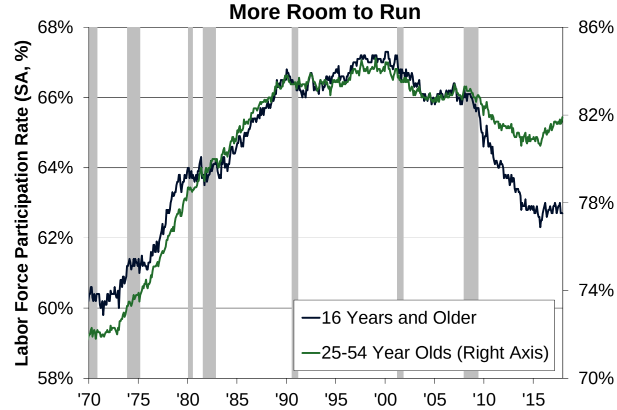
Economic Developments – January 2018

Fiscal Policy and the Fed: Stimulus/Response

Late last year, the President signed the Tax Cuts and Jobs Act into law. Most economists upgraded their economic growth forecasts when they incorporated the impact of a likely or final tax cut bill. For example, more than 90 percent of economists who participated in the Wall Street Journal monthly survey said in January that the tax cuts would increase economic growth over the next two years, similar to their thinking in earlier months when details of the legislation began circulating. Between October and January, the average forecast for 2018 real gross domestic product (GDP) growth is 0.3 percentage points higher, from 2.4 percent to 2.7 percent. Results from the January Blue Chip survey also showed the same expected growth bump during the same period. The rationale for the improved outlook is that cuts in individual tax rates should help spur consumer spending, while reductions in corporate tax rates and the allowance for equipment investment to be fully expensed for five years are expected to boost business equipment spending.

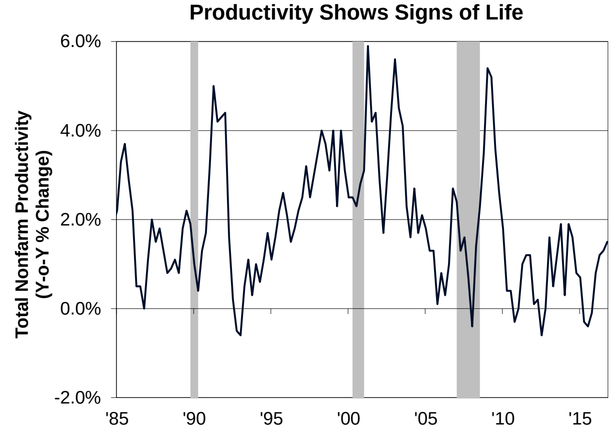
The biggest threat to continued economic expansion cited by Blue Chip respondents is a faster-than-expected rise in interest rates stemming from either higher inflation or a policy mistake by the Federal Reserve. This concern is based on a belief in a tradeoff between employment and inflation—the so-called Phillips Curve. In our view, this tradeoff has little empirical support in recent decades, and thus aggressive monetary tightening intended to preempt inflationary pressure may do more harm than good. History tells us that managing a “soft landing” has been a quite difficult task for policy makers, and the Fed’s reaction to the Tax Act is key to the expansion that is expected to reach its ninth anniversary this June. Thus, our theme for 2018 is “Fiscal Policy and the Fed: Stimulus/Response.”

