MARCH 2023

Market Insights

PALISADES

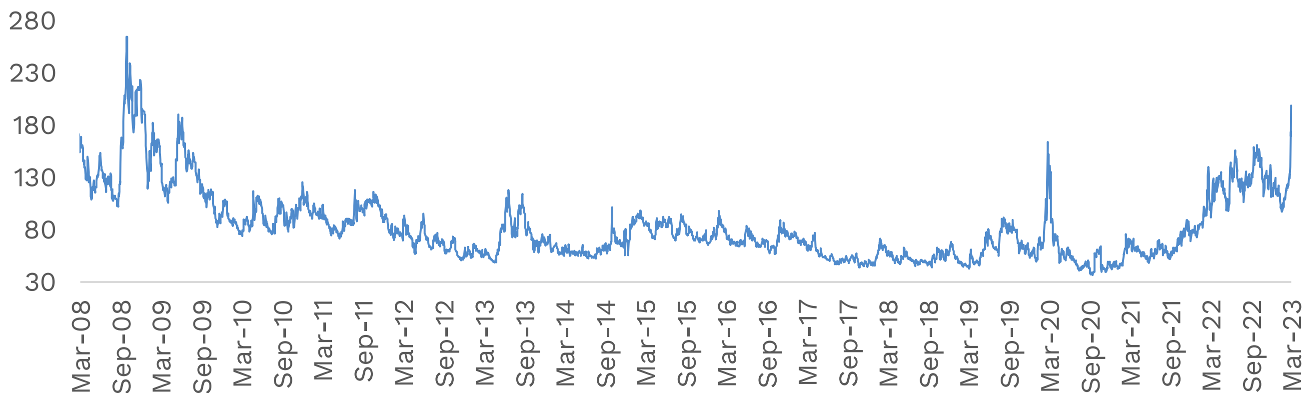
RAPID RATE INCREASES & DURATION - UNINTENDED CONSEQUENCES

It would be an understatement to describe the events of the last couple of weeks as "drama-filled". The challenges faced by many commercial banks were largely unforeseen by market participants, including those that make a living analyzing and reporting on the health of these institutions. For the rest of us, it has highlighted another level of risk management that will need to be considered when placing deposits with FDIC-insured banks.

The KBW Bank Index 1-year lookback highlights the move in equity prices across a basket of what is now 22 U.S. commercial banks (down from 24 a few weeks ago).

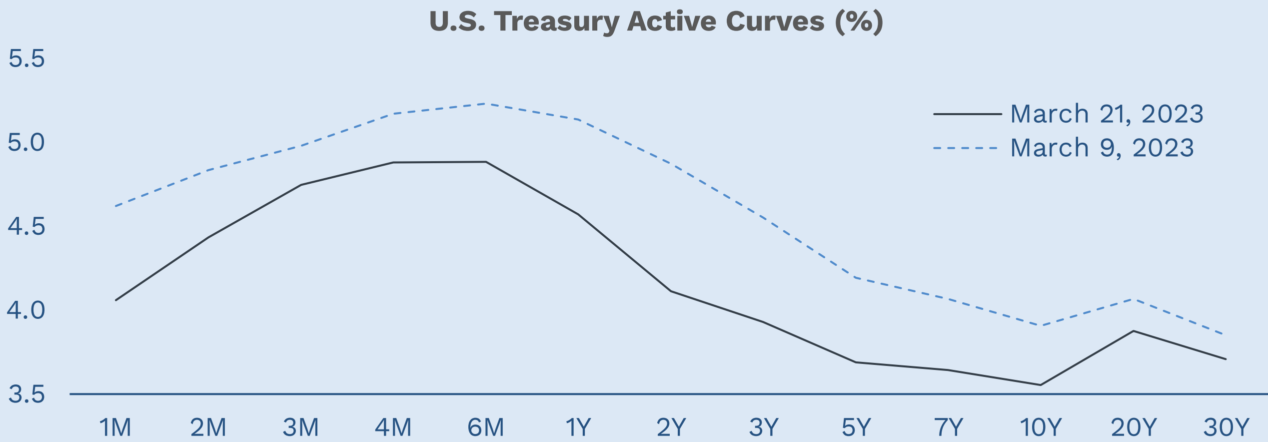
Source: NASDAQ Global Market, Bloomberg

As a result, fixed income volatility has spiked to levels not seen since the 2008 financial crisis.



