MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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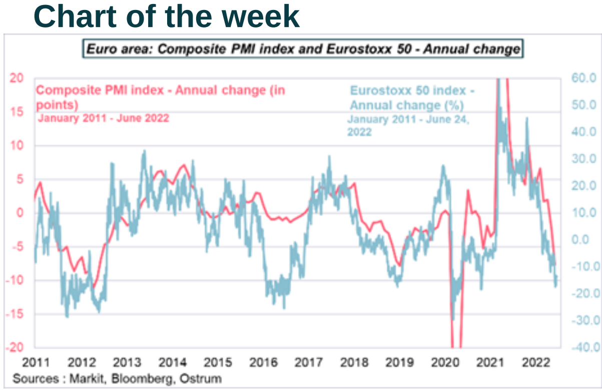
Topic of the week: US housing market; at risk?

- **The fear of a new "subprime" or at least a new accident on the US real estate market quickly resurfaced with the rapid rise in rates;**
- **A comparison with 2008-2009 shows that the parallel is unconvincing. On the one hand there is a significant shortage of supply. On the other hand, the quality of borrowers has improved;**
- **The risk can't be zero, however, and the explosion of non-bank lenders remains a topic to monitor. Finally, pressures on real estate prices should be reflected in rents, and hence in US inflation.**

Market review: Who will capitulate?

- **Sharp pullback in bond yields as European PMI decline**
- **Powell calls inflation 'unconditional'**
- **Late Friday bounce after horrible month of June for risk assets**
- **Half-year close sparks cutbacks in bond and equity short positioning**

Chart of the week



Sources : Markit, Bloomberg, Ostrum

The PMI-Markit index fell sharply in June, signaling a sharp slowdown in growth in the euro area. Demand is affected by the loss of purchasing power suffered by households as a result of the sharp acceleration of inflation but also by the tightening of financial conditions. The decline in the new orders-to-inventory ratio indicates a likely further drop in the PMI over the coming months. This activity index gives a good indication of the future evolution of the Euro Stoxx 50 as shown in this chart, which suggests a further decline in the stock market index due to the increased risk of recession in the euro zone.

Figure of the week

60

Source : Ostrum AM

Russian natural gas deliveries via Nord Stream 1 fell by 60%. Risks of a total supply cutoff raise fears of an even sharper rise in energy prices and rationing with disastrous consequences for growth.

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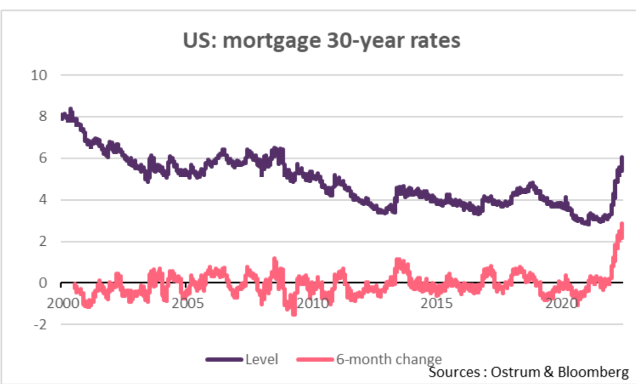
Topic of the week

American housing market; at risk?

The last financial crisis began with the problems of the American real estate market, the infamous "subprimes". This same real estate market, with the extremely rapid rise in rates, awakens old unpleasant memories. To what extent can we be concerned about this trend?

Extremely favourable monetary conditions

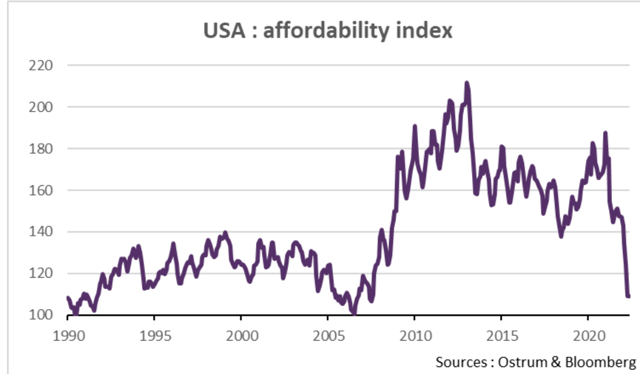
The most important point since the beginning of the year is obviously the very rapid rise in interest rates in the markets. They have led to an even sharper rise in benchmark mortgage rates. The reference rate, a 30-year fixed rate, has risen from 3.30% at the beginning of the year to 6.04% at present, an increase which is close to 3 percentage points (ppt) and whose magnitude over such a short period of time is unprecedented.



