ECONOMIC OUTLOOK

REGIONS

July 2024

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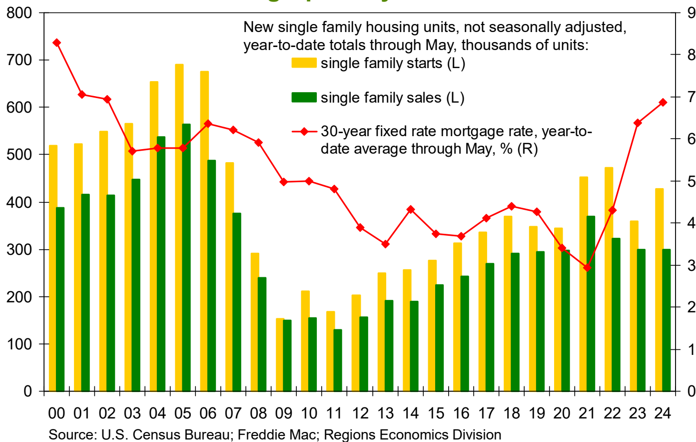
"Locked In" Homeowners Will Remain A Drag on Supply

For some time now, with time measured in years, one key pillar of our housing market outlook has been that a prolonged period in which construction of new single family homes was far below what would be considered normal levels has left the market chronically undersupplied. Lagging construction of new homes has been compounded by notably low turnover of the existing owner-occupied housing stock, which we had been pointing to for years prior to inventories falling to an all-time low in early-2022. As such, there remains a considerable degree of pent-up demand for home purchases. That is one reason that, higher mortgage rates notwithstanding, our recent forecasts for construction and sales of single family homes have been easily above consensus forecasts.

Though we anticipated this year would see rising inventories of existing homes for sale, we nonetheless expected the market for existing homes to remain far from balanced, meaning that a greater share of pent-up demand for home purchases would be funneled to the market for new homes. That builders had the latitude to use incentives to facilitate sales, particularly builders with internal financing arms that enable them to offer mortgage rate buydowns, only added to their advantage. Perhaps banking on relief on the rates front to unlock a greater share of that pent-up demand, builders have been content to add to spec inventories of new homes for sale (for-sale units that are either completed or under construction). The magnitude by which spec inventories have risen, however, has led us to ask whether builders had gotten ahead of themselves, a question we posed in our May *Outlook*.



The above chart is one way to frame this discussion. With the exceptions of 2021 and 2022, when favorable mortgage interest rates were fueling activity, there were more single family housing starts through the first five months of 2024 than in any year since 2007. This came despite the year-to-date average interest rate on a 30-year fixed-rate mortgage, at 6.86 percent, being higher than the year-to-date through May average in any year since 2002 (6.94 percent). One caveat attached to the above chart, however, is that not all single family starts are being built for sale, which helps account for the gaps between the gold and green bars. Indeed, the share of single family starts intended for the rental market was rising through 2022 and much of 2023 but has since fallen. That does not take away from our point, however, given that the count of spec inventories is based solely on new homes for sale.

At the same time, the number of new single family homes sold through May 2024 matches 2023 as the highest year-to-date total since 2007, again with the obvious exceptions of 2021 and 2022. That said, new home sales lost considerable momentum in April and May, with unadjusted sales slipping in each month, not all that surprising given that mortgage interest rates were at or above seven percent over most of this span. As we see it, that sales have dropped off isn't so much an indication that pent-up demand for home purchases has largely been fulfilled, but instead reflects growing affordability challenges that, incentives notwithstanding, are keeping more prospective buyers on the sidelines.

Either way, with still-strong levels of starts and flagging sales, spec inventories of new homes for sale have risen even further and, as of May, stand at their highest level in over a year and have hovered in a range last seen in the mid-2000s. Mortgage interest rates have been little changed through early-July and buyer traffic has remained light, which has been reflected in the Mortgage Bankers Association's gauge of purchase mortgage loan applications being stuck at notably low levels over recent weeks. As such, builders may be growing at least a bit uneasy at the prospect of further increases in spec inventories. To the extent this is the case, that would weigh on single family permit issuance and construction starts on new single family homes.