Source: Intercontinental Exchange, Banc of America

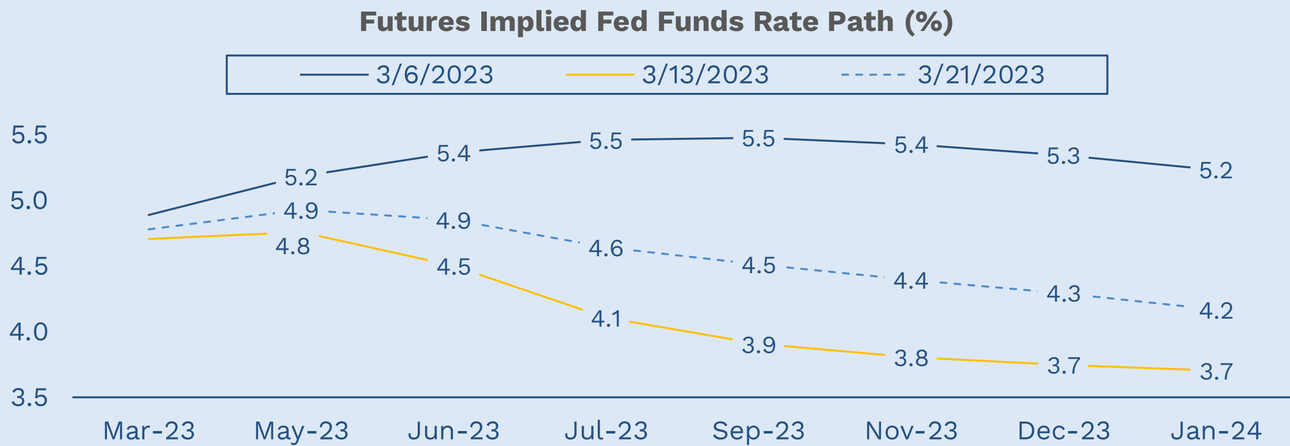
Volatility has not spared any part of the yield curve, as the chart below shows the change from March 9th to 21st.



Source: NASDAQ Global Market, Bloomberg

These types of moves often cause havoc in financial markets, although government officials in the U.S. (and now in Switzerland, with respect to Credit Suisse), stepped in to calm markets by providing liquidity to banks.

Prior to the failure of Silicon Valley Bank, et al, the Fed was on a path to raise rates by 50 basis points in March. Since then, probabilities have wavered between a nearly 0% chance of a rate hike, to the current 80% chance of a 25 basis point rate hike at tomorrow's March 22nd meeting. The forward expectations have shifted dramatically as well, with December 2023 Fed Funds expectations ranging from 5.3% on March 6th to as low as 3.7% on March 13th.



Source: NASDAQ Global Market, Bloomberg

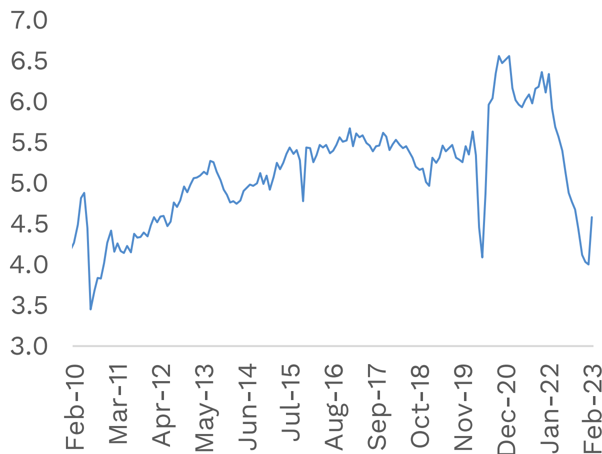
HOUSING

We have talked for some time about the dreadful level of supply in the U.S. housing market and the resulting risk to longer term inflation pressure. This update brings a mix of good and bad news.

