US housing to get a major boost from the Federal Reserve at 2pm today

3-5 years from the peak in US Housing if the Fed raises rates

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Bottom Line: Take advantage of real estate related assets this winter. The Fed has every right to delay the anticipated December liftoff. Instead, the Fed is very likely to raise the benchmark rate and *signal* that they will not raise again for "some period of time." This all-important *signal* will result in the Fed sidestepping the January or March interest rate lift, Wall Street economists lowering their year-end 2016 interest rate forecasts, and market-based interest rates[1] going lower than today's level in 3-6 months' time – with high volatility. This scenario could create a near term shock to the US Housing market and other parts of the economy, but rates near or below current levels are very attractive for US real estate and will prevail as the dominating support for US Housing if a rate shock is short-lived[2] (i.e. the Fed skips a rate increase on January 27th or March 16th). Winter 2016 will be unnerving and a little cold for the real estate industry; a year from now, however, most real estate assets will have seen continued appreciation that should continue for the next 3-5 years[3].

The back door and the window open, but staying in the house. Europe's shift to deeper economic stimulus two weeks ago left *the door open* for the Fed to reconsider its December liftoff. The President's Sunday wartime announcement last week also left a credible escape path – *an open window* – if there are doubts about disinflation, underemployment, oil price deflation, consumer confidence, or an intensifying global war. The Fed's recent rhetoric has placed their policy in a tight box where raising rates could hurt the economy, but not raising rates could increase the volatility of the Fed's most important resource[4] – their forward-looking communication tools introduced piecemeal as Quantitative Easing grew. The benchmark rate is very likely to be lifted in-line with a dominating consensus[5]. Ostensibly, postponing a December raise would inherently cause undue volatility around any future raises from 0-0.25%. The Fed is keenly aware, I hope, that the worst case scenario is to walk into 2016 with the whole world saying "I have no clue what the US Fed is going to do next."

Reversing course with Quantitative Easing is a material 2016-17 possibility. What is the Fed's next move if they raise rates at 2pm on December 16, 2015 and it hurts the economy more than anyone intended? Europe, China and Canada have each raised their benchmark lending rate since the Great Recession; each has had to reverse course in less than 2 years and rates are lower today than each region's *liftoff point.* The *liftoff point for the US = 2.2764% (4:30am on December 16, 2015)*.

It is not unreasonable to assume the US would return to Quantitative Easing if the rate increase turns out to be too damaging for the US economy[6]. The effect of consecutive rate increases, and an implicit expectation of future raises, would stoke a negative feedback loop requiring more than 50 basis points of easing, which I expect the Fed to avoid. If the Fed does not avoid this by sidestepping early 2016 rate increase opportunities[7] the risk is this: consumers and their confidence will be fixated on a polarizing election cycle with low fiscal policy support, volatile interest rates, falling oil prices and lofty startup valuations. The Fed's monetary tools will be 50 basis points of rate decrease, some shift in communication, and/or quantitative easing to stem potentially overcool conditions.

1994 and 2004 set a precedent for appreciation during rate increases. In 1994 Paul Volcker shocked global financial markets with a surprise 50 basis point lift in rates without warning. The housing market would march along successfully until 2000[8], when a recession cooled price increases to 2% from nearly 10% annual appreciation. The tightening cycle that commenced in 2004 would continue for 3 years before nationwide home prices fell flat, on their way to a decline. The increase in rates that is expected this week would be the most telegraphed Fed Funds lift in history – mostly because the Fed's new communication functions were put in place exactly for that reason. There is recent precedent for home prices to appreciate in the face of rising interest rates. If my assertion on the path of market-based rates proves correct, the 10 year treasury yield could be lower than 2.25% in 3-6 months which would be very supportive of rising residential and commercial real estate prices.

Final Words. If the stock and real estate backed asset markets avoid a 20% crash in the next 3-6 months[9], but instead have a healthy correction of 5-10%, risk assets will be attractively priced for the second leg of a bull market. A market where investors climb the seminal wall of worry – including the worry about of rate increases – is a healthy market with diversity of opinion. 3-6 months from now words like *liftoff* and *takeoff* will be tamed to *initial bump* and *test increase*. The fast money that could run rates up after a December *liftoff* would drive rates down in January or March. Dislocations in real estate related assets should be taken advantage of this winter. If price movements become somewhat volatile, but do not trigger a holistic lending contraction, there is merit for material growth in US real estate prices over the next 3-5 years.

Footnotes

[1] I typically mean the 10 year interest rate when I refer to market based interest rates.

[2] Investors were involved in 60% of market purchases in the 12 months following the unexpected June 2013 rate jump (100 bps in under 60 days) and now make up only 40% of purchases.

[3] In a December 2015 survey of 35 single family rental investors with equity as their sole capital source, 28 are preparing to at least triple in size over the next 2 years.

[4] The following link, which worked properly at the beginning of the 2015, but is no longer available, was an explanation of the power of the Fed's communication at a zero or near zero monetary policy position. This important document, that is only attainable in hard copy, outlines communication as the most important arrow in the Fed's proverbial quiver. Krishna Guha, the author of that 2012 presentation is now Vice-Chairman of Evercore ISI, an investment bank, and heads the Global Policy and Central Bank Strategy team based in Washington D.C.
http://www.newyorkfed.org/education/pdf/2012/Guha_changes_FOMC_communications.pdf

[5] As of November 12th the *Wall Street Journal* reported that 92% of economists expected the Fed to raise rates according to their own survey (http://www.wsj.com/articles/economists-overwhelmingly-expect-fed-to-raise-interest-rates-in-december-1447340397)

[6] The negative effects of $35 oil have yet to reverberate completely through the economy. Companies and employable talent that rely directly or indirectly on spot lending rates and oil prices may not be able to tell the difference between the impact of the Fed liftoff and lower oil prices in early 2016. Both constituents will likely make note of both in manufacturing surveys, Federal Reserve district commentary, and consumer sentiment surveys.

[7] Chart available upon request: Time series of how inaccurate the market and the Fed participants have been on rate increases since 2010 (joshua.pollard@omicelo.com)

[8] The US housing market strengthened through the Asian financial crisis (emerging market weakness) and the Long Term Capital Management Rescue (high profile hedge fund weakness) which were more financially impactful in the late 1990s than today's headline grabbing failures.

[9] At least one of the major US stock markets has crashed by 20% or more within the first two years of each new Fed President – Volcker, Greenspan, and Bernanke.

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