

WEEKLY ECONOMIC COMMENTARY

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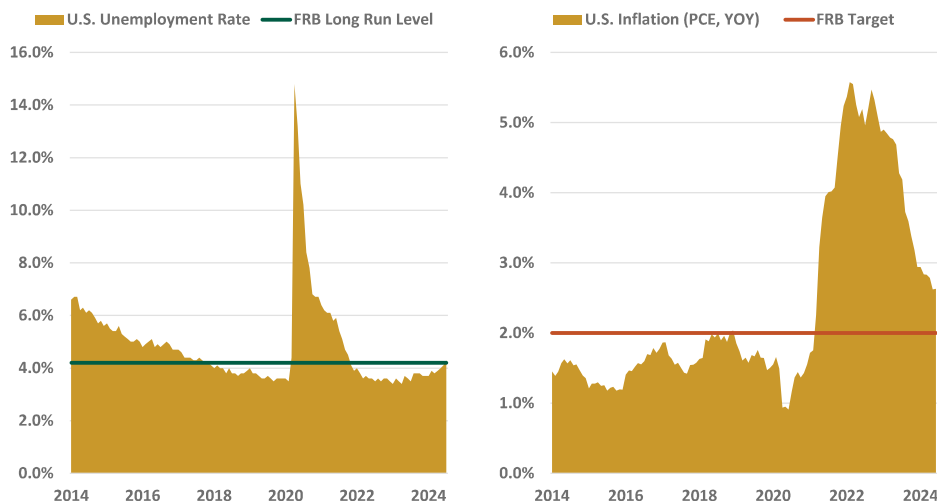
Next week, the Federal Reserve will host its annual conference in Jackson Hole, Wyoming. The Chairman's keynote address is always highly anticipated. If I had a chance to take the podium, this is what I would say.

It is a pleasure to address this conference, which brings together experts from a wide range of countries, backgrounds, and institutions. I am looking forward to the discussions which will take place in the days ahead.

The title of this Symposium, "Reassessing the Effectiveness and Transmission of Monetary Policy" is particularly appropriate. We are gathered during a transition phase for policy and in the wake of a period of market instability. I will attempt to place recent developments into perspective, and offer thoughts on what might lie ahead.

Central bankers have customarily taken a long view in their deliberations. This posture is informed by three things. Firstly, their mandates cover long terms: price stability and (in the case of the United States) maximum employment are to be achieved sustainably. Secondly, monetary policy works with long and variable lags, requiring a view of the horizon from the shore. And lastly, the information on which they rely for guidance can often be volatile, and must be considered over an appropriate interval.

The U.S. employment situation offers a case study on this latter front. Over the past year, the American labor market has performed very well. Unemployment remains low by historical standards, in spite of a record influx of immigration. We've created an average of 200,000 jobs per month this year, consistent with updated estimates of available labor.



Sources: BLS, Bloomberg

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Joblessness is higher than it was at this time last year, and those who have been displaced are in transition. I don't mean to minimize the challenges faced by their households. But the extraordinarily low level of unemployment was not sustainable, at least not in a manner consistent with a commitment to control the price level.

Labor markets can experience significant discontinuities: trickles of deterioration are often followed by more significant flows. Risks have increased, and we should watch incoming data closely.

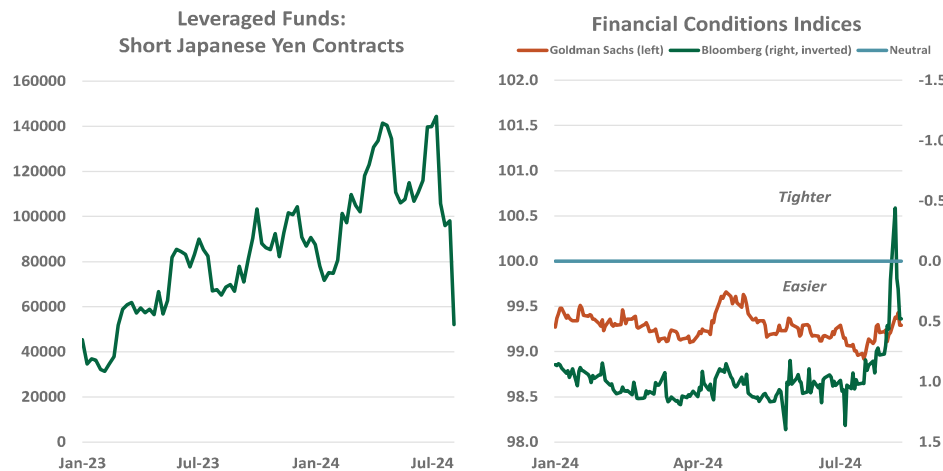
Overall economic activity continues to progress at a solid rate. Real growth advanced at a 2.8% pace in the second quarter, and has consistently defied predictions of recession over the last two years. The consensus among forecasters calls for sustained growth as we move into 2025.

Inflation is edging down. The Fed's preferred measure stands at 2.6% over the past twelve months; core consumer prices are up by about 3% over the same interval. We are beginning to see some easing in the escalation of shelter and service prices, which will be essential to reaching the 2% target. With some distance to travel before we get there, caution is still warranted.

