Capital Risk

USA ECONOMIC OUTLOOK

The Property Ladder

Photo: Dillon Kydd on Unsplash

America's buoyant economy faces a crossroads. Fiscal and monetary stimulus ignited the durable goods and housing markets in a frenzy of activity. It will not endure without further stimulus and result in slower growth in the next year as purchases brought forward are not replaced. This highwire act will require balanced policy responses as the next steps. None are as consequential as the housing market where eviction and foreclosure moratoriums reign. With 13 million people behind on their payments and four million facing immediate action, a market collapse is probable without further policy response. The challenge is that prior policy action lifted housing prices at an unfathomable rate. Policymakers must make the unpalatable policy choice of either people or capital. The choice for growth is easy.

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Monetary stimulus brought unprecedented lows of mortgage interest rates and launched housing prices and durable goods consumption higher.

This one-off event will ensure housing prices and goods consumption moderate their increases. Future housing and consumption will bear the cost as balance returns.

- *Jason Prole*

"

Highlights

- **Growth** for the year may approach **6.0%** as stimulus buoys growth.
- The **second quarter** will experience peak growth that may set records.
- The **Leisure** sector is rebounding smartly and has further to go.
- **Exports** will return in the second half of the year as vaccines propagate.
- **State & Local government** need to maintain their employment levels.
- **Inflation** will temporarily reach **near 4%** as housing and commodities surge.

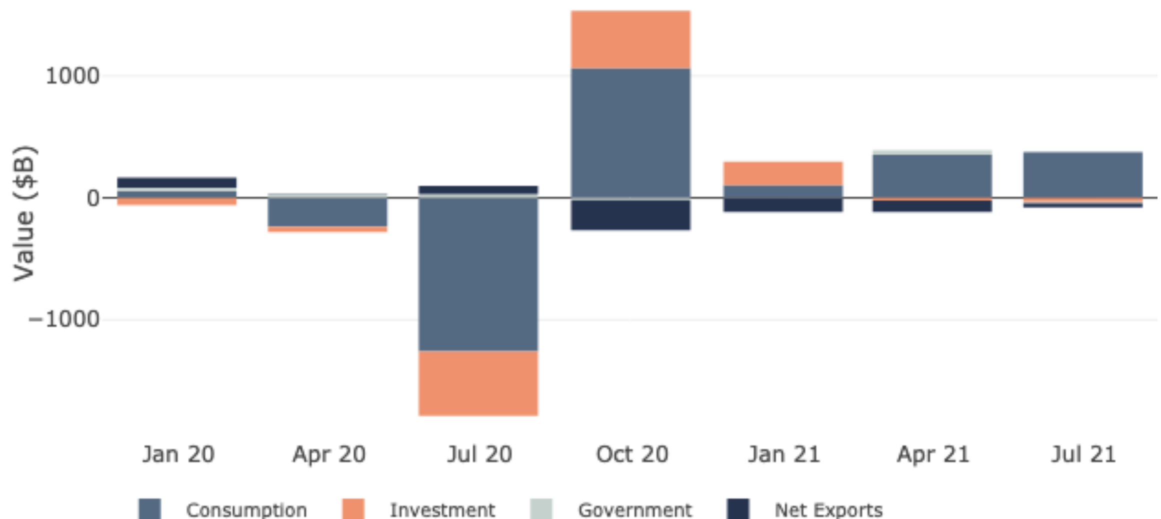
The Macro View

A room with a view. There is little doubt that the fiscal stimulus helped to avert an economic catastrophe. While monetary stimulus played a supporting role, it gave a memorable appearance that will echo for years. Interest rates dropped to levels not seen in generations, while mortgage interest rates fell to the lowest in memory. This economic euphoria is a one-time event. While some will enjoy a lower mortgage payment for decades, others levered their new borrowing capacity to climb the property ladder for a better view. This latter action *brought forward future demand* and is why the housing boom is tenuous.

The U.S. is fully recovered and filled the Pandemic gap (exhibit 1). The composition, though, is where trouble arises. Consumption's return to trend hides that goods are the driving factor as mortgage refinancing drove spending while services lag materially. Further, the investment boom was a housing phenomenon with equipment and structures also tardy. Net exports are moving further negative as imports grow and exports remain stalled well below their prior peak. With Government expenditures adding little to the pie, it leaves the economy wanting. As consumption and housing investment recede, employment gains are required, or *sluggish growth will endure*.

Exhibit 1. GDP Contribution by Component

Consumers lead the recovery.



Source: Federal Reserve Economic Database, CRM Calculations.

The Macro View

Free Money. Monetary stimulus sprang into action as the Pandemic surged in 2020 with a two-pronged approach. Policymakers reduced interest rates and restarted the quantitative easing program introduced during the Great Recession. The latter program purchased Treasuries, corporate bonds, and mortgage-back securities seeking to lower interest rates on mortgages to support the housing market. This support resulted in an outcome materially different than the last crisis: higher housing prices (exhibit 2). The difference this time was that there was not a supply and demand imbalance*: financing costs merely fell*.

House prices jumped higher and faster.

