PALISADES

Perspectives

The Housing Inflation Conundrum

MARCH
2024

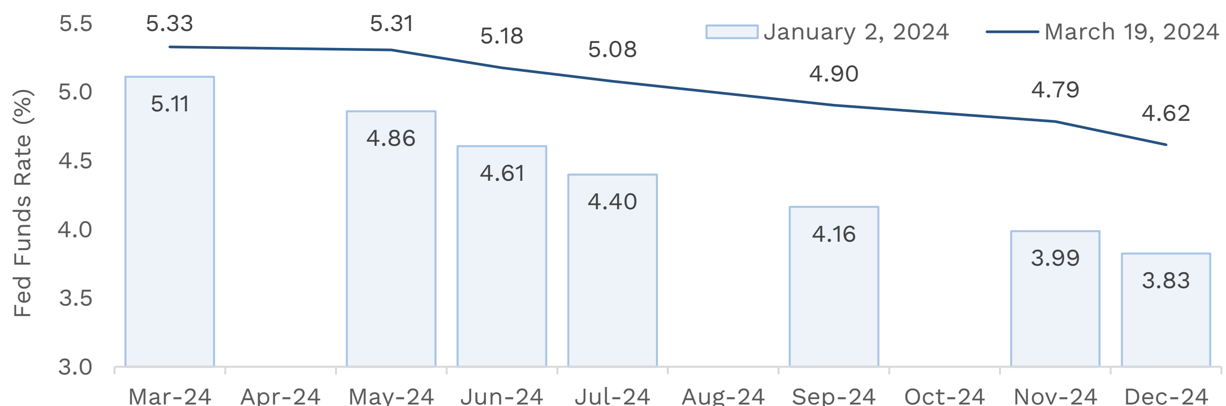
SHIFT IN MARKET SENTIMENT

The year commenced with investors harboring high hopes for a swift pivot towards monetary easing by the Federal Reserve. However, these expectations were quickly recalibrated in light of slowing rates of decline in inflation figures, a resilient labor market, and generally favorable economic conditions.

Initially, futures markets indicated a 90% likelihood of a rate cut by March and ~6 cuts during the year resulting in a December Fed funds estimate of 3.8%. Yet, as inflation and other economic data emerged, the sentiment shifted dramatically, virtually eliminating the prospect of early rate reductions. Current year-end expectations have Fed funds at 4.6%, or just ~2.8 rate cuts. This recalibration underscores the market's sensitivity to economic indicators and the Fed's cautious stance against prematurely loosening its policy grip, lest it reignite inflation.

Absent a significant 'triggering event' such as domestic terrorism, heightened geopolitical conflicts, bank stresses, or other unforeseen events, it is improbable the Fed will undertake material easing in 2024.

Federal Funds Futures
January 2 to March 19, 2024 (%)
Source: Bloomberg



Equity markets have started the year strong, corporate credit spreads are tight, and while labor market conditions are showing signs of cooling, by any measure the U.S. is at full employment. While Federal Reserve officials will likely be wary of maintaining restrictive policy and sowing the seeds of a recession, there are few indications such a risk is imminent. This likely will lead to a slow transition out of restrictive policy territory.

As many have said in recent weeks, the last mile of combatting inflation will be the toughest, and in the absence of a 'triggering event', those hoping for the Fed to initiate monetary policy easing early and often in 2024 are likely to be disappointed.

