KPMG Economics

A supply drought
Housing, inflation & the Fed

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"Water, water every where,

Nor any drop to drink."

That line from Samuel Taylor Coleridge's poem "*The Rime of the Ancient Mariner*" has always haunted me. Its imagery of scarcity amidst abundance seems an apt metaphor for ongoing constraints on the housing market, despite the strongest recovery from a recession since the early 1980s.

There is no topic that has evoked more emotion over the last year than my discussions on the dynamics of the housing market. The anger and resentment are palpable, especially when I talk about it on my X-feed (the platform formerly known as Twitter).

I understand. Shelter is a basic need, along with food and water; it is unaffordable for too many. The problem predates the pandemic, but the pivot online and shift to work and schooling from home exacerbated the problem.

Home values have gone up more than 50% since 2019, rents have risen more than 30%. Wages and salaries have risen about 18%.

Many have lost hope of ever owning a home. A recent poll revealed that eight in ten renters still aspire to own a home, but more than 60% believe they will never be able to do so. Millennials are the most disillusioned.

It reminds me of the sense of foreboding my father felt when I was young. The stagflation of the 1970s and double-digit interest rates of the early 1980s left him convinced that I and my generation would never achieve the milestones he had.

The economy remains strong

This iteration of the forecast includes an upward revision to the immigration data, which strains state and local resources, but adds to the overall economic growth. The increase in immigration boosts labor force growth, the pace that employment continues to improve and consumer spending in 2024. We have also kept a shock to the VIX before and after the election, given the high probability of a contested election outcome.

Real GDP is expected to rise 2.3% in the first quarter, a sharp slowdown from the 3.4% pace of the fourth quarter. However, much of that "weakness" is due to a large widening of the trade deficit; imports of services (travel abroad) was especially strong. Consumer spending moderates but does not collapse, while the housing market gains momentum. Business investment slows but inventories drained in the fourth quarter are rebuilt. Government spending slows in response to a drop in federal spending, which was curbed due to the continuing resolution.

Real GDP is forecast to rise 2.1% in the second quarter. Gains in consumer spending are expected to drive overall growth along with the housing market. Business investment continues to slow, inventories are little changed and the trade deficit further widens. Government spending remains subdued, with a rebound in federal spending triggered by the budget deal offset by a slowdown in state and local spending.

Fed holds. The Fed is now expected to hold off on rate cuts until September and cut only twice instead of three times in 2024.

One of his greatest accomplishments was the purchase of my childhood home with my mom, the epitome of the "American Dream." It was a tiny brick house with the same floor plan as all the others that lined our street. I never had to ask where the bathroom was when playing with all my friends on the street. It was built in the wake of WW-II to house soldiers returning home and working in the auto plants in Detroit.

Rates fell and homeownership rebounded. I ended up buying my first home at the same age that my father had. I remember the day our offer was accepted. It was Saint Patrick's Day. The realtor told me I had the luck of the Irish. In Chicago, everyone is Irish on Saint Patrick's Day.

Fast forward to today. The mortgage winter, which has frozen existing homeowners in place and buyers out, is primed to thaw. Listings are beginning to pick up. That doesn't mean the housing shortages will soon dissipate; they are chronic.

Estimates are all over the place, ranging from a low of 1.8 million to a high of 5.5 million, depending on the methodology. Reality is somewhere in between. I prefer estimates based on demographics and the stock of homes in the market. They suggest that the shortfall is closer to three million.

The data are worse for the poorest households. We need some seven million homes to house those who earn the least; that is gut-wrenching and provides context for the ranks of the working homeless.

This edition of *Economic Compass* takes a close look at the outlook for housing, what it means for the outlook for inflation and how the Federal Reserve will react to those shifts. Recent inflation data has reminded us that the path down on inflation can be "bumpy." The improvement in home values and rents could stall, while other prices related to housing could rise.

The good news is that we appear to be at a peak in rates. The Fed would rather hold rates higher for longer than risk a recession to cross the finish line on inflation. The bad news is that we now expect two instead of three rate cuts this year.

The housing outlook

Table 1 summarizes the outlook for housing given the forecast for a soft landing or better:

- New and existing home sales are forecast to rise 5.4% to 5.03 million units in 2024. New home sales are expected to pick up more than existing home sales.

