This is the first in a series of quarterly reports on the housing market in Tennessee, supported by a Tennessee Housing Development Agency grant.

**Economic Overview**

Household purchases of retail items, services, and housing depend greatly on growth of personal income. Rapid income growth contributes to housing demand, while weak income growth indicates weak housing demand. In the third quarter, total personal income increased 1.3 percent\(^1\) for Tennessee, an improvement from 1.2 percent in the second quarter and the second consecutive quarterly increase in the rate of growth. Although improving, Tennessee’s income growth is still somewhat lower than the average for the U.S. and the Southeast states, both at 1.4 percent.

Income consists mostly of earned income (wages, salaries, and self-employed income), with property income and transfer payments accounting for much smaller shares. In the third quarter, Tennessee earned income rose only slightly more slowly than the U.S. average.\(^2\) Property income, on the other hand, grew much more for the U.S. than for Tennessee. Of the two, one could argue that earned income growth is the more reliable indicator of housing demand, as property income tends to be much more volatile and concentrated in a small percentage of households.

**Housing Construction**

Permits issued for single-family home construction continued to weaken in the third quarter, falling to 27,400 units\(^3\) (Table 1). Permits peaked in the first quarter of 2006, fully two quarters after the peak nationally (Figure 1). With the exception of 2006.4, the number of permits has declined each quarter at about the same rate as nationally.

The pace of housing construction deteriorated substantially in the third quarter not just for Tennessee but for the South and the U.S. as well, with all three 10 percent lower than the second quarter. Over-the-year activity for Tennessee fell 23.4 percent, but the U.S. market fell more (-26.2 percent) and the South even more (-29.2 percent).

**Home Sales and Prices**

Although sales are down over the year, preliminary data from the National Association of Realtors show that home sales in Tennessee rose from the second quarter by 6.4 percent. Indeed, Tennessee is one of just four states experiencing a quarterly sales increase.\(^4\)
Rising prices are usually an indicator of strengthening market conditions, as prices rise when demand grows more quickly than supply. Prices for the U.S. turned down in the third quarter, 0.4 percent lower than the second quarter (Figure 2). It is important to note that the U.S. average is heavily influenced by significant price deterioration in just a few states including Florida, California, Ohio, Michigan, Minnesota, Nevada, Massachusetts, and Arizona. Over the year, home sales are down 864,000 for the U.S.; approximately 43 percent of the decline in the U.S. occurred in these eight states.

In Tennessee, housing prices continue to rise, gaining 0.9 percent from the second quarter and 6.0 percent over the year. Only nine states experienced higher over the year price appreciation, and in the South, Tennessee’s price gains are second only to North Carolina’s 6.5 percent increase.

**Real Estate Transactions and Mortgages**
Tennessee collects two taxes of interest for the real estate market. The first tax is a 0.115 percent levy on the value of new mortgages (after the first $2,000 of indebtedness), and the second is a 0.37 percent tax on most real estate transfers. These taxes offer useful measures of borrowing activity and real estate trade activity. As shown in Figures 3 and 4, collections from both taxes peaked during the first quarter of 2007. In the third quarter, mortgage tax collections dropped 7.6 percent and transfer taxes dropped 2.7 percent from the
second quarter. Falling mortgage tax collections suggest fewer mortgages are being issued by lenders in Tennessee.

To summarize the real estate situation, falling demand causes developers to build fewer homes, as evidenced by declining numbers of building permits. Stable to slightly rising prices suggest the decline in new housing has roughly balanced the fall in demand; the Tennessee housing construction industry acted rather quickly to cut back the quantity of new housing in reaction to falling demand. This clearly was not the case in other states that currently are experiencing housing price deflation.

More evidence of market stability is found in the Nashville, Memphis, and Knoxville residential real estate markets. In each of the three local markets, sales are down from last year, but inventories are holding steady (Figures 6–7).

