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ECONOMIC TALKING POINTS
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Existing Home Sales Show A Rare Upward Bounce. But It's A Brief Respite, Not A Recovery.

There is no better barometer on the health of the US economy than housing. It's an industry that encompasses a myriad of vital sectors --- banking, manufacturing, commodities, international trade, transportation and, of course, consumer spending. So it's not surprising the Federal Reserve closely monitors housing trends in the course of setting monetary policy.

When the Fed made its surprise announcement this week to refrain from any further rate increases in 2019, it was due in part to the persistent weakness in housing. This concern was raised not just in the Beige Book but also in subsequent speeches by FOMC voters.

Behind this worry is a simple truism: Sound economic growth in the US is not possible without a robust residential real estate market. And housing has been anything but robust this past year.

Early this month, the government reported that new home sales dropped 6.9% in January to a 607,000 annual rate, which happens to be 4.1% below its year ago level. Not a great start to 2019. Sales crept up a disappointing 2.2% all of last year.

Existing home sales for February, on the other hand, rebounded with an 11.8% jump over January. It was certainly better than consensus expectations, which was in the range of a 5% increase. (Yet even with this bounce, the pace is still 1.8% off the same month last year.) But before any euphoria sets in that the industry is on the comeback trail, it's important to take a step back for a more sober look at the outlook.

We believe the housing industry is at risk to face a perfect storm.

DEMAND

1. The rate of household formation remains consistently below its long term trend of 1.2 million a year. Several factors account for this. The US birth rate has been declining for years and presently stands at a 30-yr low. The number of births in 2017 (latest available) slipped to 3.85 million, the lowest since 1987. One consequence of fewer newborns is that it reduces the demand for single-family homes.

A second factor are the new limits the White House placed on immigration into the US. The number of immigrants receiving green cards fell 5% in 2017 (to 1.127 million) from the year before. The Administration's goal is to slash legal immigration by half. Keep in mind that immigration has historically contributed more than 50% of this country's population growth. If you substantially restrict foreign entry into the US, you remove another important source of home buying.

2. With baby boomers retiring at a rate of 10,000 a day, one would look to the millennial generation as the next wave of demand for homeownership. But many in this cohort are incapable of making such a financial commitment. They are burdened with a record $1.6 trillion in college debt. And "serious delinquencies" (those at least 90 days overdue or in default) of student debt topped a record $166 billion in the final quarter of 2018.

Millenials are also skeptical about the future solvency of Social Security and Medicare and so feel added pressure to save more of their income for retirement, rather than for a down payment to buy a house or condo.

More difficult to measure is the psychological impact the Great Recession (2008-2009) had on millennials. They witnessed many of their friends and families lose homes or declare bankruptcy, and watched how the steep economic downturn eviscerated the long held dogma that real estate values can forever defy gravity.

3. The 2017 Tax Act also increases the after-tax cost of homeownership, especially in regions of the country where residents face high state and local taxes. Prospective homebuyers have since recalculated the cost of homeownership versus renting.

4. With household debt reaching an all time high of $13.5 trillion and interest rates rising the last three years, lenders have also turned more cautious about granting credit to households, according to the Federal Reserve's Senior Loan Officer Survey on Banking.

