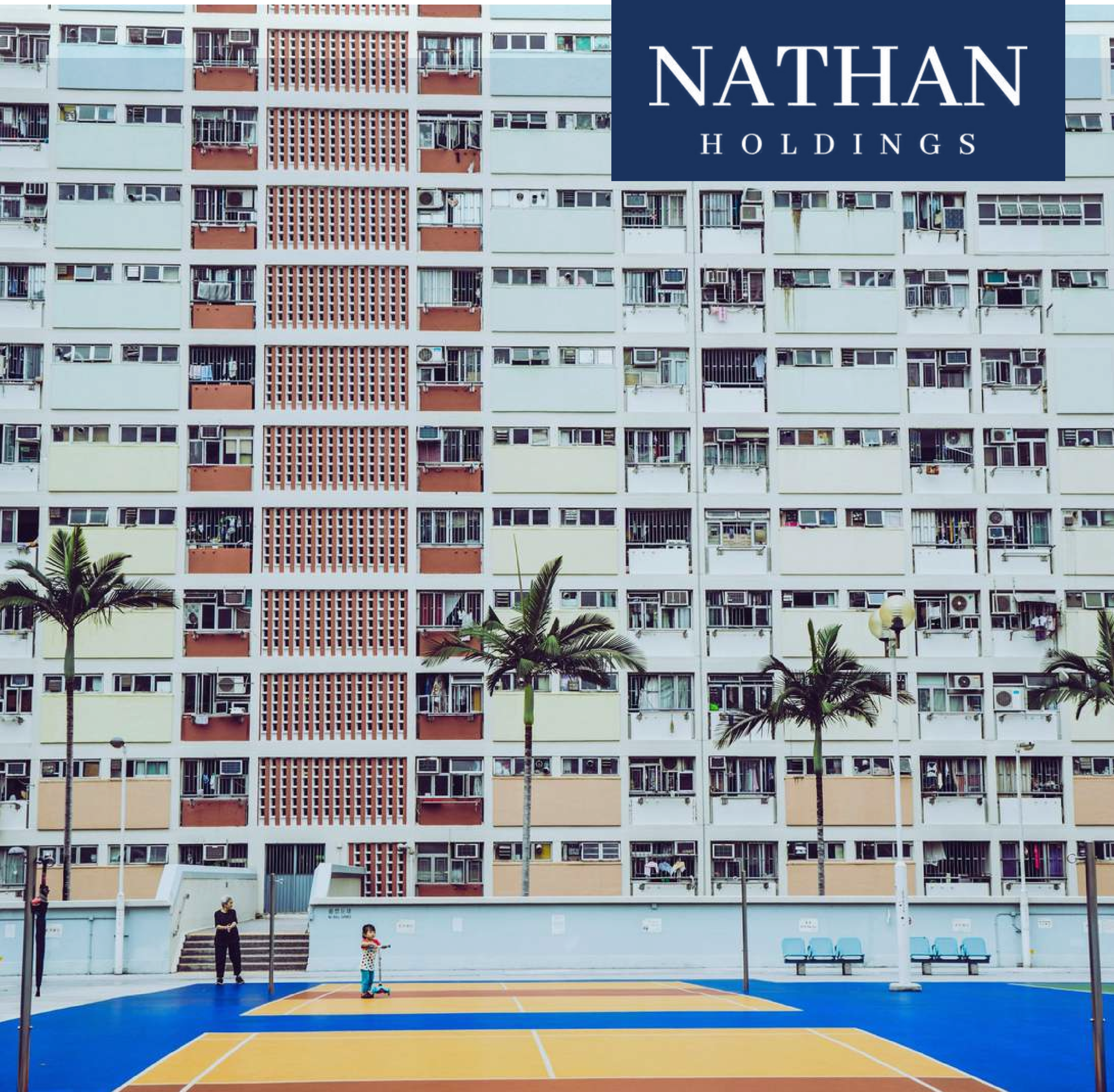
ECONOMIC SPOTLIGHT|SEP 2021

RENT INFLATION

TRANSITIONARY OR IT IS HERE TO STAY?

NATHAN
HOLDINGS



INFLATION EXCEPTIONS VARY WIDELY

As the economy recovers momentum following its pandemic-induced slowdown, attention has turned to speculation about the soaring inflation rate in the United States. However, expert opinions differ on whether the current high inflation is transitory or will have far longer-lasting effects.

Although the Federal Reserve has referred to the current 5% inflation as “transitory,” it has shied away from defining just how transitory the situation might be. Notes reveal that the Fed generally expects to see elevated inflation for the remainder of the year, with it moderating as we enter 2022. However not all Fed policymakers are as confident, with some anticipating that inflation may linger further into 2022.

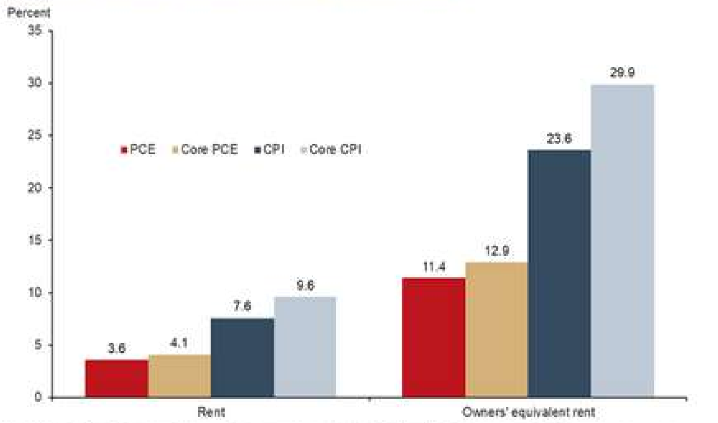
At Nathan Holdings, we expect persistent rent inflation due to rising home prices, construction costs, and the continuing moratorium on evictions. Houses currently appear to be in short supply – a condition that seems likely to endure due to changes in resident lifestyles, longer construction times, and the substantial disincentive presented in the form of rapidly rising construction prices. (The producer price index has skyrocketed since January 2020, with a 20% increase.)

That said, we acknowledge that the bulk of the current price increase can indeed be defined as “transitory” due to a base effect, as well as the supply chain bottleneck resulting from the high economic activity stirred up by the easing of pandemic-related restrictions worldwide.

