Weekly Market Insights

January 13, 2020

An odd week

Given the nature of the events that took place last week, the markets were remarkably sedate. Of course, we are referring to the events surrounding Iran. First, the United States kills perhaps the most important military leader in Iran. Then, in the midst of Iranian mass protests, Iran first denies and then admits to accidentally shooting down a Ukrainian civilian airliner. Iran again erupts in protests, this time against their own leaders. It would not have been out of the question to expect a violent market reaction, but here is what happened.

The DJIA ended the week up 0.65%, the S&P 500 gained 0.94% and the NASDAQ gained 1.75%. This market behavior speaks a lot about either investor confidence or complacency.

Which one?

I think it is confidence. No one really knows what is going to unfold politically either domestically or internationally, so investors are wise to pay close attention to economic releases and, for the most part, they point to a positive 2020. As we have written many times, pay close attention to the consumer, employment, wages and inflation. The first three have a powerful effect on consumption, while the latter gives us a window into the thinking of the Federal Reserve and, therefore, monetary policy. Consumption and monetary policy are two of the most powerful movers of the economy. Job creation, wage growth and consumer confidence remain in very positive territory, while inflation pressures are under control. Are there concerns? Of course. The three that are most prominent are: the manufacturing sector, economic malaise outside the United States, and the upcoming election.

Manufacturing

Manufacturing continues to be a concern. Employment in the sector is weak and industry confidence remains low. It is important to remember that while industrial production has not fallen, employment in the industries has, and that is primarily due to modernization, outsourcing, and Just-In-Time inventory. Also, it is reasonable to think that as personal consumption grows, investment in capital will accelerate.

International

We have written quite a bit about international. So we will be short. Economic growth in the United States is not heavily dependent on the international sector. Yes, it would be much better for the U.S. if both the E.U. and China's economy would perk up but it is not necessary. It is reasonable for investors to keep their aspirations for both the E.U. and China in check.

The Election

While very interesting to watch, it remains way too early to make any serious predictions about the U.S. Presidential election, much less the Democratic primary. These will come into play a bit later in the year. We remain confident in our view that the current 12-month outlook for the U.S. economy is positive, which should bode well for equities.

In our continuing effort to add substance to economic releases, this week we discuss Home Price Indices.

Weekly Market Insights (cont'd)

Home Price Indices: FHFA Home Price Index and the S&P CoreLogic Case-Shiller Home Prices Index

The FHFA Home Price Index and the S&P CoreLogic Case-Shiller Home Price Index are two widely-used proxies for movements in housing prices. Both indices are typically released late in the month and capture price data from two months prior. The indices do not capture prices for new home purchases, as they use the repeat-sales method, tracking the change in price of the same properties over time.

While the FHFA index covers more geographic regions, it only collects data from conforming mortgages—those securitized by Government Sponsored Enterprises such as Fannie Mae and Freddie Mac. As a result, many of the higher-priced home sales and transactions with more volatile sales prices are excluded from the FHFA reading. The S&P Case-Shiller Index, however, captures both conforming and non-conforming mortgage transactions, effectively capturing a larger share of the housing market. The Shiller Index also adds a weighting component to its methodology, so changes in price for more valuable homes impact the index more significantly.[1]

Another weakness of the FHFA index is it does not capture improvements made to the underlying homes. In other words, the index fails to differentiate between price increases resulting from improvements made to the underlying properties or increases in housing demand. The Case-Shiller Index, on the other hand, estimates a constant quality index where these improved homes are specifically excluded. So, the S&P CoreLogic Case-Shiller Index is a better gauge if interested solely in housing demand.[2]

Changes in housing prices can have a significant impact on the economy, as rising home prices have been shown to be positively correlated with increases in consumption.[3] A possible explanation for this relationship is a rise in home prices leads to increases in homeowners' perceived wealth, and consumers who feel wealthier will buy more goods. Homeowners can also use their properties as collateral for loans, and more valuable homes increase consumers' borrowing capacities. Rising home prices may also contribute to growth in inflation and reflect healthy economic growth.

Given the slight differences in methodology, one should view these indices in tandem. The FHFA reading is released on the 22nd this month, with the Case-Shiller Index reading coming in the following week. So, pay attention to the FHFA release, but reserve any conclusions until you have a chance to review both.

[1] Steindel, Charles, *Economic Indicators for Professionals*, (New York. Routledge, 2019), 133-134.
[2] *S&P CoreLogic Case-Shiller Home Price Indices Methodology*, (S&P Dow Jones Indices LLC, 2019), 4.
[3] Picker, Les, "How Do House Prices Affect Consumption?" National Bureau of Economic Research.

Michael Olin Clark | moclark@1919ic.com Ryan Schutte | rshcutte@1919ic.com

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