Existing home sales remain at historically low levels notwithstanding the February reading of 4.58 million. The low level of sales activity is due in large part to inventory levels that remain constrained at 980 thousand units.

Existing Home Sales

Millions of Units, SAAR



Source: National Association of Realtors

Headlines tend to attribute the decline in sales to reduced demand resulting from high levels of unaffordability, but the data shows a different story.

Existing Home Inventory

Millions of Units

Source: National Association of Realtors

Even with demand falling, inventory levels remain depressed. Over $10 trillion of mortgage loans were originated from late 2019 through 2021, when mortgage rates were between 2.5% and 4.0%. As a result, approximately 85% of the mortgages outstanding have interest rates below 5% (50% below 3.5%). People simply do not want to move when rates are at ~7%.

Months' supply of existing homes shows the relationship between inventory and sales.

Months' Supply of Existing Homes

Source: National Association of Realtors

With a 2.6 months' supply of existing homes, demand continues to outpace supply. We would expect to see parity at around 5 to 6 months' supply, nearly double today's reading.

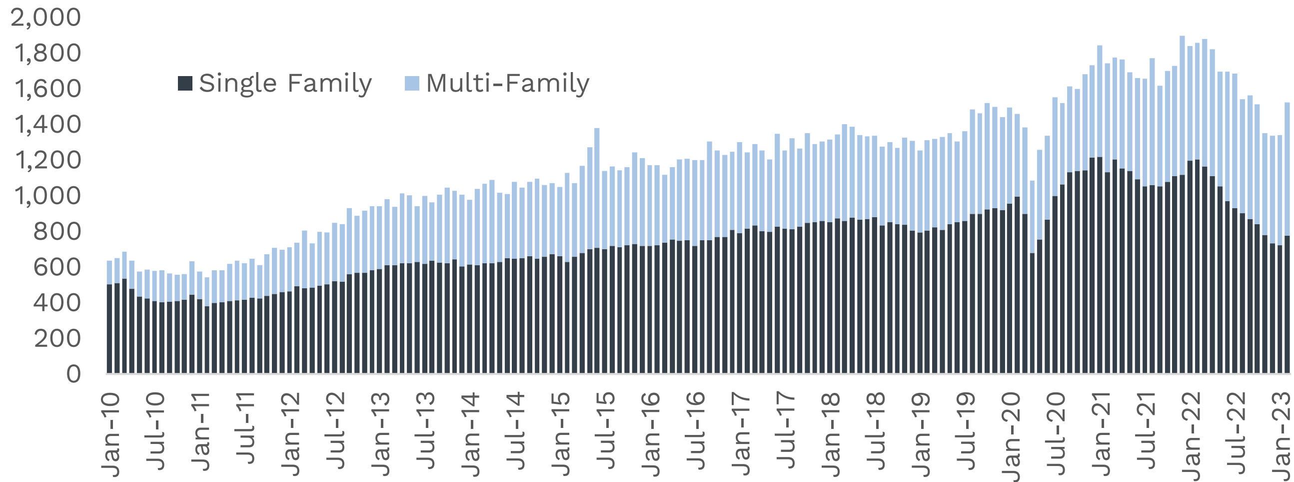
To accomplish this level of parity, we would need to see inventory increase to ~1.8 million units (from 980 thousand units), or sales to drop to ~2.1 million units (from 4.58 million units).

