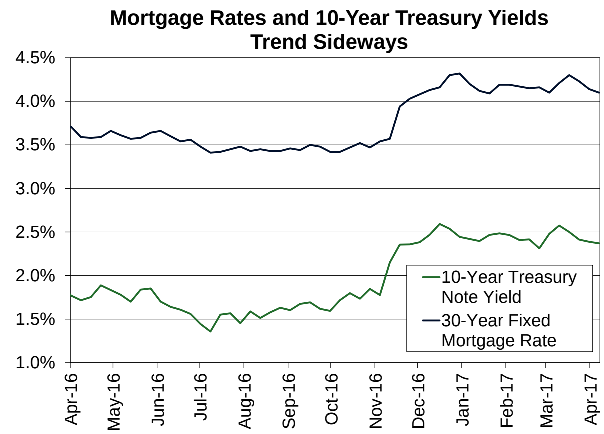
Economic Developments – April 2017

"Will Policy Changes…"

Our theme for 2017, launched in January, is "Will policy changes extend the expansion?" Policy has, by and large, not yet changed and neither has our forecast. Our forecast for full-year 2017 economic growth remains at 2.0 percent. We remain unconvinced that a meaningful positive impact from stimulative fiscal policy will occur this year. While it appears that we missed the mark on our forecast of real gross domestic product (GDP) growth last quarter, we believe special factors that depressed growth in the first quarter will partially unwind in the second quarter. Meanwhile, there are a number of indicators in what is typically a late-cycle position, such as the decline in bank lending, the level of nonfinancial corporate debt, and the level of household indebtedness.

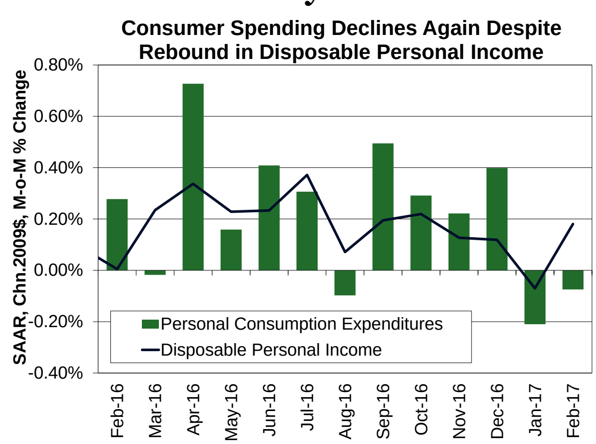


Near-term risks to the economy include a potential government shutdown on April 29 and policy uncertainty delaying investment decisions. Congressional appropriations will expire on April 28, and, if Congress does not pass an extension, the federal government will partially shut down. The economic consequences of a short shutdown would likely be minor, since lost federal pay is usually made up retroactively; however, any shutdown may weigh on consumer and business confidence in the ability of the government to bring about expected positive policy changes. Even without the government shutdown there is anecdotal evidence of business investment delays.

Long-term Treasury yields have trended sideways this year as a result. Rates dipped to the lower-end of a narrow range at the time of this writing, amid weak economic reports as well as increased geopolitical risks. The Freddie Mac survey showed that the average 30-year fixed rate mortgage fell in the first week of April for the third consecutive week to 4.10 percent, just one tick off its 2017 weekly low.

Our expectation for first quarter real economic growth has slipped to just 1.1 percent annualized, half a percentage point below what we had anticipated in the prior forecast. If our forecast is realized, this would mark the fourth consecutive year that growth has decelerated to start the new year. First quarter economic growth is likely to be understated due to lingering issues with seasonal adjustment known as residual seasonality—a pattern that remains in seasonally-adjusted data. We expect activity to rebound somewhat in the second quarter following the weak first quarter, as has occurred each of the last three years.