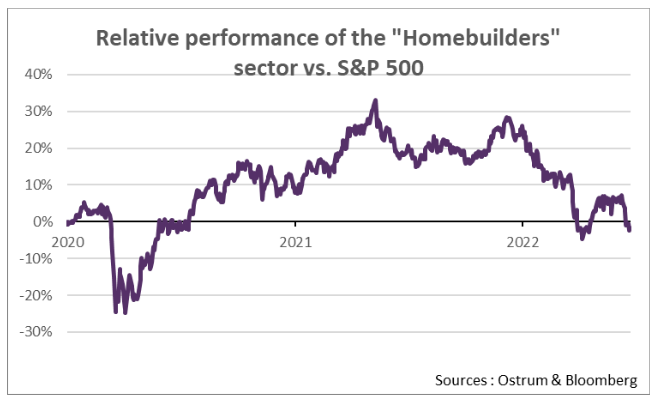
The 15-year refinancing rates have increased over the same period from 2.55% to 5.28%, again an unprecedented move.

The consequence is that the accessibility indices have deteriorated proportionately. These indices take into account the median price of American real estate, household income and their borrowing capacity, which obviously depends on interest rates.

While these indices were particularly favorable after the 2020 monetary easing, they adjusted down very quickly. They went back to their 2009 level.



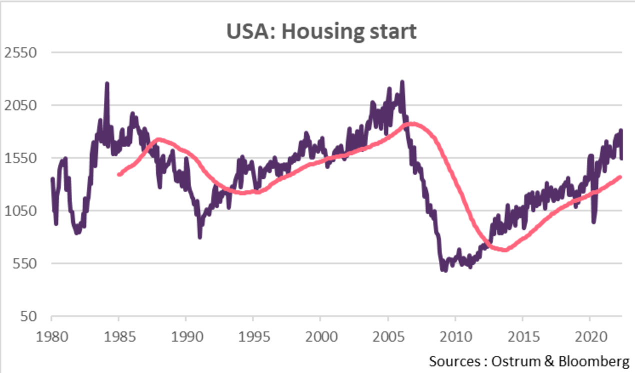
Markets have already reacted particularly with the "Homebuilders" component of the S&P 500 which has significantly underperformed. After the Covid crisis, and thanks to the Fed's extremely lax policy, the real estate market benefited enormously from the economic recovery: between early May 2020 and early December 2021, the "Homebuilders" index outperformed the S&P by almost 60%. Since then, it has underperformed by 20% in a bear market for a total performance of -33% over the period. The rise in rates has hurt a lot.



This approach simply illustrates that the real estate sector is particularly sensitive to interest rate developments. And recent movements of the curve can only send an anxiogenic signal. Especially for those of us who lived through the beginning of the previous decade. Are we close to a new housing crisis?

A very different physical situation from 2008

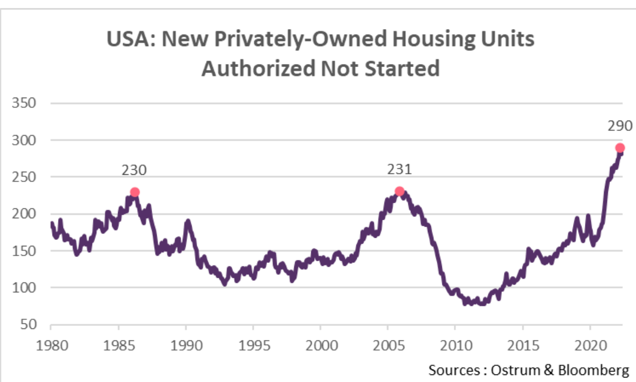
To answer this question, it is important to review the "physical" state of the market. The first point is simply to look at the amount of housing starts as we do on the chart below. The message is very clear that housing starts have been much more limited than in the pre-2009 period. Contrary to this period there was therefore no inadequately high real estate offer.



Another indicator seems to validate this diagnosis even more, the level of houses waiting to start construction is, by far, at a historic high. In other words, there is a very strong demand for housing and construction that remains unfulfilled.

This is partly due to a delayed effect of the Covid crisis. Delays in housing starts have been compounded by shortages of labour and construction materials. As a result, supply has not been able to adjust to demand.