Exhibit 2. Purchase-Only House Price Index (Annual Change, %)

Source: U.S. Federal Housing Finance Agency, retrieved from FRED, Federal Reserve Bank of St. Louis

This distinction is critical to understanding the current housing market conditions and their implications for inflation and growth. Indiscriminate credit in the early 2000s brought increased demand for housing and a subsequent surge in new housing to balance supply with demand. The current situation brought no real change of *demand*. Yet a lower cost of financing (e.g., cost to carry a house) enabled a move up the property ladder or free cash to spend (e.g., new cars). The challenge is that this outcome is not enduring because it *can only happen once*.

The Macro View

Low, lower, lowest. Interest rates were low in the periods before the 1970s inflation. Yet, people old enough to remember those interest rates are now in their seventies. For most current homeowners experienced interest rates continually moving lower to their current levels (exhibit 3). Even people who refinanced over the last decade could enjoy interest rates nearly *one percent* lower on a thirty-year mortgage. This fortuitous outcome enabled those who hadn't lost their job during the Pandemic to purchase a higher larger home or refinance with lower payments for their current house and enjoy more disposable income.

Mortgages are cheaper than ever.

Exhibit 3. U.S. Mortgage Rate, 30-Year Conforming (%)

Source: U.S. Federal Housing Finance Agency, retrieved from FRED, Federal Reserve Bank of St. Louis

These lower interest rates enabled about 13 percent more purchasing power for those wanting to climb the property ladder.[1] This number is parallel to the average housing price increase over the last year. With incomes (for those employed) and demand unchanged (i.e., new buyers did not emerge during the Pandemic), financing is the most credible driver of *current housing prices*.

[1] This number derives from a 3.75 interest rate mortgage changing to a 2.75 percent with a 30-year amortization period.

The Macro View

Spending Spree. Not everyone climbed the property ladder. Most were happy to refinance into lower rates and reduce their mortgage debt service (exhibit 4). More than nine million people took advantage of the lower rates to refinance.[2] The result is more than *$300 per month* for the average household.[3] The consumer responded with durable goods orders and new vehicles sales reaching a new high despite a global Pandemic. Indeed, the consumption rebound is unprecedented, particularly when *employment remains 6.7 million people below the prior peak*.

Carrying a house is easier.

Exhibit 4. U.S. Mortgage Debt Service as a Percent of Disposable Income

Source: U.S. Federal Housing Finance Agency, retrieved from FRED, Federal Reserve Bank of St. Louis

The availability of lower-cost financing certainly contributed to the higher housing prices and increased consumer spending. This one-off phenomenon is not likely to reoccur. Thus, the strength of future housing prices will moderate as the financing boom wanes. This outcome does not mean that other contributing factors will weaken. As in all markets, it is demand *and supply* that determine prices.

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[2] See the Mortgage Bankers Association for data on refinancing activities. www.mba.org

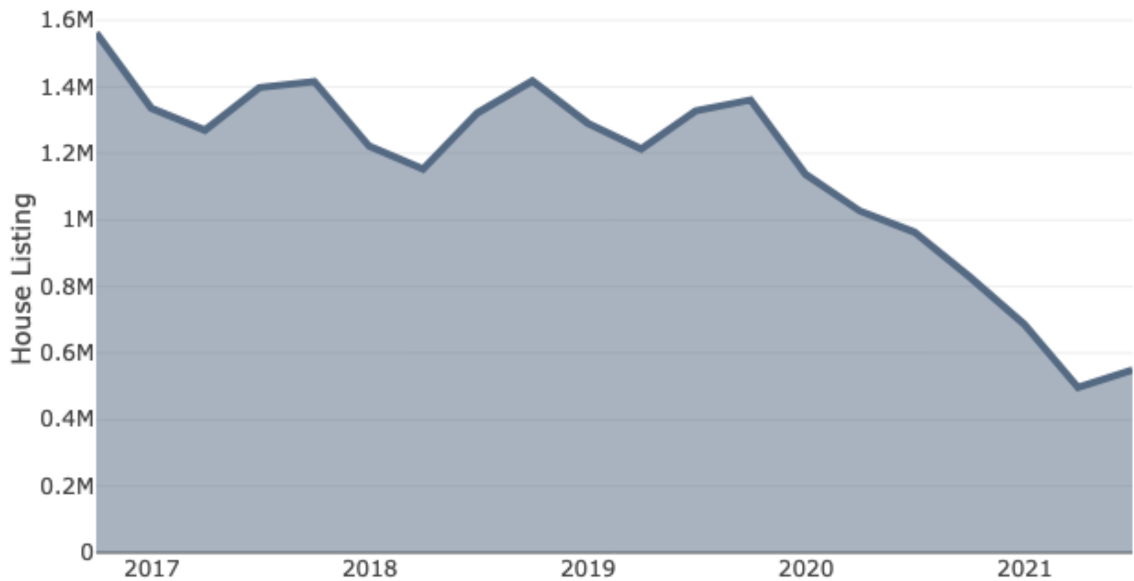
[3] Refinancing a $600,000 home from a 3.75% interest rate to 2.75% with a 30-year amortization period.

