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A tale of two housing markets

June 3, 2024

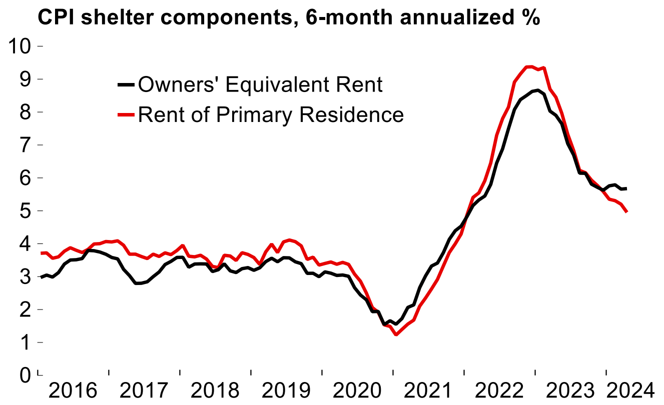
- The inflation gap between the two biggest CPI shelter components is expected to widen in the coming months with the disinflationary momentum of OER stagnating relative to rent of primary residence. Much of the slowdown in existing home sales is being offset by low inventory, keeping the months' supply relatively low and home price growth relatively high. This will expectedly feed into OER (the largest housing component) in 2024.
- Conversely, growth in CPI rent of primary residence is expected to fall as new tenant rents ease in response to oversupply in many regions. Historically, growth in new tenant rent lags home prices, but this relationship may not hold in 2024 with single and multifamily housing starts trending in opposite directions for the first time. Low market absorption of new multifamily units and rising delinquency rates will continue to impact new construction and have a disinflationary effect on rent prices.

Two inflation trends

Shelter inflation has been relatively flat in 2024, but much of that is due to just one of the two major subcomponents. Specifically, Owners' Equivalent Rent (OER) has been stagnant while rent of primary residence has continued along a disinflationary path (Chart 1). Historically, the two inflation measures move closely in tandem, but there has been a growing divergence that began around the start of this year. The current spread is not unusually large, but it is expected to widen further.

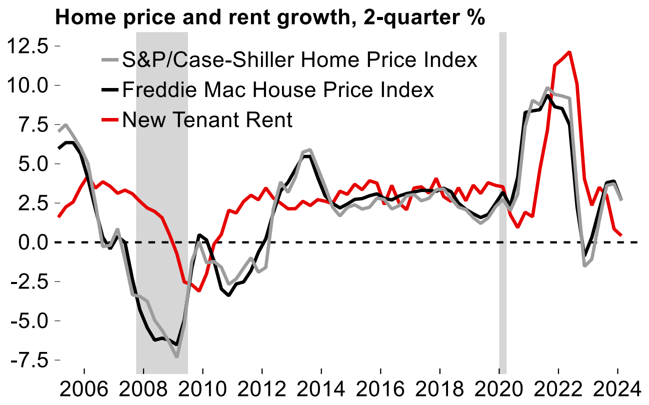
Broadly speaking, OER reflects the single-family housing market and rent of primary residence the multi-family market. And the reason the two inflation measures align closely is because their drivers are interrelated. As discussed in a , OER lags home prices by 12-16 months because it attempts to capture the consumption aspect of housing for all homeowners, not just those currently in the market to buy.

Chart 1: The inflation gap between OER and CPI rent will likely widen in the coming months



Source: BLS, MUFG Bank Economic Research Office

Chart 2: New rents historically lag housing prices, but the relationship may weaken in the coming months



