3rd Quarter 2023

ECONOMIC OUTLOOK WEBINAR

with WFG's Patrick Stone and economist Dr. Bill Conerly

FULL TRANSCRIPTION

Welcome

“My name is Pat Stone. I'm chairman and founder of the Williston Financial Group and WFG National Title and it's my pleasure to welcome you today to our Q3 Economic Outlook. Joining me today is an old friend, Bill Conerly. He's actually an economist, and a reputable and accomplished one. I share this every quarter, but I've known Bill for, I think it's coming up on 42 years now. He was the chief economist for First Interstate Bank when I met him. He now is an independent consultant and a very good one who advises businesses from an economic perspective. I get Bill's newsletters and talk to him frequently, and have a high regard for the practical aspect he brings to his economic conversations. This is a guy that understands we're in business to make money. He understands that theory is fine, but practical applications are a lot more useful. So with that, I'm going to turn it over to Bill and, by the way, and Bill is also a columnist for Forbes Magazine. So with that Bill, take it away.”

Opening Commentary from Dr. Bill Conerly

“Thank you and I'm going to talk for 10 to 15 minutes, then throw it to Pat and after Pat makes some remarks, we'll do questions that have been submitted ahead of time.”

“So I was going for a walk a block away from my house and a neighbor says, ‘Hey Bill, are we in recession now?’ And I said, kind of flippantly, as is my tendency, “I'm not in recession, but maybe you are.” And the economy of the United States as a whole is not in recession, but you may be because your sector, real estate transactions, is certainly down from what is average. Down from where it had been. But the economy as a whole, the big picture, we are not in recession, but I think we're headed there. And I think the recession we are headed to is mild, but it is delayed and there are five factors delaying it.”

“People say, ‘Hey, how could we have had such a sharp increase in interest rates and not have a recession?’ Short-term interest rates, the things that the Federal Reserve focus on, short-term interest rates went up over five percentage points in a fairly short period of time. Long-term interest rates like mortgage rates went up substantially as well. So how is it that we're not already in a recession? Normally there's a significant time lag. A rough rule of thumb is about a year, and not a year from when the Fed begins, but a year from when the Fed does its heavy lifting and moves rates a lot. But I think there are five factors that are delaying the onset of recession in this particular business cycle.”

“The first one is close to the hearts of many of you and that's single-family home sales. Housing starts of single-family homes usually go down when interest rates go up and they did, in fact, go down late last year and early this year. However, housing starts for single families are now edging up and that's because there are plenty of first-time homebuyers and yeah, they see high

mortgage rates, but they hold their nose on those mortgage rates figuring they'll be able to refi in a couple of years, and the first-time homebuyers are not seeing much inventory. People who own existing homes. Maybe they want a bigger home, maybe they want a newer home or a different house, but they're not willing to walk away from a 3% mortgage and get a 7.5% mortgage. That pretty much blows their budget for upgrading their home. So those first-time homebuyers when they go looking for something to buy, they're seeing new construction. And some of the developers are adjusting their product offerings. So we're seeing more strength in new construction. It's not huge, but it's going up a little bit rather than down a lot as typically happens."

"The second factor is not particularly relevant to you, but auto sales usually go down when interest rates rise, but we have supply chain problems that limited the availability of new cars. That was a couple of years ago. The supply chains are improving, so there's pent-up demand for new cars. That's purely a delaying factor on the arrival of the next recession."

"The third delaying factor is business capital spending. Companies usually cut back on purchases of machinery, equipment and computers when interest rates go up, but they're maintaining their spending. The biggest cause is they ordered equipment to make up for the workers they were unable to find and they still feel like it's a tight labor market, so they are spending money. There's also some reshoring going on and the chips act that's stimulating construction of new semiconductor manufacturing facilities. So we've got single-family homes, we've got cars, we've saw business capital spending."

"The fourth delaying factor is the tight labor market. There are people being laid off, but many of those people have been driving to work day after day, passing other businesses that have help wanted signs. So people who get laid off in some cases can quickly transition to a new job. That's delaying the onset of the recession. And then people who don't get a job right away or people who are worried about losing their job, they tend to cut back on their discretionary spending. But remember those stimulus checks back in the pandemic, 2020 and early 2021, most of that money got saved and there was other stimulus to businesses and state and local governments and the result of all that stimulus was a lot of bank balances, a lot of savings that just went into the bank. People started about a year and a half ago spending those savings. So when they got them, at first they just banked them. Now they're slowly spending, they've worked down about two-thirds of that extra savings and my arithmetic says they can continue until maybe April of next year before they've run out of that. So, that is delaying the cutbacks in consumer spending that usually is part of the recessionary process."

