

US housing market boosts case for rate rises

Low mortgage rates and the long-term implications of remote working are fuelling housing demand. But, as elsewhere in the economy, supply constraints are a huge part of the equation. This is boosting construction and is also driving prices higher and all that has important implications for inflation and interest rates



Demand remains strong

Demand for housing in the States spiked soon after the pandemic struck as Federal Reserve interest rates cuts and quantitative easing drove down borrowing costs right across the economy. This has of course made housing more affordable for those who kept their jobs with the 30Y fixed mortgage rate dropping from 3.82% in late March 2020 and bottomed at 2.85% in December.

It has since moved higher and is currently 3.11%, but that is still nearly 2 percentage points below the 2000-2021 average. Moreover, mortgage debt servicing costs are currently accounting for less than 4% of total household disposable income according to the Federal Reserve.

US existing and new home sales



Source: Macrobond, ING

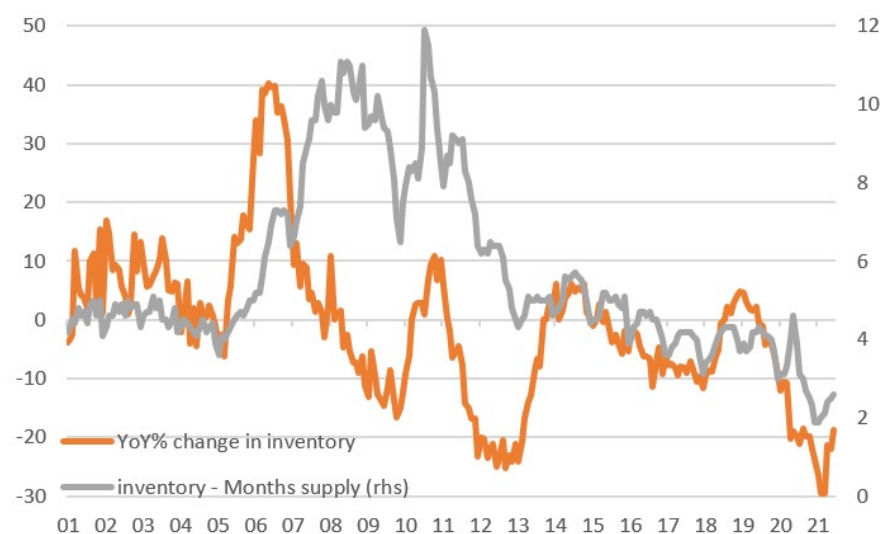
Sellers in the driving seat

As with much of the US economy, strong demand is coming up against clear housing supply issues. Consequently, the number of transactions has slowed while prices are surging higher. This was again seen in today's existing home sales report. While transactions did pick up to an annualised 5.86mn rate it is well below the 6.7mn peak in the fourth quarter of last year. We expect a similar outcome in next week's new home sales report.

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 (note the strong housing starts numbers earlier this week), the market clearly remains very stretched versus the past twenty years. The lack of property to buy is the key reason for the slowdown in the number of housing transactions and rising prices in recent months with the general fervour around the market highlighted by the fact it currently takes on average just 17 days to sell a home as buyers compete to seal the deal.

Housing supply near record lows

Housing inventory on the market (equivalent months of sales)



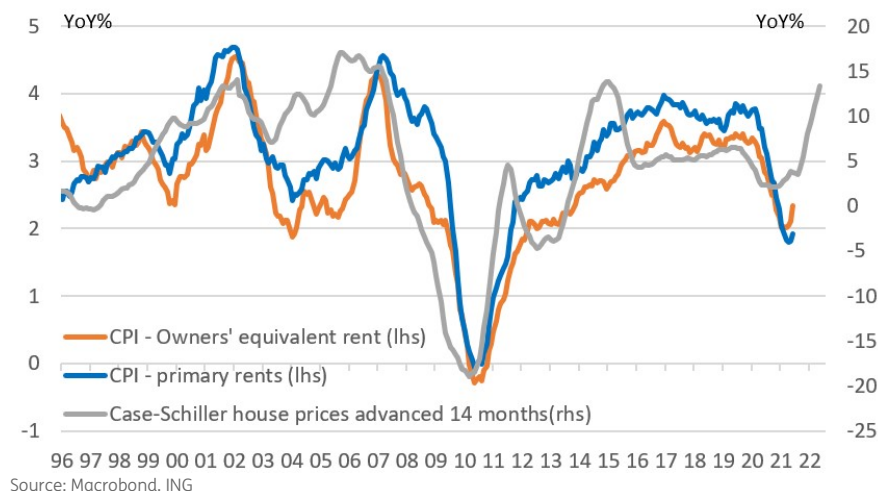
Source: Macrobond, ING

Higher prices may tempt more sellers into the market and we could start to see supply increase, but 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 pricing many potential buyers out of the market given median existing home prices are now up at \$363,300, a 23.4% increase versus 12 months ago.

Implications for Federal Reserve policy

It is important to remember that the strength of the housing market and the rapid home price appreciation 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 (YoY%)



Assuming the relationship holds – note we are now starting to see housing costs turn higher - we should expect the housing components to move swiftly higher in coming months. 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 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). This is a key story why we expect headline inflation to remain well above 4% through 1Q 2022 with core inflation persisting above 3.5%. 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 earlier interest rate increases.

We expect to hear the Fed announce the start of a swift QE tapering program in December and look for two 25bp interest rate rises in late 2022.

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