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Heightened Market Volatility; Heightened Economic Uncertainty

Complacency was a common theme in the past two editions of our *Monthly Economic Outlook*. More specifically, our expressing concern over how complacent we thought many analysts and market participants were as 2020 began. First, it was complacency over the outlook for the U.S. economy in 2020 (January), then it was complacency over the potential effects of the coronavirus (February). As we write this in early March, we can say, with a high degree of certainty, complacency is no longer an issue. Which, in terms of the outlook for the U.S. economy and the global economy, is pretty much the only thing that can be said with any degree, let alone a high degree, of certainty right now.

That analysts and market participants have been jolted out of their complacency is not really surprising. What is surprising is the speed with which that has happened. By the end of the first week of March, equity prices had posted double-digit declines off their February highs, while yields on longer-term U.S. Treasury bonds had fallen to all-time lows. The catalyst for these moves was the realization that the coronavirus had become a global issue, and that the U.S. economy was indeed vulnerable to the effects of the coronavirus, though it is hard to imagine how or why anyone would not have understood that as being at least possible, if not likely, from day one. Perhaps the biggest surprise over the past few weeks was the FOMC cutting the Fed funds rate target range by 50 basis points on March 3, ahead of the March 17-18 FOMC meeting, in response to the growing downside risks to the U.S. economy and the financial markets posed by the coronavirus.

In the early phases, many viewed the coronavirus as largely being a health issue for China that, to the extent it disrupted economic activity in China, posed a threat to global supply chains. In other words, many saw it as a potential transitory supply shock that could lead to temporary disruptions in the U.S. economy. As the virus began to spread around the globe, including into the U.S., the realization that it also posed a threat to the demand side of the economy began to take hold. In other words, the coronavirus at once represents a potential supply shock and a potential demand shock which, if of sufficient dimension, could push the U.S. economy and the global economy into recession. That no one can, at this point in time, know how broadly the virus will spread, how long it will pose a threat, how consumers will react, and how severe any disruption to economic activity will be adds extra layers of uncertainty. That our focus here is the economic costs of the coronavirus does not mean we are not mindful of the human costs, which are of course immeasurable.

While the financial markets are pricing in a severe hit to the U.S. economy, thus far there are few visible effects in the regular economic data. Clearly, with the coronavirus simultaneously

posing threats to both the supply side and the demand side of the economy, the toll on economic activity could indeed be severe, but we're just not at the point that we can even begin to quantify that. While our econometric models allow us to incorporate assumptions we make as to how different parts of the economy, such as consumer spending, industrial production, and trade, will be impacted, at present this is precisely what they are – assumptions, which can, and do, change quickly. As such, any forecast made at this point, by us and by others, comes with an even higher than normal degree of uncertainty. The incoming economic data over coming months will shed light on the actual effects and help us refine our assumptions, but that will be a slow process given the time lags involved in collecting and reporting the data.

This means that over coming weeks the higher frequency data will take on added significance. For instance, the higher frequency measures of consumer sentiment, such as Bloomberg's weekly *Consumer Comfort Index* and Morning Consult's *Daily Consumer Confidence Index* will quickly pick up any marked deterioration in consumer sentiment that would presage a pullback in consumer spending. Both measures have indeed fallen of late, but remain at fairly high levels, and as such are not sending up warning flags as to consumer spending. Indeed, given the dramatic plunges in equity prices of late, we're somewhat surprised these sentiment measures have not fallen further, but this could simply reflect consumers giving more weight to labor market conditions, which to this point remain strong. That said, should there be a rapid acceleration in the spread of the coronavirus across the U.S., these sentiment measures could fall far and fast, much in the way stock prices have over the past two weeks, which would raise the possibility of a pronounced pullback in consumer spending.

The weekly data on initial claims for Unemployment Insurance (UI) will take on added significance in the weeks ahead. If the coronavirus begins to impact the labor market, the first place we will see that is in the data on UI claims. Any such effects will turn up in the monthly employment reports, but only with a lag. This helps explain why a strong February employment report (which we discuss later) was greeted so rudely by the financial markets – the payroll survey week (which, in any given month, is the week including the 12th of the month) came prior to there being signs that the coronavirus had spread to the U.S. Still, as of the week ending February 29, initial UI claims remained notably low, with 216,000 claims filed, suggesting the labor market had yet to be impacted by the coronavirus.

