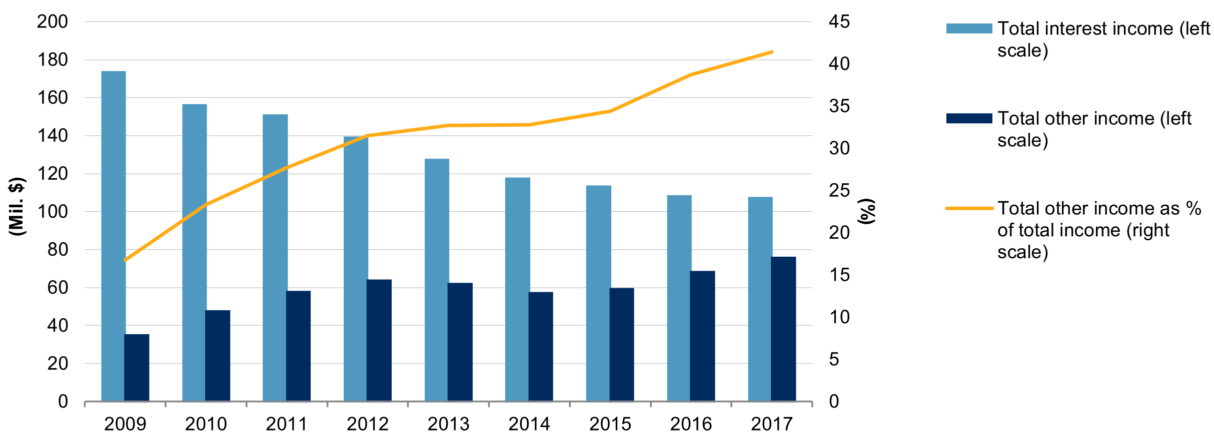


HFA--housing finance agency. ROA--Return on assets.

With this diversification, HFAs have proven to be more resilient to market forces in the past decade. Income from MBS sales, servicing and other program activities made up 40% of total HFA income (see chart 9). We expect this proportion to slow or be steady, at best, in the coming year. With rising interest rates, we expect a boost in HFA balance sheet single family lending proportionate to sales of MBS--with servicing income likely to remain an increasing stream for some HFAs.

Chart 9

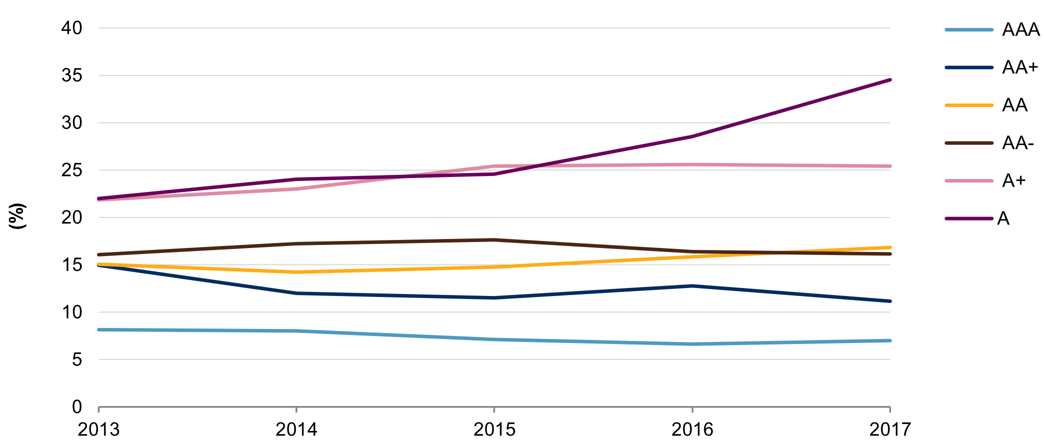
Housing Finance Agency Income By Type



Along with this shift to broader revenue sources, HFAs maintained robust liquidity positions, with lower-rated HFAs increasing liquidity to help mitigate risk (see chart 10). In the event of a downturn or other unforeseen event, HFAs that take on more risk are positioned to respond and recover quicker than they were before the Great Recession.

Chart 10

Average Housing Finance Agency Short-Term Investments To Total Assets



HFAs have also maintained resiliency in their loan and debt portfolios by increasing GSE-backed loans and reducing both counterparty and interest rate risk, such that MBS back the majority of single-family programs. We believe this shift to MBS will continue in 2019, despite the federal government's incremental steps toward GSE reform. We also expect loan delinquencies to decline further or, at worst, be steady in the event of a downturn, due to HFA loan portfolios' improved credit quality. This reflects their focus on government-guaranteed loans and their strong loan underwriting and servicing practices.

