MarketWatch

Fed's 'golden handcuffs': Homeowners locked into low mortgage rates don't want to sell

Fed's inflation fight tightens the U.S. housing supply and makes home buying even more difficult

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Conventional wisdom dictates that U.S. inflation will continue to decline as the Federal Reserve keeps interest rates high. This action, which makes loans more expensive for businesses and consumers, should lead to less spending, less consumption and higher unemployment.

Or at least that's Econ 101. Yet both consumers and investors have acclimated to the current market environment. Moreover the key driver of inflation — housing — cannot be adequately contained through the Federal Reserve's usual tactics.

In fact, the Fed's policies have created a Catch-22 in the housing market by creating "golden handcuffs." Instead of easing consumer demand, the Fed's actions unintentionally restricted U.S. housing supply, resulting in a stalemate between home buyers and sellers. Homeowners who locked into historically low mortgage rates before and during the pandemic are now reluctant to sell, which in turn is increasing the likelihood of persistent higher inflation.

The case for this condition to persist , which the market is mostly failing to consider, continues to grow stronger as the odds of a recession fade. This should be an alarm bell and a potential opportunity for investors to redeploy at least part of their capital into hard assets to serve as a hedge against inflation risk.

The recession that never was

Many economists have predicted that a recession would hit the U.S. Their reasoning was sound: aggressive monetary action by the Federal Reserve, investor dissatisfaction with inflation, loss of consumer confidence and reductions in home asking prices — all points that were hard to argue against.

Yet most of the key ingredients needed for a recession have not materialized. Investors have acclimated to inflation, consumer confidence is growing and the housing market has, by and large, entered a period of stalemate where prices remain high due to lack of supply.

In fact, the only relevant argument in the recession camp that remains is the Fed continuing its aggressive posture against inflation — now considered the fastest monetary policy tightening cycle in more than 40 years. Such action continues to lead many to speculate that recession is imminent, and the only questions left to answer are "when," and "how deep it will be?"

Housing prices obey the laws of supply and demand

Housing is perhaps the most consequential category that makes up the Consumer Price Index (CPI), which markets track every month as a core measure of inflation.

The undersupply of housing in the U.S. is grounded in years of underbuilding and is not the result of a single federal policy, war, or external event. If anything, the power to create more housing supply rests with state and local governments, which often require working through a patchwork quilt of differing zoning and land-use regulations.

The high estimate of the country's current housing shortage is pegged at about 7.3 million units, while the most conservative estimate shows it to be about 1.7 million. While the true shortage is most likely somewhere inbetween, the bottom line is that the United States faces a textbook housing shortage that cannot be solved overnight. Worse, the Fed's current policies are making the prospect of home ownership even more difficult.

Nobody wants to move and reset their loans at much higher rates.

Central bank measures designed to clamp down on inflation by making borrowing more expensive (which theoretically should drive down the costs of homes), are having the opposite effect. This is because homeowners, who locked in historically low mortgage rates before and during the pandemic, are now reluctant to sell their home.

Simply put, nobody wants to move and reset their loans at much higher rates. Would-be sellers are therefore sitting on the sidelines, which has unintentionally created an even greater shortage in supply. Meanwhile, potential buyers, who cannot afford higher mortgage rates, are incentivized to rent instead.

To end this stalemate, the Fed would need to start cutting interest rates, which it has stated is unlikely this year. But if inflation is being driven by the cost of housing, as demonstrated in the Consumer Price Index, more attempts to tame inflation via rate hikes suggests homeowners will only become more entrenched as supply dwindles further As the labor market continues to prove surprisingly resilient, homeowners, and by extension everyday consumers, don't seem to mind waiting it out.

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The case for hard assets

Seasoned investors know that during times of rising interest rates, restrictive credit and prolonged inflation, more investments flow into "hard" asset classes such as real estate. This hedging strategy is used almost like an insurance policy by investors to preserve capital from the depreciating effects of inflation. And according to research, it works. For example, a Stanford University study found that residential real estate is historically an investment haven during inflationary periods. Even during the inflation of the 1970s, home prices increased relative to the size of the economy. This is because housing is typically tied to consumer prices and rises with inflation.

With housing assets so closely tied to inflation, as well as to the laws of supply and demand, investments in this hard asset class deserve due consideration. Strong economic growth, coupled with the one-two punch of resilient consumer spending and near record-low unemployment, is good news. It also means the Fed won't be lowering rates soon. Housing will remain a key driver of inflation, and future rate-hikes will further entrench homeowners and push more would-be buyers into renting.

To achieve a return to 2% inflation, U.S. policymakers would be wise to work with state and local governments to incentivize development, which would drive down the greatest expense for most Americans. But even with decisive action, fixing the fundamental housing shortage that is responsible for sustaining stubbornly persistent inflation will be a longer process than most investors realize.

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