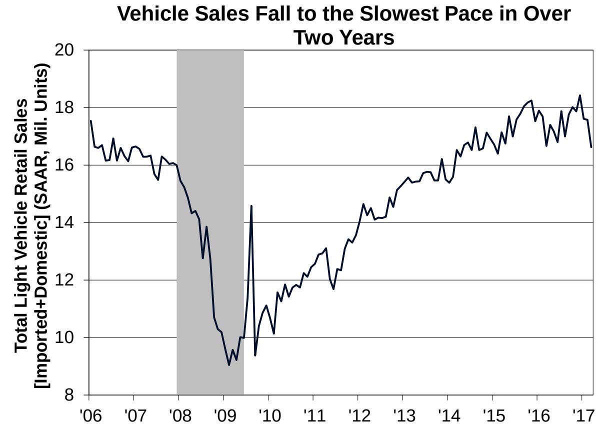
Measured Economic Activity Is At Odds with Current Sentiment Survey Results



Recent reports underscore the ongoing disparity between subdued hard data on economic activity and upbeat soft data on consumer and business sentiment. Under the hard data category, economic reports related to consumer spending for the first quarter were bearish. Real consumer spending edged down 0.1 percent in February following a 0.2 percent decline in January—the first back-to-back drops since March and April 2009.

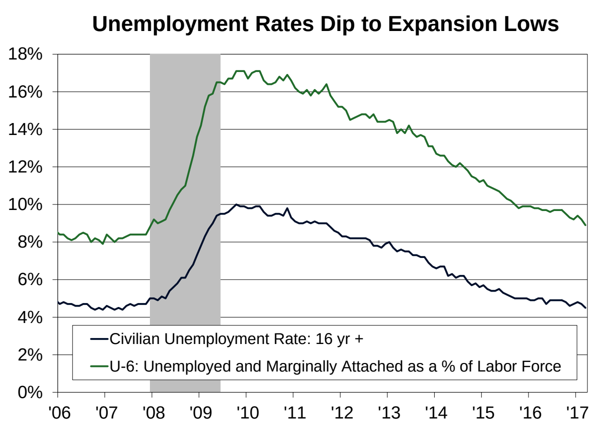
The second warmest February on record depressed utilities consumption for the second consecutive month. Given more normal March weather, we should see a rebound in utility spending to close out the first quarter. In addition, delayed tax refunds may have contributed to soft consumer spending, suggesting an increase in the pace of spending in coming months.

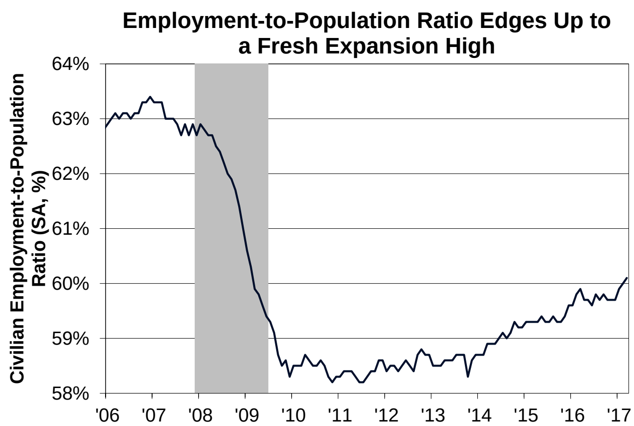
However, March auto sales fell 5.4 percent, the biggest monthly decline in a year. Thus, even if spending in some areas such as utilities picked up in March, we still expect overall real consumer spending to slow sharply to 1.1 percent annualized for the first quarter from a robust 3.5 percent pace in the fourth quarter.



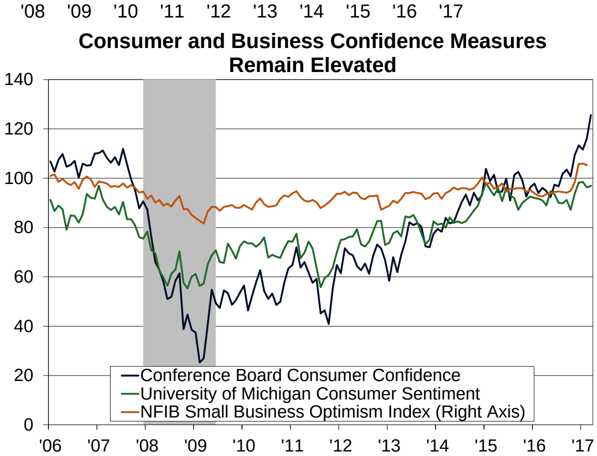
Data on labor market conditions were mixed in March, with the monthly jobs report revealing a tale of two surveys. On the disappointing side, the establishment survey showed headline job gains of just 98,000, the weakest monthly gain since last May. Downward revisions of 38,000 jobs for the prior two months pulled the three-month average gain down to 178,000 from 197,000 in the three months ending in February. The continued struggles of the retail sector were evident in the decline of 30,000 jobs in March following February's decline of 31,000. Stormy March weather following an unseasonably warm January and February was partially responsible for the overall weakness. One supporting piece of evidence of a seasonal payback was construction payrolls, whose gains moderated to 6,000 in March following the increase of 59,000 jobs in February and 34,000 in January. Meanwhile, the annual rise in average hourly earnings moderated one-tenth to 2.7 percent.