We have been concerned that diminishing levels of existing home inventory will put pressure on home price inflation to the extent rates decline and pent-up demand is released into an undersupplied housing market. Based on January data, there seems to be a psychological tipping point for homebuyers when rates dip into the low 6% area as new home sales increased to levels not seen since March 2022. The question is whether that inflection point will translate into a willingness to sell on the part of existing homeowners. In a perfect world, when/if mortgage rates decline there would be an increase in supply commensurate with the new levels of demand. As we know, however, things usually do not often transition that smoothly.

Pivoting to some good news, homebuilder confidence has shown early signs of a rebound in 2023, driven in part by the easing of mortgage rates in January. Given recent events, we would expect builders to pare back their optimism in upcoming surveys.

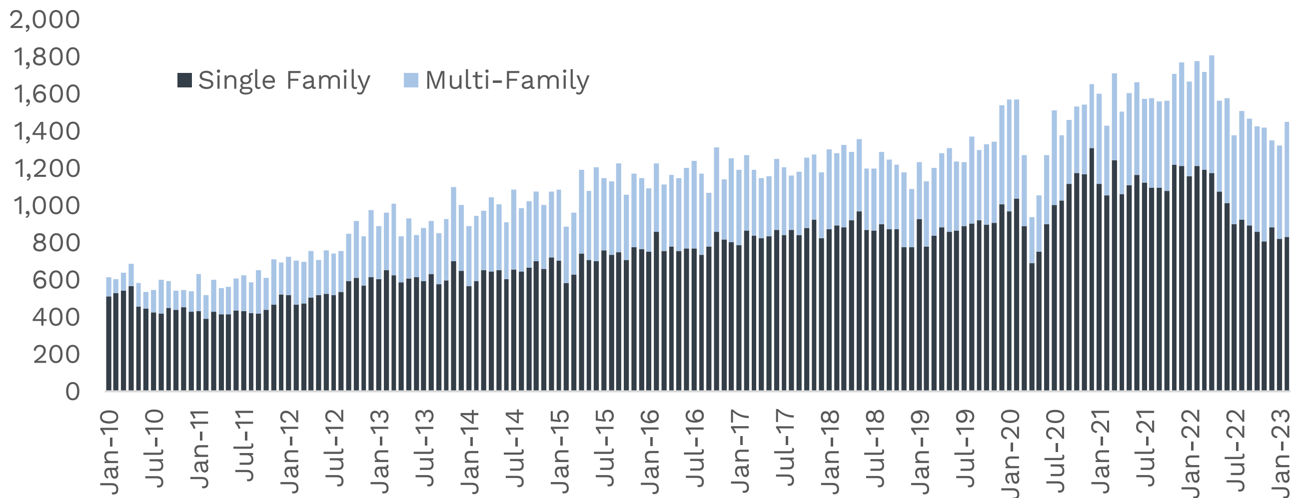
According to the most recent new home data, sales, housing starts, and completions are all on the rise, which bodes well for both supply and demand in the new home market.

Permits jumped nearly 14% month-over-month in February to over 1.5 million on a seasonally adjusted annual basis. While this is a welcome one-month trend, for perspective it is nearly 18% below the reading in February 2022. Of the 185 thousand unit increase month-over-month, 130 thousand of that increase, or ~70%, is attributable to multi-family permitting.



