Principal[SM]

Economic Insights: **US housing: is the canary still moving?**

Monthly update: November 2018

Commentary by Bob Baur and the Economic Committee

In decades past, coal miners would carry a caged canary down into the mines. If poisonous gases were present, the bird would succumb first, signaling the miners to get out. US housing activity has flattened this year and recent readings have been ugly. New-home sales in October were the lowest in 30 months, off 12.0% from the prior year. Housing starts have fallen over 7.0% this year from a recent peak. New-home inventories are the highest since January 2009, so price rises have moderated, and homebuilder confidence has plunged. Since housing is a significant driver of economic growth, some suggest the housing canary is on life support, forecasting slower US growth or worse.

Housing weakness is a yellow flag, but we'd guess the canary is still breathing. Housing activity has been fighting several headwinds. Interest rates on mortgages have risen sharply, up about 0.7% this year. The Federal Housing Finance Authority's home price index shows substantial price appreciation, up 40.5% from the June 2012 low and 13.9% beyond the prior 2007 high. So, home affordability is low. Further, the tax reform of 2017 limited the amount of state and local taxes as well as mortgage-related interest that could be deducted from one's federal taxes. That's likely what's behind the collapse in new-home sales in the Northeast where home prices are the highest.

Underlying strength: However, the fundamentals of housing demand stay robust. Job growth has been excellent and wage gains are accelerating; average hourly earnings will likely hit 3.5% by mid-2019. Growth in hourly earnings times gains in aggregate hours, a proxy for US household income, is rising at a 5.3% annual pace; the fastest since well before the financial crisis. Household formation is improving; the five-year average is

Regional economic updates

United States

A robust job market and accelerating wages suggest consumer spending will stay vigorous, likely 3.0% or more for several quarters. Christmas sales over the recent holiday have been blowout good. The old age of US capital stock and incentives in tax reform should keep investment stout; if that's not enough, higher wage costs should boost capital spending for productivity-enhancing equipment and software. We look for near 3.0% growth in 2019, front-loaded into the first three quarters. Specific US forecasts are at the end of the commentary.

Greater Europe

Growth in the Eurozone should persist in the 1.5% to 2.0% range in 2019. Economic confidence is resilient as joblessness falls and employment rises. Wage growth is picking up a bit and consumption remains healthy. The German economy is rebounding after a one-off contraction in the third quarter. The UK economy continues to grow despite heated discussions about the withdrawal agreement with Brussels. Negotiations over the Italian budget deficit create political uncertainty in the Eurozone; growth will remain lackluster until clarity improves.

A look ahead

The difference in growth momentum between an increasingly vigorous US economy and deceleration around the world was the key story of 2018. That brought US equity outperformance, a stronger dollar, and rising long-term US rates. World growth will moderate in 2019, slipping in China and a bit in the United States, while Europe and Japan keep a pace similar to 2018. Emerging markets will face headwinds from shrinking Chinese imports and decelerating world growth. However, the US dollar is likely nearing a peak and there is a potential for lower interest rates on the back of equity turmoil next year; both are real positives for emerging markets.

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nearly 1.2 million, the best since June 2009. And the number of young people under 35 years of age living with their parents has started falling. Household confidence is near record levels by essentially all measures.

In addition, the above-noted drags are diminishing. The hit from tax reform was a one-time impact; it slowed the momentum from 2017 into 2018 but won't be repeated in 2019. Second, affordability may improve. Mortgage rates are still relatively low and are no longer screaming higher; home price rises are moderating. Part of the weakness in new-home sales may have been due to limited availability of reasonably-priced starter homes; builders have been slow to reenter that market. Younger workers have seen the best job gains; wage growth has been the fastest in lower-wage job categories; anecdotal evidence suggests lower-priced homes have been selling fast.

With robust fundamentals and lessening drags, we expect the uptrend in housing activity since the financial crisis to partly resume as 2019 progresses. The recent slowdown is a yellow flag; we'll watch housing closely in case it becomes a lifeless canary.

Interest rates

Off-hand remarks by Federal Reserve (Fed) Chair Jay Powell in early October suggesting the fed funds rate (FFR) was a long way from neutral put markets into a long tailspin. But, his recent prepared comments that the FFR was "just below the broad range of estimates of the level that would be neutral" gave markets a dovish signal; the Dow Jones Industrial Average soared 2.5% that day. Investors seemed to believe the Federal Open Market Committee (FOMC) was on autopilot, raising the FFR 0.25% every quarter regardless of market volatility or inflation. The minutes of the last FOMC meeting reaffirmed the committee's dependence on incoming data. Members were listening to markets and investor qualms after all.

