CW 813- Frances Donald- Optimistic Investor Sentiment, John Hancock, Manulife Asset Mgmt.

Jason: Hey listeners from around the world. This is your host Jason Hartman. Thank you so much for joining me today. I appreciate having you, as always and I hope you enjoyed that last episode from Monday where we did the success secrets from the Venture Alliance where you got to be a fly on the wall, you know like bugging the room. And soon, with technology being what it is, we have lots of flies spying on us. We know that our Internet service providers are now going to be spying on us and selling our data so that more companies can advertise to us—just what we need, right? Wow. It's an amazing time to be alive as I always say but it's not without its challenges.

Also, I hope you enjoyed Friday's flashback Friday episode with Ellen Brown, she's the author of Web of Debt and several other books. She's got some interesting thoughts about things and we played that as a flashback Friday episode, pretty interesting, so don't miss those as well. But hey, we've got a treat for you today. We've got a good guest. I just recorded this interview. It's hot off the press. I put it to the front of the line because I thought it was very topical. I thought you should hear it right away. It's Frances Donald. She's a senior economist with Manulife. They do a lot of surveys on the economy and so forth and she's here to bring us good news. She's got some pretty good stuff to say. I think you'll like it. It's pretty new ground, you know I felt like in this interview finally I got some new stuff to talk about, some truly new stuff so we'll talk about that. She covers home ownership and it's relationship to GDP historically and just a lot of interesting stuff. I think you'll really enjoy this interview and it is a pretty amazing time to be a real estate investor so keep that in mind. You know, on our Memphis property tour and Creating Wealth seminar last weekend every property just sold. We had some investors that came early. They arrived on Thursday so they could scoop up some properties before anybody else got a shot at them and the properties are just flying off the shelves. You've heard me talk about it enough, about the lack of inventory and those challenges and it is very, very prescient so gobble up the properties when you can, while you can because the deals are still very good. The direction is pointing more and more toward an inventory shortage as we go along. So without further ado, let's jump in and listen to this interview that I just did a few moments ago with Frances Donald. I think you'll like what she has to say. Be sure to visit jasonhartman.com for all of the great resources there and also realestatetools.com for some software that can help you with the real estate investing business. Here we go with Frances Donald.

Jason: It's my pleasure to welcome Frances Donald to the show. She is a Senior Economist at Manulife Asset Management and she is here bringing us good news about the economy, I think. I'll let her tell you directly. Frances, welcome. How are you?

Frances: I'm doing well. How are you?

Jason: Good, good. So, obviously, a lot is changing. There's a lot of optimism out there. The Trump administration promises to loosen regulations to control the border, to bring jobs back to America, what are your thoughts?

Frances: Well, it seems like the US economy is pushing off the dock. There are signs that growth is reaccelerating and the seeds of this acceleration probably began in July of 2016. The consumer is looking strong, business investment intentions are rising, exports are looking stronger and the pain felt in the US economy from too strong of a US dollar and falling oil prices now seems to be subsiding so in the next six months or so I would say I have a positive outlook for the US economy.

Jason: Okay. Good stuff. You do regular investment sentiment surveys. What are those telling us?

Frances: Right. So the John Hancock, which we're affiliated, does run an investment sentiment survey. It's a poll of affluent investors and what we found is that investors are certainly more optimistic this year relative to a year ago so the investor sentiment survey rose about ten points over last year. That's the highest level in two years and when we ask investors what is making you so optimistic about the future, they come back by saying it's the stability and strong performance of the stock market. I have to say, however, when scanning the results of the survey, it is clear that there's a lot more optimism about the US economy in general.

Jason: So, the stock market and the economy, do they go in lock-step or can you differentiate them a little bit.

Frances: They certainly don't always go in lock-step. One of the differentiators is that the stock market tends to price in what's going to happen to the economy pretty far in advance so one of the things we see now is the expectation that policies out of Washington will translate into better economic growth and that economic growth is not here just yet but the stock market has chosen to price it in so the downside risk is that you don't necessarily get that upside growth and the stock market needs to correct.