Prime-Age Labor Force Participation Rate Has More Room to Run



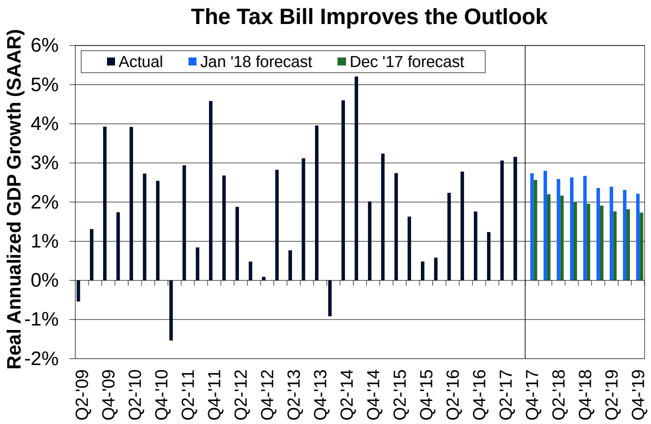
The extent to which stimulative fiscal policy will accelerate growth, and the resulting impacts on the unemployment rate and inflation, are subjects of considerable debate among economists. Although the expansion appears to be late in the business cycle, with the unemployment rate near historical lows, we believe that the labor market contains more slack than suggested by the unemployment rate. The tax bill should create demand for labor, leading to tighter labor market conditions and accelerating wage growth, which should draw more prime-age (25- to 54-year-old) workers into the labor force. The prime-age labor force participation rate has been trending up over the past year but remains well below the pre-recession level, suggesting an untapped reservoir of labor not reflected in the very low unemployment rate.

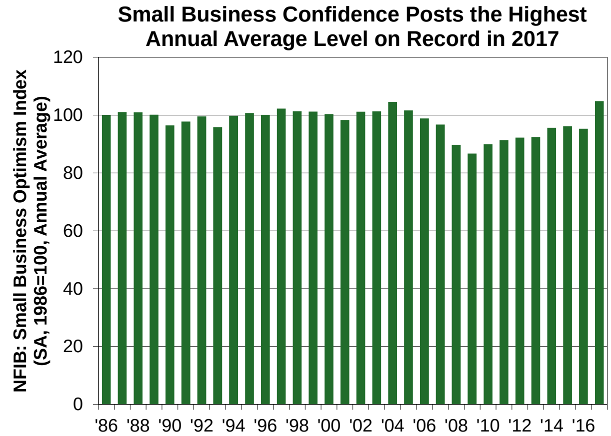
Productivity Shows Signs of Life



We also expect the tax bill to lead to stronger growth in business equipment investment, which is key to stronger productivity growth. Productivity growth has been anemic on average in the current expansion. However, amid robust growth in equipment investment last year, productivity growth has started to rise from a very depressed rate. Stronger productivity growth, even in the midst of rising compensation, should keep labor costs, core inflation, and inflation expectations contained. Therefore, we believe gradual monetary policy normalization can be consistent with stronger economic growth and a longer expansion.

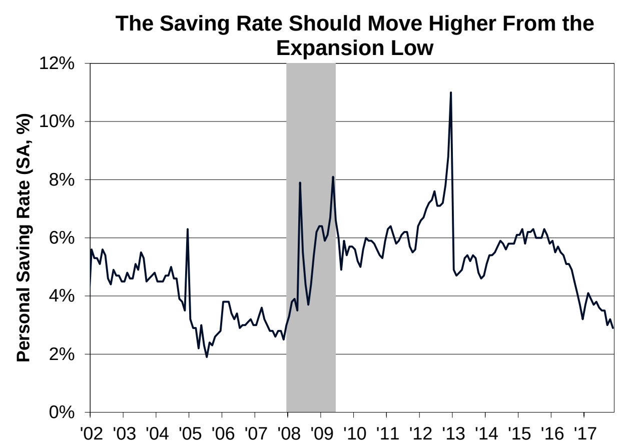
We revised higher our economic growth forecast for 2018 by 0.6 percentage points to 2.7 percent and for 2019 by 0.5 points to 2.3 percent. The improved outlook stems largely from stronger anticipated consumer spending and business equipment investment, which are expected to be partially offset by faster import growth. The unemployment rate is projected to average 3.7 percent in the second half of 2019, three-tenths lower than in the prior forecast and the lowest level in fifty years. However, we expect inflation to remain subdued, due to an anticipated increase in labor supply and a continued pickup in productivity growth from increased capital expenditures that should help offset rising worker compensation. We project the annual increase in the Fed's favored measure of inflation, the Personal Consumption Expenditures Deflator, to remain below the Fed's two-percent target throughout 2018.