Pension Risk Is Likely Minimal For The Housing Sector

Rising costs of public employees' pensions is a key credit issue throughout U.S. public finance, although we believe its impact on municipal housing providers is more muted than elsewhere. Most of the HFAs and PHAs we rate offer retirement plans via defined benefit programs. These programs are generally administered at the state level, commonly through the state employee retirement systems. While unfunded pension liabilities are nominal for the majority of the HFAs we rate, we are closely monitoring those that participate in states with severely underfunded pension liabilities and assessing their flexibility to absorb increased costs. We include contingent liabilities, such as pension and OPEB, in our capital adequacy analysis for HFA issuer credit ratings (ICRs).

Similarly, we incorporate pension costs in our analysis of PHA ICRs where appropriate. We have found the average effect of annual pension expenses on financial performance to be relatively minor. Most PHAs we rate are part of their respective state pension systems, although three authorities self-administer their pension programs. The average plan fiduciary net position for the three PHAs that self-administer their own programs was higher than the average net position for state plans in which PHAs participate. We continue to monitor the effects of PHAs' net pension liabilities and annual pension expenses relative to their ability to meet their missions.

Housing Issuers And ESG Plans

ESG factors will be an increasingly important consideration for all housing credits. Physical assets support virtually the entire sector. But the assets' ability to generate revenue can be disrupted if issuers are unprepared. As climate change and acute weather events result in increased hurricanes, floods, and fires, it is critical for housing issuers and owners to plan accordingly. As we noted in "Why It May Make Economic Sense to Tackle Global Warming" (published Dec. 5, 2018, on RatingsDirect), climate change is no longer a future problem--it has already affected how our world functions. Hurricane Harvey in 2017 and the Camp Fire in 2018 provide insights into the challenges that the housing sector faces and the need for detailed emergency and contingency plans.

ESG factors will be an increasingly important consideration for all housing credits.

Sixteen months after Harvey, many Texas homeowners haven't fully recovered yet. However, plans are in place to deal with much of the damage. In comparison, the full extent of damages and impacts from the Camp Fire, which was fully contained less than two months ago, is unknown.

According to management at Texas Department of Housing and Community Affairs, approximately $40 million, or 4%, of the department's single-family loans originated since Oct. 2016 went into forbearance directly due to Harvey. Because FHA insurance supported these loans, there was no impact on the credit quality of their resolution (AA+/Stable). As of January 2018, approximately eight months after the Harvey-caused floods, the department reported that originations had decreased about 20% in the affected areas. A handful of multifamily properties for which the department is the conduit issuer also suffered damage in the hurricane.

According to reports, the Camp Fire was the deadliest and most destructive wildfire in California history to date, with insured damage estimated at $7.5 billion-$10.0 billion. Given the extensive destruction, the Housing Authority of the County of Butte (A+/Watch Neg) is still assessing the fire's impact on the authority's housing stock and voucher program, two key components of the PHA's credit profile. Discussions with the authority further highlight that post-disaster planning is generally slow to develop and implement. While the rebuilding effort could bring growth to the area, spurred by reconstruction job opportunities and revitalization efforts, the depleted workforce and high local construction costs will cause those efforts issues. We continue to monitor the authority's progress as it assesses the extent of the destruction and implements its recovery plan.

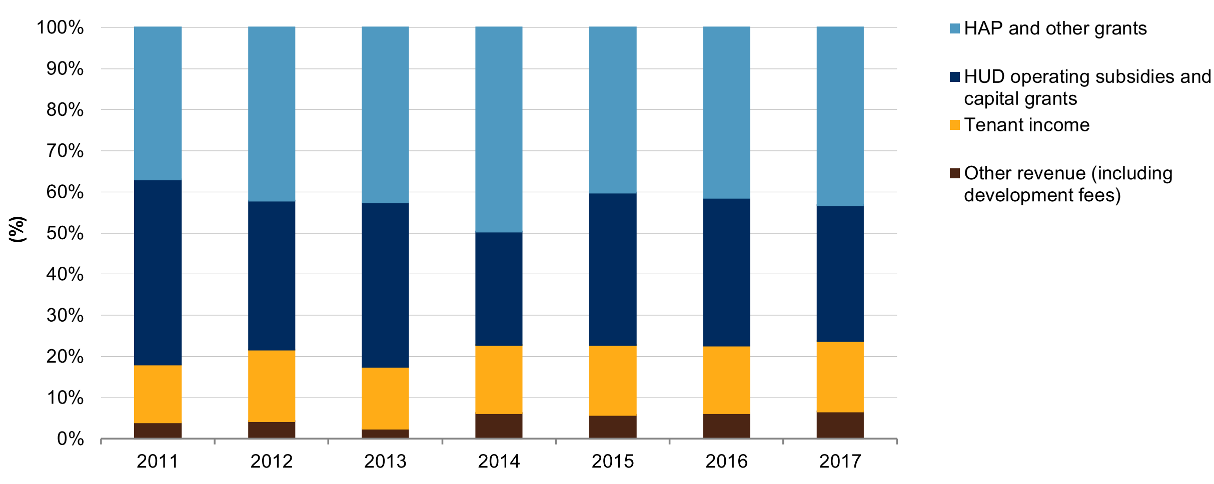
PHAs Evolve In The Face Of Federal Fiscal Changes