To our earlier point, while we don't think the pool of prospective buyers is drying, we do think that the combination of elevated prices and elevated mortgage interest rates is limiting the number of prospective buyers able to qualify for mortgage loans and come up with adequate down payments. As we have frequently pointed out, more stringent lending standards for mortgage loans over the past several years have led to a significant concentration in mortgage issuance amongst buyers with credit scores at 760 and above. Over the past five years borrowers in this credit score bucket have accounted for just under two-thirds of all mortgage loan originations, but it isn't as though there is an unlimited pool of borrowers in this credit score bucket who can be counted on to sustain growth in home sales. As such, barring more meaningful declines in mortgage interest rates than have been seen to date, it could be that affordability constraints become an increasing

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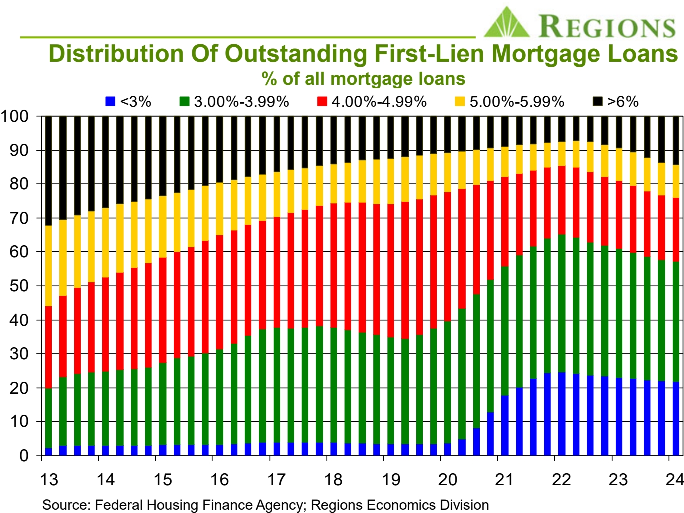
weight on home purchases while inventories of spec homes for sale rise to a level that triggers cuts in single family housing starts.

At the same time, elevated mortgage interest rates remain a drag on inventories of existing homes for sale, as significant numbers of current owners with much lower rates on their current mortgage loans remain "locked in" by those rates. It's kind of a weird *Hotel California* vibe – you can lock in any time you like but you can never leave. Okay, maybe not that extreme, but it is hard to deny that this lock-in effect has acted to hold down turnover of the stock of existing homes. We've discussed this point often, including in the January *Outlook*, where we noted that we thought mortgage rates would have to fall below 5.50 percent in order for there to be a meaningful 'unlocking" effect on existing home inventories. At the same time, however, our baseline forecast had mortgage rates remaining above six percent and we've seen no reason to change that call even if, as we and many others expect, the FOMC cuts the Fed funds rate twice by year-end 2024.

