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Bifurcation as Seen in Silicon Beach Prosperity and Eviction Boom

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Executive Summary

- Policy-induced boom in non-bank funding enabled prosperity in the technology sector and large corporate issuers
- Income growth remained stagnant in low-to-middle-skill jobs and peripheral areas amid persistent job polarization
- Combination of asset price appreciation and soft wage growth led to rising evictions in lower income households
- Bifurcated economic growth appear benign to monetary authorities as areas of growth dominate aggregate data
- Tighter funding conditions would risk cooling the "growth engine" amid declining tolerance for downside shocks
- Rising wealth inequality and popular discontent have demonstrated their ability to reshape the political landscape

One nation, two worlds apart

Sustained influx of easy funding into "new economy" sectors such as tech and finance have generated long-running booms at "growth hubs" near tech companies, large financial institutions, as well as established credit borrowers with easy access to the capital market. In one example, the outgrowth of Silicon Valley enabled the transformation of areas such as LA's Playa Vista into boomtowns, where rents for one-bedroom luxury apartment start at $3,200-a-month.

Such rapid asset price appreciation that enabled the boom in Playa Vista also unintentionally constrained lower-to-middle income households' finances, for stagnant wage growth in "old economy" sectors failed to keep up with property prices and resulted in rising number of "involuntary renters."

At the same time, rise of "Wall Street Landlords" such as large private equity funds and hedge funds also blossomed following the 2008 housing downturn, when large number of underwater properties at fire sale prices and ultra-low borrowing costs allowed non-bank institutions to leverage up and turn them into rentals. Some of the non-bank mega landlords also demonstrated stronger preference to file eviction notices on single-family homes than traditional landlords.

According to The Eviction Lab, the first-ever database of evictions in the U.S., the country is now in the midst of a new housing crisis – a claim that would likely earn dismissal from policymakers optimistic that the economy is growing with strong fundamentals and aided by the newly enacted fiscal stimulus. However, the "eviction epidemic" was precisely due to the relentless and widespread asset price appreciation; uneven wage growth would exacerbate low-income renters' financial pressure and increase the likelihood of downward spiral that begins with eviction and ends in long-term poverty:

> "Today, most poor renting families spend at least half of their income on housing costs, with one in four of those families spending over 70 percent of their income just on rent and utilities. Incomes for Americans of modest means have flat-lined while housing costs have soared. Only one in four families who qualifies for affordable housing programs gets any kind of help. Under those conditions, it has become harder for low-income families to keep up with rent and utility costs, and a growing number are living one misstep or emergency away from eviction."

Furthermore, asset price appreciation also changed developers' calculus, for it would no longer make sense to build low-rent housing on land purchased at a premium, which explained tight inventory in starter homes and low-cost rentals:

> "Developers aim for the top end of the market because they have to, said Mr. Habibi. "The promise of growth in the future is already priced in" to the cost of the land, Mr. Habibi said. Once developers have paid top dollar for a parking lot or defunct warehouse, they often cannot build mid-market housing and still turn a profit."

