Episode 86

FireSide: Q2 Research roundup: Adjusting to the old normal

Our experts dive into their outlooks for macro and markets in the second quarter.

Andrew Korz (00:05):

Welcome to FireSide, a podcast from FS Investments. My name is Andrew Kors, executive Director of Investment Research, and on today's episode, I'm thrilled to be joined by Laura Rae, our chief US economist to discuss our Q2 outlook for macro and markets. Lara, thank you for making the time.

Lara Rhame (00:20):

Is it already Q2?

Andrew Korz (00:21):

It is indeed, Q2.

Lara Rhame (00:23):

Q1 went fast.

Andrew Korz (00:23):

April 3rd today. And what a Q1 it was, I think in a lot of ways a continuation from the positivity we saw in 2023. If you consider all of the pillars of growth in our economy that drove such a strong year last year, whether it's labor market, whether it's households, government spending, even businesses are now, it seems like becoming a bit more bullish on the outlook. There's a lot of good news out there.

Lara Rhame (00:47):

Yeah, it's a long list of good news really that supports gives us momentum.

Andrew Korz (00:51):

It is, it is. And I think during the first quarter we saw the market take some rate cuts sort of out the curve, but risk assets did just fine. The s and p 500 was up 10%. Credit spreads tighten further. So I think the first thing I want to get into is your growth outlook for Q2. So outside of some slightly higher inflation data in Q1, which we'll get to later, it's been a pretty good start. All things considered. I think we've gotten used to some wild swings quarter to quarter in terms of macro data. Things appear to be maybe settling into a more normal pattern now where there's not this quarter to quarter volatility. Is that kind of what you're seeing? Yeah,

Lara Rhame (01:27):

I would agree with that. I mean, I think my underlying view of the economy in the second quarter is enjoy the ride. It's looking pretty good and don't overthink it. I think that is something that I am bringing to the conversations where people really are looking at risks and what we're watching and market pricing shows that chance of recession is receded significantly and yet there's still this lingering, I think uncertainty from so many investors. But as we know, the economy wants to grow and in any year there's call it a 15, 17% chance of a recession in any year. That's because some left tail event can happen and knock us off a growth path. But hey, where we sit today, all of the positives that you listed I think are really important to remember are giving us momentum. In my forecast for this year, I've already had to upgrade it because things are so strong looking like 2% for 2024, that's less than 3% last year. But it is a strong fundamental pace of growth.

Andrew Korz (02:38):

Our job in research is to try to look around the corner, try to understand when markets and when people in general are being complacent about the outlook. There are some risks. It's not all positive right. Now for Q2 specifically, what are some of the biggest risks that you're watching?

Lara Rhame (02:54):

I think we have to acknowledge the fact that household delinquencies are rising, not mortgage delinquencies, which is by far and away the biggest chunk of household debt, but credit card delinquencies are back to levels that we haven't seen since the financial crisis. I put that at the feet of higher credit card interest rates. So those also being the highest that we've seen in a couple of decades and auto loan delinquencies are also 90 day delinquencies are quite high. It's worth watching because to me it's more of a story that takes consumer spending from still like this yolo, I'm going to pay $2,000 for a concert ticket and fly there to see the concert to something that's a little more rational. I don't think that it's something that in and of itself causes a recession, but it certainly I think would cause consumption to look a little more rational.

(03:46):

Second thing that I think we need to have on the radar is commodity prices. Oils really jumped to the mid eighties and when oil prices are a hundred dollars a barrel, I feel like that is problematic for companies when gas prices are at $5 a gallon and we are far away from that today at a national average where like three 50 a gallon. But that seems to be a psychological trigger for households that causes a doom spiral. And then obviously in the background is the banking sector. I think still under pressure from unrealized losses. But again, I reiterate this is a list of risks against a backdrop of really feeling pretty confident that today the economy has a lot of positive momentum and things are looking good.