"What we're seeing is mostly delaying factors. The capital spending may soften the blow a little bit and maybe some of those first-time homebuyers soften the magnitude of the recession, but I think it's mostly delaying factors rather than preventing a recession. So I'm forecasting a recession to begin in early 2024, but I'm almost nervous to say recession because many of you remember the 2008, 2009 recession. It's not going to be anything like that. That recession was about twice as bad as average. 2008, 2009 was twice as bad as the average recession, and I think what we're headed to is milder than the average recession."

"So try to erase that. I wish I had one of those science fiction things where I could hold a device up to your head and just zap your memory of the 2008-2009 recession, because, yeah, we're going to call this thing a recession, but it's not going to be nearly as bad as 2008-2009, and I think Pat can talk about the real estate market as we go into that."

"And finally, people talk about Federal Reserve policy and they say to me, 'Man, inflation is coming down. Why is the Fed keeping interest rates high? So let me give you the view of inflation and monetary policy that the Fed has and it's also what I have and most of my fellow economists have.

There are transitory elements and then there's something that you might call base inflation. Base inflation, and then you add on some other things. Base inflation comes when you have too much stimulus relative to our productive capacity. And you know that in the early days of the pandemic, the federal government was just spending money on stimulus checks and a wide variety of programs and the Federal Reserve added their stimulus. They bought a lot of mortgage-backed securities, a lot of treasury securities. They brought interest rates way down. So we have a lot more dollars in the economy, but we don't have any greater productive capacity. The classic definition of inflation is too many dollars chasing too few goods, and that just conveys the idea. We threw a lot of dollars into the economy, but we cannot produce more goods and services than we used to. So somehow that extra dollar has to go somewhere and it goes into higher prices. That base inflation tends to be sluggish and it is slow to come down."

"What we have seen come down is the transitory elements. Yeah, there was unusually high gasoline prices. The cost of energy to consumers has dropped by about 20% in the last 12 months. So that's been some of the good news, but it hasn't changed the base inflation. Used car prices were unusually high because of new cars supply chain problems. That's coming down, but that's not really the issue. So the transitory elements are gone, but the Fed and Bill Conerly are still worrying about the substantial stimulus in the economy."

"I have an inflation forecasting model that's based upon historic norms and then I tweak it according to how I think the current cycle is different from historic norms, but based on historic norms, we don't need to move short-term interest rates up much. I'm forecasting another quarter point move, but what's a quarter-point among friends? I think that we're in the ballpark of as high as the short-term interest rates have to go, but the key thing is to get the effect, you have to leave those interest rates high for about a year. So, I think that short-term interest rates stay high through the middle of 2024 and then the Fed starts to cut."

"Mortgage rates are a little bit different. Mortgage rates and 10-year treasury security rates are a reflection of current short-term rates and expected short-term rates. I think that the mortgage rates start coming down early in 2024 when the 'Bondos' say, 'Oh, the Fed's next move is definitely going to be down.' Once the markets are convinced that the fed's next move will be a drop in short-term interest rates, then we'll see mortgage rates come down and I think they'll move down gradually. By the end of 2024, I'm thinking mortgages at about 5% plus or minus. I ought to say plus or minus another 5%, but maybe that's too extreme. But, I think that we will eventually see the Fed easing, but we're 12 months away from that."

"But, the good news for you folks is when I talk about recession and the Fed responding to a weaker economy, I'm mostly thinking now about the ripple effects on other parts of the economy because the most interest rate sensitive part of the economy is the work that you folks do and you've already been clobbered by that. I don't think there's any more clobbering to come, but it will be a while before things really revive in volume of real estate transactions. So, my best estimate is it doesn't get much worse for you, but it's a year before starts getting better."

"Those are my thoughts and Pat, you are free to contradict me as you often do and let's share your insights with the world."

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Opening Commentary from WFG Chairman and Founder Patrick Stone

"Well, Bill, I would start by saying that I agree with you that we will have a minor recession. I personally think that early next year, or in the first half of next year, I should say. I personally think that the cause of it is going to be the global economic slowdown. People, especially our media, does not realize how much of the global economy is controlled by the United States' companies and it's hard to get a real precise handle on it, but it's estimated about 40% of everything manufactured in the world is manufactured by US corporations and about 40% of that is manufactured overseas. So we don't necessarily get the GDP (Gross Domestic Product) impact of it, but we get the dollars and the financial impact of it. What I'm trying to say in a very cumbersome way is the global economy has more than doubled since the year 2000, much to the benefit of the United States and our economic health in the form of income and capital. And the global economy is going to slow down. China has really kind of turned downward and gotten into a deflationary environment. You're going to see, I think, a slowdown in the global economy. It will impact us, it will contribute to the small and I think fairly short-term recession Bill was referring to, and I don't see it being overly problematic for us in any sense. It'll actually be in some ways healthy for us in the sense that it will lower rates a little faster. So, I agree with Bill on the global economy, and I would also agree that this is probably the most complex environment I have seen in my adult lifetime. I've been in real estate proactively for 48 years. Done real estate, residential and commercial title insurance, and I don't think I've ever seen a time when we've had more indicators that are either contrary, conflicting or confusing than we do right now."