Jason: Of course, the stock market is always a window into the future, if you will because that's exactly what it reflects, is expectations for the future. How far out does the stock market price things in? You know, is it generally thought to be months, two years, what's sort of the time horizon there.

Frances: Well our rules are generally about six months ahead. The stock market has a good sense of where the economy will be six months from now although what we do tend to see is that a ? of economic news that hits, the stock market can price it in almost instantly. I mean we saw that when Donald Trump was elected, within 24-hours the stock market had priced in many of his policies.

Jason: Very interesting. So, talking about Trump policies and so forth, what do you think we can expect? I mean, is this all kind of like a Trump bull run or does Trump not deserve credit for what's going on?

Frances: Well I am certainly no political expert. I just look at hard data but what's clear when we're adjusting our forecast looking forward into 2017, 2018, number one we haven't made any changes to our forecast because we haven't had any actual policy announcements. As of right now, everything is a hypothetical and you'll find that central banks follow that same convention as well. Don't price anything in, don't incorporate it until we know for sure. But essentially there's three areas where we're paying a little bit more attention that could alter the forecast and these are probably where the stock market is most focused as well as the bond market, the first one is deregulation and the potential deregulation has to lift certain sectors and to put more money back into the economy. The second is tax cuts, which always tend to be good for growth. The third might be the most important and that's the expectation of infrastructure spending moving forward so the potential for these three elements to move forward or not is probably the top of most financial markets—stocks, bonds and others at this point.

Jason: What are your thoughts on real estate? Especially the housing sector?

Frances: I generally like real estate and one of the reason is because residential investment is a shared PDP; it's still very depressed by historical standards so there's room for more construction spending in housing. House prices have been growing about five percent every year, that's stable, that's sustainable—that's kind of healthy house price appreciation. The challenge for housing is that interest rates are moving up and that does tend to correlate with fewer mortgage applications and a downturn. My sense, however, is there's still enough pent up demand to compensate for higher interest rates in the system while we might see some temporary softness there's room to run in housing.

Jason: Right, and the problem with that is when you say five percent, of course, we're taking into account the three basic types of real estate markets, the linear markets and the cyclical markets and the hybrid markets. And the cyclical markets I mean prices have shot up far more than that. It's really well in the bubble territory I would say in some of those markets, but the problem with that is just as it's way out of whack with fundamentals in Los Angeles, San Francisco, Miami, Boston, New York, etcetera, etcetera, all those type of cyclical markets—I mean it can't go on for another two or three years. That's the problem with that.

Frances: Exactly. We've seen that in several housing markets, Canada is a very good example. People have been trying to short the housing market in Canada since 2012 saying it's overvalued but sometimes it can become overvalued. You point is a salient one which is that we tend to talk about housing on a national level but frankly there are really regionalized housing markets that demand particular attention. There's also tiers of housing. In the past particularly following the financial crisis we would look at Tier 1, Tier 2, Tier 3 types housing and that is to say Tier 1 being the larger, the more expensive homes, they suffered less in the crisis than the cheaper homes. Now, only recently have we been talking to people who see themselves as coming out of being underwater. There's still a lot healing happening in the housing market in certain regions in the country so I certainly take your point that talking on a national level can be dangerous but

when we're aggregating up to the forecasts and what it means for Wall Street, those national numbers are what's going to be presented.

Jason: Well, there's an old saying in real estate, "all real estate is local" so I completely agree with you on that statement. In a country as large and diverse as the US, you have about 400 real estate markets and I believe, as I've been saying for so many years, they can be categorized into one of three types: linear, cyclical and hybrid and that, you know, simplifies an analysis of it, I think. But it's interesting, Frances, and I wonder if this is meaningful or if it's just sort of an anecdotal thing, I've been saying ever since the election Donald Trump is our first real estate president, you know, he's a real estate guy, you know you might be thinking of him from The Apprentice but real estate is like in his blood, his father was a real estate developer and he's obviously done incredible things in real estate, love him or hate him, does that mean anything to the real estate market? He's as I say it our first real estate president.