The Macro View

Limiting Supply. The availability of more purchasing power alone is not sufficient to drive prices higher because not all people will leverage their newfound ability. The interaction of supply is also critical to the outcome. Since the onset of the Pandemic, the count of active hosing listing for sale dropped by *more than one-half* (exhibit 5). This outcome is unprecedented outside of times of war. During a housing crisis, supply usually *increases* as foreclosures flood the market. That supply dropped in a unique function of the Pandemic that is *not repeatable*.

Housing supply dropped by half.

Exhibit 5. U.S. Housing Inventory: Active Listing Count



Source: Realtor.com, retrieved from FRED, Federal Reserve Bank of St. Louis

This artifact of the Pandemic on housing supply is material. Over the last six quarters, the usual housing listings should've totaled two million. Listings during the period only totaled 760,000 houses, which resulted in a deficit of over *1.3 million homes*.[4] This 60% gap between supply and demand is an extraordinary event contributing to higher housing prices. Of course, the natural response to a supply deficiency is to increase it.

[4] Active listings average about 1.3 million units a year from 2016-2019. Thus, a six-quarter total is roughly two million units. www.realtor.com

The Macro View

Building Supply. Homebuilders responded by building houses at a rate not seen since the mid-2000s. Critically, it was the *speed of the jump* that was unique to this generation of owners. Supply has not jumped so much since the 1970s and the heyday of significant interest rate movements (exhibit 6). This action helped fill the deficiency of supply for active listing. Yet, the 200,000 annual rate of additional units above the prior trend *did not fill the gap*. The more troublesome outcome is that this supply is now *reverting to trend*.

New housing starts did not fill the gap.

Exhibit 6. U.S. New Housing Starts, Single Family Homes (Thousands of Units)

Source: U.S. Census Bureau, retrieved from FRED, Federal Reserve Bank of St. Louis

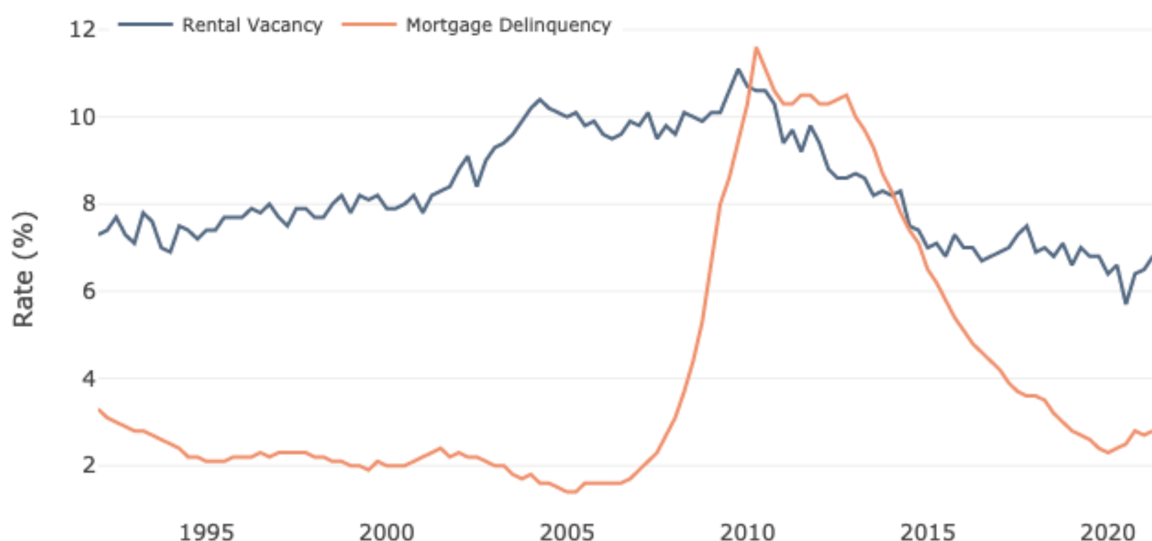
Homebuilding takes time to bring their product to market. These long lead times suggest that homebuilders do not respond abruptly to the marketplace and must see through the data. This insight is why the reversion to the trend is worrisome for the future. High prices would suggest that homebuilders should bring supply to the market. Yet, they are pulling back supply at this critical moment. Indeed, there is some degree of constraints of material supply constraining that is impeding development. Yet, if the expectation is for further demand increases, then development would continue apace because of the long lead times. Thus, builders must not see supply as a *future problem*.

The Macro View

Calm before the Storm. A crucial policy enacted during the Pandemic was mortgage and rental forbearance, where landlords could not evict renters, nor could banks foreclose on delinquent mortgage borrowers. The result is 20-year lows in rental vacancies and benign yet increasing mortgage delinquencies (exhibit 7). With continuing unemployment claims still two million higher than before the Pandemic, the probability that of the policy masking a housing catastrophe is likely.

Vacancies & delinquencies are *too low*.

Exhibit 7. U.S. Rental Vacancy & Mortgage Delinquency Rates



Source: U.S. Census Bureau & Board of Governors of the Federal Reserve System, retrieved from FRED, Federal Reserve Bank of St. Louis.

The reality is that over *thirteen million* households are behind on their payments. At the same time, around *one in three* expect eviction within the next two months.[5] This reality is why homebuilders are not building more houses in the face of high prices. Absent a policy change, the renters will face eviction at the end of July and mortgage foreclosures could follow by the fall. Adding supply when a wave of houses may enter the market is not a prudent path for most professional homebuilders. *Lower demand meets a higher supply*.