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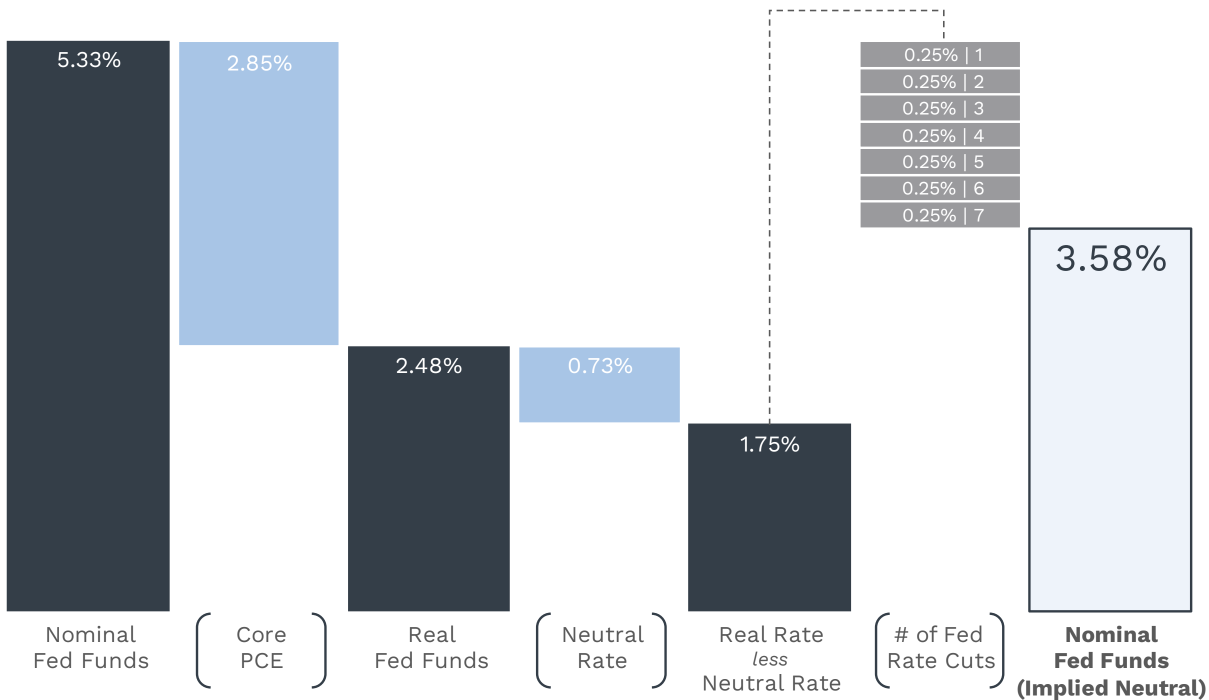
NEUTRAL RATE OF INTEREST

While the consensus view is that rates will trend lower over time, pinpointing the exact timing remains elusive due to the unpredictable nature of financial markets.

A tool used for understanding the trajectory of future rate cuts is the concept of the neutral rate of interest. This inflation adjusted rate is essentially the "Goldilocks" condition for monetary policy, is neither too hot (inflationary) nor too cold (recessionary), maintaining just the right balance to support full employment and stable prices. Although economists debate its precise utility, it offers valuable insights into monetary policy direction.

One popular **method** for estimating the neutral rate is the Holston-Laubach-Williams (HLW) model, which pegged it at 0.73% as of October 2023 (this is the estimated neutral real rate adjusted for inflation). With the current Fed funds rate at 5.33% and core inflation (excluding food and energy) at 2.85%, the real interest rate stands at approximately 2.48%. This figure is roughly 175 basis points above the neutral rate suggested by HLW, indicating potential room for up to seven 25 basis point rate cuts, bringing the nominal Fed funds rate closer to an ideal 3.58% (versus 5.33% today).

Implied Neutral Fed Funds Rate (Nominal)
As of March 19, 2024
Source: Bloomberg, Federal Reserve Bank of New York, Bureau of Economic Analysis



The Fed is trying to thread the needle between attempting to avoid premature easing that could refuel inflation, while also being mindful not to maintain overly restrictive policies that could tip the economy into recession. Based on the latest data and Fed projections, the journey toward this equilibrium is expected to be gradual, reflecting a cautious approach to adjusting policy in a manner that avoids rekindling inflation. This cautious path illuminates the intricate dance between economic theory (i.e. neutral rate of interest) and the practical realities facing policymakers in their attempt to ensure economic stability.

THE FED'S HOUSING INFLATION CONUNDRUM

As the Federal Reserve contemplates a cautious shift towards looser monetary policy, it may encounter a formidable challenge: the housing market.

Housing, a crucial driver of economic health, significantly influences inflationary pressures. According to the Bureau of Labor Statistics, it represents nearly half of the consumer price index ("CPI") and, according to White House data, approximately 18% of personal consumption expenditures ("PCE"), the Fed's preferred inflation gauge. Housing represents a significant component of inflation regardless of what measure is used, with changes to rents and home values influencing the path of inflation and monetary policy.

