Economic Update

APRIL 12, 2024

1. HOMEBUYERS ADJUSTING TO HIGHER INTEREST RATES

- A new survey by Fannie Mae suggests that home buyers are gradually adjusting to higher mortgage rates despite increasingly negative sentiments about the housing market.
- Fannie Mae's Home Purchase Sentiment Index dropped in March for the first time since November, primarily driven by mortgage rates that remain near generational highs despite expectations last fall that rate-cute could be on the horizon.
- While the delay of rate cuts is likely fueling pessimism, underneath these data, consumers appear to be recalibrating their expectations around interest rates.
- Data from the survey show that the measurements for questions asking if it's a "good time to buy" or a "good time to sell" both moved higher, suggesting that the higher rate environment is starting to be seen as a "new normal" by both buyers and sellers.
- Still, while responses moved in a positive direction, most consumers (80%) still say now is a bad time to buy a house. However, this suggests that even a slight reduction in interest rates could bring buyers and sellers off the sidelines.

2. WHY HAVEN'T RATE HIKES REDUCED SPENDING?

- While the Federal Reserve's interest rate hikes have successfully reigned in borrowing by households and businesses, it has not meaningfully reduced consumer spending or output—the critical mechanism policymakers rely on to calm inflation pressures.
- In a recent analysis, economist Matthew C. Klein suggests that this is explained in part by consumers' reduced reliance on debt in the aftermath of the Great Financial Crisis (GFC)
- As financers recalibrated their credit standards post-GFC, new spending became increasingly financed by income growth rather than debt reliance relative to before the GFC.
- Incomes have grown rapidly during pandemic and post-pandemic years while balance sheets remain healthy as increasing asset values reduce the strain of rising debt servicing costs.
- Klein points out that today's spending activity has been financed mainly by more people working and at higher pay rates. This both reduces the potential impact of rising interest rates on consumption levels and

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suggests that spending levels are sustainable relative to employment.

3. LOGISTICS ACTIVITY SURGES, FASTEST IN 19 MONTHS

- According to the Logistics Managers' Index, US logistics activity experienced its fastest monthly expansion since September 2022 during March, reaching an index level of 58.3.
- While growth levels remain at the lower end, this signals a healthy turnaround for industries that impact warehousing and transportation. According to the report, recent growth is attributed to "long-planned inventory expansions and improved efficiency in warehousing and transportation."
- An increase in inventory levels drove the overall expansion in the index in March as inventories reached their highest mark since October 2022.
- Consequently, warehouse capacity contracted, its first since January 2023. Absorption of warehouse capacity is a sign of strengthening demand, a bullish signal for the Industrial real estate market.
- Nonetheless, transportation prices continue to outpace capacity, indicating that we may still be in the midst of a freight recession.
- Overall, the analysis notes that recent data suggests that firms are gearing up for a continuation of strong consumer spending levels in the future.

4. HAS OFFICE ACTIVITY REACHED ITS FLOOR?

- A recent Moody's review of Placer AI data reports that while employee office visits fell by 31.3% between February 2020 and February 2024, they have risen by 18.6% over the past 12 months. Whether or not office activity has reached its floor may have important implications for office valuations.
- In the San Francisco metro, where office buildings have experienced the most extensive post-pandemic drop-in activity (-46%), visits have rebounded by 24% compared to February 2023, the second largest increase nationally, behind Dallas.
- However, when comparing the Placer AI data with their own commercial real estate insights, Moody's finds that higher visits do not necessarily translate into higher occupancy rates in the short term but do so over more extended periods of analysis.

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5. CPI INFLATION

- Consumer prices increased more than expected in March, rising 0.4% from February and 3.5% year-over-year, according to the latest data from the Bureau of Labor Statistics.
- On average, economists surveyed by Dow Jones forecasted monthly and annual inflation rates of 0.3% and 3.5%, respectively. Futures markets fell following the report while US Treasury yields rose.
- The core Consumer Price Index (CPI), which excludes food and energy, also rose by 0.4% in the month but accelerated faster than headline CPI on an annual basis, increasing by 3.8% from one year ago.
- Shelter costs rose 0.4% from February and 5.7% year-over-year. The Shelter component of CPI has been one of the most stubborn sources of inflation pressures throughout the post-pandemic period. Fed policymakers are keen to see shelter cost pressures decelerate before moving forward with a policy pivot.