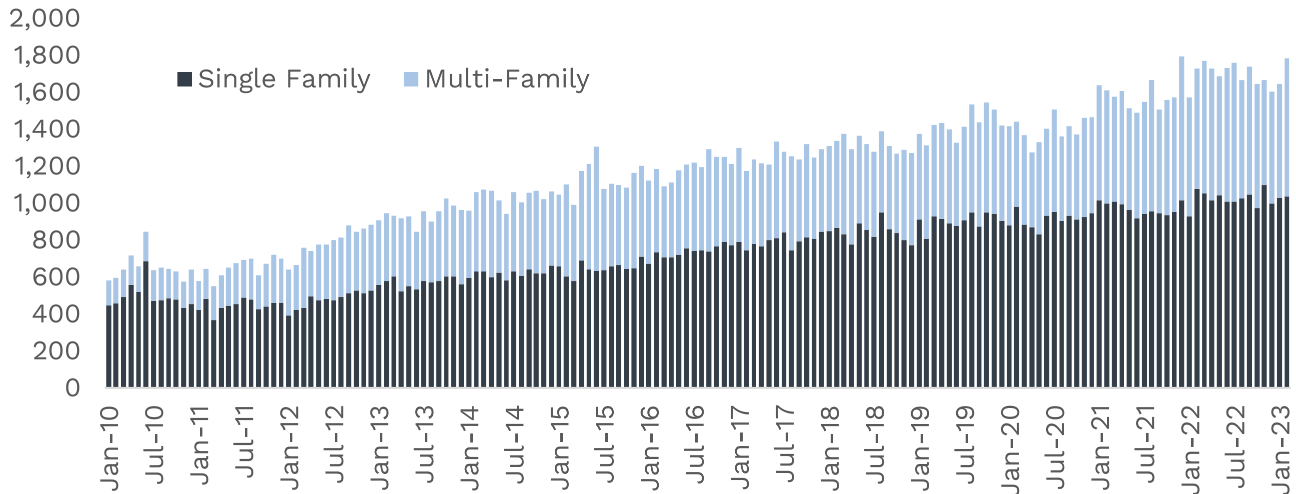
Source: U.S. Census Bureau

We are seeing a similar trend in housing starts that were reported at 1.4 million, up nearly 10% from February's 1.3 million, but ~18% below February 2022. Additionally, nearly all of the gain (93%) came from the multi-family cohort which had a 24% month-over-month gain compared to single family, which was flat.

