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WEEKLY ECONOMIC COMMENTARY

IN THIS ISSUE:

- Grandmasters of Trade
- Revival of the Mortgage Market
- The Yen’s Strength Presents Problems for Japan

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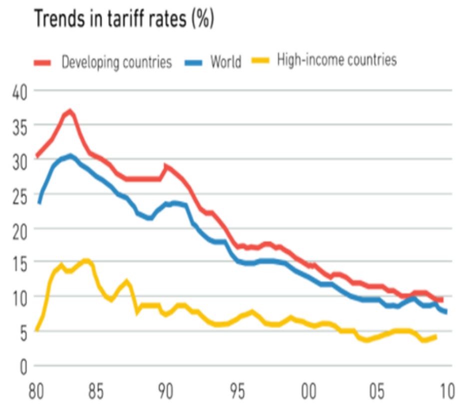
This autumn, an American will have the chance to win the World Chess Championship for the first time in nearly half a century. Fabiano Caruana earned the right to challenge current holder Magnus Carlsen in a qualifying tournament last month.

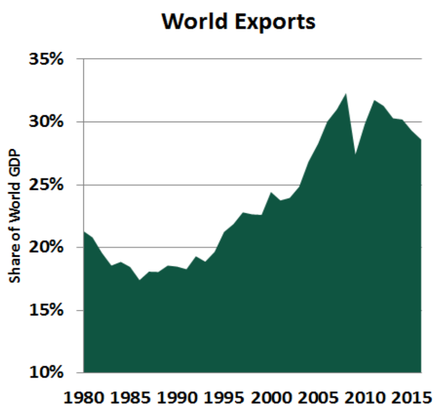
The matches will evoke memories of Reykjavik, 1972: Boris Spassky, the dour chess champion from the Soviet Union, was challenged by Bobby Fischer, the temperamental American *enfant terrible*. The contest was surrounded by political overtones and dogged by controversy. (Fischer, angry over the placement of cameras, forfeited one game.) But the event captured the world’s attention and generated immense enthusiasm for the game.

I was smitten. My father, who was an accomplished player, served as my tutor. He stressed that mastering the movement of pieces was only a first step; anticipating your opponent’s reactions, many steps in advance, was key to success. One should never, ever, telegraph strategy. And sometimes, a draw is not a bad result.

The United States and China are now engaged in thrusts and parries over trade. The actions are controversial, and they have attracted global attention. The stakes, for now, are small, but they could grow over time. Neither side has a clear path to a winning position.

Over the past generation, curtains and walls have fallen and trade channels have opened. Economic defenses have been dismantled to allow the advance of international commerce.





Sources: World Bank, IMF

The global flow of goods and capital has grown geometrically. Developed countries have prospered, and emerging economies have emerged. Wealth has been created, and millions have been lifted out of poverty. But in 2008, global linkages became channels of contagion, transmitting economic misfortune from one country to another. Many countries recovered very slowly, prompting their leaders to contemplate whether being so interconnected was really in the national interest. The number of trade barriers has been moving resolutely upward ever since.

The key ballots of 2016 were a major tipping point, as voters in the United Kingdom and the United States expressed their displeasure with the new world order. Last week, Washington acted on the will of the electorate and sought to redefine trade terms with China.

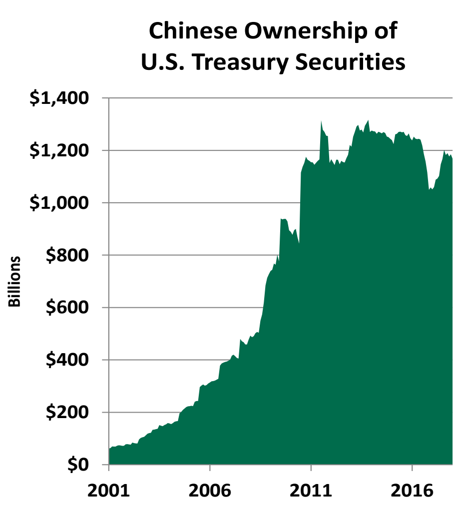
Tariffs in the first round have been carefully targeted.