"I got asked the other day, I got asked a very, I don't want to say embarrassing question. In a sense it was, but also probably a very pertinent question. That is, why was I so wrong early this year about predicting a drop in mortgage rates? And, if I may just take you through some of it, I think candidly I didn't fully understand or project the banking crisis, which really wasn't a banking crisis other than in the media. We have 4,844 banks in this country, which is probably about twice as many as we need. And we had one bank that didn't hedge its investments, which is extraordinarily unusual. Silicon Valley Bank and it failed. That caused a run on a couple other banks that caused them to go under. But, if you look at our overall banking universe, it's pretty darn healthy. In fact, right now the regulators are trying to get asset levels increased in some banks. They're having a hard time doing it because there really isn't a crisis among our banking industry. Maybe a crisis in our media, but not in our banking industry. But, I didn't anticipate the banking crisis or the impact it would have on the overall economic psychology, if you will, of the US market."

"I also didn't anticipate the debt ceiling debacle. I'm going to be a little bit crude and very blunt here. I am so tired of the political environment in Washington. I wish we could just start over. It is really pathetic that the desire to get attention and to focus on your ideology instead of what's best for the American people resulted in us having a debt ceiling crisis and a big argument about raising the debt ceiling. That impacted interest rates and also resulted in a credit downgrade, which is fairly extraordinary. It happened once right after the great recession by one credit rating agency, and it just happened again. We had the US government debt downgraded. So, I didn't anticipate that. That had an impact and held up on any sort of downgrade in dollars. I think I didn't really fully anticipate how protracted and meaningful the Russia-Ukraine war has been, especially with Russia shutting the doors on grain exports out of Ukraine and, also the result with the raises and oil prices by the Saudis. It has had a fairly meaningful impact on interest rates. Interest rates aren't coming down because of the anxiety around it."

“I don't think I fully appreciated all the conversations that are now becoming reality around the fear of the government not getting funding at the end of September. This is going to be ugly because this is like the debt-ceiling crisis. This is another ideological contest that doesn't benefit the American people in any meaningful way, and we may stop funding the government at the end of September unless we get a continuing resolution and the Freedom Caucus is against that. So it'll be interesting to see what happens, anyway.”

“So a lot of things happened that I didn't anticipate, and maybe I'm not cynical enough, and I thought I was at my age, but maybe I'm not. And consequently, we still have protracted higher interest rates even though you're seeing both CPI (Consumer Price Index) and PCE (Personal Consumption Expenditures) reductions. So, we're going to see where that goes.”

“Touching on a couple things real quickly that I just mentioned. I am and continue to worry about debt because we don't seem to understand that at some point that it’s going to have a fairly meaningful impact on us. The government debt is now about $31.7, $31.8 trillion, and they're going to issue I think in this fiscal year, which started the end of September last year, through the first 10 months of this physical year, I think we're upside down about $1.6 trillion. All projections are we're going to be upside down another $1.6 or $1.7 trillion the next fiscal year. But government debt at $31.7 trillion right now and going up, and I went back and I looked at what government debt was in some of the decades. 1970 it was $3.7 billion. 1990 it was $3.2 trillion. So, 30 years ago, we were $3.23 trillion, and we have increased the debt almost 10 times, 10 x, in the last 30 years. Their responsibility here by our government leaders is scary to me.”

“2000 it was $5.6 trillion. 2010 it was $13.5 trillion. 2020, $27.7 trillion, and now up $ 31.7 trillion. Real quick aside there. Can we do anything about it? I am a subscriber to what the German government did back I think around 2008. They had a debt issue and I think it took them about three years. They said, okay, let's get together and decide how long it's going to take us to balance our budget. They got unanimity around an idea that they could get their budget back balanced within 10 years. They did it in three years, and basically they didn't cut anything or cut very little, but they just quit spending extra money while their economy recovered after the great recession. So, we’ve got to do something like that. It's a little bit scary right now where we are, and I'm not a real avid follower of politics and I don't want to get into a discussion who's right or who's wrong. It's just that it's dysfunctional right now and we're not really dealing with it. However, I still remain somewhat positive in some ways. Yeah, there's a lot of debt with the American consumer also. I mean, we heard that credit card debt went over $1 trillion here shortly, but as Bill pointed out, there was a tremendous amount of disposable income, much higher level of disposable income for the American consumer as a result of the pandemic. Now that is being spent off, and I think we're getting back closer to where we were prior to the pandemic, but we still got a little juice there. We'll see what happens on that one. But I look at real estate and I want to take a minute, and if you'll bear with me, I want to take a minute and talk a little bit about how I think real estate prices work compared to what the media tells you.”