Andrew Korz (04:33):

Yeah, absolutely. So I think we would be remiss to talk about macro without discussing inflation and it's really been sort of the macro factor that's driven everything else over the past two to three years. And I think it's a one thing that didn't cooperate from a data standpoint in Q1. I think there's some important nuance here. The core CPI data came in hotter year over year rate's still at 3.8. Core PCE looks a little better at 2.8. That's technically what sort of the Fed likes to look at. But I think it's fair to say that we've hit a bit of a speed bump back to 2% here. And again, wouldn't giving, wouldn't be giving the proper credit If I didn't mention that you've been spot on with your call here. You've talked all along about how much would need to go for inflation to come all the way back to 2% and how challenging that could be. So walk me through how you're thinking about inflation right now and what that means for your Fed

Lara Rhame (05:24):

Outlook. Well, thank you for pointing out the place where I've been. Right. I

Andrew Korz (05:28):

Love to point out when you're wrong. So I got to give,

Lara Rhame (05:31):

We'll do that outside of the form of this podcast. So this to me is really, I think the where markets have been to complacent is assuming that inflation's not only going to easily fit back into that 2% lane, but stay there reliably like it did for the 20 years before the pandemic. And I cannot emphasize enough how important that is. We really didn't talk about inflation for almost two decades. And today not only are we still well above the fed's target, but in progress towards that target is stalled and it's like swimsuit season the last five pounds of the hardest and it matters. So when we look at the components of inflation, that services piece is still really uncomfortably high. The Fed likes to shine a spotlight on that super core measure of service go core services excluding housing because the idea being that that piece really kind of ties to wage pressure that we're also seeing and that has over the last three months accelerated and I think you put it together and it's a problematic picture that gives the Fed much less wiggle room to cut rates. And I think combined with now the commodity price pressure that we're seeing, we had the ISM date out yesterday, the pricing pressure there was high. I really reiterate that my outlook is for the core PC deflated or remain above 2% this entire year. And I think in the second quarter we're going to have to see if some of these core commodity price pressures feed into the headline inflation numbers in an unfriendly way. It's

Andrew Korz (07:21):

A bit of a whack-a-mole, right? Because it is, you've kind of been able to stem the issue from goods with healing supply chains and obviously demand from housing for durable goods has been pretty low. But all of a sudden you've got this issue where so much of what's gone on in inflation is rents coming down and the Fed raising rates has sort of disincentivized new construction, new supply, which we look out at another year or two could just bring back that supply shortage in the housing market, which can just rev up rent growth again. So it really is this whack-a-mole and you've been saying it again the whole time, how challenging it is to get that mixture

Lara Rhame (07:56):

Right. And I think this to me leads directly to the Fed to markets through higher interest rates because you coined the phrase surgical rate cuts that it's not going to be a easing program without a recession. We're not going to get one cut a meeting, we're not going to get one cut every quarter on autopilot. It's going to be surgical rate cuts. And I love that because a nip and a tuck, they're going to have to get in there and figure out how markets and data and sentiment align to sneak in a rate cut and we're just not there. I think we had kind of said two to three at the start of the year, markets today are pricing in two to three that's less than the dot plot. This is the first time that the Fed has been more optimistic about their ability to cut rates. And yet already only several days into the second quarter we're seeing some of the Fed speakers coming out and saying we may only get one rate cut in the fourth quarter. So I think we're very far from consensus on this and it's really drifting fast and I think that surgical rate cut is what I want to lead people with. It is going to be careful and it's lifting the whole interest rate complex higher.