These conditions should allow monetary policy to return to more normal levels at a measured pace. As always, the Fed should monitor developments and move with additional urgency should conditions warrant.

Let me close by offering reflections on the market unrest that occurred earlier this month. The Federal Reserve, among other central banks, has consistently raised concerns about leveraged transactions that can exaggerate market movements. The "carry trades" which unwound in the wake of decisions taken by the Bank of Japan had implications across a range of asset classes.

There is no cause for the Fed to panic.



Source: Bloomberg, Goldman Sachs

Monetary policy cannot, and should not seek to stabilize asset prices. Attempts to do so create substantial moral hazard and have little guarantee of success. Intervention is only warranted when market events create consequences for the real economy; there is no evidence that the recent episode will have such an impact. Financial conditions remain on the easy side.

The week of August 5 does, however, highlight the importance of additional surveillance into cross-currency and cross-market positioning. The Fed should seek additional insight into this space through its financial stability division and through its supervision of the banking system.

The post-pandemic era has certainly raised questions about the effectiveness and transmission of monetary policy. We have answered some of these, but the search for additional insight continues.

Builder's Square-Off

Last week, we explored the old economic rules that falsely predicted an imminent recession. Losing those guideposts has complicated our efforts to craft an outlook.

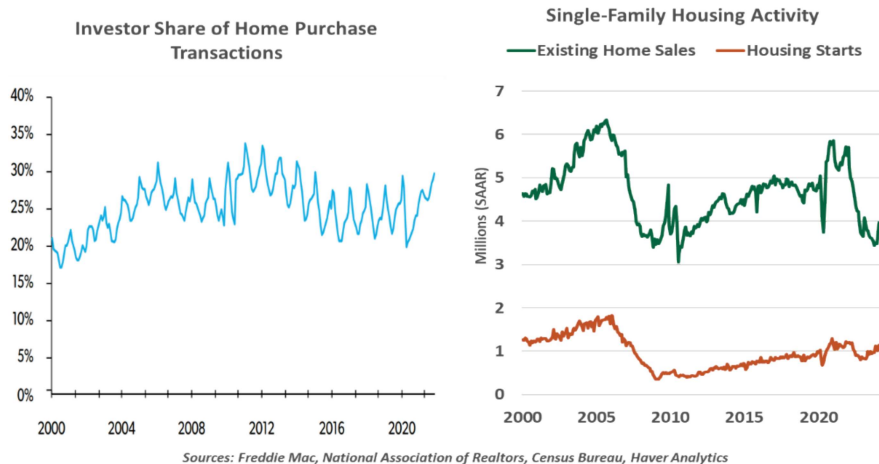
But the pandemic was not the only economic cycle that defied conventional wisdom. Prior to the Global Financial Crisis (GFC) of 2008, we took comfort in the fact that house prices had never experienced a sustained loss outside of the Great Depression. The crash that followed broke another long-standing assumption.

That not-too-distant memory has raised fear of another housing correction in the present day. High demand for space at home and easy financing drove frenetic purchase activity during the pandemic. Nationally, house price indices rose by 40% in two years. As monetary conditions tightened, the real estate market appeared primed for another crash.

Instead, house price indices in most markets have continued to appreciate moderately. In the face of lower demand and higher interest rates, how have homes remained so expensive?

Despite high prices, strong labor markets are still equipping people to buy homes. However, those potential buyers are frustrated, finding few listings and high competition when bidding.

Institutional buyers have caught some blame for the shortage. Coming out of the GFC, institutional funds were raised to purchase homes out of foreclosure and rent them out, creating a new single-family rental (SFR) asset class. Those buyers remain on the market, but their role can be overstated. Freddie Mac estimated the share of home sales to investors peaked in this cycle at 28% in late 2021; of these, only 2% of purchases were to large corporate buyers. Most landlords are small stakeholders, owning 1-4 properties. And some of them are not offering conventional leases, but rather listing properties on short-term rental platforms.



Slow construction and high regulation are impairing housing supply.

Investors make their presence especially apparent at the lower end of the market. The best returns accrue to investors who start from a low cost basis. First-time home buyers targeting these entry-level properties will face more competition, often against investors (both large and small) who can promise a quick, all-cash transaction.

Fundamentally, buyers' circumstances are difficult because supply is constrained. Current homeowners are reluctant to give up their low interest rates by upgrading to a new home. However, supply is not keeping up with demand; housing starts are holding at a rather temperate level. What's holding back construction?

High interest rates are not only weighing on buyers. Property developers also now face higher carrying costs for their construction loans. Homes that are getting built skew toward higher-end properties that offer the greatest potential payout when the keys are handed over. Every addition to housing stock can help address the shortage, but not all buyers can step into these premium properties.

And in a market with high prevailing rates, home building is just one of many attractive investments. With more liquid asset classes offering tempting returns, lenders and investors are skeptical of locking up capital in construction projects.

