

Housing strains a microcosm of the US economy

Prices are rising across most sectors of the US economy and the housing market is no exception. Record low mortgage rates and a new way of working are fuelling demand, but as elsewhere, supply constraints are a huge part of the equation and look set to persist

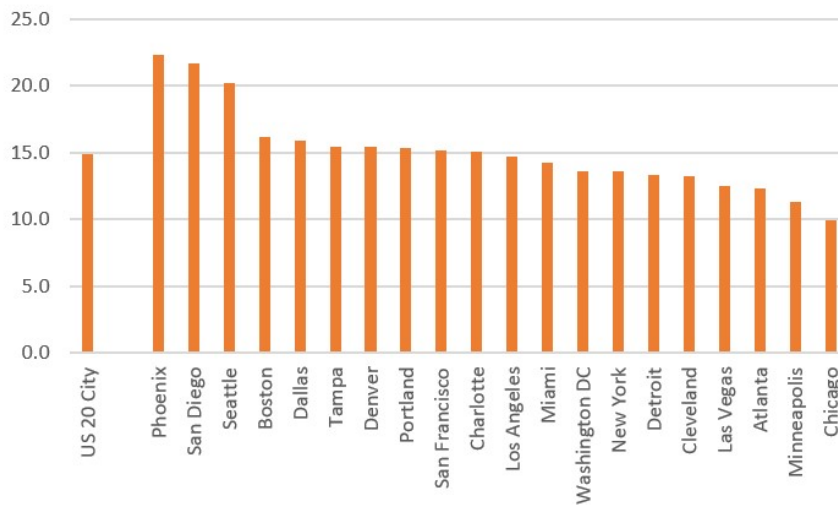


Source: Shutterstock

House prices hit new highs

The S&P Case Shiller 20 City house price index is now rising 14.9% year-on-year, the fastest rate of house price inflation since December 2005. Phoenix, San Diego and Seattle are leading the charge with 20%+ inflation, while Chicago is lagging at sub 10%. Across the major cities house prices nationally are now 24% above the peak of the mid-2000s housing bubble.

Case Shiller house prices (YoY%)



Source: Macrobond, ING

Demand remains strong

Demand for housing has been phenomenally strong since soon after the pandemic struck as Federal Reserve interest rates cuts and quantitative easing drove down borrowing costs right across the US economy. The 30Y fixed mortgage rate dropped from 3.82% in late March 2020 and bottomed at 2.85% in December. It has since moved higher and is currently 3.18%, but that is still nearly 2 percentage points below the 2000-2021 average. According to the Federal Reserve, mortgage debt servicing costs are currently eating up less than 4% of total household disposable income.

House prices are rising even faster in towns given existing home prices are rising 23.6% YoY nationally versus today's 14.9% cities' figure. The success of working from home and the prospect that many employees will continue to spend less of their working life in an office and commuting also is likely to be boosting demand for properties further out of cities. Demand for second/vacation homes is also likely to be driving a growing divide between city and town price appreciation.

While supply remains heavily constrained

Supply is also a hugely important factor that is boosting prices. The chart below shows that the stock of inventory for sale is close to record lows for existing home sales and while it has risen for new homes due to a construction boom, the market clearly remains very stretched versus the past twenty years. The lack of property to buy, we suspect, has been a key reason for the slowdown in the number of housing transaction in recent months.

Housing supply near record lows – housing inventory on the market (equivalent months of sales)



Source: Macrobond, ING

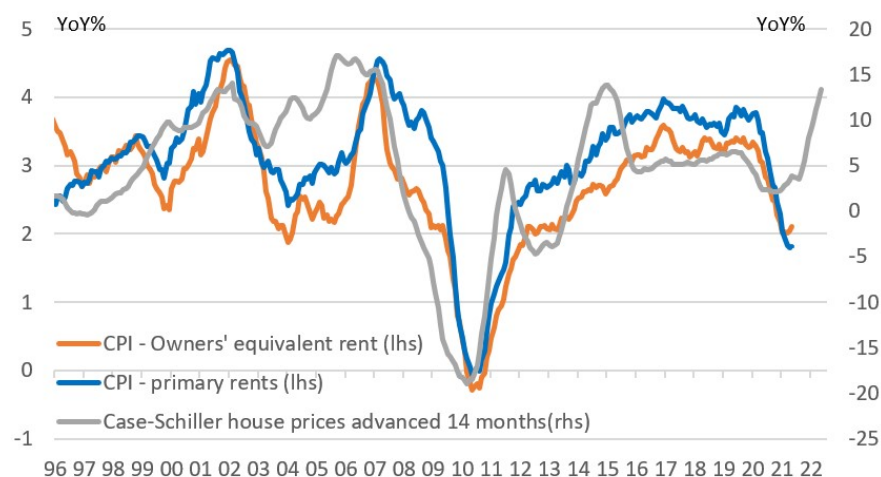
Moreover, construction has shown signs of stalling of late due to issues over labour supply and elevated commodity prices, particularly for lumber. This has created uncertainty over construction timelines and profitability. While lumber prices have subsequently corrected lower, the labour issues persist and so we do not expect to see a significant uptick in new home supply imminently.

While it is true that higher prices may be tempting more sellers into the market and we could soon start to see supply increase, we presume that these people will still need to find somewhere else to live (aside from the sale of vacation/second homes) so the net effect on the demand-supply mismatch may be minimal. Instead, a more likely factor that will bring some balance is that rapid home price inflation is likely to have priced many buyers out of the market so we suspect that the rate of home price inflation will slow. Given strong underpinnings, we are a long way from any price falls though.

Housing price growth will influence broader inflation

It is important to remember that today's numbers have broader implications for consumer price inflation and Federal Reserve monetary policy. Primary rents and owners' equivalent rent account for a third of the CPI basket and as the chart below shows, movements in these components tend to lag 12-18 months behind the S&P Case Shiller house price series.

House prices and the impact on housing components within CPI



Source: Macrobond, ING

Assuming the relationship holds we should expect the housing components to swing significantly higher in the months ahead. Given their heavy weighting within the CPI calculation, it looks set to be the story to watch through the second half of this year.

If we see the the CPI housing costs merely move from 2% YoY to 4% YoY, that on its own will be enough to add 0.7 percentage points to headline inflation and even more to core (ex food and energy). Such an outcome would further dent the Fed doves' optimism that inflation will be transitory and in a strong growth environment add more momentum behind the case for a 2022 first interest rate hike.

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