INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

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A Check-In on the Housing Market Slowdown

Residential investment is broadly regarded as the most interest rate sensitive component of GDP and, therefore, matters a lot in the business cycle. Accordingly, the housing sector's behavior and response to interest rate moves in the current tightening cycle has been important in shaping the economic outlook. In this issue, we assess the recent housing sector stabilization following the contraction that occurred as the Federal Reserve (Fed) tightened rates. In particular, we examine how the 2024 dynamics might differ between single and multi-family housing, as well as the pipeline for construction that we believe may impact rent and owners' equivalent rent (OER) and ultimately feed through into broader inflation.

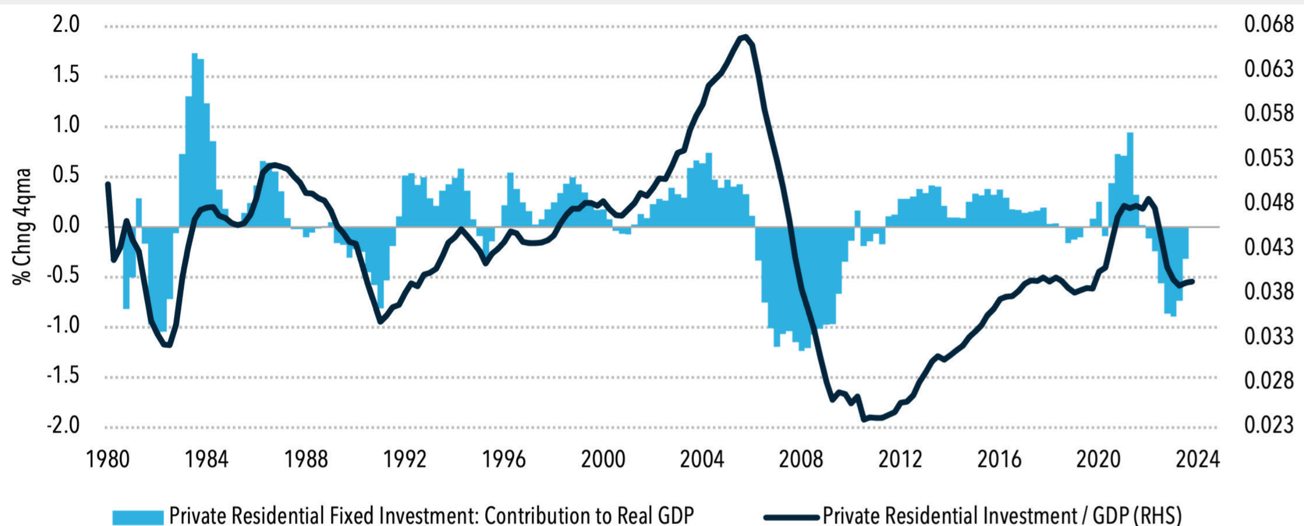
"A man travels the world over in search of what he needs and returns home to find it"

– George Moore, Irish Writer

In the aftermath of COVID, residential investment jumped significantly, rising from just under 4% of GDP to nearly 5%. That building boom was pushed by both an increase in demand for housing and low mortgage rates as the Fed supported the overall economy. Despite the increase, housing investment was still well below prior peaks—in 2006 it reached nearly 7% of GDP and was around 5½% in the mid-80s. Moreover, the increase followed a decade of very low residential investment in the aftermath of the housing market crash of 2008. Today, the legacy of a decade of underbuilding housing remains an issue. As Figure 1 illustrates, the contraction in residential investment subtracted nearly a full percentage point from GDP growth in 2022 and 2023. But that contraction has faded significantly, and the GDP growth contribution was roughly zero in 2023.

One interesting idiosyncrasy of this cycle is the different behavior of single-family and multi-family housing. We think the details are helpful in understanding the current state of the housing market against a backdrop of mostly better inflation data and as the Fed watches closely for signs that could further boost its confidence that inflation and growth have both moderated enough, at least partly from the effects of tighter policy, allowing it to begin the rate cutting cycle.