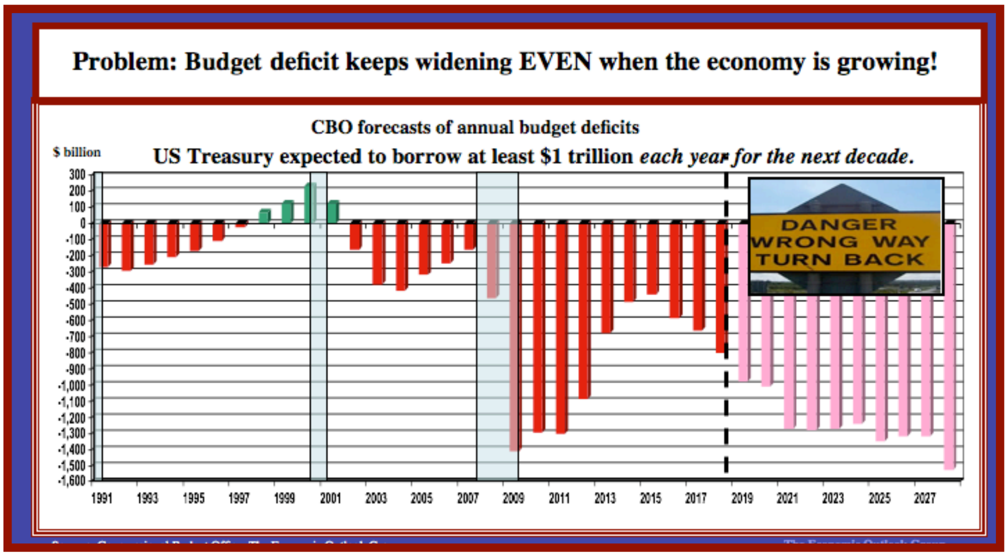
5. The average low rate of 4.50% last year on a 30 yr conventional mortgage was not enough of a catalyst to spur much home buying, especially for existing units. With the Fed now declaring a pause on further hikes in short term rates, mortgage rates have dropped to 4.34% this week, which is the lowest in a year. That rate will certainly drop further in the next few days now that Treasury yields have plummeted to a 14 yr low Friday morning and this could entice more prospective homebuyers to get off the fence and act.

But there are two offsets to consider. If the economy is markedly weakening, as the Fed's downward revisions to growth show, Americans may instead choose to back away from such a major purchase until they feel more confident the US is not heading into recession. That is especially the case now that 3-month to 10 yr Treasury yield curve inverted.

Secondly, we believe the current low mortgage rate is just not sustainable. Borrowing rates to purchase a home are closely tied to the 10 yr Treasury yield. We're projecting the T-note yield will climb about 100 basis points over the next year and a half. What would be driving this surge?

Simple. The US will need to lure US and foreign investors to fund trillion dollar budget deficits every year for perhaps the next decade. The problem is global investors are already top-heavy owning dollar denominated assets. In fact, foreign investors have begun shedding US government debt from their portfolio in recent years. The percentage of US federal debt held by foreigners has fallen from 53% in 2009 to 41% last year.

What this suggests is that investors will demand a more attractive return (i.e., higher yield) that is commensurate with the risk of carrying an excessive amount of new US debt on their portfolios. Stated another way, the Treasury department will pay whatever rate the market demands in order to successfully unload an unprecedented volume of new debt issuances. Our forecast thus calls for the 10 Yr. Treasury yield to climb over the next 18 months, and that could lift the 30 yr mortgage rate to 6% or more by the second half of 2020.



SUPPLY

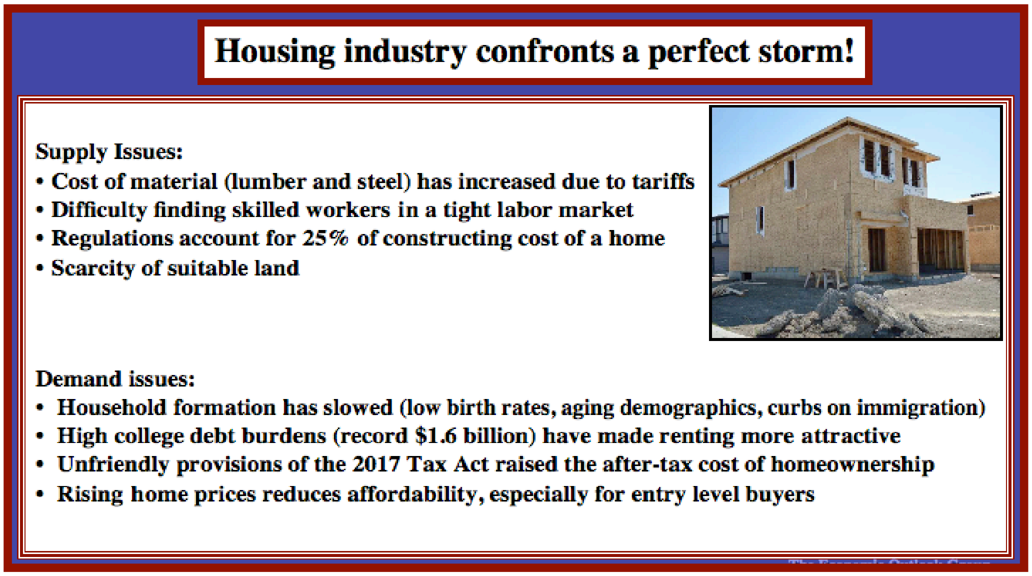
Aside from the challenges homebuyers face, builders have hurdles of their own to overcome.

