National Housing & Rehabilitation Association

Annual Meeting

February 27 – March 2 Miami, FL

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Economic Update

NH&RA Annual Meeting
Miami, FL
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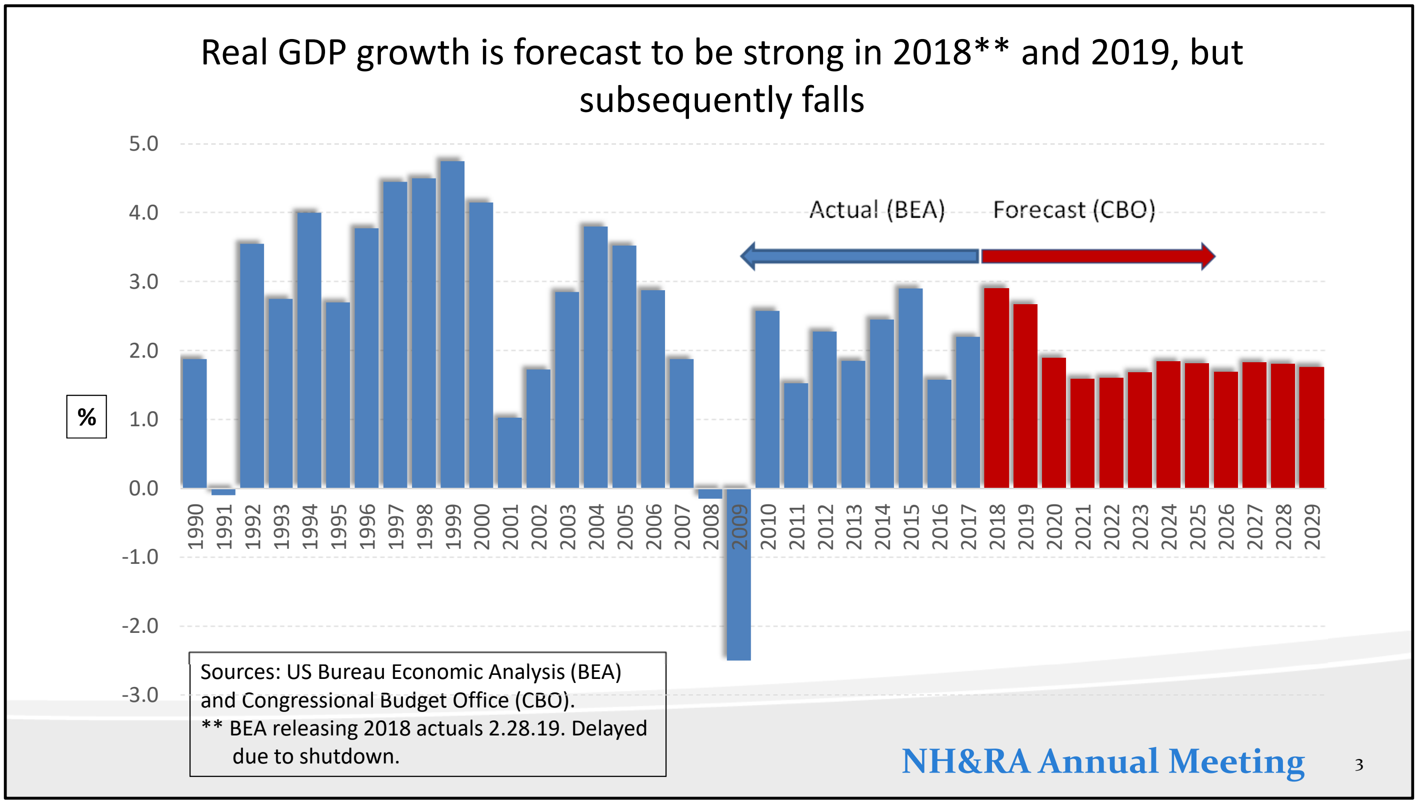
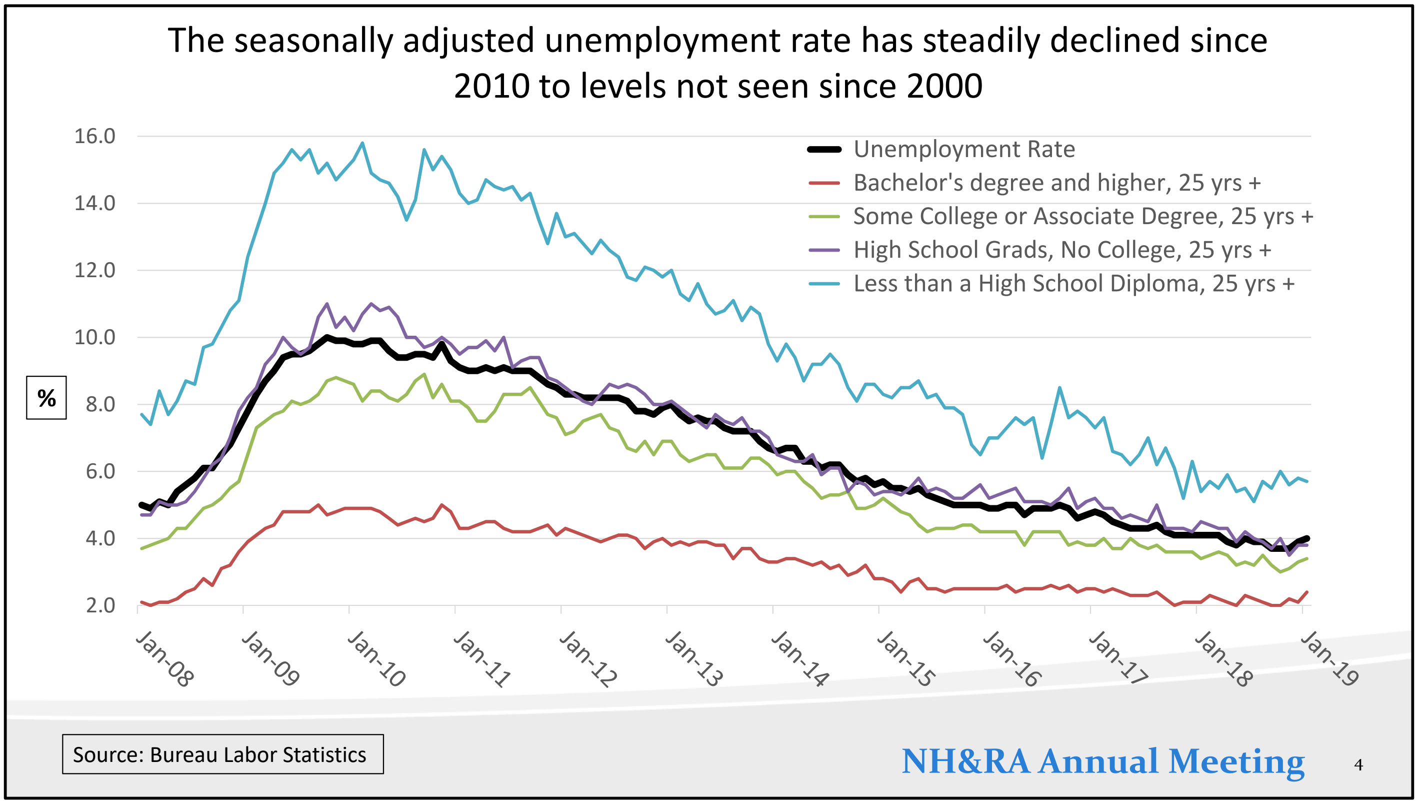
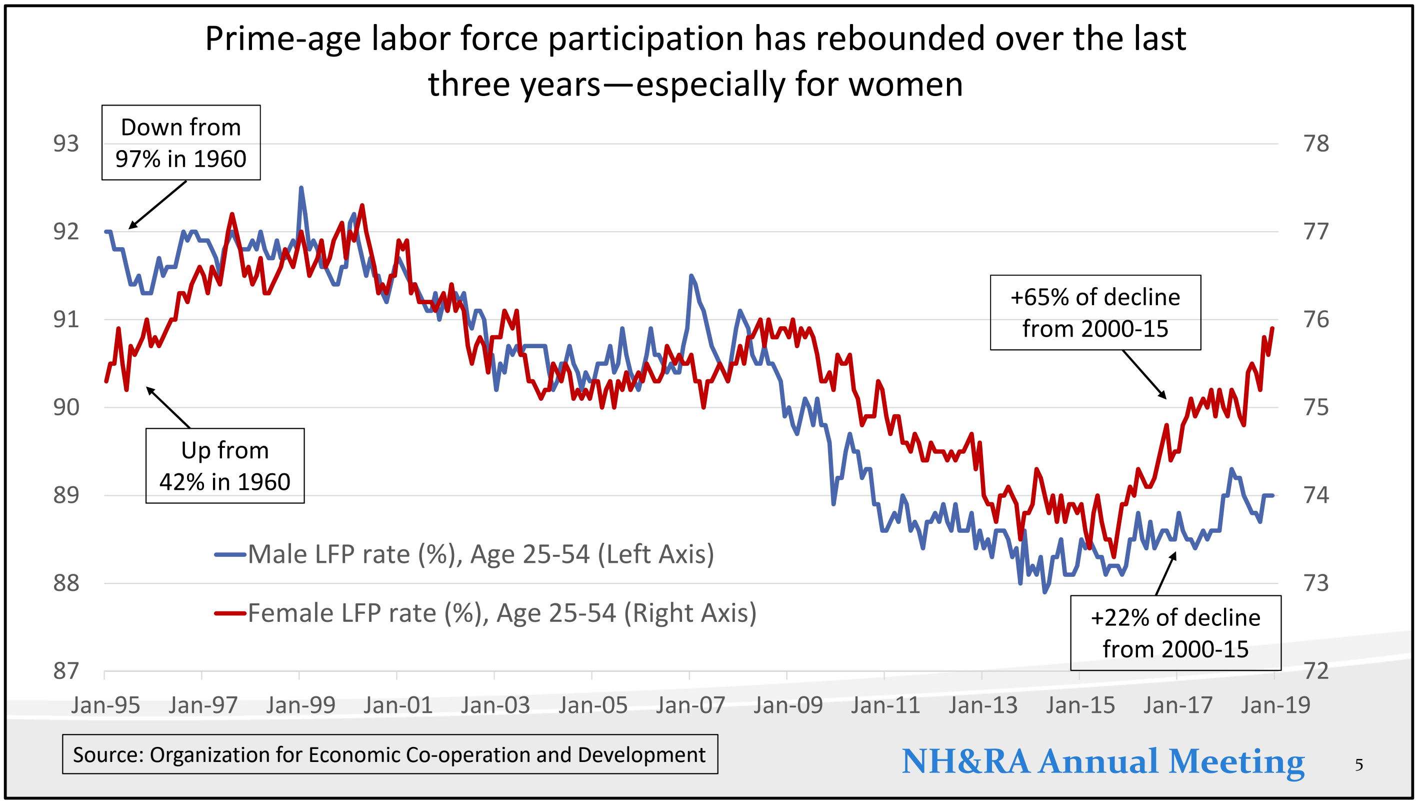


