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Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the Ziman Center and UCLA Anderson Forecast, surveys the impending global slowdown and the role of the U.S. economy. A larger version of this report will be in the UCLA Anderson Forecast March 2019 Economic Outlook.

How Housing and Interest Rates Figure in the Coming Global Slowdown

By David Shulman

A year ago we were looking forward to a synchronized global expansion; today we are staring at a synchronized slowdown. The U.S. economy is part and parcel of that slowdown. After growing at 3.1% clip on a fourth quarter-to-fourth quarter basis in 2018, growth will slow to 1.7% in 2019 and to a near recession pace of 1.1% in 2020. However, by mid-2021 growth is once again forecast to be around 2%. Similarly, payroll employment growth is forecast to decline from the 220,000 a month recorded in 2018 to about 160,000 a month in 2019 to a negligible 20,000 a month in 2020 with actual declines occurring at the end of that year. In this environment the unemployment rate will initially decline from January’s 3.9% to 3.6% later in the year and then gradually rise to 4.2% in early 2021.

“The failure of housing activity to provide a propellant for the expansion has been a distinct negative.”
We believe that the 3% growth in 2018 was a one-off based on the fiscal stimulus from the tax cuts and spending increases, especially for defense enacted in late 2017 and the lagging effects of the extraordinarily easy monetary policy pursued by the Federal Reserve. With the fiscal stimulus now waning and with the partial normalization of interest rates, it seemed inevitable that growth would slow. Further, the failure of housing activity to provide a propellant for the expansion has been a distinct negative. The slowdown in U.S. economic activity will be exacerbated by concomitant weakness among our global trading partners.

Although 2018 started out strong globally, by year-end there seemed to be weakness everywhere. The weakness is amplified by the protectionist policies of the Trump Administration and the uncertainties associated with BREXIT. For example, compared to 2018 German growth is expected to slow from 1.5% to 1.3%, China from 6.6% to 6.2% and Italy is for all practical purposes in recession. Although these declines in growth appear modest, recent data suggests that there will be substantial downward revisions to the outlook once first quarter data become available. The global weakness will be transmitted to the U.S. economy by a less than robust export environment and a reduction in corporate profits.

This weakness has triggered a major contraction in global interest rates making it difficult for the Fed to conduct its normalization policy and it has put a lid on long-term interest rates. Where in the recent past we thought yields on 10-year U.S. Treasury would to top out over 4%, we now think that a 3.25% peak is more likely as German interest rates work to suppress U.S. yields.

**FED WILL REDUCE PREVIOUSLY PLANNED RATE HIKES IN 2019 AND CUT IN 2020**

The combination of the global slowdown, the 20% sell-off in stock prices in the fourth quarter and still quiescent inflation triggered a fundamental shift in Fed policy. Instead of penciling three or four rate hikes next year, it now looks like it will be zero or one. We are in the one-hike camp in 2019 because we believe that inflation will be less than benign. However, because we are more pessimistic on the real economy than the Fed, we are forecasting that there will be three rate cuts of 25 basis points each in 2020. In this setting of very slow growth and an end to the Fed normalization process coupled with very low interest rates in Europe and Japan, it is hard to see long-term interest rates going much above 3.25%. 

Sources: U.S. Department of Commerce and UCLA Anderson Forecast
Moreover, it now looks like the Fed is rethinking its balance sheet target. Instead or contracting its balance sheet from the $4.5 trillion peak to $3 trillion or below, it now looks like the shrinkage process will end this year with a balance sheet of around $3.5 trillion. This change in policy will put less pressure on the long end of the treasury curve.

Although there has been much discussion of the potential for the treasury curve to become fully inverted (long rates lower than short rates), we do not believe that will be the case. To be sure, the curve is currently inverted between one- and five-year maturities, but we do not believe that the all-important 90-Day Treasury Bill to the 10-Year Treasury bond will invert. Similarly, we do not believe the 2-10 year spread will invert as well.

**HOUSING STARTS STUCK BELOW DEMAND**

We reckon the underlying demographic demand for housing starts to be around 1.4 million - 1.5 million units a year. But we have yet to achieve that level for over a decade and we forecast that it will not be until late 2021 that housing starts exceed an annual run rate in excess of 1.4 million units. There are a number of explanations for the housing’s failure to launch. They include the after-effects of the Great Recession, high levels of student loan debt, the aging-in-place of baby boomers that is keeping housing units off the market, the concentration of job growth in high-cost metropolitan areas and environmental/zoning restrictions that are choking supply. We believe the main culprit is the last factor.

Because investment capital will remain plentiful, multifamily housing starts will hold up reasonably well over the forecast period. After recording 380,000 starts (2+ units) in 2018, we see multifamily starts remaining at that level in 2019, dipping slightly to 365,000 units in 2020 and returning to 380,000 units in 2021. Nevertheless, if we are correct about employment growth stalling in 2020, both vacancy rates and rents will come under pressure.

**Housing Starts, 2011Q1 - 2021Q4, Thousands of Units, SAAR**

*Source: U.S. Bureau of the Census and UCLA Anderson Forecast*
CONCLUSION

Our forecast has been roughly consistent for over a year. We forecast that real GDP growth will slow to below 2% in 2019 and around 1% in 2020 with a modest rebound in 2021. The jolt from the very expansionary fiscal policies of the Trump administration will soon exhaust itself and there is a very real risk of a recession in late 2020. Meantime the unemployment rate will continue to decline to 3.6%, before gradually returning to 4%. Inflation will remain modestly above 2% and after increasing the Fed Funds rate by 25 basis points mid-year, the Fed will embark on an easing policy in 2020. By 2021 real growth will return to a 2% track.