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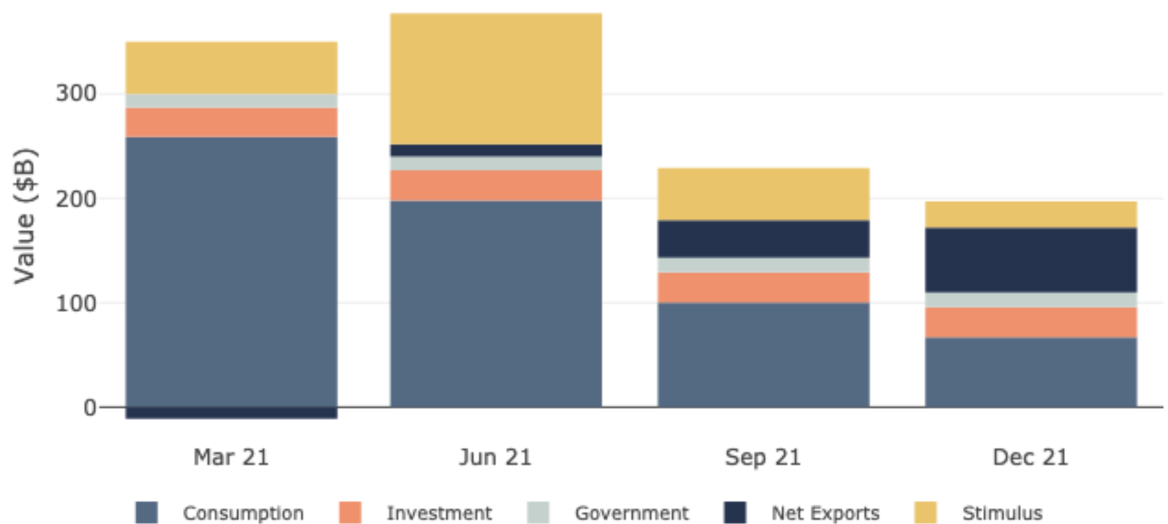
[5] U.S Census Bureau, *Household Pulse Survey*, July 2021. https://www.census.gov/programs-surveys/household-pulse-survey.html

The Macro View

A full house. While mortgage refinancing and stimulus payments lifted consumption, they are transient lifts to the economy. A new home filled with the latest technology certainly brings a smile to the face yet *reduces future consumption*. Herein lies the problem for the world and the U.S.: future growth will require *future stimulus* because of the response to the Pandemic. The reality is that absent stimulus, technology that delivers higher productivity will need to be the lever to lift growth. If not, *higher debt with lower interest rates and growth* is the outcome in the long term.

Exhibit 7. Forecast for US GDP Growth

A 6.0% rise is forecast for 2021.



Source: CRM estimates. Amounts are annualized rates. The first quarter forecast composition is adjusted to include the enacted fiscal policy.

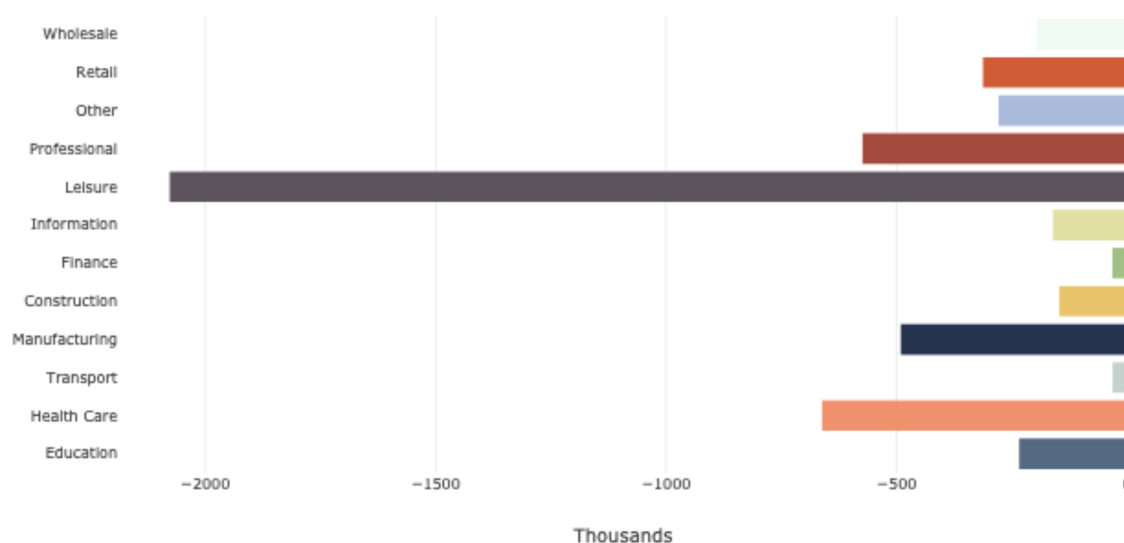
The policy measures enacted will lift growth in the short run, with most of the benefits arriving in the first and second quarters. For 2021, growth will approach 6.0% (with 1.3% from the stimulus) and achieve a rate not seen in forty years (exhibit 7). The two key risks are that exports do not rebound in the latter half of the year due to continued uncertainty from the virus and investment declines rather than slows. Both risks are *probable* outcomes. *Fiscal policy is the antidote* to help cure the nearly seven million people unemployed and the four million people who face falling a rung on the property ladder.