- CBO released its 10-year forecast for real GDP in January. This includes a 2.9% forecast growth in 2018 (Actual 2018 numbers delayed b/c of shutdown).
- Strong numbers expected to continue—CBO's current 2019 forecast (2.7%) is slightly lower than it's forecast from August 2018 (2.8%).
- Growth slows to 1.9% in 2020 and 1.6% in 2021 (with similar rates through 2029).
- Long post Great Recession expansion may come to an end in 2020. Why?
    - **Deficits**: 2017 revenues were 17.3% of GDP, outlays 20.8%. Deficit of 3.5% ≈ $665 billion. Deficits predicted to grow to 4.9% in 2019-28.
        - **Debt** held by public: 76% GDP (= $15 T) up to 96% (= $29 T) in 2028.
    - In SOTU, President said a war will stop expansion. Yes, a ***trade* war.**
        - March 1 deadline for tariffs with China.
            - Note that US sources 20% of its manufactured imports from China. But tariff increases have been largely offset by a 13% depreciation in the Yuan relative to the U.S. dollar.
        - NAFTA replacement (USMCA) needs approval for 2020 implementation.
    - **Slowdown in other economies**—China slowest growth (6.4%) since 1990 (with fixed investment spending in 9-yr downward trend), European Central Bank acknowledged growing downside risks, BREXIT, Bank of Japan—deflation risk.



