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The Carlyle Compass

By **Jason Thomas**
May 21, 2024

*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team.*

When discussing what the recent battery of official statistics might mean for Fed policy, a mentor suggested I stop looking at the data and focus instead on the implications of the 75bps of cuts the Fed delivered in 1998.

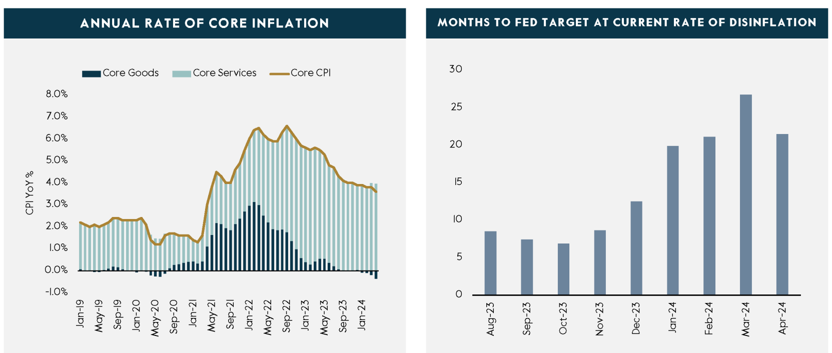
For those who don't remember, that year boasted arguably the strongest U.S. economy on record. Real GDP expanded at a 4.5% annual rate. Economy-wide fixed investment grew by over 7%, spurred by the competitive entry facilitated by the Telecommunications Act of 1996 and commercialization of the internet. A larger share of the population had a job than at any prior point in recorded history. And cable television channel VH1 debuted 43 *Behind the Music* episodes.

But backstage, things were falling apart. In August, Russia devalued the ruble and defaulted on its domestic debt. Fears of contagion swept financial markets. The S&P 500 dropped by nearly 20% (still up 8% year-over-year at its nadir). Single-B credit spreads widened by 350bps. Market illiquidity led to the near-collapse and Fed-facilitated recapitalization of hedge fund Long-Term Capital Management (LTCM). Less than a week later, the Fed cut rates by 25bps. Two weeks after that, the Fed announced a (then) rare intermeeting cut of another 25bps. The Fed cut a third time at its next scheduled meeting November 17.

These actions calmed markets. Credit spreads and market liquidity measures returned to normal by year-end. The S&P 500 rose by 50%(!) in the 12 months following its August 1998 low. But critics argue the victory was pyrrhic. By responding to financial stress despite no evidence of economic damage – the economy added 741,000 jobs and grew at a 5% annualized rate in the three months this unfolded – the Fed revealed an aversion to market losses that couldn't help but accentuate market participants' taste for risk.

The personalities have changed since then, but institutional predilections have not. For markets, the key question answered by last week's data was *not* whether inflation is slowing – core CPI rose by 3.6% over the past 12 months, almost the exact same as the 3.5% annualized increase in the month of April and less than the 4.1% annualized rise over the past three-and-six months (Figure 1) – but whether inflation remains in a range that affords the Fed room for maneuver that didn't exist a year ago. And market participants (correctly) perceive that it has.

Figure 1: Slowing Rate of Disinflation



Source: Carlyle Analysis; Bureau of Labor Statistics, Bloomberg, Federal Reserve, May 2024. There is no guarantee any trends will continue.

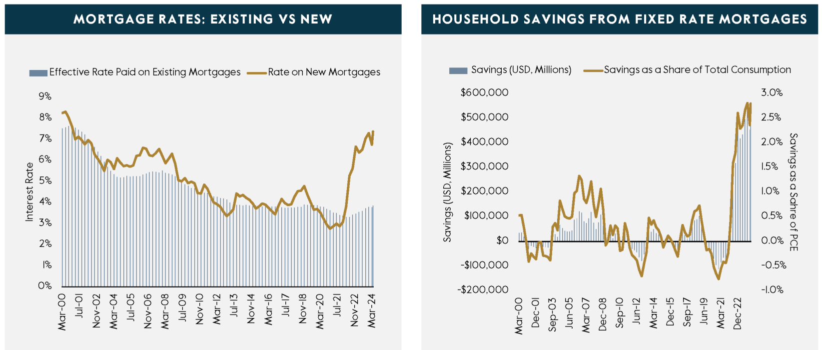
So, my interlocutor concluded, the capex cycle tied to the Inflation Reduction Act (IRA), CHIPS Act, and advent of ChatGPT may indeed resemble that of the late-1990s, but just as then, growth will only keep the Fed on hold until a market pullback spurs action.

Houses Everywhere but Not a Place to Buy

In an appearance at the Foreign Bankers' Association, Fed Chair Powell suggested the Fed would likely need to stay "at the current rate for longer than had been thought." Higher rates have not worked as fast as expected, Powell averred, because "people financed themselves into very low-rate mortgages and now they won't move."

Appreciation for this encumbrance to monetary transmission has been the key to understanding the strength of the U.S. consumer over the past two years. The average interest rate paid on the existing stock of nearly $13 trillion in mortgages remains less than 4%. When measured relative to current rates on new mortgages, fixed rates save households over $500 billion per year, equal to nearly 3% of consumption (Figure 2).

