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Markets will respond to good data and participants with strong due diligence and analysis will excel - by Brett Pelletier

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Financial markets are based on a fundamental principal of trust. Trust that borrowers will repay loans, depositors will leave their deposits, and contracts are enforceable, and enforced.

Without trust and confidence, things can start to fall apart. First at the seams, then the entire thing begins to unravel. Last year at this time I wrote about catastrophe, crisis, and failure, and our struggle with learning from our mistakes. I've given a lot of thought to it over the year and all things considered, we're okay. But there are red flags if you know where to look. Most major market indexes measured a dip of 5% in two days last week, and I'm not entirely sure why. The cost of construction is up nationwide about 6% over the year with no end in sight. We're not building enough housing to keep up with demand and what we're building is too expensive, and incomes for the middle- to low-income wage earners in the U.S. have been stagnant for nearly 40 years. Bad news.

Over the summer I was at a meeting of the minds, where very sophisticated and very competent real estate practitioners gathered to discuss the market and where we're going. During a Q&A with an economist, a simple question was asked, 'are we headed for a recession?' The response was a very frank 'oh, yes!' I was surprised how many people in the audience were surprised by that answer. The timing and severity and the causes will be debated until the recession is long over, but we've been riding a roller coaster to the top for a long time, and at some point, we need to get back down on the ground.

On September 26, 2018, the Federal Reserve Open Market Committee (FOMC) reported that "the labor market has continued to strengthen and that economic activity has been rising at a strong rate", thus supporting the most recent rate increase from 2.00% to 2.25%. The FOMC commentary suggested that the increase in the target rate is in line with inflation expectations and macroeconomic growth and sustainability patterns. Labor markets have recently shown signs of improvement and inflationary pressures have been generally consistent with expectations and therefore a hike in the rate appears reasonable and consistent with the overall macroeconomic trends within the U.S. Increases in the cost of consumer debt will likely be experienced in the near and mid-terms as mortgage rates, home equity, and automotive loan rates increase, further tightening credit markets and underwriting standards. This all has an impact on the Treasury market and bond yields, as well.

Increases in bond yields start to eat away at the shiny coating of the stock market for some investors and if abnormal volatility continues in the stock market, the bond market is likely to see a push. The current treasury yields are experiencing upward pressure that has had, and may continue to have, an impact on the U.S. stock market. As the bond market becomes more attractive, it could have spillover effects in other commodities and securities markets. As yields increase on more secure fixed income and debt instruments, they become more attractive alternatives to stocks, especially for institutional investors. This flight of capital from stocks to bonds could have a chilling effect on the stock market and increase volatility, especially if upside growth potential is reasonable to assume in the shorter-term bond market, which I think it is. As of October 18, 2018, the U.S. Department of the Treasury reported yields on 10-year treasury bonds of 3.17%, while the 1- and 2-year yields were 2.67% and 2.87%, a spread of only 50 and 30 basis points, respectively; down 6bp and 3bp from 10 days earlier. Many economists and financial professionals have reported that the spreads on the treasury yield curve between short-term (1-2-year) and longer-term (10-year) bonds have been tightening, potentially indicating that the yield curve will flatten and invert. An inversion of the yield curve would show that short-term rates were higher than long-term rates thus historically signaling a more likely possibility of recession.

Do market participants trust each other, the Federal Government, or where interest rates are going? There's a lot of volatility and pressure in the short-term markets that could have an impact on long-term stability and pricing. Let's hope this recent round of inquietude is not indicative of a particularly aggressive correction, if it points to a correction at all. There's a lot going on in the world right now that needs squaring and thoughtful analysis. Markets will respond to good data and participants with strong due diligence and analysis will excel. I welcome the autumn and the holiday season with family and friends to remind me of why we all do what we do. Happy Autumn to you all!

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