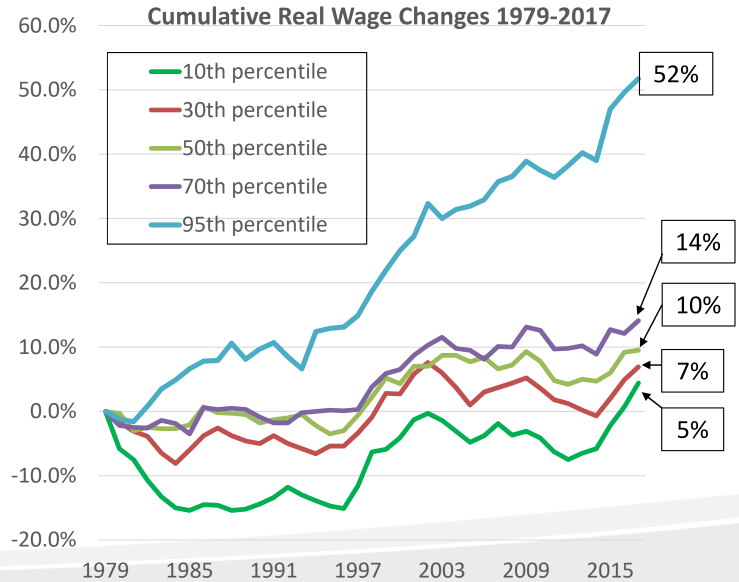
- The official unemployment rate, U-3, was 3.7% in Nov. Lowest since 1969. Ticked up to 4.0% in Jan. (N.B., U-3 was affected by the shutdown).
- 304k jobs added to non-farm payrolls in Jan. (Establishment survey data not directly impacted by shutdown). Payrolls increasing for 100 straight months.
    - Consensus was 170k. 234k avg over last 12 months.
    - Residential construction employment (incl. specialty trade contractors) was up by 24k in Jan to 2.9 million. (Was 2.0 mill at end of 2010).
- Natural rate of UE is approx. 5%. CBO predicts U-3 will fall to 3.5% by the end of 2019. **Tight market**. Will then rise gradually to 4.8% in 2022.
- The broad measure, **U-6**, jumped from 7.6% to 8.1% in Jan.
    - Includes marginally attached and part-time.
    - Part-time workers up 0.5 mill to 5.1 mill b/c shutdown.
    - U-3 rate was 3.8-4.0% in 2000. At that time U-6 was under 7%.
- **Issues**: Drill-down—2.4% in red. 5.7% in blue. Still room for improvement.
    - Improvement would give upward pressure on wages.
- Special topic: **Measuring the gig economy**.
    - Household employment surveys used to measure traditional employment arrangements don't fully capture non-employee work.
    - Need to develop linked data sets that combine household survey data, tax data and employer survey data to get better measurement.



- Low unemployment and high job openings (7.3 mill in **JOLTS**) should translate into upward wage pressure and (discouraged) workers reentering labor markets.
    - Wages up 3.1% in 2018; there were 3.4 mill quits in Dec 2018.
        - Quits indicate worker optimism.
- There is a close link between LFP and economic growth.
    - For example, increased female LFP from 1970 added 13.5% to GDP.
- We focus on **prime-age**—if include seniors, post-2000 decline more profound.
- **Long-term decline for males**—less demand for low skilled workers, increase in social security disability take-up rate (by 2%), increased incarceration, lower marriage rates, increased schooling after 25.
- **Female LFP** decrease since 2000 (on the heels of decades long increase).
    - Similar patterns to male LFP since 2000.
    - Reasons for changing patterns not well understood.
- Is **2015-2018 increase** short-term cyclical post-recession recovery or a return to longer term trend?
    - Return has been weak for **lower educated women**. Without child care or elder care, it will not be possible to increase their LFP rates.
    - **Male LFP still below long-term trend**. Suggests that rate will continue to increase—especially as millennials increase rates of household formation.

Inequality has increased since 1979 leaving all but the top earners and wealthiest behind

Category and Year	Bottom 50% Share	Middle 40% Share	Top 1% Share
Pre-tax Income			
1979	20%	45%	11%
2014	13%	40%	20%
Net Personal Wealth			
1979	1%	34%	22%
2014	0%	27%	37%



Sources: World Inequality Databases (table) and Economic Policy Institute (chart)