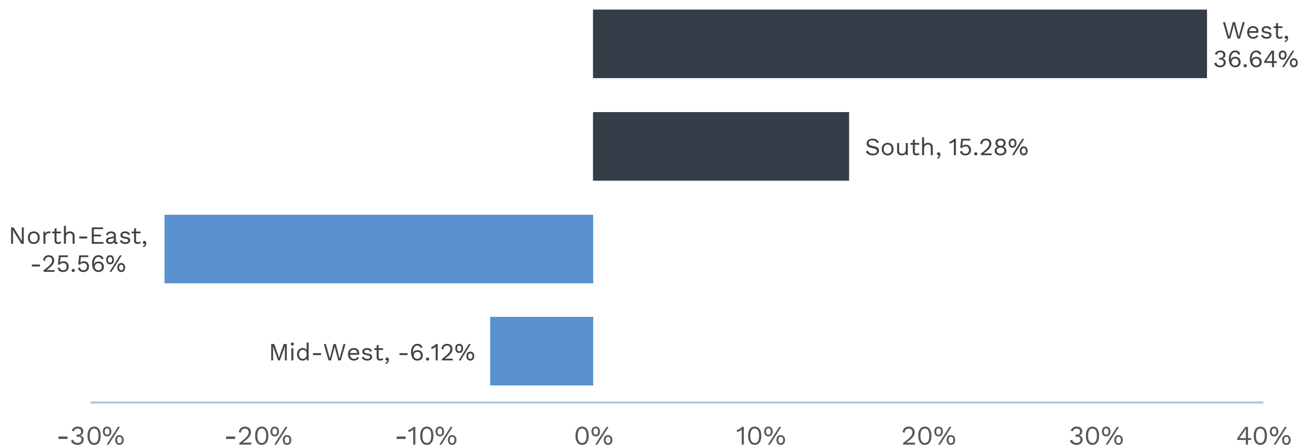


Source: U.S. Census Bureau

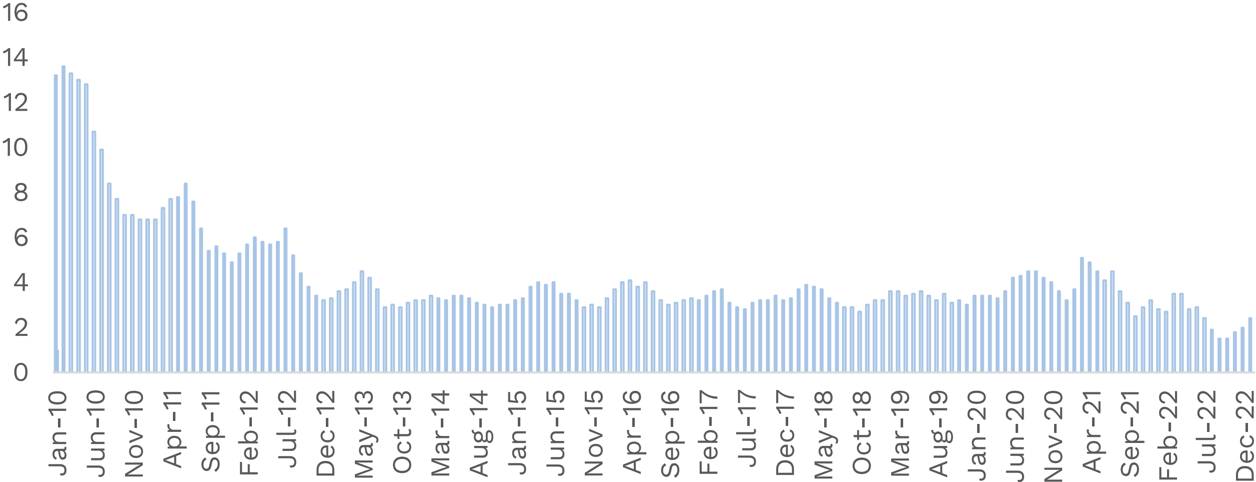
Multi-family is also leading on the completion side, accounting for nearly 93% of the new home completions in February. Unlike building permits and housing starts, completions are up ~13% year-over-year as labor and supply chain challenges have in large part normalized.



Completions vary greatly by region, with the South and West regions up year-over-year ~15% and ~37%, respectively, while the Midwest and Northeast regions are down ~6% and ~26%, respectively.



Through January, demand for new homes as measured by the Census Bureau's months to sale since completion is reported to be 2.4 months. This represents one of the lowest readings in the history of the data set, only surpassed by levels reported during the second half of 2022. The pace at which newly completed homes are selling highlights the strong demand for finished new home product.



Source: U.S. Census Bureau

It is a welcome sign to see positive trends in permits, starts and housing completions, as we believe it is important to use this time of transition to rebuild inventory levels. We would like to see more balanced activity between single family and multi-family, but we'll take what we can get.

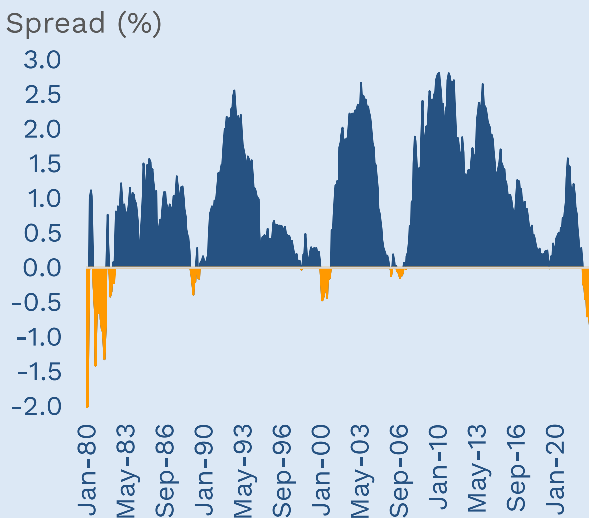
RECESSION RISK

The current banking crisis has reminded markets that duration risk can lead to credit problems. We must ask if this is an isolated event that policymakers have remedied with the Bank Term Funding Program, or if the Fed's commitment to tightening rate policy is leading an otherwise healthy credit market into a significant default cycle.