1. The current tariffs on imports and the retaliatory actions by our trading partners have significantly raised the cost of building a home. The price of steel mill products, softwood lumber, aluminum mill shapes, and plywood have jumped 20% to 30% in the past year.

2. Homebuilders still face a plethora of regulations, which account for 25% of the cost of constructing a home.

3. Finding skilled labor has become especially difficult in this tight labor market. After the housing bubble and credit crisis of 2007- 2009, many construction workers found more secure and even better paying jobs in the growing shale oil/gas industry. As a result, homebuilders have had little choice but to lure new hires by offering higher compensation. Others have resorted to investing more in robotic technology to offset the scarcity of workers.

4. Finally, there's a shortage of suitable land in key cities. What lots are available have skyrocketed in price, but that ultimately reduces the affordability of purchasing a newly built home, especially for entry-level buyers.

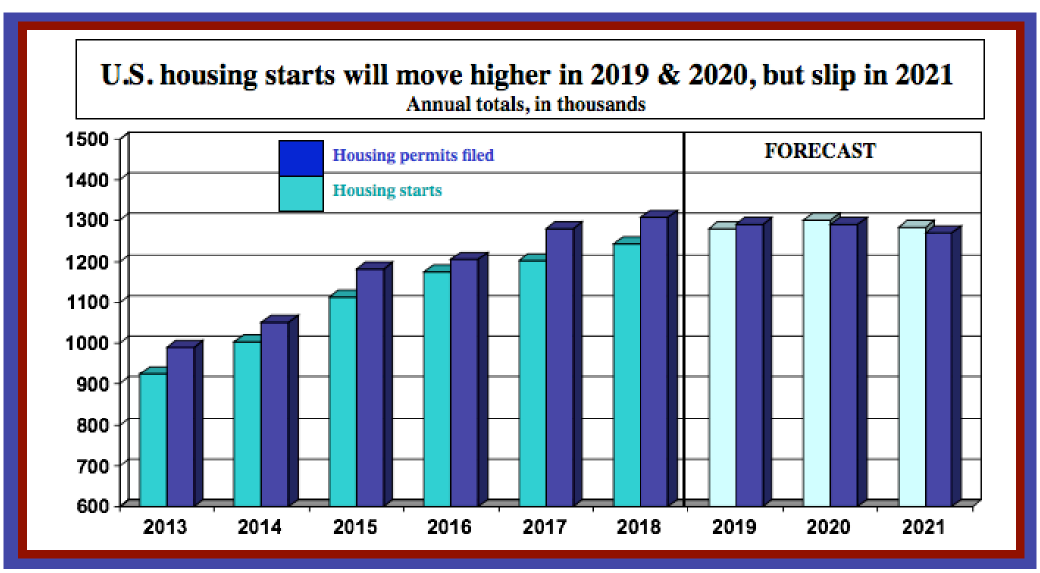


Bottom line:

While the latest NAHB figures on homebuilder sentiment show that confidence has stabilized in March with the index holding at 62 (any figure above 50 should be viewed as positive), the metric with a better predictive track record is the traffic flow of prospective buyers into homebuilder showroom. That component fell another 4 points this month, to 44, which marks the fourth month it has been in negative territory.