A CLOSER LOOK AT THE RISING COST

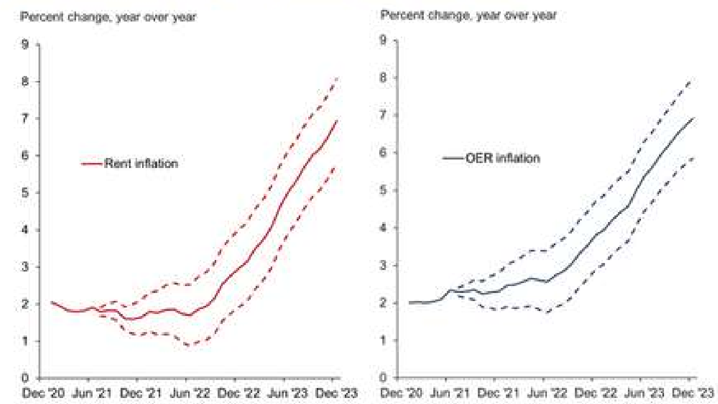
Shelter is the single largest component of the consumer price index. Via their impact on rents, higher house prices affect inflation, but with a lag. We may see some persistence in “rent” inflation due to limited housing supply in the near future. The year-long eviction moratorium (recently extended by the Biden administration) and suppression of rent payments also contribute to this outcome, as landlords have borne a disproportionate economic burden. So, there will be significant upward pressure on rents, which will only accelerate now, when the eviction moratorium is finally lifted.

Chart 1
Weights of Rent, Owners' Equivalent Rent in Major Price Indexes



NOTES: PCE refers to the personal consumption expenditures price index; CPI refers to the Consumer Price Index. Core measures exclude food and energy.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics.
Federal Reserve Bank of Dallas

Chart 4
Inflation Forecasts for Rent, OER Indicate Steadily Rising Rates



NOTES: Forecasts are based on authors' estimation of a vector autoregressive model. Solid lines show actual inflation rates (before July 2021) and point forecasts (from July 2021 onward); dashed lines indicate 90 percent prediction intervals.
SOURCES: Authors' estimates based on data from the Bureau of Economic Analysis and Zillow.
Federal Reserve Bank of Dallas

New research from economists at the Federal Reserve Bank of Dallas has backed our opinion, with their report entitled, “Surging House Prices Expected to Propel Rent Increases, Push Up Inflation.”

The report stated that “Historically, house price growth (expressed as a 12-month growth rate) has led rent inflation and OER inflation by somewhat less than two years. This calculation reveals that current house price growth is most strongly correlated with rent inflation 18 months later, with the correlation coefficient reaching 0.74 at its peak.”

It continued: “Rent inflation is expected to increase from 1.9 percent in June 2021 to 3.0 percent at year-end 2022 and to 6.9 percent at year-end 2023. The predicted path of OER inflation is higher for 2021 and 2022. OER inflation is expected to rise from 2.3 percent in June 2021 to 3.8 percent by year-end 2022 and to 6.9 percent by year-end 2023. The rates of the increase reached in late 2023 for rents and OER would be the highest in more than 30 years. CPI data yield similar results.”

The report then added, “Given their weights in the core PCE price index (which excludes food and energy), rent and OER together are expected to contribute about 0.6 percentage points to 12-month core PCE inflation for 2022 and about 1.2 percentage points for 2023. These forecasts also suggest that rising inflation for rent and OER could push the overall and core PCE inflation rates above 2 percent in 2023, when current supply bottlenecks and labor shortages may have subsided.”

WHERE IS THE PRICE RISING?

In June, the National Federation of Independent Business (NFIB), found that 47% of small business owners are raising their average selling prices, the highest reading since January 1981, at the tail-end of the Great Inflation of the 1970s.

Price hikes were most frequent in wholesale (82% higher, 4% lower), retail (63% higher, 1% lower), and manufacturing (62% higher, 5% lower). Seasonally adjusted, a net 44% plan price hikes (up 1 point). The NFIB report concludes, “The incidence of price hikes on Main Street is clearly on the rise as owners pass on rising labor and operating costs to their customers.”

WHY PRICES ARE RISING?

THE FEDERAL RESERVE HAS HIGHLIGHTED TWO MAIN CULPRITS FOR THIS CURRENT RISE IN PRICES: SUPPLY SHORTAGE & HIRING DIFFICULTIES.

SUPPLY SHORTAGE

Due to the supply chain bottleneck mentioned above, the prices for many goods and products have risen significantly. For example, in May, lumber (LBS) reflected a massive 461% increase over the past year. However, lumber prices have begun to fall, and as of mid-August are only 20% up on their pre-pandemic price, at the end of January 2020. This data may support the Fed's position that current inflation will mostly be short-lived.

In terms of shelter, which makes up nearly one-third of the CPI, prices increased 0.5% for the month, and are now 2.6% up on the June 2020 figures.

"What this really shows is inflation pressures remain more acute than appreciated and are going to be with us for a longer period," said Sarah House, senior economist for Wells Fargo's Corporate and Investment Bank. "We are seeing areas where there's going to be ongoing inflation pressure even after we get past some of those acute price hikes in a handful of sectors."

Returning to the lagging effect of higher house prices on inflation, a paper by Fannie Mae suggests that CPI components for rents tend to follow the Case-Shiller price index, with a delay of about five quarters. Eric Brescia, an economist at Fannie Mae, has drawn the following conclusions:

Due to how shelter costs are measured, the housing components of the indices decelerated considerably over the past year, despite robust home price appreciation.
This has kept topline inflation from being even higher.

Lagged effects from the past year's house price appreciation and more recent rent recovery could begin to flow into inflation measures as soon as the May readings.

House price gains to date suggest an eventual acceleration in shelter inflation from the current rate of 2.0 percent annualized to about 4.5 percent. If house price growth continues at the current pace, shelter inflation would likely move even higher.

Timing lags suggest that increasing shelter inflation will last through at least 2022, meaning "transitory" increases to the overall inflation rate may be more prolonged than many expect.