Fed Funds futures seem to think the latter and predict the Fed will begin easing policy in just a matter of months. Many believe that the yield curve inversion is a leading indicator of a recession.

10-YEAR vs 2-YEAR UST

Spread (%)



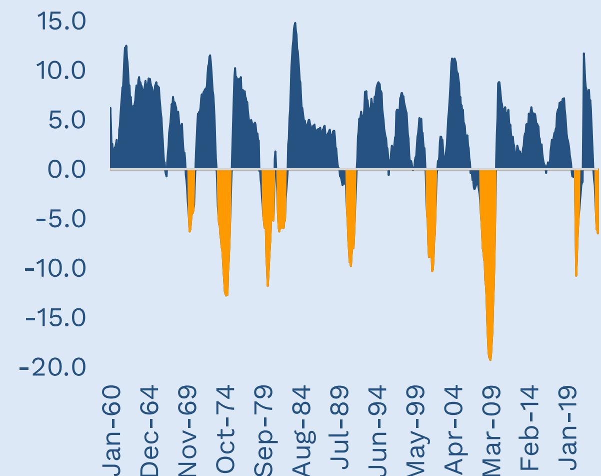
Source: Bloomberg

The yield curve inversion during this cycle reached over 100 basis points, levels not achieved in any other period since the 1980s. The curve has narrowed in the wake of the current banking crisis, and now stands at 57 basis points, which is below the levels during the 2006-2007 credit crisis and around similar levels as the 2000 dotcom bust.

The yield curve has been inverted for nine months, and all eyes will be on the Fed's rate decisions and guidance. According to Cantor Fitzgerald research, there have been **ten yield curve inversions since 1950, with 90% of the inversions resulting in a recession within 36 months**. Similarly, there have been **eight instances where the Leading Economic Indicator Index reported a year-over-year change below -4%, with 100% of such occurrences resulting in a recession within 24 months (we are currently four months in)**.

LEADING ECONOMIC INDICATOR INDEX

Year-over-Year Change (%)



Source: Conference Board

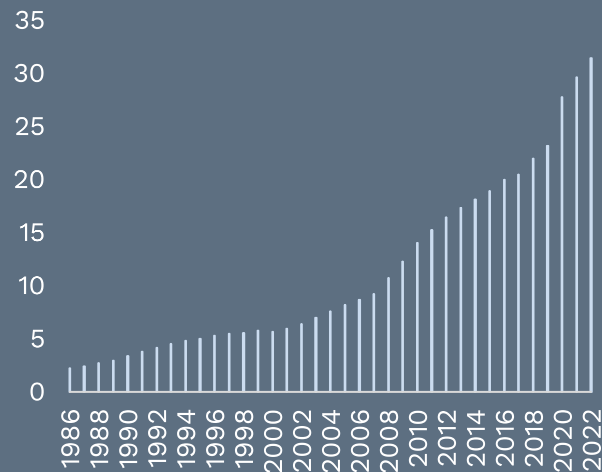
The Fed will likely raise rates by another 25 basis points on March 22nd, which will bring the target rate to 5.0%. As defaults undoubtedly rise across sectors, and credit availability becomes more constrained, the Fed will likely come to a crossroads between price stability and financial stability. Currently, it seems resolved to remain focused on price stability.

QUICK TAKE - WHAT ARE WE DOING?

A much bigger problem facing the U.S. than anything in housing, banking, or otherwise, is the degree of comfort our elected representatives in Washington DC have with respect to the exponential growth in the country's national debt, which now sits at nearly $32 trillion.