“One of the problems we have is that the media, of course, uses the stock market and the financial markets as an example of supply-demand and what happens with prices going up and down. The real estate market, and I don't think it's a good example, because if you look at the financial markets and the stock brokerage, about 90% of investments are really not investments. They're speculative in the sense that people are betting on the future. You look at real estate, I think less than 4% right now of real estate is what I would call speculative in the sense that it's investors buying homes, and they're buying homes to rent out, not necessarily because they think the price is going to go up.”

“So real estate is really more of a true supply-demand environment than you see in the financial markets. And I look at real estate, the supply side is existing homes being resold or new

construction. So that's the supply side. The demand side is what I call need, desire, and affordability. Need, candidly is the amount of people that need a place to live, and that is pretty encouraging if you take a hard look at it. If you look at millennials, who are 27 to 42 years of age, there's about 72.1 million. And if you look at Gen Z, who are 20 to 26 years of age, they're 69.5 million of them. Baby boomers, we're 68.5 million or 68.5 million right now. So you take millennials and Gen Z, you actually outweigh what the baby boomer bubble was all about coming into home buying. So you've got a tremendous amount of need building and evident. Now, desire: do they want to own a home? There's a recent survey that said 75% of millennials and Gen Z felt that owning a home was still the American dream."

"68% of them said that owning a home was the first step towards creating intergenerational wealth. So, I think that plus what's happened in the pandemic with people being much more conscious of their living environment, really elevated need. So, you've got elevated desire. You've got need in terms of the amount of people that need a place to live. You've got desire at a very high level. Unfortunately, you've got affordability that's a real issue right now with mortgage rates."

"So, if you realistically expect mortgage rates to come down over the next year. Bill said, I think 5% at the end of 2024. And there are projections by Fannie Mae, National Association of REALTORS®, Freddie Mac, Mortgage Bankers Association, and all that, and they're pretty much in that line, too. They say probably 5.5% by the end of 2024. I personally think that it's closer to what Bill said than where they said, but I think affordability will become a positive factor over the next year and a half."

"It'll take a while before it starts. I don't see any real meaningful change in mortgage rates through the end of this year. I think you start to see a decline in first quarter of next year and then a steady drop. And there's a lot of positives around the real estate business and what's being said and told about real estate. I'll give you some examples real quick and pardon me, I'm going to have to look at my notes on this. You look at it, home sales are down 14.7 year over year, but price declines have been really minimal and somewhat selective in certain areas. We've seen price declines of about 6.1% now on active listings. Mortgage purchase apps are down 28% year over year, but median sales price is up 4% year over year. Time on market is 13 days below the same week in 2019."

"So you can see evidence of the demand right there. Active listings are down 18% year-over-year, down 36% from 2019. 39% of the homes are off market within two weeks, and the first-time buyer right now is 53.1% of all purchase loans. That is pretty incredible and pretty encouraging. We have a lot of demand sitting on the sidelines wanting in the business, and once rates come down, you're going to see it. I am very, very candidly, very, very optimistic about where we're going to be in the second half of 2024 and really excited about where we could be in 2025 if rates get down around 5%."

"Now, let's be real honest. I don't think we're going to see rates under 4% again in my lifetime. The low rates we saw that really caused a tremendous surge in real estate in 2021-2022 was really a result of the Fed's quantitative easing project where they bought $120 billion worth of T-bills of mortgage-backed securities every month for I think what? Nine years, Bill? A long time. And they drove rates down trying to get us back out of the great recession. I think it worked. It worked very, very well. But you're not going to see that again unless we have a major issue like the great recession, and I don't see that happening for quite a while, to be honest with you."

"So a couple things real quickly. I found it really interesting on this. I'll share this with you. One in four US homeowners say mortgage rates will not impact their decision on when they would sell their home. Of these, 26% say it's because they don't need a mortgage to buy a new home. We've

gotten a lot of conversations about why people aren't doing anything because mortgage rates are low, but the reality is that a lot of people aren't doing anything in part because they don't move as often anymore. What I mean by that is if you go back to 1985, about 20% of all US homeowners moved every year, and then there was a gradual steady decline from 1985 all the way through 2019 when it got down to about eight and a half percent moving every year."

"So as a society, we quit moving as often, and we have a lot of people that don't really need a mortgage to rebuy. Like 38% of homebuyers under 30 also have family help. They're called 'nepo-homebuyers,' meaning they receive family help to buy a home. So, I think mortgage rates have an impact. I think it's overplayed right now. I do think when we get rates down though, the need for homes will really, really drive up volume very, very quickly, and I do see things getting very, very good by the end of 2024 and early 2025."

Question and Answer Segment

What key stats do you look at other than CPI when attempting to predict what the Fed will do with rates the next time they meet? In the absence of a recession, what are some leading indicators that will prompt the Fed to lower rates?