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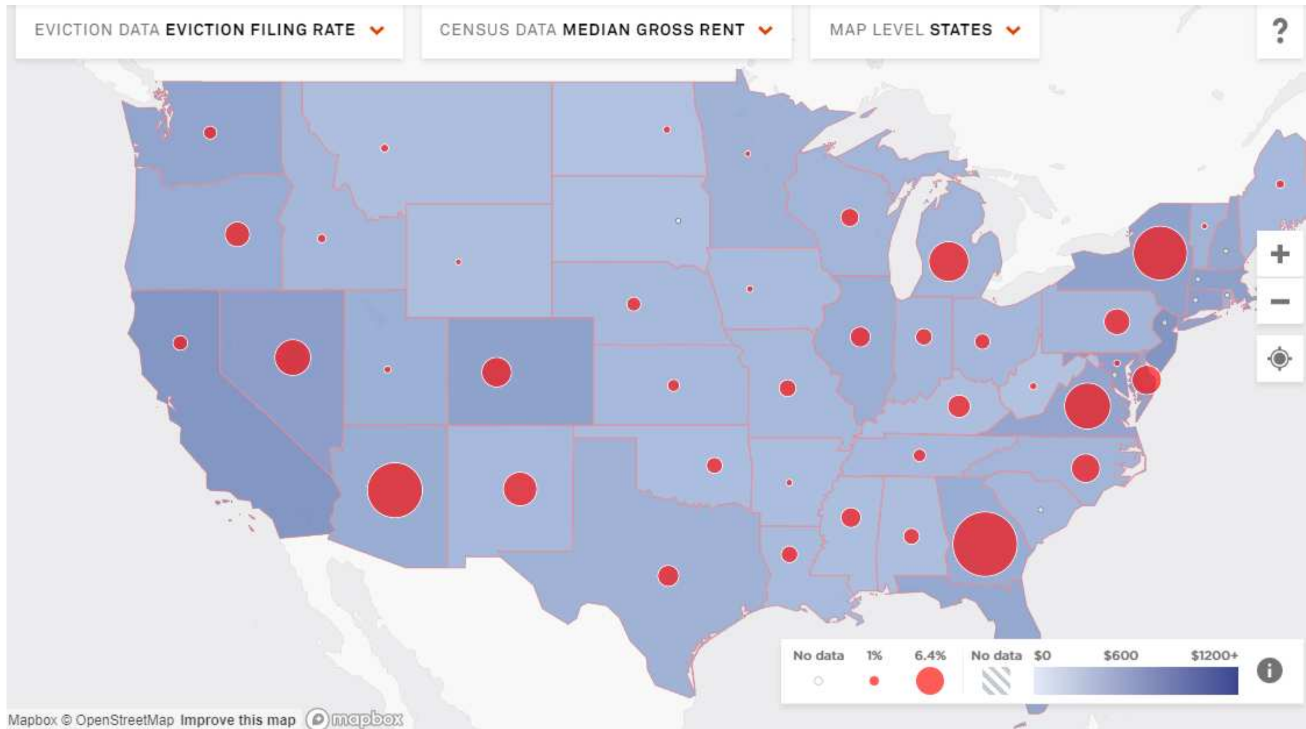
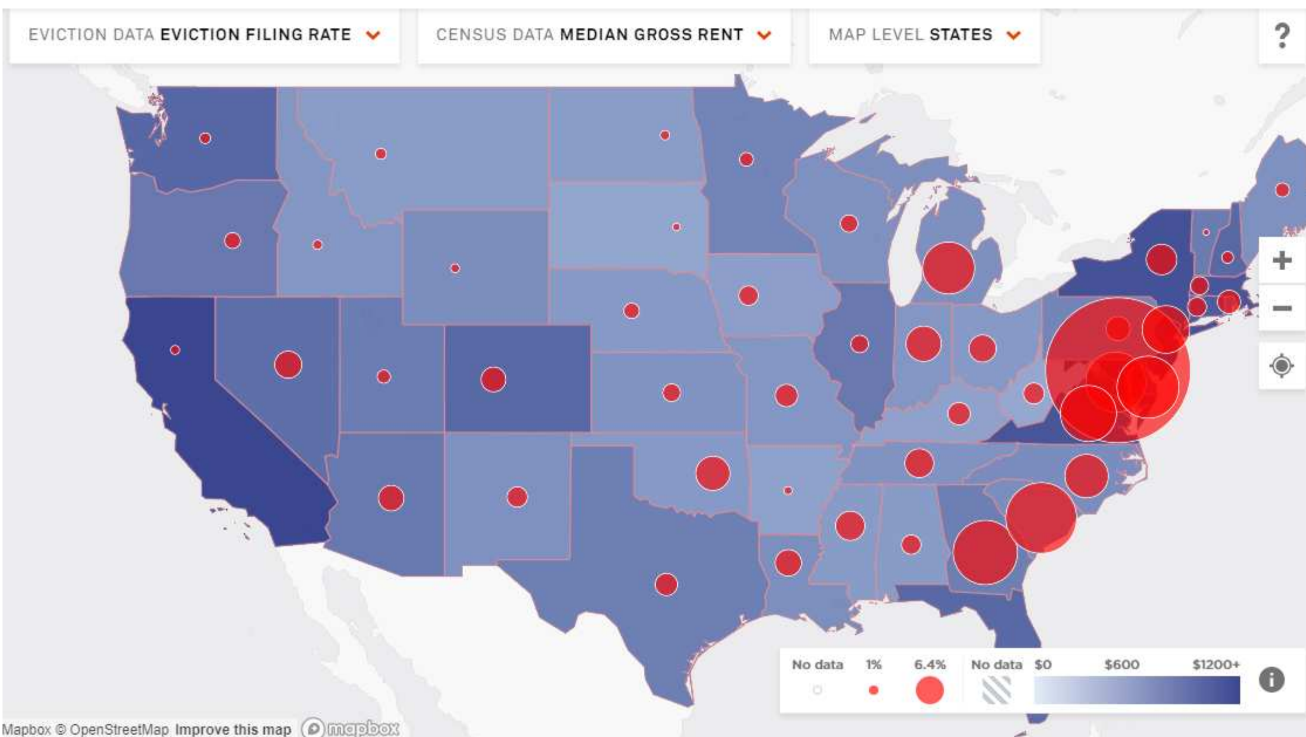
Thus, a confluence of factors such as asset price appreciation, developers' lack of incentive to build affordable housing on costly land, soft wage growth among low-to-middle-income households amid job polarization, and the rise of well-funded but draconian "investment fund landlords" with little hesitation to file for eviction have culminated in an "eviction crisis" with eviction filing rate rising rapidly along the east coast:





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Catalysts behind policy-induced economic extremes

Almost all Fed officials have concluded that present economic conditions are strong, and disagreements on policy path have largely centered on degree of residual economic slack (with Phillips curve acting as a transmission mechanism between slack and price pressure) as well as appropriate path of policy tightening. Their views are shaped by institutional preference to rely on aggregate macroeconomic data and numerous business contacts from each of the twelve Districts.

Unfortunately, benign macroeconomic data failed to capture the potent mix of policy-induced credit boom and bifurcated economic growth, or the resulting "eviction crisis" would not have come as a surprise (or at least being recognized by policymakers). Fed officials' reliance on District contacts also led to perceptions which largely affirm major PMI indices (business surveys), for business leaders would aptly outline one perspective of a bifurcated economy. On the other hand, households with adults working multiple jobs and facing the threat of eviction might as well be living in another country (which is not too far from reality), with a sense of disconnect occasionally interrupted by media reports.

Despite a bias in information input, policymakers are nevertheless justified to rely on aggregate data, for many Fed officials would acknowledge policies tools are "blunt" and "gets into all the cracks," and it would be unfeasible to micro-manage and respond individually to different sectors of the economy. However, monetary authorities would also acknowledged that monetary policies are not without costs; thus, focusing solely on aggregate data to justify a policy path (while accepting policy tools' distributional effects) may incur significant costs if micro and secondary effects are ignored.

Claudio Borio, Head of the Monetary and Economic Department of the BIS, previously highlighted an easing bias in modern central banks' reaction function:

> "Over time, the effectiveness of the policy mix diminishes and its side effects increase. This reflects, in particular, the multifaceted impact of persistently ultra-low interest rates (Borio (2014a), BIS (2016)). They tend to weaken the profitability and resilience of financial institutions, by compressing banks' net interest margins and inhibiting their incentive to take losses and repair their balance sheets, and by raising the value of insurance companies' and pension funds' liabilities, thereby also highlighting the need to save more for retirement. They can encourage resource misallocations more generally: everyone looks "sound" when nominal interest rates are effectively zero in nominal terms and negative in real terms. They can promote the wrong forms of risk-taking, hence the dissonance between exuberance in financial markets and sluggish investment, at least in advanced economies: firms prefer to borrow to pay back shares and hand out dividends rather than invest. And they can fuel unsustainable financial booms in other countries in a different cyclical position. They can do so directly: recall the huge post-crisis expansion of dollar credit outside the United States, as just confirmed in the latest issue of the BIS Quarterly Review (BIS (2017)). And they can do so indirectly: as domestic transmission channels weaken, the exchange rate becomes more important by default, but as unwelcome appreciation elsewhere is resisted, policy rates there are kept lower than otherwise: easing begets easing."

> "Note how, all along the way, interest rates tend to decline. This is partly the result of a monetary policy that responds asymmetrically to the financial cycle. And over successive business and financial cycles, such a policy can induce a longer-term decline in the real interest rate. As long as inflation does not rise much during booms, partly held back by the tailwinds of globalization and by central bank credibility, a monetary policy focused on near-term price stability has little incentive to tighten to restrain the build-up of financial imbalances. But then it has every reason to ease aggressively and persistently if the economy weakens and inflation declines further."

Hence, the bifurcated economic growth can be attributed to policymakers' easing bias, effects of prolonged credit boom and resource misallocation, with costs of asset price appreciation ignored in favor of benign aggregate data.