Consumption

The leisure sector continues to bear the burden of the Pandemic. The unfortunate people in these sectors also endure low wages, job insecurity, and lack of housing capital. The Pandemic may augment salaries for them yet will not deliver job security or capital to climb the rising housing ladder. The tragedy is that the sector still accounts for more job losses than *all the other sectors combined* (exhibit 8). The *economic epidemic for the leisure sector* continues as the Pandemic recedes and is the area of the most urgent need for a policy response.[6]

The leisure sector's recovery awaits.

Exhibit 8. U.S. Private Employment Change by Sector (Thousands)



Source: Federal Reserve Economic Database. Change from December 2019 to June 2021.

Further policy responses should target the leisure sector to ensure their employees' economic fortune does not take a virulent path. The cost would be reduced consumption for a generation. Vaccine distribution is lifting the leisure sector, yet it faces the headwinds of the Delta variant and mask mandates renewals. This circumstance ensures that the return of the leisure sector predicates further consumption growth, which is a *policy decision*.

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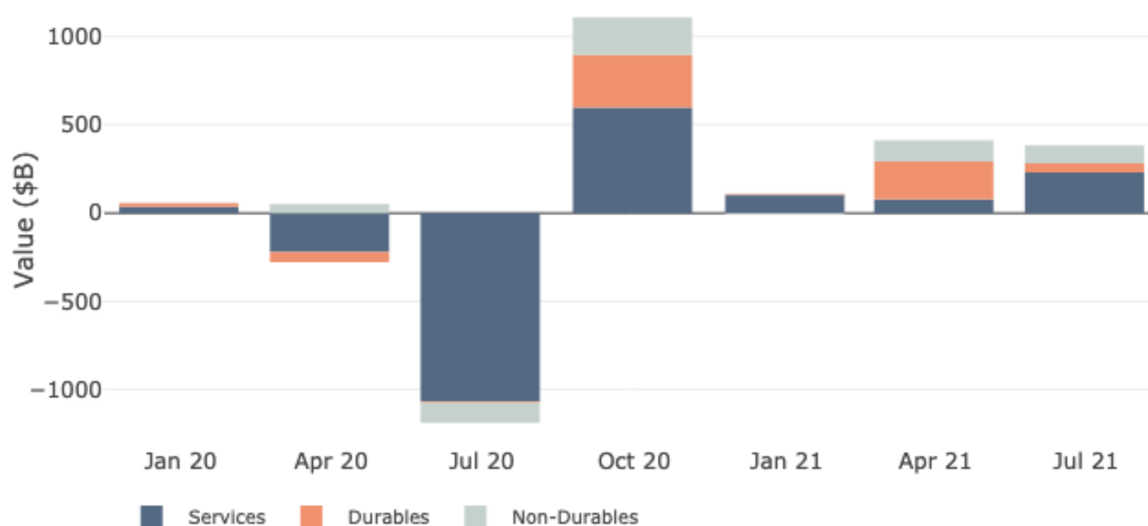
[6] See Capital Risk's **Economic Epidemic** (March 2020) for more details on sector impacts and the risk to consumer behavior over the long term.

Consumption

A Pyrrhic Victory. Policy actions are indiscriminate in their application. While online data can precisely target demographics, public fiscal and monetary policies are not yet up the task. While lower interest rates help consumers and businesses borrow, they *only help those able to borrow*. The forlorn unemployed people cannot access these cheaper financing costs, yet they are most in need. In parallel, rebates checks help everyone, yet they are insufficient for those most in need as their *lost income persists after the rebates*. The result is a *fallacy of division*, with the restoration of the aggregate yet lagging components.

Service consumption is not yet back.