Consumer Price Index – Component Weights

December 2023 (%)

Source: Bureau of Labor Statistics

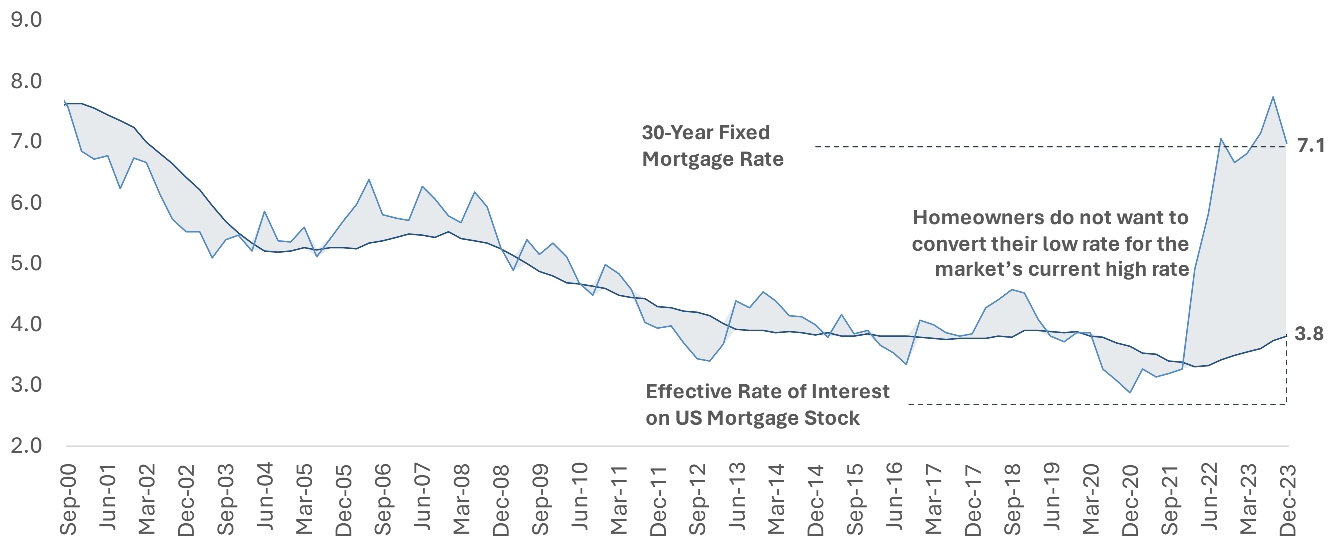
Home purchase demand has been suppressed due to high mortgage rates and strained affordability. Many would-be homebuyers have delayed purchases due to high mortgage payments and lack of available and/or affordable inventory. This has resulted in pent-up demand for home purchase activity.

Similarly, but much less discussed, is **pent-up deferred sales**. As a result of the $10.5 trillion of home purchases and mortgage refinance activity between late 2019 and early 2022 at historically low rates, the U.S. has a current mortgage stock that enjoys an average interest rate of 3.8% - versus a 30-year fixed rate mortgage of 7.1%, according to Bankrate.com.

Current 30-Year Fixed Mortgage Rate versus Effective Rate of Interest on US Mortgage Stock

September 2000 through December 2023 (%)