On the brighter side, the household survey was upbeat, suggesting that the establishment survey likely overstated worsening labor market conditions. Both the official unemployment rate and the broadest measure of labor market slack, the U-6 rate, slipped to fresh expansion lows of 4.5 percent and 8.9 percent, respectively. While the labor force participation rate was flat at 63 percent, the employment-to-population ratio increased for the third consecutive month to 60.1 percent, a new expansion best.





Despite some signs of weakening economic activity in the spending and jobs data, consumers were more upbeat in March. The Conference Board Consumer Confidence Index jumped to the highest level in more than 16 years, and the University of Michigan Consumer Sentiment Index improved from February, remaining just below the 13-year high reached in January. Small business owners remained optimistic. While the National Federation of Independent Business Optimism Index edged down in February for the first time in five months, it remains near its record high.



Incoming data on trade and investment showed some improvement during the first quarter. The trade deficit narrowed in February, partly because of weak consumer demand that caused a pullback in imports of autos and other goods amid a small increase in exports. Factory orders rose in February for the third consecutive month, indicating continued improvement in the manufacturing sector as the headwinds from the strong dollar and declining energy prices faded. While core orders (nondefense capital goods orders excluding aircraft), a leading indicator of business investment in equipment, dipped slightly during the month, it was the first drop in five months.

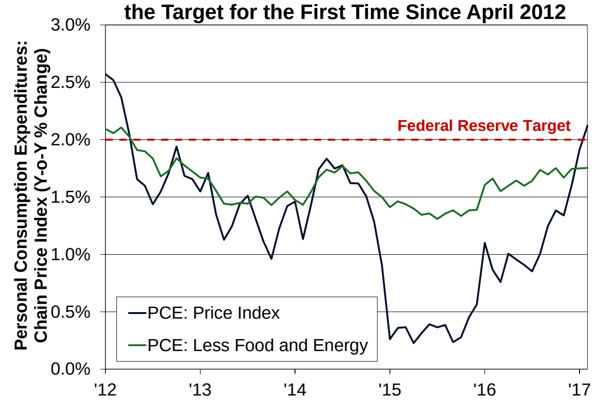
Despite recent improvements in indicators of manufacturing activity, including manufacturing payrolls, they continue to lag behind results from surveys of purchasing managers. For example, the Institute for Supply Management (ISM) Manufacturing Index rose in February for the sixth consecutive month, showing the fastest expansion in the sector since August 2014. The index edged down only slightly in March, remaining at an elevated level.

Manufacturing Sector Activity Slows Slightly In March From a Two-and-a-Half Year High

Fed Comments Become More Hawkish

The Fed's favored measure of inflation, the personal consumption expenditures (PCE) deflator, edged up 0.1 percent in February. From a year ago, prices rose 2.1 percent, achieving a pace above the Fed's 2.0 percent target for the first time in nearly five years. Retail gasoline prices, which have risen from the seven-year low reached last February, helped boost the headline PCE deflator over the past year. Excluding energy and food prices, the annual increase in core prices has been more stable, hovering between 1.7 percent and 1.8 percent for the past seven months. Combined with the decline in the unemployment rate to 4.5 percent, we expect firming inflation will prod the Fed to raise the fed funds rate in June and September, compared with September and December in the prior forecast.

