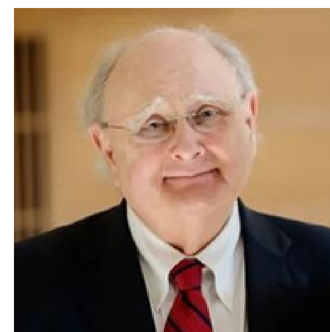
Viewpoint Update (April 5, 2023): Homebuilding

By Thomas Goho

It’s quite apparent that interest rate increases, from early 2022 to the most recent meeting of the Federal Reserve, are having the impact that the Fed would like: Housing starts have slowed down. Housing starts up to the present went from some 1.8 million starts on an annualized basis down to some 1.45 million units on an annualized basis. That's a significant drop. Rather than saying homebuilding is a fairly good barometer of economic health, I’m more inclined to say that it is a barometer for what the Fed is doing—and what it can do.



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The construction and homebuilding industries constitute somewhere between 3 percent and 5 percent of the nation’s GDP in a typical year. To be sure, the drop in housing starts will have a ripple effect on lumber prices and the demand for forestry workers. The precipitous drop over the past year will also impact the price of copper, paints, chemicals, and other staples of homebuilding.

What’s notable, however, is the extent of the Fed’s influence. Over the decades, the ability to raise interest rates and precipitate whatever it was that the Fed wanted to precipitate has become a lot less limited than, say, 40 years ago. Today, a whopping 80 percent of America’s GDP is made up of services. The services economy is vast. Whether it's a dog groomer, a dentist, or a person who does automotive detailing, whatever the service is across a wide and varied spectrum, it tends not to be capital-intensive. These are not businesses that have significant borrowing needs.

Every now and then a business owner will need a new pick-up truck or delivery van and, most likely, get financing in place. But think about the example here with the automotive sector. Even with higher interest rates, there's a tremendously pent-up demand in that sector. If the Fed continues to raise rates along the lines of what they've been doing so far—say, to 5 or even 5.25 percent—that could indeed impact the auto market. Until then, however, there's still a kind of overhang because of everything from the shortage of microchips to the reduction in available supply.

That housing prices are beginning to suffer is a manifestation of higher interest rates. But only for the western half of the United States. It's not true in the East, where housing prices continue to go up and sales are robust. The country is potentially going to see a different impact, at least for a while, between the West and the East. Yet in an aggregate sense, the Fed hasn't really accomplished what it wants to accomplish by any stretch of the imagination.

Notwithstanding what the capital markets are saying, I think the Fed is going to keep interest rates elevated for significantly longer than the market analysts are saying, especially those following the bond market. Most Fed watchers think that its mission has yet to be accomplished. I think Jay Powell has been very explicit about wanting rates to go up enough so that we begin to see a softness in labor markets. Of course, the ultimate goal is the stabilization of prices—something I don't see anywhere in the near future. Read the minutes of Fed meetings and they're certainly more optimistic than I am. My view is that inflation isn't going to be coming down within the timeframe of what the Fed thinks it needs. The Fed has blundered in so many ways with its behavior that at this point they've put themselves into a box. That's unfortunate because their job is truly a long way from being completed.

I'm not saying they're going to keep raising rates all the way through 2023, but I certainly don't see them even thinking about bringing those short rates down until sometime in 2024—if they're lucky. Many economists simply can't understand what the Fed has been thinking. They were citing data in 2021 that inflation was transitory. Then they waited five months and all along continued to expand their balance sheet. It can be difficult to separate a federal agency from the political realm. The Fed is supposed to be pursuing an independent policy. But at the same time, they've been buying up large chunks of Treasury debt. That debt level is going to do nothing but escalate. That's when we need to ask the question: Who are the buyers of this debt in significant quantities if not the Fed itself?

The Fed balance sheet looked like it was beginning to roll down a little bit. They said that as debt matured they wouldn't put it back out in more treasuries and mortgage-backed securities. But look at the data: Before the pandemic, its balance sheet was hovering near $4 trillion. It then peaked out at some $9 trillion and dropped back to around $8.6 trillion. Today, with serious troubles at Silicon Valley Bank, and then Signature, and even First Republic, that amount is ticking back up again.

The bottom line? The Fed has not demonstrated that it can implement balance sheet adjustments to be more in tune with reality. With the wave of debt coming, it's a completely unanswered question as to how the market is going to clear of this debt, even where rates are now.

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