



The Daily Dish

The Fed and Housing

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Today at 9:00 a.m., S&P will release the May data for Case-Shiller house price index. Since this is essentially a piece of economic history, it will not yet reflect the Fed's recent interest rate increases or the decline in mortgage applications. Instead, it will likely show a year-over-year increase in the neighborhood of 20 percent and will be a reminder of the overheated state of the U.S. residential market. To get a glimpse of the same phenomenon on the rental side of the market (or if you just have a taste for housing gallows humor) check out this *Wall Street Journal* [story](#) about bidding wars for rental units.

As a reflection of these facts, the shelter component of the Consumer Price Index (responsible for one-third of the index) has exhibited an uninterrupted rise in inflation, from 1.6 percent in January 2021 to 5.5 percent in May 2022, with no signs yet of peaking. Notice that if shelter inflation gets to 6 percent, inflation on everything else must be zero for the Fed to hit its 2 percent target.

This leads to three observations: (1) As noted above, the Fed will have to take aim at housing just as a matter of fighting inflation, (2) it will take aim at housing as a way of broadly slowing the economy, and (3) the stated plan by the Fed cannot avoid affecting housing disproportionately.

To track the evolution of the housing market, stay tuned to Thomas Wade's [housing chartbook](#), which is updated quarterly. Notice, however, that as housing starts and residential construction decline, so does the demand for all sorts of goods and services associated with homebuilding - durable goods such as furnaces, air conditioners, stoves, ovens, and the like; household items such as carpeting and rugs, curtains, furniture, and so forth; and services such as inspections, landscaping, and others. Housing has always been an important channel for the transmission of monetary policy and slowing the housing market reduces demand in a broad swath of the economy.

Finally, the Fed's plan cannot avoid affecting housing especially strongly. As the Fed raises the federal funds rate, all interest rates will rise. Credit cards and auto loans will go up, and so will mortgage interest rates. (Indeed, mortgage rates have already risen sharply.) But there is a second channel of impact. As part of its monetary stimulus, the Fed purchased \$30 billion monthly in mortgage-backed securities (MBS), pumping \$30 billion in capital into the mortgage market each month. As part of tightening financial conditions, this will no longer occur. That means to get the same total amount of funds into the mortgage market, rates will have to rise even further to attract the \$30 billion in capital. But it doesn't end there. The Fed intends to draw down its holdings of MBS by \$35 billion a month, essentially pulling \$35 billion in capital out of the market. The upshot is that rates have to rise even a bit more to completely offset the \$65 billion (roughly 20 percent of mortgage funds at 2021 rates) net swing in mortgage funds.