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Rate cuts will exacerbate housing inflation

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- Rising home prices may have already begun to feed into official housing inflation, specifically Owner's Equivalent Rent (OER). This can help explain why housing inflation has been stagnant since mid-2023, but the cause is hardly demand driven. Home sales have largely been muted since the beginning of the Fed's hiking cycle and the pace of sales is continuously slowing. Lack of supply underpins growth in prices, and though rate cuts will likely increase the rate of home building, it is unlikely to surpass the increase in demand that the same cuts precipitate.

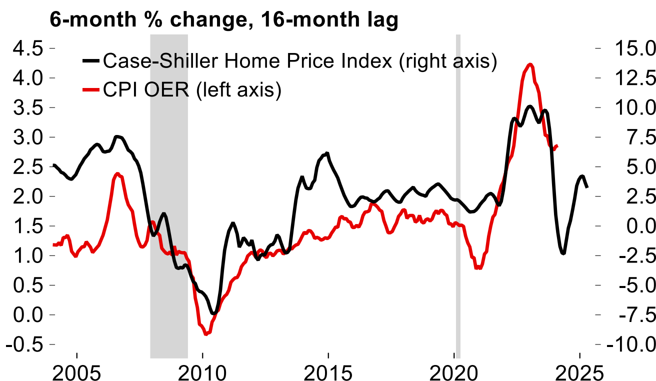
Prices have risen despite weak demand

Shelter is one of the more predictable components of inflation. The housing market is cyclical where demand moves in line with changes in borrowing rates, and as mentioned in a previous brief, growth in private sector measures tend to lead CPI and PCE housing by 12-16 months. Even though official housing inflation does not capture home prices directly, growth in Owner's Equivalent Rent (OER), the largest housing component of the CPI and PCE, correlates with growth in the Case-Shiller/S&P Home Price Index (Chart 1).

The relationship is certainly not a perfect one. A one percentage rise in home prices will not necessarily lead to a one percentage rise in OER 12-16 months from now. But historically, the relationship is strong enough to suggest that housing disinflation will, at the very least, be slower in 2024 than it had been in much of 2023. At most, if we assume a very strong feedthrough of home prices into housing inflation, we could see OER accelerate until the end of this year (Chart 1).

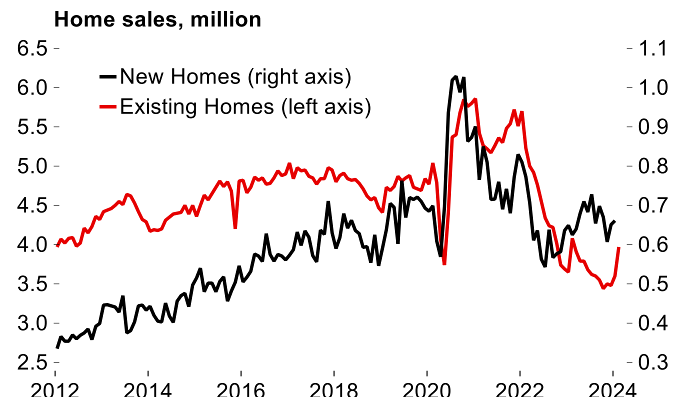
Which scenario becomes reality depends largely on the path of rate cuts from the Fed. Holding rates "higher for longer" makes the "at most" scenario unlikely given that home price growth has moderated in recent months. On the other hand, expedited rate cuts would risk a resurgence in demand that would almost certainly lead to more inflation.

Chart 1: Growth in OER has a lagged relationship of about 12-16 months with price sector measures of home prices



Note: Case-Shiller/S&P Home Price Index is lagged by 16-months
Source: BLS, S&P, MUFG Bank Economic Research Office

Chart 2: Restrictive monetary policy has supressed demand for single-family homes



Source: Census Bureau, NAR, MUFG Bank Economic Research Office

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Home price growth reached positive territory around the middle of last year, despite continued weakness in housing demand. This should be particularly concerning for the Fed considering the magnitude to which home sales (demand) fell. In aggregate, restrictive monetary policy has been very effective at quelling demand for housing with home sales falling, and remaining, well below the pre-pandemic level (Chart 2).