Source: Bureau of Economic Analysis, Bankrate.com



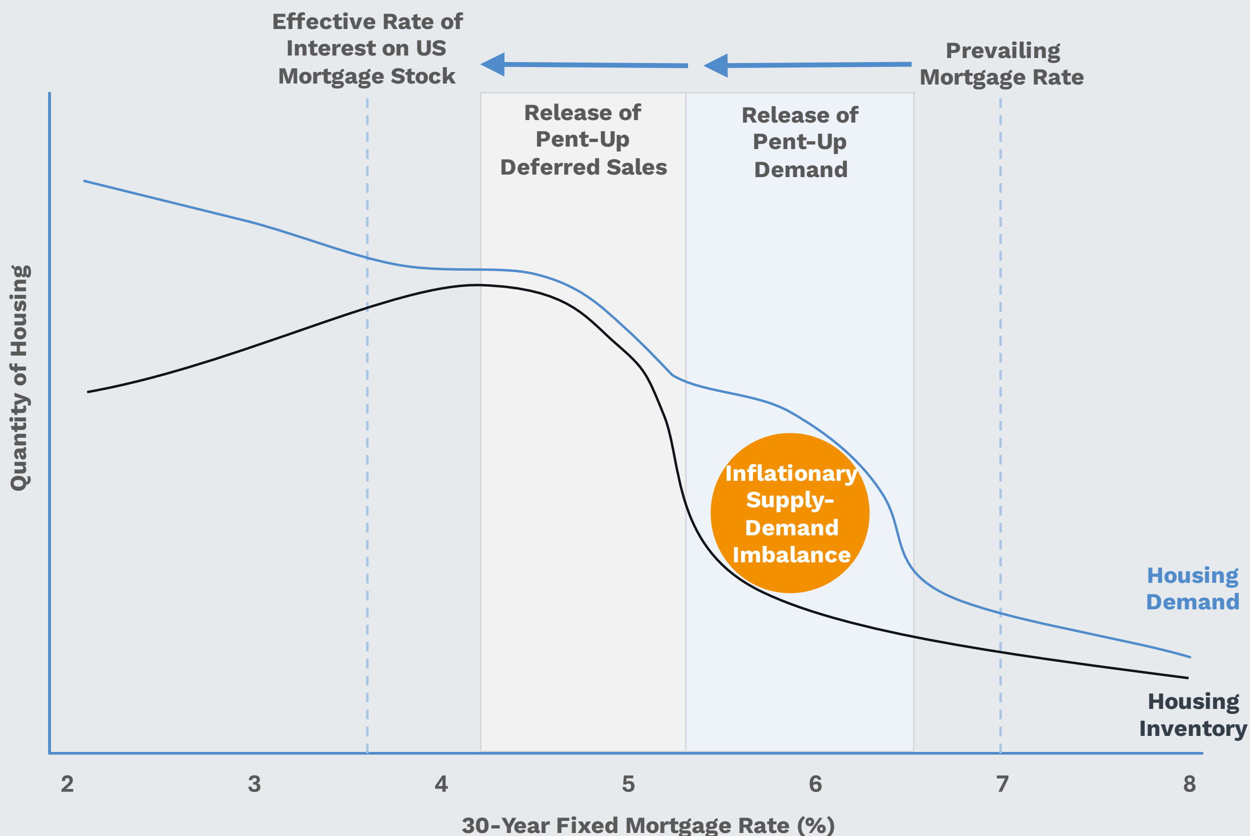
At the current average rate of 3.8% for existing mortgages, there's a noticeable gap indicating that many current mortgage holders are benefiting from rates significantly lower than the prevailing market rate of 7.1%. This disparity creates a situation where there is pent-up demand (due to the higher prevailing rates discouraging new buyers) and pent-up deferred sales (since current homeowners with lower rates are less inclined to sell, keeping supply low).

This environment has disproportionately impacted supply and created an imbalance supportive of home values (6.13% year-over-year home price appreciation according to the S&P Case Shiller 20-city home price index in December 2023). At some lower level of mortgage rates, pent-up deferred sales will be released creating much needed resale inventory and re-introducing supply-demand parity into the housing market.

The problem faced by the Fed is the reality that along the path of easing policy, **pent-up demand will likely be released BEFORE pent-up deferred sales**. This timing differential will exacerbate the supply-demand imbalance and drive-up housing inflation. Until mortgage rates are low enough to entice homeowners to give up their low-rate mortgages, effectively unlocking the lock-in effect, the U.S. housing market is likely to continue to be plagued by an inflationary supply-demand imbalance.

Theoretical Housing Supply-Demand Curves

Source: Palisades



The Fed faces the dilemma that slowly transitioning into easier policy creates a catalyst for housing inflation, whereas supply-demand parity likely will only develop when mortgage rates approach the low 5.0% area, or nearly 200 basis points below today's rates.

This assumes the U.S. economy continues along the path toward a 'soft-landing' and inflation approaches the Fed's 2.0% stated target. However, unforeseen 'triggering events' could drastically alter this trajectory, demanding more decisive action from the Federal Reserve.