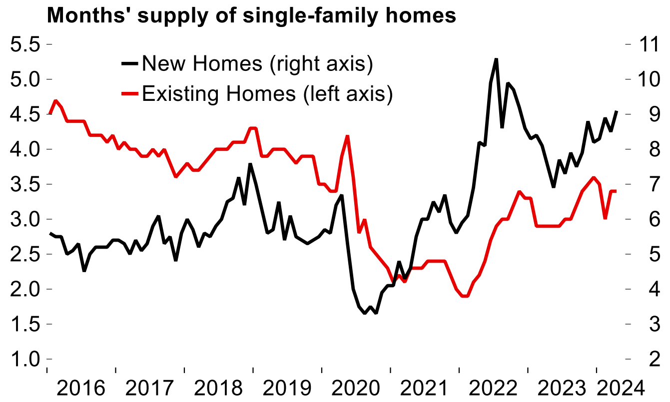
Source: S&P, Freddie Mac, CPI, MUFG Bank Economic Research Office

Putting aside the criticisms of the modelled approach to OER, we can expect growth to average out to having only a slightly negative slope over the next 6 months given that home prices were accelerating throughout the second half of 2023 (Chart 2). Home prices certainly don't have perfect predictive power, but the relationship is strong enough to expect slow disinflation in OER.

As for the reason why home prices are rising, the answer is fairly straightforward; demand is still high relative to supply. Home sales of existing family homes (the vast majority of home sales) has fallen well below the pre-pandemic level, and they continue to be low. However, inventory remains very low as well as many current homeowners are reluctant to put their house up for sale, in part because many locked in a lower mortgage rate.

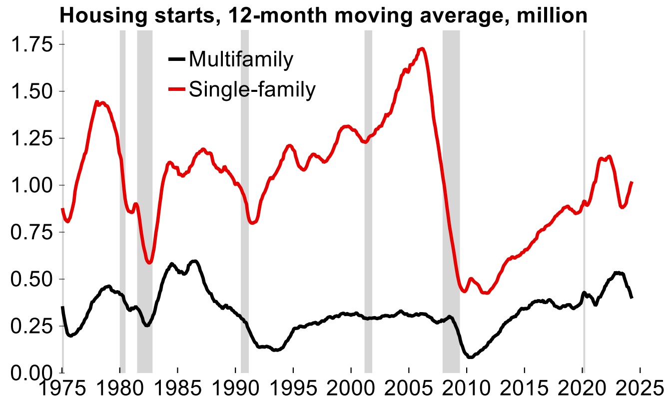
This has the months' supply of existing homes (ratio of homes for sale to homes sold) hovering at a relatively low rate by historical standards (Chart 3), applying upward pressure to home prices. The story is different for new homes, where they are being built faster than they are being sold, but they comprise a much smaller share of the total housing market.

Chart 3: Low inventory has offset slower sales of existing homes, keeping the month's supply low and prices high



Source: NAR, Census Bureau, MUFG Bank Economic Research Office

Chart 4: Single and multifamily construction starts are trending in different directions for the first time



Source: Census Bureau, MUFG Bank Economic Research Office

For the other major shelter component, rent of primary residence, the drivers are very similar. Like OER, rent of primary residence attempts to measure prices for all tenants, not just new ones. For this reason, it expectedly lags new rents by about 4 quarters, though again with less than perfect predictive power. Shown in Chart 2, growth in the CPI New Tenant Rent Index is trending downward and approaching deflationary territory, suggesting that we will see continued disinflation in rent of primary residence for most, or all, of 2024.

Herein lies the divergence between the two major subcomponents of shelter inflation: growth in home prices points to elevated OER and easing new rents to further disinflation in rent of primary residence. The question now is what will happen in 2025?

Home price growth will depend heavily on interest rate policy, and whether rate cuts will significantly increase inventory and current homeowners' willingness to sell relative to demand for buying. It's difficult to say which force will be stronger for existing homes, but continued construction of new homes will have some disinflationary effect on overall price growth. Home price growth may fluctuate between 2-4% on a 6-month annualized basis in the first half of 2025, with growth in OER unlikely to fall below 4%.