Table 1

Housing Outlook

	2022	2023	2024
Home Sales*			
Total (Thousands)	5724	4767	5025
Existing	5087	4101	4300
New	637	666	725
Housing Starts			
Total (Thousands)	1551	1422	1460
Single-family	1004	946	1100
Multifamily	547	476	360
Prices (% change, year-end)			
Median existing single-family	1.8%	3.7%	2.0%
S&P CoreLogic Case-Shiller	5.7%	5.6%	3.9%
FHFA	6.8%	6.7%	5.0%

*Includes condos, co-ops and single-family homes.

- Housing starts are forecast to rise 2.7% to 1.46 million units in 2024. A double-digit jump in single-family starts is expected to offset a sharp drop in multifamily construction.
- Home values are forecast to rise between 2% and 5%, depending on the measure. That is a slight moderation from last year.

"The outlook for the housing market rests on a complex mix of the ability and willingness to buy."

Underlying fundamentals

Millennials are a force to reckon with

The outlook for the housing market rests on a complex mix of the ability and willingness to buy:

- The economy is expected to continue to grow in 2024, but at a slower fourth-quarter-to-fourth-quarter pace than in 2023; unemployment is expected to remain near record lows.
- Wage gains are expected to cool but not collapse, which is helping to improve affordability along with a slowdown in the pace of housing appreciation.
- The number of new homes completed topped 1.7 million in February, the largest number since the start of 2007. That is not enough to meet all demand, especially for those with the lowest incomes, but it is a step in the right direction.

- Builders have proven themselves nimbler, moving downscale on size and offering incentives, including mortgage rate discounts to attract first-time buyers.
- Listings are starting to pick up.
- Millennials are forming households, having children and moving into their peak home buying age – more than 12,000 are turning 35 a day, the largest cohort to do so on record.
- The desire to buy remains elevated, despite low affordability; the largest hurdle to acting among high-income prospective buyers is a drop in rates.
- Every time rates drop below the 7% threshold, applications to purchase a home pick up; we are close to that level now.
- Aging in place continues, but more arbitrage opportunities exist for buyers willing to trade their suburban homes for smaller condos and co-ops.

It would not take much of a drop in rates to unleash pent-up demand, especially among the largest generation of young adults we have ever seen.