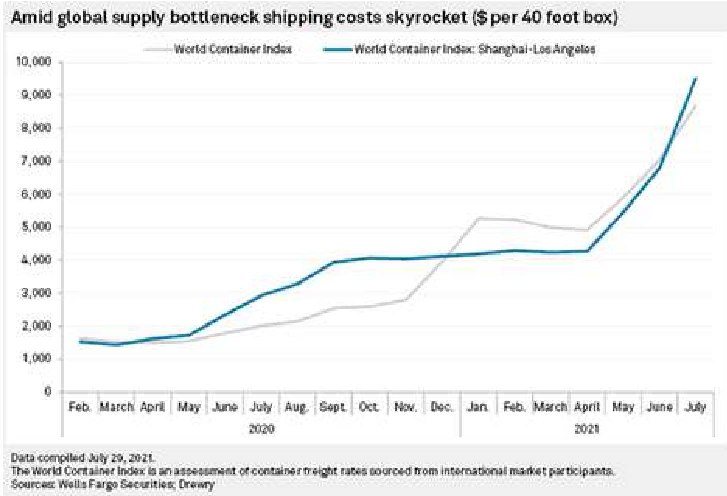
Due to the heavyweight given to shelter, housing could contribute more than two percentage points to core CPI inflation by the end of 2022 and about one percentage point to the core PCE. Both would be the most substantial contributions since 1990.

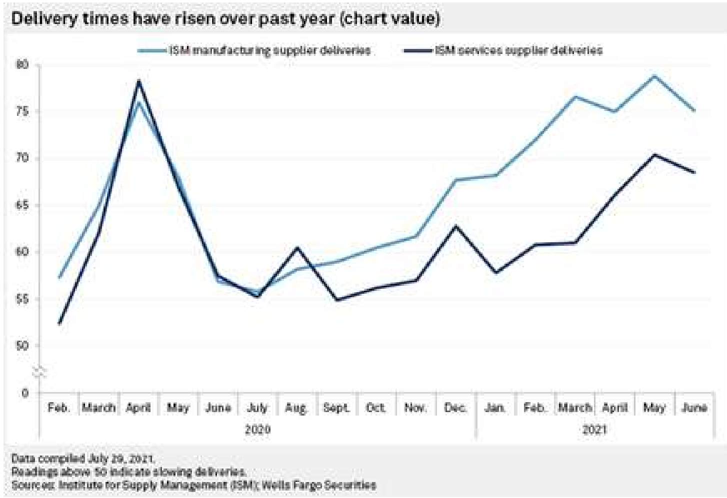
SUPPLY SHORTAGE

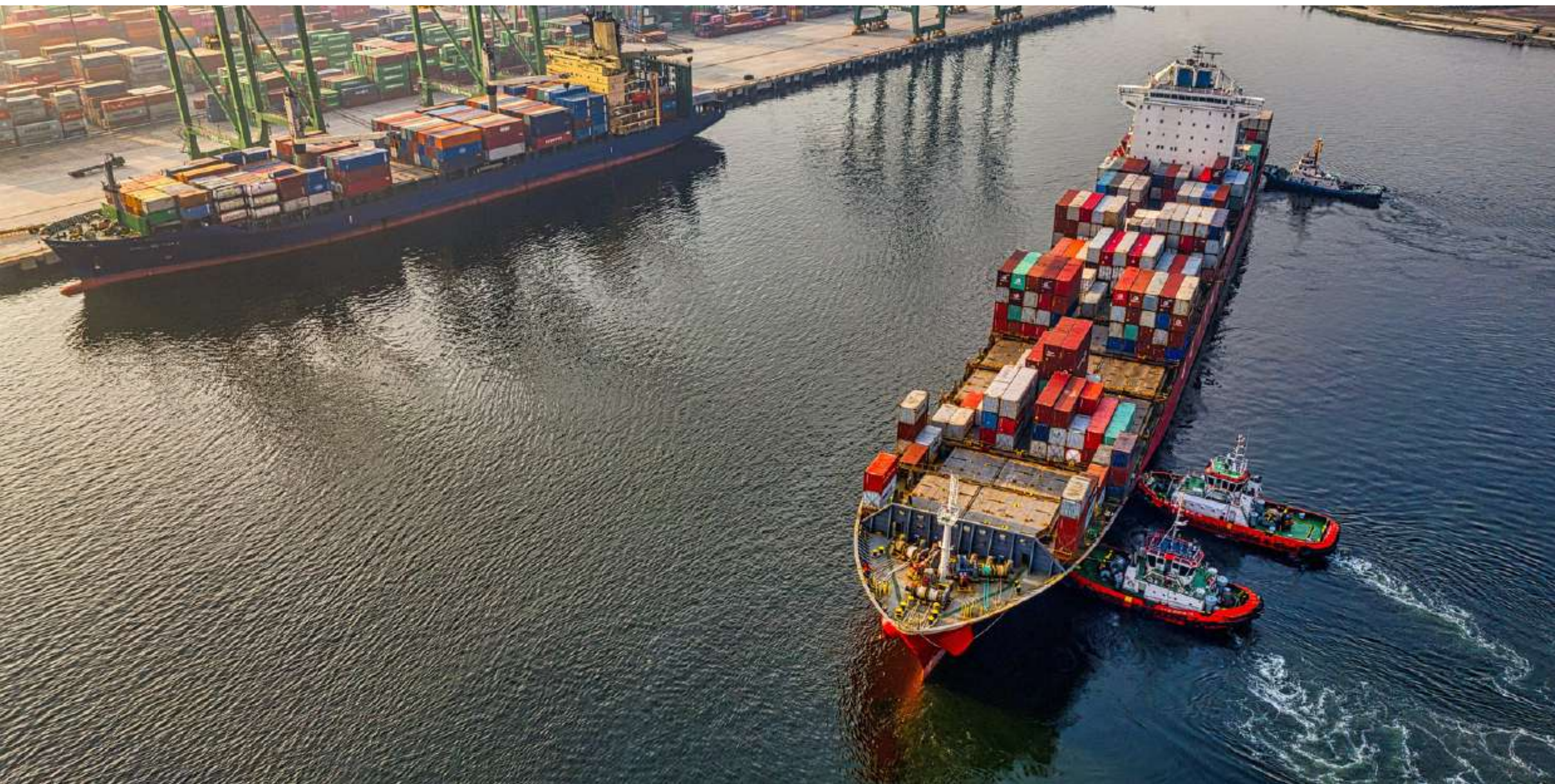
The global supply chain gridlock may not be cleared until well into 2022. Shipping rates continue to soar, delivery delays are up significantly, and inventories are in steady decline. Container freight rates, for example, have increased more than 400% over pre-pandemic levels.

According to the Institute for Supply Management's latest data, delivery times have also slowed, with manufacturing supplier delivery times roughly 30% slower than they were a year ago.