That can, and almost surely will, change in the weeks ahead, and the weekly data on UI claims will provide the first warning signs. One caveat is that it is unclear how quick firms might be to lay off workers if they view the effects of the coronavirus as transitory. As of February, the jobless rate stands at 3.5 percent, a rate that prior to the past few months had last been seen 50 years ago. With labor market conditions as tight as they are, firms may not

be as quick to lay off workers in response to a transitory disruption in business activity, particularly given what have been growing concerns over the ability to find skilled labor and the costs involved in searching for and onboarding new employees. This is why, though somewhat lagged, the monthly employment reports will still bear watching. Keep in mind that the “headline” job growth number atop the monthly employment report is a net job growth number, i.e., it reflects the difference between the number of workers coming on to payrolls and the number of workers rolling off payrolls. While firms may be hesitant to let current workers go, they would surely be quick to cease hiring new workers, such that measured monthly job growth could decline sharply even absent a spike in initial UI claims. Additionally, firms may opt to keep current workers on the payroll but cut weekly hours worked, which is another metric reported in the monthly employment reports.

The weekly data on applications for mortgage loans will also be more informative than usual in the weeks ahead. The sharp decline in mortgage interest rates triggered by growing concerns over the coronavirus has already prompted another spike in mortgage refinancings, which will free up cash for those households taking advantage of the opportunity. What these households will do with this cash, however, remains to be seen; whether, or to what extent, these households will be willing to spend this extra cash will in part depend on how the coronavirus impacts the labor market and consumer confidence. Those same factors will also help shape the path of home sales over coming months, making the weekly data on applications for purchase mortgage loans perhaps more of a real time indicator of how consumer confidence is holding up in the weeks ahead.

As a side point, the ability to do things online could mitigate the economic effects of the coronavirus. Though somewhat limited across industry groups, the ability of workers to work from home will provide at least somewhat of a buffer against the effects of the coronavirus on the labor market. But, to the extent that people can do things like file UI claims, apply for mortgage loans, and shop online, this could soften the economic effects of the virus. The obvious caveat is that all of these activities ultimately rely on the humans who do things such as approve applications for UI claims and mortgage loans, and transport and deliver goods, being able to do their jobs.

At this point, however, the only honest answer anyone can give to the question of the economic impact of the coronavirus is “we don’t know,” even if this is not a very satisfactory answer. Being able to identify the various channels through which the virus may impact the economy is not the same as being able to quantify the timing, magnitude, and duration of any of these effects. As such, we’ll monitor the data, particularly the high frequency data, and be more specific as the data allow. Market participants are making their own implicit assessments, with heightened risk aversion reflected in commodity prices and asset prices, which will change as the perceived risks of the coronavirus change.

Policy makers, however, cannot afford to wait, whether that means acting or making it clear that they stand ready to act. That is apparent in the FOMC having cut the Fed funds rate ahead of this month’s scheduled meeting, and we expect a further cut to the funds rate at the March 17-18 meeting. In a sense, the FOMC was in a no-win situation, regardless of what they did, and what

they do going forward, they have been and will be criticized, whether it is for acting, for acting too aggressively, or for not acting aggressively enough. None of which will not keep them from acting as they deem most appropriate. And, while no one thinks cutting the Fed funds rate will remedy impaired global supply chains or prop up consumer confidence, the FOMC’s concern is with overall financial conditions and the functioning of the credit markets, and the FOMC will base its decisions on these grounds.

That said, there is a difference between there being adequate liquidity in the financial system and individual firms being able to access that liquidity. This matters in that even a transitory economic slowdown increases the risk that heavily indebted firms default on their debt obligations. We’ve been on the record for some time with our concerns over the potential for rising debt service stresses in the nonfinancial corporate sector in what we expected would be a slowing economy, and the potential effects of the coronavirus only amplify those concerns.