Exhibit 9. Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

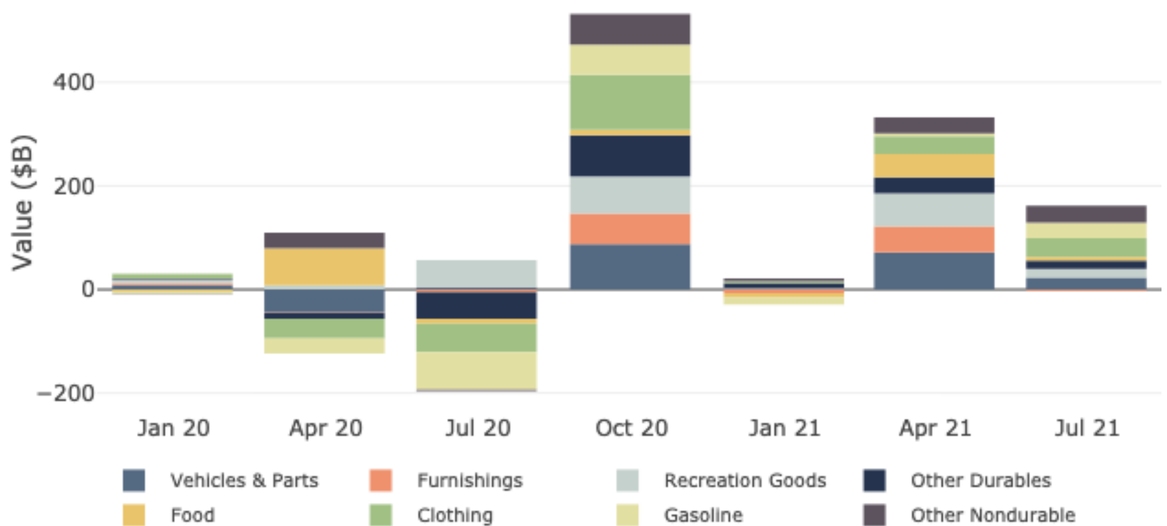
The consumption rebound is an immediate benefit, while its changing composition is an enduring challenge (exhibit 9). Non-durable consumption growth is *triple* its previous average, while durable goods growth is *five times* its regular growth rate. These unprecedented growth rates filled the services gap that is still *$300 billion* below its prior level. The drawback of the changing consumption composition is that durable goods do not require frequent restocks. Thus, a service rebound is needed soon or risk a permanent change in consumer behavior that may *endure for a generation*.

Consumption

Borrowing from the Future. The composition of goods consumption highlights the challenges ahead (exhibit 10). First, the magnitude of the rebound was materially higher than the loss. The current level is about *$600 billion above* the prior trend rate. Second, the expected life span of durable goods is generally more than three years, with refreshing occurring every few years. The trouble is that the jump in durable goods *brought forward future purchases*. These insights suggest reduced future growth for purchases that include vehicles, furnishings, and recreation goods.

Exhibit 10. Goods Consumption Contribution by Component

Stimulus brings goods consumption.



Source: Federal Reserve Economic Database. Values annualized rates.

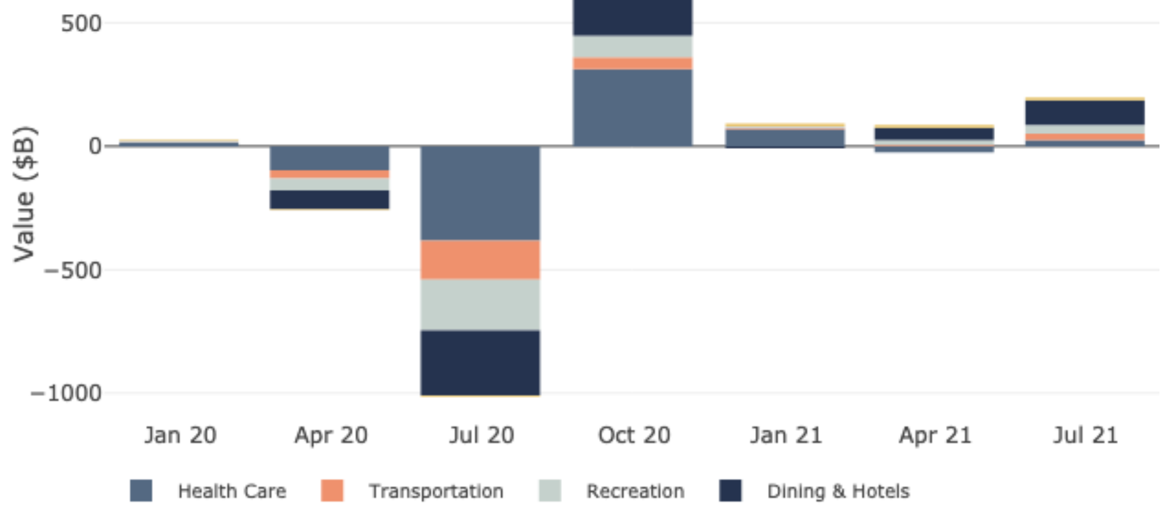
A further challenge awaits related to the other durable goods (e.g., jewelry and cell phones) and clothing categories. Both jumped substantially above trend as stimulus reached the pockets of the consumer. The durability of these jumps is tenuous. Indeed, clothing and mobile phone will be refreshed, but they do not bode well for the *next two years*, while the challenge for jewelry may persist for longer. With future stimulus limited or non-existent, goods consumption will return to *trend levels at best*. Thus, a transitory policy benefit will limit near-term growth, while a consumer behavior change may *limit long-term trend growth*.

Consumption

A Health Paradox. During a Pandemic, intuition would suggest that health care services would expand, which was not the case (exhibit 11). While the demand for emergency services skyrocketed, they are only a minor component of total health care spending. Doctor visits and other non-vital services plummeted as people avoid a place where they are sure the virus resided: the doctor's office. Health care spending remains *$100 billion below* the prior peak. Yet, it continues to push higher as people partake in their regular health care activities and does not suggest a permanent change in consumer behavior.

Exhibit 11. Service Consumption Contribution by Component

The leisure sector returns modestly.



Source: Federal Reserve Economic Database. Values are an annualized rate.