A second sign flashing yellow is the ratio between housing permits filed and new starts for single-family homes. Permits are by definition a leading indicator of future construction. But for the pace of construction to increase in the future, we need to see permits consistently exceed starts. Ideally the ratio of permits to starts should be higher than 1. But the latest data points for January show permits actually slipped below starts. (Starts = 926,000 annual rate vs. permits = 812,000)

Should such a trend be repeated in the months ahead, it would represent the clearest evidence yet that housing may be in a prolonged slump – and that will suppress overall economic growth this year and next.

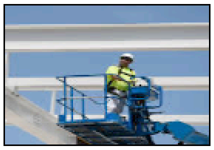


Construction spending to increase in 2019, but pace will ease in 2020 and 2021

Residential construction spending

	2018	2019	2020	2021
	(% change from previous year)			
Single-family homes	5.2%	3.3%	2.7%	-04%
Multi-unit dwellings	0.7%	1.2%	0.9%	-0.2%

Nonresidential construction spending*



	2018	2019	2020	2021
Infrastructure	10.4%	12%	7.8%	6.9%
Manufacturing	-2.0%	3.9%	3.1%	2.4%
Office	9.2%	4.9%	1.1%	0.6%
Education	3.6%	4.5%	2.7%	1.9%
Lodging	11.7%	4.4%	1.9%	1.0%
Amusement	6.8%	3.8%	0.3%	-1.1%
Healthcare	0.2%	2.2%	2.8%	3.8%
Retail	2.5%	1.8%	0.3%	-0.8%

* Total includes private and public construction activity

United States

	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019	I 2020	II 2020	III 2020	IV 2020
Real Gross Domestic Product (GDP):												
%	2.2	4.2	3.4	2.6	1.2	2.5	2.2	2.1	1.8	1.8	1.3	1.5
Personal Consumption Expenditures:												
PCE %	0.5	3.8	3.5	2.8	1.0	2.3	2.0	2.2	1.2	2.0	1.1	1.6
Inflation, end of period, year-over-year:												
CPI %	2.4	2.9	2.3	1.9	1.6	1,8	2.1	2.4	2.5	2.4	2.4	2.1
Unemployment Rate (end of period):												
%	4.1	4.0	3.7	3.9	3.7	3.6	3.7	3.9	3.9	4.1	4.2	4.4
Non-farm Payrolls, monthly avg. thousand:												
	218	211	190	233	182	180	170	140	140	120	95	110
Treasury 10-yr Note Yield % (end of period):												
	2.74	2.85	3.06	2.76	2.60	2.68	2.85	3.05	3.25	3.40	3.30	3.15
Federal funds rate % (end of period):												
	1.63	1.88	2.13	2.38	2.38	2.38	2.38	2.63	2.63	2.38	2.13	2.13

Economic & Geopolitical Risks to Monitor

Projections are for 2019 and 2020

PROBABILITY	U.S.
HIGH	White House achieves partial trade deal with China. Further talks continue. Punitive 25% tariffs on Chinese imports suspended
HIGH	Economy picks up slightly mid-year. Early signs of wage/price spiral emerges. Fed hikes rates once more.
MODERATE	10 Yr.Treasury yield creeps higher as global investor appetite for new US debt begins to fade
LOW	US companies significantly ramp up capital expenditures in 2019
MODERATE	U.S. economic recession to begin by 2020
	FOREIGN
HIGH	Venezuela's Maduro regime collapses in 2019; new elections are held
HIGH	China boosts official spending and extends credit to fend off economic downturn
MODERATE	U.S. - Chinese military clash in the South China Sea and over Taiwan
MODERATE	Saudi monarchy in turmoil in 2019. Oil prices climb
MODERATE	Major clashes erupt between Israel & Lebanon's Hezbollah
HIGH	UK postpones Brexit by several months, followed by a second referendum on whether to leave EU
LOW	Fighting between India and Pakistan escalates. Both countries edge closer to a nuclear conflict