The path for rent of primary residence is perhaps more predictable, at least for the worst-case scenario with respect to inflation. New rent prices historically lag home prices by about 2-4 quarters (Chart 2), and if this relationship holds, we can expect new rents to begin to reaccelerate in the second half of this year, leading to rent of primary residence accelerating in early 2025 (this being the worst-case scenario). Once again, the relationship is not perfect, and there are reasons to believe that home prices will be a weaker leading indicator of new rents going forward (the best-case scenario).

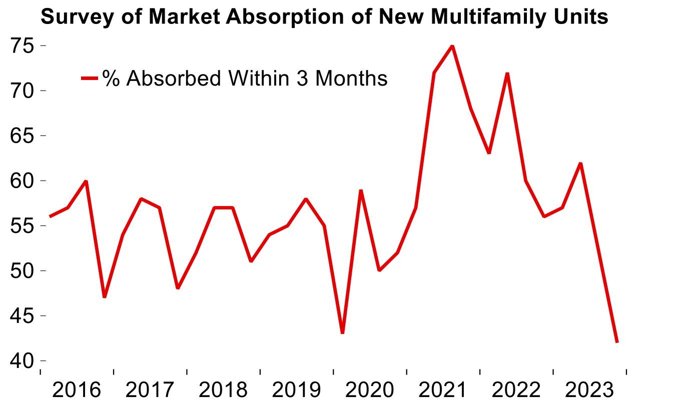
Shown in Chart 4, housing starts for single and multifamily units now have the clearest divergence in trend compared to any other period in history. Inflation typically favors multifamily housing developers as they are better able to pass on higher costs to renters, but oversupply of new developments in what were previously key growth markets has driven vacancy rates higher, especially in the South. In aggregate, new multifamily units are now less able to pass on higher rents, and the percent of new units absorbed under a short time frame has fallen dramatically (Chart 5).

Delinquency rates have also risen sharply for multifamily affordable housing developments (Chart 6). A significant majority of multifamily rental housing financed by Fannie Mae and Freddie Mac are affordable for households earning at or below 120% of the median area income. With delinquency rates having reached 2008 recession levels for Freddie Mac, and hovering at historically high levels for Fannie Mae, this subset of the multifamily sector is facing significant headwinds.

Being that these loans primarily cover affordable housing developments and the vast majority of them are securitized, the impact to the broader commercial real estate sector is likely limited. However, it does illustrate the inability to pass high costs onto renters. Given the headwinds facing multifamily housing units, growth in new tenant rents may continue to hover at very low rates despite growth in single-family housing prices. Rent of primary residence will likely continue to have a disinflationary contribution to overall shelter inflation.

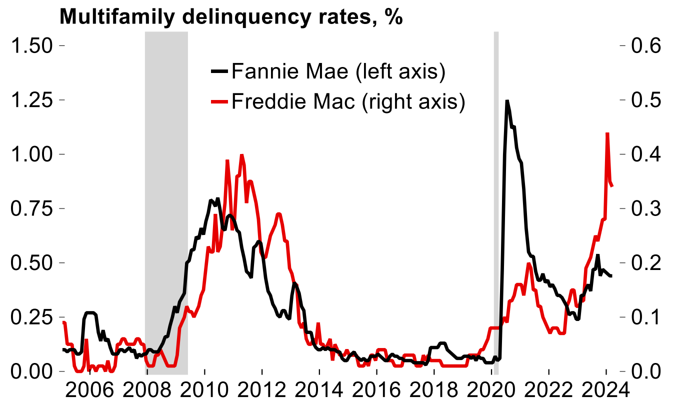
For the Fed and their fight against inflation, this is good news. Even though rent of primary residence comprises a smaller weight than OER in the CPI (about 7% and 26% respectively), there are downward price pressures present in the multifamily housing market that will help make their job easier.

Chart 5: New multifamily units are struggling to pass off high rents onto consumers



Source: Census Bureau, MUFG Bank Economic Research Office

Chart 6: Rising delinquency rates for multifamily housing units pose issues for the commercial real estate sector



Source: Fannie Mae, Freddie Mac, MUFG Bank Economic Research Office

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