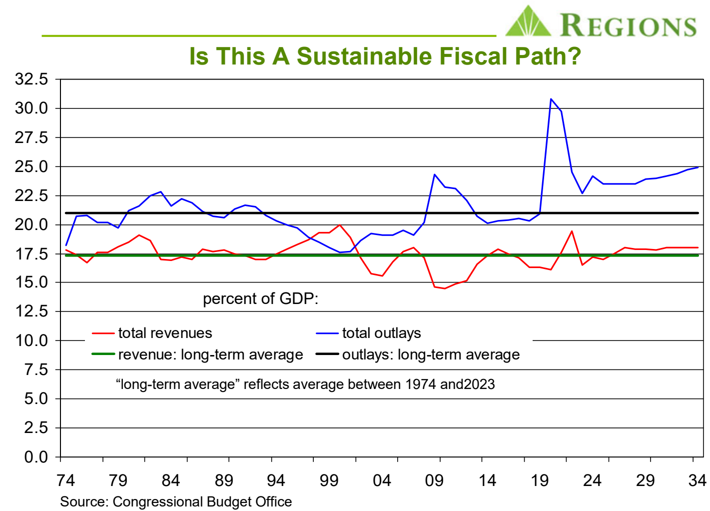


The notion of current owners being locked in place by favorable mortgage interest rates was reinforced with the recent release of the Federal Finance Housing Agency's (FHFA) *National Mortgage Database* which includes an interest rate distribution of current first-lien mortgage loans. We illustrate this distribution in the chart above. Note the jump in the share of mortgage loans with interest rates below three percent in the quarters subsequent to the onset of the pandemic, reflecting the spike in new home sales and significant shares of homeowners taking advantage of notably low mortgage interest rates to refinance into lower rates. The FHFA data show 14.3 percent of outstanding first-lien mortgage loans with an interest rate above six percent as of Q1 2024; this share has risen over the past few quarters and is the highest share since Q4 2017, reflecting recent mortgage originations at higher rates.

The average interest rate on all outstanding first-lien mortgages as of Q1 2024 was 4.1 percent. This is a not so subtle reminder that, in addition to weighing on the demand side of the housing market, elevated mortgage interest rates are also acting as a meaningful drag on the supply side of the market in that they are holding down inventories of existing homes for sale. While it is true that builders stand to profit from this lock-in effect, it is also true that the longer mortgage rates remain elevated, the fewer chances builders will have to do so, as affordability constraints effectively lock a higher share of prospective buyers out of the market. While further deceleration in inflation and the FOMC cutting the Fed funds rate will bring some relief, we see somewhat limited scope for rate cuts, and in turn mortgage rate relief, if the broader economy performs in line with our expectations. As such, we've revisited our forecasts for construction and sales of single family homes, with our July baseline forecast anticipating weaker trajectories for each than we had previously anticipated. Of course new homes will still be built and sold, and existing homes will still trade hands, but all at lower volumes than would be the case with lower mortgage interest rates. As such, any meaningful relief from the long-running undersupply of single family homes gets pushed further and further into the future

Unsustainable Fiscal Path Isn't A Problem. Until It Is . . .

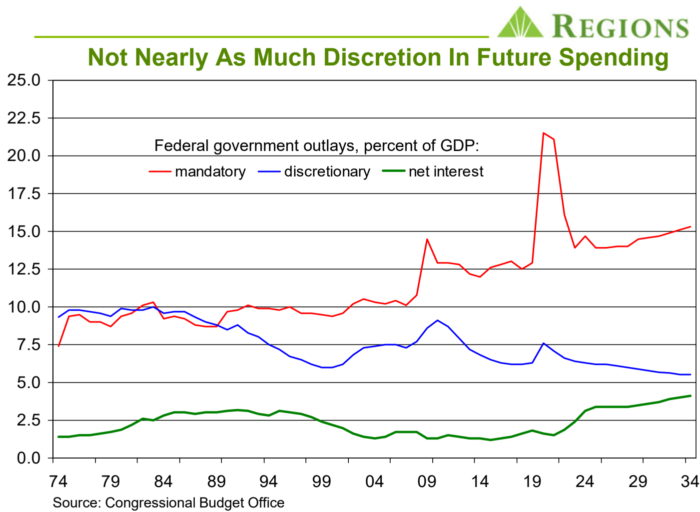
We do a fair number of events with clients, often in tandem with our esteemed colleagues in our firm's wealth management arm. For us, the best part of these events is listening to CEOs, CFOs, small business owners, and wealth clients describe what they are seeing in their world and hearing what's on their minds. We've always thought that what we hear from them is infinitely more valuable than anything they hear from us. Of late, growing numbers of wealth and commercial – from across the spectrum of industries – clients have gravitated toward one specific topic – the fiscal path of the federal government. The degree to which they have gravitated to this topic has been somewhat striking, but even more striking has been the degree of frustration, even anger, that many express when discussing this topic.