Figure 2: Fixed-Rate Mortgages Save US Households Over $500BN Annually

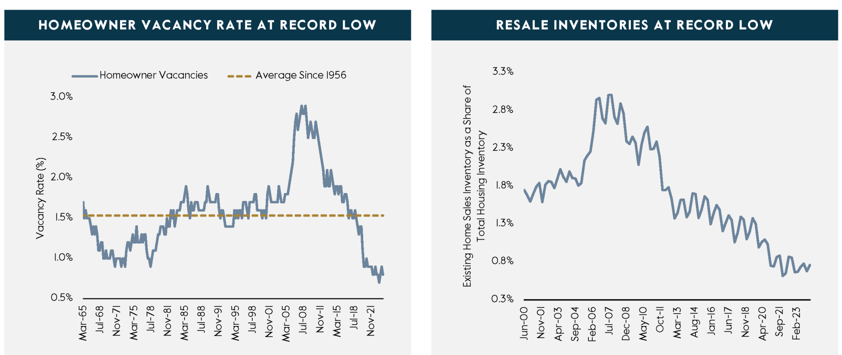


Source: Carlyle Analysis; Bureau of Economic Analysis, April 2024. There is no guarantee any trends will continue.

But the second part of his statement was equally important. Borrowers only retain the low rate if they remain in the property. U.S. fixed-rate mortgages embed a call option that allows borrowers to prepay ***at par***, the exercise of which benefits borrowers when rates fall but hurts them when rates rise. No surprise so few today are willing to move, effectively spending $300,000 (in foregone sales proceeds) to buy back a mortgage with a market value of less than $250,000.

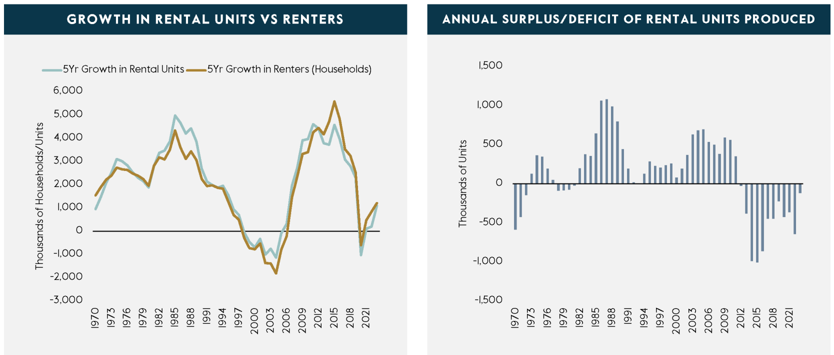
As a result, inventories of existing homes for sale have reached all-time lows (Figure 3), which has pushed house prices higher even as 7% mortgage rates have made houses less affordable at the old prices. This, in turn, will boost the number of households seeking rental properties, likely increasing future rents due to past underproduction of such units (Figure 4).

Figure 3: Record Low in Vacancies, Resale Inventories



Source: Carlyle Analysis; U.S. Census Bureau, Federal Reserve, Bloomberg, May 2024. There is no guarantee any trends will continue.

Figure 4: Growth in Rental Units Insufficient to Meet Demand

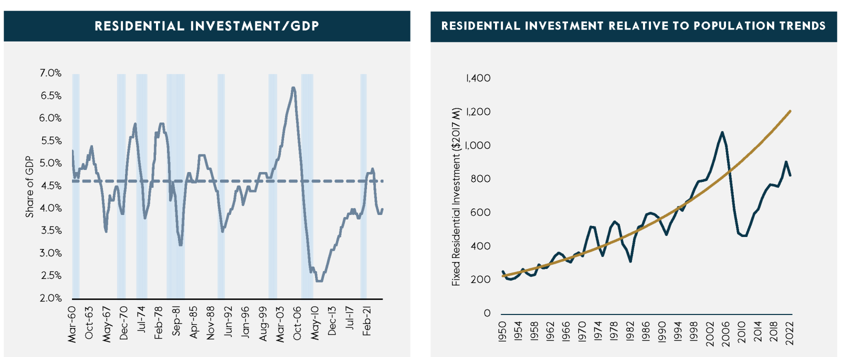


Source: Carlyle Analysis; Census Bureau, American Housing Survey, 2024. There is no guarantee these trends will continue.

Blunt Instruments Offer No Solution

While there are several metro areas where recent deliveries of new units have dampened rents, residential investment has been insufficient to meet housing demand on a nationwide basis for nearly 15 years, whether measured relative to the size of the economy or population (Figure 5). But, as Powell has noted, higher rates impede the obvious solution – a sharp upturn in residential investment – by increasing developers' cost of capital. In other words, by depressing for-sale inventories (due to the call option embedded in fixed rate mortgages) and new construction, higher interest rates may intensify the very problem they purport to solve.

Figure 5: Post-GFC Bust in Housing 3x Larger Than Preceding Boom



Source: Carlyle Analysis; Federal Reserve, Bureau of Economic Analysis, Census Bureau, April 2024. There is no guarantee any trends will continue.

Given where shelter ranks in Maslow's hierarchy of needs, it's difficult to see why residential property rents (both primary and imputed) won't consume a larger share of national income in the years ahead.

JASON THOMAS
Head of Global Research
& Investment Strategy