KNOXVILLE AREA
ASSOCIATION OF REALTORS®

FORECAST REPORT 2023

KNOXVILLE AREA ASSOCIATION OF REALTORS®

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2023 Local Housing Market Forecast

East Tennessee's housing market experienced extraordinary growth over the past two years, culminating in booming home sales and home prices growing at the fastest pace on record. Much of that growth can be attributed to a substantial supply-demand imbalance and fundamental market forces, such as favorable demographic trends, migration and changing household composition. Other trends, such as pandemic-induced migration, fiscal stimulus, and ultra-low borrowing costs, were unique to the pandemic era, and their impact already is waning.

With mortgage rates at the highest level in more than a decade and widespread concerns about inflation, the pandemic-induced housing frenzy has come to its inevitable end. As a result, East Tennessee's housing market is expected to recede in 2023, while retaining most of the gains accrued over the past two years.

- **Home price growth is decelerating but remains above the historic average. Home prices in the Knoxville, Tennessee, metropolitan area rose 18.3% from the previous year in Q3 2022, according to the Federal Housing Finance Agency House Price Index (FHFA HPI).**

- **Rent growth remains high, although rent increases have moderated in recent weeks. Rents in the Knoxville, Tennessee, metropolitan area were up 19.6% from the previous year in Q3 2022 outpacing the rent growth of 10.5% nationally.**

- **After a record-breaking year, home sales are expected to decline 10% year-over-year in 2022. The deceleration in home sales is likely to continue next year, with home sales forecasted to decline between 10% and 12% in 2023.**

- **Despite the expected decline in home sales due to deteriorating affordability conditions, a lack of inventory continues to place upward pressure on prices, with home prices forecasted to increase between 3% and 5% in 2023.**

- **Knoxville's rental market is poised to experience moderate growth in 2023, with rents forecasted to grow around 4% next year.**

- **After reaching an all-time high of 98.86% in Q4 2021, the rental occupancy rate is forecasted to decline to an average of 96.5% in 2023.**

Economic Conditions

Economic conditions deteriorated appreciably over the past year under the weight of higher-than-anticipated inflation and the fastest pace of monetary policy tightening on record. Many prominent economic analysts are divided over whether the United States can successfully tame inflation without going into a recession next year, although the consensus prediction is the U.S. economy will at the very least experience muted growth in 2023.

Knoxville's real gross metropolitan product grew at an average annual rate of 2.0% from 2015 to 2019, according to KAAR analysis of RealPage data, before plummeting 7.2% year-over-year in Q2 2020 as COVID-19 proliferated across the world. Due in large part to employment gains, Knoxville's economy experienced a robust recovery from the pandemic-induced recession.

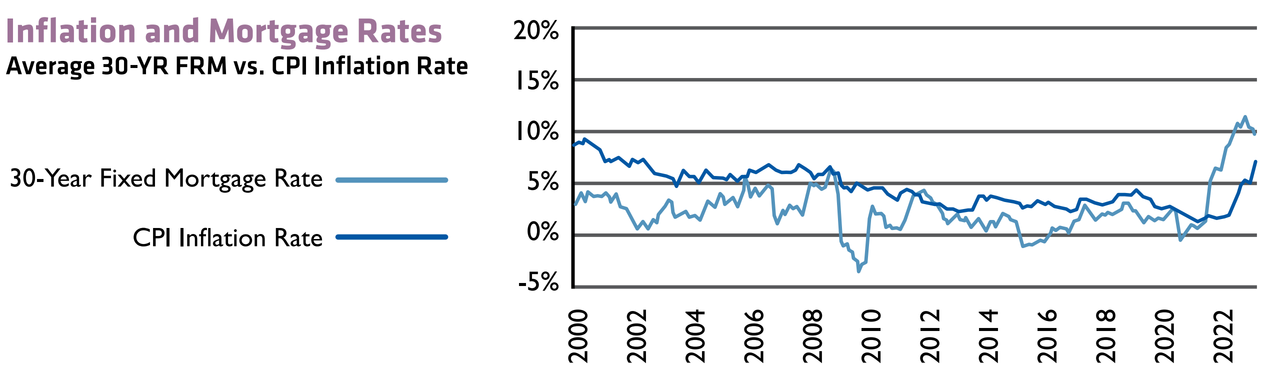
In the year-ending Q3 2022, Knoxville's inflation-adjusted economic output expanded by 1.3% and the employment base expanded by 4.1% during the same period, with a net gain of 17,000 jobs. Knoxville's current employment base now sits about 5% above the pre-pandemic level in early 2020.