The Congressional Budget Office's (CBO) mid-June release of their updated projections for the federal government budget – the paths of revenue, spending, deficits, and outstanding debt – through 2034 probably wasn't all that soothing to anyone concerned with this issue. The CBO's updated projections peg the fiscal year 2024 budget deficit at $1.9 trillion, up from their February 2024 estimate of $1.5 trillion. Moreover, deficits are expected to hover around this higher level over the next few years before becoming larger, both absolutely and as a percentage of GDP, over the later years

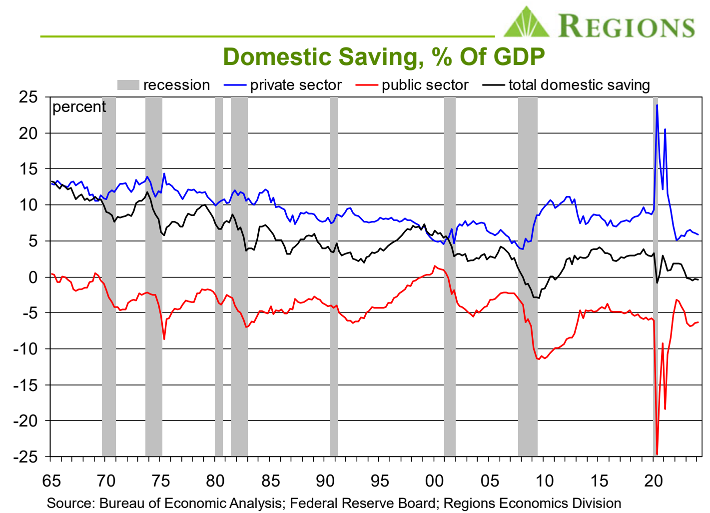
of the forecast horizon. Sure, it's easy to dismiss such long-term forecasts on the grounds that a lot can, and almost surely will, change over the next decade, to the point that any forecast made at present will quickly be proven wrong. What is different in this case, and not at all in a comforting way, is that the path of a considerable portion of federal government spending is, under current law, pretty much pre-determined.

This accounts for some, but not all, of the upward trend in federal government outlays as a percentage of GDP shown in the chart on the prior page. As seen in the chart, even as the spike in spending associated, however loosely, with the pandemic subsides, the expected trajectory of spending still leaves the outlays/GDP ratio above the pre-pandemic trend and easily above the average seen over the past fifty years. In contrast, federal government revenues as a percentage of GDP are expected to be more or less in line with the average seen over the prior fifty years. The growing divergence between outlays and revenue as percentages of GDP is reflected in the CBO's estimates of growing budget deficits.



To our earlier point about a considerable portion of spending being pre-determined, the chart above breaks federal government spending down into the three broad components. Mandatory outlays, including Social Security and Medicare, will continue to grow at a rapid rate over the coming decade. The trend shown in the chart above has been known not for years but for decades, as it reflects demographic trends. From a budgetary perspective, however, what makes this trend more challenging is that over the years the ratio of workers paying into Social Security to benefit recipients has been steadily shrinking. Another striking element of the above chart is the growth in interest costs, reflecting not only steadily increasing levels of outstanding federal government debt but also higher interest rates. The CBO's projections anticipate that net interest outlays as a percentage of GDP will, beginning next year, be higher than at any point since at least 1940, which is the first year for which the Office of Management and Budget reports such data. CBO also notes that net interest expense will be greater than spending on national defense. Between continued rapid growth in mandatory expenditures and rising interest expense, there is increasingly less room in the federal government budget for discretionary spending over the coming decade, as seen in the downward trend in the chart above.

Whether or not the fiscal path anticipated by CBO is sustainable is one question, and perhaps the question most people are focused on, judging from the questions we and our colleagues field from clients. Another question, in our minds equally as important, is whether there are economic implications of such a fiscal path. We've already touched on one, i.e., the increasingly narrow scope for discretionary government spending. A much more relevant implication is the potential impact on private domestic investment. One way to think about this is to go back to one of the most basic points in any first semester macroeconomics course, which is that in any economy the aggregate level of investment equals the aggregate level of saving. Which matters because, as we've said and written more times than we could possibly begin to count, investment is the main fuel of any economy's growth over time.