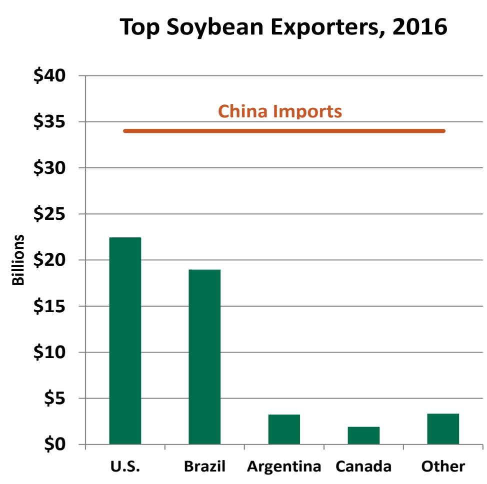
The measures and countermeasures announced recently are at once consequential and inconsequential. The new tariffs cover exactly the same volume of products. Both are strategically aimed at perceived vulnerabilities: the U.S. is targeting technological products, seeking to arrest China's plans for leadership in that sector. China's response focuses on agricultural products; a map of the affected areas corresponds interestingly with the strongest base of support for the president. The consequent market volatility could also shake the resolve of American policy makers.

But the measures aren't as directly worrisome as the headlines might suggest. Each side's tariffs won't become fully binding for a number of months, leaving an opening for negotiations. Total gross domestic product (GDP) for the United States and China totaled more than $31 trillion last year; the new restrictions cover a very small fraction of that sum. It should be noted that the presence of tariffs does not automatically mean imports will shift; that takes time, and some producers will choose to accept lower margins to preserve market share.

But openings aren't last moves. A middle game follows: gambits are pursued, and sacrifices are offered, as each side hopes for an end game where it has a material and territorial advantage. Much depends on where the play progresses from here.

At this early juncture, China appears much better prepared. One gets the sense that it has been planning for this situation ever since the 2016 election. China is better structured to play the long game; a recent castling move provided President Xi Jinping the opportunity to stay as long as he likes. Internal dissent is carefully controlled; you will not see open expressions of concern from business groups. China has immense financial reserves, which can be used to ride out any storms or to apply strategic leverage.





Sources: Bloomberg, OEC

Meanwhile, the Americans have done everything they can to telegraph their strategy. When Peter Navarro was promoted to the post of assistant to the president for trade policy, it was fairly clear what was coming. (Navarro directed a film that gives a clear outline.) Patience may be limited; with expanding national debt, the United States can ill afford an interruption to the current economic expansion. November's midterm elections could diminish the president's support, and further muddy the course of trade strategy.

But in the aggregate, China would seem to have more to lose. Its exports to the United States represent 4% of China's GDP; U.S. exports to China total less than 1% of U.S. GDP. It will be difficult for China to find other sources for all of the soybeans it purchases from the U.S.; the tariffs will therefore raise the prices of tofu and soy sauce paid by Chinese consumers.

Settling before the conflict reaches an endgame would be the best outcome.

It's a pity it has come to this. In classical economics, trade leaves all parties better off. Arguably, its modern expression has delivered on this promise. But the benefits of trade are often subtle, while the consequences for certain populations are all too apparent. Proponents of global commerce have done a poor job of making their case, while antagonists have their elevator speeches down cold.

There a few black and white issues in trade. What is clear is that a prolonged conflict is unwinnable. When those situations arise in chess, the players will confer and agree to end the match on even terms. That might not be a bad outcome for China and the United States.

