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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, senior economist for UCLA Ziman Center for Real Estate and UCLA Anderson Forecast, looks at the coming uptick in inflation.

The Inflation to Come in Housing, Healthcare and Wages

By David Shulman, Senior Economist UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast

For the past year, U.S. inflation has remained at very low levels. But that is about to change, led by price increases in housing and healthcare, and by modest wage increases. And that will eventually cause the Fed to abandon its zero interest rate policy.

Inflation, for now, is quiescent. With the year-over-year increase in the personal consumption deflator – minus food and energy – the Fed's preferred inflation gauge, is now running at 1.1%, well below the 2% target. (See Figure 1) Indeed there is even fear of deflation in the air. With inflation practically nonexistent and with the unemployment rate still running at a high 6.7%, many market participants now believe that the Fed's zero interest rate policy that began in December 2008 will continue well into 2016 consistent with its dual mandate to maintain maximum employment and the purchasing power of the dollar.

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However, those market participants will soon be disappointed. Inflation, as measured by the core consumer price index, will by the second quarter be running at a 2% plus annual rate on a sequential basis, and the Fed's gauge will be at that run rate later in year. Why? The era of very low inflation is coming to an end.

The era will not end with a burst in energy and commodity prices as history would suggest, but rather from sources much closer to home. Specifically housing.

Housing costs are now rising in excess of 2% a year and healthcare cost pressures have been unduly dampened by the weak economy, a factor noted by Fed Chairman Ben Bernanke in his December 2013 press conference. On a year-over-year basis owners' equivalent rent, the government's fancy measure for the cost of owner occupied housing, is now running at 2.4%. For tenants who pay cash rents the year-over-year gain is 2.8%. Thus in terms of housing costs, above target inflation is already here. We would note that numerous private rental surveys have been reporting rent increases on the order of 3%-5% for the past several years.

A major difference between the private surveys and the official data is that rent controlled jurisdictions (i.e. New York, Los Angeles, San Francisco and Washington, D.C.) are over-weighted in the housing price indices. As a result, measured housing inflation has been suppressed and will likely accelerate from here as controlled rents are marked to market through the process of vacancy decontrol. Furthermore 2014 will bring with it the eighth year of under-building. Recall that housing starts bottomed at an annual rate below 500,000 units in 2009 and just crossed the one million mark in November 2013. In contrast housing starts averaged 1.47 million units from 1959-2012. Simply put, the lack of supply is working to put upward pressure on home prices and rents.

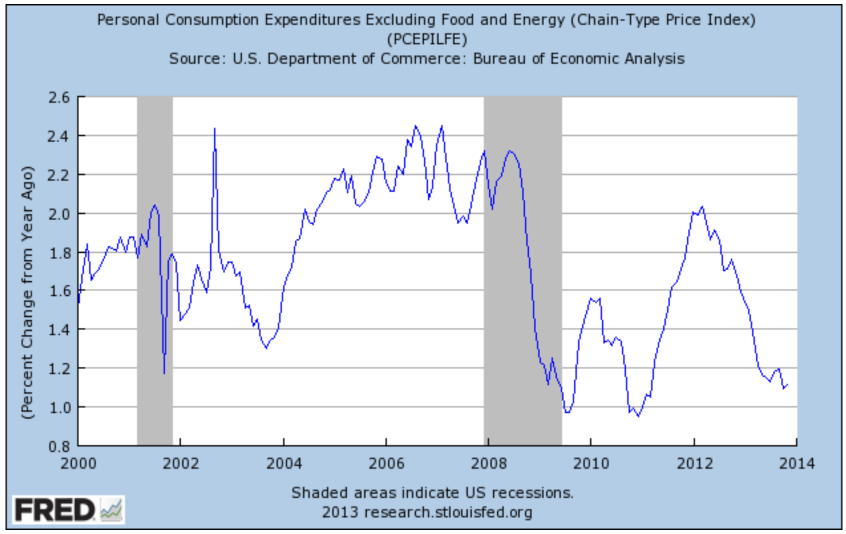

Figure 1: Personal consumption expenditures excluding food and energy, Chained Price Index, January 2000-November 2013, Percent Change Year Ago

The healthcare sector has enjoyed very low inflation recently, but those days are behind us. Healthcare inflation plummeted from 4% in late 2012 to the 2.2% year-over-year increase reported in November 2013, well below the 3-3.5% increases reported from 2008-2011. But with new demand coming from an improving economy, the Affordable Care Act and the potential pricing opportunities created by its sloppy implementation, it is likely that we have seen or are very close to the low in healthcare inflation.

To be sure housing and healthcare are major components of the price indices, but a general increase in inflation will not come from those sectors alone. In order to have a sustained uptick in inflation, wages have to rise and that is precisely what we are expecting to happen. For example, the year-over-year increase in average hourly earnings bottomed at 1.3% in October 2012 and is now running at 2.2%. At the upper end of the labor market there is anecdotal evidence indicating that shortages are developing for skilled manufacturing workers and in parts of the high technology sector.

At the low end of the labor market a substantial hike in the minimum wage will likely take effect in 2015. Political pressure is growing for a hike in the minimum wage as evidenced by the recent passage of a host of local referenda on the subject and with 2014 being an election year Congress will oblige with a hike. For those who argue that the Republican House will prevent a hike, they don't know their history which is replete with Republicans voting for hikes in the minimum wage. To be sure it won't go to the $10.10 an hour the Democrats are asking for, but something on the order of $9.00-$9.50 an hour is a likely compromise, well up from the current $7.25 an hour.

As a result, the combination of higher housing costs, a modest snap back in health care inflation and moderate wage increases will soon push inflation up from the extraordinarily low level of the past year. Instead of having a very low inflation rate of 1%, we will soon be witnessing a low inflation rate of 2%. The Fed wants this increase and it will get it. The uptick in inflation combined with an improving labor market will cause the Fed to abandon its zero interest rate policy in early 2015.