Subdued gains

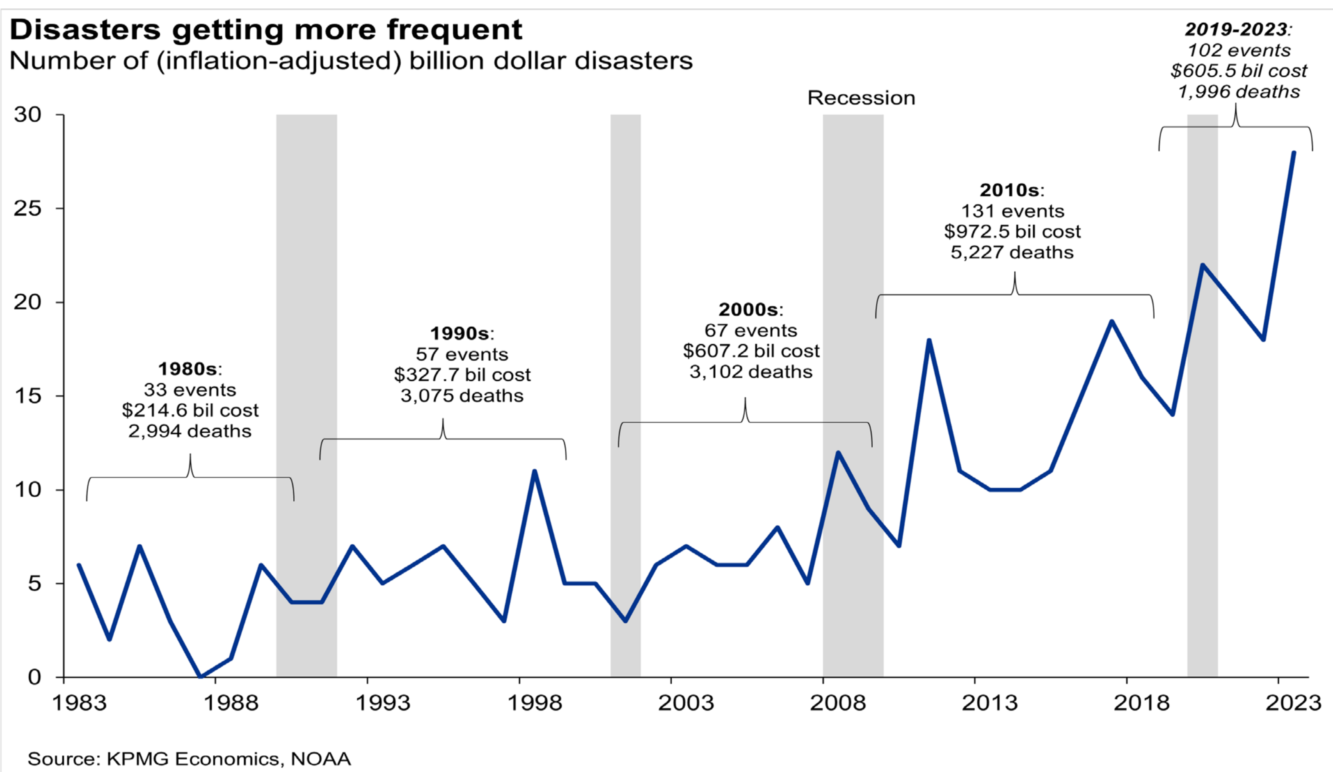
Existing and new sales rise

Existing home sales are expected to rise to 4.3 million in 2024, up 4.9% from 2023. The gains are expected to come in fits and starts, given the uncertainty about the timing of rate cuts but the trend is in the right direction. Supply is the primary constraint to stronger growth but other factors are now weighing on decisions.

Climate change is beginning to affect decision making. Areas most exposed to climate disasters are selling at a discount relative to properties with lower risks. Low-income households were left no choice but to live in the highest risk and least desirable areas.

The damage associated with extreme climate events is accelerating. (See Chart 1.) Insurance companies have begun to raise premiums or pull out entirely from areas with the highest risks. Lenders are likely to follow suit and tighten standards for homes in the most exposed areas. Those shifts hit low-income households harder.

Chart 1



Wealthy households who want the amenities of a beach view are more likely to take or discount that risk. They can either afford the exorbitant insurance associated with building near rising water levels or discount the risk of a disaster affecting them. Consumers who have done better financially, and suffered fewer setbacks in their lives, tend to believe they will continue to do so and vice versa.

The pivot to work-from-home and surge in weddings and births post-pandemic has prompted buyers to move much further from their work than they were pre-pandemic. Average commutes have increased by 10 miles to 27 miles; millennials have moved the furthest away from their work. That suggests that: 1) there is no putting the work-from-home genie in the bottle and 2) demand for homes in suburban and even exurban areas is expected to remain robust.

Urban centers still offer students, empty nesters and many families opportunities. Cities offer a broad spectrum of services that small communities might not have, from healthcare to entertainment and mass transit. Their demise has been greatly exaggerated.

There is an arbitrage opportunity for empty nesters to trade in their suburban home for a premium and get a deal on condos and co-ops in some urban centers. I talked to two who have done so in the last week alone in Chicago.

Many of the hottest pandemic markets have seen a drop in prices, but migration to those markets remains strong. Austin is a good example.

First-time buyers are relying more on their parents to help them with down payments than in the past. Many have parents who have either locked into ultralow rates or paid off their mortgages, which has made it easier for them to help their children with down payments.

The downside to the shifts associated with climate change and the inter-generational wealth transfers is that they tend to exacerbate inequalities. Older, white parents own an outsized share of homes and are better positioned to help their children than other groups.

Single women are the fastest rising demographic of home buyers. They have out-attained men in education through graduate school, and narrowed but not fully closed the gap in what they earn relative to men.

New home sales are expected to rise faster than existing sales, reflecting a move downstream by builders. Builders have become extremely nimble and able to adjust to market conditions as they change. They rolled back incentives in recent months as demand picked up from falling mortgage rates.