2019, one and done? For some time, we have suggested that after the hike next March, the FOMC is very likely to pause its rate hikes and take stock of how the economy had adjusted to higher rates and a smaller Fed balance. A rise of 0.25% at the December meeting seems a foregone conclusion. Another hike in March would put the FFR top at 2.75%, above some estimates of neutral. With no inflation problem at all, that seems like a good spot for Fed reflection and a timeout. In the last few days, some investors have warmed to the idea of a rate pause next year. In addition, with the deceleration of local growth, neither the European Central Bank nor the Bank of Japan will be raising official rates for some time.

The future of long-term yields is harder to discern. We've been expecting another wave higher in yields on 10-year and 30-year US treasury bonds. It hasn't happened yet. Ten-year yields fell back below 3.0%, the lowest since mid-September. The Fed suddenly seems less committed to automatic rate hikes; there are significant concerns about slowing global growth; inflation has softened recently; all are potential explanations for the fall in yields.

However, long-term government yields should still have an upward bias. Current US nominal growth is over 5.0% and potential US growth has likely risen to 4.0% or more as productivity growth improves and inflation stabilizes around the Fed's target. Nominal growth that robust surely necessitates higher long-term rates since rates and growth tend to equalize in the long run. The coming surge of US Treasury bond issuance should also help forge the uptrend. We expect 10-year yields to make a new cycle high because US growth may remain stronger than consensus expectations in 2019.

Stock markets

October was dismal for stock markets, and except for the last few days, November was almost as bad. An uptrend may have begun from oversold conditions the last Monday of the month. The gain that last week of November was terrific: The S&P 500 Index jumped 4.8%, which put the year-to-date return into the green, up 3.2%. Outside the United States, few major indices had year-to-date gains through November. The MSCI All-Country World Index fell 4.3% for the period. Nevertheless, most markets bounced that last week.

In coming weeks, we expect this stock upturn to push back to or near the recent highs in the United States, with other markets enjoying a similar boost. The tentative pause in trade tensions between the United States and China could be the spark investors need to return as buyers after two months of volatility and correction. Interest rates are still very low and equity earnings are excellent. Concerns about world growth are overdone: the economies of the Eurozone and Japan are rebounding; China is cutting household taxes and making liquidity more available. Recession is not a worry.

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Changing monetary environment: However, that upturn, if it happens, may be the last of the long US investment cycle that began in March 2009. For years, the super-accommodative monetary policy and ultra-low interest rates made stock markets a mere extension or derivative of monetary policy. The world was awash in liquidity provided by world central banks during and after the financial crisis, liquidity which found its way into all asset markets, pushing prices ever higher. With much improved economic growth, monetary policy is tightening, liquidity is being withdrawn, and markets are having to adjust. That adaptation is behind the surge in volatility this year; it's what kept stock and bond market returns this year so miniscule. That adjustment is likely not over yet, since monetary policy and interest rates have farther to go to find normal. More turmoil may be ahead.

Investment implications: It's a time for investors to be cautious. We expect the good world economy, robust earnings, and rebounding investor sentiment to push stock prices higher into year-end or beyond, maybe back to this year's highs. We expect short- and long-term yields to rise right along with the stock market rally.

Those higher yields will take a toll on the stock market. It's the mathematics of interest rates: a higher discount rate means future earnings have a lower present value. A moderate bear market is surely possible in 2019; earnings will likely disappoint with rising wage and debt costs, credit stress, slightly slower US growth, and continued deceleration in China. So, it may be wise to take advantage of the rally and reduce stock weightings or move to safe-haven investments. For stock investors, we'd suggest defensive sectors, like utilities, real estate, health care, and consumer staples. After a significant downdraft, major US indices may end 2019 flat at best. US indices would likely underperform those outside the United States.

Credit spreads exploded since early November, but will likely tighten somewhat if equities continue to rally. Stress could return to credit markets before long in 2019, so, fixed income investors may want to hide in high quality bonds. Long-term US Treasury bonds at somewhat higher yields might be a great trade for six to twelve months if equity and credit market turmoil bring a flight to safety in 2019, and 10-year US Treasury yields fall to 2.5% or below.