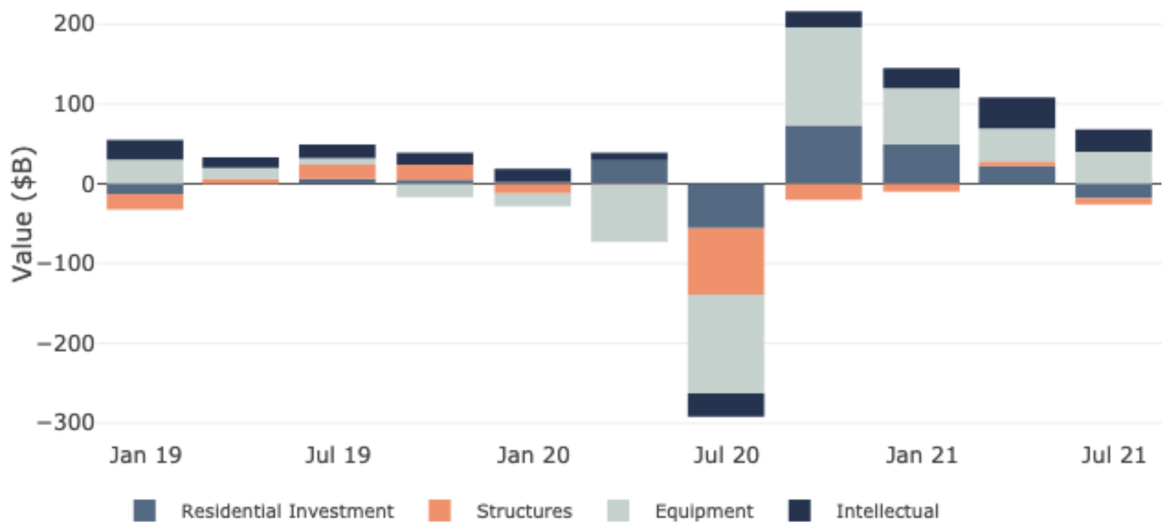
While dining & hotels continue to recover, two service categories remain at risk: transportation and recreation services. They each are *$100 million below* their prior peaks. While some of this loss is from limits on or difficulty with international travel, at 80% of their previous heights, it may suggest some degree of permanent change to consumer behavior. Given the high degree of discretion in this spending and two economic crises within a decade, the threat of a permanent reduction of consumption is real. The implications for employment and savings/investment are substantial.

Investment

The residential housing boom is reversing course by joining with commercial structures to *decline*. With housing prices at all-time highs, this action seems counterintuitive for builders seeking to maximize prices. While building materials costs are inflating, they don't squeeze profits when house prices rise. This incongruence results from future housing supply, which builders correctly forecast has the potential to jump higher as eviction and foreclosure moratoriums wane. This decision compounds the effect of slowing equipment investment (exhibit 12). With savings at an all-time high (and the mirror of investment in the national accounts), the lack of investment is astonishing given the cost of financing.

Equipment investment is a risk.

Exhibit 12. Investment Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

A challenging dimension of the equipment component is that the information technology component filled the transportation void. While the lifespan is shorter for information technology than for transportation goods, it's not evident that the growth is durable. Future growth will reduce accordingly over the next few years as the investment growth rate returns to normal. The convergence of abundant savings and insufficient investment delivers *lower interest rates* in the absence of further fiscal stimulus.

Exports & Imports

The U.S. consumer is renowned for their conspicuous in their consumption. While the Pandemic gave pause to it, the rebound makes evident that behavior is unchanged. Import goods continue to flood into the U.S., while exports remain subdued (exhibit 13). The result is a *$300 billion* expansion of the trade deficit and a 1.5% drag on GDP. This divergence between imports and exports is unparalleled in the last *50- years.* While mainly a function of divergent vaccine rollout, it might lead to a permanent change of consumer behavior that impairs *future investment*. This outcome would compound the investment component and further dampen future growth.

Exhibit 13. Net Exports

Export growth is *zero.*

Source: Federal Reserve Economic Database. Values are an annualized rate.