Inflation & Mortgage Rates

Much like the overall U.S. macroeconomic outlook, the path ahead for inflation remains uncertain. Despite the most aggressive action by the Federal Reserve in more than 40 years, clear evidence of sustained progress on slowing inflation has yet to materialize. According to the U.S. Bureau of Labor Statistics, the Consumer Price Index (CPI) increased 7.1% from the previous year in November 2022 – 5.1 percentage points above the Fed's 2% target inflation.

While many private-sector forecasters expect inflation to decline considerably over the next year, Federal Reserve Chair Jerome Powell acknowledged in a recent speech that "forecasts have been predicting just such a decline for more than a year, while inflation has moved stubbornly sideways."

Policymakers are likely to slow the pace of rate increases in the coming months, but Powell indicated ongoing rate increases will be necessary. In addition to additional rate increases, the "sideways" trajectory of inflation suggests that the Fed will need to keep rates elevated for longer than anticipated, especially given Powell's consistent warnings against loosening policy prematurely.



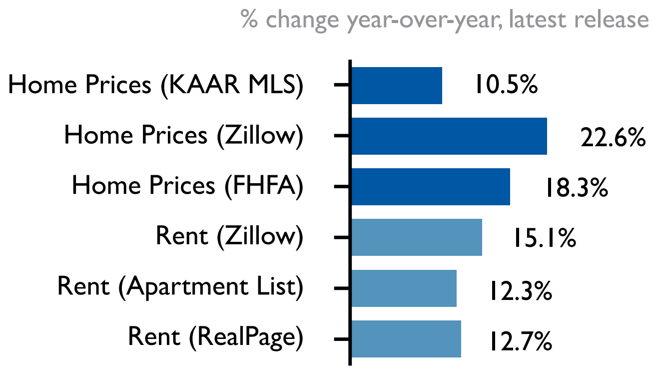
The Federal Reserve has raised the target range for the federal funds rate by 4.25 percentage points since March 2022, prompting mortgage rates to rise at their fastest pace in more than four decades. As of the end of November, mortgage rates were more than double what they were a year ago. With future rate increases on the horizon, mortgage rates are likely to remain elevated in 2023.

Housing Affordability

Deteriorating affordability conditions are a primary driver behind the current softening in the housing market – a constraint that's likely to persist over the next year. Demand is waning because a growing share of households cannot afford to purchase a home, not because they don't want to.

Growth in Measures of Housing Costs

Knoxville, TN Metro Aera



Elevated borrowing costs in the form of higher monthly mortgage payments have eroded affordability over the past year, pricing many prospective homebuyers out of the market. Although the median sale price rose 10.5% from October 2021 to October 2022, higher interest rates resulted in the monthly payment increasing more than 57% over the same period. In other words, homebuyers need to earn substantially more money than they did just a year ago to purchase the typical home.

Table 1: Higher Interest Rates Have Eroded Affordability

	October 2021	October 2022	Change 2021-2022
Interest Rate (Percent)	3.07	6.9	3.83
Median Sale Price	$285,000	$315,000	$30,000
Down Payment & Closing Costs	$22,800	$25,200	$2,400
Monthly Principal & Interest Payment	$1,152	$1,971	$818
Total Monthly Owner Costs	$1,491	$2,346	$855
Annual Income Needed	$59,656	$93,850	$34,195

Note: *Estimates assume a 5% down payment on a 30-year fixed-rate loan with zero points, 3% closing costs 0.5% property taxes, 0.40% property insurance, 0.558% private mortgage insurance and a maximum 30% debt-to-income ratio.*