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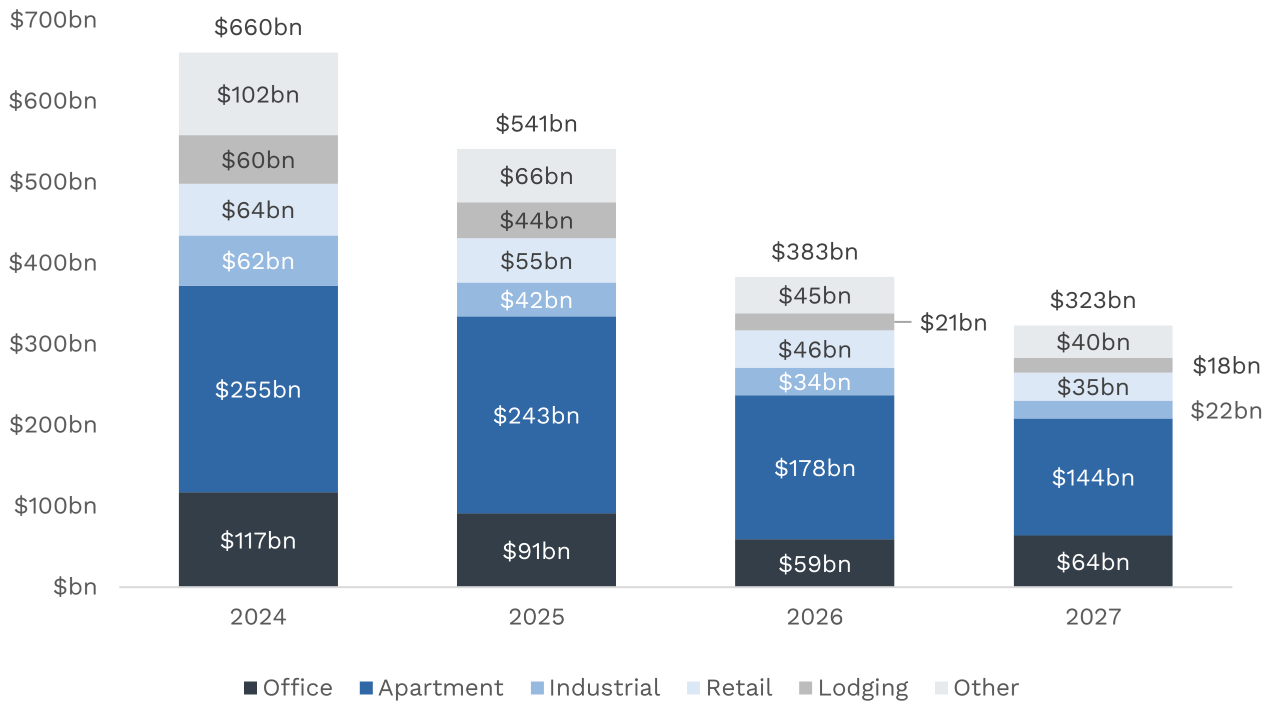
TRIGGERING EVENTS MAY CHANGE THE COURSE OF POLICY

Fed caution toward easing may give way to the need for rapid policy accommodation if the U.S. encounters a 'triggering event' such as domestic terrorism, escalation in geopolitical engagements, bank failures/bailouts, or some unforeseen events. Each of these, including the unknown unknowns, are at heightened levels of risk.

For example, the 2024 Homeland Threat Assessment produced by the U.S. Department of Homeland Security noted "…the threat of violence from individuals radicalized in the United States [is] to remain high" and "the complex border and immigration security challenges we have faced over the last year are likely to continue." For interested parties, **Academy Securities Geopolitical Insights** as well as **Global Recaps** are two great resources for quick and up to date intelligence on geopolitical news.

Moreover, financial stability is directly threatened by the looming risk of bank stresses, particularly as over $1.2 trillion in commercial mortgage loans approach maturity in 2024 and 2025, according to the Mortgage Bankers Association. A considerable portion of these loans are concentrated within regional banks, posing a risk of financial distress and the consequent need for government intervention.

Commercial Mortgage Market Maturity Schedule
As of December 2023
Source: Mortgage Bankers Association, Guggenheim Investments



The stability of financial institutions is heavily influenced by several factors: the size and health of the bank, its concentration in commercial mortgages, and its exposure to different property types. These elements collectively help determine the resilience of banks to shifts in market conditions and potential crises of confidence among investors, depositors, and regulators.

Currently, the market appears relatively unconcerned with these potential vulnerabilities, possibly due to the contained nature of risks as perceived through prevailing economic indicators and regulatory oversight. However, the lessons of recent history caution against complacency.

BANK BAILOUTS ARE MORE LIKELY THAN FED BAILOUTS IN THE NEAR TERM

Counterintuitively, a rapid descent in interest rates may be the only way to avoid housing inflation, and the only way we are likely to see such a swift decline in rates is through some form of material economic or global event. Absent such an event, the most likely scenario is for a slow decline in rates that will be defined by bouts of housing inflation. Those waiting for a bailout vis-à-vis lower rates may be waiting longer than anticipated, and perhaps in some cases longer than they can remain solvent.

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