Economic Weekly

Owners’ Equivalent Rant

April 15, 2024

Highlights

- US inflation is mismeasured.
- OER is the key culprit.
- Fed risks policy mistake.
- Ironically limiting housing development.
- CRE investment faces risk and opportunity.

Last week inflation came in hotter than expected. But it isn't rising nearly as quickly as that data indicated. The rate occurred due to the shelter component of inflation. Frequent readers of this weekly know that we have serious issues with how the shelter component of inflation gets calculated in the major consumer-oriented inflation indexes, especially the consumer price index (CPI) and to a lesser extent the personal consumption expenditures (PCE) index. In particular, we take umbrage with what's known as owners' equivalent rent (OER). The problems with OER consequently cause problems with overall inflation because OER represents 27% of CPI[i]. Rent for apartments represents about 7% and gets calculated on a more straight-forward basis. Therefore, this week we are focusing exclusively on OER and shelter inflation. More than a pure methodology question, the issues hold serious implications for the economy. What questions do OER, and shelter inflation raise and what do they mean for commercial real estate (CRE)?

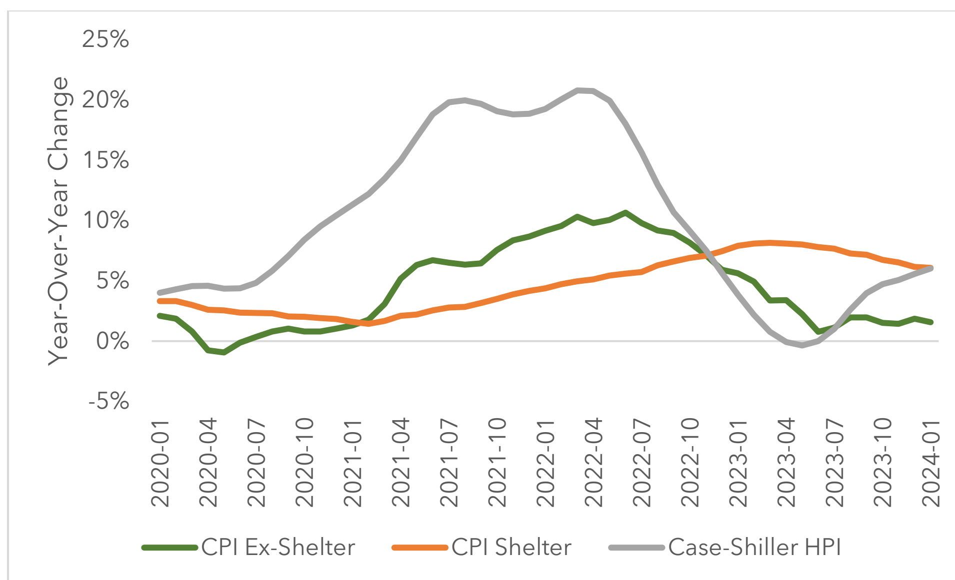
Problems With OER

What are the problems with OER? By no means an exhaustive list, here are some key concerns:

1. <u>OER is arbitrary.</u> To calculate OER, the BLS asks homeowners, "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?" The average homeowner has no idea how to calculate the market rent for their home in any individual period. We recently polled a large number of CRE professionals and even they did not know. That makes both the levels of and the changes in OER highly dubious.
2. <u>It represents an expense that literally nobody pays.</u> The BLS is trying to capture the cost of shelter independent of price appreciation. As noted in the question above, it is purely hypothetical. It doesn't represent any real-world expenditure. Other costs of homeownership, such as utilities, are directly tracked and included in inflation. Roughly two-thirds of households in the US are homeowners and do not pay anything like OER. For the one-third that don't own their dwelling, they pay rent. Rent more directly represents a cost to use a good or service as opposed to the price of ownership of an asset.
3. <u>Homeownership as an investment.</u> Certainly, homeownership holds great utility value. But it is often looked at as an investment, similar to that of stocks and bonds, as opposed to a consumption good like food or clothing. The price of a home most directly impacts homeowners via the mortgage. However, most homeowners hold a fixed mortgage whose combination of interest and principal repayment does not increase. In fact, this is a key reason why the economy has proven so resilient in the face of rising interest rates. The BLS argues that OER captures the "cost of ownership" over a prolonged period of time as opposed to just at purchase. But again, this seems arbitrary. What about homeowners with no mortgage? 40% of homes in the US are mortgage-free[ii]. Does their "cost" end when they have no mortgage? What if they never had a mortgage? What if they own a house and don't rent it out but also don't primarily (or never) live in it?
4. <u>OER reflects the past, at best.</u> The BLS claims that OER represents housing costs, but with a lag because tranches of housing get surveyed only every six months. Setting aside

outright mismeasurement two problems still exist. First, waiting six months will certainly produce problems because the BLS simply performs a straight-line interpolation between observations, and we know that's not how housing markets behave. Second, why should we use stale information as a proxy for what's supposed to be happening today?

