Current Economic Conditions

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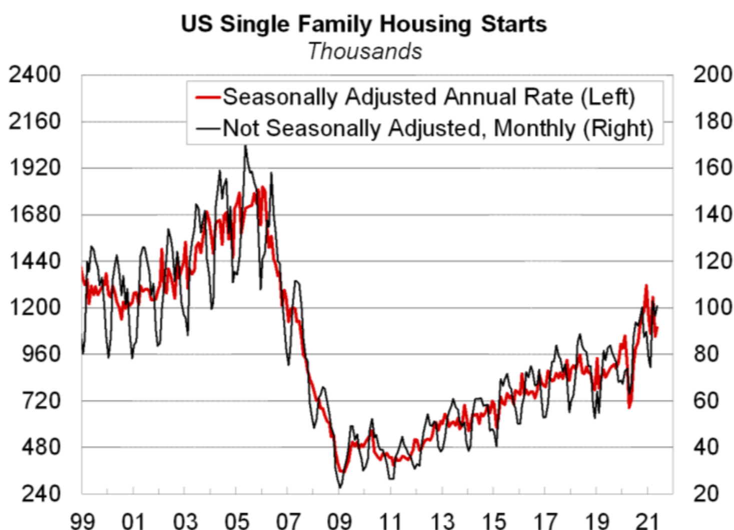
HOME CONSTRUCTION BEING CAPPED BY SUPPLY CONSTRAINTS

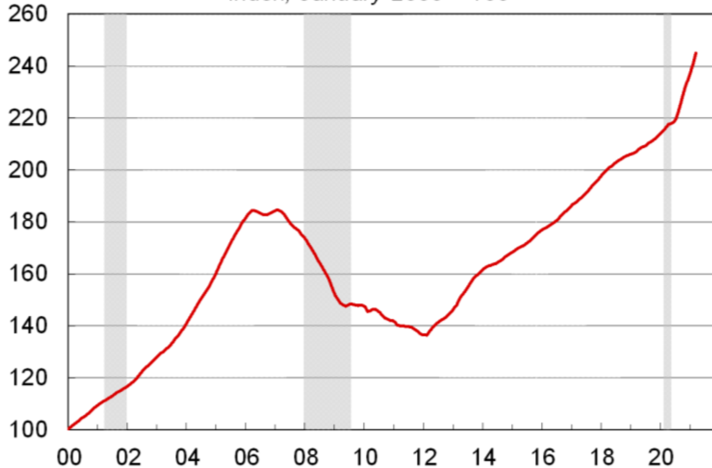
U.S. single-family housing starts, **reported as a seasonally adjusted annual rate**, declined 19.8% from December 2020 to April 2021, before a slight uptick in May. On the surface, this seems worrisome, not because of housing's direct contribution to Gross Domestic Product (less than 5%), but because housing sector activity tends to be a reliable leading indicator for the rest of the U.S. economy. However, the raw data tell a different story. **Not seasonally adjusted** starts rose to a 14-year high in March and remained near that level in May. The apparent decline in housing starts is the product of supply constraints and the seasonal adjustment process. Reported housing starts are likely to rebound later this year as supply constraints ease and seasonal adjustment factors become more favorable.



Like most government data, housing starts are adjusted to remove the effect of regular seasonal fluctuations, enabling comparisons of data from any two months or quarters rather than restricting meaningful comparisons to the same months or quarters in different years. In the case of housing, activity is generally much stronger in the spring and summer than in the winter. The seasonal adjustment process removes these seasonal swings by reducing starts during the spring and summer and boosting them in the winter. In most cases, the seasonally adjusted data are more useful, at least to economists and policy makers. But that isn't the case when starts are capped by supply constraints. If (unadjusted) starts remain constant because supply constraints won't allow them to go any higher, seasonally adjusted data will decline from January to June, then increase over the rest of the year. That's what we've seen so far this year.

