3rd Quarter 2023
ECONOMIC OUTLOOK WEBINAR

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

TALKING POINTS

Dr. Bill Conerly's Opening Commentary Summary

- Recession anticipated to begin early 2024, but it's expected to be milder than average, especially when compared to the 2008-2009 one.
- Despite decreasing inflation, the Federal Reserve continues to maintain high interest rates due to concerns about base inflation.
- Base inflation results from an oversupply of dollars in the economy against our unchanged productive capacity - a situation caused by the early pandemic stimulus measures.
- Transitory elements of inflation, like gasoline prices and used car prices, have decreased, but base inflation remains an issue.
- Dr. Bill Conerly's inflation forecasting model predicts that short-term interest rates won't need to increase much more, with another quarter point move anticipated.
- Short-term interest rates are expected to remain high until mid-2024, after which the Federal Reserve will likely begin cuts.
- Mortgage rates and 10-year treasury security rates, which reflect current and expected short-term rates, are predicted to start decreasing early 2024.
- By the end of 2024, mortgage rates are expected to hover around 5%.
- The predicted recession and Federal Reserve's response mostly impact other parts of the economy, as the real estate sector has already felt the brunt of high interest rates.
- No further significant downturns expected in real estate, but a recovery in transaction volumes is predicted to take a year.

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WFG Chairman and Founder Patrick Stone's Opening Commentary Summary

- Agree with the prediction of a minor recession in the first half of the year, primarily caused by a global economic slowdown.
- The global economy, significantly influenced by US corporations, has more than doubled since 2000, benefiting US economic health.
- The global economic slowdown, especially a deflationary environment in China, will impact the US and contribute to a short, minor recession.
- Unanticipated factors like the banking crisis, debt ceiling debacle, Russia-Ukraine war, and the uncertainty around government funding at the end of September have influenced current economic conditions.
- Despite the current state of the banking industry and media-created crisis, overall banking health remains strong.
- Interest rates haven't dropped due to anxieties resulting from the mentioned factors and the fear of the government not getting funding at the end of September.
- The government's rising debt, currently at $31.7 trillion – a 10x increase over the last 30 years, raises concerns.
- Despite the economic concerns, there remains optimism due to significant disposable income and prospective developments in the real estate sector.
- Real estate prices function differently from what media suggests, with less than 4% being speculative investments.
- The real estate market is likely to benefit from the high desire and need for homes among millennials and Gen Z, despite the current affordability issue due to high mortgage rates.
- Anticipation of a drop in mortgage rates over the next year and the strong demand for homes provides optimism for the real estate business.
- Home sales may be down 14.7% year over year, but minimal and selective price declines, along with other positive indicators like decrease in time on market and high first-time buyer percentages, point towards a healthy demand.
- Future optimism rests on the expectation of a decline in mortgage rates, potentially driving a surge in real estate in the latter part of 2024 and into 2025.

Question and Answer Segment

What key stats do you look at other than CPI (Consumer Price Index) 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 summarized response: Key stats to consider, other than the CPI (Consumer Price Index), when predicting the Fed's next move on rates:

- Gross Domestic Product (GDP) adjusted for inflation
- Four coincident indicators that represent the current state of the economy:
  - Total employment in the economy
  - Industrial production
  - Total business sales, adjusted for inflation
  - Disposable income, excluding transfer payments, adjusted for inflation

- The Fed's decision-making model does not react to every small economic fluctuation. They largely consider base inflation.
- The time one could spend digging into these economic statistics may be more effectively used by focusing on serving clients and enhancing individual productivity. Let economic statisticians handle the complex data analysis.

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

Patrick Stone's summarized response:

- Absolutely not. The worry is overdone, exaggerated, and unnecessary.
- Reasoning: The quality of mortgages originated in the last 13 to 14 years significantly differs from those prior to the Great Recession.
- Evidence: Over the last five years, more than two-thirds of all mortgages have had FICO scores of 760 or higher, indicating extraordinary loan quality.
- Market Condition: The housing credit availability index, product risk, and borrower risk have all seen improvements. Product risk has decreased significantly due to the end of practices such as stated income loans and subprime lending to Wall Street.
- Current State of Mortgages: The mortgage origination market has been tightly controlled since the Great Recession. Less than 1% of homes have negative equity, and over 60% of homes have positive equity above 50%.
- Conclusion: There is no looming issue of foreclosures. There is no cause for concern or loss of sleep.

