



# Surging Home Prices May Lead to Rate Hikes

The return of housing as an economic driver gives the Fed options.

June 2021

## KEY INSIGHTS

- Booming U.S. house prices will likely give the post-coronavirus recovery a very different complexion compared with that which followed the global financial crisis.
- The restoration of housing as a key economic driver may give the Federal Reserve more leeway to hike rates in the short to medium term.
- In the long term, overbuilding and slow population growth may keep the “natural” rate of interest low.



**Nikolaj Schmidt**  
*Chief International Economist*

Home prices in the U.S. are booming and may continue to do so for a while yet. This will likely give the post-coronavirus economic recovery a very different complexion compared with the recovery that followed the global financial crisis (GFC), when weak demand meant that growth was slow and interest rates continued to fall. The restoration of residential housing as a key economic driver may give the Federal Reserve more leeway to hike rates in the near to medium term—although its ability to raise rates over the longer term will likely be constrained by changing demographics.

The strength of the U.S. housing market is a matter of supply and demand. Following the GFC, the economy faced two major headwinds that kept activity in the American construction industries depressed for almost a decade. First, the crisis triggered broad-based deleveraging by torpedoing both

lenders' and borrowers' balance sheets: Lenders faced the dual headwind of increased regulatory scrutiny and stricter internal risk management requirements, which served to depress mortgage availability; borrowers, weighed down by poor employment prospects and negative equity in their houses, chose to repay their debts to reduce their leverage.

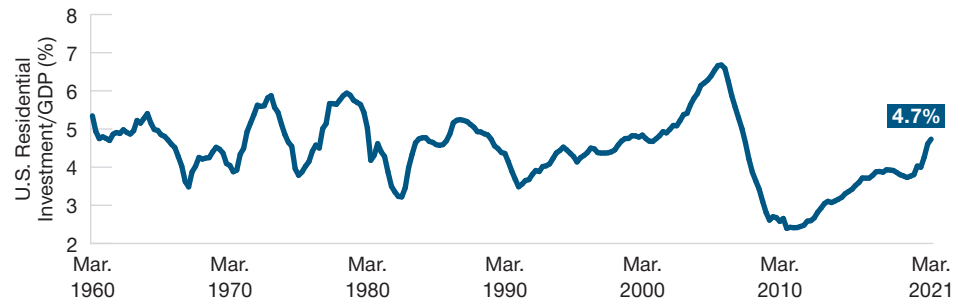
Second, there was a substantial overbuild of houses during the boom years prior to the GFC—an overbuild that would take almost a decade to digest.

In 2019, I argued that the clearing of the housing inventory overhang and improvement in household balance sheet meant that the era of household deleveraging had come to an end—and, therefore, that the belief among some economists that we had entered a period of “secular stagnation” was likely false. At the time, I expected activity in the construction sector to

“The strength of the U.S. housing market is a matter of supply and demand.”

## The Construction Industry Strikes Back

(Fig. 1) Residential investment has been rebounding strongly



As of March 31, 2021.

Source: The Bureau of Economic Analysis.

“  
The construction sector is returning with a vengeance...”

pick up quickly. The unexpected shock from the coronavirus affected the timing of that call, but it did not derail it: The construction sector is returning with a vengeance as, courtesy of fiscal transfers and rising savings rates, household balance sheets have improved further.

### The Coronavirus Has Fueled Demand for New Homes

The coronavirus has fueled demand for housing in two ways: First, because the pandemic-induced fall in interest rates has made owner-occupied housing more affordable; and second, because the lockdown has made many existing householders yearn for more space. Combined, these two factors have reinvigorated the demand side of the residential housing market.

On the financing side of the ledger, the combination of high cash balances and healthy bank balance sheets imply that the supply of mortgage financing is unimpaired: Banks have a lot of low-yielding assets on their balance sheets in the form of cash and, consequently, are seeking to accumulate slightly higher-yielding assets such as mortgages. While banks continue to operate under tighter regulatory scrutiny, they appear to be in a good position to support the recovery of the housing market.

For mortgage lending to accelerate further, economic uncertainty and unemployment have to fall—both of which facilitate risk-taking by banks. We expect both to occur in tandem with the vaccine rollout and the economic reopening.

On the supply side of the housing market, after a decade of subdued construction, the housing inventory overhang had already cleared prior to the coronavirus recession. As the demand for additional living space accelerated during the pandemic, the number of unoccupied homes in the U.S. fell to a level that is low by historical standards.

Thus, construction should reengage as a strong cyclical driver, and in my view, the dynamics of the housing sector will be very different compared with the dynamics that followed the GFC. The restoration of construction as a key economic driver will likely add power to the post-pandemic recovery and may pause—if not end—talk of “secular stagnation.”

### Two Key Challenges to the Housing Recovery

There are two key challenges to the U.S. housing recovery story. The immediate near-term challenge arises from the fact that the number of people per household in the U.S. fell markedly

during the pandemic and currently sits close to its historic low—making it possible that some of the demand for housing has already been satisfied. Even if this is the case, however, the stock of vacant housing remains low, and construction will need to reestablish an appropriate inventory of vacant housing.

The second, and more significant, challenge arises from the changing demographics. While home construction should be strong for some time as inventories rebuild, it will eventually need to settle at a pace that is slower than that of the boom times of the mid-2000s. As housing investment settles to reflect the demographic headwind, its potency as an economic driver will likely diminish.

Overall, I believe that improved demand for housing will continue to support home prices, and the low stock of vacant housing will keep construction activity buoyant. Altogether, this will raise inflationary pressures and may give the Fed more scope to hike rates.

Over the next couple of years, however, it is likely that the housing inventory restocking will be completed and there will be some overbuilding as the macro impact of demographics will be slow to register with households and construction companies. In turn, this may keep the natural rate of interest—also known as the  $r^*$ —low relative to history.

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

### Important Information

**This material is being furnished for general informational and/or marketing purposes only.** The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

**Australia**—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

**Brunei**—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

**Canada**—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

**China**—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

**EEA ex-UK**—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

**Hong Kong**—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

**Indonesia**—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

**Korea**—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

**Malaysia**—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

**New Zealand**—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

**Philippines**—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

**Singapore**—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

**South Africa**—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**Taiwan**—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

**Thailand**—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

**UK**—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

**USA**—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2021 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.