FIGURE 1: Contraction in Residential Investment Meaningfully Impacted GDP Growth



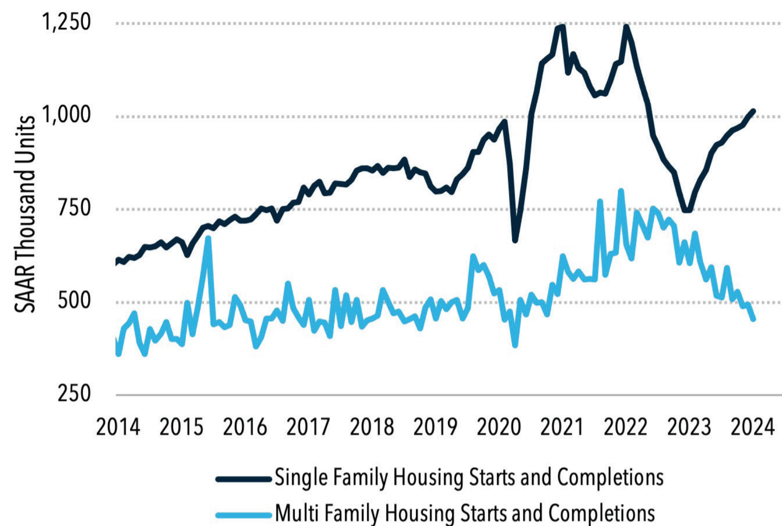
Analysis as of 16 February 2024, using latest available data. Sources: BEA, Haver, Stone Harbor Investment Partners. For illustrative purposes only

Using building permits, as it's less noisy than starts, initiations of housing construction moved down significantly from the post-COVID peak over the last several years, but the pattern differs across single family and multi-family housing. Figure 2 shows that single-family permits dropped first and precipitously, falling from 1.25 million to 0.75 million over 2022 as the Fed was hiking. But, single-family permits have recovered about half of that over the past year, despite mortgage rates remaining high. Looking at vacancies (Figure 3) helps in understanding this move. Homeowner vacancy rates were already low entering COVID—due to the decade of underbuilding we mentioned earlier—but on top of that COVID was a positive shock to the demand for housing, among many other things. As a result, vacancy rates dropped to some of the lowest rates on record and below the prior lows from the 1970s (see Figure 3). This rise in demand into the face of very low supply, as proxied by vacancies, helps explain why permits rebounded despite the much higher mortgage rate environment. Even if it was less affordable than previously, people needed places to live.

On the multi-family side, residential investment also surged: the volume of multi-family construction in 2022 was about 50% higher than in 2019. However, due to longer planning periods and longer lead time for approvals of those plans, the multi-family building permits took longer to ramp up, with a gradual increase across 2020 and 2021 in comparison to the sharper move up on the single-family side.