Frances: Well the way I look at it we're seeing a president that's unlike those we've had in the past and falling in lockstep with that we've seen unprecedented rise in consumer sentiment and small business sentiment and CEO sentiment so you could probably segment that into real estate and other sectors but what we're seeing is the expectation among business owners, among investors and consumers of a more favorable environment moving forward. Now, as I mentioned earlier, all of these remain hypothetical so there's a downside risk to these confidence metrics but even at the margin, if a small company is feeling a little better about their future prospects even if they hire one additional person, the real estate sector feels just a little bit more optimistic about a certain investment. That can have a self-fulling prophecy as well.

Jason: That's a very good point. Now you said earlier, Frances, you talked about how by historical standards, real estate, you were talking about development maybe, real estate was still at a relatively small proportion of the overall GPD, can you give us any numbers on that or just a sense of the scale on that in terms of where we are now versus where we have been historically?

Frances: The best way to think about it is that residential investment as a share of GDP is still running about one standard deviation along the long-term average. Following the financial crisis, housing peaked around 6.5-7 percent. The total economy tanked to about 2.5-3 percent if I'm not mistaken. It's really having trouble coming back into play so, you know, the caveat to that is we often say, I remember in 2007 it was very common to hear, there's no way that housing could cause a financial crisis. It's only six percent of the economy. Well, we learned from there that there are all sorts of tentacles that run from real estate, but in terms of sheer construction activity, in terms of investment in residential activity, it is still at depressed levels.

Jason: And one thing, this is something predicted many, many years ago, I was telling people, you know, our clients and talking at my live conferences and so forth, I was saying that there was going to be a real estate market in southern California in 2003-2004 and into 2005 and people were arguing with me and I'd get in these huge arguments with Realtors, and one of the reasons I knew that was coming is not because of the financial crisis, if you will, and all of the games and

tricks that Wall Street was playing but it seems the way we're packaging loans we all learned a whole bunch of, well maybe not you, but the rest of us learned a whole bunch of acronyms after the—

Frances: Oh no, we did, we did too. We learned to gather data, we learned data we didn't even know we should be gathering. Certainly, even the experts were caught off-guard.

Jason: Yeah, yeah. But my point in saying that, so that's good to know. It makes me feel a little better. But my point in saying that was I didn't know that the mortgage lending was way too liberal. You know, I knew that a lot of people got three one-arms, five one- arms, at certain points in the year 2000 or so and then 2002 there were big swaths of those loans that were made and you knew there would be adjustments three to five years later, right. That was in hindsight, kind of pretty easy to see and predict but one of the things I really want to caution people about, you mention construction and the tentacles the real estate market has, so yeah, it's six percent of GDP but it's so important to politicians because every time someone buys a home, I remember years ago when, and I'm sure this is higher now adjusted for inflation if not for real dollars versus nominal but at least in nominal dollars that on average they spend at least $15,000 more on other stuff—appliances, organizers, gardening, whatever they spend it on, right? There's all these add-on effects, right?

Frances: Yes, that's definitely consistent with what we've seen and one of the challenges is that because we're seeing depressed home ownership rates and there's a lot of reasons for that, we see more rental market, well there's fewer multipliers to grow from a rental market than there are from a housing market. People are not so excited to tear down walls in their rentals or invest in the garden out in front, so that's a longer term concern that probably weighs on the multiplier effects in housing and something economists have been watching very closely.