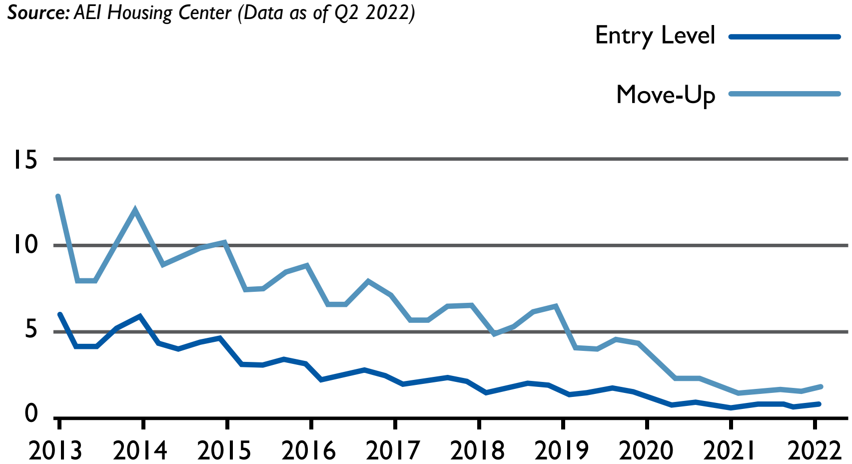
Source: *KAAR tabulations of Freddie Mac, FHFA and MLS data; Atlanta Fed*

Affordability concerns also center around the price distribution of the housing supply. While inventory remains significantly constrained across all price levels, inventory in the lower price range remains the most constrained segment of the market. As shown in the chart, the month's supply of inventory, or the number of months it would take for the current inventory of homes on the market to sell given the current sales pace, is lowest for entry-level homes.

Housing Inventory

Month's Supply By Market Segment: Knoxville, TN

Source: AEI Housing Center (Data as of Q2 2022)



Trends To Watch

The "lock-in" effect.

Approximately 93% of outstanding mortgages have rates below 6% according to First American – well below the prevailing 30-year fixed mortgage rate. As a result, prospective home sellers are likely to be more hesitant about listing their home for sale, with some opting to pursue remodeling projects rather than purchase a new home with a higher mortgage rate. However, homeowners have accrued a record amount of home equity which could help mitigate the rate "lock-in" effect.

Migration levels.

The COVID-19 pandemic spurred record-high domestic migration levels, a trend that boosted East Tennessee's housing market. Nearly three years later, this trend has yet to subside according to data provided by Redfin, a national real estate brokerage, which indicates nearly one-quarter (24.2%) of U.S. homebuyers were looking to move to a different metro area in the third quarter of 2022 – a record high. Similarly, a recent survey by Rent. found that more than half (55.16%) of U.S. renters were interested in moving, with nearly 40% indicating a willingness to relocate outside of their current city. As higher mortgage rates and house prices make low-cost areas even more attractive to homebuyers, East Tennessee is poised to benefit if higher-than-expected migration levels continue.

Buyer and seller hesitancy.

Amid uncertain economic conditions and higher mortgage rates, consumer confidence in housing reached a new low in October 2022 according to Fannie Mae's Home Purchase Sentiment Index® (HPSI) and many prospective home buyers and sellers have moved to the sidelines. This is evidenced by a recent survey by Avail that found more than seven in 10 renters (72.7%) who are considering purchasing a home also are considering delaying moving forward with their home purchase due to rising interest rates and concerns about inflation. As a result, overcoming mounting consumer pessimism will prove to be a significant challenge for East Tennessee's housing market in 2023.

Is the Bubble About to Burst?

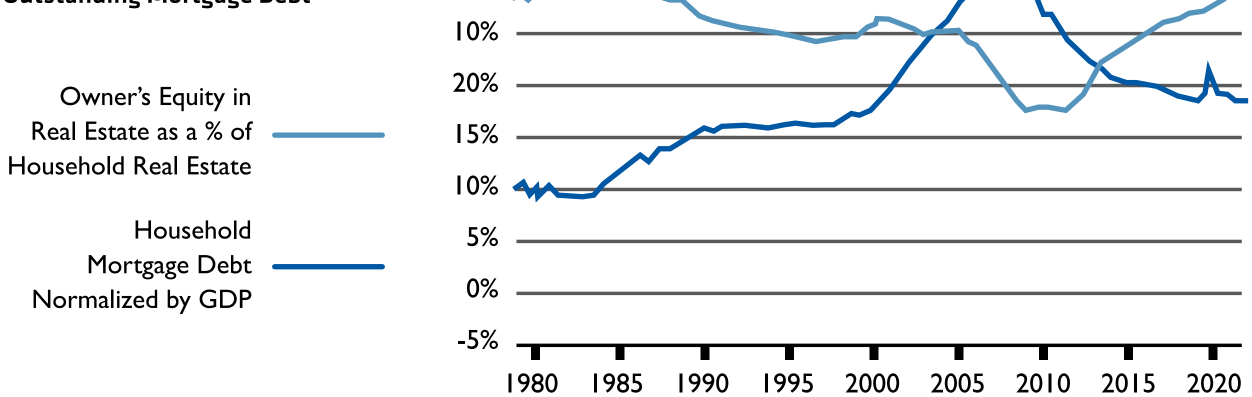
With the 2008 financial crisis still top of mind, a changing economic landscape and higher mortgage rates have spurred consumer concerns about the potential for a housing bubble or repeat of the 2008 financial crisis. For example, an October 2022 survey by LendingTree found 41% of Americans believe the housing market will crash within the next 12 months, while Google Trends data has shown spikes in the number of people searching for the terms "housing bubble" or "housing crash." Despite these concerns, several factors suggest the potential for a housing downturn resembling anything like 2008 is very unlikely.