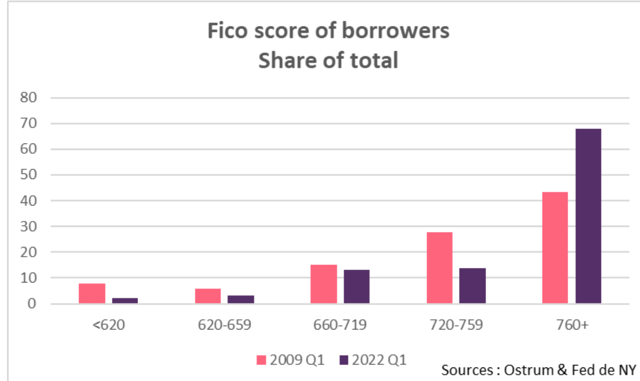
More structurally, we understand that housing starts have remained relatively low over the past decade compared to historical levels. So, there is a structural undersupply.



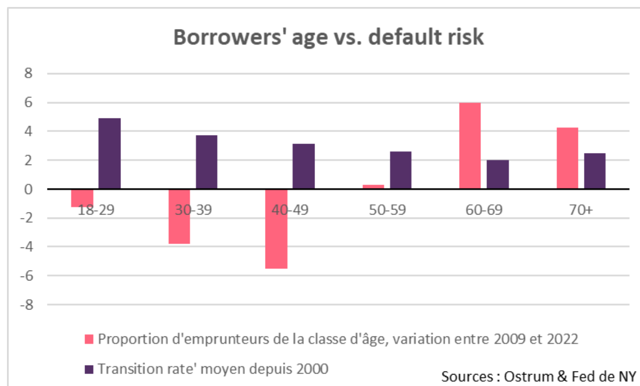
In conclusion, if in 2009 the physical market was showing signs of unmistakable overheating, the current situation is one of a shortage of housing relative to demand.

A stronger credit market

The other point worth noting is the quality of the borrowers. The "subprime" referred to poor quality borrowers. In the United States, thanks to data from the New York Fed, we have the FICO score of borrowers that gives their individual credit quality level. The chart below shows that these scores have significantly distorted and that the proportion of borrowers with a score above 760, a very good score, has increased from 43% in early 2009 to almost 68% in the last quarter.



Another aspect is the age distortion of borrowers. The chart below shows that the proportion of 60-69 borrowers increased by 6.0 ppt between 2009 and 2022, that of 50-59 borrowers increased by 0.3 ppt and that of those over 70 by 4.3 ppt. All this to the detriment of the youngest. However, the "transition rate", the probability that these borrowers will default, declines with age: the older a borrower is, the less he defaults.



The change in the age ratio of borrowers thus corroborates the message of the FICO scores: the profile of borrowers has significantly improved.

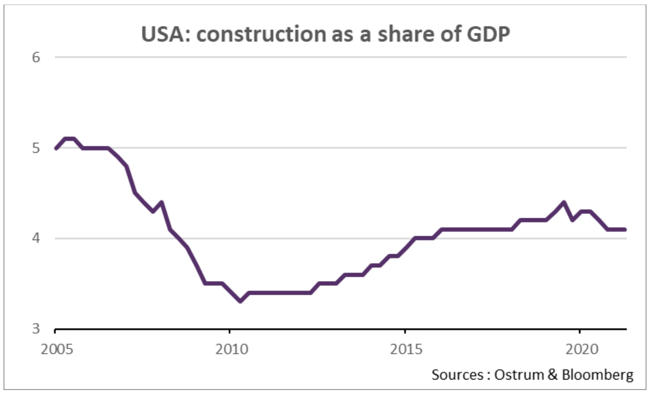
Where are the risks?

While a financial shock such as the one we experienced during the Subprime crisis thus seems much less likely, a slowdown in the impact of recent developments on the construction sector is not, however, neutral for the economy.

Activity

The evolution of the construction sector is very much related to the evolution of GDP. The cycles are very correlated. But the construction sector's share of GDP remains limited, at around 4% according to the Bureau of Economic Analysis.

To give an order of magnitude, between the low point of the first quarter of 2020 and the following four quarters, construction rebounded by 12.5%, but this added only 0.55 percentage points of growth to GDP, which gained it 12.2% over the period. The order of magnitude was similar to the decline in Q1 2020, as the sector was severely impacted by Covid, falling 27.1% over the quarter (annualized) versus 9.7% for GDP. Construction, despite this unprecedented collapse, therefore contributed only 1.2% to the decline in GDP.