Jason: Yeah, that's a good point. Just to finish my thought there and then I have a question about that. I would say that you need to be especially in areas, and I saw this happening in southern California. I knew this would be like the double whammy. It's because when the housing market softened a lot, all that construction would go away and there were so many construction workers and so much investment in construction that that was like another… you know, it was a one-two punch and too much of the economy was based on all of this construction and then to make it even worse, in Orange County, California, where I was at the time, you hit ground zero for the mortgage industry. So all those mortgage people too became unemployed or under-employed. Yeah, it was like a one-two-three really but when you mention the multiplier effect and I totally agree with you that it happens in housing and this is why the government and central bankers all want to pump money into housing and support housing any way they can. They're really fans of real estate because of that multiplier effect that you get out of it. But, if more people rent, and I'm one of these weird people that probably a lot of people disagree with me, I think the home ownership rate should actually be lower. You know, I don't think we should have a 69 percent or even a 62 percent home ownership rate. I think it should be about 55 percent but whatever you can debate that all you want, but doesn't that money go somewhere else, I mean, because

someone didn't buy a house and they chose to rent instead and certainly the rental market strengthened and investors benefited from better cash flow on rental properties as the rental market strengthened, doesn't the money go somewhere else? They don't spend it, or use it or invest it, right?

Frances: Well, it depends on what the drivers of rental are. It seems right now that there's a few drivers for rentals, one is before 2007-2008 there was a common conception about how the prices always went up and how housing was the best investment you could make and that's dissipated so preferences have changed and there are fewer who want to go into housing but there's also the ongoing issue of those who can't get into housing and in part that's fueled by incomes not rising in real terms as quickly as they should be and it's also fueled by very high student loans that cap the amount of mortgages that young people can get into so it's not necessarily that you're making the choice you could afford either and you chose rentals and put that other money toward something else. A lot of it being unable or unwilling to access the housing market. The other element I see here is we've seen higher demands for rentals. The average mortgage price and the average rental price are actually floating about the same. That's atypical. That doesn't usually happen, so it's not like we're seeing $100 per month savings from those who are currently in the rental, but I think your point is a good one, which is what is the optimal home ownership rate and we do see it lower in Europe and higher in places where the preconception of real estate being a great investment is still prevalent, like Australia or Canada that hasn't seen real estate collapses and have that view that the best thing you can do with your last dollar is put it in your house. Americans have to learn that that's not always the case. I don't think that's a cyclical issue. I think that's going to permeate for many decades.

Jason: And I think that's a good thing, you know, being a real estate guy. It's counterintuitive that I would say that but I think that is a good thing that they think that. But, tell us more about the atypical nature just mentioned of rents and mortgage payments being about the same. What is the historical thought on that versus how it's atypical now to be about the same?

Frances: Well, typically what happens, and it makes a lot of sense, is that as housing prices go up, people can't afford to get into housing so they go into rentals. Then rental prices go up and there's less demand for housing and they sort of work in opposite directions, what we call a healthy rent versus buy environment but we're seeing now it's taking a very long time for banks to open up their pocketbook, millennials are choosing to stay at home much later than they have in the past and the student loan issue really eliminating the amount of debt that young people are willing or able to take on. This natural relationship of going back between housing and rental is in my view, right now broken and it won't be fixed until we see student loan numbers come down so that young people aren't carrying several hundred thousand dollars of debt by the time they want a mortgage and it won't be fixed until we go back to the environment for banks to be willing to open up liberally and provide mortgage loans to young people.

Jason: I was going to ask you about that when you mentioned it before and listen I just rail on these universities and the whole student loan debt complex. It's a complete scam. It makes me

very angry. You know, it's like these millennials that, Gen Y generation, they all have a mortgage, they just didn't get a house with it so it's ridiculous what they're going through and what they're saddled with, but even if you pay a student loan and you have to because it's the only type of financing that's not dischargeable in bankruptcy so they are literally indentured servants, they are slaves, they are debt slaves, and those loans probably won't be discharged. If Obama couldn't do it certainly Trump probably not going to do it. They're going to pay those loans, but someone is getting that money, right? You know, there's a finance company, there's the university so that money does flow and it has a multiplier, right?