Unlike in the lead up to the 2008 financial crisis, home equity levels are at the highest level since the 1980s and continue to trend upward. As shown in the chart, owner's equity in real estate increased to 70.5% in Q2 2022, meaning more than 70% of the value of the average house is owner equity compared to the 30% owned by a financial institution. In the years preceding the Great Recession, however, the rising value of outstanding mortgage debt was accompanied by a sustained decline in the share of owner's equity.

Today's housing market also features starkly higher mortgage lending standards, with a disproportionate share of loans going to borrowers with strong credit history and sizable down payments. In addition, affordability loan products – which carry a higher risk of default – comprised around 2% of mortgage products over the last two years, compared to around 40% in the years preceding the Great Recession.

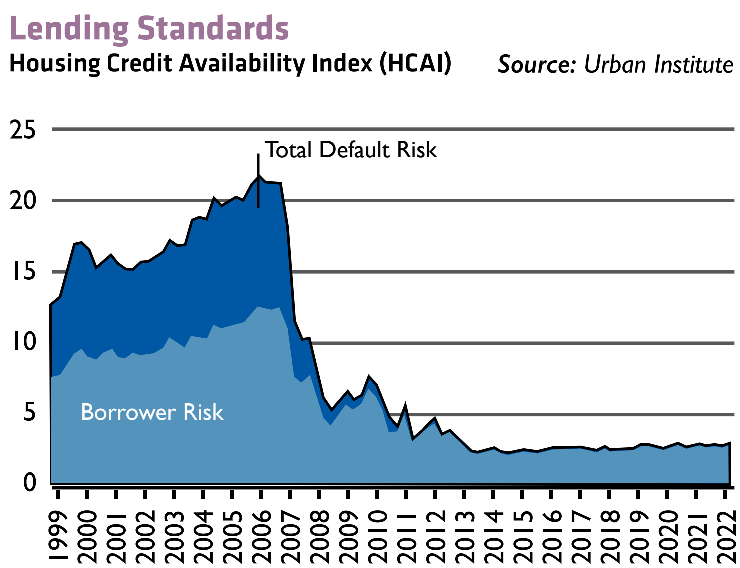
Mortgage Debt and Equity

Owner's Equity in Real Estate vs. Outstanding Mortgage Debt



Source: *U.S. Federal Reserve System; BEA*

Tighter lending conditions are evidenced by the Urban Institute's Housing Credit Availability Index (as shown in the chart), which measures the difficulty of getting a mortgage by assessing lenders' tolerance for both borrower and product risk. As of Q2 2022, the index remains at one of its lowest levels on record.



Differences Between Today and the Great Recession

Great Recession	Today
Loose credit standards	**Tight** credit standards
Owners' equity **low** relative to outstanding debt	Owners' equity **high** relative to outstanding debt
Weak labor market	Strong labor market
Many over-leveraged primary residents **(No ATR/QM Rule)**	Few over-leveraged primary residents **(ATR/QM Rule)**
High mortgage delinquency rate	**Low** mortgage delinquency rate
High share of adjustable-rate mortgages	**Low** share of adjustable-rate mortgages

While housing market activity has receded during the second half of 2022 – an intended result of the Fed's interest rate hikes – there is no compelling evidence that a significant market downturn lies ahead.