“Shipping costs are increasing at a double-digit pace, wait times for products remain unusually long even as throughput at ports has improved, inventories are still inadequate, and labor is hard to find,” the Wells Fargo economists wrote. “Not only are these problems symptomatic of ongoing supply chain constraints, they are a source of price pressure that continues to filter through the economy and stoke inflation.”







SUPPLY SHORTAGE

Ken Simonson, chief economist at the Associated General Contractors of America, commented in the AGC's June release that, "Steadily worsening production and delivery delays have exceeded even the record cost increases for numerous materials as the biggest headache for many non-residential contractors. If they can't get the materials, they can't put employees to work."

He added that contractors are being told they must wait nearly a year to receive steel shipments and 4-6 months for roofing materials. As a result, homebuilders could not keep up with demand, manufacturers faced delivery delays of materials needed to finish goods, and "it remained difficult for many firms to hire new workers, especially low-wage hourly workers, truck drivers, and skilled tradespeople."

Of course, the construction industry is far from being alone in this predicament. Two other notable sectors suffering from supply issues are the semiconductor and automotive industries, as the Computer Chip Shortage of 2021 shows no signs of slowing.

Intel has warned that the global semiconductor shortage that has affected the auto industry and raised the cost of some consumer electronics could last until the middle of 2023. "While I expect shortages to bottom out in the second half [of 2021], it will take another one to two years before the industry is able to completely catch up with demand," CEO Patrick Gelsinger said recently.

That is particularly disheartening news for carmakers, with many of their plants lying idle this year due to a lack of chips – General Motors was forced to stop making most of its full-sized pickup trucks for a week in July. Due to the limited supply of new vehicles, used car prices are soaring.

Goldman Sachs has said that new car inventories are unlikely to recover until September and will remain well below pre-pandemic levels through the end of next year. The bank said it expects new car inventories to fall further in August, to around 1 million vehicles, before beginning to steadily increase in September. The firm forecasts that new car prices will likely continue to rise over the next few months, peaking around 6% above their pre-pandemic level toward the end of this year.

HIRING DIFFICULTIES & WORKERS ATTITUDE

THE U.S. ECONOMY CURRENTLY HAS MORE OPEN JOBS THAN JOB SEEKERS

Experts attribute current hiring difficulties to several primary factors: unemployment benefits, pandemic concerns, and childcare. One thing is clear, the issue is not down to a shortage of jobs. In June, according to the Job Openings and Labor Turnover Survey, U.S. job openings soared to a record 10.1 million, exceeding available workers for the first time since the pandemic recession began. A handful of sectors were even tighter than the broad ratio implied. The wholesale trade sector — businesses that sell goods and merchandise to retailers — had a three-month average ratio of just 0.4 workers-per-opening, per Economic Policy Institute data. That made it the tightest industry in the U.S. Meanwhile, the finance, insurance, and government sectors displayed similar ratios of 0.6, and restaurants and accommodation businesses had ratios of 0.8.

U.S JOB OPENING HIT RECORD HIGH AS WORKERS QUIT IN DROVES

Hires, quits, and layoff rates, 2000–2021

The sectors most adversely affected by the COVID-related economic shutdown are still struggling to fully recover. Pandemic-related concerns are still a key factor for many Americans, as jobs that require physical interaction with other people (nurses, servers, checkout staff, hotel cleaners, etc.) continue to receive substantially fewer candidates than open positions. University of Massachusetts Boston professor Françoise Carré noted that retail jobs have been particularly grueling during the pandemic because of their "frantic pace" and employees' fears over catching COVID-19.