The corporate tax cut should be a boon for business equipment investment. During the third quarter, business investment in equipment posted the strongest quarterly increase in three years. Incoming data suggest it ended 2017 on a strong note, setting the stage for continued acceleration this year amid very high business confidence. While small business confidence edged down in December, the average reading for all of 2017 set a record high since the monthly survey from the National Federation of Independent Business (NFIB) began in 1986. The tax bill should encourage businesses to accelerate capital expenditures, especially given that the 100-percent expensing will expire in five years and will be phased out over the subsequent five years. However, the lowering of the corporate income tax rate to 21 percent from 35 percent also makes the deduction less valuable, countering some of the benefits. We expect little investment impact from the one-time repatriation tax on accrued foreign profits, as past experience suggests that repatriated cash will likely be used for dividends and share buybacks.

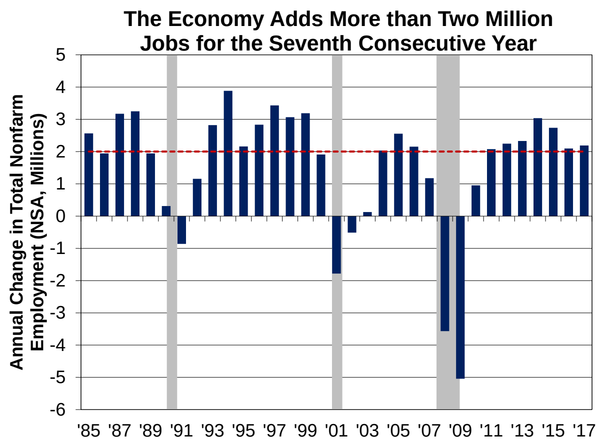
On the individual taxpayer front, because the tax bill also changed deductions (e.g., doubled the standard deduction and placed a $10,000 cap on combined state and local tax (SALT) and property tax deductions), its impact on final tax payments could vary significantly among households across the nation. Meanwhile, taxpayers can choose to spend the increased disposable income, save it, or use it to pay down debt. Thus, it is difficult to estimate how consumers will react to the windfall. Using the impacts of the 2001 and 2008 tax cuts as a guide, we expect real consumer spending growth to pick up by two-tenths in both 2018 and 2019, to 2.7 percent and 2.5 percent, respectively. The saving rate, which dipped three-tenths in November to the expansion low of 2.9 percent, should trend up as a result of the tax bill. Thus, while the tax cut may not boost consumer spending substantially because some taxpayers will choose to save the windfall or use it to pay down debt, it would help provide a savings cushion for rainy days and strengthen household balance sheets.

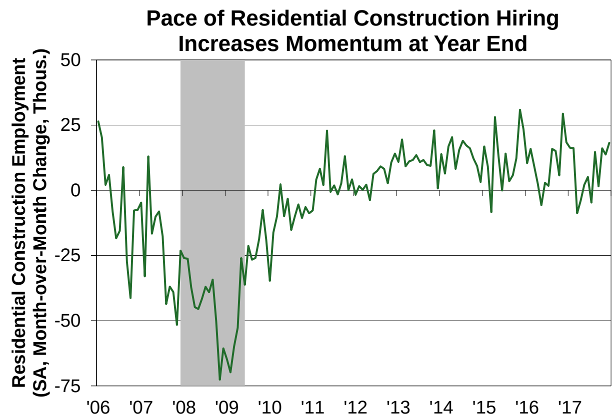


The labor market ended 2017 on a relatively subdued note, with nonfarm payrolls increasing 148,000 in December, weakening from the strong back-to-back gains following hurricane disruptions. A small net downward revision for the prior two months put the three-month average gain at 204,000. The survey of households was also uninspiring. The unemployment rate and the labor force participation rate were unchanged at 4.1 percent and 62.7 percent, respectively, and the broadest measure of labor underutilization, the U-6 rate, edged up one-tenth to 8.1 percent.

Other aspects of the establishment survey also disappointed. The average workweek was unchanged at 34.5 hours, and average hourly earnings rose 0.3 percent from November and 2.5 percent from a year ago, near the lower end of the 2.4 percent to 2.8 percent range witnessed throughout the year. We believe that wage gains will accelerate this year given a shortage of skilled labor. The December NFIB survey showed that the share of small business owners with few or no qualified applicants for open positions surged 10 percentage points to 54 percent—a record high.