Fed's Favored Inflation Measure Climbs Above the Target for the First Time Since April 2012

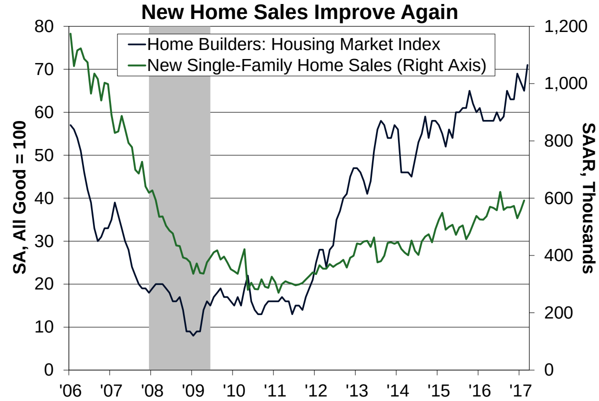


The minutes from the March Federal Open Market Committee (FOMC) meeting suggested that the Committee is laying the groundwork to begin shrinking the Fed's balance sheet. The minutes noted that, if the economy performs as expected, "most participants" viewed that "a change to the committee's reinvestment policy would likely be appropriate later this year." Our view is that an explicit portfolio policy statement is likely to be included in the December meeting statement. Of course, all of this is "data dependent," to use the Fed's own words.

Late Cycle Housing Dynamics

Through February, news from the housing sector was more upbeat than reports from other areas of the economy, partly because of the unusually warm winter weather. Single-family starts jumped in February, as permits rose to an expansion high. By contrast, multifamily starts fell for the second consecutive month, while permits fell for the third time in four months. The National Association of Home Builders' Housing Market Index (HMI), a gauge of home builders' confidence in the single-family market, jumped six points in March to 71, an expansion best. (A reading of more than 50 indicates more builders view the market as good rather than poor.)

Home Builders' Sentiment Climbs Higher as New Home Sales Improve Again

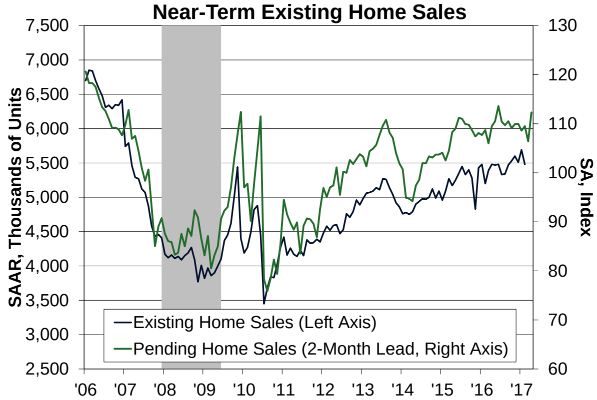


Heading into the spring home selling season, the housing market should benefit from a seasonal increase in listings. However, extremely low for-sale inventory remains the primary headwind. While construction activity has picked up, single-family building still significantly lags the demographic driven level of demand. Declines in household mobility are suppressing existing home supply.

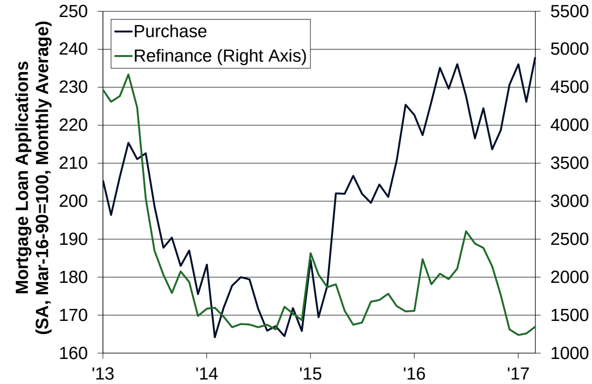
Home sales were mixed in February. Existing home sales posted the largest monthly drop in a year, falling from the expansion best reached in January. New home sales, on the other hand, rose to the second highest level of the expansion. Even so, in yet another indication of how hard data on economic activity is trailing softer measures of sentiment, gains in new single-family home sales are lagging far behind improvements in builder sentiment reflected in the HMI.

Forward-looking indicators of home sales have been positive. Pending home sales, which record contract signings for existing homes, jumped in February to the second-highest level in over a decade, suggesting improvements in closed sales in coming months. Another leading indicator of home sales, purchase mortgage applications, rebounded in March, regaining the levels seen before the post-election mortgage rate spike.

