MIXED MACRECONOMIC SIGNALS

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EXECUTIVE SUMMARY

Having focused on its mandate for maximum employment, the U.S. Federal Reserve is now singularly focused on inflation. Combined with increased geopolitical risk and vanishing fiscal stimulus, tightened monetary policy will place upward pressure on cap rates and market volatility. Real estate transaction volume will, however, likely remain vibrant. Given signals from liquid bond markets, an economic recession is unlikely in the near term. The proximate threats to continued economic growth remain the pandemic and monetary policy errors.

2019 AND PRE-COVID

When teaching the honors fall 2019 finance course, I told my students that a negative yield curve probabilistically predicted a recession in the next year 18 months. In early September 2019, the curve stood at -50 basis points (bps) and had been negative since late July and would remain negative until early October. The Fed was also intervening in overnight lending markets.[[1]](#footnote-1) Simply put, in 2019, the U.S. economy’s longest recorded expansion was ending before Covid-19 entered the lexicon.

THE PANDEMIC IMPACT

Initially a demand shock, Covid-19’s impacts persist today. First-time claims for unemployment insurance (UI) skyrocketed, and between early March and early June 2020, over 40 million Americans filed first-time claims [Weekly UI Claims].[[2]](#footnote-2) The unemployment rate quadrupled between March and May 2020 [U-3 Unemployment Rate]. By the end of Q2 2020, real output was contracting by nearly 10%, and the advanced estimate for Q1 2022 showed a slight contraction based on inventory reduction [Real GDP Growth].[[3]](#footnote-3) During the pandemic, market volatility exploded to levels not seen since the global financial crisis [VIX].

THE FEDERAL RESPONSE

The magnitude of the crisis drove a substantial policy response. Fiscal policy included extended UI payments, the 2020 Paycheck Protection Plan, and the 2021 American Rescue Plan. Focusing on direct cash infusions to support consumption, this response amounted to a quarter of annual U.S. GDP.[[4]](#footnote-4) The Federal Reserve lowered its overnight lending rate to zero and more than doubled its balance sheet with asset purchases [Federal Reserve Balance Sheet]. The 10-year U.S. Treasury fell to an historic low of 54 basis points (bps) in March 2020, and the average 30-year fixed residential mortgage fell to approximately 270 bps [Key Interest Rates].[[5]](#footnote-5)

DURABLES DRIVES INFLATION

Given the complexities of modern supply chains, the pandemic was also a supply shock with a substantial impact on inflation. Supported by federal policy, overall consumption recovered rapidly but was distorted relative to pre-pandemic levels. Basically, consumers substituted dining out (non-durables consumption) with buying furniture (durables consumption). By April 2021, durables consumption was nearly 40% higher than its pre-pandemic level, while non-durables consumption was only 14% higher [Changes in Consumption Patterns]. Shipping costs associated with durables increased substantially and remain elevated [Shipping Cost PPI Index]. These pandemic supply shocks have driven inflation well above the Fed’s stated policy of two percent. By one standard measure, inflation is at levels not seen since the early 1990’s [Trimmed Mean Inflation]. The ten-year break-even inflation rate, an index based on tradeable and liquid markets, remains above 200 bps [10-Year Break-even].

THE FED’S PIVOT

With the Fed’s dual mandate of maximal employment and price stability, its initial focus was labor markets, which have largely recovered. It has now turned to price stability, signaling substantial rate increases in the medium term, including the recent increases in the FFR. It has also announced a “run-off” in its balance sheet. Both of these policies will place upward pressure on long-duration Treasurys, as well as cap rates, absent an offsetting increase in demand.

As of this writing, macroeconomic signals are decidedly mixed. On the downside is ongoing equity market volatility, given these markets are (imperfectly) forward-looking. On the upside, according IHS Market’s monthly GDP indicator, April’s GDP increase more than offset March’s decline, which itself was revised upward slightly.[[6]](#footnote-6) Moreover, the 10-year minus 3-month Treasury yield curve remains has been well above 100 bps [Yield Curve]. Job growth remains strong with upward revisions typical. There is always the “next recession,” but absent an unforecastable stock, a recession is improbable in the near term. Proximate economic threats remain sustained pandemic supply-chain problems and Fed policy errors.

1. Source: this [statement](https://www.federalreserve.gov/econres/notes/feds-notes/what-happened-in-money-markets-in-september-2019-20200227.htm). [↑](#footnote-ref-1)
2. Federal Reserve Economic Database (FRED). [↑](#footnote-ref-2)
3. The advanced estimate for Q1 2022 showed a slight contraction based on inventory reduction. [↑](#footnote-ref-3)
4. Source: this [report](https://taxfoundation.org/us-covid19-fiscal-response/). [↑](#footnote-ref-4)
5. It should also be noted that a key yield curve, measured by the 10-year minus the three-month, inverted in late summer 2019 for a considerable period of time. Both the Fed intervention in repo markets and a negative yield curve were indicators that the U.S. economy was not entirely healthy in the second half of 2019. [↑](#footnote-ref-5)
6. [Source](https://ihsmarkit.com/research-analysis/us-monthly-gdp-index-for-april-2022.html). [↑](#footnote-ref-6)