# Economic Update

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MARCH 17, 2023

## 1. INFLATION

- The Consumer Price Index (CPI) rose 0.4% month-over-month and 6.0% year-over-year on a seasonally adjusted basis through February, according to the Bureau of Labor Statistics' March 14th release. Both the monthly and annual measures decelerated from January.
- Last month's annual inflation rate was the lowest since September 2021, while the previous two months have seen a rise in monthly inflation after slowing to 0.1% and 0.2% in the final months of 2022. Core prices have risen by 5.5% over the past 12 months, the lowest annual climb since 2021, but registered their highest monthly increase since September.
- Shelter accounted for roughly 70% of monthly price increases, rising 0.8%. Food prices rose 0.4%, while energy prices fell by 0.6% month-over-month.
- Eyes now turn to the Fed — with their March policy meeting on the horizon, markets have tried to telegraph their upcoming policy decision in the face of tight labor markets, recent US bank collapses, and mixed inflation data. Following Tuesday's CPI release, futures markets coalesced around a 25 basis point forecast for next week's policy decision.

## 2. SILICON VALLEY BANK CRISIS

- The March 10th collapse of Silicon Valley Bank — and Signature Bank a few days later — became the largest US bank failures since the 2008 financial crisis. For the former, a requested capital raise triggered a crisis in confidence among depositors who feared a deterioration in bank liquidity, triggering a run on the bank and, eventually, government intervention.
- The collapse highlights the risk posed by a rising interest rate environment on the financial system, resurfaces questions about moral hazard in banking, and complicates the Federal Reserve's hawkish stance as it prioritizes price stability amid high inflation.
- Markets initially fell in the wake of the bank failures but have rallied in the days since as federal intervention and reduced fears around contagion restore confidence in the financial system.
- While regulators stepped in with depositor guarantees and public assurances to help affirm faith in the financial system, futures markets have adjusted their forecast for the upcoming FOMC rate-hike decision to reflect an expected 25 basis point hike, down from a projected 50 basis point hike that markets predicted just a few weeks ago.

## 3. CRE EXPOSURE TO RECENT BANK COLLAPSES

- The recent closures of California's Silicon Valley Bank (SVB) and New York's Signature Bank could have implications for commercial real estate lending. While much of SVB's business was concentrated in the tech sector, the bank's 2022 financials showed that 15% of its loans were attached to residential mortgages or commercial real estate projects.

- Moreover, Signature Bank's business focused on CRE lending. The bank's balance sheet shows that it held $110.36 billion in assets and $88.59 billion in deposits at the close of 2022. $35.7 billion of Signature's portfolio included loans for multifamily, commercial property, acquisition, development, construction, and home equity lines of credit.
- The tech sector's exposure to SVB could also have implications for prop-tech firms, not only due to direct exposure but due to the common thread of venture capital firms whose portfolio consisted of several businesses that lacked diversified banking relationships. Banks often typically require single-banking relationships from lending agreements with large depositors — a standard that will likely come under increased pushback in the future.
- On the other hand, many analysts believe that The Federal Reserve's backstopping of affected banks last weekend helped restore confidence among depositors at tech-focused banks. Some VC groups focused on prop-tech have stated that recent distress will not significantly impact their activity in the sector.

## 4. MORTGAGE RATES FALL

- Mortgage rates fell to begin the week, with the 30-year fixed mortgage dipping to 6.57% on Monday, March 13th, from a recent high of 7.05% registered last Wednesday.
- Movements in mortgage rates are generally concurrent with movements in US Treasuries, which saw yields fall sharply in the wake of last week's bank collapses.
- After reaching a high of 7% last September, mortgage rates declined to close 2022 and fell as low as 6% in January, prompting an 8% jump in pending home sales that month. Recent rate reduction could generate a similar jump in homebuying activity in March.
- Since mortgage rates are indirectly influenced by movements in the Federal Funds rate, recent volatility around March rate hike projections is likely also contributing to the recent fall in rates.

## 5. MARCH RATE-HIKE PROBABILITIES

- Forecasts for this month's interest rate decision by the FOMC are somewhat split as of March 15th, 2023. According to the Chicago Mercantile Exchange's Fed Watch Tool, markets are pricing in a 55.4% probability of a 25-basis point hike at the Fed's March policy meeting, while 44.6% see the committee holding rates at the current range of 450-475.
- Recent US bank failures catalyzed the current split consensus and increased the likelihood of a rate-hike pause. Some investors are betting that the financial market distress will encourage the Fed to pause rate increases to provide liquidity to the market.