In the long run, the number of houses built depends mostly on population growth. (More on that later.) In the short run, it depends on the four Ls: loans, lumber, labor, and lots. While loans and mortgage interest rates often get the most attention, they aren't restraining housing activity now. Quite the contrary; mortgage rates are near all-time lows. Home construction is being restrained by short supplies and high prices for lumber, by the inability of builders to find enough workers, and by difficulties builders encounter in finding lots on which to build. Because of shutdowns of sawmills early in the pandemic, beetle damage to trees, and tariffs on Canadian lumber, lumber futures prices rose 550% from April 1, 2020 to May 7, 2021. This added $36,000 to the price of an average single-family home. Lumber prices have since declined 40% but remain more than three times pre-pandemic levels. Labor supply has been a problem for builders since the 2008-2009 recession. Many immigrant workers left the United States then, and tighter immigration enforcement has made it hard for them to return. More recently, enhanced unemployment benefits have kept potential workers from filling the many job openings in construction. Difficulties in finding lots are another long-term problem, the result of local zoning boards restricting building to keep house prices up and large national builders' buying up lots during the 2008-2009 recession.

The combination of low interest rates, the desire to move from apartments and condos in the cities to single-family homes in the suburbs and exurbs, and supply constraints on building have pushed house prices to record highs. The median sales price of existing single-family homes stood at $347,400 in April, up 20.3% from a year earlier. In the short run, rising house prices, like rising stock prices, boost consumer spending. However, there is no long-term wealth effect, as gains to (older) people who own homes come at the expense of (younger) people who want to buy them. (Economists at the Federal Reserve don't seem to realize that there is no net wealth effect from higher house prices. Homeowners who celebrate higher house prices don't seem to realize that their gains are coming at the expense of their children.)



Supply constraints on home building are also keeping the economy from recovering as quickly as it could. The silver lining in this gray cloud is that the inability to meet demand for housing this year means that home building is likely to remain strong for a few more years as pent-up demand is satisfied. Because the business cycle in the United States has historically been mostly a housing cycle, this makes a recession very unlikely before 2024. Eventually, though, the Federal Reserve will have to react to rising inflation by ceasing asset purchases and raising short-term interest rates. The resulting increase in mortgage interest rates will trigger a decline in home construction and threaten to end the economic expansion. The subsequent recovery in construction is likely to be muted for demographic reasons. The combination of deaths due to COVID-19, a big decline in births, and a reduction in immigration during the Trump administration has significantly reduced Census Bureau projections of the U.S. population and – as I mentioned earlier – in the long run, the number of houses built depends mostly on population growth.

The Consumer Price Index surprised on the upside again in May. The total CPI rose 0.6% and was up 5.0% year-over-year. The core CPI (excluding food and energy) rose 0.7% and was up 3.8% year-over-year, the highest since 1992. Over the last three months, it has risen at an 8.3% annual rate. A third of May's CPI increase (and nearly a third of April's) was due to price increases for used vehicles. These will likely be reversed as the semiconductor shortage eases and vehicle production returns to normal. But rents – which account for about 40% of the core CPI – are accelerating, so inflation is likely to remain higher than the Fed expects even if some recent price increases are reversed. Higher inflation means the eventual rise in interest rates is getting closer, but continued dovish statements from the Fed suggest it probably isn't close enough to prevent an increase in inflation that could require a recession to reverse.

Housing tends to lead the overall economy because the building of a new house or the sale of an existing house triggers a stream of expenditures on building materials, paint, floor coverings, appliances, furniture and furnishings. Consequently, supply constraints on the building of new houses and the paucity of existing homes on the market will slow the recovery in industrial production this year, but satisfying pent-up demand for housing will provide continued support for industrial production over the next couple of years. Industrial production in U.S. manufacturing rose 0.9% in May, surpassing January's post-recession high. Motor vehicle production accounted for much of the increase but remains depressed.

To the extent that supply constraints in the housing sector and overall economy are caused by enhanced unemployment benefits and childcare responsibilities, they should ease in September when enhanced benefits expire and schools reopen. According to the Job Openings and Labor Turnover Survey (JOLTS), there were a record 9.3 million U.S. job openings at the end of April. I expect many of those openings to be filled in September as workers reenter the labor force and payroll employment surges.

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