

outlook

Cooling inflation, economic growth, strong consumer spending, and a robust economy show how resilient the U.S. economy is

What Recession?

I've written in past letters that the Fed is trying to create a recession with aggressive rate hikes. Inflation is beginning to moderate. The 3.7% inflation reading in August was way off the high of 9.1% in June 2022. Inflation in the Eurozone peaked at 10.6%, and reached 11% in the U.K. Yes, we still have a way to go to reach the Fed's 2% target, but the steady decline is very encouraging. The Fed raised rates 525 basis points via 11 rate hikes since March 2022. This is the highest number of rate increases in 22 years and the fastest pace of increases ever! The Fed's overnight rate is now in the 5.25%–5.5% range, another 22-year high.



Bob Hofmann, CFP
President

In the September Fed meeting, we were told that interest rates will stay higher for longer, and we should expect rates to be elevated until at least 2026. Moreover, the Fed believes at least one more rate hike will be needed this year. All of this is in an effort to bring inflation down to the Fed's 2% target.

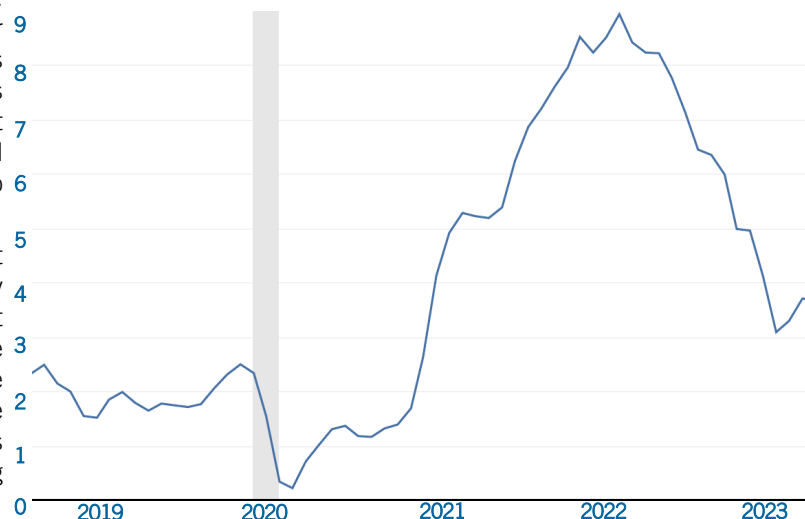
Although the Fed is telling business leaders that a recession is coming, employers aren't listening, as the unemployment rate for August was only 3.8%, which is near a 50-year low. As compared to August 2022, unemployment has risen only 0.3%. Even though job growth is slowing, we're still adding jobs at a higher rate than the growth in the labor force. And when Americans are working, they are spending. Consumer spending was up 0.6% month-over-month in August. This was probably entirely from Taylor Swift! Since 65% of our economy is consumer spending, the large-scale recession that most economists have been predicting for over two years isn't here and probably won't be here. This is why the Fed thinks rates need to be higher for longer.

So, after a couple of years of wrong predictions, the August survey of the National Association for Business Economics Policy found that two-thirds of panelists are now predicting a "soft landing," and I'm starting to hear the word Goldilocks again. I've been in the soft-landing camp for a long time, but I realize we're not out of the woods yet. Monetary policy takes time to circulate through the economy. We won't know the full extent of the Fed's tightening policy for a year or more, but it appears the hiking cycle is nearing an end.

Cooling inflation, economic growth, strong consumer spending, and a robust economy show how resilient the U.S. economy is. Long-time readers know my affinity for Warren Buffett as I often quote him: "For 240 years, it's been a terrible mistake to bet against America." Well said, Warren. However, that doesn't mean that everything is working perfectly.