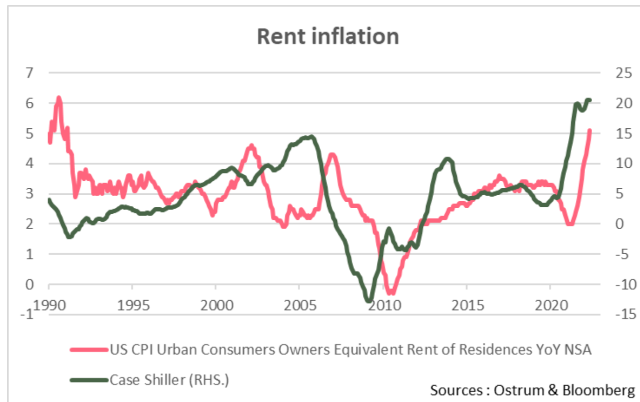
As we can see, the direct impact of construction on GDP is limited even in extreme cases. The problem is elsewhere, in the case of 2009 it was the bursting of a speculative bubble that led to a number of side effects, beyond the accounting impact of construction on GDP. The particularity of the real estate sector is that it also serves as a collateral to the financial system. On the one hand for households who borrow with a de facto mortgage on their property, which has important implications for their solvency. On the other hand for the financial system, especially the banks which lend against this asset and are therefore very sensitive to price changes.

The problem, therefore, is not really the direct impact of construction on GDP, but rather the price effect which induces wealth effects and effects on the quality of collateral with, ultimately, a credit crunch risk.

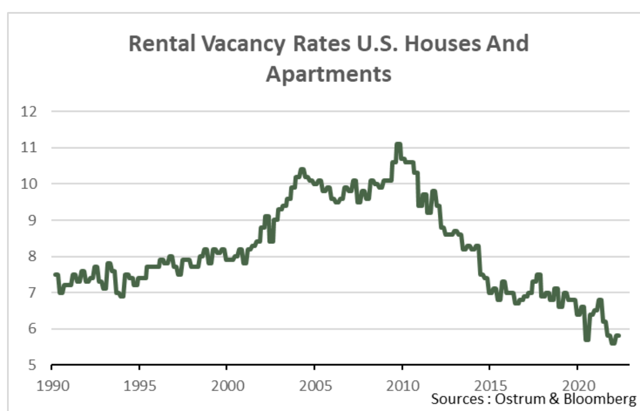
Inflation

The most widely used measure of inflation in the United States is the Bureau of Labor Statistics index. This is the benchmark for indexing TIPS (Treasury indexed to inflation). Unlike the European index, in the methodology for the US, CPI housing accounts for about a third of the basket of goods and services. The housing component includes the actual rents paid to landlords by households and an equivalent measure of imputed rents to landlords (owner-equivalent rent, OER). In the latter case, owners are surveyed to "estimate" the rental value of their property. This estimate is not of absolute reliability. Homeowners do not always have an adequate level of information on the actual rental value of their property or to deduct from their monthly mortgage expense an approximation of its rental value. However, monthly mortgage payments depend on interest rates in the mortgage market and the amount of loans obviously depends on housing prices.

This results in rent inertia and a slow reaction to underlying changes. For example, the Case-Schiller housing price index is an excellent leading indicator of rents, with a 12-month lag. Real estate prices have been soaring since 2020 and are starting to show up in the US CPI index, with the rental component increasing 2.0% in early 2021 to 5.1% in May of this year. Given the behavior of this index, in particular its inertia, this implies not only that the component should be higher in the coming months but also remain at high levels for a long period.



These tensions are likely to continue. On the one hand, the vacation rate remains very low, as the chart below shows, which should facilitate the increase in rents. On the other hand, the significant deterioration in the affordability index (cf. above) is pushing a number of Americans to rent in a market that remains tense. This increases rental demand and, paradoxically, tends to keep rents at a high level.



Pressures on US real estate inflation are therefore not expected to disappear quickly.

Explosion of non-bank loans

Finally, we must point out a development in the mortgage supply in the United States with the appearance and very strong increase of non-bank lenders. Non-bank institutions are financial institutions that offer typical banking services, such as mortgages, while providing users with an easier way to obtain loans.

Since the 2008 financial crisis, banks have seen their share of the mortgage market decline. In contrast, the ability of non-bank institutions to take advantage of digital technology has enabled them to meet customers' demands for efficiency and convenience through online services. They also benefit from less stringent regulations, at least for the moment.

As a result, non-bank mortgage lenders in the U.S. issued 68.1% of total mortgages in 2020, up from 58.9% in 2019, according to a study by Inside Mortgage Finance.

