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A Head-Fake

May housing starts jumped nearly 22% to 1.62 million units, the highest reading since April 2022 as both the single (19%) and multi-family (27%) components soared. Notably, housing permits rose by a much lesser, but still healthy, 5% for the month. Is this the beginning of a sustained housing market recovery? No. The better-than-expected figures simply reflect an inevitable bounce after a sustained period of extraordinary weakness. Only when the cost of financing declines will a meaningful recovery begin.

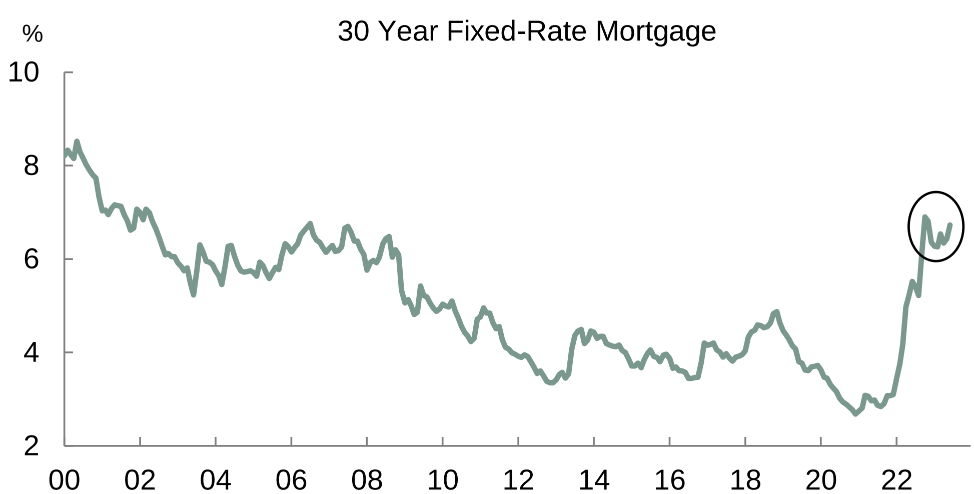
Real residential investment spending as measured in the GDP accounts peaked in Q1 2021. The series has fallen for eight consecutive quarters, although the May bounce in housing starts does hint at an increase in residential investment this quarter. This is the longest streak of declines since the record of 13 straight drops which spanned 2005 to 2010. It is not unusual for housing to retrace previous softness only to decline again. The data generally do not move in a straight line.

Since the peak in residential investment, spending is down a cumulative 22%, which is massive. There are only a handful of instances when activity declined more than this in a two-year period. It happened in 1952, 1974-1975, 1980-1982 and 2007-2010. Eventually, housing improved but only after borrowing costs fell and the yield curve normalized. In other words, the Fed started cutting interest rates.

Today, borrowing costs are high, and the curve is deeply inverted. **Mortgage rates remain up near 7% and mortgage spreads are close to 300 basis points** (bps). This has negatively impacted housing affordability at the same time because it is now harder for prospective buyers to obtain financing. It is hard to imagine a sustained housing improvement has begun.

Only Fed easing will rectify the situation of high mortgage rates and an inverted curve. But monetary policymakers are leaning toward further rate hikes, not rate cuts. If our employment projections are on the mark (243k on nonfarm payrolls and 3.7% on the unemployment rate) the Fed will likely raise rates another 25 bps at the July 26th FOMC meeting. Consequently, the latest housing figures are probably a head-fake in what is an otherwise poor fundamental backdrop for the real estate sector.

Elevated Mortgage Rates Point to Elusive Housing Recovery



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