WALL STREET JOURNAL

For Fed, Nothing Going on but the Rent

Inflation is too low for the Federal Reserve, but not as low as it would be if rising rents weren't propping it up.

By Justin Lahart

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Low as inflation is, it would be even lower if not for one group that has been remarkably adept at pushing through price increases: Landlords.

When Federal Reserve policy makers meet this week, they will likely signal that they have essentially given up on the idea of raising rates in June. Inflation, which has been running well below the central bank's 2% target, is a big reason why.

Indeed, economists estimate that March inflation data from the Commerce Department's Bureau of Economic Analysis, due Thursday, will show that its index of core consumer prices, which excludes food and energy items, was up just 1.4% from a year earlier, the same as in February.

Core inflation readings would be even weaker but for the pace of gains in the BEA's measure of housing costs, which counts toward about one-fifth of its core price index. This was up 2.9% from a year earlier in February. Absent that, core inflation would have been running at just 1%. Housing counts for an even bigger chunk of the Labor Department's consumer-price index, which is a big reason why its core measure has been running ahead of the BEA's.

Core inflation readings would be weaker if not for the pace of gains in a measure of housing costs by the Commerce Department's Bureau of Economic Analysis. Photo: Getty Images

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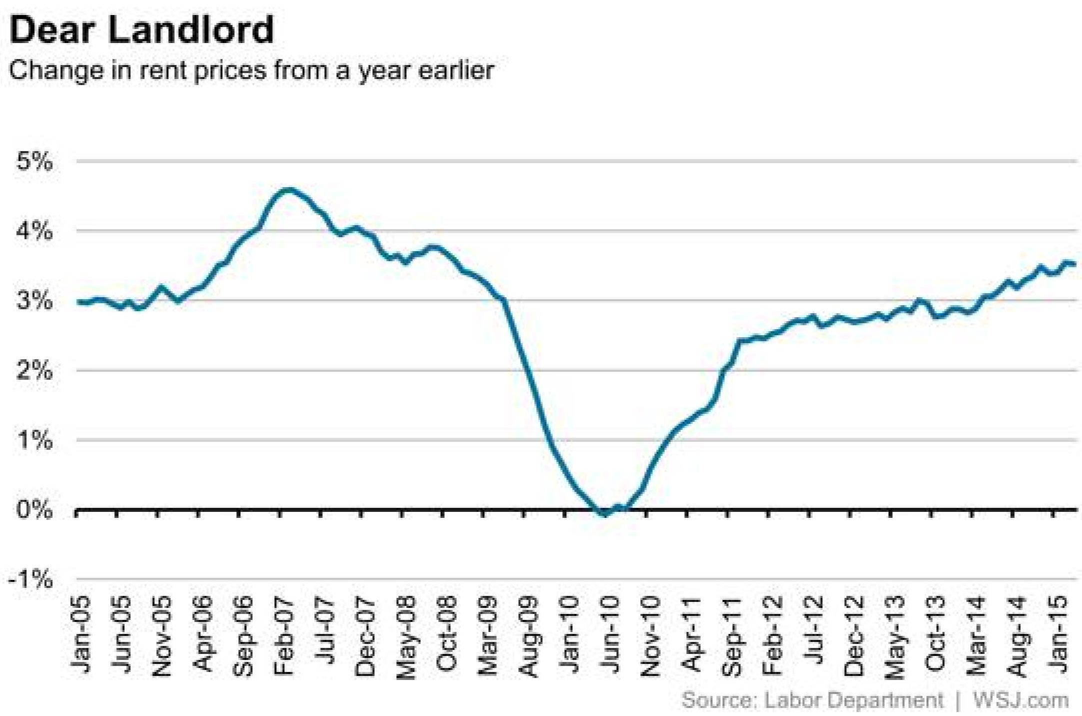

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The increase in housing costs within consumer-price figures is really about rising rents. Measuring housing costs for homeowners is tricky; people bought their houses at different times and bear differing insurance and mortgage payments. Since the 1980s, government statisticians have calculated them by estimating what homeowners would pay in rent for comparable living spaces, or owner's-equivalent rent. So when rents go up, they drive overall housing costs higher.

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Rents, which by the Labor Department's measure were up 3.5% in March from a year earlier, are rising due to a simple mismatch between supply and demand. Since the recession hit in 2008, the U.S. has been adding only slowly to its housing stock. Builders started construction on 1 million homes over the past year, which compares with about 1.5 million annually in the 1980s, when the population was significantly smaller.

Over on the demand side, however, there has lately been a pickup in the number of households as, thanks to a better job market, more people are finally setting out on their own. This first step usually entails renting. Meanwhile, many would-be first-time homeowners are having a harder time getting mortgages than they would have even before the easy conditions that fed the last housing bubble. So they are continuing to rent.

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The result: A tighter rental market. While the data are volatile, the rental vacancy rate fell to 7% in the fourth quarter from 8.2% a year earlier, according to the Census Bureau. That put it well below its 2009 peak of 11.1% and at the lowest level since 1993. First-quarter figures are due Tuesday.

Yet while rental inflation is indeed inflation, it is also the sort that will likely take care of itself. One of the things about businesses with better pricing power than others is that they invite investment. There is a reason the NAREIT index of apartment real-estate investment trusts has returned 49% since the start of last year versus the S&P 500’s 17%. So it seems likely that more new rental units will start coming onto the market in the year ahead. And if more renters find the wherewithal to buy homes, this should make the rental market a bit looser.

For investors, the message is that the business of building homes, whether for rent or for purchase, may be a bit more lucrative going forward than the business of renting them to tenants. That is also a message the Fed can probably get behind as it ponders when to finally raise rates. Persistent weakness in home construction has been one of the economy’s sorer spots, hampering a fully-fledged recovery. So until the Fed sees signs that prices for other things are heating up, it may see the pickup in rents as something to be ignored.

Write to Justin Lahart at justin.lahart@wsj.com

David Weisz 8 hours ago

How startling efficient: raise interest rates, which will effect the entire economy, to combat price pressure in one (relatively small) sector of the economy. In other words, to save the patient kill the patient.

Caroline S. Rock 4 hours ago

@David Weisz   Its startlingly efficient for all those rich folks who have

sufficient collateral backup to enable them to BORROW OTHER PEOPLE'S

MONEY at LOW interest COST and buy assets (like stock shares) and get

even richer!   In other words, the mode of operation now is that old

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saying "ROB PETER to payPAUL"

There will be one excuse after another to continue the same process

(recall that it began with the high unemployment rate) until bad things happen!

Lee Adler 20 hours ago

The errors of fact and logic in this report are material to the conclusion.

First. The Owner's equivalent rent component of CPI was 283.216 as of March 2015. It was 275.795 one year before. That is an increase of 2.69%.

The BLS counts rent twice in CPI, as owner's equivalent rent at 23.9% of the total index and as rent of primary residence at 7%. That second figure is what they plugged at 3.5%.

I would link to the sources of this information on the BLS website, but the WSJ, in its infinite wisdom doesn't allow it.

Question- If renters' rent is imputed at 3.5%, why is owner's equivalent rent, which is based on the owner's OPINION of what his house would rent for, weighted at more than triple renters' rent?

Another issue is that BLS bases its rent survey on the respondent's contract rent, not what it would currently cost to rent the same unit at market.

Most third party services report market rent growing at 4-7%, not 3.5% or 2.7%.

CPI is understated. PCE understated more.