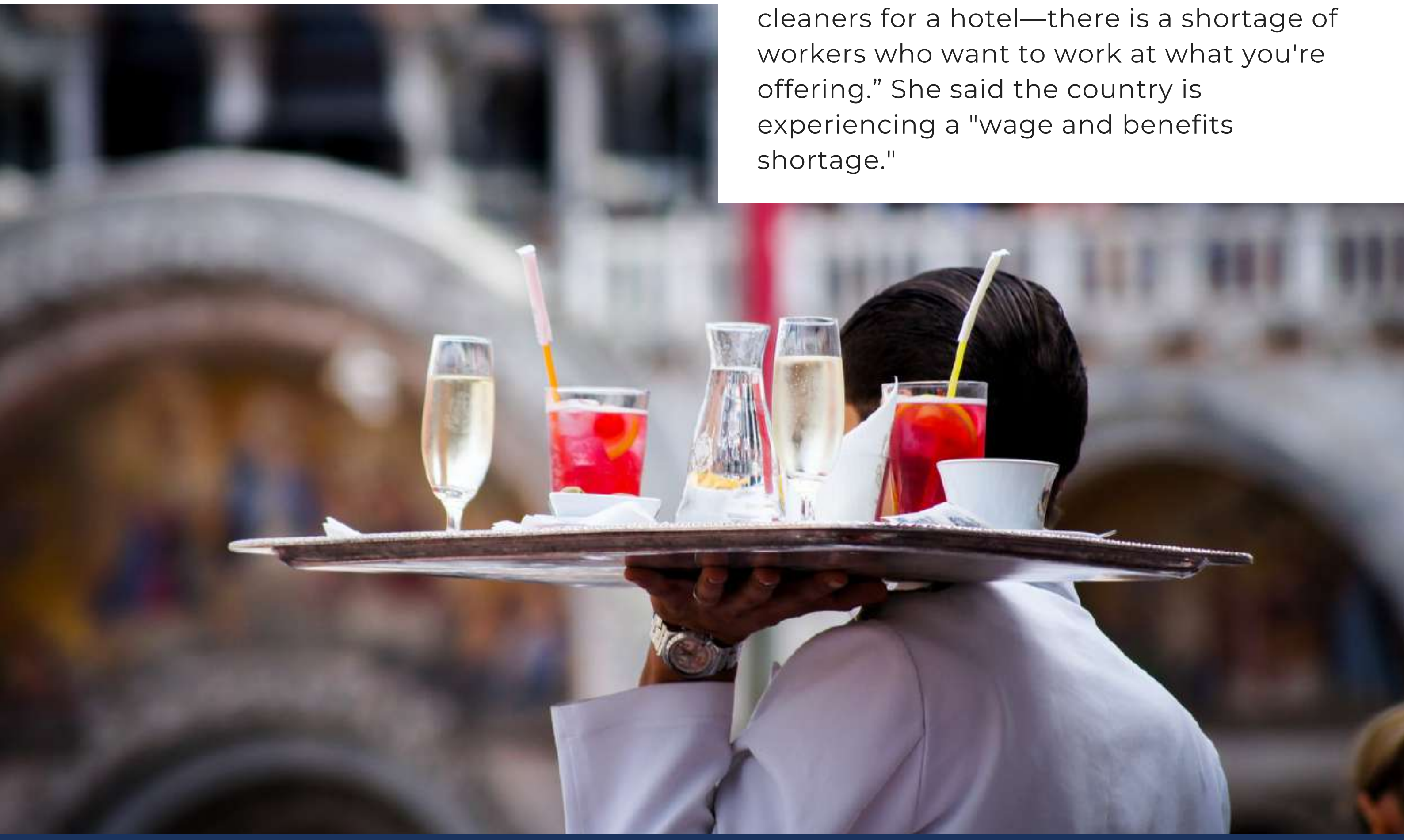
WORKERS ATTITUDE

Harvard University economist Lawrence Katz has highlighted the fact that, while many employers might want things to go back to the way they were before the pandemic, many workers have something else in mind. "It's a mismatch of expectations and aspirations," he said.

Rich Templin, a lobbyist for Florida AFL-CIO, a federation of labor unions around the state, commented that the biggest issue is that jobs in the tourism and service industries don't pay well and don't provide benefits. "We are seeing a major reset of the labor market in this country because of what we just went through and what we're going through right now. What business owners are saying is, 'We want you to come back under the old rules and be paid poverty-level wages,'" Templin said. "And people are saying, 'no.'"

Chris Tilly, a professor at UCLA's Luskin School of Public Affairs, said it's hard to make predictions about what's next for the labor market, but noted that consumer demand appears to be outpacing retailers' ability to staff stores – circumstances that give workers more leverage. "I don't think we're at a point where workers have permanently gained the upper hand, but I would be cautious about saying exactly when the power is going to shift back more to employers," he said. The central issue is that "retailers are having trouble attracting workers at the rates of pay that they're offering. Consumer demand is expanding faster than people are able and willing to go back into the labor force," he said.

Echoing his sentiments, Sylvia Allegretto, a UC Berkeley labor economist, pointed out: "There's simply no labor shortage when you're talking about finding house cleaners for a hotel—there is a shortage of workers who want to work at what you're offering." She said the country is experiencing a "wage and benefits shortage."



LOGISTICAL DIFFICULTIES

Federal Reserve Chairman Jerome Powell blamed additional human resource factors for supply shortages and the consequent price rises, including skills mismatches and geographic differences. Hiring new employees is a time-consuming process. There are limits on how fast employers can hire, and the problem is only aggravated by the high level of people now quitting their jobs to pursue other opportunities.

Skills mismatches are a solid contributor to rising costs and slower economic recovery, including within the real estate industry in particular.

Kevin Liang, vice president at Argo Construction, commented that builders have not been able to keep up with demand due to skilled labor shortfalls. “That raises concerns about the quality of work being done on construction sites,” Liang said. “And the current supply chain issues, everything from material shortages to scarce shipping containers, to a shortage of truckers, everything in that supply chain has a significant effect on construction.”

Gary Kaplan, president of construction for AXA XL, noted that the sector's labor shortage concerns are not new, but the shortfall effects are beginning to be reflected in insurance claims. Namely, unskilled workers are being mentioned as the number one cause for subcontractor default insurance claims.

It is also likely that geographical mismatches are occurring between where businesses are hiring and where the unemployed are currently located. These mismatches are not only present across state lines, but also within metropolitan areas.

MARKET TRENDS
LOCATION IS EVERYTHING

For several reasons, manufacturers of all sizes are taking a hard look at location – both where they produce and where their supplies are located. Recent upheaval and supply chain issues, including the COVID-19 pandemic and trade disputes, have driven home the point for companies that it is irresponsible to maintain just one point of production far away from their consumer base. In addition, rising labor costs in China and other parts of Asia, when coupled with the economic power of the U.S. consumer, are encouraging manufacturers to rethink their conventional goods production strategy.

Of course, the issue of relocating production closer to home dovetails with another high-profile challenge: hiring difficulties in the USA and other developed nations.

CHANGING WORKFORCE DEMOGRAPHICS

Apart from the wage angle, hiring difficulties have also led many businesses to expand their horizons when it comes to recruitment considerations, which includes lowering their standards in terms of qualifications and experience. Teenagers are now filling an essential gap for businesses across the U.S. who are struggling with a labor shortage. In May 2021, more than 22% of teens ages 16-19 had a job, the highest level since 2018, according to the Bureau of Labor Statistics.

Companies and other employers are also beginning to introduce phased-retirement and part-time work opportunities. Americans' increased longevity, coupled with the need to finance a growing share of their care, are significant factors driving older adults to delay retirement and remain in the labor force. While the U.S. workforce is expected to grow at just 0.5% over the next decade, adults over age 65 represent the fastest-growing segment. By utilizing their potential, companies are able to draw on several other benefits, such as retaining skilled workers for longer, and enabling them to pass on key institutional knowledge to their younger colleagues.