Clearly, the current low-rate environment acts as a constraint on any monetary policy response, which heightens the importance of having a fiscal policy response formulated and at the ready. Or, to be more specific, a timely and targeted fiscal policy response. To the surprise of no one, there are those beating the drum for “big and bold” fiscal policy measures, ranging in size from hundreds of billions of dollars to over one trillion dollars, much of which would be spent on things that have nothing at all to do with, and would have no impact on, the effects of the coronavirus. Rather than spending for spending’s sake, a meaningful fiscal policy response to the coronavirus would be much more targeted. First and foremost, supporting the health care system to ensure testing and care, particularly for those without health insurance. Ensuring that those who are laid off due to a virus-related slowdown/downturn are quickly provided with Unemployment Insurance benefits is a must, while supplementing state UI payments, adding to food assistance programs and providing increased Medicaid matching for states would be meaningful steps that could be triggered on a state-by-state basis as the number of UI claims filed by residents of each state rise beyond a certain threshold. Other potential steps include increased funding for small business loans and deferring taxes for firms in those industries, such as travel and hospitality services, most impacted by the virus.

What these responses have in common is that they would be timely, targeted, and transitory, which cannot be said for some of the “big and bold” proposals we’ve seen, which would use the coronavirus as a front for adding broader based spending that would persist well beyond the effects of the virus. Here’s a news flash for those making such proposals: big, bold, and ridiculous are not mutually exclusive concepts. Even if it would not have to be fully implemented, having a targeted plan to address the specific impacts of the virus would at least help inspire some confidence amongst businesses and consumers, and the sooner this happens, the better.

Housing Market On A Nice Run, But Headwinds Remain

One sector of the U.S. economy that entered 2020 with a spring in its step is the housing market. That is a stark, not to mention

welcome, contrast to the way in which the housing market stumbled into 2019 after having been knocked off stride by the affordability shock of late-2018. As with any discussion of any part of the economy these days, the great unknown at this point is how the effects of the coronavirus will impact the housing market. As noted above, with mortgage interest rates having declined sharply as concerns over the virus have intensified, we’ve already seen a spike in applications for mortgage loan refinancings. What that decline in mortgage interest rates means for home sales remains to be seen, given that mortgage rates are only one of the many factors that go into the decision to purchase a home.

It had been our plan to use this space to discuss the current state of the housing market and what we see for the housing market over the remainder of 2020. While neither ignoring nor discounting the possible effects of the coronavirus, we still think it worth having that discussion. Even before the virus emerged as a threat to overall economic activity, we saw limited upside for the housing market in 2020 despite the housing market having carried positive momentum into 2020, momentum which was clearly sustained through February before concerns over the coronavirus intensified. With the obvious caveat that the coronavirus taking a significant toll on the labor market and on consumer confidence would be a clear hit to the demand side, we continue to argue that the issues in the housing market lie mainly on the supply side of the market.

five years the seasonal top in listings has been below that of the prior year, and we do not expect that string to be broken in 2020 – a view we held prior to the coronavirus potentially impacting this year’s Spring sales season.

Though we’ve addressed this point before, we’ll do it again here. It has become popular to dismiss the NAR inventory data as not being representative of actual inventories of existing homes for sale, on the grounds that the internet has facilitated sales by owners that bypass the traditional MLS channel and, as such, are not captured in the NAR data. While this is a plausible argument, it does not hold up to closer examination. For starters, those who opt to sell a home on their own rather than using a real estate agent, have the option of paying to have their home listed on the MLS, and many do so, meaning their homes are picked up in the NAR inventory data.

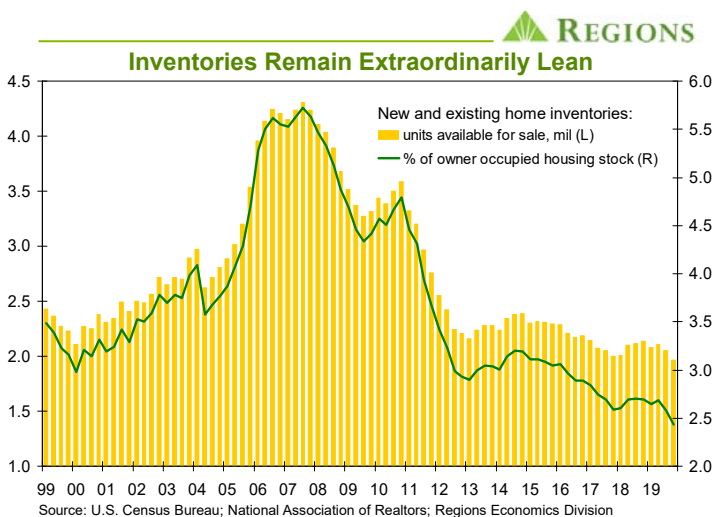
Moreover, if sales-by-owner were making up a significant, and increasing, share of total existing home sales, there would be divergent patterns in sales as reported by the NAR and by other real estate data providers who report sales on the basis of publicly recorded transactions data. In our case, we examined data from our preferred source of housing market data, CoreLogic. While we have access to the CoreLogic data and the right to use it for analytical purposes, we do not have the right to reproduce it here, but we can at least report on what we see in the data.