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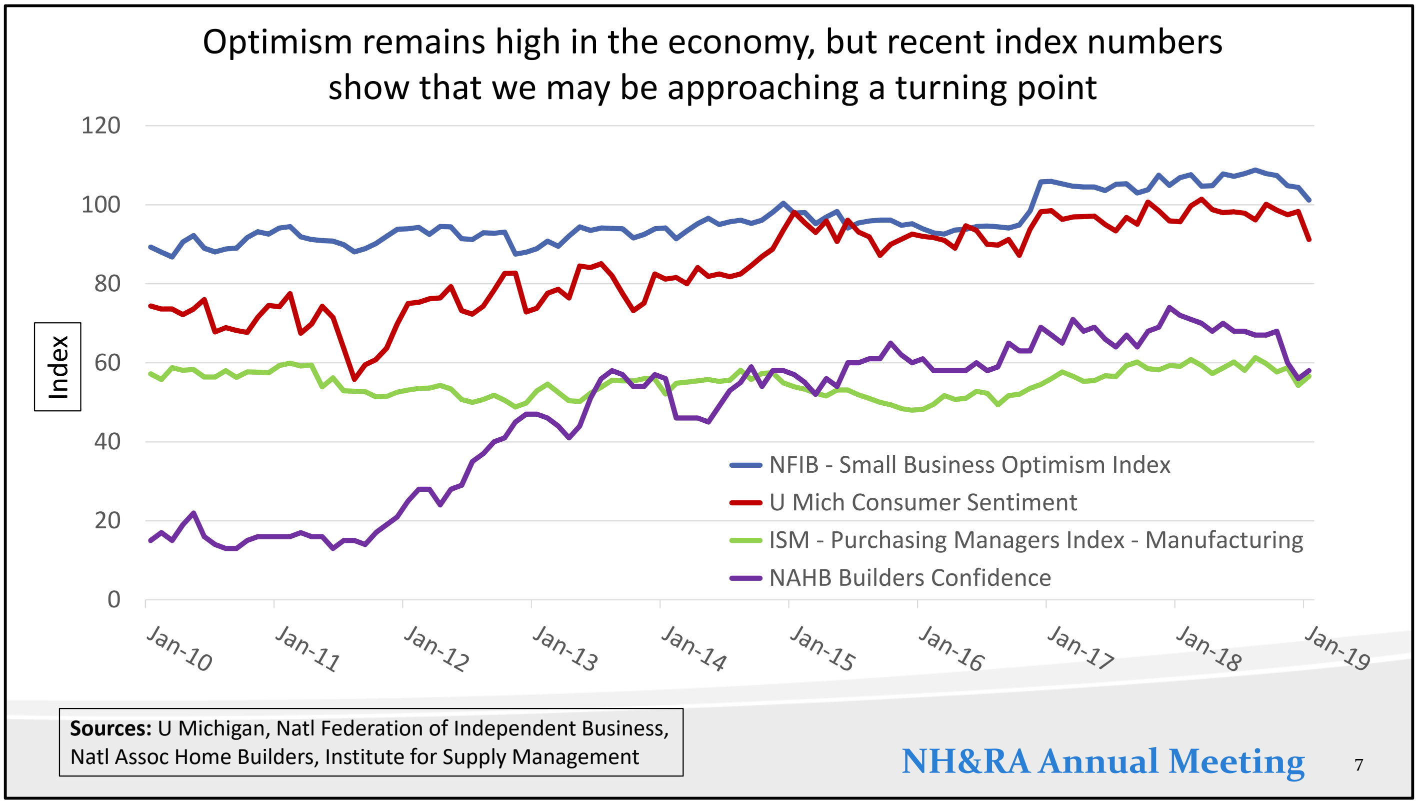
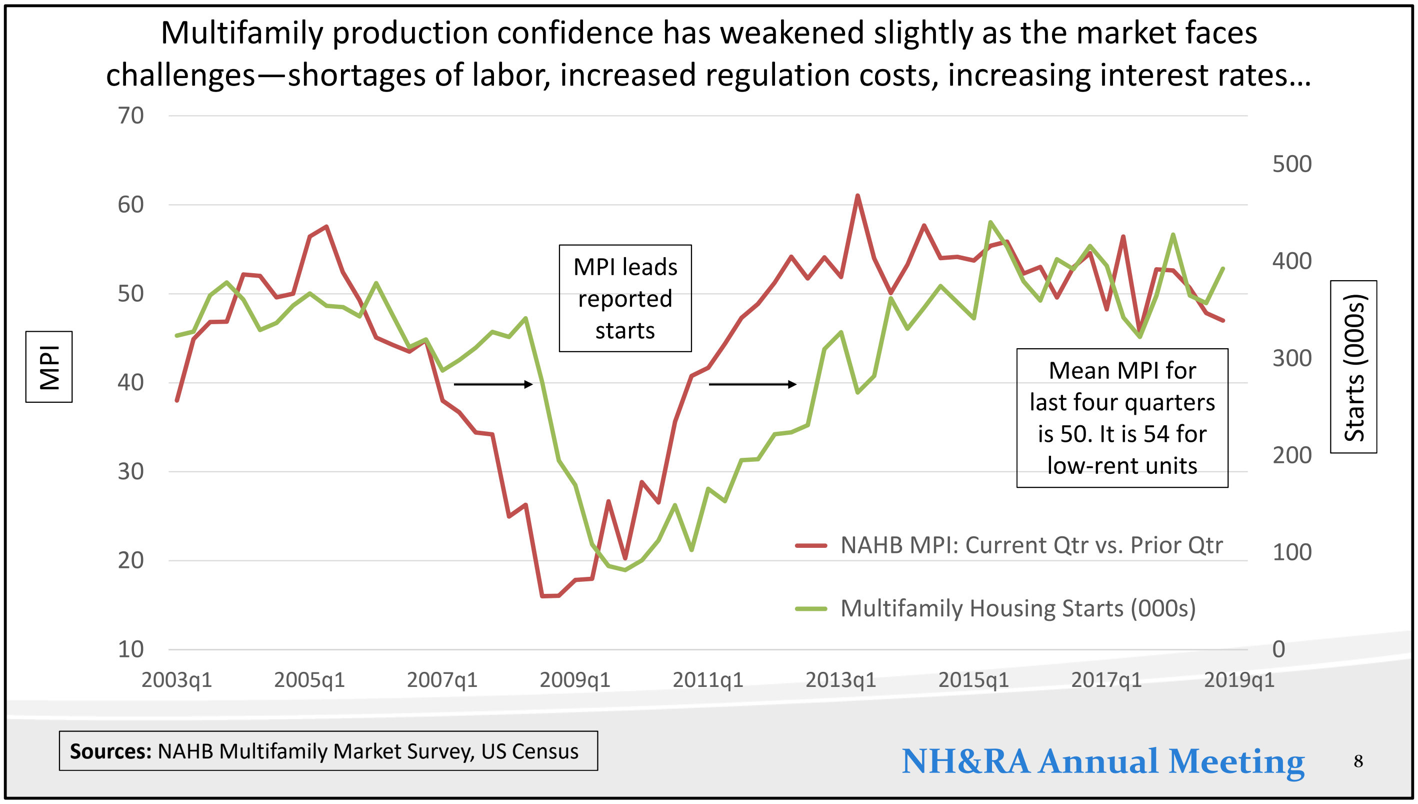
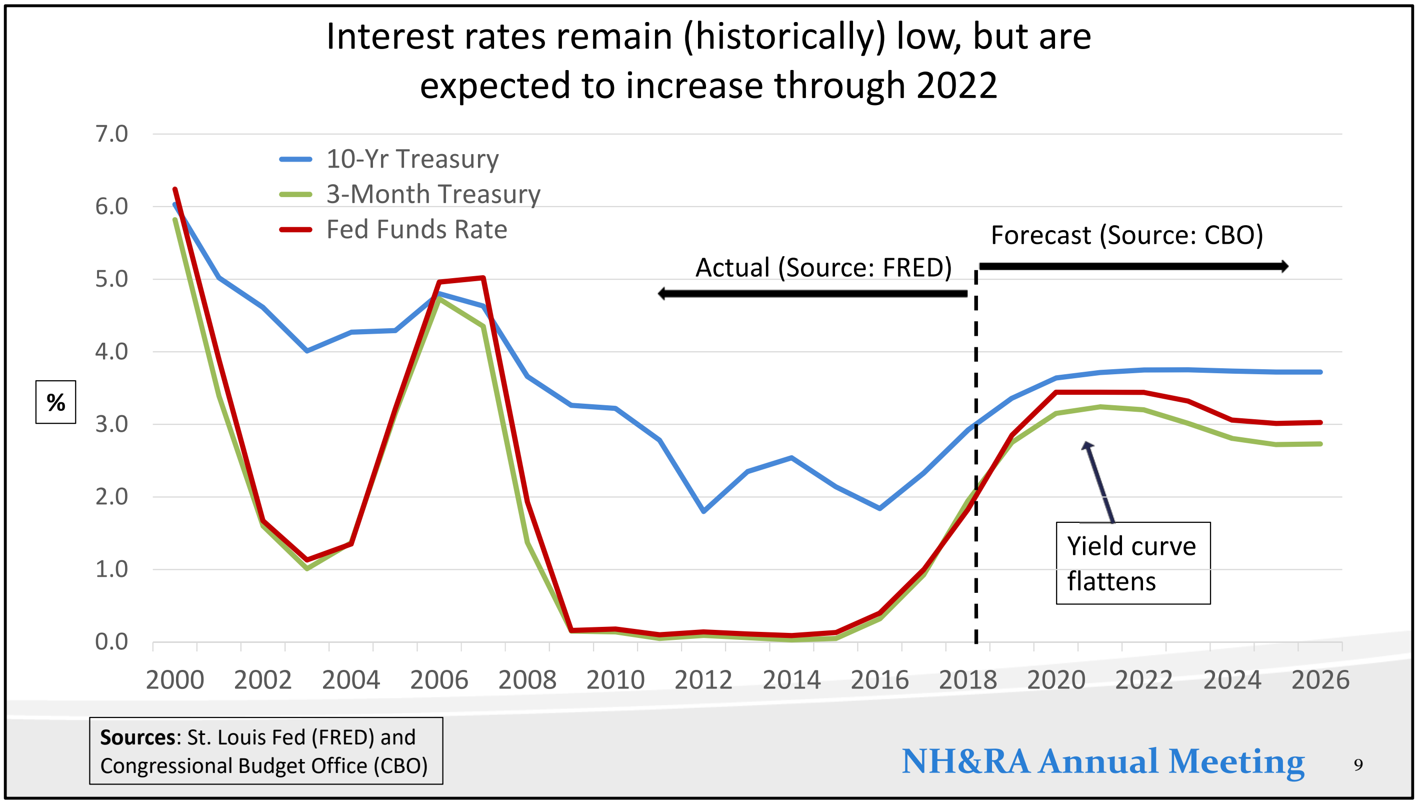
- More people are working and there is upward wage pressure.
  - **Are we all better off** than last year? Than our parents?
- **Inequality has risen**:
  - Pre-tax income share of top 1% was up to 22% in 2015.
  - Wealth share was 40% in 2016.
  - CEO to worker compensation ratio was 30:1 in 1978, 312:1 in 2017.
  - GAO report on retirement security: 55% of households age 55-64 have less than $25,000 in retirement savings, including 41% who have zero.
- **Wages and salaries increased 3.1% in 2018 and increased 2.5% in 2017.**
- Minimum wage increases in 19 states on Jan 1 affected approximately 5.2 million workers.
  - Annual increases for year-round workers of $90 to $1,300 on average.
- Still, among ALICE (Asset Limited, Income Constrained, Employed) households, 16 million live in poverty and more than twice that number earn “less than what it takes to survive in the modern economy.”
- Many social scientists believe the **increasing inequality is due to poverty traps**:
  - The probability for children to attain higher incomes than their parents has dropped dramatically (Chetty et al. “Fading American Dream”).
    - 90% of children born in 1940 would earn more than their parents but 50% of children born in the 1980s can expect to.
  - Consensus: the way to overcome this **opportunity inequality trap** is through education.