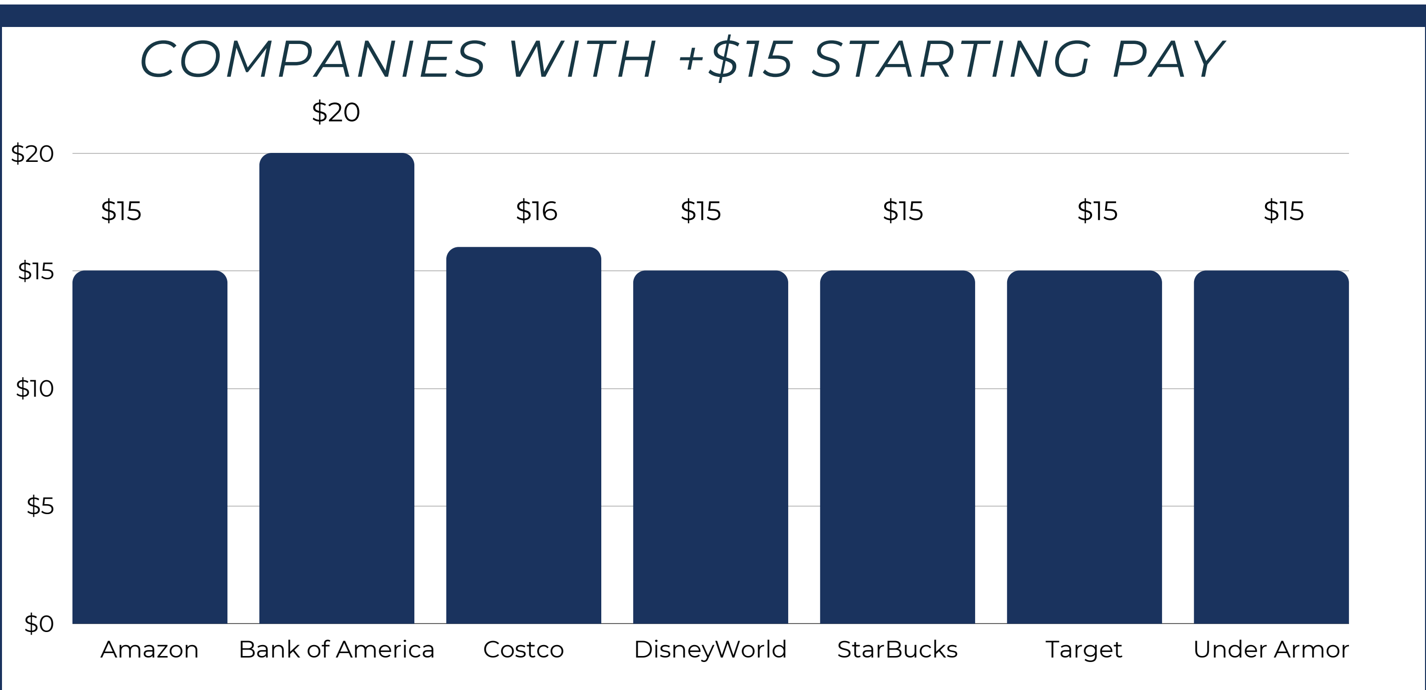
LEADING BRANDS ARE RAISING WAGES

The availability of vaccines, paired with a broader reopening of the economy, has spurred a snapback in economic activity in recent months, and consumer demand has vastly outpaced businesses' hiring ability. Scrambling to find workers as business surges, many companies have started to raise wages and offer hiring bonuses to attract candidates. Average hourly earnings were up 4% last month over the same period last year.

In May, Chipotle announced plans to raise its hourly wages to an average of $15 by the end of June. Soon after, McDonald's said it would raise the hourly wage of its restaurant employees by an average of 10%. Costco is among other companies that recently pledged to increase their minimum wages to at least $15. Disney is also offering $1,000 bonuses to recruits who sign up to become housekeepers and kitchen staff amid the labor shortage.

"If a bunch of large employers in the labor market raises pay, other employers are going to be compelled to raise pay a little bit too, to make sure that they can recruit and retain their workforce," Ben Zipperer, an economist at the left-leaning Economic Policy Institute, told Insider in March. Zipperersaid that small businesses in those areas will probably feel those spillover effects and will likely feel compelled to respond.

A recent working paper from the University of California examined the impact of Amazon, Whole Foods, Target, Walmart, and Costco's starting wage increases. The researchers found that minimum wage raises at big firms may have had a knock-on effect on other businesses in the area. Following wage increase announcements at large companies, nearby firms followed suit, even matching the announced wage in some cases



MANY INDUSTRY LEADERS SUCH AS AMAZON, WALMART, DISNEY, AND MORE HAVE ALREADY MADE THEIR STARTING WAGE AT +15$ AN HOUR.

LEADING BRANDS ARE RAISING WAGES

The study looked at the companies that were most affected by these increases or employers in the same labor market where a large share of wages before the announcements was at rates below the new voluntary wages of these major companies. According to the research brief, the more affected companies went from having similar wages to the less affected companies before the big company announcements to then raising their advertised wages significantly afterward.

A separate report from the Labor Department's Bureau of Labor Statistics noted that the big monthly hike in consumer prices translated into negative real wages for workers in the month of June. Real average hourly earnings fell 0.5% for the month, as the CPI increase negated a 0.3% increase in average hourly earnings.

UBS Group has recently stated its lack of confidence in higher house prices and wages spurring the Fed to action. “U.S. house prices are rising at their fastest pace in 30 years but only indirectly feed into inflation indexes. The housing part of inflation is calculated using rents as an input, and U.S. rents remain subdued,” commented Mark Haefele, UBS Chief Investment Officer. “Away from the direct inflation calculations, very low long-term interest rates limit monthly mortgage costs, so most homeowners are not facing significantly higher direct housing costs, despite rising home prices. While large wage increases in a couple of sectors are also making headlines in the current political environment, broader level wage pressure is less evident. The Atlanta Fed wage tracker, for example, shows wages falling for higher-income workers.”