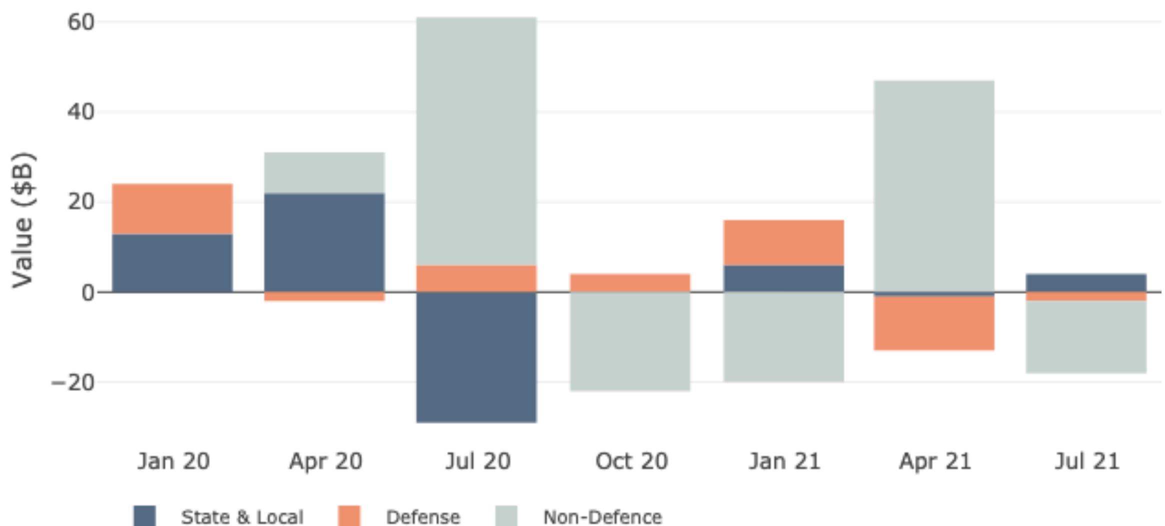
The imbalance in the trade position is perplexing when considering that the US dollar is down slightly since the onset of the Pandemic. This outcome brings higher import prices and lower exports prices. This reality illuminates the challenge the rest of the world faces in their vaccine rollout and emergence of the Delta variant. Global demand and U.S. exports will remain depressed until policymakers overcome these hurdles. A global recovery will follow the Delta variant's demise, which is a function of vaccination rates.

Government

Federal fiscal supported the economy throughout the Pandemic, with the more consequential State & Local levels notable for *not cutting spending* rather than adding support (exhibit 14). The debate, however, is changing as the vaccines propagate with federal spending retreated in the last quarter. The challenge for fiscal stimulus is making it an enduring feature, the current infrastructure bill under consideration notwithstanding. Given the dependence of the housing market and investment on supportive policy, it is not evident that employment gains will continue without augmenting policy.

The Federal Government lags.

Exhibit 14. Federal and State Government



Source: Federal Reserve Economic Database.

State & Local Governments were highly dependent upon fiscal transfers to maintain their spending during the Pandemic. Disappearing fiscal stimulus would impair them as their balanced budget mandates kick in and further threaten the nascent recovery. Since they account for *ten percent* of the economy, there is a substantial impact if they cut spending. Since real estate taxes account for a material component of their revenue, a housing downturn would further compromise their financing and growth. In the current environment, the property ladder only extends as far as fiscal policy reaches. An ounce of prevention is better than a pound of cure.

Forecast

The GDP forecast for *2021 is 6.0%*, with a current consensus estimate of 6.3%.[7] These new growth rates account for the stimulus plan enacted in the first quarter. Capital Risk estimates the stimulus will augment growth by 1.3% in 2021. A material jump of consumption driven by stimulus payments supports this forecast, particularly rebate checks. The expectation is that the rebates primarily boost the second quarter with minor effects in the other quarters. This action modestly rebalances the forecast, with the most significant growth occurring in the year's first half.

The expected headline CPI Inflation for *2021 is 3.9% (prior 2.8%), and core CPI is 3.7% (prior 2.5%)* versus a revised consensus rate of 3.0% and 2.1%, respectively. The main driver of the divergence from consensus is the belief that commodities will drive the headline number lower by yearend as supply constraints fade and demand wanes. The expectation is that this occurrence will return inflation to the Fed's target of 2% during the subsequent year.

Off consensus growth and inflation forecasts.

Exhibit 15. Annual Forecast Versus Actual (%, y/y)

	2021	2020	2019	2018
Real GDP				
Forecast	**6.0**	-3.5	2.5	2.5
Actual		-3.5	2.8	2.3
Consensus	**6.3**	-5.6	2.7	2.9
CPI				
Forecast	**3.9**	1.2	1.0	2.2
Actual		1.3	2.3	1.9
Consensus	**3.0**	0.5	2.3	2.4
Core CPI				
Forecast	**3.7**	1.8	2.3	2.1
Actual		1.6	2.2	2.2
Consensus	**2.1**	1.5	2.4	2.2

Note: all rates are percent change year/year. Consensus is the Survey of Professional Forecaster's.

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[7] Survey of Professional Forecasters, *May 2021*. https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/

Exhibit 16. GDP Component Data

Component	Value ($B)	Q/Q (%)	Y/Y (%)
Gross Domestic Product	19,358	1.6	12.2
Personal Consumption Expenditures	13,659	2.8	16.2
Services	8,222	2.9	13.9
Goods	5,629	2.8	20.6
Durable Goods	2,307	2.4	33.2
Non-Durable Goods	3,368	3.0	14.2
Investment	3,510	-0.9	21.0
Fixed Investment	3,591	0.7	15.0
Non-Residential Fixed Investment	2,865	1.9	13.0
Residential Investment	712	-2.5	21.7
Federal	1,358	-1.3	-0.8
State & Local	2,021	0.2	0.5
Defense	798	-0.2	0.0
Non-Defence	558	-2.7	-1.9
Research	651	2.3	9.4
Exports	2,296	1.5	18.2
Imports	3,555	1.9	30.8

Capital Risk

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For more insight, please contact:

Dr **Jason Prole** CFA CAIA FRM
Managing Principal

Capital Risk Management LLC
213-459-3332 | 415-373-7152
contact@capitalriskmanagement.com

www.capitalriskmanagement.com
Los Angeles | San Francisco

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