Andrew Korz (09:13):

Yeah. Yeah. And I mean when you kind of think about it, for the fed to cut rates, you need one of two scenarios to happen. If growth is going to be strong, you need inflation data to be really, really benign. And if inflation data is going to be a bit above where they want it to be, you're going to need to see growth slow. And neither of those things are happening

Lara Rhame (09:30):

Right now. I think you and I discussed the fact that if the Fed had to choose between two policy mistakes, I think the mistake of them easing too fast and having inflation re-accelerate would be literally their worst nightmare after they missed it so badly 2022. So for that reason, and here I'm going to push back a little bit on the higher for longer phrasing because as we take it from the Fed and we look at two year interest rates and 10 year interest rates, they're all moving up. But this idea that it's higher for longer to me implies that we're still on a trajectory backed down to very low interest rates. The 10 years started the year around 4% we're at four 40 today. I still think not in the second quarter, but sometime this year we retest 5%. And to me that's more of a renormalization to where we were in the 1990s and the early two thousands. I mean, this isn't just my Q2 outlook, it's yours too. I mean, I think the question that I get the most is what does all of this mean for the economy? Can the economy operate with interest rates where they are today and maybe even a little higher? And my answer is yes, and real estate obviously is ground zero for that. So this is residential CRE all top of mind. What's your Q2 outlook?

Andrew Korz (10:54):

Yeah, I mean real estate is a levered asset class both in the housing market and in commercial real estate and taking those one at a time on the housing market, I think it's important probably to insert a little disclaimer here, I'm actively in the market for a home, so any views expressed here may be heavily skewed by my own challenging experience currently. But with all of that said, I

Lara Rhame (11:18):

Don't think you're alone.

Andrew Korz (11:19):

No, I don't think so either.

Lara Rhame (11:20):

You're a millennial too, so that's that whole generation.

Andrew Korz (11:24):

I think a lot of listeners can probably understand my pain. But with all that said, the housing market did weather the surge in interest rates remarkably well. I think all things considered considering the pace of the magnitude of the rise rates, and it's probably be more specific, the market weathered it well in some respects. So prices have remained elevated. The reduction in supply driven by higher mortgage rates has been greater than the reduction in demand. Employment market's been strong. Household balance sheets are really strong. Demand has stayed pretty okay despite the affordability issues. Home builders, right? So price stability and the lack of supply from the existing home market have kept construction activity pretty strong. Housing starts are well above pre covid levels. Home builders, stock stock prices, if you check your Bloomberg are really high. The one thing that hasn't been good is home sales and it's hard to have sales if there aren't any homes in the market. And that's kind of been

Lara Rhame (12:18):

The issue. Yeah, it's a supply issue. It's a supply issue. I think that's really key. At the start of this rate hike cycle, it was a rates issue and now it's a supply issue and that everybody was waiting for this big correction lower in-house prices and it never came. Really? Yeah,

Andrew Korz (12:34):

I

Lara Rhame (12:34):

Think believe you missed it.

Andrew Korz (12:35):

This is where Q2, I think we can really talk about how important the upcoming quarter is because it's going to be really pivotal, right? It's the spring housing market season. Sure. Yes. Super important. Selfishly, my hope is that we get this massive deluge of supply onto the market. I don't think that's going to happen, but I do think we are seeing a bit of a shift. There are signs that new listings are running well above last year, still record low supply, but better than last year, hopefully gradually starting to get more homes in the market. You have not necessarily any relief on the rates side where people are more incentivized to sell their homes. But you do have, as we've talked about a lot life events come up, whether it's marriage, whether it's having kids, whether it's divorces, whatever it may be, people need to sell their homes. The more time goes on, the less willing they are to wait. Sure.

Lara Rhame (13:25):

Yeah.

Andrew Korz (13:25):

And the last thing I would mention is that 40% of homes in the US are owned outright with no mortgage. So there is this cohort of folks who own mostly older folks who own their homes with no financing and they have a little bit more flexibility, but they also may not want to leave those homes. So there's a lot of sort of cross currents here that are hard to triangulate, but I think it all sort of leads to slightly increased supply on the market, which ultimately I think will come out in higher transactions, not necessarily lower home prices. Sure.

Lara Rhame (13:57):

Sorry.

Andrew Korz (13:58):

Yeah, no, that's okay. That's okay. My expectation is that home prices will just never come down from here, so I may as well just buy as soon as I can.