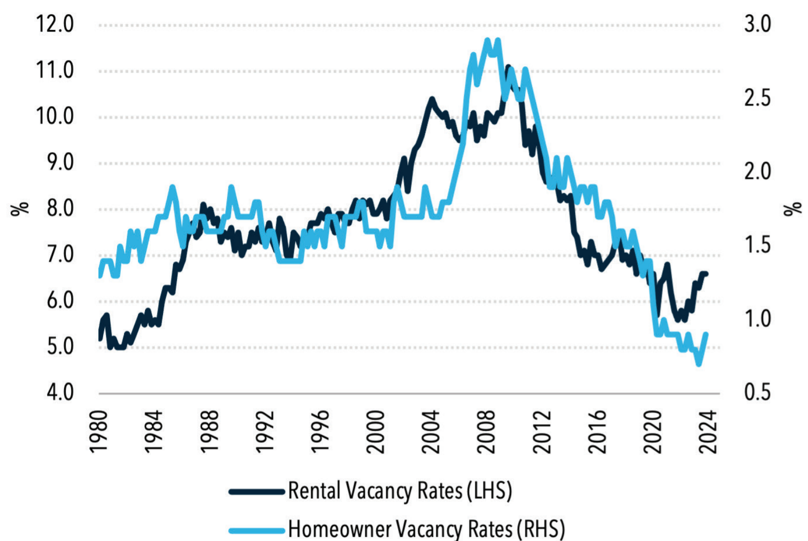
Those timing differences continue to reverberate through the markets now. There are currently large differences in the number of units of each type that are under construction as shown in Figure 4. There is still a lot of multi-family housing that is in the process of being built. Indeed, the number of multi-family units under construction has, despite the move down in permits, not yet seen any significant dip down. It remains very elevated compared to the last decade. Despite the rebound in permits, single-family units under construction remain substantially below the 2022 level and only modestly elevated compared to the 2018/2019 pace.

FIGURE 2: Single Family Activity Fell First, But Has Rebounded While Multi-Family Took Longer to Fall and Has Yet to Rebound



Analysis as of 16 February 2024, using latest available data. Sources: BEA, Haver, Stone Harbor Investment Partners.

FIGURE 3: Vacancy Rates Are Low Relative to History, For both Rental and Homeowner.



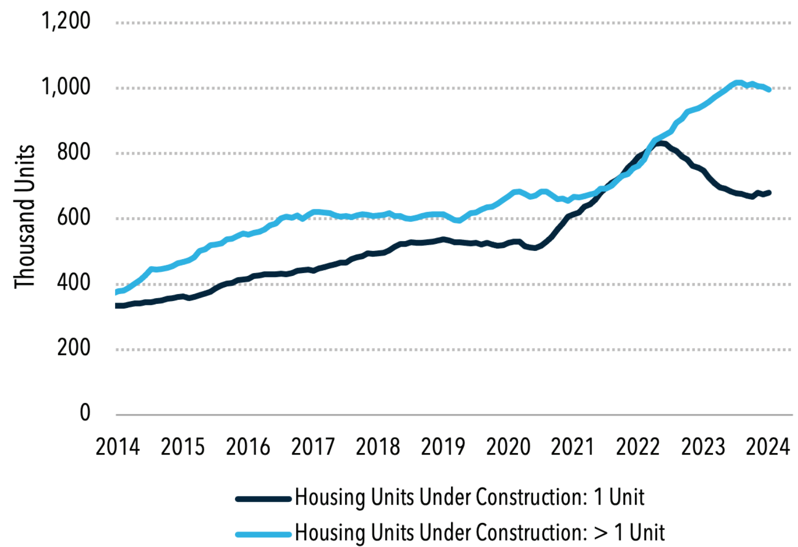
Analysis as of 16 February 2024, using latest data available. Sources: Census Bureau, Haver, Stone Harbor Investment Partners.

Given these patterns, we still see some potential growth drag to come from the multi-side as the number of homes under construction—and hence the spending—will likely adjust down over time from the current elevated levels. And the move down in permits over the past year implies that the pipeline isn't robust enough to keep them high. On the single-family side, the dearth of supply, as proxied by the low vacancy rate, will likely keep activity from falling too much. That's what we've seen from the single-family permits side, and that looks likely to be strong enough to support construction.

Housing is important to the economic outlook not just for its impact on growth but also as it's a very significant component of inflation, especially for core inflation; housing represents about 40% of core consumer price index, though lower for core personal consumption expenditures price index. The multi-family building coming online from all the units under construction will likely be an important factor in sustaining the ongoing moderation in rents. Rent and owners' equivalent rent are down a lot from the peak, but not yet back to the "normal" from 2014-2019. The ongoing multi-family supply that will continue to enter the market as under construction turn into completions will likely help extend that move lower in rents. One sign of this is the last several quarters of rental vacancy rates, which have started to drift higher as part of the process of normalization.