Baseline Economic Forecasts for 2018 - 2019

A. Growth in Real GDP - Qtr-Qtr (% Change, Annualized):

	1st Quarter 18 Actual		2nd Quarter 18 Actual		3rd Quarter 18 Actual		4th Quarter 18 Forecast		2016 Actual		2017 Actual	
Real GDP	**18,324.0**	**2.2%**	**18,511.6**	**4.2%**	**18,671.7**	**3.5%**	**18,776.2**	**2.3%**	**17,659.2**	**1.6%**	**18,050.7**	**2.2%**
Personal Consumption Expenditures	**12,722.8**	**0.5%**	**12,842.0**	**3.8%**	**12,957.2**	**3.6%**	**13,064.4**	**3.3%**	**12,248.2**	**2.7%**	**12,558.7**	**2.5%**
Durable Goods	1,628.2	-2.0%	1,662.3	8.6%	1,678.3	3.9%	1,694.8	4.0%	1,476.8	5.5%	1,577.9	6.8%
Non-Durables	2,858.6	0.1%	2,886.7	4.0%	2,923.9	5.3%	2,949.2	3.5%	2,763.9	2.7%	2,822.0	2.1%
Services	8,267.9	1.0%	8,329.8	3.0%	8,393.8	3.1%	8,443.7	2.4%	8,022.5	2.3%	8,184.5	2.0%
Gross Private Domestic Invest.	**3,321.0**	**9.6%**	**3,316.7**	**-0.5%**	**3,435.4**	**15.1%**	**3,440.0**	**0.5%**	**3,050.5**	**-1.3%**	**3,196.6**	**4.8%**
Bus. Fixed Invest.	2,654.0	11.5%	2,710.1	8.7%	2,727.0	2.5%	2,768.2	6.2%	2,411.2	0.5%	2,538.1	5.3%
Structures	533.3	13.9%	551.7	14.5%	549.3	-1.7%	557.4	6.0%	494.7	-5.0%	517.5	4.6%
Equipment	1,250.9	8.5%	1,264.9	4.6%	1,275.7	3.5%	1,294.4	6.0%	1,116.2	-1.5%	1,183.7	6.1%
Intellectual Property Products	875.7	14.1%	897.9	10.5%	907.4	4.3%	920.7	6.0%	803.9	7.5%	841.1	4.6%
Residential Invest.	615.3	-3.4%	613.2	-1.3%	609.2	-2.6%	613.7	3.0%	591.3	6.5%	611.1	3.3%
Change in Inventory	30.3	-	-36.8	-	86.6	-	35.0	-	23.4	-	22.5	-
Net Exports	**-902.4**	**-**	**-841.0**	**-**	**-945.8**	**-**	**-952.2**	**-**	**-786.2**	**-**	**-858.7**	**-**
Exports	2,517.8	3.6%	2,574.2	9.3%	2,545.7	-4.4%	2,565.2	3.1%	2,378.1	-0.1%	2,450.1	3.0%
Imports	3,420.1	3.0%	3,415.2	-0.6%	3,491.5	9.2%	3,517.4	3.0%	3,164.4	1.9%	3,308.7	4.6%
Gov't Purchases of Goods & Services	**3,152.2**	**1.5%**	**3,171.8**	**2.5%**	**3,192.2**	**2.6%**	**3,203.3**	**1.4%**	**3,132.5**	**1.4%**	**3,130.4**	**-0.1%**
Federal	1,213.1	2.6%	1,224.0	3.7%	1,234.6	3.5%	1,237.9	1.1%	1,187.8	0.4%	1,196.4	0.7%
National Defense	722.8	3.0%	733.3	6.0%	742.2	4.9%	744.1	1.0%	709.2	-0.6%	713.8	0.7%
Non-Defense	489.5	2.1%	490.1	0.5%	491.9	1.5%	493.2	1.0%	478.0	1.9%	481.9	0.8%
State & Local	1,937.7	0.9%	1,946.6	1.8%	1,956.5	2.0%	1,963.8	1.5%	1,942.8	2.0%	1,932.3	-0.5%
Final Sales of Dom. Product	18,274.4	1.9%	18,515.9	5.4%	18,571.4	1.2%	18,722.4	3.3%	17,617.5	2.1%	17,769.1	0.9%
Final Sales to Dom. Purchasers	19,141.3	1.9%	19,330.8	4.0%	19,477.5	3.1%	19,650.2	3.6%	18,387.2	2.3%	18,550.0	0.9%
year-over-year	2.6%		2.9%		3.0%		3.0%					