Lara Rhame (14:09):

Well, and I think this is something that we can take through to other markets, right? Because it's this idea that the pace of the rate hike was so dramatic. The most aggressive rate hike cycle that started in 2022 and kind of went into the middle of last year was the most aggressive since the 1980s. And I think you and I have talked about this a lot. It was the shock of the higher interest rates happening so fast, not necessarily the level of interest rates. I do talk to some younger folks who say, I could never afford to buy a house. Now that mortgage rates are seven and a half. And my answer is, the first house I bought because I am a Gen Xer was nine and a quarter mortgage rates. So we can have a robust real estate market, we can have a robust corporate credit market, we can have a robust m and a market with higher interest rates.

(15:07):

It's just adjusting to the old normal, I'm going to say old normal, not new normal, the old normal because it is this renormalization. I think the longer that we're here, the more that we will learn to swim in these waters. And I think the CRE market is obviously top of mind for so many investors as well because the doomsday headlines keep coming and you always talk me off the ledge with those. So I thank you for that. But is there anything you're watching in the second quarter for CRE? Does it sort of track this residential path?

Andrew Korz (15:36):

Yeah, I think it's a little bit different because housing is maybe 25% institutional buyers who are looking for a return. CRE is almost entirely institutional, so it's going to be much more driven by return expectations and the ability to get return given market prices, financing costs relative to the housing market where it's going to be like me, I just would like to buy a home. I'm not looking necessarily for a return. Although that would be nice too. I think investors have been on pause for the past, call it 18 to 20 months. There's been very few transactions in the market because like I said, the cost of debt just makes it so that the clearing price in today's market makes it very challenging for those deals to pencil out in terms of returns. I do think actually, and we wrote about this a lot in our Q2 outlook, I do think we're seeing a shift that's not necessarily yet showing up in the hard data. These sentiment measures. There's a lot of different trade groups in real estate that survey brokers, investors, lenders, et cetera, and pretty much all of them are showing significantly improved sentiment outlook, et cetera for the next 12 months relative to the past 12

Lara Rhame (16:44):

Months. Oh good. You can't have a recovery with that animal. Spirits turning somehow.

Andrew Korz (16:47):

It's usually the first thing. Cap rates have risen a hundred to 150 basis points. That's not nearly as much as financing costs have risen. But for some buyers, whether you're using low leverage, maybe not as much debt, maybe you have a long investment horizon, these types of buyers unlevered returns in real estate actually look pretty attractive right now. And then you have, as we've talked about, loan maturity starting to come up, which are going to require reappraisals from lenders, just get that sort of wheel of price discovery in motion. So when we look at Q2, I think there's a growing understanding in the market that rates are not coming to the rescue for commercial real estate. I don't think this better sentiment is predicated on rates coming down. I think it's predicated on them calming down

Lara Rhame (17:35):

It.

Andrew Korz (17:36):

I like it. Yeah, just coin to that. In all seriousness, I think investors need more certainty, right? Yeah. Financing costs are just such a big line item, especially now given how much rates have gone up, you can't go into a deal with no clear understanding whether your debt's going to cost 6% or 9% when it closes ultimately. So I think ultimately we do think the market is going to improve from an activity standpoint this year, maybe starting in Q2, but just like the housing market, it's going to be slow going. It's going to be more of a trickle than a deluge. And I think the important distinction here is that more activity may not actually be good for prices, so it'll be good for price discovery. But what investors, there's a little

Lara Rhame (18:18):

Dip first. Yeah.

Andrew Korz (18:19):

What investors might actually discover is that prices will have another five or 7% to drop before they stabilize to these market interest rates. And so what does that mean for investors? This probably means equity returns remain fairly muted in the short, better medium term, better be lender returns and debt are probably going to be more attractive going forward.

Lara Rhame (18:39):

Alright, so final plug for the anatomy of A CRE correction, which Andrew wrote and is just a fantastic piece on our website if you want to learn more about this market. I think in juxtaposition to these slower moving real estate markets, I want to finish on the one market that is moving fast and furious, which is equities. And Andrew, you are also our equity guru. So are we just going to make a new record every week is in store for us in the second quarter? Where are we going from these starting point of these stratospheric valuations? Yeah,

Andrew Korz (19:15):

What an incredible 15 months it's been really for our 4 0 1 ks collectively, huh? The s and p five hundreds up 40% since the end of 2022.