- So, how are we feeling? Do we expect things to continue to improve?
    - **Confidence** often impacts economic decisions going forward.
        - These **indexes are leading indicators**.
- The **U Mich Consumer Sentiment:** 91 in Jan (down 7 from Dec). Feb prelim # 95.
    - Loss due to gov't shutdown, impact of tariffs, instabilities in financial markets, global slowdown, and the lack of clarity about monetary policies.
    - Index 6% above average (at 56th percentile).
- Mood of **small business** owners is similar: At 101—lowest reading since Nov 2016.
    - This is still solid—at 75th percentile.
    - Decline (mainly) due to inventory investment plans, softer expectations for real sales growth and business conditions.
- **ISM PMI manufacturing index** is based on five areas: new orders, inventory levels, production, supplier deliveries and employment.
    - PMI > 50 expansion, < 50 contraction (it is a *diffusion* index).
        - At 57. Was 61 in August.
        - New Orders @ 58. This is > 50 for 37 straight months.
            - Caterpillar provides good example for new orders. Stock price ≈ 133. Analysts' median 12-mo prediction is 154.
        - ISM non-manufacturing at 57 (was 58 in December).
- **NAHB**: Builders confidence (**HMI**)—pulse of the single-family housing market.
    - Rates mkt conditions for the sale of new homes (now and in the next 6 months) as well as buyer traffic. **Feb value is 62**. Was 72 one year ago.