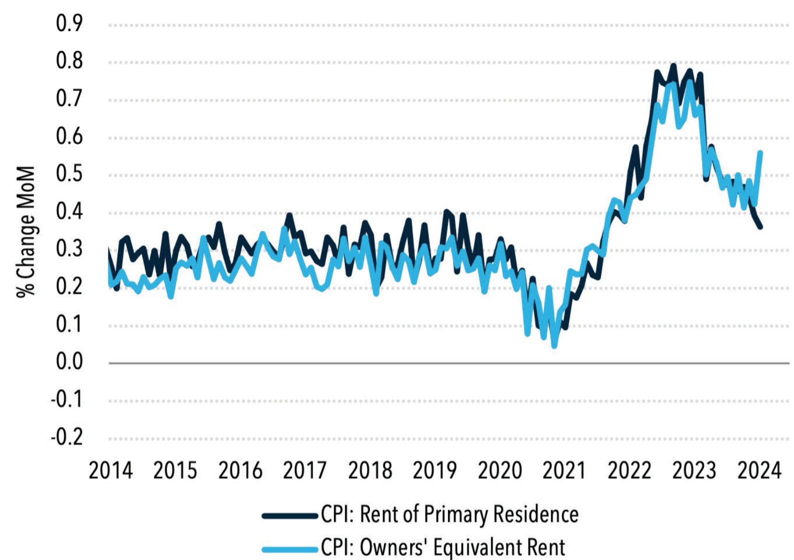
Our base case (40% probability) assumes that inflation continues falling globally, growth slows, and the Fed keeps rates unchanged through early 2024 and starts cutting rates in the summer. Our base case probability has been bumped up by 5% from our last report. The two other most likely scenarios will lead the Fed to cut policy rates more aggressively, either to contain an economic recession (20% probability), or to keep up with falling inflation while growth in the U.S. converges toward target (30% probability). All three scenarios point to lower U.S. policy rates around mid-year. Another scenario leads the Fed to hike policy rates as inflation turns back higher. We still assign only a 10% probability to this outcome.

FIGURE 4: Though Single-Family Units Under Construction Have Slumped, Multi-Family Units Under Construction Remain Elevated



Analysis as of 16 February 2024, using latest data available. Sources: Census Bureau, Haver, Stone Harbor Investment Partners.

FIGURE 5: Rent and OER Are Down Significantly but Not Back to Normal from 2014-2019



Analysis as of 16 February 2024, using latest data available. Sources: BLS, Haver, Stone Harbor Investment Partners

Soft-Enough Landing

(40%)

- High policy rates keep U.S. growth modestly below potential. Growth slowdown rotates from the most interest rate sensitive sectors—e.g., housing—to consumer and business investment. Eurozone growth remains quite sluggish.
- Weakness in global economic activity and a continuing housing slump constrain China's growth.
- Growth in other EMs is supported by rate cuts in the second half of 2023 and solid domestic demand in some EMs offsetting the drag from low DM growth. Commodity exporters still benefit from supportive terms of trade.
- U.S. core PCE inflation rebounds slightly from still solid services prices.
- Fed keeps rates flat through early 2024 and balance sheet runoff continues at sustained $95bn/month pace. Inflation moderation sufficient for the Fed to start cutting rates in the summer. They continue to reduce at a modest pace through the rest of the year. ECB dynamics similar.
- Rate cuts across many EMs following lower inflation pressures.
- China continues gradual monetary easing. Some fiscal stimulus measures are being rolled out, but high debt levels restrain the aggressive use of credit policies. Large-scale bailouts or debt restructurings are avoided due to moral hazard concerns.