U.S. National Debt

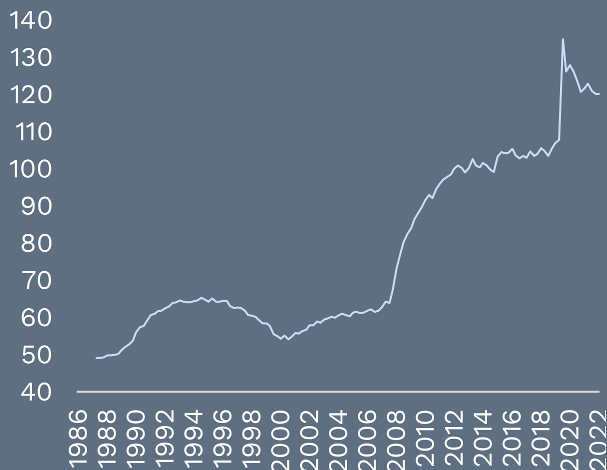
$ in Trillions



Source: U.S. Treasury

U.S. Federal Debt to GDP

(%)



Source: Office of Management & Budget

For better or worse (and arguably better for the U.S.), the global economy runs off the U.S. dollar. The reserve currency status affords the U.S. many benefits, including providing domestic companies with easier access to capital and places the U.S. in a special place geopolitically. The ever-increasing national debt jeopardizes economic growth and undoubtedly restricts opportunities for future generations.

Servicing this debt is one of the federal government's biggest expenses, according to Pew Research:

"Net interest payments on the debt are estimated to total $395.5 billion this fiscal year, or 6.8% of all federal outlays, according to the Office of Management and Budget. That's more than $100 billion more than the government expects to spend on veterans' benefits and services and more than it will spend on elementary and secondary education, disaster relief, agriculture, science and space programs, foreign aid, and natural resources and environmental protection combined."

The Congressional Budget Office ("CBO") estimates that interest payments on the national debt will increase by 35% in 2023, to $640 billion due in large part to the increase in interest rates on U.S. Treasury securities. And worse, the CBO projects interest costs will rise to $1.4 trillion, or $3.9 billion per day, by 2033.

We need both political parties to come together and agree on steps to phase in austerity. There are calls for increasing taxes and while most can agree that everyone should pay their 'fair' share, there are varying opinions as to what 'fair' represents at different levels of earning capacity. While raising taxes sounds like a reasonable way to reduce the federal debt burden, it seems questionable when considering that a Gallup poll taken nearly a decade ago put estimated government waste at 51% of each tax dollar.

"Americans Say Federal Gov't Wastes 50 Cents on the Dollar"

Tax increases are part of the solution, and one way to increase tax revenue is to broaden the base by reducing loopholes, deductions, and credits that are outdated, and/or no longer serve their originally intended purpose. Reducing these incentives would be a good step in simplifying an incredibly complex tax code that offers numerous opportunities to elude taxes.

However, raising tax rates without addressing government waste seems like a bad trade. To ensure better use of citizens' tax dollars, any increase in taxes outside the elimination of loopholes, deductions and credits should be conditioned upon (i) increased transparency and accountability with respect to government spending, (ii) a bipartisan effort to review and eliminate outdated and no longer necessary government programs, and (iii) implementation of cost-saving measures aimed at reducing wasteful spending.

Over the years, there have been coherent bipartisan plans put forth to address the federal debt and wasteful government spending, including the Simpson-Bowles Plan in 2010, among others. With respect to Simpson-Bowles, according to the Peter G. Peterson Foundation, while 11 of the Commission's 18 members endorsed the co-chairs' recommendations, the proposal fell short of the 14 votes required for it to be presented for a vote by the Congress. If the plan had made it to Congress for a vote, it would have faced an uphill battle as not many successful election campaigns are run on platforms focused on austerity.

People have been raising red flags about government spending, deficits, and the federal debt for decades. Nobody knows when, or even if, the music will stop, but given the sheer size of the debt, the inevitable increase in debt service obligations due to rising interest rates, and the resulting misallocation of capital there needs to be a call to arms to address spending and create an actionable path toward reducing debt to manageable levels. Successful efforts will surely reduce geopolitical risk related to the U.S. dollar status as the world's reserve currency, increase U.S. global financial credibility, and improve opportunities for future generations.

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