Economic INSIGHT

July 3, 2023

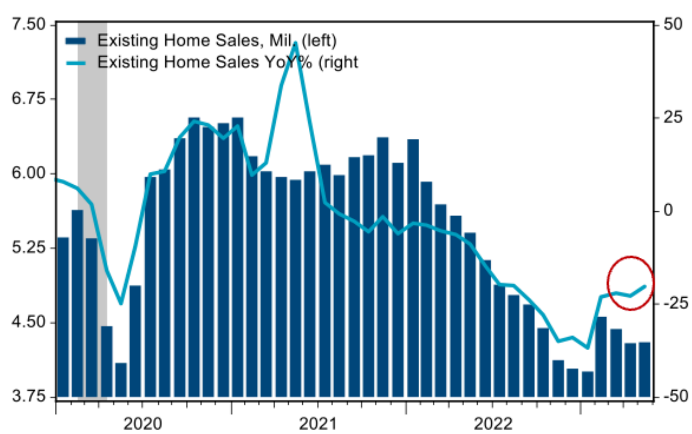
An "*Unexpected Rebound*" in Housing

Despite rising borrowing costs, the latest read of housing market metrics suggests ongoing resilience. While mortgage rates have risen alongside the Federal Reserve (Fed)'s 500 basis point (bps) increase in its short-term benchmark rate over the last 14 months and presumably undercut affordability, construction activity and sales, as well as prices, have ticked up recently. This suggests the Fed may have significantly more work to do before successfully tamping down activity and restraining the housing market enough to cool topline growth and by extension, tame inflation.

THEN AND NOW: AN IMPROVEMENT IN SALES

Arguably late to the inflation-taming party, the Fed initiated its first rate hike of a mere 25 bps in March 2022. Realizing they were behind the curve, the Committee temporarily accelerated the size of rate hikes to 50 bps in May and then 75 bps in June before bringing the federal funds target rate to 4.50% by the end of 2022[1]. As a result, housing, arguably the most interest rate sensitive sector of the economy, pulled back markedly – at least initially.

Higher prices, elevated borrowing costs, a lack of access to labor – particularly skilled labor – as well as a longer-term trend of negative real income growth worked to precipitously slow housing market activity. Dropping from a peak 6.6 million unit pace in October 2020 to a low of 4.0 million unit pace in January this year, the pace of existing home sales contracted nearly 40%. More recently, however, the annual pace of sales has staged what Fed Governor Christopher Waller termed an "*unexpected rebound*." While still in net negative territory on an annual basis, the pace of deceleration has slowed with monthly sales gaining 0.2% in the latest report.



Source: National Association of Realtors/Haver Analytic

Similarly, new home sales have also staged a surprising comeback, gaining over 12% in May to a 763,000 unit pace, the highest since

[1] The Federal Reserve raised rates by 75bps in June, July, September, and November. In December, the Federal Reserve raised rates 50bps to bring the upper bound of the federal funds target rate to 4.50%.

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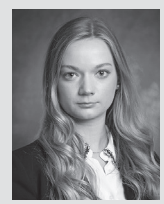

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February 2022. According to the median forecast, new home sales were expected to *decline* 1.2% in May. Over the past 12 months, new home sales rose 20.0%, a vast improvement from a 23.4% decline at the end of last year.

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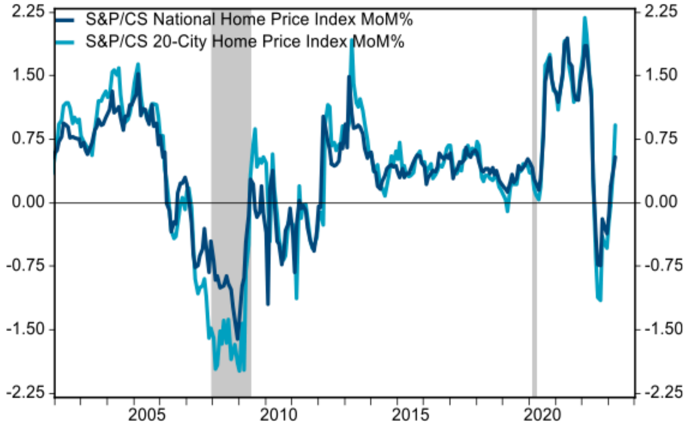

Source: Standard & Poor's/Haver Analytic

After rising to a peak of 1.8% in March 2022, monthly home price appreciation slowed markedly, slipping into negative territory in mid-2022, according to the National Case Shiller Home Price Index. More recently however, like sales, prices too have begun to rebound. While still off earlier highs, the national home price index pushed back into positive territory as of February with the latest report noting particular strength in the southern region of the U.S.

Unlike in prior periods, a tight supply of the housing stock has offered somewhat of a welcome support to prices. Mitigating the interest rate sensitive nature of the housing market, the current cycle began with a significant supply deficit that has only been exacerbated by a growing reluctance to sell by those who refinanced at low rates in 2020/21, a surge of post-pandemic millennial demand, and a work-from-anywhere environment. Thus, even with demand cooling off of peak levels and supply rising off of lows as builders – slowly – increase construction, with normal population growth, immigration and household formation there remains a sizable disconnect between supply and demand. As long as the current appetite for housing outpaces the available stock of housing units, a natural support to prices will continue.

Source: National Assoc. of Realtors/Bloomberg

The months' supply of existing homes, which was averaging close to four months heading into the pandemic, remains well established in a lower range between 2.5 to 3 months as it has been since December of last year. Months' supply of *new* homes, meanwhile, has also slowed markedly, dropping to 6.7 months as of May, the lowest since February 2022.