Historical uncertainty of federal government funding and rising overhead costs have led PHAs to implement a range of efforts to diversify revenues. HUD funding constituted a median 75% of total revenue among the PHAs that we rate. Housing authorities have made incremental steps to diversify their sources of revenues, expanding their non-HUD funded revenues (including tenant-income and other revenues) to 24% of total revenue in fiscal 2017 compared with 18% in 2011 (see chart 11).

We expect that more PHAs, fueled by generous capital funding in 2018-2019, will continue to use HUD's Rental Assistance Demonstration program. The program could address immediate needs of deteriorating housing stocks, provide increased operational flexibilities and stabilize revenue for PHAs, although we have not yet observed significant operating savings. The Senate's fiscal 2019 appropriations bill for transportation and housing and urban development suggests a 4% increase over fiscal 2018, which will alleviate some of the risk to authorities' financial operations, but managing debt and liquidity profiles is critical to continued stable performance.

Chart 11

PHA Median Composition Of Operating Revenue



PHA--Public Housing Authority. HUD--Department of Housing and Urban Development. HAP--Housing assistance payments.

In the past year, high demand for affordable housing and the elevated need for alternative financing sources led more PHAs to seek ratings.

We anticipate an increasing number of authorities will pursue debt financing as they plan for a multiyear effort to redevelop their respective public housing stock and seek non-HUD-funded revenues through mixed-income developments and workforce housing acquisition. We also believe the Moving to Work program's expansion could be a credit positive for any rated PHA which is designated, allowing for more efficient strategies and financial flexibility.

Community Development Financial Institutions Look To Build Fiscal Sustainability

We have seen an increasing interest by rated CDFIs in issuing public debt to expand their lending products to include longer term funding. CDFIs have specialized in originating short-term early financing loans, with the majority coming due in under five years. They experience very low delinquencies in part because CDFIs' close ties to the communities they serve provide an in depth understanding of the needs and likelihood of a project coming to fruition. CDFIs live the "know your customer" rule and forge tight bonds with their borrowers.

CDFI actions limit their liquidity and flexibility to react to a possible change in the credit cycle.

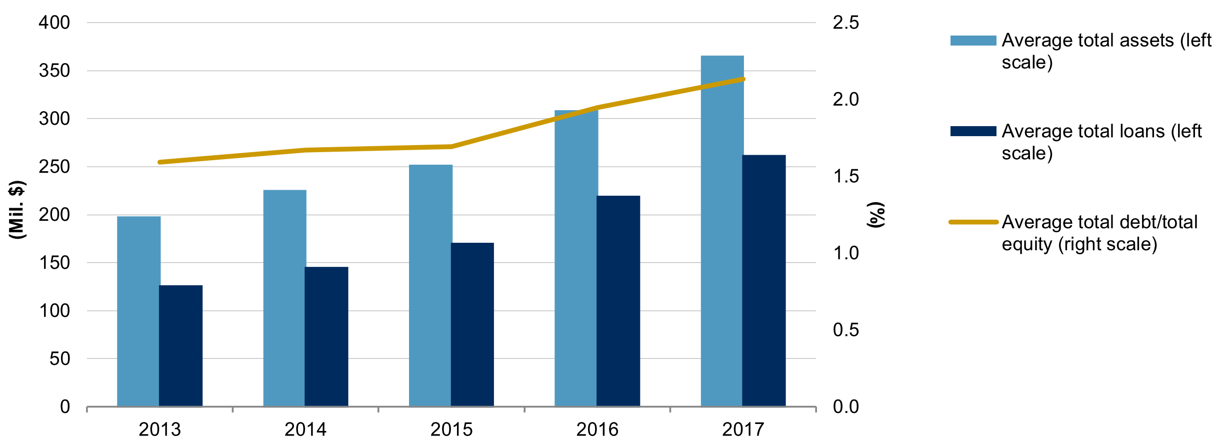
For the eight CDFIs we rate, the increase in assets and loans is pronounced (see chart 12). From 2013-2017, loans increased to 72% of total assets from 64%. During the same five-year period, total assets increased 85% and total loans over 108%. With 72% of assets tied up in loans, CDFIs are limiting their liquidity and flexibility to react to a possible change in the credit cycle and the resulting market volatility and decreases in loan performance that would follow. Leverage has also increased since 2013. On average, the rated CDFIs debt-over-equity ratio increased to 2.13 from 1.59, with some CDFIs' leverage increasing by 200-300%. Although CDFI leverage is still relatively low compared to non-CDFI lenders, a continual trend of increased leverage can cause negative rating pressure in the future.

