Jerry Howard: Welcome to Housing Developments. I'm Jerry Howard.

Jim Tobin: I'm Jim Tobin. Good afternoon, Jerry.

Jerry Howard: Hello, James. It certainly is a good afternoon and a lot has transpired since we were together last week, in the world largely I guess.

Jim Tobin: Yeah. I feel like I've been glued to cable TV and Twitter and accounts of what's going over in Ukraine. And I know we're anxious to talk about it. Tomorrow and night will be President Biden's first State of the Union Address. And obviously the activities in Ukraine and with Russia are going to probably dominate that speech.

Jerry Howard: I guess so, and I know that in my conversations over the course of the past week, many of our members are very concerned about the impact of what might be a protracted war or even a short war that impacts the availability of goods and services in the impacted areas in this case, Ukraine, but also now with some of these sanctions in Russia. So I asked Rob Dietz, our chief economist to do a little research into that subject. And I think we're going to have an interesting show with a conversation with Rob about that. First let's thank our sponsor, Wells Fargo Home Mortgage. We appreciate what they do for NAHB. And I know that our members and our listeners appreciate what Wells Fargo Home Mortgage can bring to the table for their individual businesses. You should check them out before you sign on the dotted line with anybody else. Wells Fargo Home Mortgage.

Jim Tobin: Yeah. That's right. So let's jump right into it, right?

Jerry Howard: Rob Dietz is joining us in studio now. Rob, welcome.

Rob Dietz: Thank you, Jerry. It's good to join you guys.

Jim Tobin: Hey Rob.

Jerry Howard: You and I talked, I don't know where you were, somewhere out in the hinterlands last week, about the impact of war on an economy as a whole and on housing in particular, and whether there was even any reasonable comparisons that can be made from recent wars. I asked you to look into it. What'd you find out?

Rob Dietz: Yeah, I think if we're thinking about the macro forecast, the impact on housing, what builders and remodelers and apartment developers need to be concerned about as they watch all the news on cable TV, I think we need to think about the prospect for higher inflation. We know that this part of the world, for example, produces a lot of energy and natural gas. In fact, Russia is responsible for about 40% of the natural gas supply to Europe. Ukraine, as students of history will know, is the bread basket of Europe. They produce a lot of wheat. So on the inflation front, we can expect higher costs for energy and food products. And that adds to an already existing inflation challenge.

The second impact is on interest rates. This is an odd one. It's a little counterintuitive because when you do have uncertainty at the international level, political uncertainty, investors will move from equities that is stocks to bonds, and that tends to push interest rates down. Now it's not a whole lot. In fact, I was just looking at the bond market data right now that looks like the 10 year treasury rates, just a little under 1.9%. It was getting up above 2.05% before this all started. So it looks like the impacts about 15 basis points and that would be the impact on mortgage interest rates. So it's not particularly that large.

And then the last factor is what you suggested in terms of thinking about a long war and what it would do to commodity prices. And when you do see shifts in economic production, whether it could be more agricultural production in the US to make up for Ukraine wheat production, that would then maybe be shipped to Europe. You'll see shifts in the economy, and that can have an impact on things like the raw materials.

And then I think we also have to keep wild card factors in play. The COVID crisis itself was a wild card, but I think the big risk for the US economy coming out of this, just having done a little bit of research, is prospect of a cyber war between the US and Russia. And that can have impacts on financial markets, the ability to move credit around. It's something that's kind of been discussed by both sides openly as not a traditional form of warfare, but it would certainly have big economic consequences.

Jim Tobin: Rob, you talked about the stock market and the flight to bonds. Is that what we're seeing in the stock market that seems over the last week, it just the stock market, there's been rumors about it being, I guess, frothy. But now we're really entering this productions here. Is there any, other than the fear of either a shorter or a long term war out there, is the American economy still strong and the underpinnings are still there, this is just a blip?

Rob Dietz: Maybe something bigger than a blip. Usually what happens is you get a short term overreaction by investors. The stock market already was fairly elevated given some of the challenges that the economy faces. So this is a repricing event. You can see the impact on bond rates is not particularly large. So I think we have to be careful, not kind of overstate the impact. Political uncertainty, markets don't like that. It's certainly something that you'll see equity effects, but I think the risks here really are more tilted toward the unknown. What we know right now is the economy's generally solid. It faces the concerns about inflation, the concerns about what the federal reserve is going to do. And a situation like this really presents a wild card to the Fed. Do they see higher inflation coming from higher energy prices, which we know Europe is going to face and is going to spill over into the United States.

And do they interpret that as a higher inflation requiring tighter monetary policy, pushing rates up? Or do they see it as is a macro risk that could soften GDP output and thereby they have to go a little bit slower on monetary policy. I think the two things kind of wash out and they kind of stick to the plan that they had at the start of the year while making sure that they can tamper down some of the financial insecurity.