Dr. Bill Conerly's response:

Yeah, well, I'm maybe not the best person to ask because I look at all the statistics. The work that I do is looking at everything that comes out about the economy. In terms of somebody who is actually trying to run a business, I think the number one thing to watch is GDP, gross domestic product, adjusted for inflation. That comes out quarterly, but there are estimates that are revised. So GDP is first. Then there are four that we call coincident indicators. Things that tell us the current state of the economy. And the four there are employment or total employment in the economy, industrial production, total business sales adjusted for inflation. And then the final one is disposable income, excluding transfer payments adjusted for inflation.

Those are the things I think would give you the best sense of whether the fed is likely to want to tighten or ease. But you also have to keep in mind their model is not that they respond to every little wiggle. They're thinking about that base inflation, and I know you're curious about it, but to tell you the truth, the time that you could spend looking into these economic statistics is maybe better spent trying to serve clients and being more productive in your own work and leave the statistics to people like me.

Do you anticipate a huge surge in foreclosed homes hitting the market nationally like we saw in 2008 to 2010?

Patrick Stone's Response:

Absolutely not. I just candidly think that all the worry is not only overdone, over exaggerated and unnecessary, in part because if you look at where we are on the quality of the mortgages originated in the last 13 to 14 years, it's really extraordinarily different than it was prior to the Great Recession. Give you a little bit more specificity on that. The last five years, over two-thirds of all mortgages have had FICO scores of 760 or higher. I mean, come on. I mean this is, the quality of the loans out there is extraordinary. And if you look at housing credit availability index, you look at product risk and borrower risk, product risk dropped like a rock because we quit doing stated income loans and all the subprime crap that was sold to Wall Street prior to the Great Recession.

And we've had a fairly limited and tightly controlled mortgage origination market now ever since the Great Recession.

I think the amount of homes out there with negative equity right now is under 1% and homes with positive equity over 50% is like 60 some percent. So, there's no issue out there about foreclosures. It's not going to happen. I'm not worried about it at all and don't lose any sleep over that one.

How will the coming stress in the commercial real estate debt affect liquidity and the economy? How big of an issue will liquidity be? Affect of commercial real estate loan foreclosures on bank liquidity and lending: Do you foresee additional banks failing?

Dr. Bill Conerly's response:

Yeah, the last one is easiest. I think there will be some bank failures because there always are in a downturn. In fact, there are often random bank failures even in a strong market. But let's talk about commercial real estate in the big picture.

We know that downtown office buildings are weak right now. Suburban office is doing okay, and then there are other sectors. Retail. The malls, many of them, but not all of them, are soft. The lower quality malls are becoming ghost towns, but retail as a whole sector is doing well if you look at vacancy and rents. Because a lot of retail are like local shopping areas anchored by a supermarket, and they've got the yoga studio, the nail salon, and a couple of specialty stores. That part of retail is doing fine and industrial and warehouse has been doing very well. So commercial real estate, it's a couple of segments that are having trouble, but big picture, commercial real estate is not a problem. But that downtown high-rise office building, yeah, that's a problem. And the banks that have lent on it are going to be having to do some write-downs, no doubt about that. But I don't think it's going to be so massive that the banking industry as a whole has to contract. I think they'll still be making loans so long as the outlook for that sector and the collateral loan-to-value ratios all look good.

But there probably will be some community banks and regional banks that have to take some write-downs on their real estate portfolios and they will probably have to cut back on their lending. And there may be some others that are just a little bit nervous about showing a lot of commercial real estate. But I think that will be a more specific problem rather than a general problem. If anybody's doing real estate development, it maybe would be worthwhile to think about the bank that you want to work with. Is that a bank that has a high exposure to a commercial real estate? That might be the kind of institution that cuts back, but there are some banks that have a lot of commercial and industrial loans, a lot of lending that's not tied to real estate, but they also do real estate. That might be a better institution for those of you who have a choice.

Patrick Stone's response:

If I may, can I just touch on the commercial real estate comment, Bill? There's about 1.5 trillion in commercial real estate loans that are going to come due by the end of 2025, and that's caused a lot of backroom conversations about, well, that's going to really kill regional banks. I'm going to tell you, I'm not very worried about it at all because there's about $2 trillion worth of money sitting on the sideline ready to chase those loans with banks. I'm personally involved in a $200 million fund, and we have seven regional banks we're having conversations with the idea if they have a borrower that can't make the payment that we'll step in and take care of the problem and buy the property. So, there's going to be some limitations both geographically and type of

commercial real estate. But I see a tremendous amount of money out there to pick up assets where the borrowers fail. And the real risk there probably is with regional banks. So, we will see what happens on that one.

Do you see any indication that inventory will increase enough to change the market anytime soon?