We often use the above chart to illustrate this point. Domestic saving consists of combined saving amongst the household, corporate, and government sectors. Any single sector of the economy can engage in dissaving (i.e., run a negative saving rate), as has long been the case in the public sector of the U.S. economy. In a closed economy, negative saving in one or more sectors must be offset by saving in the remaining sector(s), while in an open economy foreign saving can compensate for a lack of or a low level of domestic saving. By definition, however, for any economy the flip side of lower (higher) levels of net saving is lower (higher) levels of total investment which, over time, is associated with lower (higher) rates of sustainable economic growth.

As of Q1 2024, net domestic saving was negative and equivalent to 0.44 percent of nominal GDP (savings, deficits, and debt are measured in nominal terms, so nominal GDP is the relevant marker in this context). This is the fifth consecutive quarter in which net domestic saving was slightly negative, which reflects a falling household saving rate at a time when federal government budget deficits have been growing larger. But, that this is the starting point from which we embark on the fiscal path anticipated by the CBO makes the prospect of that fiscal path more unsettling as it leaves us with a set of less than desirable outcomes. Either we see lower and lower levels of investment, we become increasingly reliant on foreign saving to finance a given path of investment, or we end up with some combination of these two outcomes. Again, given that investment is the main fuel for growth in any economy,

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anything that puts longer-term growth in investment on either a lower or a potentially unstable/unsustainable path will ultimately translate into a lower sustainable rate of economic growth.

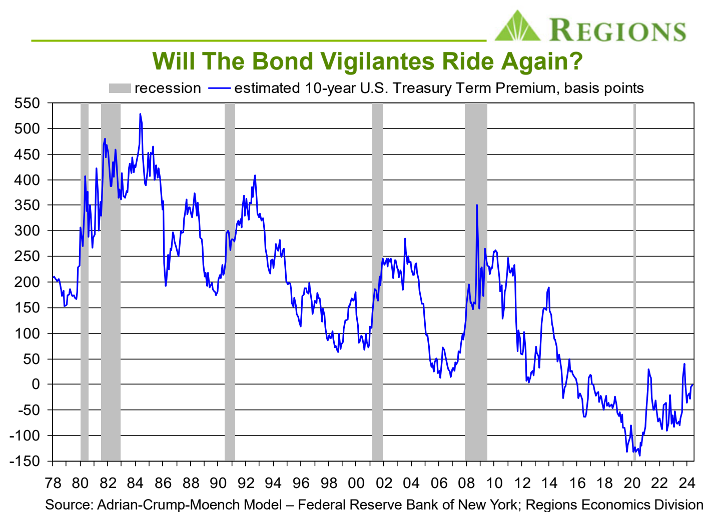
This, at least to us, is the most important context into which any discussion of federal government finances can be put, though this tends to get lost in the discussion of whether or not the fiscal path envisioned by the CBO can be sustained. Net domestic saving will almost surely become increasingly negative on this path, meaning that we will become increasingly reliant on foreign saving in order to sustain a given path of investment. The cost of doing so, however, will only increase as domestic dissaving becomes more and more pronounced, i.e., it will take higher U.S. interest rates to attract foreign savings. One advantage the U.S. continues to enjoy is the U.S. dollar's status as the de facto global reserve currency, which has helped make it possible, and less costly, for the U.S to attract foreign saving to finance both current consumption and future growth. While there are at present no viable threats to that status, that doesn't mean that no such threats will emerge. Indeed, mounting geopolitical tensions and the prospects of intensifying trade wars are two such potential threats.

One thing that makes this topic difficult to discuss is that there is no clear line in the sand which, if crossed, would trigger an outflow of foreign saving which would in turn result in a sharp and sudden rise in U.S. interest rates. "It isn't a problem, until it is" may be the right answer, but that just isn't an answer that many people find all that comforting, or all that useful. Moreover, many are quick to assume that because that line has yet to be crossed means that there is no such line and are just as quick to dismiss discussions of such a line as needlessly alarmist. We obviously don't agree.