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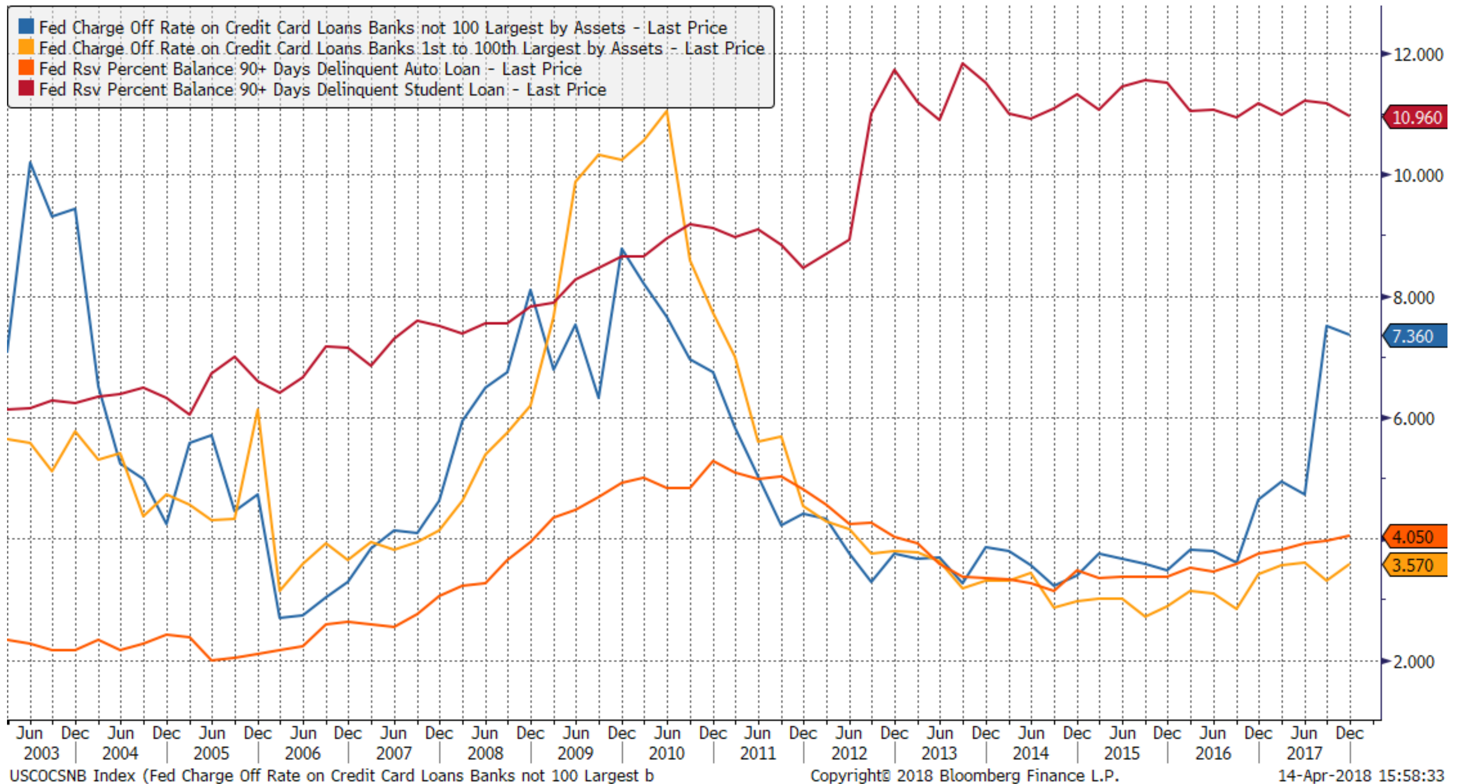
Market implications of a bifurcated economy

A bifurcated economy with uneven growth is brittle and reliant on continued credit easing and plentiful funding, and while the woes of households facing stagnant wage growth, financial hardship amid "eviction epidemic" seemingly "do not matter" to some market participants, the "left behind" households would not be able to help buttress the economy during periods of heightened volatility and tighter financial conditions, when such help would be most needed to offset weakness in credit-dependent industries. This is in line with BIS research that impacts of credit boom bust cycles can be "twice as large in the wake of a subsequent banking crisis." It is also worth noting that these developments are occurring under the backdrop of worsening household financial conditions as higher housing costs forced borrowers to increase leverage:



In terms of market impact, uneven growth would imply less "dip buying" as policy regime shifts away from "lower for longer," and economic recovery after a recession will be even more credit dependent in the absence of "organic growth" in non-financial sectors. This would also support a bullish volatility thesis in asset markets, for consensus risk-parity (long equities, credit and duration risks) positions are correlated with policy-induced resource misallocation, and investors are increasingly facing asymmetric risk rewards across multiple asset classes.

Some investors argued that extreme wealth inequality can be sustainable over the long run, for there is little people can do if they are being evicted or going homeless (they become powerless and would prioritize survival over political change), but recent political developments indicate discontent can be forged into a powerful source of support by political campaigns and threaten incumbent officials. Given that anti-establishment sentiment would generally favor policies that run contrary to the status-quo, economic bifurcation can also act as a catalyst for shifts in fiscal policy and induce knock-on effects on markets and outlook (as well as reactions from monetary authorities).

In conclusion, worsening economic disparity is connected to distributional effects of prolonged "lower for longer" policy regime. Consistent with views expressed in "Central Bank Quantitative Easing as an Emerging Political Liability," bifurcated growth is brittle to credit shocks, and markets have consistently underestimated the social, economic, and political impact from voter discontent.

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