There are essentially two problems related to this development. On the one hand these institutions have portfolio of borrowers which tends to be of lower quality. If, as we have shown above, the quality of borrowers has significantly improved since the 2008 crisis, there may be pockets of lower quality borrowers. This also awakens the old demons of the “subprime”. The other point is that these institutions do not take deposits and therefore finance themselves on the markets, with the inherent liquidity risks in case of crisis. It is important to highlight the operational risks inherent in some small structures (Quicken Loans, the industry leader, employs 17k people), the liquidity risk and the end of opportunities for QE. This creates a volume problem for these lenders whose business model has benefited greatly from the Fed’s extremely lax policy.

Fitch conducted a study of this sector and, after noting the risks we listed above, concluded that “legislative and regulatory attention is expected to intensify…. Nevertheless, Fitch believes that service providers are better equipped today than during the financial crisis, with improved processes and regulatory compliance measures. Enforcement measures and fines imposed by the regulator will increase but should remain manageable in the context of available liquidity and capital.”

Conclusion

The Pavlovian reaction of many commentators is to go back to the previous crisis to predict the current one. The fear of a new “subprime” or at least a new accident on the US real estate market quickly resurfaced with the rapid rise in rates. A comparison with 2008-2009 shows that the parallel is unconvincing. The very strong pressure on real estate prices is more the consequence of a shortage than of unbridled speculation. The quality of the borrowers is much higher, there is no longer a "NINJA" (these borrowers "No-Income, No-Job, No-Asset" which constituted a part of the subprime), and therefore little sign of inadequate leverage. A repeat of 2008-2009 therefore seems unlikely even if the ballooning of non-bank loans is to be monitored closely and if real estate has this characteristic of serving as collateral for a good part of the financial system; a sharp fall in prices, which seems unlikely, would inevitably affect the sector.
On the other hand, the sector can only suffer with the level of current rates and activity is bound to fall. As the sector accounts for only 4% of US GDP, the accounting impact on total growth is expected to remain limited. On the other hand, the impact on inflation, with rents having to catch up with soaring prices, is a major source of inertia in US inflation.

Stéphane Déo

Market review

Who will capitulate?

The risk of recession does not seem to alter the Fed's determination to bring inflation back to 2%, but the markets are hoping for an inflection.

The financial market narrative has refocused on the recession risk this week. Jerome Powell reminded Congress of the Fed's unconditional commitment to bring inflation down to the 2% target, which implies that the Central Bank will assume a recession. In Europe, the plunge in PMIs, though unsurprising given the economic backdrop, triggered the largest downward movement in bond yields in the past 14 years. The German Schatz yield lost 25 bp in two trading sessions, as much as in March 2008, after JP Morgan announced the takeover of Bear Stearns, barely six months before the collapse of the US banking system. These swift short covering trades show the importance of investor sentiment shifts in volatile markets with strong consensus positioning. The half-year closing always generates flows of reallocations. Short covering on bonds are accompanied by reductions in (long) positions on commodities, including oil and base metals, and less selling pressure on stock markets after a monthly drop close to 9% in June . Cryptocurrencies, like the Nasdaq, remain sensitive to any sign of easing in bond market tensions. The bullish trend of the US dollar is weakening somewhat but the greenback is still a safe haven. The dollar-yen exchange rate seems to be at a crossroads around 135. Cross-currency spreads turned more favorable to the Japanese yen this week, which compensates for the relentless BoJ action on Japanese government bond yields. Meanwhile, credit markets continue to deteriorate alongside equities.

The US economic growth has been moderating since the start of the second quarter. Near zero GDP growth is plausible between April and June. Regional manufacturing surveys indeed point to a slowdown, which is not yet visible in industrial production data. However, the labor market remains relatively upbeat. Initial jobless claims are stable at around 230k per week, despite sometimes thundering announcements from large, listed companies. Household consumption is holding up despite inflation. Conversely, real estate investment is expected to decline given high mortgage rates and high house prices. However, the resilience of new home sales is remarkable (696k in May) but that may only delay the inevitable slowdown.

The essential question is no longer that of an economic slowdown but of its disinflationary potential. Supply issues fueling inflation will persist beyond the cyclical weakening of demand. In this case, inflation will remain too high, invalidating current market inflation expectations and the forecasted path for the Fed fund rates. This is a considerable risk for fund managers. The rebound in equities following the violent rally in the interest rate markets this week reflects a form of 'hope' for a capitulation by the Fed and other central banks. The opposite risk, probably more likely if the Fed keeps a firm hand on inflation, is obviously the investors' capitulation in equities and credit markets, in the wake of flows in the fixed income markets. Weekly outflows from global bond funds are the largest since April 2020 ($23.5 billion) and now total $193 billion in 2022, as speculative short covering on US Treasury bond futures on Wednesday and Thursday cannot hide this heavy selling trend. The accelerated outflows from equity funds to the benefit of cash or gold, in the week to last Wednesday, is undoubtedly more significant than the slight rebound in prices after a 9% plunge in June on the major equity indices.