As discussed in our midyear review ("U.S. Municipal Housing Midyear Review: Volatility In the Multifamily Sector And An Upturn For Housing Finance Agencies," published Sept. 13, 2018), while the CDFI sector benefits from strong strategic management, their significant growth in loans as a percentage of assets has resulted in negative rating trends. We rate six of the eight 'AA-', one 'AA', and one 'A-'.

We anticipate that CDFI presence in the market will grow in 2019. Access to funding through long-term rated debt will lend to increased financial stability and expand the influence of this small, but growing subsector. A continued challenge for CDFIs is the potential to grow too quickly, which could result in downward pressure on capitalization and leverage ratios. If capitalization ratios continue to decrease because of loan growth outpacing net assets or an increase in loan losses, the negative rating trend could continue. However, if CDFIs are intentional in weighing the benefits of increased lending with maintenance of equity reserves, we believe the sector should see gradual and sustainable growth into the future.

Chart 12

CDFI Average Assets And Profitability



CDFI--Community development financial institutions.

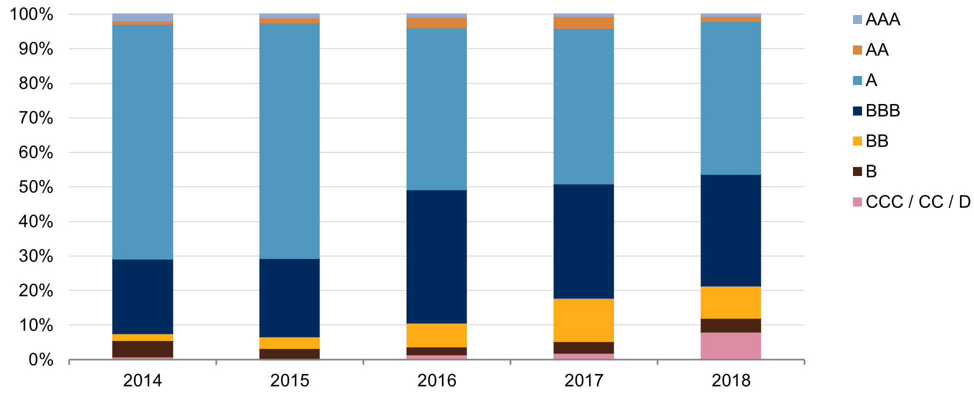
AHP Performance Declines And Ratings Follow, But Military Housing Holds Strong

The stand-alone, or small pool, affordable multifamily sector saw noticeable declines in credit quality in 2018, accompanied by negative rating actions. Military housing issues were the exception, with most ratings in the AA or A category. For 2019, we expect continued stress on occupancy and high expenses to challenge financial stability in Section 8 and unenhanced issues, potentially resulting in further rating deterioration. As discussed in our Oct. 2, 2018 article "For U.S. Affordable Housing Issuers, Debt Service Payments are Key To Ratings, But What Else Matters?", this is primarily caused by declining property performance and management oversight, actions, and decisions that drive their performance.

Twenty-one downgrades in 2018 were associated with a single property operator: Global Ministries Foundation. The number of speculative-grade ratings increased by 21% (six ratings) in 2018. Although there were no defaults in 2018 (compared with two in 2017), the increased volume of multiple-notch downgrades and movement into speculative-grade categories during the past year continued the negative rating trend identified in January 2018. We downgraded or placed on CreditWatch with negative implications other owner-operators whose performance has been below our expectations (see chart 13).

Chart 13

Affordable Housing Portfolio Rating Distribution



Related Research

- U.S. Biweekly Economic Roundup: The U.S. Labor Market is Holding Its Own, Jan. 4, 2019
- Only Two Rate Hikes From The U.S. Federal Reserve Now Expected In 2019, Dec. 21, 2018
- Why It May Make Economic Sense to Tackle Global Warming, Dec. 5, 2018
- The New Year Will Likely Ring in a Record U.S. Expansion: Could It Be A Last Hurrah?, Dec. 4, 2018
- David Blitzer, "Housing Slows," Indexology Blog, S&P Dow Jones Indices, Oct. 9, 2018
- For U.S. Affordable Housing Issuers, Debt Service Payments Are Key to Ratings, But What Else Matters?, Oct. 2, 2018
- U.S. Municipal Housing Midyear Review: Volatility In The Multifamily Sector And An Upturn For Housing Finance Agencies, Sept. 13, 2018

This report does not constitute a rating action.