Patrick Stone's response:

Not anytime soon. We underbuilt in the market over the last 13 years, in my estimate, about 3 million homes. Okay. And you see estimates, and I've done a lot of research on this, the lowest estimate I've seen is 1 million, the highest estimate is 5 million, but, however you want to cut it, builders really underbuilt because of uncertainty, recovery in the economy, lack of demand. They got terrified about inability to really estimate the prices that they would pay for goods, materials to build a home. Right now we've got a couple issues. I mean, those issues have abated somewhat and builders are stepping it up and I think delivered homes on the market by new construction this year will be back to where it was prior to the great recession. It's recovering, but it will take another five years before we see new construction to where it needs to be. I do think when rates come down, you will see a little bit more resale market for sure. People will downsize, you'll still have people being moved, then there'll be a little bit more activity around relocation. But inventory is going to be a problem for the foreseeable future. It is not going to be corrected real quickly and we'll have to deal with that. I guess where I'm going with that is I don't see the prices coming down because demand is going to slightly outweigh supply for the foreseeable future.

How does the insurance of homes and condos affect the economy?

Dr. Bill Conerly's response:

Well, let's do a little basic economics here. Microeconomics, not macroeconomics. We economists sometimes say a price is a signal wrapped in an incentive. It's a signal about relative value and relative cost wrapped in an incentive to minimize that. So when you see a high price for insurance in a hurricane-prone area or high price for insurance in a wildfire-prone area, that is the market's way of saying, 'Hey, if you want to live there, you have to be ready for an expense more so than if you live in a safer area.' So that's when the insurance markets are working well, and that expense is roughly comparable, whether you're a homeowner or a tenant because the landlords will pass on that insurance costs onto their tenants. But we have some broken insurance markets. California and Florida in particular have too many controls, and we also have federal things like federal flood insurance that pull the signal and the incentive out of the price. There are some properties that have multiple claims. A claim one year and then four years later another claim for a flood, and then five years later another claim for a flood. And those are subsidized policies. So how does it affect the economy? It's a cost. It's a relatively small cost, and unfortunately, it leads to more property ownership and more construction in risky areas. A well-functioning system would discourage people from that. But in terms of the overall economy, it's not a factor that I would expect to lead us into a recession or a sluggish economic growth.

Do you think home prices will go down and what are the prospects for home prices once the Fed starts cutting rates?

Patrick Stone's response:

As I mentioned earlier, the driver here in residential real estate is really, again, one of those parts of the economy where I think you have probably the truest balance between supply and demand and the result and pricing. So Fed cuts rates, you're going to have an increase in demand. We need to have more resale homes come on the market, and I think you will, because part of the segment that owns existing homes that is impacted by mortgage rates will be more inclined to move. I do also think as the Fed cuts rates, you'll see a pickup in builder activity. And builders, again, they had a lot of uncertainty. Tariffs created problems with pricing. Immigration issues have created problems with labor. They still have a lot of issues, but they are getting more optimistic and they are ramping up gradually, but carefully. I think the Fed cuts rates, they'll get a little bit more aggressive about new construction.

So, will supply keep up with demand as rates go down? Probably, not precisely. So I think you're still going to see appreciation of single-family homes, but that appreciation will run 2% to 5% annually. I don't think it'll be off the charts like it was with a great recession.

One of the things that on the demand there that I would say, and it was talking about those 24 to 54-year-old component of our society, how many there are and the demand they create. A really interesting number is 62.9% of people in 2022 had a 30-year high in happiness on the job. And that group of 24 to 54, that particular group actually had an increase in job participation and job holdings over pre-pandemic. And that's the only group that does. So again, demand is there. If we get the supply back on the market, then I think we'll be fine, but I don't think the supply will come back exactly in line with demand. So prices will continue to increase, and I don't think they're going to slow it down for a while. They're going to be the 2% to 5%. Historically they've been 3.6%. So I guess that probably works out pretty well.

How much does the Chinese economy, and perhaps its slow down, affect our economic outlook?

Dr. Bill Conerly's response:

Yeah, it certainly is something that I pay attention to. We think of China as a country that manufactures stuff for us, but China's one of our major customers for US-made products. We export a good bit to China. That's especially true on the West Coast, but also true to a lesser extent for the East and the Midwest. And I have been not optimistic about China. I've written a few articles about that. President Xi Jinping is prioritizing political control over economic growth, and he doesn't much understand economics, even if he did want economic growth. So I think that their days of fast growth are behind them. They have been growing at double-digit growth rates on GDP. But, I recently decided to look at what the real China experts, (I mean, China is something I keep an eye on occasionally,) but I went through the forecasts of a couple of dozen China experts, the economists who focus on that, and they're all saying, 'yeah, the growth rate will be slower, but it will be growth, not a recession.' And the most pessimistic said in 2024, the Chinese economy would grow by 4% a year. Well, we'd be delighted to have the US economy grow by 4%. So, I think it's more matter of slower growth. But it does mean that China will not be providing the US as big a boost to our economy as it had provided in the past. So that's China.

