If home prices don't cool, watch for Fed tightening and rising mortgage rates

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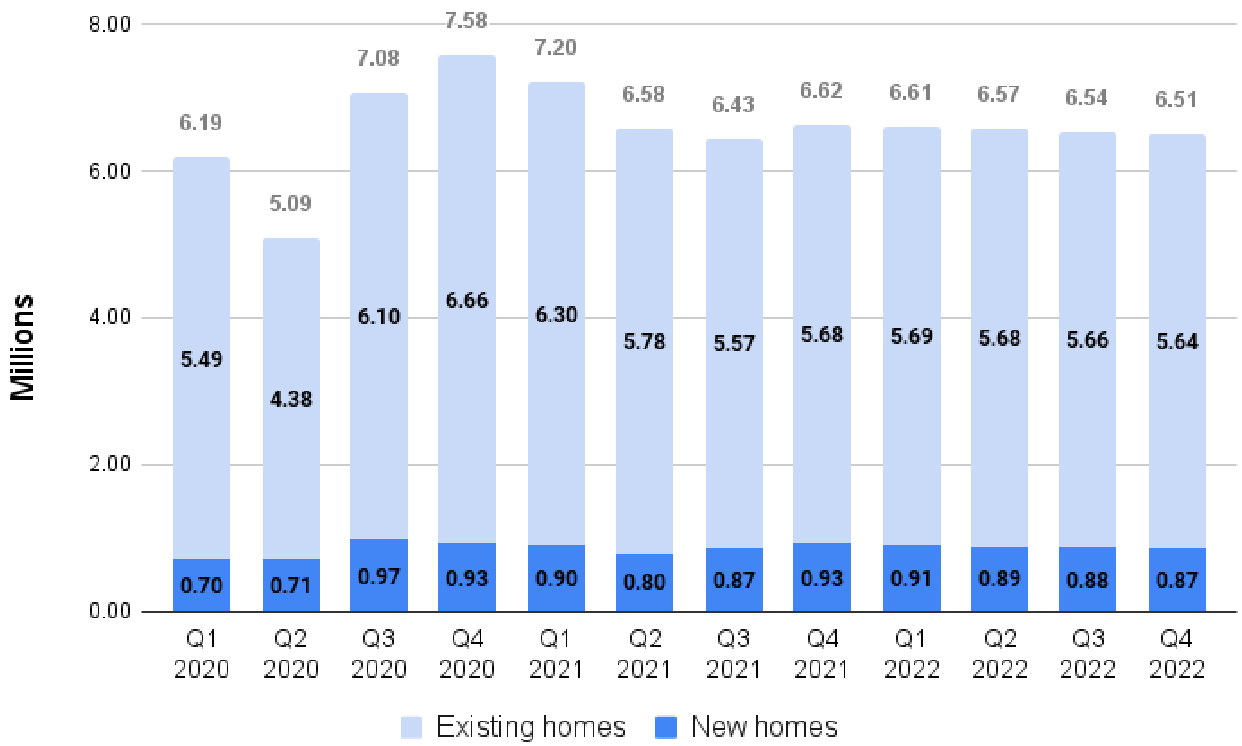
Economists at Fannie Mae are again sounding warnings that rising rents and record home price appreciation could contribute to long-lasting inflation that leads to earlier, more aggressive tightening by the Federal Reserve.

But homebuilders may yet save the day. As supply chain constraints and labor shortages ease, more new homes should start coming on the market. That could encourage homeowners who want to trade up to put their own homes on the market — boosting sales of both new and existing homes and slowing the pace of price increases, Fannie Mae forecasters say.

In their latest economic and housing forecast, Fannie Mae economists say that after adjusting for seasonal factors, they expect the pace of sales to pick up in the last three months of 2021 and the first three months of 2022.

Annual rate of sales, new and existing homes

When the pandemic hit, sales of new and existing homes plummeted to a seasonally adjusted



Seasonally adjusted annual rate of sales of new and existing homes by quarter. Annual rates of sales after the first quarter of 2021 are projections. Source: Fannie Mae Economic and Housing Outlook, July 2021.

annual rate of 5.09 million during the second quarter of 2020, before rebounding to 7.58 million in the final three months of the year.

Although sales in the months ahead aren't expected to be as brisk as they were during the fourth quarter of 2020 and the first quarter of this year, that should help bring some balance back to the market. Nearly two-thirds of would-be homebuyers surveyed in Fannie Mae's June Home Purchase Sentiment Index (HPSI) said it was a bad time to buy a home — a sentiment felt even more strongly by renters who would like to buy their first home.

As demand for homes eases and more homes come on the market, that should cool price appreciation, said Fannie Mae Deputy Chief Economist Mark Palim.

"While recent home price growth has been historically high, we're forecasting further home price appreciation to moderate through the remainder of the year and into 2022," Palim said.