New home prices dropped in recent years, as builders built smaller homes. However, there is a limit to how much more they can continue to reduce prices. Zoning laws and land values are buoying property costs, while supply chains remain fragile and complaints of worker shortages are still common.

Regional differences. Pending home sales, which tend to lead overall sales by a month or two, rebounded slightly in March after losing ground earlier in the year. The South and Midwest saw gains, while higher cost regions in the Northeast and West continued to struggle. A drop in mortgage rates will more evenly spur demand across regions, although migration from high- to low-cost areas continues.

The new low-cost areas are now in the Midwest, which didn't experience the surge in migration or prices that occurred in pandemic hot spots. Pockets in the South remain destinations, including Texas and Florida. Arizona has cooled substantially over the last year, which is reflected in a rise in listings.

Housing starts diverge

A jump in single-family starts, which are counted when ground is broken on a new project, is expected to offset a sharp drop in multifamily construction. Publicly traded home builders have deep pockets and have been able to clear a profit as they moved downscale and offered mortgage buydowns to tap millennial demand.

Multifamily construction ballooned in recent years but started to slide in 2023. The softening of rents, higher rates and tighter lending standards took a toll on valuations. The largest overbuilding occurred in the markets where people were migrating.

However, most in the industry believe that valuations on multifamily properties are nearing a bottom. Apartment demand remains strong in many of the most overbuilt markets.

That suggests that the relief we see in rents could be temporary. Space could be scarce again as we get into 2025 and 2026. Overall rent indices have already begun to move up after slowing dramatically in 2023.

Why can't we just convert more office space into affordable housing? The tradeoff is hard to make economically feasible, given the costs. Office spaces lack the basic amenities needed for housing, including things like plumbing for kitchens and baths. Many have hefty tax consequences along with all the other zoning and regulations required to convert to residential.

Regional differences. The South has long been the dominant player in construction markets, as they have the easiest permitting process and an abundance of land. (The South includes Texas in the official statistics.) The move from colder climates to warmer winter climates, notably by retirees, has combined with the migration of younger professionals to the region.

The West and Midwest are expected to gain some ground in the year to come. The largest constraints on land are in the Northeast, which has limited its recovery. Permits in the Northeast have not moved much in recent years and are expected to remain subdued.

Moderating price pressures

Home prices are forecast to continue rising, but at a slower pace in 2024. First-time buyers are expected to put a cap on how much higher homes appreciate. Much depends on the extent to which listings rise.

Another hurdle is the stock of housing, which has aged and fallen into disrepair. The median age of existing homes is 40 years old, nearly a decade older than the median age of homes going into the housing bust.

Fewer owners repaired and upgraded their homes after home values plummeted. Homeowners who age in place are often constrained by low fixed incomes. Both trends have left us with fewer move-in ready homes.

Other costs that could put a damper on the price that buyers are willing to pay include real estate taxes and insurance. Retirees can get taxes capped but younger homeowners cannot. Homeowners' insurance has skyrocketed or disappeared entirely. Even those who paid off their mortgages or locked into ultralow rates are struggling with escalating expenses.

Lenders are starting to take note and, much like insurers, are likely to pull out of some of the riskiest areas. That will further limit access to affordable housing. Some of the cheapest homes have the highest exposure to climate change.

The number of overvalued markets according to Moody's has dipped over the last year, as prices in some of the hottest pandemic markets moderated. However, affordability remains low across much of the nation.

Over the next year, prices are expected to rise in the Midwest and parts of the Northeast, such as New York and Pennsylvania. Georgia, Alabama and Louisiana are expected to also see increases. The soft spots are expected to be Arizona, Colorado, Idaho and Utah – those areas saw outsized gains earlier in the recovery.

Implications for inflation

Changes in shelter costs tend to show up with a lag, as it takes time for homes and leases to turn over. That is one reason that many expected overall inflation to further moderate in 2024. It is unclear if the slowdown we are seeing in rents and prices will be enough to accomplish that goal.