Sales-by-owner that bypass the traditional MLS system would not turn up in the NAR sales data but would turn up in the public records captured in the CoreLogic data. As such, were sales-by-owner accounting for a significant share of total existing home sales, you would expect to see a divergence in the trends in the raw (or, not seasonally adjusted) data on existing home sales as reported by NAR and by CoreLogic. This is decidedly not the case. Sometimes, extraordinarily lean inventories are just that, i.e., extraordinarily lean inventories. This is, at least to us, clearly the case with inventories of existing homes for sale.

We can also make the same case with spec inventories of new homes for sale, or, new homes for sale that are either complete or are in some stage of construction. That may seem surprising in the face of what were blowout numbers on single family housing starts in both December and January. With an assist from atypically mild weather, these two months saw the highest rates (seasonally adjusted and annualized) of single family housing starts since July 2007, yet, in January the inventory of spec homes for sale fell to its lowest level since August 2018.

This brings up an important distinction in the data on residential construction, in this case the distinction between total single family construction and construction of single family homes intended for sale. In any given time period, a sizeable share of single family construction is either owner built or, to a far lesser extent, built for rent, as opposed to being built for sale. Over the past six years, the share of single family starts and single family completions intended for sale has hovered right at 75 percent.

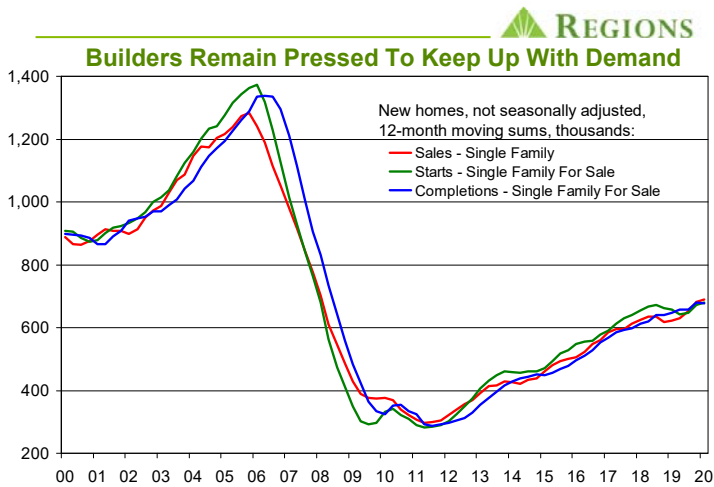
While single family starts and completions have been steadily increasing over the past several years, the rate of increase has been somewhat slow. This is pretty much the same pattern seen in new single family home sales. Allowing for the built-for-sale distinction, what we find is that builders have basically been selling



The above chart is one we’ve used often to illustrate our point, and the version above includes the data for Q4 2020. On both an absolute basis (the number of units) and a relative basis (as a percentage of the owner occupied housing stock) the inventory of new and existing homes available for sale was the lowest on record in the life of the data. While in the current iteration the data only go back to 1999, we nonetheless find the above chart to be striking. For some context, the owner occupied housing stock has grown by roughly 15 percent during the time period shown in the above chart, but turnover of that stock has slowed sharply.

Indeed, December saw the number of existing homes listed for sale fall to the lowest in the life of the National Association of Realtors’ data series. That number did increase marginally in January, but spec inventories of new homes for sale declined. While the annual Spring sales season typically brings an increase in the number of existing homes listed for sale, in each of the past

them as fast as they've been able to build them, but constraints on the rate at which builders are able to build them are acting as a drag on new single family home sales.