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 summarized response:

- Stress in commercial real estate debt could impact liquidity and the overall economy.
- Foreclosures on commercial real estate loans might affect bank liquidity and lending.
- Bank failures are possible, they frequently occur during downturns and sometimes randomly even in a strong market.
- Commercial real estate's big picture is not concerning, despite weakness in downtown office buildings. Suburban office spaces, certain retail sectors, industrial and warehouse spaces are doing well.
- Banks with high exposure to downtown high-rise office buildings may face write-downs, but it's unlikely to cause the entire banking industry to contract.
- Community and regional banks that have to take write-downs on real estate portfolios might reduce their lending capacity.
- Banks with high exposure to commercial real estate might cut back on their lending, impacting real estate developers.
- Banks with a diverse portfolio including commercial and industrial loans, and not solely reliant on real estate, may be a better choice for real estate developers.

Patrick Stone's summarized response:

- There's about 1.5 trillion in commercial real estate loans due by the end of 2025. This has sparked a lot of behind-the-scenes discussions on the potential impact on regional banks.
- Despite these concerns, I am not overly worried. Why? Because there's approximately $2 trillion on the sidelines ready to support these loans.
- I am currently involved with a $200 million fund, and we are in talks with seven regional banks.
- Our strategy is to step in and resolve issues when a borrower can't make the payment, by buying the property.
- Geographical and commercial real estate type may impose some limitations, but there's a substantial amount of money ready to acquire assets when commercial borrowers default.
- The real risk, as it seems, lies with regional banks. It remains to be seen how this situation will play out.

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

Patrick Stone's summarized response:

- Not anytime soon.
- We underbuilt in the market over the last 13 years, in my estimate, about 3 million homes.
- The lowest estimate I've seen is 1 million, the highest estimate is 5 million.
- Builders underbuilt due to uncertainty, economic recovery, lack of demand, and fear of misestimating the prices for goods and materials to build a home.
- Current issues: Though these issues have abated somewhat, and builders are increasing their output, new construction will only return to pre-recession levels this year.
- It will take another five years before we see new construction at the level it needs to be.
- When rates come down, there will be more resale activity. People will downsize and relocate, but inventory will remain a problem for the foreseeable future.
- Inventory correction will not happen quickly and we will have to deal with that.
- 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 summarized response:

- The price of insurance acts as a signal about relative value and cost, wrapped in an incentive to minimize that cost.
- High insurance prices in areas prone to natural disasters are the market's way of suggesting the increased risk and cost associated with living in those areas.
- These costs are usually reflected in either homeownership or rental prices, as landlords pass on the associated insurance costs to their tenants.
- In some cases, the insurance markets are not functioning effectively due to excessive controls or federal insurance policies, as seen in California and Florida.
- This distortion in the insurance market leads to more property ownership and construction in high-risk areas, which should ideally be discouraged by a well-functioning system.

- Although insurance costs are a factor in the economy, they are relatively small and not anticipated to lead to economic recession or sluggish 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 summarized response:

- Residential real estate presents a true balance between supply and demand, and this balance influences pricing.
- Federal rate cuts will stimulate demand as they motivate current homeowners to sell and increase builder activity.
- Obstacles such as tariffs and immigration issues have created challenges for builders, but the outlook is increasingly optimistic.
- As federal rates decrease, builders may become more aggressive about new construction, though supply might not precisely match the increased demand.
- The appreciation of single-family homes is anticipated, but it will likely range from 2% to 5% annually, rather than the drastic rates seen during the Great Recession.
- The 24 to 54-year-old portion of the population, which reported a 30-year high in job satisfaction in 2022, is increasing in job participation and holdings, thereby fueling demand.
- While supply will likely not align exactly with demand, home prices are expected to continue increasing at a rate of 2% to 5% annually. Historically, the rate has been 3.6%.

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

Dr. Bill Conerly's summarized response:

- The Chinese economy plays a significant role in the U.S. economic outlook, according to Dr. Bill Conerly.
- China doesn't only manufacture goods for the U.S., but is also a major customer for U.S.-made products, especially on the West Coast.
- Conerly expresses a non-optimistic view of China's economic trajectory, citing President Xi Jinping's focus on political control over economic growth.
- Despite slower growth, expert forecasts suggest China will continue to see growth, not recession - even with a pessimistic forecast predicting 4% annual growth by 2024.
- The slowing growth implies that China's contribution to the U.S. economy will be less substantial than in the past.

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 summarized response:

- Patrick Stone believes that a range of 5% to 5.5% interest rates sustained over time would help achieve a balanced inventory sales ratio in residential real estate.
- He predicts this balance could occur within a three to five year timespan, given consistent rates within this range.
- However, he acknowledges this is contingent on multiple variables, including potential tariffs that could disrupt cost prediction for builders.
- Stone emphasizes the necessity of a stable political environment and consistent mortgage rates to foster predictability for builders, which he considers essential for normalizing the sales ratio.
- In his view, achieving balance requires consistent mortgage rates around 5% to 5.5% and steady political engagement over the next three to five years.

What worldwide event might help ease inflation?