And on that last point, if you compare where the US is, even where Europe is compared to Russia, Russia is under some real extreme financial pressure right now. The ruble has come down more than 50%, just over the last few weeks. If you have assets in Russia, it's going to be very difficult to sell them. And then the actions undertaken by the EU and the United States to essentially remove Russian financial systems or financial institutions from the swift system, which is a way of doing international transactions, basically exiles them from the global economy. And so for Russian investors, Russian economic participants, they're under extreme stress right now in a way that even Europe is not facing.

Jerry Howard: Let me ask a question about that, Rob. Russia is under extreme stress right now. They're basically an island unto themselves, economically. They do not have the natural resources in country to reproduce the munitions that they've expended, basically utilizing as I've read, most of the munitions on their Western front. They're going to be looking somehow someway to restore their armaments, number one. Number two, if they stay at odds with Ukraine, Ukraine gives Russia a boatload of that very wheat that you were talking about earlier. And number three, the rest of the manufacturing that Russia does is based on natural resources that they import from other countries. If they can't do that, and they are left completely isolated, no arms, no food, no hope for any manufacturing sort. and imports cut off. What does Putin do?

Rob Dietz: Well, I think in the short run, it's probably a good time to own a rail system that connects China to Russia because they're isolated, their only source for things like munitions and economic trade, coal, agriculture, elements, is going to be this Russia China network. And this has been playing out for the last few years. Absent that, kind of just putting that additional kind of safety valve aside, it's a real political challenge and you guys are the political experts. What happens when you have an autocrat and his biggest supporters are facing huge economic losses? And maybe something that was promised as a short term, military/political event then begins to look like something, and Jerry, you and I have discussed this, something more like 1979's invasion of Afghanistan. Something that plays out over years. And then what kind of political pressure is put internally on Putin as a result? I think that's something we're going to have to look at over the next few weeks.

Jerry Howard: Well, I mean, that's what I thought you were going to say. And I guess my follow up question then is if you have an economic access, if you will, of Russia and China, could those two countries make enough products grow enough food to keep themselves and their populations mollified if not happy?

Rob Dietz: Yeah. And maybe the first but not happy. I think increasingly China's going to have to make a decision. Are they going to be that bridge to Russia, which then becomes an island unto itself? Or are they going to integrate and remain integrated in the rest of the global economy? Which of course then for builders has impacts in terms of building materials that come out of the Pacific rim. So I think if you take a step back and think of it from a US perspective, this is an event that's going to raise the already elevated inflation pressures in the US.

We know building material pricing and aggregates up 20% year over year, inflation's up 7.5%. Some of the modeling we've looked at suggests that rather than you at a 7.5% rate, if this were to stay in place, we bid at 8.5 or even a 9% rate. So it adds a 100 or 150 basis points because then the rest of the economy is looking for imports for things that used to be provided by Ukraine and Russia. And that would include a fair amount of Europe. So it can have big impacts on global trade. And this isolation of Russia of course, then will have those political impacts as well.

Jim Tobin: Hey, Rob, going back to Jerry's question about Russia being an island, the old phrase that America sneezes and the world catches the cold... Russia's economy isn't big enough to do that, so it's really if China becomes that bridge like you were talking.

Rob Dietz: Yeah. And if you look at the data, Russia and Ukraine together represent just about 3% of global GDP. So you've probably heard it on cable news, the Russian economy is basically the size of Texas. Now, Texas has got a big economy, but it is just a small share of the US economy. And one economist said a few years ago that Russia is basically a gas station with nuclear weapons. Their primary exports are natural gas, but their primary importers are the European Union. So I think you can see this kind of changing trade patterns where maybe the US and the EU come together more in terms of trade. That could be an opportunity for us in the building industry. We're looking for other places to bring lumber in, maybe increases in, Jerry, as you've said it, and increases in the lumber from Germany or someplace like that as this kind of cross board to trade evolves as a result of an event like this.

Jim Tobin: Yeah. Rob, another question on fuel and oil in particular, talked about obviously natural gas coming out of Russia and empowering Europe, we've seen, Texas oil prices go higher. That's a good thing for the Texas economy and anybody who's heavy into Texas oil, but with so many transportation costs out there that are challenged to the supply chain for us in particular. And we've got, it seems like it's been 10 years ago, but there were fuel surcharges on everything from taxi cabs all the way up to delivery trucks. Play out the play out the oil scenario for me.

Rob Dietz: Yeah. So if you look at oil prices right now, they're at an eight year high. If they were to continue to rise, you would definitely see an impact on GDP. So for example, if we see a permanent 20% increase in oil pricing, it's not unreasonable to believe you would lose maybe 30 or 40 basis points from US GDP growth. So rather than a GDP growth rate for 2022 of 3.9%, it could fall to 3.6 to 3.5.

So it is not a huge impact, but that's an impact large enough to affect job markets and have regional economies. I think the good thing here is that the US has capacity to step up oil production, if prices are high. We actually saw a sidelining of some of that production in recent years, as oil prices trended lower. Now that they're trending higher and we'll see how long, it depends on how long this conflict is, but you could see an increase in exports in that sector to the US economy. And then what does that mean for the US housing market? Those regional economies that are tied to natural gas and oil production and fracking. We'll see a corresponding increase in the demand for new home building.