Residential real estate is beginning to slow as the Fed's aggressive rate hike cycle continues to push mortgage rates higher. Mortgage rates are now above 7%, way above their 2020 lows when a 30-year fixed-rate mortgage fell below 3%! A few years ago, many homeowners refinanced at what may have been a once-in-a-lifetime interest rate (editor's note: I locked in at 2.5% for 30 years). This was great for those who took advantage of the opportunity to refinance, but it's causing some pain for the current housing market. Anyone who refinanced at or around 3% is now reluctant to sell their home because they want to maintain their low interest rate and payment. By staying put, those homeowners are creating a shortage of available homes in an already supply-shortened market. In fact, sales of previously owned homes have fallen around 36% since the beginning of 2022. Higher interest rates would have reduced home prices in the past because most homebuyers purchase homes based on their monthly mortgage payment. Today, home prices are stubbornly high due to the lack of supply.

U.S. Consumer Price Index
year-over-year percent change through August 2023



Source: U.S. Bureau of Labor Statistics, St. Louis Fed

Median home prices are within 5% of all-time highs. Prices have fallen slightly, but housing prices in the Philadelphia area are up almost 50% over the last five years. Affordability is near an all-time low. In fact, in the third quarter, the monthly cost of maintaining a home rose above \$2,000 for the first time. Moreover, the typical monthly mortgage payment rose to over 35% of the average national wage. Usual lending standards call for a 28% debt-to-income ratio, putting home ownership out of reach for many Americans today. Further price declines would be welcome by would-be buyers, and lower rates might put more homes on the market.

Average rate on a 30-year fixed mortgage



Builder sentiment is falling as both labor and buildable lots are hard to find. Housing starts declined 11.3% according to the U.S. Department of Housing and Urban Development. Single-family starts on a year-to-date basis are down 15.1% and mortgage applications in August were at their lowest level since April 1995. This slowdown in residential real estate has significant implications for our economy. Residential investment, which includes construction of new single-family and multi-family homes, residential remodeling, production of manufactured homes, and brokers' fees, accounts for 3%–5% of GDP. A slowdown in housing matters.

In some markets, homebuilders have reduced their asking prices by up to 15%. Also, in select areas, some homebuilders are offering a lower-rate mortgage to entice homebuyers. For instance, Lennar, a Fortune 500 company, is offering a 30-year fixed-rate mortgage at 4.25% in Colorado. Granted, Denver is Lennar's weakest market, but this is another sign of a weakening real estate market. Even with these concessions, homebuilders like Lennar are well capitalized and still have profit margins far above pre-pandemic levels.

Commercial real estate investors are facing uncertainty. On average, commercial real estate is down almost 20% since its peak. Remote working is one of the factors contributing to the fall in the prices of office buildings.

Our building in Philadelphia, although coming back to life, still feels empty compared to pre-pandemic levels. Last year, we extended our lease and our rate decreased for the first time ever. I'm also seeing office buildings in Philadelphia being converted to condominiums. I live in southern New Jersey, and our class A mall, the Cherry Hill Mall, is thriving. Our class B mall, the Moorestown Mall, is struggling. The large retailers like Macy's and Sears closed, and Cooper University Health Care is opening an outpatient surgery center there. Next year there are plans to build a residential community with 375 units on the property. Many of the small stores inside the mall are empty, and going forward, the mall will have more restaurants than stores. Our class C mall, the Burlington Center Mall, has been demolished and replaced by Amazon warehouses.

Global banks hold about \$6 trillion in commercial real estate debt. According to Goldman Sachs, about 80% of commercial real estate loans are held by small and mid-sized banks, most maturing between 2023 and 2026. According to Morgan Stanley, commercial real estate could fall 40%, which would rival the collapse of the 2008 financial crisis. Earlier this year, Jamie Dimon warned investors about the looming crisis in commercial real estate when he said: "You're already seeing credit tighten up because the easiest way for a bank to retain capital is not to make the next loan." Fearing defaults, banks are rushing to shore up capital. Given the heightened risk level with mid-sized and small banks, I feel good about owning the two largest U.S. banks: J.P. Morgan and Bank of America.

"In the middle of every difficulty lies opportunity." – Albert Einstein

Adding to our troubles ahead are the slowing demand for U.S. exports and geopolitical risks. Despite all the challenges in the world, the U.S. economy is the envy of every developed nation. If you would like to review your overall allocation, financial plan, or discuss how to put additional cash to work, please contact your Roffman Miller Investment Advisor.

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