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Global Markets Research

Research Alert

Sticky US housing inflation

Services inflation, especially housing remained elevated despite softer headline prices

Tightened monetary policies have a lagged impact on house prices and rental

Expect 25bps hike to 5.00-5.25% at upcoming FOMC meeting next week

Background

Inflation, as measured by both the CPI and PCE indices, have stayed stubbornly higher than what the Fed had expected. While prices of goods have receded, services inflation has not decelerated much, raising questions on whether monetary policy is even an effective tool to tame price pressures. Taking centre stage is the rent inflation, which has skyrocketed since early 2021.

A closer peep at shelter inflation

The fed funds rate has risen by 475 bps since March 2022, PCE prices have eased from its peak of 7.0% in June 2022 to 5.0% currently. While prices of goods have decelerated sharply from 10.6% in June 20022 to 3.6% currently, services inflation has shown no signs of receding but in fact accelerated from 5.1% to 5.7% for the same period. A huge part of this price pressure emanated from housing. Growth in the housing index has accelerated from 5.6% in June 2022 to 7.7% in December 2022 and 8.2% currently, driven by both tenant (+8.8% vs Dec: +8.4%) and owner-occupied non-farm dwellings (+8.1% vs. Dec: +7.5%).

In the same-breath, CPI has decelerated from +9.1% to +5.0% currently, but services inflation picked up from +6.2% to +7.1%. The shelter index, specifically, accelerated from +7.3% to +8.2%, with rent on shelter surging from +5.7% to +8.3%. In fact, from the graph (Figure 1), higher interest rates seem to be driving the higher housing costs.

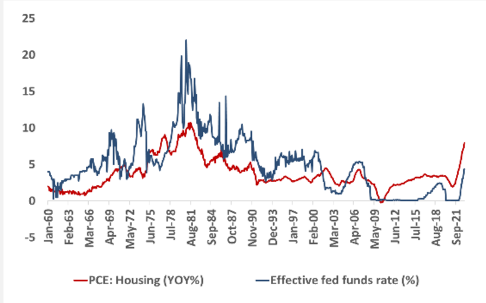
Given that housing accounts for 34.5% of CPI (less for PCE), every 1ppts increase in housing costs will add approximately 0.3ppts into inflation. As such, it is inevitable to ask when will housing costs and thus, inflation rate will soften enough such that the Fed will be comfortable with it?

In our last write up dated 31 Jan 2023, we have already written on the lagged impact of six quarters between housing data and fed funds rate, while the Bank of International Settlement estimated four to eight quarterly lags between interest rates and real house price growths. The Fed first increased the fed funds rate in March 2022 and this suggests that impact on prices for owner-occupied non-farm dwellings will filter through earliest in March 2023.

Why is rent inflation so sticky?

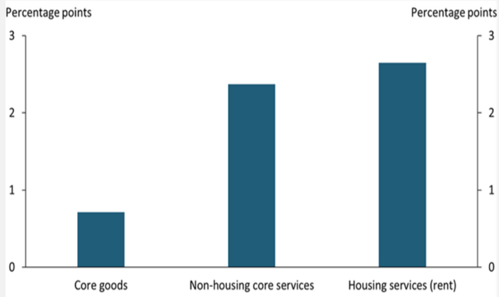
In terms of rent, one of the reasons why shelter and rent inflation was so sticky was due to the time needed for leases to roll over into a new contract. Landlords typically renew leases every 12-24 months, which means current price dynamics can only be reflected in new contracts next year. Secondly, basic economic theory suggests that changes in housing demand and supply can drive both rents and house prices. For example, remote working due to the pandemic has increased demand for housing, raising both house prices and rents, while the current tightness in the labour market will contribute to lower housing inventory and thus supply.

Figure 1: PCE-Housing vs Fed Funds Rate



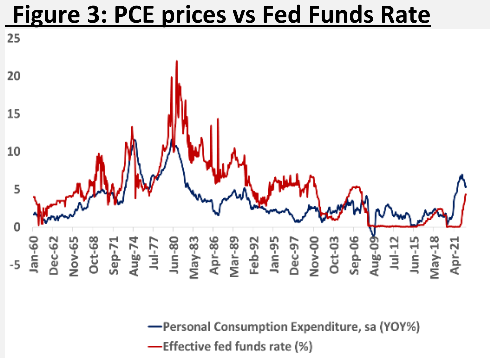
Source: Bloomberg, CEIC, HLBB Global Markets Research

Figure 2: Rent inflation responds more to a tighter labor market compared with other inflation components



Source: Bureau of Labor Statistics (BLS), Bureau of Economic Analysis (BEA), Federal Reserve Bank of New York, and authors' estimates. All data sources accessed through Haver Analytics

Figure 3: PCE prices vs Fed Funds Rate



Source: Bloomberg, CEIC, HLBB Global Markets Research

Lastly but not least, studies have shown that rent inflation has historically coincided with labor market tightness, explaining why the Fed is eyeing wage inflation closely. As seen in Figure 2 by the BEA, study has shown that labor market tightness has the smallest pass-through to goods inflation, likely because the sector is less labor-intensive than services. The pass-through to non-housing core services inflation and housing services, on the other hand, are three times as large.

Having said that, we believe that the tighter monetary policy for rent inflation will work, although with a lagged impact, just like general housing indicators. In fact, based on our calculation, rent inflation lagged fed funds rate by five quarters. So as such, any sustainable softening in shelter inflation, will only trickle through in June 2023 earliest. A separate study by the San Francisco Fed also showed that "On impact, a 1ppt increase in the federal funds rate reduces rent inflation about 0.6ppts relative to its preshock level. Over time, rent inflation declines gradually, falling about 3.2ppts in the 10 quarters following the impact."

Monetary Policy Implications – the Fed at the cross road

With this, as a conclusion, we have decided to skim through past inflation and fed funds rate data to look for the pivot points historically for Fed's tolerance level for inflation. We have also decided to use headline PCE rather than core prices because: 1) Ceteris paribus, the focus of core inflation in policy decision was by and large introduced only in the 2000s and we will be using data from 1960s, which would also include times of oil shocks. 2) While the Fed has largely focused on core prices, recent arguments to exclude food, energy, and housing prices towards a narrower inflation target will not paint a fair picture what consumers are facing in their daily lives given that a large chunk of household spending will be allocated to this.

Time Period	Fed Funds Effective Rate (%)	PCE (% YOY)
August 1969	9.75	+4.6%
June 1974	13.31	+10.4%
December 1980	22.00	+10.6%
June 2000	6.86	+2.7%
February 2007	5.41	+2.4%

Source: CEIC, Bloomberg, HLBB Global Markets Research

The Fed is set to meet next week and it is widely expected that the Fed will increase its fed funds rate by another 25bps to 5.00%-5.25% and end its tightening cycle thereafter. Yet, a slew of weak economic data recently had traders pricing in rate cuts at the end of the year, while Fed hawk James Bullard continued to discount recession fears and called for the opposite. Notably, the Conference Board's Leading Economic Index worsened more than expected by -1.2% m/m in March to the lowest level since November of 2020, while its Consumer Confidence Index fell more than expected to a 9-month low of 101.3 in April. Regional activities also deteriorated further. Orders for non-defense capital goods excluding aircraft, a proxy for business spending plans, also contracted more than expected by 0.4% m/m in March. On the flip side, new home sales unexpectedly registered positive growth of +9.6% m/m while home prices from both FHFA and S&P CoreLogic accelerated, despite higher rates.

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