Frances: Well, I would expect it to have probably a low multiplier compared to where that money could go elsewhere, so you asked me earlier where's the extra money coming from, those who are renting over buying, well, I would say where's the money not going if you're spending $250-350 a month and sending it to the student loan payments, that historically would have gone into saving for a down payment either for a home or buying a car or having children younger so you don't see the fertility rate dropping in the past as much as it has now, so multiplier effects for things that would have been traditionally used for that several hundred dollars are much larger but I think most importantly, and these questions you're asking are so salient, is our models for looking at the worlds in the 80s, 90s and early 2000s do not function in the current environment because the entire spending appetite and needs of today's consumer have radically changed over the last 15 years so we cannot use the same models that we used in the past to look forward to the future and the same for the rent versus buy equation, we can't think of it the same way as we have in the past.

Jason: I agree with you. It's quite interesting. So the downside of a lower home ownership rate and a higher rental population rate is you don't get the multiplier. Let's say we agree on that although I do think you get some multiplier, you just don't get as much. The real reason you don't get a multiplier is you have an anemic job market and wages have stagnated in real dollars for decades now and that'll change under Trump. Well, that's a good question for you. Do you think that will change under Trump? Look, he wants to stop the ability to bring in low cost labor from south of the border, he wants to have more protectionist trade policy—that'll bring jobs back to the US, I believe it will. I believe both of those will. Those both look like wage growth to me. He won the Rust Belt. That's surprising that a Republican, although Trump is sort of not even a Republican, he's just kind of a different kind of character completely, but a Democrat did not win the Rust Belt, which was an amazing thing, so people have realized that the Democratic Party, even though they talk about supporting them, they haven't really brought home any results. And so these blue collar workers, I think they're going to prosper under a Trump administration. Do you agree or disagree with that and are we going to see some wage growth? Because that's really what we need to have a multipliers wage growth, right?

Frances: Wage growth in my view is very difficult for federal governments to actually make any sizable change to with the exception of increasing minimum wages which does have the effect of pushing all wages higher to a certain extent. Wage growth at the end of the day is going to come down to supply and demand of labor and the United States right now has a very tight labor

market, the unemployment rate about 4.7 percent, it'd be hard to get that unemployment rate much more lower than that. Maybe we can getb 4.4 or 4.2…

Jason: Which means wages will go up, just by supply and demand, right?

Frances: It should mean that wages go higher. There are, however, some structural issues that are weighing on total wages and one of them is as simple as demographics and that is that we have an older segment of our population that is retiring. The way it works is the older you are, the more money you make or that's the idea we've all been fed. Well, the people at the top end of that wage curve are getting out of the labor force and being replaced by younger people so that has the effect of suppressing wages across the entire country and that's very, very difficult for any government to come in an improve upon.

Jason: Well, and so I would say to you, look at Japan. There's a good example of a huge demographic. But that's not abnormal, granted the size of it might be different, that baby boomer demographic, that cohort is a very large one but Gen X, my generation, is very small and then Gen Y's very big again so that always happens. This is not new.

Frances: So you mention Japan. Japan actually has some of the lowest wage growth in the developed world and policy makers have found it impossible to see nominal wages rise in large part because of the demographics, among others. And one additional disadvantage that Japan has over the United States is that Japan has extremely strong companies and unions and these unions limit the ability of companies to raise wages… but companies in Japan never want to raise wages too much because they can never cut wages so the wage rigidity in Japan that is not present in the United States. The United States has a much more free market of wages. But I wouldn't downplay the structural impacts are having a pronounced impact on the ability for US wages to continue to rise. Now I will say they're not stagnated right now. Wages in the United States are growing 2.8-3 percent. That's nothing to sneeze at and it does correspond with a very low unemployment rate. It's just that if inflation is growing at two percent then when you adjust for inflation you're not left with too sizable a leftover. To say that we haven't seen any wage growth in this cycle is based on is false.

Jason: Very interesting. Frances, I really appreciate your insights into a lot of this stuff. Please give out your website and if you want to share any resources where people can maybe see some of your sentiment report or anything, feel free.

Frances: Sure. You can head to JohnHancock.com, we have a lot of information posted there and you can always follow me on Twitter at FrancesDonald. I post all sorts of things related to the US and global economy.

Jason: Fantastic. Frances Donald, thank you so much for joining us.

Frances: Thank you.