The above chart illustrates our point. Whether due to shortages of buildable lots, regulatory constraints, and shortages of labor, or some combination of these factors, builders are pressed to keep up with demand, which has resulted in diminishing inventories of spec homes for sale. Whether new or existing homes, lean inventories are holding down sales and supporting a faster pace of price appreciation than would be seen in a more balanced market. This is an important point to keep in mind, as faster price appreciation can offset some, if not all, of the boost to affordability in the form of lower mortgage interest rates. To the extent that the recent declines in mortgage interest rates do spur greater demand for home purchases, lean inventories act as a binding constraint on sales, and to the extent that something has to give, that something will be prices. This has been, and remains, why we argue that there is only limited upside for home sales, despite what of late have been some encouraging monthly sales numbers.

February Employment Report: Starting Points Matter

For as long as we've been doing this job, which is a long time, the monthly employment report has been considered the most important single economic data release in any given month. Yet, concerns over the potential impacts of the coronavirus have led to the monthly employment report being dismissed as "old news." That accounts for the rather rude welcome market participants gave to what was a strong February employment report. Total nonfarm employment rose by 273,000 jobs in February, prior estimates of job growth in December and January were revised up by a net 85,000 jobs for the two-month period, job growth remained notably broad based, the unemployment rate slipped to 3.5 percent, and aggregate private sector wage and salary earnings were up 4.7 percent year-on-year. Had those same numbers come two months ago, or even one month ago, they would have sent equity prices and bond yields higher. Coming on the first Friday in March, however, they did little, if anything, to stem further declines in equity prices and bond yields. As noted

above, many dismissed the February employment report out of hand given that the end of the payroll survey period came prior to there being signs the coronavirus had spread to the U.S. While we understand that, our view is that starting points matter, and the February employment report shows the labor market was on solid footing when first confronted with the effects of the coronavirus.

As was the case with the January data, measured February job growth got a boost from atypically warm winter weather. On a seasonally adjusted basis, construction payrolls rose by 42,000 jobs in February, on top of an increase of 49,000 jobs in January. The not seasonally adjusted data show construction employment was stronger than is typical for the months of January and February, thus translating into the outsized increases reported in the seasonally adjusted data. The same patterns are seen in the leisure & hospitality services group, particularly in hiring amongst restaurants. This simply sets us up for payback in the March data. For instance, in any given year, not seasonally adjusted construction payrolls rise sharply in the month of March, but with hiring having been pulled forward into January and February this year, the March increase will be much smaller than normal. On a seasonally adjusted basis, this could easily leave construction payrolls flat-to-slightly lower, and the same holds for leisure & hospitality services payrolls, with both sectors likely acting as drags on growth in total nonfarm employment in March.

Aside from our usual annoyance over people drawing conclusions based on what is clearly seasonal adjustment noise in the data, we think it worth emphasizing this point, as many expect the first signs of the coronavirus to turn up in the March employment data, particularly in leisure & hospitality services. If we are correct in expecting the March data to show payback for outsized job gains in both January and February, this could easily be conflated with any effects of the virus that do appear in the data. If you had to guess whether most analysts and market participants would react to a soft March job growth number by scouring the not seasonally adjusted data for signs of payback for the prior two months or instead by simply attributing it to the coronavirus, which would you pick? It does actually matter, given what will most likely be an asymmetrical reaction to the March employment report.

We'll have an answer to that on April 3. For now, though, we know that hiring held up through mid-February, even allowing for the noise in the data, and we know that by the end of February there had been no virus-related spike in layoffs. Hiring remained notably broad based in February; the one-month hiring diffusion index, a measure of the breadth of hiring across private sector industry groups, rose to 58.7 percent, a three-month high. Moreover, the average length of the workweek rose by one-tenth of an hour which, along with the outsized increase in private sector payrolls (up by 228,000 jobs) and a 0.3 percent increase in average hourly earnings, led to a 0.8 percent increase in aggregate private sector wage and salary earnings, leaving them up 4.7 percent year-on-year. We think it also worth noting that the number of long-term unemployed (27 weeks or more) fell to 1.102 million people in February, the lowest total since December 2006, a testament to how a prolonged period of steady job growth has pared down labor market slack. It could well be that the February employment report is the last strong employment report we see for a while and, though some may think it doesn't matter, we at least know the labor market was on solid footing ahead of the coronavirus.