IMMIGRATION

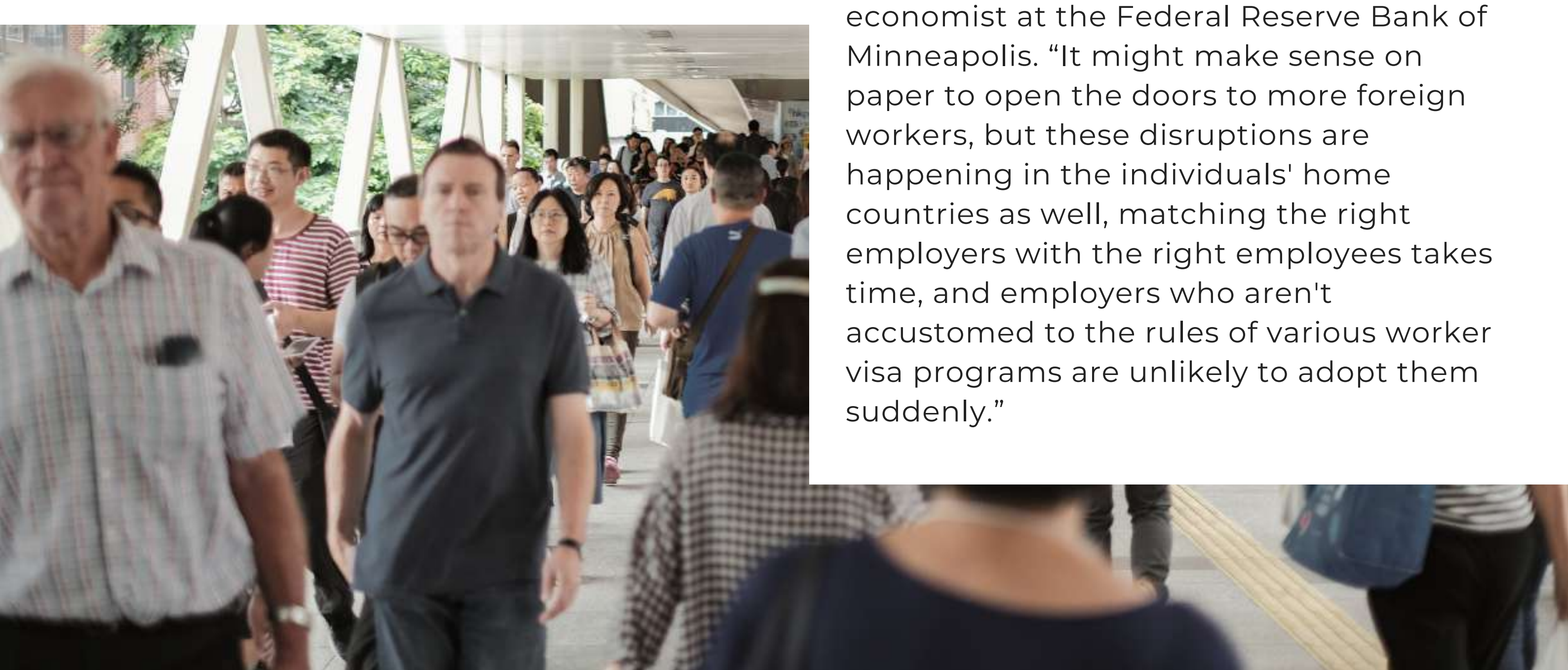
Looking elsewhere for workers will also result in many companies opting to import workers from overseas in order to resolve hiring problems and offset the increasing wage and product costs driven by current inflation. This may however be bad news for American talent, as the presence of foreign guest workers can depress wages and conditions in the sectors that employ them, argued Kent Wong, director of the University of California, Los Angeles Labor Center and former staff attorney for the Service Employees International Union. “Historically, employers have pushed for relaxing visas and relaxing immigration policies in order to maintain a low-wage workforce,” he said.

Global businesses that have established connections and an existing pipeline of migration workers will enjoy far greater flexibility in their hiring process. During 2020, the COVID-19 pandemic had a significant effect on immigration and visas, fueling calls for lawmakers to allow for additional H-2B visas, those allocated to temporary seasonal workers in non-agricultural jobs, such as hospitality, landscaping, food service, and processing.

Perhaps unsurprisingly, the unemployment rate for leisure and hospitality workers, while shrinking, was still the highest of all industries in the BLS May jobs report, at 10.1%. In a June 21 report, Goldman Sachs economics researchers wrote: “We expect that the collapse in visa issuance during the pandemic will reduce the labor force for the next few years.” That collapse reduced the labor force by 750,000 people, with 450,000 of those stemming from a drop in temporary worker visas and 300,000 from immigrant visas. “Since the loss in immigration in 2020 won't be offset by higher immigration going forward, most of this drag will persist,” they continued.

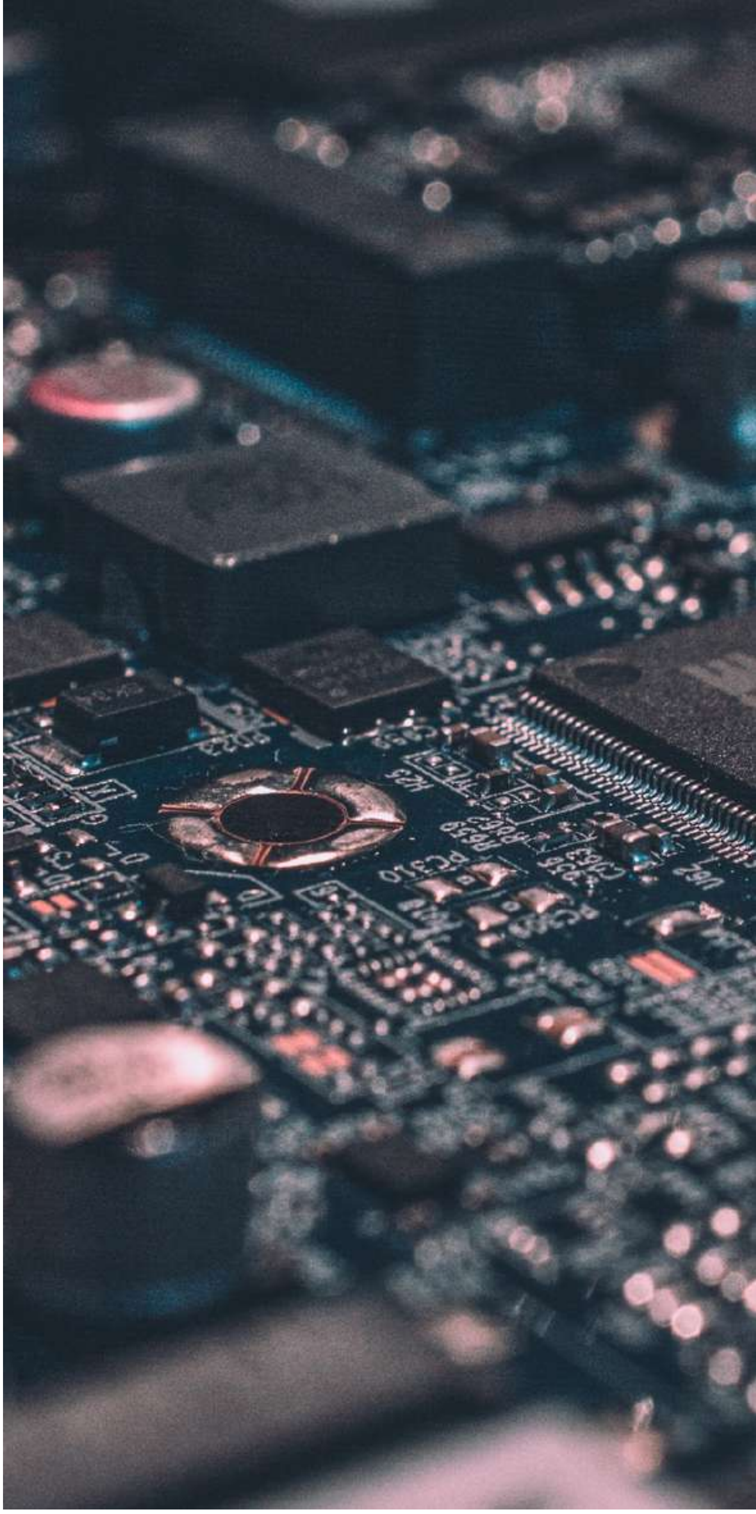
In response, the U.S. Chamber of Commerce has advocated expanding legal immigration and access to worker visas by doubling the annual H-2B visa quota and introducing a permanent exemption for returning workers, among other measures. While many agree that more worker visas are generally beneficial to the economy, it may not be a straightforward solution.