NEW DEMAND, NEW OPTIMISM

Despite the Fed intentionally trying to slow the economy – including the housing market – by increasing the cost of capital, homebuilders are feeling more optimistic as of late. According to the National Association of Home Builders Housing Market Index,

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

GDP – Gross Domestic Product

MBA – Mortgage Bankers Association

MoM – Month over Month

NAHB – National Association of Home Builders

OER – Owners' Equivalent Rent

YoY – Year over Year

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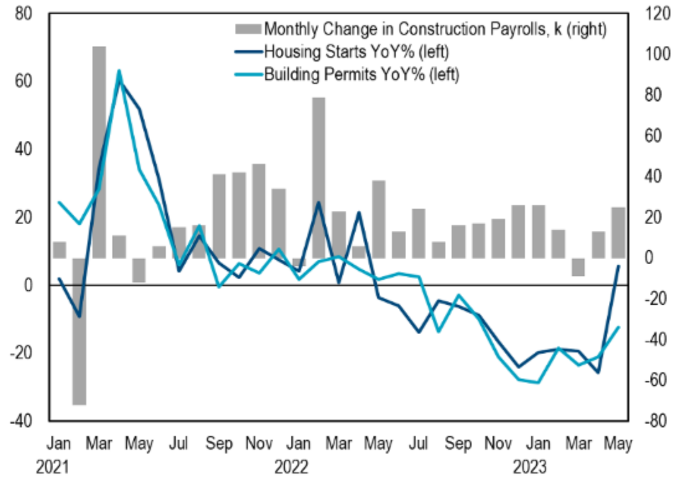
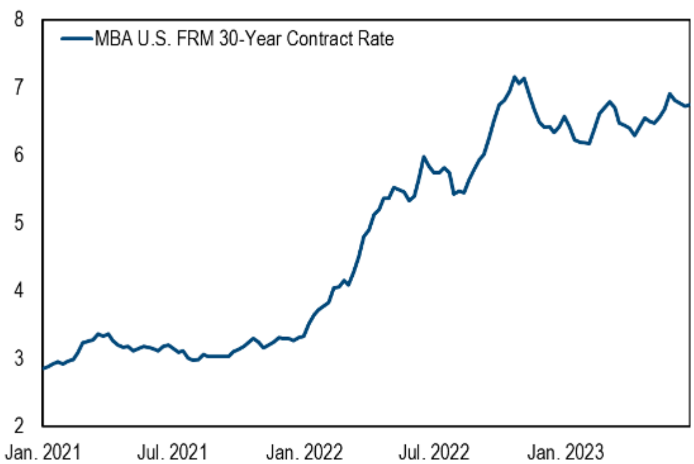
homebuilder sentiment rose to an 11-month high in June. Assessing improvement in current conditions coupled with a more positive outlook, construction companies are ramping up hiring. Construction payrolls, for example, have gained nearly 70,000 since the start of the year.



Source: Census Bureau/Bureau of Labor Statistics/Haver Analytics

Developers are also increasing new project development with applications for new projects also on the rise – a welcome development to address the aforementioned undersupply. Housing starts, a measure of new residential construction, jumped a whopping 22% in May alone, pulling the annual pace up to 1.63 million, the highest since April of last year. Year-over-year, housing starts rose 5.7%, the first positive reading since April 2022.

Permits similarly increased in May, rising over 5% and pulling the annual pace up to 1.49 million, an eight-month high. Year-over-year, however, building permits declined 12.7% in May, marking the 10th consecutive month of decline, albeit a lesser drop following a 21% decrease in April.



Source: Mortgage Bankers Association/Bloomberg

While housing market activity has seemingly gained some momentum with mortgage rates off of peak levels by roughly 43 bps and home prices declining, or at least home price appreciation slowing, market activity remains restrained. Shaving off 0.2% from first quarter growth, residential investment will likely remain a drain on topline activity for some time, although perhaps less of a drain amid the latest improvement in activity. Nevertheless, this remains a stark contrast relative to just two years prior when residential investment was a considerable driver of activity, adding 0.5% to topline GDP.

HOUSING AND THE FED

The Federal Reserve has increased rates at the fastest pace in 40 years; however, it hasn't been enough to slow the economy – or the housing market – or enough to tame inflation. In fact, the recent uptick in housing market metrics suggests the broader economy may be proving increasingly resilient, suggesting the Fed may have – significantly – more work to do in its efforts to slow growth enough for inflation to cool back down to its desired 2% target.

For now, the surprise uptick in housing activity does not seem sufficient to thwart the Fed's pathway to price stability. "*The housing sector nationally has flattened out, and maybe ticked up a little bit, but at a much lower level from where it was,*" Federal Reserve Chairman Jerome Powell said in his testimony last week before Congress. Of course, not all Fed officials are convinced of such positive – or inconsequential – sentiment. After all, elevated demand and prices could lead to a sizable increase in shelter costs, including rental costs, which feed directly into the Federal Open Market Committee's inflation calculations.

As of late, the Owners' Equivalent Rent (OER), or the proxy used to account for shelter costs in the Consumer Price Index (CPI), rose 0.5% following a similar gain in April. However, as Fed Governor Christopher Waller noted last month, an upturn in activity, even with sustained elevated borrowing costs, raises questions "*about whether the benefit from the slowing in rent increases will last as long as we have been expecting,*" potentially complicating and intensifying the Fed's need to raise rates to root out price pressures.

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