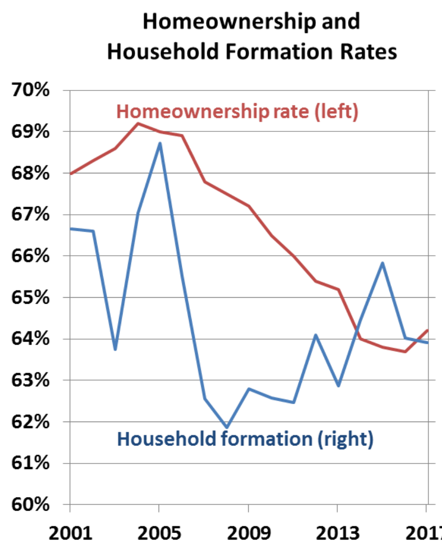
You May Find Yourself in a Beautiful House

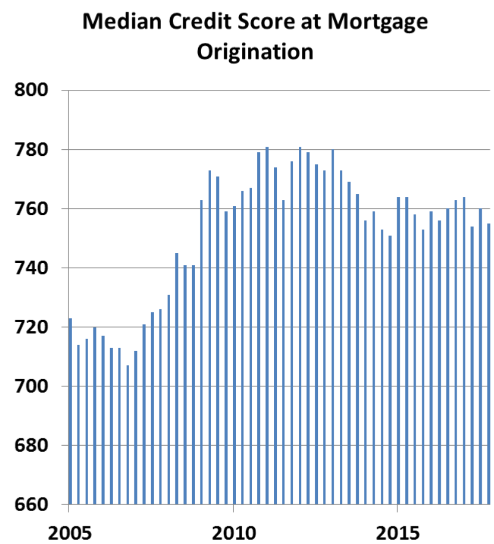
Owning a home is a long-term store of value, preferable to paying rent, and supports stability within a community. It has been an aspiration of generations before us, a common lifetime goal—until the Great Recession. The homeownership rate fell steadily during the course of the current economic cycle, but it has recently started to rise again, a coda to this well-established recovery.

During the economic crisis, as employment levels and home values fell, we witnessed an unprecedented number of homes with mortgage balances greater than the home's value. Some of these loans ended in distressed sales; as the former owner-occupants moved on, the homeownership rate fell. Foreclosures added to the inventory of available homes, but obtaining a mortgage was (and still is) no small feat. Mortgage lenders quickly adopted strict underwriting requirements, forcing borrowers to meet high credit criteria and thoroughly demonstrate their ability to repay the loan.

Departures from homeownership were only part of the equation. The homeownership rate remained depressed as consumers' attitudes toward homeownership changed. Unemployment was elevated for several years; without a steady income, buying a home is a distant dream. Stories of homeowners losing their savings made home purchases look like a gamble, not a safe store of value. Younger workers are more indebted than ever before, especially by student loans. These circumstances did not merely impair the housing market: Household formation fell to low rates as people put off life milestones like marriage and having children.

Years of gradual, painful adjustment are finally yielding greater home ownership. Property values are now ascending, alleviating some of the fear of losing one's life savings in a home that loses value. Established owners who struggled through an interval of negative equity are now able to sell their homes and upgrade, freeing up more entry-level housing stock. Mortgages are still difficult to obtain, but buyers have learned how to demonstrate a positive credit history that allows them to originate a mortgage.





Sources: U.S. Census Bureau, Equifax, Federal Reserve Bank of New York, Haver Analytics

In the depths of the crisis, mortgages were available to only the most creditworthy borrowers. More recently, the median credit score (assigned on a scale of 250-850) of newly originated mortgages has fallen. It now stands at 755 after peaking at over 780. While this score is still relatively high, it shows that more borrowers with more diverse credit histories are attempting to buy homes. Lenders are becoming more accommodating while staying above the risk tolerance that brought about the subprime crisis.

Among consumer loans, the mortgage market has shown the slowest recovery post-recession.

Economic circumstances are enabling home purchases. Employment is strong, and household formation is back to its normal rate. Stereotypes of millennials staying in their parents' basements have faded as job prospects have improved; today's young generation is entering a vibrant job market. Rational actors may see our rising interest rate environment as a reason to purchase sooner, locking in a good interest rate now before it inevitably moves higher.