Assuming (or perhaps hoping for) an undisturbed inflow of foreign saving is one way around the question of whether the paths of federal government deficits and debt anticipated by the CBO are either sustainable or desirable. Though there are exceptions, there does not seem to be a great deal of political will to address this question, and it seems unlikely that any combination of outcomes from this November's Presidential and Congressional elections would materially alter the fiscal path anticipated by the CBO.

If reversals of capital inflows and/or sufficient political will are not enough to alter the fiscal path envisioned by the CBO, there is another possibility. The release of the CBO's updated fiscal outlook prompted considerable discussion of whether the "bond vigilantes" will return, pushing interest rates up to a degree sufficient to more or less force fiscal policy makers to act to curb federal government deficits and growth of federal government debt. By way of either an introduction to (for younger readers) or a reminder of (for, well, more "seasoned" readers), the bond vigilantes last rode to the scene in the early-1990s. At the time, federal government budget deficits were growing, to the point that government dissaving was equivalent to more than six percent of GDP, as has been the case over the past five quarters. Increasingly concerned over the prospect of even further increases in the size of the deficit, the bond vigilantes rode roughshod over the bond market, pushing yields on longer-term U.S. Treasury securities up sharply.

That was seen as a major catalyst for a bipartisan agreement to rein in growth in government spending, to the point that by the end of the 1990s the federal government was running a budget surplus. Such was the influence of the bond vigilantes that noted political advisor James Carville famously observed that, if there was reincarnation, he'd like "to come back as the bond market – you can intimidate everybody."



Whether the bond vigilantes will saddle up again remains to be seen, as does the degree of influence they may have this time around. One way to think about the potential scope of that impact is illustrated in the chart above, showing the term premium on 10-year U.S. Treasury notes as estimated in a widely followed model developed by staff at the New York Fed. The term premium captures the added compensation an investor would require to hold a long-term security rather than a series of shorter-term securities. As seen in the above chart, the term premium on 10-year U.S. Treasury note is at present hovering around zero after a prolonged period of being negative. But, note how the term premium shot up to over four hundred basis points during the ride of the bond market vigilantes in the early-1990s.

Should the bond vigilantes saddle up again, the term premium would begin to rise, and even if not to the same extent seen in the early-1990s, this would translate into meaningfully higher interest rates on longer-term U.S. Treasury securities. As a point of reference, the average term premium on 10-year notes from 1965 through 2019 was 173 basis points, so even a return to that historical average would be somewhat painful. Also, note that bond vigilantes can, and do, reside all over the globe, going to our earlier point about U.S. reliance on foreign saving. So, a bond market rout could, and almost surely would, be one manifestation of foreign saving pulling up stakes and exiting the U.S.

Whether the bond vigilantes would have enough clout this time around to restore some semblance of order over fiscal policy remains to be seen. It is worth noting that the FOMC tapering the rate at which the Fed balance sheet is winding down and ultimately ending that tapering will blunt upward pressure on U.S. Treasury yields. We'd argue that any such relief will ultimately be offset by widening deficits if the CBO's projections are on or near the mark. As such, though it may not be apparent as soon as it otherwise might be, the current fiscal path clearly seems unsustainable, the questions at this point being how long it can be sustained and what will be the catalyst for a change of course. It would, of course, be less painful to act out of choice rather than out of necessity but, at some point, the choice may no longer be ours.