Jerry Howard: All right, Rob let's do a little crystal balling here and this is crystal balling that I'm going to say right now to the listeners, nobody can predict what I'm about to ask Rob to predict. So please don't hold him to it. This is just a discussion to get information out and to get thoughts flowing. These talks that are ongoing right now between the Ukraine and Russia are successful. They come to some kind of an agreement where hostilities cease, the Ukraine remains largely independent, and the war is over. Impact on the economy for this year. Second part of that question is the war drags on until Russia conquers the Ukraine, makes it a puppet state yet again, what's the impact on the economy globally and nationally in that scenario? And thirdly, everybody's worst nightmare, Putin takes it a step further and then goes into one of the former Soviet puppet states, now NATO states, up in the Baltics. So three potential scenarios, three outlooks for the economy.

Rob Dietz: Yeah, so I think on the first one, which is a fairly quick resolution, maybe a recognition of a fait accompli, where Russia seizes some territory where they're already occupying, but overall the independence of Ukraine is recognized. Maybe there's some promise that they don't join NATO for some period of time. The impact on GDP would be fairly small, maybe 10 basis points, reducing from 3.9 to 3.8%. An impact on inflation, we could see maybe a 30 basis point increase from something like that, due to ripple effects and the damage that's already been done to trading networks. To the medium term scenario, so that's where Russia certainly occupies Kiev, occupies a large part of Ukraine. Its sovereignty and independence are essentially taken away, and its made into a puppet state similar to some other areas that neighbor Russia, the impact could be larger because then you're talking about persistent impacts the global trade patterns.

You could see a 50-100 basis point increase in inflation. You could see a 30 basis point or larger impact on GDP. I don't think that's large enough to really slow the economy down because we're surging out of that COVID type environment, but it would be enough to be noticeable. And it would certainly slow some of

	the momentum on job growth. And it would create a much more challenging environment for the Federal Reserve because they have to balance the idea of the economy slowing, but inflation going up. And so, rather than maybe looking at four rate hikes from the Fed this year, we would see five or six. Think about what that means to the yield curve, short term interest rates going up with long term interest rates coming down as those investors buy bonds. And that means a flattened yield curve, which is traditionally a sign of some softening for the overall economy.
	The third scenario where Putin is basically threatening Poland or the Baltic states is a nightmare scenario. I would put maybe between that and the medium scenario, something where we have a full fledged cyber war, that could get challenging. You could see pipeline shut down, financial institutions removed for periods of time. And it would cause some limited disruptions to the US economy. That could have an impact on GDP growth. You could see a full hundred basis point decline. But if we're talking about the nightmare scenario, there we've really exited the economic world and we're fully in the political world. What does it mean when you have a nuclear superpower threatening sworn allies of another nuclear superpower? I think we just all need to pray that we don't face that kind of situation and that some kind of resolution that recognizes the bravery of Ukraine can be worked out here in the coming weeks.
Jerry Howard:	[crosstalk] Any other questions?
Jim Tobin:	No. When you lay out the last nightmare scenario, it gives you a little bit of a pause.
Jerry Howard:	There were rumors over the weekend that some unknown agents were in fact conducting a cyber strike on the Kremlin. And I never heard Moscow come out and deny those. I don't know if either of you guys did, I did hear them repeated by a couple of United States senators over the course of the weekend. That would be interesting. And I'm wondering if that in conjunction with the bravery of the Ukrainian people is part of what's drawn Putin to the table.
Rob Dietz:	Yeah, it could be. I mean, we could be facing a world kind of like the 18th century, where there was a certain amount of piracy between the European powers, but it was sort of recognized as something that just sort of happens and doesn't require a war. Maybe the piracy is the new cyber world where this kind of ongoing attacks back and forth are just sort of tolerated because no one wants to escalate it. What that means, of course, then for individual firms, for US financial Institutions is more expenditure on upping your cyber defenses and making sure that your supply chains and your business relationships are more robust, because we could see some disruptions here this year as a result of, as you indicated, some of these initial cyber strikes back and forth.
Jerry Howard:	And I do know that our government talked to virtually every component of our financial sector and the energy sector and urge them to reinforce their cyber

securities. They've been talking to them for the last two or three months. So I think that's pretty interesting too. Anyway, Rob, God willing, we won't need to have you back to talk of about this again, but obviously you have your finger right on the pulse of everything that's going on. We appreciate you being here.

Rob Dietz: Thanks guys.

Jim Tobin: Thanks Rob.

Jerry Howard: Ladies and gentlemen, thank you very much. I ask us all to keep in our prayers our own service men and women who are now over in Europe. I know several of whom are the children of our members. We certainly are thinking of them, praying for them, and we hope we get out of this sooner rather than later. Thanks for listening. Once again thanks to Wells Fargo Home Mortgage.

Jim Tobin: Yeah. Thanks Rob. Thanks, Jerry. And this has been Housing Developments. See you next time. Thanks.