Dr. Bill Conerly's summarized response:

- Dr. Bill Conerly notes that as the U.S. inflation rate has decreased, inflation rates in Europe and Asia have also dropped.
- Asia, however, never experienced the inflation issue to the same degree as North America and Europe.
- Progress is being made in managing global inflation.
- A potential resolution of the Ukraine-Russia conflict could have widespread implications in further reducing global inflation.

Any updates on Fannie Mae not requiring title insurance?

Patrick Stone's summarized response:

- Fannie Mae is no longer considering an alternative product to title insurance, after recognizing the complexity of loss ratios in title insurance and the industry's state-by-state regulation.
- Despite the shift away from an alternative product, they still accept Attorney Opinion Letters, with 45 received last year.

- However, these letters do not cover fraud, which accounts for about 30% of all title losses, creating potential risks for lenders and Fannie Mae.
- Fannie Mae's focus on creating affordable homes by reducing costs is a positive pursuit, and there may be potential for further discounts in the industry for disadvantaged individuals.
- Overall, worries about Fannie Mae moving away from traditional title insurance are no longer a significant concern.

What are the impacts, short-term and long-term, of Fitch downgrading the U.S. credit?

Dr. Bill Conerly's summarized response:

- The impact of Fitch downgrading the U.S. credit can be viewed from two aspects - the substance and the announcement.
- The substance of the downgrade, which highlights the U.S.'s unsustainable level of spending relative to federal government borrowing, is concerning and is a bipartisan issue.
- This excessive spending was prevalent during both Republican and Democrat administrations.
- The announcement of the Fitch downgrade essentially echoes what is already known and doesn't provide new information.
- While bond agency downgrades can often impact lesser-known corporate bonds, the situation is different with the U.S. government, as its fiscal details are widely observed.
- Therefore, while the Fitch downgrade may draw attention to an existing issue, it is unlikely to affect the economy or 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 summarized response:

- Thriving title agencies focus on managing what they can control, a philosophy inspired by stoic philosopher Epictetus, instead of dwelling on uncontrollable factors.
- Successful agencies prioritize delivering value to their customers, maintaining robust relationships through meaningful engagement and demonstrating a genuine interest in their needs.
- They strategically manage costs by converting fixed costs to variable costs. By analyzing their fixed costs, they determine which functions can be outsourced, thus only paying for the services when they are utilized, rather than maintaining a constant financial obligation.

- An array of functions can be outsourced, including document management, office products, job placement ads, gifts, outsource printing, payroll services, information technology, and data security. WFG offers many of these services, as well as others, through its Blocks program.
- In addition to converting fixed costs to variable ones, these agencies continually reevaluate their expenses by comparing current costs to those from more prosperous times. This analysis allows them to identify any disproportionate increases in expenses and work to either eliminate them or make them variable.

Where do you see oil prices going?

Dr. Bill Conerly's summarized response:

- Current trading price of oil is around $89.
- A fair long-term price, without short-term issues, is estimated to be $70.
- The ongoing Ukraine-Russia issue is a significant factor affecting current oil prices.
- Once resolved, the conflict might lead to a slight decrease in oil prices.
- The disparity between the time it takes to adjust supply and demand often leads to imbalances.
- For those heavily reliant on oil, considering the associated risks is critical.
- Predicted oil prices five years from now are speculated to be around $70, not close 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 summarized response:

- Economic uncertainty is a prevalent concern for many today.
- Despite this uncertainty, there are significant opportunities for businesses to shine.
- Patrick Stone believes the key opportunity lies in better serving customers and exceeding their expectations.
- WFG National Title sees themselves as an integral part of their clients' process, and they repeatedly emphasize this.
- By performing well and enhancing their clients' processes, the clients gain more recommendations, referrals, and business.

- Patrick Stone asserts that helping the clients make more money leads to their own company making more money.

- The primary strategy amid uncertainty is to focus on clients, and by helping them succeed, businesses can also succeed.

Dr. Bill Conerly's summarized response:

- The current economic uncertainty presents numerous opportunities.

- Adopting an entrepreneurial mindset is crucial to seize these opportunities.

- Entrepreneurship, according to Nobel laureate economist Frederick Hayek, involves identifying and capitalizing on opportunities that others have overlooked.

- Those likely to struggle during uncertain times are those resistant to change and innovation.

- By way of example for the necessity of change, Conerly observed notable changes in farming methods during a recent visit to an Iowa farm, which were different from the traditional practices he observed in his youth.

- New opportunities may exist in previously untapped markets, improved sales strategies, or cost reduction methods.

- The essence of true entrepreneurship lies in identifying potential opportunities, testing their viability, and implementing them aggressively when found to be valuable.

- Wishing everyone good luck in exploring and leveraging these opportunities.

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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-suite 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 subscribe to Conerly’s monthly newsletter, visit: https://conerlyconsulting.com/newsletter/