Housing Market Outlook

After record-setting growth since the pandemic, East Tennessee's housing market is poised to contract in 2023 as elevated borrowing costs, higher home prices and uncertain economic conditions slow buyer and seller activity. Although demand is expected to moderate over the next year, upward pressure on home prices isn't expected to subside in the near term.

Mortgage Rates

Mortgage interest rates grew at a record pace in 2022, with the 30-year fixed mortgage rate rising from an average of 3.07% in November 2021 to an average of 6.81% in November 2022. After reaching the highest level since 2002 this year, economists at Freddie Mac expect the 30-year fixed mortgage rate to average 6.4% in 2023.

Home Sales & Prices

With two months of data outstanding, home sales are expected to decline 10% year-over-year in 2022. This deceleration in home sales is likely to continue in 2023, with sales forecasted to decline between 10% and 12% from 2022. Despite the expected decline in home sales volume, price growth is expected to edge closer to the long-run average with house prices forecasted to increase between 3% and 5% in 2023.

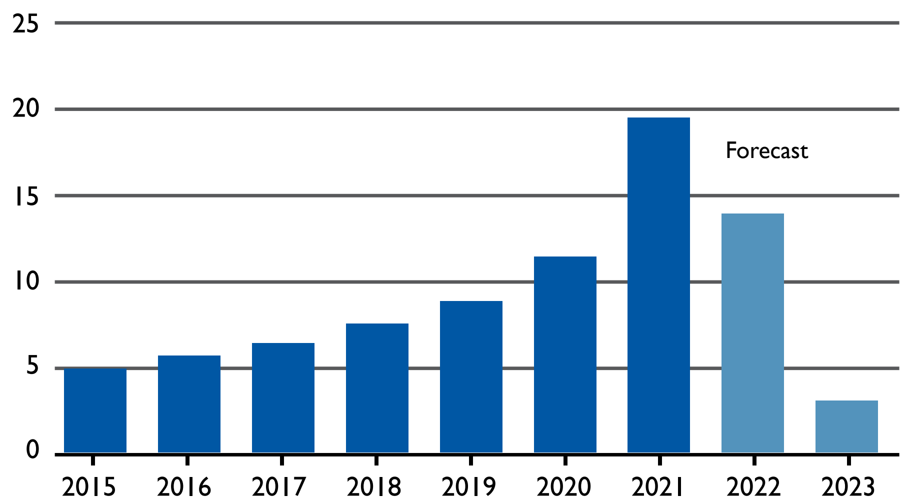
Table 2: 2023 Housing Market Forecast

Summary	2021	2022 Forecast	2023 Forecast
30-Year Fixed Mortgage Rate (%)	3.0	5.4	6.4
Home Prices	+20%	+14%	+5%
Home Sales	+8%	-10%	-12%
Dollar Volume	+40%	+5%	-8%

Source: *Freddie Mac; Knoxville Area Association of REALTORS®*

Home Price Growth

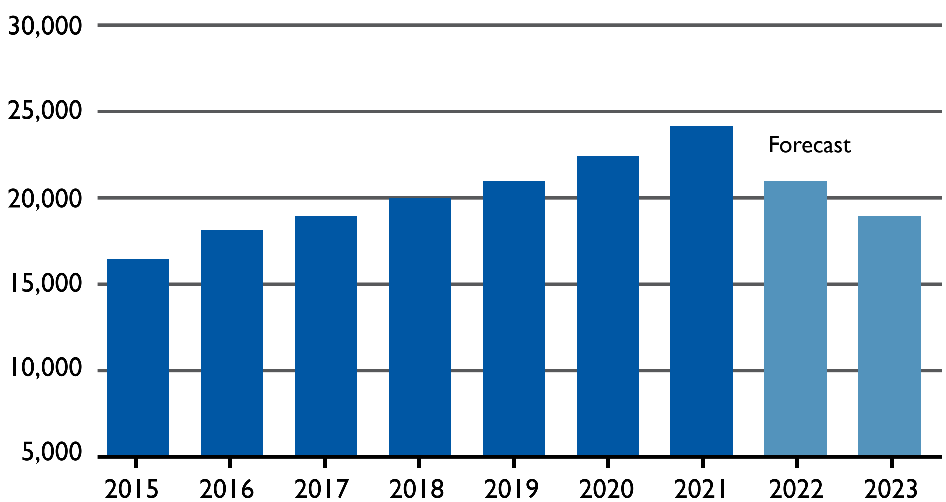
Annual Home Price Growth: Knoxville Area



Source: *Knoxville Area Association of REALTORS®*

Home Sales

Annual Home Sales: Knoxville Area



Source: *Knoxville Area Association of REALTORS®*

While some downside risks exist, a significant decline in home prices remains unlikely. But the outlook for East Tennessee's housing market in 2023 ultimately hinges on the trajectory of mortgage rates and whether the United States is able to avoid a significant recession.