Lara Rhame (19:24):

It's got to be one of the biggest asset moves.

Andrew Korz (19:27):

Unbelievable in history. 10% last quarter. It's been up at least 7% in four of the last five quarters.

Lara Rhame (19:34):

Yeah,

Andrew Korz (19:35):

That's only happened the other times 20 21, 19 83 and 1976. Just a remarkable, not only its magnitude, but in the consistency, it's just been up and to the right for the better part. 15

Lara Rhame (19:47):

Months. And this is at a time when money supply is contracting and the Fed is still quantitative tightening, it flies in the face and the fed is fed rate cuts are being like the market doesn't need fed rate cuts to go up. We've priced a lot of those out.

Andrew Korz (19:59):

I think what it's shown us is for the equity market to go up, low rates are one option, one possible force to drive equities up, but they're not a requirement for

Lara Rhame (20:11):

Stock. Does stock to go up

Andrew Korz (20:12):

Does. But I do think the clear concern right now, as we've talked about a lot is valuation. The s and p five hundred's trading at 21 times next 12 months earnings that's really high, that's top 5% going back through history. And it's not just the MEG seven, everything pretty much within the US market, at least outside of defensives and energy looks historically expensive right now. So here's what I think is going on. I think it's kind of two things. Number one, I think expectations for earnings growth are really strong for the next two years. 10% this year, 14%

next year, investors see no sign of earnings deceleration over their forecast horizon. So they're kind of willing to buy equities today based on 2026 earnings, which based on those earnings multiples are more reasonable around 17 and a half, still high. But basically they're willing to let equities grow into their multiple, if that makes sense. Yeah.

(21:06):

The other thing is obviously ai and I think at the low end, AI has added probably $6 trillion to market cap in the US alone. That's very conservative. And Nvidia was responsible for a quarter of the market's return in Q1. Just remarkable. I think what makes AI such a powerful force is kind of twofold. First is it's profitable today. A lot of these market narratives are sort of aspirational. We're seeing it already in a lot of specifically semiconductor stocks. It's cashflow generative today. And the second thing is to the upside, there's sort of a call option aspect to this because nobody knows how profitable this technology could be. It could be the most profitable thing of all time. And I want exposure to that bet, even if it's low-ish probability. So I think over the next three months we need to sort of acknowledge that these stocks have gone really far. The momentum factor had one of its best quarters ever. And Q1, usually throughout history there's a pullback in momentum stocks. So I sort of think in Q2, the biggest risk to the market continue to be any sign of earnings, disappointment, growth, disappointment, or any sign that the AI growth rate is sort of, we need to revise that down.

Lara Rhame (22:16):

So it sounds like you're not bearish on equities, but we've come really far really fast and we may just have sort of like a breath, a pause here.

Andrew Korz (22:26):

I think if things stay as they are, growth expectations can continue to be really strong. AI continues to just grow to the moon. There's really not much of a catalyst for a big pullback, but I think we've priced in a lot of good news and any chink in that armor, if you will, might be caused for some sort of pullback.

Lara Rhame (22:46):

Alright, well it's going to be an interesting quarter to be sure. It

Andrew Korz (22:50):

Is. It is. And I think we'll sit here three months from now and discuss how things went, but hopefully the economy stays as strong as it's been and markets keep going up. Yeah,

Lara Rhame (23:01):

I think we're going to be in good shape. Yeah.

Andrew Korz (23:03):

Yeah. Awesome. Well thanks for joining us s Lara, and I'll talk to you in three months. Thank

Lara Rhame (23:06):

You. Alright. This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was produced by the investment research team. It was edited and engineered by Erin Sherman video, produced by Melissa Vanti and copy provided by Harrison Beck. Special thanks to show coordinators Ellie Zang and Laura Coleman. Thanks for listening.