Financing is not the only obstacle. Local zoning policies often limit the uses of land and prevent more dense development in established communities. Land use policies are local matters and difficult to reform broadly. Short-term rentals have come under scrutiny, sometimes prohibited by homeowners' associations; larger cities may levy taxes or limitations on these arrangements, but more extensive restrictions are unlikely. National legislation like the stalled "End Hedge Fund Control of American Homes Act" would not significantly change demand dynamics.

Like markets for other goods and services, housing is bound by the law of supply and demand. The supply of homes is short of demand, and their prices are rising. This is one economic rule that we expect to hold.

No Pain No Gain

In neurology, shock therapy is a course of treatment that can help to counteract severe depression, psychosis, and catatonia. With proper coordination among anesthesiologists, psychiatrists and nurses, the therapy is safe and effective.

In economics, shock treatment involves sudden, intense changes in policy to cure long-running afflictions. While they can produce discomfort, proper coordination among the government, the central bank and the private sector can allow shock therapy to produce improved economic health.

Argentina's persistent struggles have made it a candidate for this approach. That is what the self-declared "anarcho-capitalist" and current president Javier Milei has prescribed to halt the country's decades-old economic malaise.

Last December, President Milei inherited a government that had been spending beyond its means for years, an economy that was being choked off by government regulations and financial markets that had endured multiple crises. Foreign reserves were running dry, while inflation was skyrocketing. The Argentine peso (ARS) had endured a dramatic devaluation in the past two decades. Currency and price controls have led to shortages of essentials like rice, while auto manufacturing suffered from a scarcity of the dollars required for imports. Argentina has one of the world's lowest levels of credit access for households and businesses; the nation has defaulted on its debt on nine separate occasions.

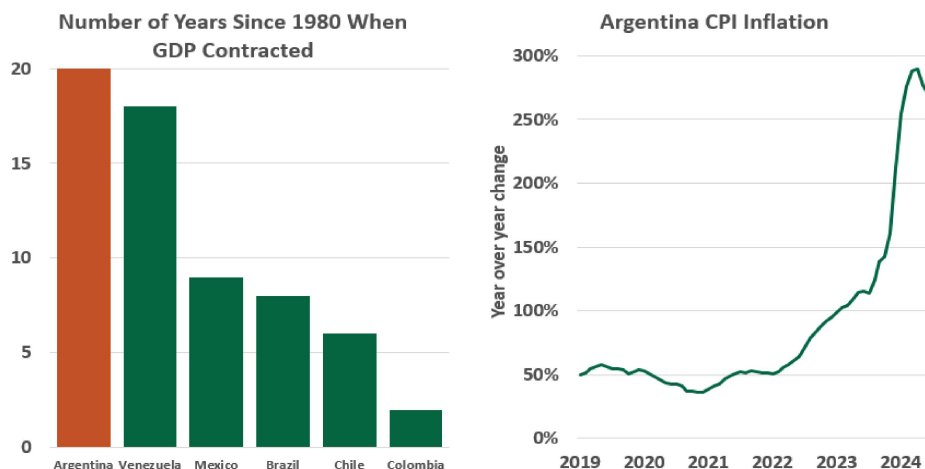
Milei's economic blueprint called for slashing government spending, dealing with hyperinflation, lowering interest rates, rebuilding reserves and creating a more market-oriented economy. Primary government spending was cut by 40% in the first quarter of 2024, led by a significant reduction in capital spending and transfers to provinces. Pensions were cut by 36% year-over-year, which contributed the lion's share of the overall fiscal adjustment.

The peso was devalued from ARS391 per dollar to ARS833 just three days into Milei's term of office. The devaluation bridged the gap between the official exchange rate and the informal or

Argentina is trying to shock itself out of a long-running economic malaise.

blue-chip rate, used to get around strict capital controls. More recently, reforms were passed to allow deregulation, privatization, and promotion of private investments in large projects.

Curbing unchecked printing of money has allowed the government to post its first budget surplus in 16 years. It has also helped cool monthly inflation to 4% in July from a three-decade high of about 26% at the end of last year. The central bank has cut interest rates six times since last December, bringing the policy rate down to 40%. While still low and insufficient to settle the large debt owed to importers, the central bank has been able to boost gross reserves.



Sources: Bloomberg, Haver Analytics

Milei's radical policies have yielded some positive results, but much work remains to be done.

That said, much of the broader macroeconomic mess remains. The immediate cost of austerity was a deep recession. Protests against Milei's program have grown in recent months, as Argentines struggle to feed their families. Government agencies have been closed, costing thousands of jobs. Public works have come to a halt.

The policy rate of 40% remains far below the annual inflation rate, discouraging Argentines to save in pesos. The government has failed to remove capital controls, which restricts the ability of investors to get money out of the country. Foreign direct investment is still virtually non-existent.

Milei's radical plan to fix the deep-rooted problems of Argentina's economy has had some success, and it is being watched by other countries facing comparable challenges. But there is still much work to be done. Given the frail social landscape, the president needs to deliver more progress. If stakeholders cannot remain aligned, shock therapy can be a very risky treatment.

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