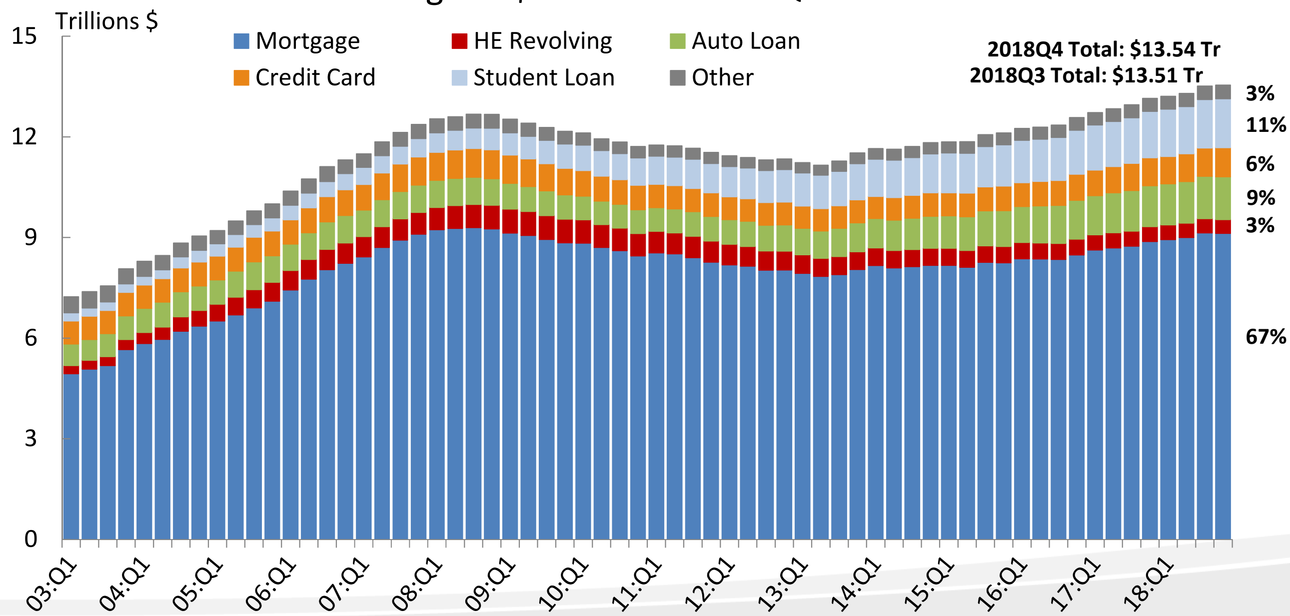


- NAHB's **Multifamily Market Survey** of builders and property managers:
    - Monitors conditions for multifamily production (starts) and rental occupancy in the current vs. preceding quarter and in the next 6 months.
- The **Multifamily Production Index** (MPI) dropped 1 point to 47 in 2018q4 (vs. last qtr).
    - Index indicates improving conditions when MPI > 50.
    - **Low-rent component** was down 11 to 48, **mkt-rent** was up 3 to 49 and the **for-sale** component was up 5 to 44.
    - Numbers for 6-month expectations: 54, 48 and 44 respectively.
- **Multifamily starts** average 371k for first 11 months of 2018 (vs. 345k for 2017).
    - Given MPI is a leading indicator, do we expect these to come down in 2019?
- The **Multifamily Vacancy Index** (MVI), which measures the multifamily housing industry's perception of vacancies, is at 45 (MVI > 50 indicates more vacancies).
    - 2018 average annual score is highest since 2010.
    - Class A @ 54, B @ 40 and C @ 38.
- **What we expect for 2019:**
    - Supply to marginally outpace absorptions. Vacancies up 20 bps to low 5% range, expect annual rent growth of 3% (Freddie Mac).
    - Cap rates expected to stay below 6% (Real Capital Analytics).
    - A lot of the supply in 10 "hot" metros. Mostly Class A.
        - Imbalance is placing a lot of stress on supply of affordable units.



- Fed Chairman Powell's message: **Patience** with regard to additional monetary tightening, **continued data dependence** with a close watch on inflation.
- FOMC adopted a more **dovish stance**. Expect next hike to be in Q3. Previously expected two hikes this year.
- Current Fed Funds Rate (2.25-2.5%) gives the Fed leeway in case of recession to use policy lever.
- CBO forecasts have rates increasing quickly due to faster growth.
  - The **yield curve** is also expected to flatten (but not invert—that often signals a recession).
- Previously, forecasts were flat after increase. Now, with increased deficits and slower economy, CBO forecasts that rates will decrease after initial increases.
- Things to remember:
  - Rates are still historically low
  - The Fed has ≈ $4 trillion of securities on its balance sheet from QE. Continuing to deleverage
  - Deficits will increase in the short run due to tax changes
  - As US debt increases, rates should increase.

Household debt increased in each of the last 18 quarters and reached a new high of $13.54 trillion in Q4 2018



Source: New York Fed Consumer Credit Panel/Equifax

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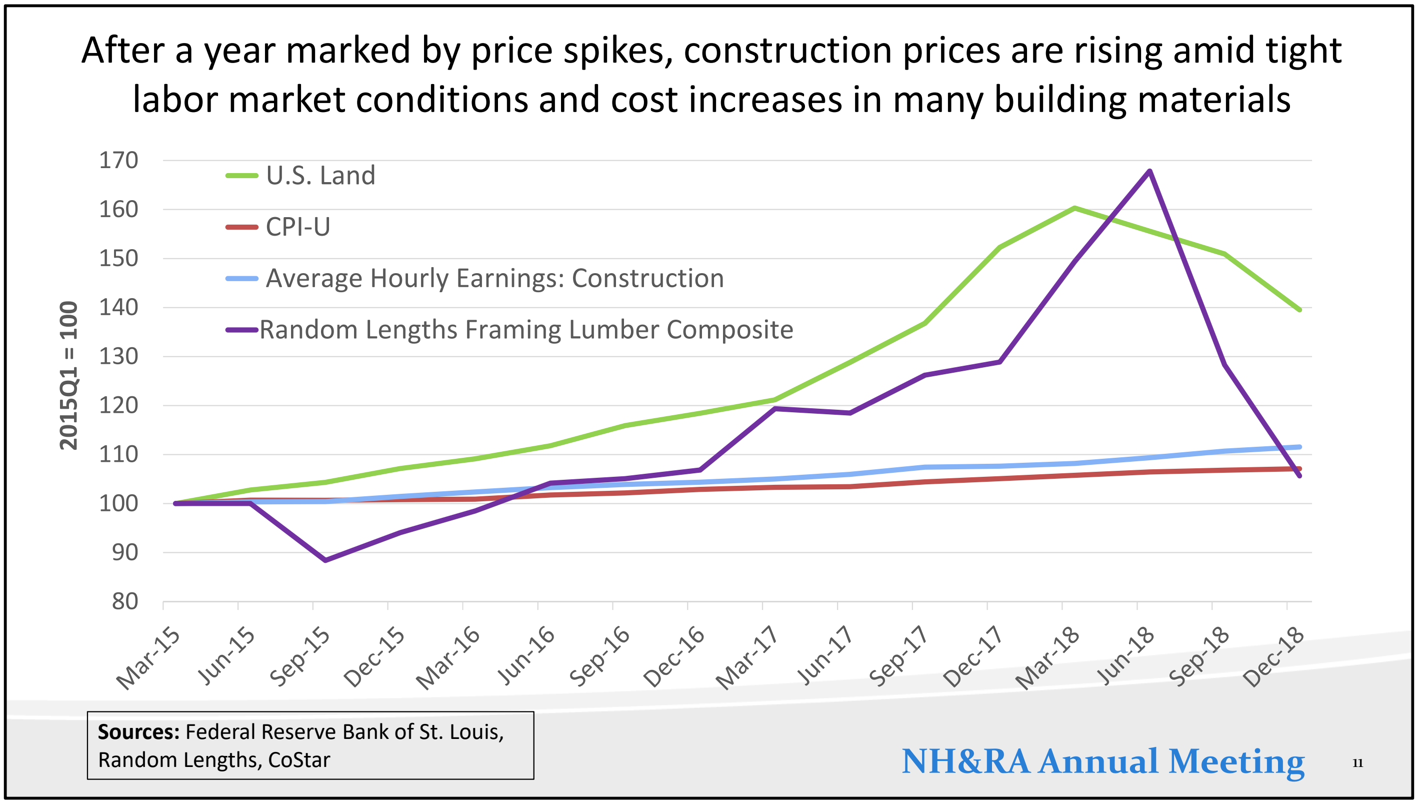
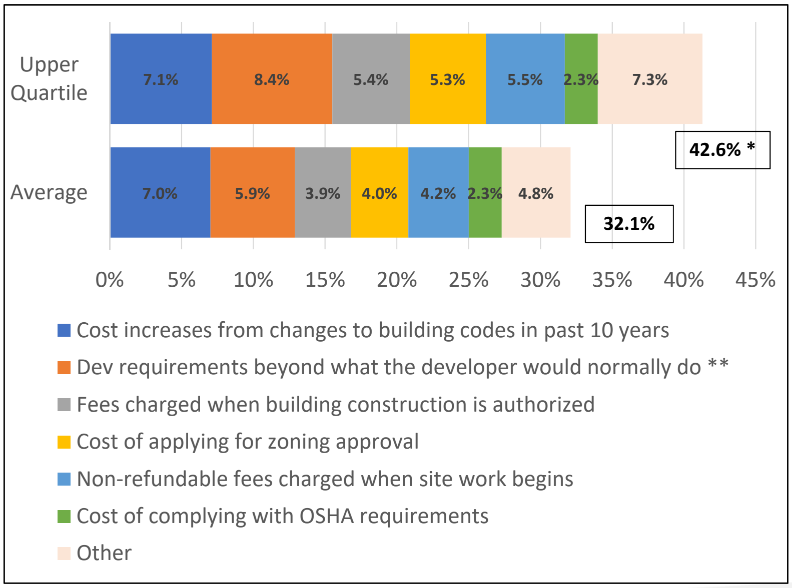
- Household debt has increased by more than 21% since 2013 and reached a record $13.54 trillion in 2018 Q4.
- Despite this growth, **household debt service payments** (relative to disposable income) are below 10%, and **90+ delinquencies** continue to hover around 3%.
    - It would appear that current debt levels do not pose an excessive risk.
    - For comparison, at the **last peak** 2008 Q3 ($12.68 Tr), the debt payments to disposable income ratio was 13% and 90+ dlqs were climbing rapidly to 7% (and eventually reached 8.7% in 2010).
- While **home secured debt** 90+ dlqs are low (at 1.1%) we cannot ignore the **disconcerting trends** for other components:
    - In the last 5-years **student** and **auto loan** debts grew by 35% and 50% (to $1.46 Tr and $1.27 Tr respectively).
    - The decrease in **credit card** debt that followed the financial crisis has been eroded—at $870 B it is up $200 B from 2013.
    - 90+ dlqs for auto loans have slowly trended upward since 2012 (to 4.7%), and the 90+ level for student loans remains high at 11.4%.
    - The flow into 90+ delinquency for credit card balances has been rising and remains elevated (at 5.0%).