The Tax Cuts and Jobs Act of 2017 altered some of the tax advantages of home ownership, but we do not believe this will affect the lower end of the market. While mortgage interest and the first $10,000 of property taxes are still deductible, entry-level borrowers will probably take the higher standard deduction now offered. We will monitor changes to the real estate market in light of tax reform.

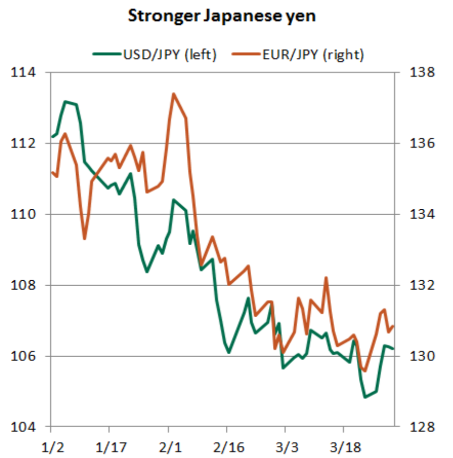
We continue to view homeownership as an important step toward financial security and an investment that improves communities. Buying a home is a milestone we hope more people can achieve, at least once in their lifetimes.

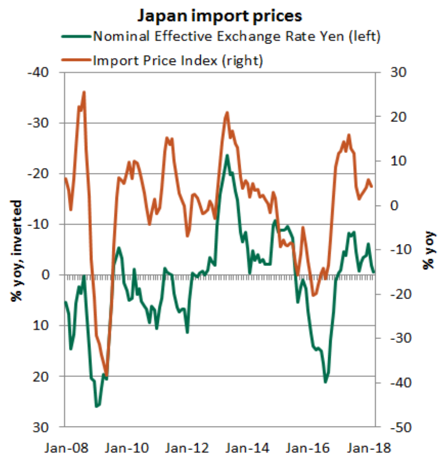
Unwelcome Popularity

A relatively weak economy, low inflation, massive public debt and negative interest rates are not normally the factors associated with a currency that investors run to in times of trouble. But that is exactly the case with Japanese yen, which has appreciated notably this year against the U.S. dollar and the euro.

The confounding status is explained by several factors. Decades of current account surpluses and large holdings of dollar-denominated assets by Japanese investors have positioned the country as the world's largest creditor nation, which provides assurance of its solvency. Two decades of a low interest rate environment have made the yen an ideal currency for carry trades. A recovering domestic economy over the last couple of years has also helped.

There is some risk on the horizon, as Japan has been omitted from the list of countries temporarily exempted from the U.S. steel and aluminum import tariffs. But Japan's steel and aluminum exports account for only around 2% of total exports to the U.S. These are high-value added products which cannot be easily substituted. Hence, the direct impact on Japanese economy will be limited.





Source: Haver Analytics

The BoJ is running out of options to prevent further yen appreciation.

The Bank of Japan (BoJ) is in a catch-22 state of bringing inflation back by ensuring a stronger economy and a weaker yen, but the two typically do not go together. The problems will increase if the stronger yen starts exerting downward pressure on 10-year rates; the BoJ's yield curve control policy would require monetary policy to counteract the movement by selling some of the Japanese government bonds (JGBs) that the BoJ currently owns. But these operations could become ineffective, as the market participants will not be willing to buy JGBs at very low yields.

To head off this situation, the BoJ might consider reducing its JGB purchases preemptively, but this could push the yen higher. Other than "talking down" the yen, policy makers do not seem to have enough options to prevent further appreciation.

Another "risk-off" episode, such as a further escalation of trade friction, would intensify the flight to the "safe haven" yen, hurting Japanese exports and its progress on inflation. While Japan has been an innocent bystander in the recent trade battles, it has nonetheless been importantly affected.

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