The price action in the fixed income markets is staggering. The Bund traded between 1.35% and 1.79% this week, as market participants priced out fully 50 bps of ECB tightening ahead of December 2024. The ECB, however, confirmed the 25 bp hike in July. At the same time, the forthcoming implementation of an anti-fragmentation mechanism did not prevent Italian spreads from rising back towards the 200 bp level. In turn, expected inflation is falling in the wake of the decline in oil and other industrial commodities. Fears about activity and a decrease in open positions before the half-year close sparked those (welcome) price declines. The ECB's new monetary policy tool probably exposes France more than the other core countries. However, the OAT spread is stable at 54bp against 10-year Bunds, also ignoring the political hurdles to come. The bond rally also reminds us of the importance of the leading US treasury bond market. The T-note yield broke through the lower limit of 3.20-3.50% range that seemed consistent with the latest FOMC. Inflation breakevens are stabilizing somewhat as nominal interest rates fall. The downward revision of household inflation expectations (Michigan survey) is a stabilizing factor. Most of the G10 bond markets went strongly up in price terms in spite of the hawkish rhetoric of the central banks. Canadian inflation (7.7% in May) points to a 75bp rise soon, Norway has surprised by raising its rate by 50bp following the SNB or the RBA in recent weeks.

Credit spreads are having an extremely difficult month. The average spread on the euro IG is up by 39 bp against the Bund so far in June. The severe tensions in swap spreads in the first half of the year spilled over recently to asset swap spreads. Optically cheap valuations do not attract final interest given the cyclical risks in the second half of the year. Liquidity is poor and not expected to improve as summer approaches. High yield is clearly underperforming. The only possible hedge remains the iTraxx crossover which marks a new high at 570 bps mid-week before a relaxation on Friday.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	27-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.87%	-29	+52	+149
EUR Bunds 10y	1.5%	-25	+54	+168
EUR Bunds 2s10s	62.5bp	+4	+2	+19
USD Treasuries 2y	3.08%	-10	+60	+234
USD Treasuries 10y	3.17%	-6	+43	+166
USD Treasuries 2s10s	8.5bp	+5	-17	-69
GBP Gilt 10y	2.37%	-24	+45	+139
JPY JGB 10y	0.24%	0	+9	+6
€ Sovereign Spreads (10y)	**27-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	52.78bp	-3	+3	+17
Italy	200.12bp	+4	0	+64
Spain	111.49bp	+2	+1	+37
Inflation Break-evens (10y)	**27-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.49%	-19	-32	+39
USD 10y Inflation Swap	2.85%	-5	-10	+7
GBP 10y Inflation Swap	4.09%	+1	-44	-11
EUR Credit Indices	**27-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	201bp	+4	+31	+106
EUR Agencies OAS	71bp	-2	+6	+22
EUR Securitized - Covered OAS	78bp	-1	+6	+32
EUR Pan-European High Yield OAS	588bp	+36	+77	+270
EUR/USD CDS Indices 5y	**27-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	107bp	-2	+20	+59
iTraxx Crossover	524bp	-24	+93	+282
CDX IG	94bp	-6	+15	+45
CDX High Yield	528bp	-49	+71	+235
Emerging Markets	**27-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	506bp	+6	+24	+138
Currencies	**27-Jun-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.059	0.542	-1.444	-6.9
GBP/USD	$1.233	0.620	-2.383	-8.9
USD/JPY	JPY 135	0.015	-5.872	-14.8
Commodity Futures	**27-Jun-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$113.7	-$0.4	-$1.8	51.00
Gold	$1 837.8	$1.9	-$16.0	0.47
Equity Market Indices	**27-Jun-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 912	6.68	-5.93	-17.9
EuroStoxx 50	3 561	2.61	-6.52	-17.2
CAC 40	6 119	3.36	-6.09	-14.5
Nikkei 225	26 871	4.27	0.33	-6.7
Shanghai Composite	3 379	1.92	7.95	-7.2
VIX - Implied Volatility Index	27.23	-12.53	5.87	58.1

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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