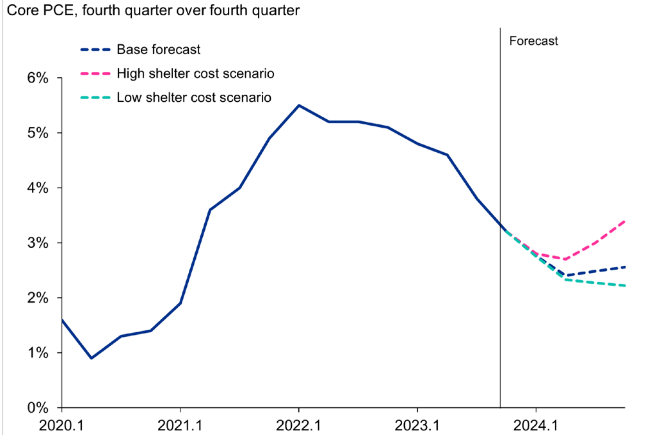
Prices in the services sector picked up at the start of the year. Medical costs and insurance premiums are only beginning to reflect the surge in demand and constraints due to staffing shortages.

A pickup in housing should spur spending on goods which could derail the drop in goods prices. Meanwhile supply chain fragility persists. The slowdown in traffic in the Panama and Suez Canals are two examples. The collapse of the Francis Scott Key Bridge, which carried 4,900 trucks per day, is another example - $28 billion in goods will need to be rerouted.

Chart 2 shows three scenarios for core PCE inflation, the Fed's favored measure. Comparisons in the back half of the year get harder when measured on a year-over-year basis, due to the sharp deceleration we saw in price levels in the second half of 2023. The trajectory underscores the challenges that the Fed faces. The base case suggests that inflation will cool but less so than a month ago.

Chart 2

Shelter inflation a risk for back-half 2024
Core PCE, fourth quarter over fourth quarter



Note: Forecasts are time-sensitive and dated as of April 5, 2024.
Source: KPMG Economics, BEA, NAR, FHFA, S&P CoreLogic

Risks. The forecast only has modest increases in energy prices. A surge in oil prices can't be ruled out, given escalating tensions in Ukraine and the Middle East.

A slower glide path for the Fed

Participants in the March Federal Open Market Committee (FOMC) meeting were closer than many realized to two instead of three cuts for the year; 9 of 19 participants forecast two cuts or less. We now expect only two rate cuts in 2024.

The next forecast is due in June but the players around the table will shift. President Loretta Mester of the Cleveland Fed, who favored waiting on cuts, is retiring. President Alberto Musalem of the St. Louis Fed starts in April and will attend his first official meeting in May. He is not a voting member of the FOMC this year.

Rate cuts for 2025 were also scaled back. The Fed is using a slower glide path to enable supply more time to catch up with demand. That is an especially heavy lift in the housing market, given how large the gab between supply and demand remains.

Risks. The Fed is the world's most influential central bank. Emerging markets are particularly sensitive to the Fed's decisions. The slower glide path may cause them to delay their own cuts. If emerging market central banks cut too fast, then their currencies may rapidly depreciate. That could raise their import prices and debt servicing costs. The more the Fed delays rate cuts, the more downward pressure that puts their currencies, inflation and the costs of servicing the debt. That could delay rate cuts and up the risk of a larger financial crisis.

Bottom Line

The economy has made great strides since the depths of the COVID-recession, but gains remain uneven. Scarcities in the housing market persist, despite some catch-up in construction in recent years. My childhood home was not much by today's standards. It didn't need to be; it represented the first rung on the ladder to building wealth for a young family that had little.

That is all millennials and those behind them want, a chance at achieving that same dream. The goal is to allow some catch-up for those still feeling left behind. Even a small drop in rates represents a step in that direction.

