Capital Markets Group

Points to Ponder

October 14, 2022

The First Tee...

Haunted House…real-estate market is spooked by inflated borrowing and property costs

- The doubling of mortgage rates has scared away buyer demand and unnerved investors:
  - The rate on a 30-year fixed mortgage has levitated to 7.14% (the highest in over twenty years)…while home prices soared to record highs with the year-over-year cost increase peaking at almost 21% in March:
    - Rising borrowing costs is placing a larger portion of the population (who are already at their limit) out of reach to buy property:
      - Quantitative easing has induced another real-estate bubble, housing affordability is stretched, and debt-service ratios are rising:
        - Falling home prices erode household wealth, damage consumer confidence, and potentially curb future economic development.
- **Freaking Out**…would be homebuyers are facing massive sticker-shock as measures of affordability are getting worse at the fastest pace on record…the volume of home sales is slowing faster than seen following the global financial crisis:
  - The spread between benchmark interest rates and mortgages have reached levels unseen in decades:
    - The current spread between the benchmark 10-year U.S. Treasury Note and a 30-year fixed mortgage stands at about 320 basis-points…this spread was less than 150 basis points in March 2021 when mortgage rates were trending at 3.17%:
      - Bond market volatility and the Fed ending its quantitative easing mortgage-backed security buying program has reduced the number of large investors buying mortgage-backed paper…adding to the higher cost of home borrowing.
- **Flipped Out**…real-estate investors are being terrorized by the swiftly changing housing environment:
  - Moving properties was a lucrative business the past decade with constantly appreciating home values:
    - Housing flippers (large and small) have freaked-out over the turn in the market, taking losses on quick deals with hopes of heading-off problems before they morph into something worse…flippers with loans are feeling possessed by rising carrying costs:
      - Investors became enchanted with house flipping the past few years…accounting for a record 1 in 10 transactions at the start of the year:
        - Panicked selling has traumatized flipper margins, that have collapsed in some of the hottest housing markets from 45% in March, to 6.5% now.
      - Flippers have been a key influence for outsized home price swings, pushing values higher when mortgage rates are low and forcing them down with borrowing rates increase…flippers have a shorter holding period than traditional homeowners, who can wait for better selling conditions.
- **No 2008 Zombies**…a repeat of the housing crisis, that ignited the Great Recession, seems unlikely:
  - Lenders have tightened credit standards, household savings are still solid, many countries have housing shortages, employment remains robust, and numerous households have locked-in low mortgage rates:
    - Housing affordability is less of an issue for existing homeowners…most households have fixed-rate mortgages that a majority have refinanced to low rates over the past couple of years (leaving them insulated from the current market impact):
      - Mortgage origination volumes hit new record highs in 2020 and 2021…evidence of the large number of borrowers who took advantage of low rates.
    - Would-be home buyers, highly leveraged owners, or those with floating loans, are more sensitive to market changes:
      - Distressed sales of homes should be fairly limited as long as the job market manages to stay relatively healthy.
  - **Mummified**…home prices could remain well supported as inventories of properties for sale remain tight:
    - Four key factors for home prices are supply, demand, affordability, and credit availability…the first two components tend to not change quickly, while the last two can move rapidly…this is the housing environment we are seeing presently:
      - For a current homeowner to sell their residence, they would have to borrow money for their new home at mortgage rates that are 200 to 300 basis points higher than their current level…it does not seem feasible many are going to see value in selling:
        - The housing market may be heading into paranormal territory, where activity measures deteriorate rapidly, even as prices remain firm.
      - After rising about 18% in 2021, single-family home prices are forecast to rise 10% this year, and 5% in 2023 (according to Freddie Mac).
- **Decomposing**…the commercial real-estate market is struggling (due to higher borrowing rates and changing demographics)
  - There is a large amount of unfilled capacity as the assumptions office-space demand would return to pre-pandemic levels have proved to be incorrect (empty commercial retail properties also continue expand):
    - The price of Real Estate Investment Trusts (REITs) are lower than they were 20-years ago, and moving close to the level seen during the worst of the pandemic…the falling price of REITs are reflective of the declining state of the commercial real-estate market:
      - Many of the holders of office property, such as pension funds and endowments, are large enough that can absorb large losses in asset values…but an extended downturn in the commercial real-estate market could expose some property developers to loan defaults.