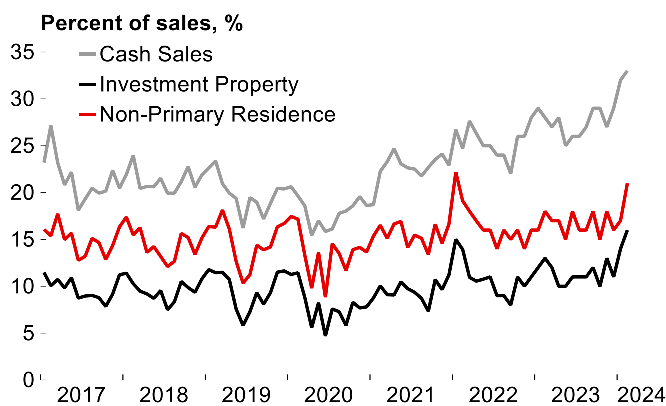
Sales have partially recovered for new homes after hitting their trough in 2022, but new homes comprise a small share of total inventory and their sales tend to be very sensitive to changes in mortgage rates. Volatility in the 10-year treasury yield throughout 2023 had a roller coaster effect on mortgage rates, despite the growing spread between the two, and new home sales bounced up and down as a result. The effectiveness of monetary tightening is much more evident in existing home sales, which make up nearly 90 percent of the market.

Existing home sales have fallen well below the pre-pandemic level and up until the latest February data was released, the level was even below the worst of the COVID-19 pandemic. But even this dramatic rise in February is not likely a sign of resurging demand. Sudden growth in sales of investment properties, non-primary residences, and even cash sales supported this recent upswing (Chart 3). Lending rates are not a factor for cash sales, and they are much less of a deterrent for high income households that purchase non-primary residences. For investment properties, higher costs associated with mortgage rates can be pushed onto future tenants. The February rise in existing home sales is not consistent with strong aggregate demand growth.

Weak demand can also be seen in the National Association of Realtors (NAR) Pending Home Sales Index, where there has been no growth since the index fell significantly in 2022. There has even been a considerable rise in the median number of days a home is on the market, a signal of continued weaking of demand.

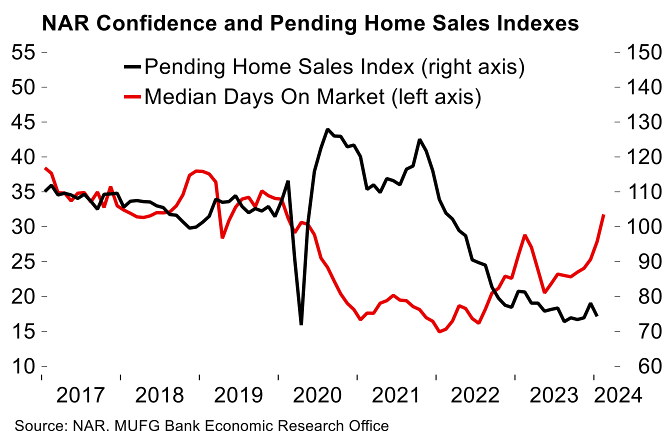
The current level of restrictive monetary policy is evidently working to suppress demand in the single-family housing market. The concern going forward is a resurgence in demand, brought about by premature rate cuts.

Chart 3: Recent acceleration in home sales is not likely a result of resurging demand given the composition of growth



Source: NAR, MUFG Bank Economic Research Office

Chart 4: Growth in median days on market and weak pending home sales suggests that demand is still weak



Source: NAR, MUFG Bank Economic Research Office

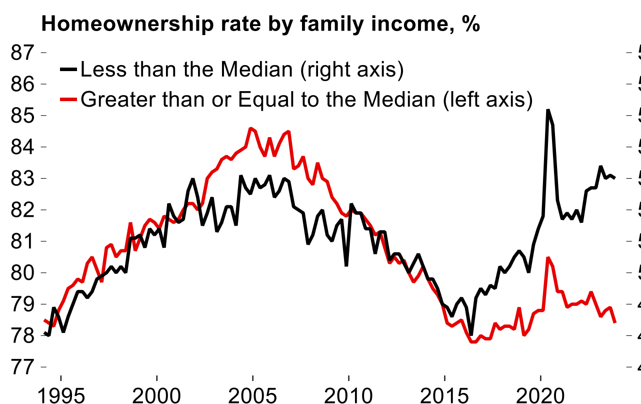
Supply is the driving force

The recent rise in home prices (both at a 6- and 12-month growth rate) illustrates the severity of housing shortages in the US, where despite falling demand, supply remains even lower. Homeownership rates have fallen considerably since 2005 and there is virtually no positive growth trend for households earning at or above the median family income (Chart 5). Conversely, the homeownership rate for those earning less than the median continues to rise and it has surpassed the 2005 level, though it remains comparatively low.

Lower income households benefit from government subsidized programs that support both the purchase of homes on the demand side and the building of lower-cost housing on the supply side. Households and families earning more than the median are largely subject to market forces, where contractionary monetary policy restricts both demand and subsequently new home building.