The Forbidden "T"-Word

(30%)

- Inflation really was "transitory"…just a (very) long version of transitory. The pandemic and its aftershocks caused a surge in prices, but that surge didn't translate into lasting inflation. Inflation into early 2024 essentially converges back to target in the U.S. and other DM economics.
- With 6-month core PCE staying around 2% through the end of the first quarter of 2024, the Fed looks at their policy rate, finds it too restrictive, and initiates a cutting cycle. Rates are back below 4% by December.
- The Eurozone, with inflation also moderating rapidly and growth even weaker, also turns to cuts. Japan moves short-term rates up to zero but doesn't increase any further as their inflation rate follows other DMs down, just with a lag.
- Growth in the U.S. remains modestly above trend, but importantly without signs of inflation; European growth remains somewhat more sluggish.
- EMs also broadly see inflation continue to moderate. In response, EM central banks continue already-initiated cutting cycles.
- EM growth solid, both from the easier financial conditions and from solid DM growth.
- Oil prices little changed as supply response helps constrain prices.

Global Recession

(20%)

- Lagged effects of tighter fiscal and monetary policies combine with renewed banking issues, commercial real estate issues, and associated credit contraction to tip global economies into recession.
- U.S. growth fades into the spring. Interest rate sensitive sectors—housing, business investment, and durables—sink. Recessionary dynamics take hold in the labor market and weakness spreads.
- Inflation moderates rapidly with the consumer slow and demand contracting.
- Already sluggish European growth follows U.S. growth down. The recession spills over into other DM and EM economies, though they perform relatively better than the U.S./E.Z.
- China also stalls amid global growth headwind and initially tighter financial conditions. Policy stimulus limits downside.
- As recession dynamics take hold, the FOMC reverses course and starts to cut the funds rate. By the fourth quarter of 2024, rates are back to around 2½% with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart. ECB likewise has moved to substantial rate cuts.
- EM economies policy stance also shifts, with more decisive cuts than in base case scenario.

High Growth, High Rates, and Inflation Still Too High

(10%)

- U.S. growth remains solid, notably over current estimates of the potential growth rate (~1¾%).
- The ongoing firm growth outlook, despite substantial rate increases, does two things. First, it keeps upward pressure on inflation rates, which turn back higher, returning to inflation run rates of over 3%. Second, it supports upward reassessments in markets of where neutral interest rates are.
- Inflation moves back higher into 2024 and, in response, the Fed pushes up policy rates further—to over 6%—so as to put more downward pressure on growth and inflation. Longer-term rates also move higher with the higher expected future neutral rates.
- Eurozone growth firms from the current dip, but as in the U.S., inflation remains stubbornly high. Solid U.S. growth provides some support to other DMs.
- EM effect varies. Positive impact from solid U.S. and better E.Z. growth dominates, but some countries feel the effects of the higher rate environment.
- Oil broadly supported by the robust growth.

	Soft-Enough Landing (40%)	The Forbidden "T"-Word (30%)	Global Recession (20%)	High Growth, High Rates, and Inflation Still Too High (10%)
U.S. Real 4Q GDP (%)	1.25	2.25	-1.00	2.50
Fed Funds (%)	4.38	3.63	2.63	6.38
U.S. Core PCE (%)	2.50	1.90	1.75	3.50
2yr Treasury (%)	3.80	3.25	2.00	6.00
10yr Treasury (%)	3.75	3.15	1.75	5.50
10yr Bund (%)	2.25	1.75	1.00	3.50
China 4Q GDP (%)	4.75	5.25	3.25	5.50
EM 4Q GDP (%)	4.25	4.75	2.00	4.75
Oil (WTI/Brent)	$75/80	$75/80	$55/60	$90/95

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Main Office - New York
31 W. 52 Street
16th Floor
New York, NY 10019
+ 1 212 548 1200

London Office
48 Dover Street
5th Floor
London W1S 4FF
+ 44 20 3205 4100

Singapore Office
3 Killiney Road
Winsland House 1
Singapore 239519
+ 65 6671 9711

shipemd.com

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