Rental Market Outlook

After experiencing tremendous growth in 2022, with demand reaching its highest level on record, Knoxville's rental market is more expensive than ever. As of Q3 2022, effective rents in Knoxville have risen 47% since 2019 – meaning today's typical monthly rent payment is nearly $450 more expensive than pre-pandemic. Occupancy also is hovering near a record high at 98.02% as of Q3 2022.

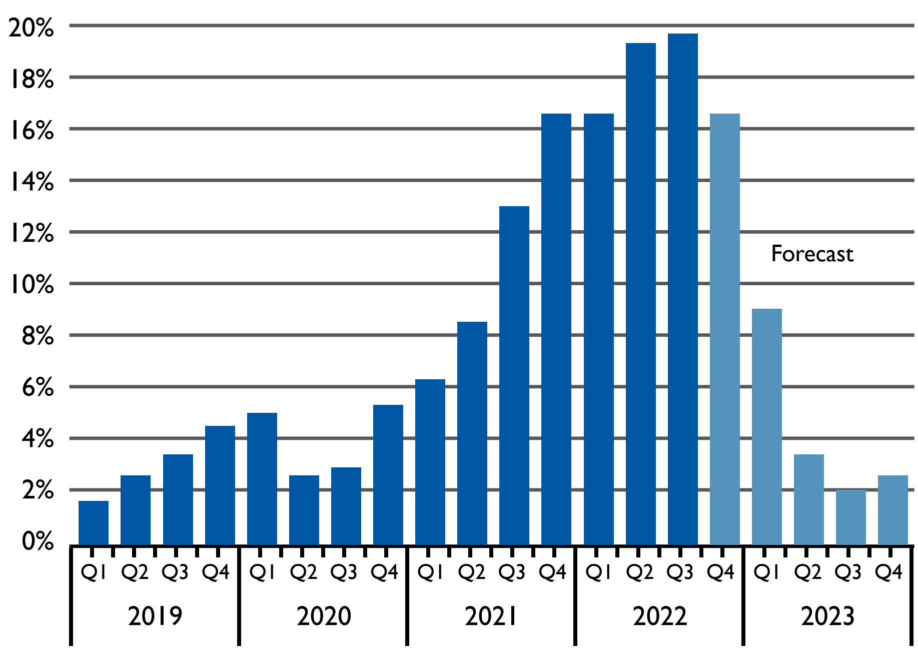
While facing multiple headwinds in terms of supply and demand, Knoxville's rental market is poised to experience moderate growth in 2023.

Despite lower demand, recent survey results indicate most landlords still plan to increase rents over the next 12 months, although the size of the increases is expected to fall from the double-digit increases experienced over the last year. As a result, rent growth is expected to moderate by mid-2023, with rents in the Knoxville metro area projected to grow 4% on an annual basis in 2023.

Similarly, lower levels of new household formation and a substantial number of units scheduled to become available over the next year indicate occupancy could taper downward in 2023. Despite the potential supply expansion, inventory should nonetheless remain relatively tight, as renewal rates continue to hover around an all-time high and underlying demographic trends indicate strong demand will persist. Occupancy is forecasted to decline to an average of 96.5% across 2023 – down from the all-time of 98.86% registered in Q4-2021.

Rent Growth

Year-Over-Year Effective Rent Growth: Knoxville, TN Metro



Source: *KAAR tabulations of RealPage data*

Rental Market Outlook

Table 3: 2023 Rental Market Forecast

Summary	2021	2022 Forecast	2023 Forecast
Occupancy	98.2%	98.3%	96.6%
Effective Rent	$1,080	$1,302	$1,355
Rent Growth	+11.2%	+18.0%	+4.2%

Source: *RealPage; Knoxville Area Association of REALTORS®*

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