SOME CLARITY TO MIXED MACRECONOMIC SIGNALS

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EXECUTIVE SUMMARY

Having focused on its mandate for maximum employment, the Federal Reserve has strongly signaled that its focus is now inflation. Combined with increased geopolitical risk and vanishing fiscal stimulus, tightened monetary policy will place upward pressure on cap rates and market volatility. Transaction volume in real estate will likely remain vibrant. Given signals from liquid bond markets, an economic recession is unlikely in the near term. The proximate threats to economic growth remain the enduring pandemic and potential policy errors.

THE PANDEMIC’S ECONOMIC IMPACT

As a natural disaster, Covid-19 created an unprecedented macroeconomic landscape. Initially, it was a demand shock, and its adverse impact on labor markets and economic growth was unprecedented. 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].[[1]](#footnote-1) 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 contraction based on inventory reduction [Real GDP Growth].[[2]](#footnote-2) Market volatility exploded to levels not seen since the global financial crisis and remains elevated to this day [VIX].

THE FEDERAL RESPONSE

The magnitude of the economic 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.[[3]](#footnote-3) The Federal Reserve lowered its overnight lending rate to zero and more than doubled its balance sheet with asset purchases [Federal Reserve Balance Sheet].[[4]](#footnote-4) 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)

BUYING FURNITURE 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 was nearly 40% higher than its pre-pandemic level, while non-durables 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 AND MIXED MACROECONOMIC SIGNALS

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 50-bps increase in the FFR. It has also announced a “run-off” in its balance sheet. Both of these policies will put upward pressure on long-duration Treasurys, as well as cap rates, unless there is an offsetting increase in demand for CRE. As of this writing, macroeconomic signals are mixed, but one measure provides clarity.

On the downside, there is the Q1 2022 advanced GDP announcement and heightened equity market volatility. But yield curves remain an important economic signal, and because of their liquidity, the 10-year minus 3-month Treasury curve is an informed choice. It has been well above 100 bps since January 2021 [Yield Curve]. Job growth remains strong with upward revisions typical since summer 2021. There is always the “next recession,” but absent a shock that is unforecastable today, a recession is improbable in the near term. Proximate economic threats remain: sustained supply-chain problems due to the pandemic and Fed policy errors.

1. Source for all materials is the Federal Reserve Economic Database (FRED) and its underlying data sources, unless otherwise noted. [↑](#footnote-ref-1)
2. The advanced estimate for Q1 2022 showed a contraction based on inventory reduction. [↑](#footnote-ref-2)
3. Source: this [report](https://taxfoundation.org/us-covid19-fiscal-response/). [↑](#footnote-ref-3)
4. It should be noted that the Fed was intervening in overnight money (or repo) markets in September 2019, long before the word “Covid” entered the lexicon. Source: this [statement](https://www.federalreserve.gov/econres/notes/feds-notes/what-happened-in-money-markets-in-september-2019-20200227.htm). [↑](#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)