5. Other advanced economies don't do this. Other advanced economies, such as the UK and the Eurozone, do not utilize OER for all of the reasons mentioned above and more. While they would ideally like to capture something like the cost of homeownership, they view the OER method as too flawed and problematic. As a consequence, their CPIs are falling faster than US CPI. If the US used the same harmonic method the year-over-year US CPI would be 2.2%, far below the current 3.8% and basically at target.



So What?

This is more than a spirited debate or an academic exercise. Bond yields already moved higher after the data release, and it seems as if these readings will stay the Fed's hand on rate decreases for now. But that's a big problem. Real interest rates are already positive, by hundreds of basis points, and are restraining economic activity. And if inflation is getting overstated, then we are understating the real interest rate – which means the longer we delay bringing rates down the greater than probability of collateral damage in the economy, if not an outright recession. That remains low risk, but not zero risk. Even if we want to take the BLS's word that the data isn't wrong, just lagged, it can cause a lot of irreparable damage before that data finally catches up. Effective rents for apartments have barely grown for 18 months. Moreover, we should make monetary policy decisions based on future expectations, not based on things that have already occurred but simply haven't yet manifested in the official inflation data. One could argue that inflation was understated on the way up, and that's a valid criticism, especially since the Fed got behind the curve and raised rates relatively late after inflation had accelerated. But that's no reason to repeat the same mistake while inflation is slowing. Objective forecasts for shelter

inflation, including OER, project further slowing ahead. The Fed should focus on these forecasts, particularly given the many problems of shelter inflation.

Moreover, does the Fed believe keeping interest rates elevated will alleviate housing price pressures? Housing remains very expensive because it is chronically and acutely undersupplied. While cost plays a role in that process, undersupply mostly stems from thorny issues like zoning, permitting, NIMBYism, and tighter lending standards in the wake of the global financial crisis (GFC). And somewhat ironically, raising interest rates might have exacerbated home price inflation. Because demand for housing remains so strong, raising rates did not make a dent in it. Even at roughly 8% rates for 30-year mortgages, excess demand for housing persisted. But undoubtedly, the increase in the cost of debt capital restrained the development of new housing. Additionally, with many homeowners locked into cheap mortgage rates they obtained before the Fed started tightening, they will be reluctant to sell because they'll have to take on higher borrowing costs for their new home. That also is limiting available housing inventory. The Fed effectively bet that it could destroy more demand for housing than supply. But it clearly lost that bet. Therefore, this presents an argument to cut rates, or at a minimum, removes an argument for keeping rates elevated. Cutting rates might actually alleviate home price pressures if supply can marginally grow faster than demand. That will not reduce housing costs but could potentially slow growth in home prices and rents. In sum, the downside risks to the economy from cutting rates seem limited since inflation for everything excluding OER is basically at target. But the upside risks, including avoiding a recession and potentially slowing housing inflation, could be substantial.

None of this suggests that separating the cost of using owned housing as shelter from (1) its pure investment value and (2) the cost of running and maintaining a house (to the extent that such a thing should be done, which again, is highly debatable) is easy. But if inflation is going to include some measure of the cost of usage of an owned home, there exist much better and timely ways to do this than via OER and that would help avoid a serious monetary policy mistake.

CRE Implications

The implications are twofold for CRE. First, keeping interest rates elevated will delay the recovery of the CRE capital markets. Transaction volume and pricing respond well during periods of monetary loosening. While that loosening should still occur, it pushes out the time horizon. While that should create additional time for shrewd investors, it could also prolong negative total returns and limit debt capital availability.

Second, it reinforces the investment thesis for housing of all types, especially multi-unit housing that can add to inventory at scale. Apartments and built-to-rent (BTR)/single-family rental (SFR) continue to offer attractive long-term investment prospects, even if prices and rents aren't growing nearly as quickly as the BLS would like everyone to believe.

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[i] All cited CPI data from the BLS.
[ii] US Census Bureau.