At the turn...

The Back Nine…

Trick or Treat…strong dollar can be viewed as a curse or constructive (depending on your viewpoint):

- Companies generating a large number of sales abroad get bloodied, while consumers gain:
  - A strong dollar diminishes the value of a companies' foreign revenue when it converts back into dollars:
    - U.S. company products are also more expensive in other countries in local currency terms (making competitiveness gruesome):
      - Some of the most impacted industries include consumer staples, automobiles, materials, technology, and communication.
  - Dollar strength could hurt profits for about a third of companies in the S&P 500…a $60 billion revenue hit:
    - A rule-of-thumb for companies impacted, for every 10% increase in the value of the dollar, earnings are decreased 3%:
      - On average, the $60 billion revenue hit caused by the strong dollar would equate to an earnings per share hit of about 6 cents.
  - A strong dollar benefits U.S. consumers by increasing their buying power for imported goods & services:
    - Traveling abroad is also more affordable…the dollar is 17% more valuable when exchanged with the euro, compared to a year ago.

That Old Black Magic…has the financial markets in its spell (down and down it goes):

- Data format: Oct 1, 2021 / January 1, 2022 / July 1, 2022 / Oct 1, 2022:

Equities

Dow: 33843 / 36338 / 30775 / 28725
S&P 500: 4307 / 4766 / 3785 / 3586
NASDAQ: 14448 / 15644 / 11028 / 10575
Russell 2000: 2204 / 2245 / 1707 / 1664

Commodities

CRB: 228 / 232 / 291 / 268
Oil: $75.03 / $75.21 / $105.76 / $79.49
Gold: $1796 / $1829 / $1807 / $1660
Copper: $408 / $446 / $371 / $341
Natural Gas: $5.86 / $5.85 / $5.42 / $6.76
Bitcoin: $43436 / $46,333 / $18731 / $19425

Borrowing Benchmarks

SOFR: (U.S. Secured Overnight Financing Rate)
1 day: .05% / .05% / 1.50% / 2.96%
1mo: .057% / .080% / 1.68% / 3.04%
3mo: .057% / .091% / 2.11% / 3.59%
IORB (Interest on Reserve Balances)**:** .15% / .15% / 1.65% / 3.15%

Treasuries Issues

3mo: .03% / .03% / 1.72% / 2.79%
6mo: .03% / .17% / 2.51% / 3.92%
1yr: ..07% / .37% / 2.80% / 4.05%
2yr: .28% / .73% / 2.92% / 4.22%
3yr: ..91% / .95% / 2.99% / 4.25%
5yr: ..98% / 1.26% / 3.01% / 4.06%
7yr: 1.31% / 1.43% / 3.04% / 3.97%
10yr: 1.51% / 1.51% / 2.98% / 3.83%
20yr: 2.02% / 1.93% / 3.38% / 4.08%
30yr: 2.08% / 1.90% / 3.14% / 3.79%

Currencies

Euro: 1.158 / 1.137 / 1.048 / .908
Yen: 111.30 / 115.08 / 135.72 / 144.74
Peso: 20.640 / 20.529 / 20.118 / 20.138
Canadian $: 1.268 / 1.263 / 1.287 / 1.382
Yuan: 6.444 / 6.356 / 6.699 / 7.128

Grain Futures

Corn: $9.37 / $5.93 / $6.19 / $6.78
Soybeans: $12.57 / $13.39 / $13.66
Wheat: $5.37 / $7.70 / $8.84 / $9.23
Random Lumber: $630 / $1147 / $694 /$422

Job / Inflation Indicators

Unemployment: 54.8% / 3.9% / 3.6% / 3.5%
Consumer Price Index: 5.4% / 7.0% / 9.1% / 8.2%
Core PCE Index: 3.7% / 4.7% / 4.7% / 4.9%

Federal Funds Open: .07% / .07% / 1.56% / 3.05%
Prime Rate: 3.25% / 3.25% / 4.75% / 6.25%

19th Hole...

We all go a little mad sometimes. Haven't you?

Norman Bates

Ross Elford, Senior Vice President

Direct: 314.746.3679 I Mobile: 314.223.9739 I Fax: 314.746.8737