"Tight Money" Making a Dent

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For borrowers in general, a point or two increase in interest rates doesn't seem like a lot. But for homebuyers, the Fed's recent policy of raising rates has had a numbing effect on the housing market. From the low point last year of 3.03%, the 30-year fixed rate mortgage has doubled in cost to a recent high of 6.11%. The Wall Street Journal reported that existing home sales fell consecutively for the last six months. (Here in Charleston, South Carolina, sales have fallen for the last eight months.) For the nation, that is the longest decline in more than eight years. Nationally, the decline was attributed to higher mortgage rates and a shortage of homes. Not so in Charleston where inventories are up 15% over a year ago.

Monetary policy can be a driving force particularly when it comes to the housing market. Back in the Sixties, the Fed had some hefty means to manipulate the economy. One especially powerful tool was Regulation Q that was created in 1933, in accordance with the Glass-Steagall Act; with the goal of prohibiting banks from paying interest on checking accounts. Regulation Q eventually led to the emergence of money market funds as a workaround to the prohibition of paying interest on deposits. In 1965, this regulation crimped the mortgage market as interest rates rose above the set limit. As a result, the housing market went into a tailspin as savings and loan associations lost deposits to other financial intermediaries that could pay higher interest rates, such as money market funds. In 2010, the original version of Regulation Q was repealed. Even though the Fed does not have such heavy-handed tools today, hints of higher interest rates can still strike fear into financial markets.

For short-term investors, once the Fed embarks on tighter money policy, a conservative investment strategy makes sense. Back in the fourth quarter of 2018, the Fed began to raise interest rates and investors abandoned the stock market, with the S&P 500 falling by more than 9% in the month of December 2018 and finishing the year down 6.2%. By early 2019, the Fed reversed policy, lowered rates and markets rallied.

Will the unwinding of the current housing bubble change the Fed's policy on interest rates? Already the recent hit to the housing market has the Fed rethinking another 75-basis point increase in the fed funds rate. Let's hope we get a continuing decline in energy prices that puts downward pressure on the PCE deflator (the Fed's preferred measure of inflation) and more typically followed metrics such as the PPI and CPI. If that happens further rate hikes may be less aggressive.

Even though the fallout from the Fed's tight money policy has hurt the housing market, it has benefitted the residential rental property. As a result, the price of apartments has been skyrocketing. The city of Orlando, Florida is reportedly considering imposing a ceiling on soaring rents; in other words the introduction of rent control. History tells us that rent controls only serve to cause a shortfall in the production of new rental units making the situation even worse, not better. The problem is that the boom in house prices is not a statistic that affects the consumer price index; the rental price index is included in the CPI. By that measure, it looks like inflation will be running at a high level for the foreseeable future if potential buyers are forced to become renters.