- The weighted average of all goods and services used in construction rose by **3.8%** in 2018 (Associated General Contractors of America).
- **Land**: Vacant commercial land was up more than 80% in 2012-2017.
  - This is national, but is worrying in certain markets – was this a bubble or really high demand relative to inelastic supply?
  - Land prices were down 8.4% in 2018 (CoStar). Still elevated.
- **Lumber**: Tariffs on softwood Canadian lumber of almost 21% came after prices were up post the hurricanes in last 4 months of 2017.
  - Random Lengths framing lumber composite price for 1000 board feet hit $564 in June (up from $398 a year earlier). Retreated to $355 in December. Up to $370 in mid-February.
  - Questions have been raised whether this is a potential case of non-competitive pricing.
- **Labor:** There is a shortage of construction workers: 382,000 construction jobs remained unfilled in Dec (JOLTS and NAHB). The open position rate is 4.9%.
  - Construction wages hit $30.39/hr. in Dec.
  - Questions: Infrastructure program? Immigration policy? Disaster recovery?
- **Regulatory Costs:** Big expense not on chart. According to NAHB, these have gone up by 29% in the last 5 years. (Further discussion on next slide).
- **Resolving costly trade disputes and addressing labor shortages will help relieve much of the inflationary pressure on construction costs.**

Regulation accounts for almost one-third of multifamily development costs



Sources: NAHB and NMHC
* All types of costs do not sum to the total
** Including streets, sidewalks, parking, landscaping, etc.

- Between 2011 and 2016, regulatory costs increased by almost 30% (Source: NAHB)
- Moreover, "*new* regulatory barriers have also served to limit the supply of land available for homes and increased the time, complexity, and risks of housing development" (JCHS 2018 Report)
- **Bottom line:** Most regulations are well intentioned, but are all consequences being fully thought through?