	1st Quarter 19 Forecast		2nd Quarter 19 Forecast		3rd Quarter 19 Forecast		4th Quarter 19 Forecast		2018 Forecast		2019 Forecast	
Real GDP	**18,924.9**	**3.2%**	**19,068.6**	**3.1%**	**19,204.1**	**2.9%**	**19,331.6**	**2.7%**	**18,570.8**	**2.9%**	**19,132.3**	**3.0%**
Personal Consumption Expenditures	**13,156.8**	**2.9%**	**13,253.4**	**3.0%**	**13,346.7**	**2.8%**	**13,436.9**	**2.7%**	**12,896.6**	**2.7%**	**13,298.5**	**3.1%**
Durable Goods	1,711.5	4.0%	1,728.4	4.0%	1,743.3	3.5%	1,758.3	3.5%	1,665.9	5.6%	1,735.4	4.2%
Non-Durables	2,974.7	3.5%	3,004.0	4.0%	3,033.6	4.0%	3,059.8	3.5%	2,904.6	2.9%	3,018.0	3.9%
Services	8,494.0	2.4%	8,544.5	2.4%	8,593.2	2.3%	8,642.2	2.3%	8,358.8	2.1%	8,568.4	2.5%
Gross Private Domestic Invest.	**3,491.1**	**6.1%**	**3,532.0**	**4.8%**	**3,568.7**	**4.2%**	**3,599.4**	**3.5%**	**3,378.3**	**5.7%**	**3,547.8**	**5.0%**
Bus. Fixed Invest.	2,810.2	6.2%	2,851.5	6.0%	2,883.6	4.6%	2,914.6	4.4%	2,714.8	7.0%	2,865.0	5.5%
Structures	566.9	7.0%	575.2	6.0%	583.6	6.0%	590.8	5.0%	547.9	5.9%	579.1	5.7%
Equipment	1,313.4	6.0%	1,332.7	6.0%	1,345.8	4.0%	1,359.1	4.0%	1,271.5	7.4%	1,337.8	5.2%
Intellectual Property Products	934.2	6.0%	947.9	6.0%	958.4	4.5%	969.0	4.5%	900.4	7.0%	952.4	5.8%
Residential Invest.	622.8	6.0%	627.4	3.0%	632.0	3.0%	636.7	3.0%	612.9	0.3%	629.7	2.7%
Change in Inventory	35.0	-	30.0	-	30.0	-	25.0	-	28.8	-	30.0	-
Net Exports	**-957.6**	**-**	**-962.3**	**-**	**-966.6**	**-**	**-968.1**	**-**	**-910.3**	**-**	**-963.6**	**-**
Exports	2,584.2	3.0%	2,604.0	3.1%	2,622.7	2.9%	2,638.9	2.5%	2,550.7	4.1%	2,612.5	2.4%
Imports	3,541.8	2.8%	3,566.3	2.8%	3,589.3	2.6%	3,607.1	2.0%	3,461.1	4.6%	3,576.1	3.3%
Gov't Purchases of Goods & Services	**3,214.0**	**1.3%**	**3,224.8**	**1.3%**	**3,234.6**	**1.2%**	**3,242.7**	**1.0%**	**3,179.9**	**1.6%**	**3,229.0**	**1.5%**
Federal	1,243.7	1.9%	1,249.6	1.9%	1,254.6	1.6%	1,257.7	1.0%	1,227.4	2.6%	1,251.4	2.0%
National Defense	748.7	2.5%	753.3	2.5%	757.1	2.0%	758.9	1.0%	735.6	3.1%	754.5	2.6%
Non-Defense	494.4	1.0%	495.6	1.0%	496.9	1.0%	498.1	1.0%	491.2	1.9%	496.2	1.0%
State & Local	1,968.6	1.0%	1,973.5	1.0%	1,978.5	1.0%	1,983.4	1.0%	1,951.1	1.0%	1,976.0	1.3%
Final Sales of Dom. Product	18,871.2	3.2%	19,019.8	3.2%	19,155.4	2.9%	19,287.8	2.8%	18,521.0	4.2%	19,083.5	3.0%
Final Sales to Dom. Purchasers	19,804.4	3.2%	19,957.7	3.1%	20,097.6	2.8%	20,231.6	2.7%	19,400.0	4.6%	20,022.8	3.2%
year-over-year	3.3%		3.0%		2.9%		3.0%					

Source: U.S. Dept. of Commerce, Bureau of Economic Analysis; Principal Global Investors

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