Economic Forecast — April 2024

	2023	2024	2025	2023:4(A)	2024:1	2024:2	2024:3	2024:4	2025:1	2025:2	2025:3	2025:4
National Outlook												
Chain Weight GDP[1]	2.5	2.6	1.9	3.4	2.3	2.1	1.7	1.8	1.8	1.9	1.9	2.1
Personal Consumption	2.2	2.5	2.4	3.3	2.6	2.6	1.8	2.4	2.6	2.5	2.6	2.6
Business Fixed Investment	4.5	3.0	2.3	3.7	3.2	2.1	3.0	1.8	2.3	2.5	2.4	2.7
Residential Investment	-10.6	4.7	0.7	2.8	10.6	5.2	0.1	-0.5	-0.5	0.8	1.8	3.9
Inventory Investment (bil $ '17)	44	76	77	55	70	75	80	81	80	79	75	76
Net Exports (bil $ '17)	-928	-995	-1053	-919	-968	-995	-1004	-1013	-1032	-1044	-1060	-1076
Exports	2.6	3.9	4.3	5.1	5.5	3.3	5.0	4.8	3.7	3.9	4.7	4.5
Imports	-1.7	4.8	4.7	2.2	10.0	5.6	4.6	4.5	4.8	4.2	5.1	5.0
Government Expenditures	4.1	2.3	0.4	4.6	1.0	0.9	0.6	0.3	0.2	0.3	0.3	0.3
Federal	4.2	1.5	0.5	2.4	-0.8	1.1	0.8	0.4	0.4	0.4	0.6	0.6
State and Local	4.0	2.8	0.2	6.0	2.1	0.8	0.5	0.2	0.2	0.2	0.2	0.2
Final Sales	2.9	2.5	1.9	3.9	2.0	2.0	1.6	1.8	1.8	2.0	2.0	2.1
Inflation												
GDP Deflator	3.6	2.5	2.4	1.6	3.1	2.5	2.5	2.4	2.3	2.4	2.5	2.5
CPI	4.1	3.1	2.3	2.7	3.7	3.4	2.6	2.0	1.4	2.4	3.1	3.1
Core CPI	4.8	3.4	2.6	3.4	4.1	3.1	2.9	2.7	2.4	2.5	2.6	2.6
Special Indicators												
Corporate Profits[2]	5.1	5.9	1.6	5.1	10.8	13.2	9.9	5.9	2.9	0.9	1.1	1.6
Disposable Personal Income	4.2	2.1	3.4	2.0	1.3	2.6	3.4	3.5	4.2	3.0	2.7	2.9
Housing Starts (mil)	1.42	1.46	1.42	1.48	1.46	1.49	1.48	1.44	1.43	1.43	1.42	1.42
Civilian Unemployment Rate	3.6	3.9	4.2	3.8	3.8	3.8	3.9	4.0	4.1	4.2	4.2	4.2
Total Nonfarm Payrolls (thous)[3]	2936	1582	619	617	727	401	286	168	121	161	151	186
Vehicle Sales												
Automobile Sales (mil)	3.1	3.1	3.1	3.1	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Domestic	2.3	2.1	2.1	2.3	2.1	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Imports	0.9	0.9	1.0	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0	1.0
LtTrucks (mil)	12.4	12.6	12.9	12.6	12.3	12.6	12.7	12.8	12.8	12.9	13.0	13.0
Domestic	9.9	9.9	10.0	9.9	9.8	9.9	10.0	10.0	10.0	10.0	10.0	10.0
Imports	2.5	2.7	2.9	2.6	2.5	2.7	2.7	2.8	2.8	2.9	3.0	3.0
Combined Auto/Lt Truck	15.5	15.7	16.0	15.7	15.4	15.7	15.8	15.8	15.9	16.0	16.1	16.1
Heavy Truck Sales	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.0	16.2	16.5	16.2	15.8	16.2	16.2	16.3	16.4	16.5	16.5	16.6
Interest Rate/Yields												
Federal Funds	5.0	5.3	4.5	5.3	5.3	5.4	5.3	5.1	4.8	4.6	4.3	4.1
10 Year Treasury Note	4.0	4.0	3.3	4.4	4.2	4.3	4.0	3.8	3.6	3.4	3.2	3.0
Corporate Bond BAA	5.9	5.9	5.5	6.2	5.7	6.0	5.9	6.0	5.7	5.6	5.4	5.2
Exchange Rates												
Dollar/Euro	1.08	1.09	1.10	1.08	1.09	1.08	1.09	1.09	1.10	1.10	1.10	1.10
Yen/Dollar	140.5	147.6	138.8	147.8	148.5	150.0	147.0	145.0	143.0	140.0	137.0	135.0

[1] in 2023, GDP was $22.4 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.