What level of interest rates will be needed to return to a more normal inventory sales ratio, and when do you think that will happen?

Patrick Stone’s response:

Well, as I've indicated, there's a lot of variables that will go into balancing that supply demand in residential real estate. My personal feeling is if we get down between 5% and 5.5% and stay there for a while, we will get balanced in three to five years. But it will take a little while and we'll have to stay in that range fairly consistently during that period of time. Again, there's so many factors. I mean, if you get more tariffs or something like that, forget it. Because builders, if you're sitting there a builder and you're building a spec home and you can't predict what your cost of material is and you can't predict what your cost of labor is, what do you do? You don't build a home. So let's hope we get a little bit of steady, consistent political engagement. And we also get a fairly steady and consistent mortgage rate of around 5% to 5.5%, in three to five years I think we'll get back into a level of balance that we can all live with.

What worldwide event might help ease inflation?

Dr. Bill Conerly’s response:

Well actually as the US inflation rate has come down, also inflation rates in Europe have come down and in Asia. Asia never had the inflation problem that we had in North America and Europe. So there is progress being made, but obviously a resolution of the Ukraine-Russia war would have widespread impacts to help lower global inflation.

Any updates on Fannie Mae not requiring title insurance?

Patrick Stone’s response:

Yeah, they're done with that. Well, let me change that, if you will. They have backed off the idea of trying to embrace or develop an alternative product to title insurance. I think part of the underlying confusion there or misunderstanding there was they didn't realize what the loss ratios were in title insurance and how it varies based on the changes in underlying databases as you go around the country. Also, how title insurance is regulated. It's an insurance industry regulated state by state. I think once they got information, they said, well, an alternative title product is probably not feasible, maybe not smart. They still are taking Attorney Opinion Letters, and I think they took 45 of them last year, if my memory serves me correctly. So the problem with attorney opinion letters is they do not cover fraud. And fraud runs on average about 30% of all title losses. It goes up in down markets, comes down in good markets, but it is a huge factor. And if you're going to embrace Attorney Opinion Letters on an ongoing basis, be prepared to lose some significant money if you're the lender and/or Fannie Mae. So I don't think that issue over Fannie Mae is necessarily a big issue going forward. However, and I'm sorry, I'm going to get a little bit political here, I do believe that their desire to create more affordable homes by lowering some of the costs is not such a bad idea. Our industry does grant discounts and reduced rates for certain factors. We could probably continue to do that for disadvantaged people. So we'll see where it goes. But I think the concerns over Fannie getting out of control, I am not worried about that one anymore at all.

What are the impacts, short-term and long-term, of Fitch downgrading the US credit?

Dr. Bill Conerly's response:

Well, there are two ways to look at it. One is the substance and the other is the announcement of the downgrade. The substance, as you described, worries me. The US has an unsustainable level of spending relative to our federal government borrowing, and let me add that is a bipartisan error. It was true in the Republican administration as it's true in the Democrat administration. But, the Fitch downgrade, they're just sort of saying what everybody else knows. They don't have any information that the rest of us don't have access to. Sometimes a bond agency will downgrade some corporate bond that nobody really follows, and the downgrade makes a sense because hey, nobody's paying attention to the details the rating agency is. But I mean, there are lots of people paying attention to the US government's fiscal details. So I think the Fitch decision, maybe it highlights an issue, but I don't think it will have any impact on the economy or on the Treasury's ability to borrow.

What's the difference between title agencies that have thrived and those who have struggled in this market?

Patrick Stone's response:

Well, it is about managing more specifically the things that you could control. And I do this way too frequently for my wife, but I'm going to share with you. I'm a great believer in the stoic philosopher Epictetus, and he really advocated understanding what you control and what you don't control. Put your time and energy onto things you control. So getting a little bit more specific, if I may, I think everybody should start by making sure they focus on delivering value to their customers. You got to keep your customer relationships going, and you do that by making sure the customers feel like they're getting value. So step up the level of interface, make sure the interface is meaningful and that you are tight with your clients and your prospective clients know that you care, you're interested in what they want and need, and that you'll do everything possible to get there.

Then take advantage of converting fixed costs to variable costs. I mean, this is the biggest one we have in our industry. We have a tremendous amount of fixed costs that you have to analyze and decide, do I really need to pay that or can I outsource that functionality? Make it a variable cost where I'm actually paying for something I need when I actually use it, not paying to have someone sitting there waiting for it to happen. So do a real hard look at all your costs. Look at your fixed cost and your overhead, your back office costs, and then see what you can outsource. And here are things that you can outsource. You can outsource them to us at WFG through our Blocks program. There are other sources out there, but real quickly: document management, office products, rental cars, job placement ads, gifts, outsource printing, personal services like temps, payroll services, information technology, and data security. You can really take a lot of things you do and move them out so that they become a variable cost where you actually incur the cost when you use it, and not have to sit there and maintain that capability to do something that you don't do at a high level. So take a hard look at it.