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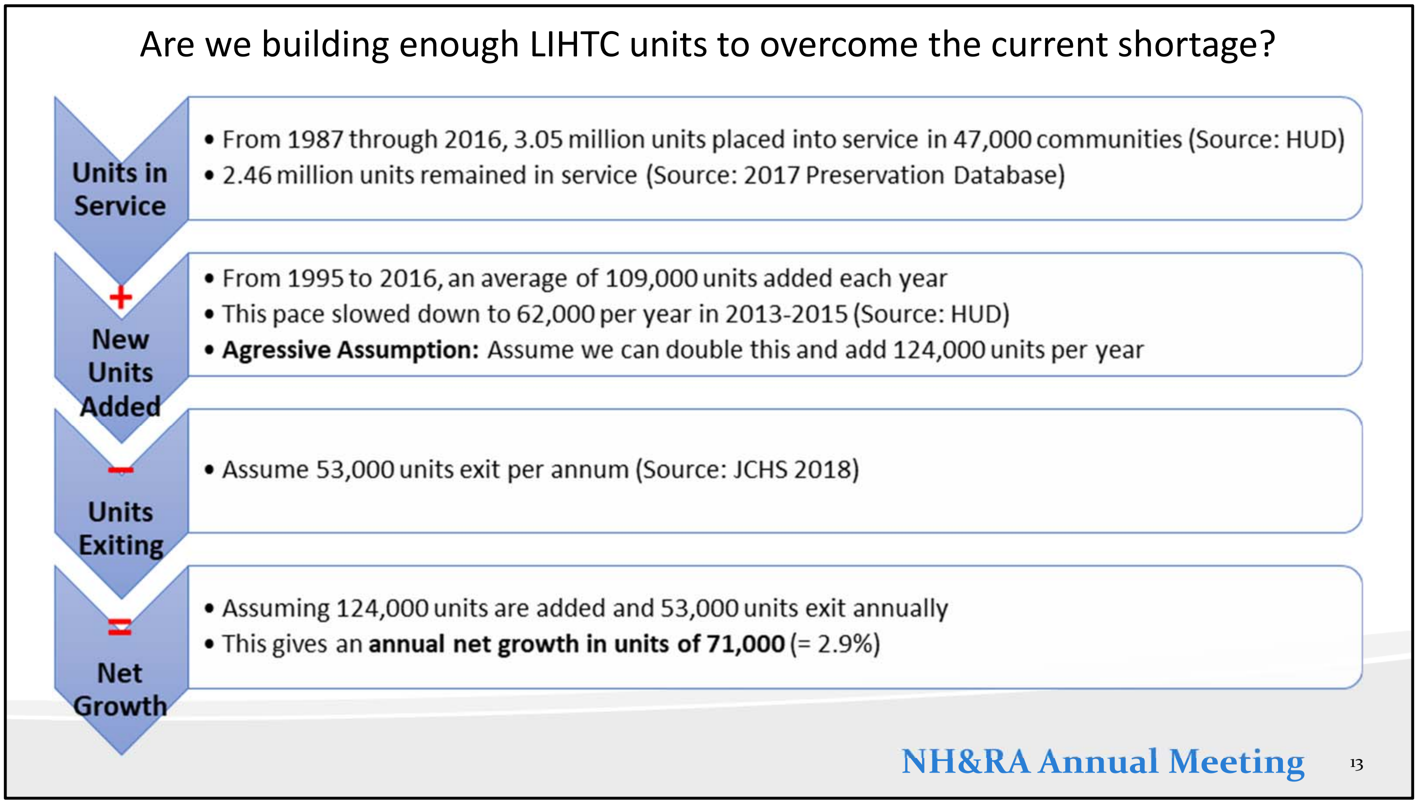
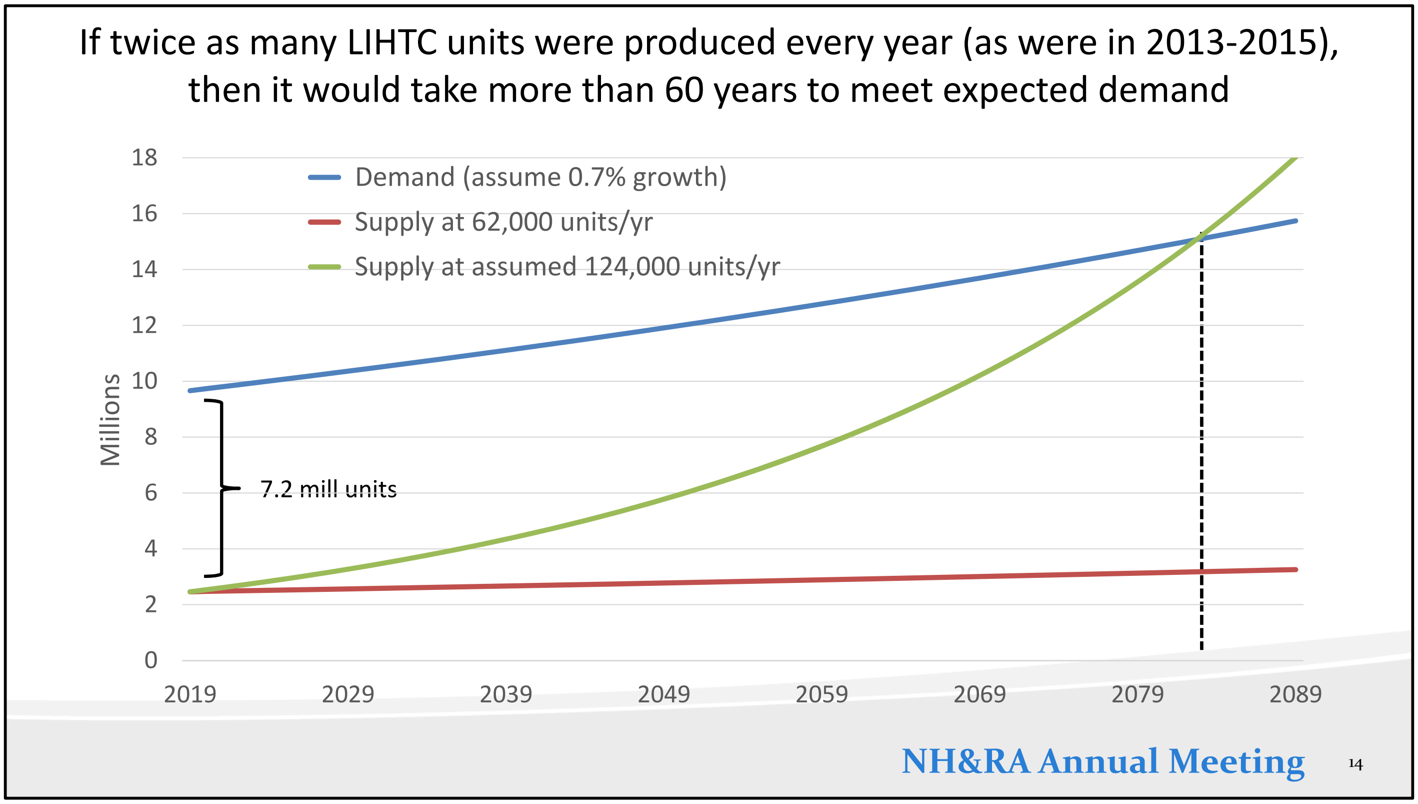
- Regulatory costs are enumerated for projects that are built.
  - However, regulations also restrict supply of new units—increasing renters' cost burdens.
- Terner study for San Francisco discussed local drivers of rising costs:
  - City permitting processes
  - Design and building code requirements
  - Workforce regulations and procurement rules (e.g., small and local business)
  - Environmental regulations
- We may also consider costs of federal policies on immigration and tariffs as regulatory. These are not captured in the NAHB studies.



- The **shortage** of affordable units has been exacerbated in last decade because additional units are increasingly being built for higher end income renters.
    - This is in part due to development costs rising faster than inflation.
- 40% of new rentals in 2016 have rents > $1500/month (vs. 15% in 2001).
- New rentals for < $850/month fell from 42% to 18% over the same period (all in real $).
- Nationally, there are only 62 affordable and available units for every 100 VLI renters (< 50% AMI) and 38 for ELI renters (< 30% AMI).
- So, are we building enough?
    - To analyze, we (aggressively) assume that the annual net growth in LIHTC units is 71,000.



- The U.S. has a shortage of more than 7.2 million rental homes affordable and available to very low-income renter households (NLIHC 2018 GAP Report).
- If LIHTC unit net growth was 2.9%, then it would take more than 60 years to meet the demand.
- At the current 62,000 (= 0.4% net growth), the shortage intensifies.