“The labor supply everywhere is disrupted,” said Abigail Wozniak, a labor economist at the Federal Reserve Bank of Minneapolis. “It might make sense on paper to open the doors to more foreign workers, but these disruptions are happening in the individuals' home countries as well, matching the right employers with the right employees takes time, and employers who aren't accustomed to the rules of various worker visa programs are unlikely to adopt them suddenly.”



TECHNOLOGY ADOPTION

THE COVID-19 PANDEMIC AND RESULTING ECONOMIC SHUTDOWN HAVE SUBSTANTIALLY INCREASED TECHNOLOGY ADOPTION ACROSS ALL INDUSTRIES. A MCKINSEY SURVEY FROM OCT 2020 FINDS THAT COMPANIES' RESPONSES TO THIS CRISIS HAVE SPED UP THE ADOPTION OF DIGITAL TECHNOLOGIES BY SEVERAL YEARS—AND THAT MANY OF THESE CHANGES COULD BE HERE FOR THE LONG HAUL.



According to the McKinsey Global Survey of executives, their companies have accelerated the digitalization of customer and supply-chain interactions, as well as their internal operations, by three to four years. Furthermore, the share of digital or digitally enabled products in their portfolios has been expedited by an unprecedented seven years. Nearly all respondents agreed that their companies have instituted at least temporary solutions to meet many of the new demands on them, and much more quickly than they had thought possible before the crisis.

In addition, respondents expect most of these changes to be long-lasting and are already making the kinds of investments that all but ensure they will stick. When asked about the impact of the pandemic, executives say that funding for digital initiatives has increased above all else—more than increases in costs, the number of people in technology roles, and the number of customers.

TECHNOLOGY ADOPTION

Consumers have moved dramatically toward online channels during the pandemic, and companies and industries have responded in turn. The survey results confirm the rapid shift toward interacting with customers through digital channels. They also show that adoption rates are years ahead of where they were when previous surveys were conducted. Respondents are now three times likelier to say that at least 80% of their customer interactions are digital.
However, the results also suggest that rates for developing digital products during the pandemic differ across sectors. Given the timeframes for making manufacturing changes, the differences, are more apparent between sectors with and without physical products than between B2B and B2C companies. For example, respondents in consumer packaged goods (CPG) and automotive and assembly report relatively low levels of change in their digital product portfolios. By contrast, the reported increases are much more significant in healthcare and pharma, financial services, and professional services, where executives report a jump nearly twice as substantial as those reported by CPG companies.

The customer-facing elements of organizational operating models are not the only ones that have been affected. Respondents report similar accelerations in the digitalization of their core internal operations (back office, production, and R&D processes, among others) and supply chain interactions. Unlike customer-facing changes, this rate of adoption is consistent across regions.
The speed with which respondents say their companies have responded to a range of COVID-19-related changes is remarkable, even more so than digitalization processes. In the case of remote working, respondents say their companies moved 40 times more quickly than they thought possible before the pandemic. Previously, respondents say it would have taken more than a year to implement the level of remote working that took place during the crisis. In actuality, it took an average of 11 days to implement a workable solution, and nearly all companies introduced workable solutions within a few months at most.
Respondents across sectors and geographies are most likely to report a significant increase in remote working, changing customer needs (a switch to offerings that reflect new health and hygiene sensitivities), and customer preferences for remote interactions. Respondents reporting significant changes in these areas and increasing cloud migration are more than twice as likely to believe that these shifts will remain after the crisis than to expect a return to pre-crisis norms. Both remote working and cloud migration are viewed as more cost-effective than previous practices, while investments in data security and artificial intelligence are most often identified as helping to position organizations better than before the crisis.

TECHNOLOGY ADOPTION

The extent of technology's differentiating role in this crisis is stark. At the organizations that experimented with new digital technologies during the pandemic, and among those that invested more capital expenditure in digital technology than their peers, executives are twice as likely to report outsize revenue growth. The results also indicate that, along with the multiyear digital acceleration, the crisis has brought about a sea change in executive mindsets on the role of technology in business. In McKinsey's 2017 survey, nearly half of executives ranked cost savings among the most important priorities for their digital strategies. Now, only 10% view technology in the same way; in fact, more than half say they are investing in technology to pursue a competitive advantage or refocusing their entire business around digital technologies. The report's authors concluded: “The notion of a tipping point for technology adoption or digital disruption isn't new, but the survey data suggest that the COVID-19 crisis is a tipping point of historic proportions—and that more changes will be required as the economic and human situation evolves.”

Edward Yardeni predicted, “In my Roaring 2020s scenario, technological innovations will boost productivity-led growth and real pay per worker while keeping a lid on inflation.” Digitalization is the key to modernization. This is why 85% of companies accelerated their digital transformation programs last year. Technology leading to improved productivity via platforms like Instawork, ShiftPixy, Shyft, and Jobletics can also help to fill short-term workforce gaps. The Instawork network, for example, has more than 1 million workers across the U.S., and the number of available shifts on its platform has grown 8x in less than two years, with professionals finding work in less than 24 hours.

TECHNOLOGY ADOPTION

The pandemic, in conjunction with a difficult insurance market, has pushed contractors to reevaluate their old ways of doing business. "The pandemic forced contractors to do their work differently, and I think that was an improvement," Gary Kaplan, president of construction for AXA XL, said. “They brought in technology to automate some stuff that was pretty clunky.”

According to Kaplan, the adoption of technology by construction firms tended to be a lower priority before the pandemic. But COVID forced the sector to bring in newer, more innovative tools to improve safety. Michael Teng, assistant vice president of regional pricing, products, and underwriting at Sentry Insurance, agreed that the pandemic has spotlighted workplace safety. That includes the use of telemedicine, which picked up significantly in construction: “We began to see a lot of contractors starting to utilize electronic badging.” The sector also improved processes for workers entering job sites and increased the use of wearable technology tools, such as monitors.

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