Spike in Pending Home Sales Bodes Well for Near-Term Existing Home Sales



Purchase Mortgage Demand Recovers

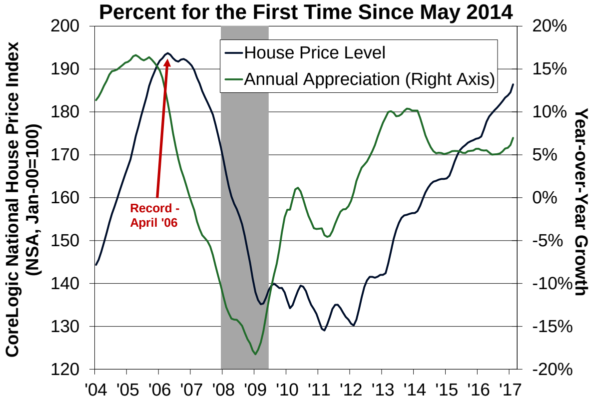


A potentially faster pace of Fed rate hikes poses a downside risk to the home sales market. In March, the Fannie Mae Home Purchase Sentiment Index (HPSI) gave back some of the gains accumulated over the prior two months that sent the index to its survey high in February. One of the HPSI components, the net share of consumers who expect mortgage rates to rise over the next year, increased during the month, exceeding that reported during the 2013 taper tantrum. However, in the absence of stimulative policy actions, we anticipate the Fed actions will lead to a flatter yield curve and minimal upward pressure to longer term rates, in which case those consumer rate concerns would not be realized.

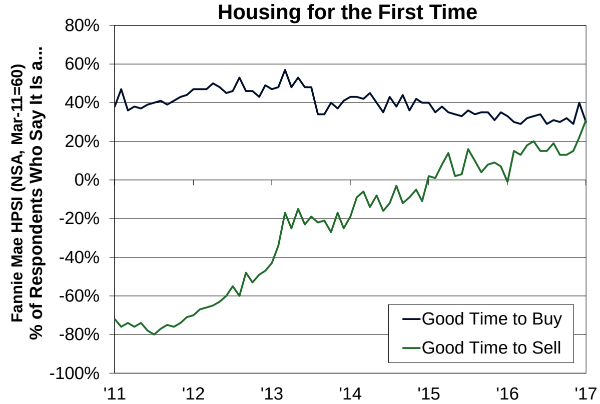
The aforementioned extremely lean inventory continued to boost home price appreciation, with the CoreLogic National House Price Index rising 7.0 percent in February from a year ago, the fastest pace of gain since May 2014. The CoreLogic measure tends to show stronger appreciation than other price measures and is prone to downward revisions. However, other measures also showed healthy annual home price appreciation at the start of this year.

The strength in recent home price appreciation has turned into a double-edged sword for two components of the March HPSI. High home prices were the most important factor behind both the bad time to buy and good time to sell indicators, cited by 39 percent of consumers who say it is a bad time to buy (a survey high) and 24 percent of those who say it is a good time to sell. The net share of consumers saying it's a good time to sell jumped to a record high, surpassing the plunging good time to buy indicator for the first time in the six-year history of the survey.

Annual Home Price Growth Climbs to Seven Percent for the First Time Since May 2014



Consumers Think It Is a Sellers' Market in Housing for the First Time



In addition to the potential seasonal rise in for-sale inventory, perhaps boosted by some sellers seeking to lock in profits from recent rapid home price gains, the home sales market could also get a boost from homebuyers who decide to jump into the market before rates rise further. We expect about a 3.0 percent increase in home sales for 2017, a slight improvement from the previous forecast. Our outlook for mortgage rates is little changed from the prior forecast, with 30-

year fixed mortgage rates averaging 4.3 percent in the fourth quarter of 2017. We expect total mortgage originations to drop about 20 percent this year to $1.58 trillion. We also expect purchase originations to rise moderately amid a sharp drop in refinance originations, pushing the refinance share lower 16 percentage points from 2016 to 32 percent in 2017.

Economic & Strategic Research (ESR) Group

April 10, 2017

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: *The Federal Reserve Board, Freddie Mac, Bureau of Economic Analysis, Autodata Corporation, Bureau of Labor Statistics, The Conference Board, The University of Michigan, The National Federal of Independent Business, The Institute for Supply Management, Census Bureau, The National Association of Home Builders, The National Association of REALTORS®, Mortgage Bankers Association, CoreLogic, and Fannie Mae.*

ESR Macroeconomic Forecast Team

Doug Duncan, SVP and Chief Economist
Orawin T. Velz, Director
Hamilton Fout, Director
Mark Palim, VP and Deputy Chief Economist
Frank Shaw, Economist
Michael T. Vangeloff, Strategic Planning Analyst III