Housing: Heartburn, Not a Heart Attack

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When interest rates go up, many analysts start to worry about recessions. That's not wrong to do, after all Federal Reserve rate cycles are important. Lately, the market has settled on expectations for a total of about 2.25% or more of interest rate hikes this year. The result is a jump in many longer-term yields. The 10-year Treasury yield is 2.77%, while the typical 30-year mortgage has climbed from 3.2% in December, according to Bankrate.com, to 5.1% recently.

So, some analysts think that a housing bust is likely, which would drag down the entire economy. We certainly agree that higher mortgage rates will be a headwind for the housing market in the year ahead. But what we see is some heartburn, not a heart attack.

While 5% mortgage rates are high relative to where they were, home prices should still rise 5 - 10% this year, meaning home prices either keep up with or exceed borrowing costs. Real mortgage rates (the rate minus inflation) are still negative.

Negative real rates are also why we are not yet worried about an inverted yield curve from the 2-year Treasury to the 10-year. In the past, when inverted yield curves preceded recessions, real interest rates were positive, not negative.

Now, back to housing...It is true that national home prices have soared in the past couple of years. However, so have construction costs. The Census Bureau's price-index for single-family homes under construction, which does not include the rising cost of land, is up around 25% from two years ago. For 2022, we expect mortgage rates to help slow national average home price increases versus 2020-21, but for prices to still go up in the 5 - 10% range.

By contrast, rents should accelerate for several reasons: (1) general price inflation, (2) the end of the eviction moratorium, (3) higher mortgage rates shifting demand toward renting, and (4) the fact that home prices are already high relative to rents.

Home sales are a different story. Higher mortgage rates make it likely that fewer existing homes should sell in 2022 than in 2021. But this is not the end of the world. Existing homes don't reflect new construction and add only slightly to GDP (via brokers' commissions, for example). Existing home sales slowed in 2018 and 2019 and the economy did fine. New home sales should be roughly flat to slightly down this year, but new home sales also fell in 2021 and real GDP grew 5.5%. Again, not the end of the world.

What really matters for the economy is how higher mortgage rates affect the pace of home construction. There, again, we see some heartburn, but no calamity and no collapse. Builders started 1.605 million homes last year and we expect total housing starts to exceed that in 2022. However, starts for the full year will probably lag the 1.713 million annual pace of January and February.

But starts are not the whole story when it comes to home construction. The total amount of construction can rise as builders move toward completing homes they began months ago. And remember: home building includes not only single-family homes but also multi-family units, which captures building designed for people who want to rent.

The US has underbuilt homes for the past decade. Higher mortgage rates don't change that, although they may shift around the share of the population that rents versus owning. Monetary policy is now getting less loose; that's going to lead to some indigestion. The real problems won't start until policy actually gets tight. And for that we have longer to wait.