For all of 2017, the economy added 2.2 million jobs, marking the seventh straight year with over two million jobs created. We expect another year of more than two million in payroll gains this year, with an average monthly gain of 186,000, about 10,000 more than in our prior forecast. One bright spot in the December jobs report was the biggest monthly rise in residential construction employment of 2017, raising hopes for some supply relief for housing this year.





Note: Residential Construction Employment combines construction of buildings and specialty trade contractors

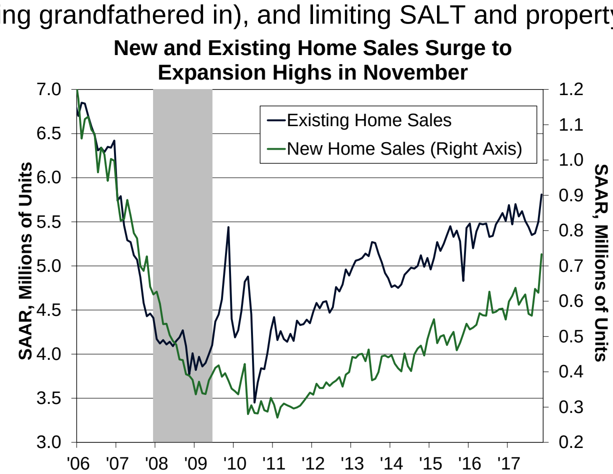
The Fed Will Likely Remain Cautious

At the December Federal Open Market Committee (FOMC) meeting, the Federal Reserve raised the fed funds rate 25 basis points. The Fed appears to be counting on modest, synchronized global growth to continue as they attempt to get some distance between a zero percent short-term rate and the current policy rate. The shrinkage of the balance sheet, another measure of monetary policy normalization, continues as expected. The Fed also released its updated Summary of Economic Projections (SEP), which revealed a slight upgrade for growth expectations for 2018 and 2019 and a lower unemployment rate forecast. While final details were not known when the FOMC met in December, the tax bill under consideration at the time was quite similar to the final enacted tax legislation. The updated SEP "dot plot" implied that FOMC members expect three rate hikes in 2018, the same as in the September projections. We believe that the Fed will wait for evidence of increased inflationary pressure before responding with a faster pace of rate increases. We expect the Fed to hike in March and in September of this year; however, a third rate increase this year is quite possible.

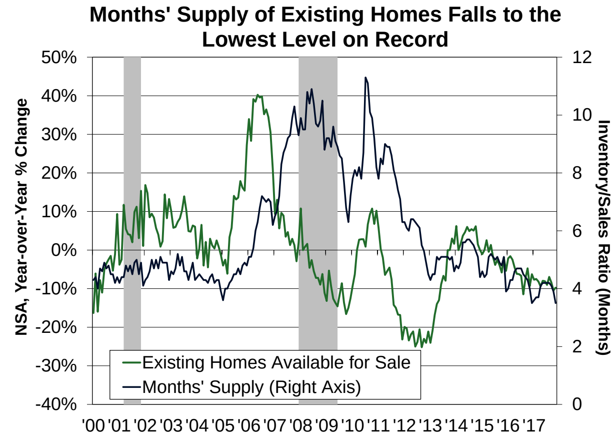
Housing Roundup

The Tax Act will create winners and losers in the housing market. While the individual tax cut should boost housing demand by increasing disposable household income, the tax bill reduces the incentive for homeownership by doubling the standard deduction, reducing the mortgage debt cap on which homeowners may take a mortgage interest deduction to $750,000 from $1,000,000 (with loans made before December 14 being grandfathered in), and limiting SALT and property tax deductions to a total of $10,000. As a result, the bill will lead to substantially fewer itemized returns.