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- However, financial markets have normalized in recent days. While concerns about the banking system remain front of mind, recently released inflation numbers showed only a marginal month-over-month deceleration in price pressures. With inflation still the primary focus of ongoing Fed policy, they are likely to move forward with a 25-basis point hike.
- Futures markets now anticipate a slower pace of Fed rate increases moving forward and forecasts that the committee will terminate rate hikes after the May meeting.

## 6. NAIOP INDUSTRIAL SPACE DEMAND

- NAIOP, a commercial real estate development trade association, raised its projection for Industrial net absorption in 2023 in the latest Industrial Space Demand Forecast.
- The Q1 report, released earlier this month, revised its estimate for net absorption in 2023 up to 310 million square feet, which reflects a more resilient economic start to the year than previous estimates anticipated and upwardly revised net absorption totals from 2022. NAIOP forecasts 323 square feet of Industrial net absorption in 2024.
- During the final two quarters of 2022, Industrial net absorption averaged 176 million square feet, a significant drop from the 236 million square feet absorbed during the first two quarters of last year. Overall, the sector finished 2022 with a net absorption of 413 million square feet.
- Despite rising interest rates and new supply coming online, the Industrial market remains a standout in CRE performance, with low vacancy rates and industry-leading transactions and price growth.

## 7. FEBRUARY JOBS REPORT

- According to the Bureau of Labor Statistics, the US economy added 311,000 jobs in February while the unemployment rate ticked up ten basis points to 3.6%.
- While US job growth declined from a 6-month high of 517,000 in January, February's growth was still robust in a historical context, remaining well above the average job-add levels seen during the post-GFC jobs cycle.
- Despite the uptick in unemployment and a recent rise in jobless claims, last month's jobs numbers combined with February's inflation rate of 6.0% are likely to reinforce policymakers' conclusion that the labor market is too tight relative to price stability, prompting them to push forward with a March rate hike.
- The leisure and hospitality, retail trade, government, and healthcare sectors saw the most significant employment growth. Employment declined in Information occupations, including tech, and transportation.

## 8. JOB OPENINGS AND UNEMPLOYMENT

- Total US job openings declined in January, falling from 11.2 million in December to 10.8 million in the first month of 2023.

- Total hires and separations were little changed during the month, registering 6.4 million and 5.9 million, respectively. However, breaking down the separations data, a decline in quits was offset by a rise in layoffs, a potential signal that the labor market is beginning to loosen.
- Job openings per unemployed person continue to sit near record highs, holding at 1.9 available jobs per unemployed worker, unchanged from the previous month. The ratio has been persistently high since mid-2022. In January 2020, shortly before the pandemic began, the ratio stood at 1.2, which had been a post-GFC peak.
- While record job openings continue to elevate the ratio, continued increases in joblessness may begin to place downward pressure on it. During the week ending on Saturday, March 4th, 211,000 people filed initial jobless claims, up from 190,000 the week before.

## 9. APARTMENT MARKET INVESTMENT INDEX

- The Freddie Mac Multifamily Apartment Investment Market Index (AIMI), a measure of overall multifamily sector investment health that tracks asset prices, property-level incomes, and mortgage rates, fell by 7.6% during Q4 2022 and 25.8% year-over-year.
- The AIMI declined in all the 25 major market tracked by Freddie Mac, and
- corresponds with rising mortgage rates that dampened investment demand, resulting in the index's sharpest annual drop in its history.
- Analysts generally agree that the Multifamily sector fundamentals have not, nor are they expected to, weaken significantly, but falling net operating income and property price are indicative of broader monetary constraints as borrowing costs climb and investors become more selective.

## 10. CONSTRUCTION COSTS

- According to the latest Cost of Construction Survey by the National Association of Home Builders (NAHB), roughly 60% of sale value consisted of construction costs in 2023, based on average home sales prices.
- Since NAHB began tracking construction cost-to-value ratios in 1998, the metric has only risen above 60% on three other occasions. However, the recent uptick is not a significant deviation from historical patterns. Construction costs last crossed the 60% threshold in 2019, when they contributed towards 61.1% of home values, with the other two instances in 2013 and 2015, which saw ratios of 61.7% and 61.8%, respectively.
- Breaking construction costs down further, interior finishes accounted for the largest sub-share (24.0%), followed by framing (20.5%), major system rough-ins (17.9%), exterior finishes (11.8%), foundations (11.0%), site work (7.4%), final steps (5.9%), and other costs (1.5%).
- Finished lot costs contributed the second highest cost at 17.8%, a decline from 2019's 18.5%. Overhead and

general expenses averaged 4.9%, unchanged from 2019, and were followed by sales commission (3.6%), financing costs (1.9%), and marketing costs (0.7%) — all of which have fallen from 2019 contribution levels.





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