

Are there cracks in the housing market's foundation?



By Timothy Garvey
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Looking back over time, the housing market has served as an effective barometer of the economy and the business cycle. What drives a strong housing market? Typical factors include household formation, employment, wages, and interest rates. Since the recession ended in 2009, the housing market has been in a sustained uptrend. Interest rates hit their lowest levels ever and have remained below historical levels, and the labor market has improved dramatically. Strong jobs gains and low mortgage rates have helped drive robust home sales and rising home prices.

As we approach the tenth year of the current economic expansion, however, the steady housing market has begun to show some signs of peaking. Over the last several months, the growth rates in both new construction and existing home sales have started to fade. There are both supply and demand dynamics at play here. On the supply side, a consistently insufficient inventory of available properties has forced home prices up; in addition, rapid increases in the costs of building materials such as lumber and copper reduced incentives to build, although those seem to have moderated recently.

On the demand side, incomes haven't kept pace with home prices, making housing less affordable for many first-time buyers. Rising mortgage rates (now at their highest levels since 2011) are also starting to put a damper on home purchases. Record-low birth rates and sharply falling immigration also reduce demand for new homes.

So is now the time to be worried? We recognize the recent housing slowdown, but we don't think it will translate directly into problems across the economy. For one thing, many homeowners are renovating their current homes rather than buying new ones, which still helps fuel economic growth. More broadly, GDP growth remains strong, the job market is robust, wage growth is at its highest since the beginning of the expansion, and consumer confidence is at an 18-year high. Equally important, business investment is rising, and can supplant housing as the primary driver of economic growth in this upcycle. In the months ahead, we believe the U.S. economy has the fortitude to weather the current headwinds in the housing market.

>> PERSPECTIVES ON THE ECONOMY

Prices are rising, so where are those inflation blues?



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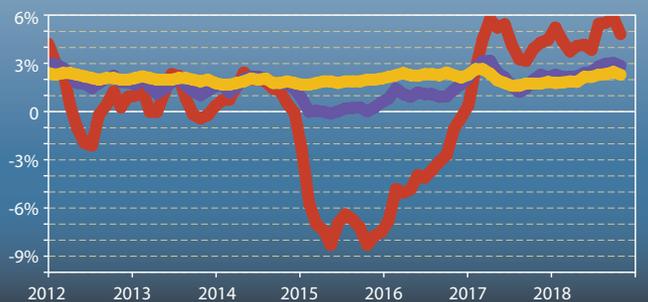
Inflation has begun to heat up again for the first time in a decade. Home prices have been rising at about 6%. Wage growth is nearing 3%, and total compensation (including bonuses, commissions, stock options, etc.) growth has topped 5%. In energy, OPEC's production limits and insufficient American pipeline capacity, combined with high demand, have sent oil from a low of \$26 to over \$70 in two years.

These are all big contributors to the Consumer Price Index, so it's no surprise that the CPI has surpassed the Federal Reserve's target of 2% and may even touch 3%. But unlike B.B. King, the Fed's governors haven't "got those inflation blues." Why not?

One key reason is that there are also some important disinflationary forces at work. Most notably is the "Amazon effect." Prices fall with fewer intermediaries between the manufacturer and the consumer. The relentless focus on cost reduction by large retailers such as Amazon.com and WalMart has clearly led to lower consumer prices across a large portion of the economy.

Another factor is the strength of the U.S. dollar. As the Fed has raised interest rates, the dollar's value has likewise risen against that of other currencies. That means import prices have fallen, which has kept a lid on high-value items such as automobiles and electronics. The dollar's strength is probably sustainable given the Fed's interest rate trajectory, and consequently the inflation rate isn't likely to be a major concern.

U.S. CONSUMER VS. PRODUCER PRICES



While "headline" inflation gauges are rising, "core" inflation remains tame.

>> FOCUS ON EQUITIES

Despite challenges from interest rates and trade, U.S. stocks remain attractive



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Investors who elected to avoid what historically have been considered the stock market's weakest months and instead followed the long-standing adage "sell in May and go away" would not have fared well this year. After an essentially flat first half, over the summer the U.S. stock markets posted their strongest calendar quarter in at least five years, with the S&P 500 finally reaching new record highs.

Stocks have done well despite having had to contend with many challenges this year. The ongoing verbal skirmishes over trade policy — and the imposition of meaningful tariffs — have created concerns of a long and costly trade war; China is the country currently in focus as both sides have ratcheted up the number and value of tariffs. A second challenge has come from the Federal Reserve, which has increased interest rates eight times in the last three years. Rising interest rates always bring fears that the Fed will go too far and hinder economic growth. Adding to these worries are recent reports showing higher input prices and higher labor costs as reported through companies' quarterly earnings.

As investors have surveyed this "wall of worry," the current bull market has slowly become the longest bull market on record. It began in March 2009, and recently surpassed both the 1960s Nifty Fifty and 1990s dot-com bubble eras. The fuel for the current equity market's continued vigor is the corporate tax cut, which resulted in increased earnings expectations for 2018. Through September, corporate earnings growth has surpassed 20%. While the tax cut accounted for half of the EPS growth, sales numbers have also been solid, up nearly 10%. Corporate confidence has improved. Company management teams are increasing both capital spending and hiring, along with buying back shares and raising dividends. Meanwhile, overseas stock markets are struggling as evidence shows their economies have lost some of their momentum.

Overall, fundamentals for the U.S. economy remain strong. Inflation is slightly higher but not enough to cause the Federal Reserve to change its current pace of fed funds rate increases. Valuations are reasonable, the economy remains healthy, and solid earnings growth prospects remain.

>> FOCUS ON FIXED INCOME

What's the bond market telling equity investors?



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Bond markets are conveying mixed messages to investors. The yield curve has flattened, so recession must be coming; yet credit spreads are very narrow, so there's no recession on the horizon. What gives?

Credit spreads, the additional yield earned by corporate debt over Treasury notes of the same maturity, are very tight. This indicates that bond investors are not worried about companies' ability to meet their financial obligations. Boosted by a strong economy and added cash flow from tax reform, companies have fortified their balance sheets and are well equipped to service their debt. Undoubtedly, if signs of a slowdown were imminent or fear of recession present, investors would demand higher interest rates on corporate debt, causing spreads to widen. Tight spreads illustrate that bond investors, at least for now, appear unconcerned.

While a flat yield curve is not bad, an inversion of that curve would be an ominous signpost: Each time this has occurred since WWII, a recession has followed. Why is the yield curve so flat given such a robustly growing economy? U.S. Treasury debt offers higher yields and better stability than debt from any other nation. As foreign capital flows into the 10-year Treasury it dampens the yield and flattens the curve.

On the surface it appears as though we are receiving mixed messages. However the yield curve's flatness is largely due to extraneous factors unrelated to our economy and an inversion is unlikely. Fixed income markets are informing equity investors there is more room to run.