Looking back, housing activity through November was upbeat across the single-family segment. Both single-family starts and permits rose in November to the highest levels in more than a decade, while homebuilder sentiment surged to an 18-year high in December. Through the first 11 months of 2017, single-family housing starts were 8.7 percent more than during the same period in 2016. Meanwhile, multifamily building has clearly peaked, as year-to-date multifamily starts through November were 8.2 percent below their 2016 level.

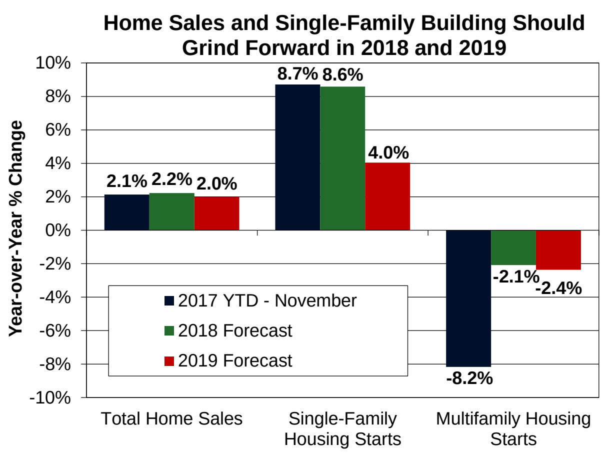


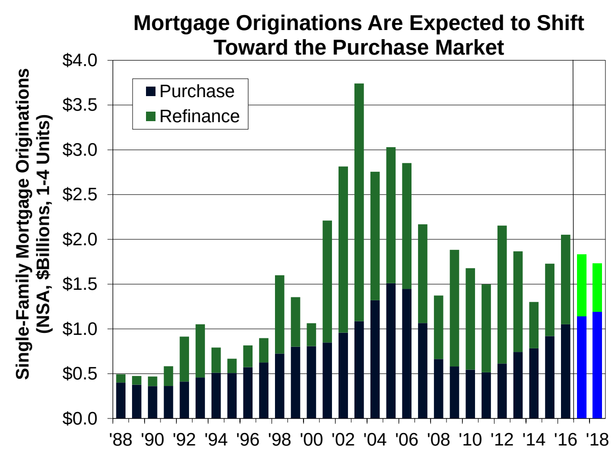
Existing home sales were also upbeat in November, rising for the third consecutive month to reach the strongest pace in nearly 11 years. Meanwhile, new home sales surged to the highest level since July 2007. Year-to-date existing and new home sales through November were 1.4 percent and 9.0 percent higher, respectively, than during the corresponding period in 2016.



The principal problem facing the housing market, especially for the existing home segment, remains one of supply rather than demand. The number of existing homes for sale in November was 9.7 percent below the level a year earlier and has fallen year-over-year for 30 consecutive months. The months' supply plunged to 3.4 months, the lowest level since the inception of the series in 1999. We expect tight inventory will continue to restrain home sales this year, even with the positive income effect from the tax cuts. The tax bill could negatively affect home prices in the high-end market; however, this segment accounts for a very small share of the total market and should have limited impact on overall home price appreciation.

Mortgage rates will continue to support the housing market as we expect them to rise only modestly over the next year, averaging 4.1 percent in the fourth quarter of 2018, up from 3.9 percent in the fourth quarter of 2017. Total housing starts should increase about 5 percent in 2018, solely because of the single-family segment, as multifamily starts are projected to decline further. We expect total new and existing home sales to rise about 2 percent, similar to the gain through 11 months of 2017. Total single-family mortgage originations should decrease about 5 percent this year to $1.73 trillion from an estimated $1.83 trillion in 2017, with a 7 percentage point decline in the refinance share to 31 percent in 2018.





For information on multifamily market conditions, read the January 2018 Multifamily Market Commentary.

Economic & Strategic Research (ESR) Group

January 10, 2018

For a snapshot of macroeconomic and housing data between the monthly forecasts, please read ESR's Economic and Housing Weekly Notes

Data source for charts: *Bureau of Labor Statistics, Bureau of Economic Analysis, National Federation of Independent Business, Census Bureau, National Association of REALTORS®, Fannie Mae Economic and Strategic Research*

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