6. FOMC MEETING MINUTES

- Minutes from the FOMC's March policy meeting reflect that officials remain cautious about the timing of a potential policy pivot, noting that inflation rates weren't moving lower quickly enough.
- The committee held the benchmark federal funds rate unchanged at its latest meeting in March, continuing its wait-and-see approach regarding any decision to begin rate cuts.
- Comparing language from the March meeting minutes with those from the previous meeting in January, officials again expressed that they need to have "gained greater confidence" that inflation was on a path towards their 2% targeting before cutting rates.
- At the time of the meeting, the US economy had come off of back-to-back higher-than-expected inflation readings in January and February. Since the Fed's March meeting, consumer prices have again charted higher than estimates suggested, validating officials' concerns about recent trends.
- Officials also cited geopolitical turmoil and rising energy prices as persisting inflation risks.

7. SUMMARY OF ECONOMIC PROJECTIONS

- In The FOMC's latest Summary of Economic Projections, policymakers kept the end-of-year federal funds and PCE inflation rate forecasts constant. Still, they shifted their projections on 2024 growth, the year-

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end unemployment rate, and core inflation rates.

- FOMC officials project that the federal funds rate will fall to 4.6% by year's end, which aligns with December's forecast. The current federal funds rate stands at 525-550 and would require three quarter-rate cuts in 2024 to reach the committee's projection by the end of the year.
- Helping explain the static interest rate forecast is a similarly unchanged projection for headline inflation, which the committee expects to fall to an annual rate of 2.4% by the end of the year.
- However, policymakers have become slightly more hawkish on core inflation since their last projections to close 2023. In the latest reading, projections for core-PCE were raised from 2.4% to 2.6%.
- Higher economic growth forecasts help explain the uptick in core-rate projections—projections for real GDP at the end of 2024 are up from 1.4% to 2.4%. Consequently, officials expect the unemployment rate to fall more steeply this year, revising their projection down by ten basis points to 4.0%.

8. CONSTRUCTION SPENDING

- According to data from the US Census Bureau, construction spending fell by 0.3% month-over-month and increased by 10.6% annually in February, the latest reporting month.
- The drop follows a 0.2% decline in January and surprised forecasters who projected a 0.7% increase during the month.
- The decline was led by a 1.2% fall in public construction spending, while private construction spending was mostly unchanged.
- Within private construction, the residential segment rose 0.7%, but this was offset by a 0.9% decline in nonresidential construction spending.

9. MARCH JOBS REPORT

- Job growth soared past economists' consensus expectations in March as employers added 303,000 new positions, the largest monthly tally since May last year.
- The historic post-pandemic trend in US job growth has defied many expectations, with many who thought that by now, the pandemic recovery would be finished and job growth would have slowed to its pre-

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pandemic trend.

- Nonetheless, the US labor market has remained resilient amid 11 interest-rate hikes and stubbornly elevated inflation. The unemployment rate ticked down ten basis points to 3.8% in March.
- Annual wage growth softened from 4.3% in February to 4.1% in March. The trend will be welcomed by Federal Reserve policymakers looking for a decline in inflation's leading indicators, of which employee wages constitute a significant part.

10. BLACKSTONE GOES ON INVESTMENT "OFFENSIVE"

- The Wall Street Journal (WSJ) recently reported on a deal by Blackstone to purchase Apartment Income REIT (AIR Communities) for upwards of $10 billion.
- The deal is significant in that it is the largest Multifamily market transaction in the firm's history and reflects bullish sentiments by larger firms on commercial real estate more broadly.
- In addition to positive investment sentiment about the rental housing market, the report suggests that Blackstone believes that commercial real estate may be reaching its cyclical floor, making now a good time to buy.
- Referencing data from Commercial Mortgage Alert, WSJ notes that while real estate transaction activity has cratered in the past year, CMBS issuance during Q1 2024 was roughly three times (3x) the volume in Q1 2023. Remerging bullishness in the CMBS market could indicate an improving outlook for the broader financing market. Still, much depends on the future path of interest rates.

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SUMMARY OF SOURCES

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