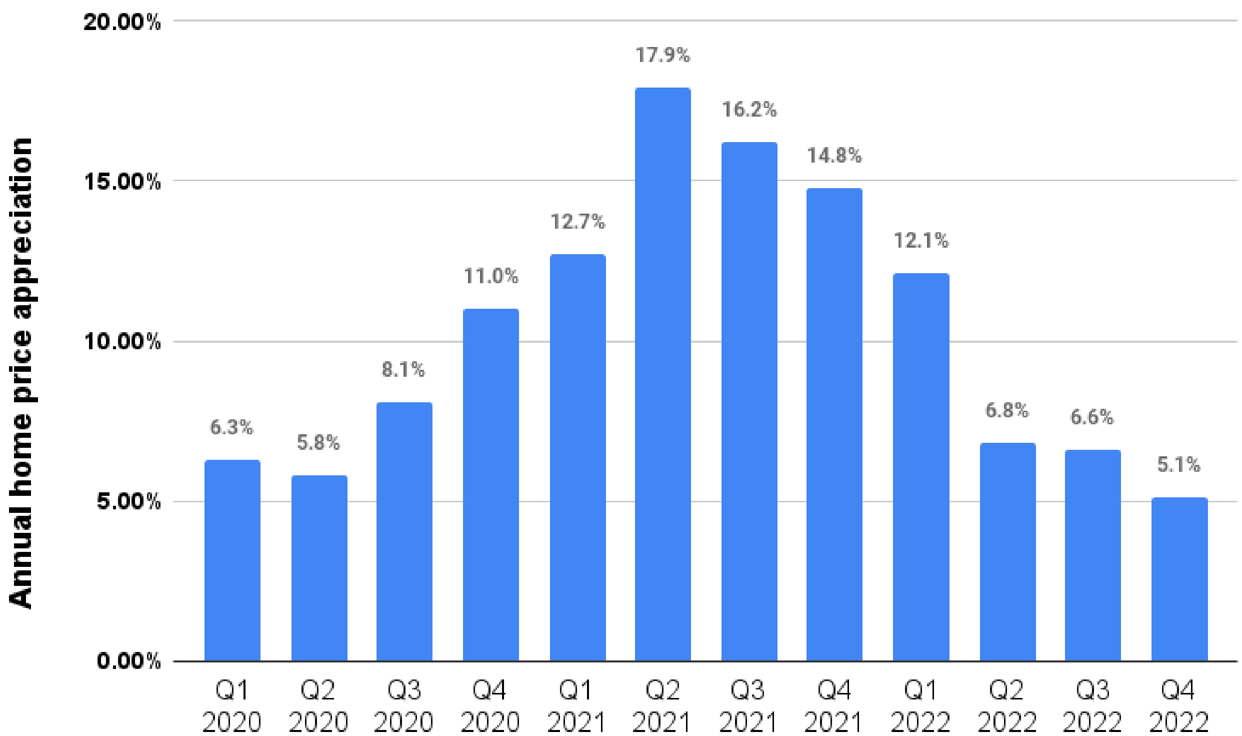
On the supply side, Palim said, "We think homebuilders will be able to increase production as supply chain disruptions and labor shortages alleviate, which should add to the inventory of new and existing homes available for sale."

On the demand side, “we expect the increase in housing demand we saw over the past year to ease, as the impact of unique recent factors lessens, including adjustments to accommodate pandemic-related remote work arrangements, stimulus checks bolstering household savings, and record-low mortgage rates.”

A recent analysis by tech firm and brokerage HouseCanary seems to bolster that view, finding that the gap between the number of new listings and the number of listings going under contract is shrinking.

For now, home price appreciation keeps setting new records. According to the Federal Housing Finance Agency’s Purchase-Only Index, home prices were up 15.7 percent in April from a year ago — the fastest annual growth in records dating to 1991.

Home price appreciation projected to decelerate



Annual home price appreciation by quarter. Appreciation after first quarter 2021 is projected. Source: Fannie Mae Economic and Housing Outlook, July 2021.

Fannie Mae economists say they now believe home price appreciation peaked at 17.9 percent during the second quarter of this year and will gradually decelerate over the next year and a half, averaging 5.1 percent during the fourth quarter of 2022.

“Nevertheless, we expect home price growth to become one of the more persistent drivers of inflation going forward, as other, more transitory factors diminish,” Palim said.

Those transitory factors include surging auto prices and charges for services like airline tickets, hotel rooms and eating out, driven by the relaxing of restrictions imposed during the pandemic.

Although many economists expect those transitory factors will diminish in the months ahead, Fannie Mae economists believe “broader inflationary pressure is building,” driven by other sectors including housing.

It takes awhile for the impact of rising home prices and rents to show up in statistics that track inflation, but housing could increasingly be an inflationary factor next year — an issue Fannie Mae analysts explored last month.

It’s also worth nothing that small businesses, which are having trouble hiring workers, are raising prices at rates not seen since 1981, according to the most recent survey by the National Federation of Independent Business.

Even temporary price increases “can affect consumer and firm psychology,” Fannie Mae researchers noted. “If inflationary expectations rise further, a wage-price spiral could potentially develop. If this occurs, a jump in longer-term interest rates is possible, along with a potentially earlier or more aggressive pace of Fed tightening.”

A crucial issue for housing markets is when the Federal Reserve will start tapering its purchases of long-term Treasurys and mortgage-backed securities. Those purchases, which have totalled $120 billion a month during the pandemic, have helped keep mortgage rates near historic lows.

Minutes from the Fed’s June meeting revealed that some members of the Federal Open Market Committee “expected the conditions for beginning to reduce the pace of asset purchases to be met somewhat earlier than they had anticipated.”

With the U.S. employment still down by 7 million jobs from a pre-pandemic peak, “we expect the Fed to be patient for now, but with growing inflationary pressure, talk of tapering sooner rather than later is likely to continue,” Fannie Mae researchers noted.

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