**Mortgage Delinquencies and Foreclosures**

The percentage of Tennessee mortgages past due rose in the third quarter to 7.63 percent, up from 6.75 percent one year ago (Table 2). Nationally, mortgages past due also increased over the year, rising from 4.84 percent to 5.81 percent. It is interesting to note that Tennessee has a higher prevalence of mortgages past due but a lower rate of foreclosure. In fact, Tennessee’s foreclosure inventory (as a percentage of all mortgages) has been relative steady for several quarters, while that of the U.S. has been on the increase each quarter.
As is well established, the recent increase in the number of foreclosures nationally and in Tennessee can be related to the number of adjustable rate mortgages (ARMs) that are resetting to higher interest rates. Foreclosure rates are highest for subprime ARMS, but prime ARMs are not immune. The table shows Tennessee’s exposure to both subprime and ARM mortgages in existence during the third quarter of 2007. It is interesting that Tennessee has somewhat above-average exposure to subprime loans (14.6 percent, compared with 12.9 percent and 12.6 percent for the South and U.S., respectively) but much less exposure to adjustable rate loans (13.6 percent compared with 18.4 percent for the South and 20.9 percent for the U.S.). This lower prevalence for ARM loans may help explain Tennessee’s stable foreclosure rate compared with the U.S. Also, as more ARM loans reset in 2009 and 2010, Tennessee should not be as adversely affected as will the U.S.
Conclusion
Similar to most other markets, Tennessee is experiencing a housing construction slump. In Tennessee, however, the reduction of the new supply of housing appears to have just about balanced declining demand, as suggested by relatively steady housing prices and inventories of homes for sale. By contrast, prices are falling in the U.S. market.

The prevalence of past due mortgages is higher in Tennessee, but the foreclosure rate is steady. In comparison, the U.S. foreclosure rate is on the rise. Tennessee has much less exposure to adjustable rate mortgages compared with Southern states and the U.S. While more weakness in the market is likely for 2008, Tennessee will probably not be as affected as the U.S. and other states in the South.

Table 3. Distribution of outstanding mortgage loans (third quarter 2007)

<table>
<thead>
<tr>
<th></th>
<th>Tennessee</th>
<th>Fixed</th>
<th>ARM</th>
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<tbody>
<tr>
<td>Prime</td>
<td>60.8%</td>
<td>7.1%</td>
<td>68.0%</td>
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<tr>
<td>Subprime</td>
<td>8.7%</td>
<td>5.8%</td>
<td>14.6%</td>
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<tr>
<td>FHA</td>
<td>11.8%</td>
<td>0.6%</td>
<td>12.5%</td>
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<tr>
<td></td>
<td>81.4%</td>
<td>13.6%</td>
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<table>
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<th>South</th>
<th>Fixed</th>
<th>ARM</th>
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<tr>
<td>Prime</td>
<td>60.6%</td>
<td>11.9%</td>
<td>72.5%</td>
</tr>
<tr>
<td>Subprime</td>
<td>6.8%</td>
<td>6.1%</td>
<td>12.9%</td>
</tr>
<tr>
<td>FHA</td>
<td>6.1%</td>
<td>0.4%</td>
<td>6.5%</td>
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<tr>
<td></td>
<td>73.5%</td>
<td>18.4%</td>
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<table>
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<th>U.S.</th>
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<td>14.0%</td>
<td>74.7%</td>
</tr>
<tr>
<td>Subprime</td>
<td>6.1%</td>
<td>6.5%</td>
<td>12.6%</td>
</tr>
<tr>
<td>FHA</td>
<td>6.1%</td>
<td>0.4%</td>
<td>6.5%</td>
</tr>
<tr>
<td></td>
<td>73.0%</td>
<td>20.9%</td>
<td></td>
</tr>
</tbody>
</table>

Notes
1. Quarter-to-quarter rate. Annualized, the rate of growth equals 5.3 percent.
2. Earned income (basically the sum of wages, salaries, and self-employment income) rose 1.13 percent for the U.S., with Tennessee slightly lower at 1.07 percent growth in the third quarter.
3. Seasonally adjusted annual rate.
4. The other states experiencing a quarter-to-quarter gain are Pennsylvania (+13.0%), Michigan (+6.0%), and North Dakota (+2.9%).
5. According to the same-sales price index published by the Office of Federal Housing Enterprise Oversight (OFHEO).