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Q4 '23 (a)	Q1 '24 (a)	Q2 '24 (f)	Q3 '24 (f)	Q4 '24 (f)	Q1 '25 (f)	Q2 '25 (f)	Q3 '25 (f)		2021 (a)	2022 (a)	2023 (a)	2024 (f)	2025 (f)
3.4	1.4	1.2	2.2	2.0	2.4	2.2	2.3	Real GDP[1]	5.8	1.9	2.5	2.3	2.2
3.3	1.5	1.8	2.4	1.8	2.1	1.9	2.0	Real Personal Consumption[1]	8.4	2.5	2.2	2.2	2.0
3.7	4.4	2.2	3.6	4.0	4.0	3.8	3.9	Real Business Fixed Investment[1]	5.9	5.2	4.5	3.5	3.8
-1.1	1.6	0.4	2.6	3.0	3.4	3.4	4.1	Equipment[1]	6.4	5.2	-0.3	0.7	3.1
4.3	7.7	5.7	5.3	5.1	5.1	5.0	4.9	Intellectual Property and Software[1]	10.4	9.1	4.5	5.2	5.1
10.9	3.4	-2.0	1.8	3.3	3.0	1.8	1.4	Structures[1]	-3.2	-2.1	13.2	5.1	2.0
2.8	16.0	-2.1	-2.5	0.4	2.9	-0.5	1.1	Real Residential Fixed Investment[1]	10.7	-9.0	-10.6	4.3	0.4
4.6	1.8	1.7	1.3	1.5	1.7	1.8	1.4	Real Government Expenditures[1]	-0.3	-0.9	4.1	2.8	1.6
-918.5	-960.3	-1,006.9	-1,012.7	-1,017.4	-1,015.4	-1,016.3	-1,013.0	Real Net Exports[2]	-933.8	-1,051.0	-928.1	-999.3	-1,015.5
1,060	1,062	998	984	984	982	983	983	Single Family Housing Starts, ths. of units[3]	1,131	1,006	949	1,007	983
421	345	307	304	300	297	294	294	Multi-Family Housing Starts, ths. of units[3]	474	546	473	314	295
5.5	5.3	4.5	3.0	2.1	1.8	1.9	2.0	CoreLogic House Price Index[5]	15.4	13.2	3.9	3.7	1.9
15.7	15.3	15.7	16.1	15.9	15.9	15.9	16.0	Vehicle Sales, millions of units[3]	14.9	13.8	15.5	15.7	16.0
3.7	3.8	4.0	4.1	4.2	4.2	4.2	4.2	Unemployment Rate, %[4]	5.4	3.6	3.6	4.0	4.2
1.9	1.8	1.7	1.6	1.5	1.2	1.0	0.9	Non-Farm Employment[5]	2.9	4.3	2.3	1.6	1.0
0.9	1.3	1.9	3.3	2.1	3.2	2.2	2.7	Real Disposable Personal Income[1]	3.2	-5.9	4.1	1.7	2.7
2.6	2.4	2.6	2.4	2.6	2.4	2.4	2.3	GDP Price Deflator[5]	4.6	7.1	3.6	2.5	2.3
2.8	2.6	2.6	2.5	2.7	2.5	2.4	2.5	PCE Deflator[5]	4.2	6.5	3.7	2.6	2.5
3.2	3.2	3.2	3.0	3.0	2.7	2.6	2.6	Consumer Price Index[5]	4.7	8.0	4.1	3.1	2.6
3.2	2.9	2.6	2.7	2.8	2.5	2.4	2.5	Core PCE Deflator[5]	3.6	5.2	4.1	2.8	2.5
4.0	3.8	3.5	3.4	3.3	2.9	2.7	2.7	Core Consumer Price Index[5]	3.6	6.2	4.8	3.5	2.8
5.38	5.38	5.38	5.34	5.09	4.84	4.57	4.34	Fed Funds Target Rate Range Mid-Point, %[4]	0.13	1.73	5.07	5.29	4.45
4.44	4.16	4.44	4.38	4.40	4.40	4.37	4.38	10-Year Treasury Note Yield, %[4]	1.44	2.95	3.96	4.35	4.37
7.30	6.75	7.00	6.90	6.87	6.82	6.71	6.63	30-Year Fixed Mortgage, %[4]	2.96	5.34	6.81	6.88	6.67
-3.2	-3.4	-3.3	-3.1	-3.1	-3.1	-3.0	-3.0	Current Account, % of GDP	-3.7	-3.9	-3.3	-3.2	-3.0

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2017 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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