One thing I also tell people is it's always good to sit down with your P and L (Profit and Loss Statement) when you were doing real well and look what your cost by line item was as a percentage of your revenue. Look at what it is today. Obviously, the percentages are gone up because your revenue's gone down, but some expenses will move out of proportion to others. And then really dig into those expenses. Get really analytical and get really aggressive about eliminating expenses or making them variable and not fixed.

Where do you see oil prices going?

Dr. Bill Conerly's response:

Yeah, right now, I think this morning they were trading at about $89. I think $70 is a fair price on a long-run basis if you don't have a weird short-term issue. And Ukraine-Russia is a weird issue. I wish it were short-term, but if that war ever gets resolved, I think the biggest impact will be oil prices coming down a little bit. But let me also add that oil prices vary largely because it takes a long time to bring new supply online, but it doesn't take very long for demand to go up or down. So we have sort of a slow-moving supply and a fast-moving demand. So it's easy to get demand-supply imbalances. So anybody for whom oil is critical needs to be thinking about a lot of risk. But my best estimate is that say five years from now, we'll probably be in the neighborhood of $70 rather than closer to $90.

Most questions today are on economic uncertainty. Please share the incredible opportunities coming from this uncertain environment we're in.

Patrick Stone's response:

I mentioned earlier, in my opinion, the opportunity is to outshine your competitors with regard to the customer's concept or perception of who you are and what you are about. In my company and our company, WFG National Title, we're a part of our client's process. We say that over and over and over again because we are actually a part of their process. And if we do a good job that makes their process work better, it reflects well on them. They get recommendations, they get referrals, they get more business. And I'm a crude old man, and I say, 'Hey, if you make more money, I make more money.' So I think it's really the one thing you can do is you can really focus on your clients, enabling your clients to do better in the process, you will do better. Bill, you want to address that?

Dr. Bill Conerly's response:

Yeah. I would say it is time to think like an entrepreneur. And we often use entrepreneur as a synonym for small business owner or medium-sized business owner, but that's not really what it is. The great Nobel laureate economist Frederick Hayek said, 'entrepreneurship is about looking for opportunities and seeing opportunities that other people have missed.' So, I think the folks who are not going to benefit from this period of uncertainty are the people who just want to do it the way they've always done it. And whether it's running a business or running a farm. I was on a farm in Iowa a couple of weeks ago and I was amazed. Not done the way my grandfather did farming. And I think that's true of businesses. So I'd say that, look, are there new opportunities that we didn't have before? And that may be a market for selling that you have not sold to before. It may be a way to upgrade sales. It may be a way to lower costs, find better ways to do it. And the key to being a true entrepreneur is looking for opportunities, testing what you think are opportunities, and then implementing those vigorously when you do see the opportunity. And I wish you all good luck in that endeavor.

Closing Remarks from Dr. Bill Conerly and Patrick Stone

Patrick Stone: "Well said, Bill. And I agree with you a hundred percent. Hey, everybody, thank you for your time. We obviously didn't get to all the questions. You can forward questions if you'd like, and we'll try to deal with them and give you good feedback. Really appreciate you attending today and wishing you nothing but the best! Take care, stay healthy and be successful."

Dr. Bill Conerly: "And we'll do it again in another quarter."

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About Patrick Stone

Patrick Stone is Chairman and Founder of Williston Financial Group, the Portland, Oregon-based parent company of several national title insurance and settlement services providers, including WFG Lender Services and WFG National Title Insurance Company. Stone's lengthy career in real estate and related services includes C-level positions with three public companies and serving as a director on two Fortune 500 boards. His senior executive management positions include nine years as president and COO of the nation's largest title insurance company, chairman and co-CEO of a software company, and CEO of a real estate data and information company. Stone also served as vice-chairman of Metrocities Mortgage, a 2005 top-20 mortgage lender, and as chairman of The Stone Group, an Austin, Texas-based tenant-represented brokerage company. In 2013, Inman News named him one of the year's "100 Most Influential People in Real Estate." Stone received HousingWire's coveted Vanguard Award for lifetime career achievement in 2019 and again in 2021, was recognized in 2019 and 2020 as a Lending Luminary by Progress in Lending, and was the recipient of October Research's annual Leadership Award in 2020.

About Dr. Bill Conerly

Bill Conerly has a Ph.D. in economics from Duke University and more than 30 years of experience helping companies adapt to changing economic conditions. He was formerly Senior Vice President at a major bank and held positions in economics and corporate planning at two Fortune 500 corporations. He is also an online contributor to Forbes, chairman of the board of Cascade Policy Institute, and the author of The Flexible Stance: Thriving in a Boom/Bust Economy (2016) and Businomics (2007), a book about economics for business leaders. To subcribe to Conerly's monthly newsletter, visit: https://conerlyconsulting.com/newsletter/