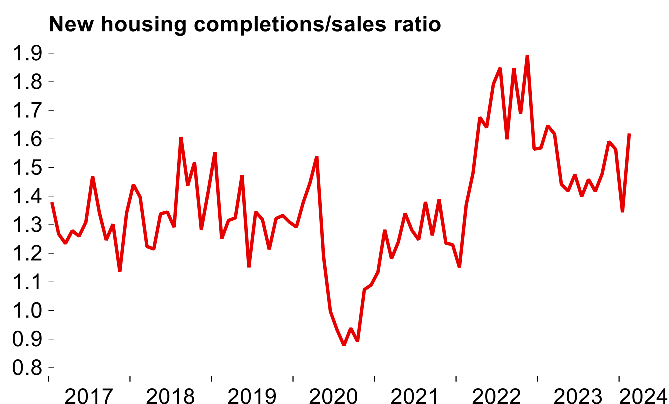
On a positive note, home building (supply) was less restricted than sales (demand) for much of this tightening cycle. Despite a considerable drop in new home construction starts, new homes were being completed faster than they were being sold in 2022 (Chart 6). While the ratio of completions to sales slowed in 2023, there has been a recent uptick in 2024, consistent with the positive trend in new construction starts.

Chart 5: Homeownership rates remain low for those earning at or above the median family income



Source: Census Bureau, MUFG Bank Economic Research Office

Chart 6: Homes are being completed at a rate faster than they are being sold



Source: Census Bureau, MUFG Bank Economic Research Office

But for new home construction to noticeably alleviate housing shortages, the ratio of completions to sales would need to remain elevated for a considerable period of time to eventually increase the stock of existing homes. This is unlikely to happen given current expectations of rate cuts.

The expectations of rate cuts by home buyers more than doubled from October of last year to February of this year (Chart 7). These expectations mirror the Fed's dot plots and market expectations of cuts this year, and they have helped drive the Fannie Mae Home Purchase Sentiment Index higher in recent months. The sentiment from buyers is improving largely from expectations on lower rates sometime this year. The sentiment is partially matched on the home builder side, with the NAHB Housing Market Index rising in 2024. However, the index level remains well below what it was before the rate hiking cycle began, signalling less optimism from builders than buyers.

With that said, expectations have yet to fully translate into growth in sales and a growth trend may not be evident until after the first rate cut occurs. From the Fed's perspective, the current circumstances are very favorable given how effective monetary policy has been at slowing housing demand and how low inflationary pressures for housing construction have been. Annual growth in the Census Bureau's Construction Price Index for single-family homes has hovered around 0% since July of last year.

Yet despite the current environment, home prices have still grown and housing inflation has been elevated since the summer of 2023. Fed rate cuts will likely lead to a resurgence in housing demand that will exceed the rate of growth in new construction, exacerbating housing shortages and keeping inflation elevated above the Fed's 2% target.

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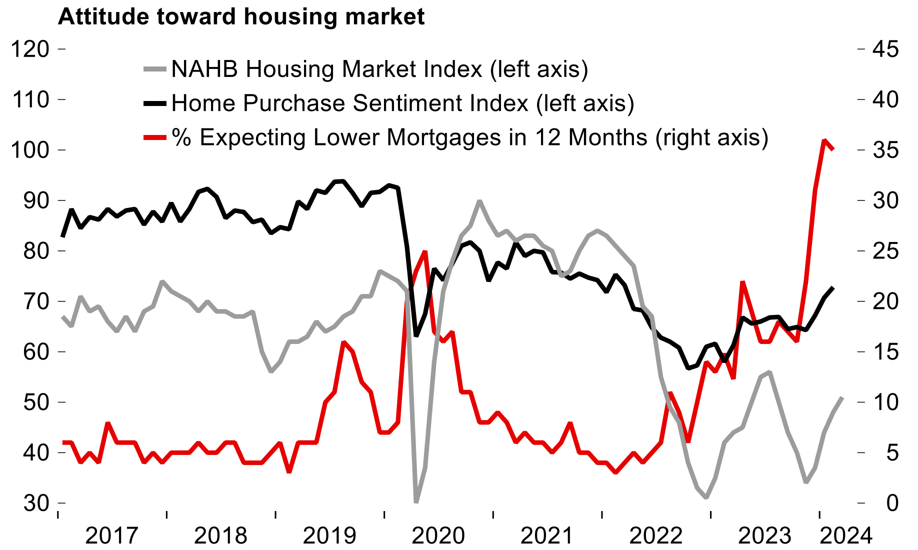
Chart 7: Home buyer and builder optimism has grown on expectations of rate cuts



Source: Fannie Mae, NAHB, MUFG Bank Economic Research Office

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