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LATEST U.S. ECONOMIC OUTLOOK

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U.S. Economic Outlook Report

June 8, 2021: The Hot Housing Market and Its Impact on Inflation

Prevedere Chief Economist, Andrew Duguay, provides a personal view on topical economic issues

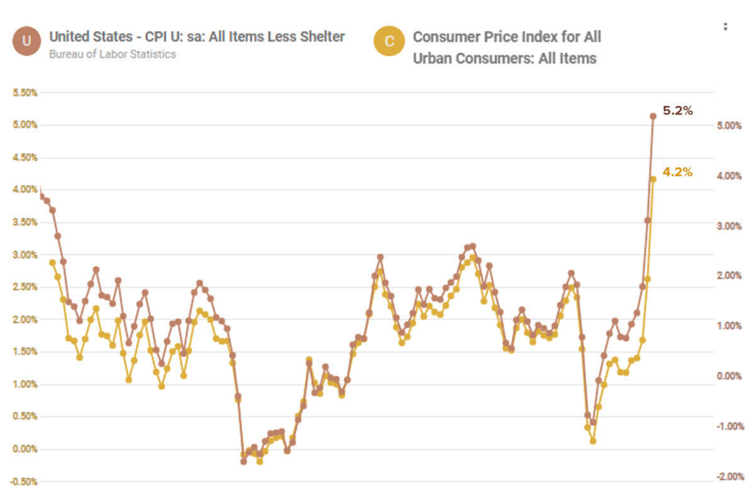
Some of the biggest headlines right now center around the U.S. housing market and inflation. With tight inventory and rising prices, the housing market seems to be spiraling out of control. Uncertainty around housing can often translate into increased worries about inflation. In this report, I discuss how the two actually interact with each other.

Housing Impact on Inflation

While several different measures are used to track inflation, one of the most commonly used is the Consumer Price Index (CPI). The CPI is a basket of goods meant to represent what the average consumer buys. When you break the CPI into its components, housing, including mortgage payments and rental payments, is the biggest piece of the pie.

According to the CPI, inflation is starting to increase. Economists will be quick to note that some of the year-over-year “inflation” is due to a base effect created by the pandemic. Gas prices and other consumer goods prices fell sharply last year at the onset of COVID-19 induced lockdowns. Now, amid a robust economic recovery for many sectors, there is a strong year-over-year comparable. This type of inflation is deemed temporary, or “base effect” inflation because once the comparison to the pandemic is out of the denominator, the inflation rate will fall. But not all inflation we are seeing today will go away so quickly; the cost of housing is a good example of this.

When it comes to price increases, one of the most talked-about areas is housing prices. However, just because the housing market contributes most to the CPI, the run-up in home prices does not necessarily translate into immediate inflationary pressures. The graph below compares the total CPI in yellow, which is rising at 4.2% on a year-over-year basis. In red, CPI Excluding Housing is increasing at a faster rate of 5.2% year-over-year. Despite the strong housing market, the housing component is pulling down the overall CPI.



What we are witnessing is a lead-lag relationship between inflation and increases in the housing market. Today's home price gains are often next year's inflation, as higher real estate values gradually filter to higher rents, mortgages, and taxes.

To demonstrate this further, we correlated the CPI with several different home pricing metrics, including the Case-Shiller 20 City Home Price Composite and the Purchase Only House Price Index by the U.S. Federal Housing Finance Agency. Looking at the historical data for the Housing Price Index on a year-over-year basis indicates that the United States had a record increase in home prices of 13.9%. Moreover, data from Redfin indicates that there are record-low inventories while home sales are high, which is putting upward pressure on prices. This will show up in inflation, but it will take time. There is a shadow effect that if home prices rise, the CPI tends to increase around 17 months later.

Conclusion

Overall, the sky-high housing prices going on in the market right now suggests that the U.S. is going to see ongoing inflationary pressure throughout the next year and a half beyond just the "base effect".

Businesses have to consider how the current housing market will impact inflation. While the CPI is meant to generalize consumer spending, consumer sub-sectors will feel personal inflation rates that are much higher than the often quoted headline rate of inflation rate. Anyone trying to purchase or build a house or even secure a larger apartment in this market will feel a sting of much higher personal rates of inflation than the headline of 4.2% annual rate suggests. This will create a very interesting market dynamic as these consumers change how they purchase. Moving forward, businesses, retailers, and producers that respond appropriately to these consumers and are sensitive to their inflation fatigue will be the most successful.