Economics from Washington

SECOND THOUGHTS

April 25, 2016

L. Douglas Lee
dlee@econfromwashington.com

- *Despite confusing data, the housing sector is providing steady support for the economic expansion. This will continue for an extended period.*

- *Supply has caught up with demand in the rental market, causing the composition of construction to shift. This will boost the impact of housing on economic activity.*

- *Rental vacancy rates are starting to rise, which promises to slow rental inflation. This may put a brake on the Fed's hopes for higher inflation later this year.*

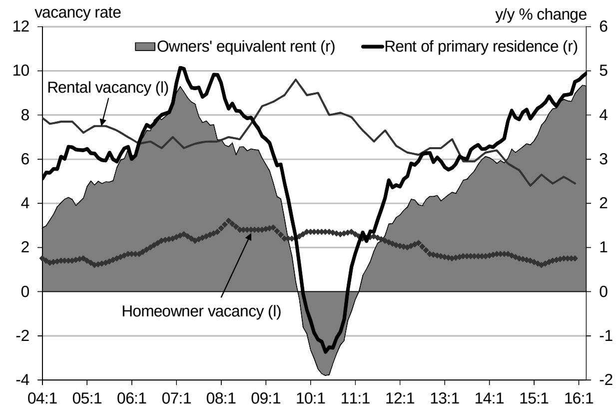
Economics from Washington, Inc.
T 301.365.6395 ▪ F 301.365.2686
www.econfromwashington.com

The housing sector is not only one of the most important parts of the US economy, it can also be one of the most confusing. Data is frequently volatile and seems to move in different directions – sales are up but starts are down; prices are rising, but mortgage rates are falling, etc. Sorting through these conflicting signals is critical, because this sector of the economy affects two key aspects of the economy for investors. First, housing is a major reason the expansion is not sputtering out and will likely extend into next year. If you are looking for some upside potential in the economic forecast, this is the place to focus. Second, while construction is supporting economic growth, a shift in the supply/demand balance in rental markets may put a brake on the Fed's hopes for higher inflation.

Since the recession, multifamily construction has been the dominant part of the housing story. With the crash in house prices and curtailment of credit to potential homebuyers, builders refocused on the rental market and multifamily buildings. This shift had important implications for overall economic growth. According to the NAHB, construction costs for an average single family home are about 2 ½ times as much as for an average multifamily rental unit. Thus, when the composition of house construction fell from about 80% single units before the recession to about 65% after, the impact of house construction on the total economy fell significantly. There is a multiplier effect as well – single units have more than twice the space of multi units, which means they need more furniture, carpet, etc. to fill them.

The trend toward multi-unit construction is shifting again. Supply has caught up with demand in the rental market. While this is not yet obvious in the Government survey, reliable data from Reis show a rental vacancy rate in 1Q16 of 4.5% compared to 4.4% in 4Q15 and 4.3% in 1Q15. The National Multi Housing Council's apartment conditions index also declined in both 4Q15 and 1Q16. Although multifamily starts peaked in mid-2015 and have fallen since, they still increased 11.6% last year and it takes about a year for these units to reach the market. Multi-unit starts are still slightly higher than completions. This means there will be another large increase in supply in 2016. Meanwhile, single unit starts are trending higher and are back to about 70% of house construction.

West



Source: Bureau of Labor Statistics, US Census Bureau

All the factors which support strong housing demand are in place. Job and income growth are primary. Household formation is always erratic, but is trending higher along with population. Credit is available and rates are very reasonable. Prices are rising, but this seems to have contributed to more favorable attitudes about homeownership, and the share of ownership ticked higher in Q4. While housing will not return to its pre-recession status any time soon, it provided important support to the economy last year, and conditions are right for this to continue throughout 2016 and 2017.

The supply/demand balance in rental markets also has important implications for inflation – shelter is about 40% of the core CPI and 17% of the core PCE price index. In reality, house prices have little influence on these index numbers – they are all about rents, and rents are very sensitive to vacancy rates. Shelter prices have consistently been the most rapidly rising part of inflation, and the largest increases have been in the West. After falling in 2010, shelter inflation reached 2% in 2012 and 3 ¼ % in early 2016, with an increase of almost 5% in the West leading the way. This week's chart illustrates what happens when vacancy rates rise. In a two year period starting in mid-2008, the rental vacancy rate increased about 2 ½ points and shelter inflation vanished. The owner vacancy rate was very stable over the same period, but this has no impact on owner occupied inflation as measured by BLS. Other regions show a similar, but more muted pattern.

Although we are not expecting anything this dramatic in 2016, the change in the rental supply/demand balance promises to have an important impact on the largest single component of the price indexes. Recently, inflation has firmed and it is generally expected to edge higher as the year unfolds. Given its large weight in the index, even a small slowdown in shelter inflation may up end this story. Of course, there are lags between an increase in vacancies and a slowdown in rental inflation, so it will be months before these changes become apparent in current data reports. We do not expect them to influence any of the Fed's monetary policy decisions at the next few FOMC meetings. Nevertheless, a slowdown in rental price increases will make it difficult to reach the Fed's overall inflation target, even with continued tightening in labor markets and other parts of the economy.

Economics from Washington, Inc. ▪ T 301.365.6395 ▪ F 301.365.2686