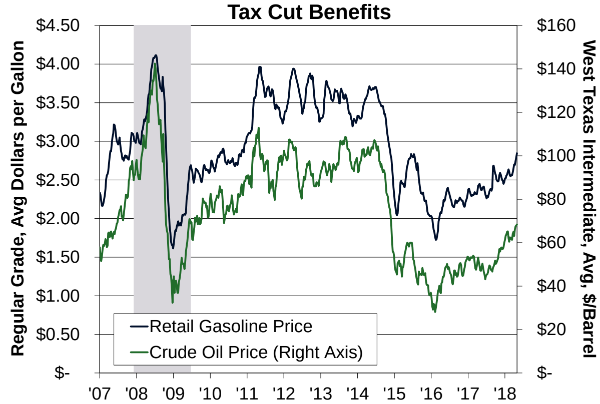
Economic Developments – May 2018

Boost from Fiscal Policy to Fade in 2019

First quarter economic growth of 2.3 percent annualized is now in the rearview mirror. It was the slowest pace in a year, down from 2.9 percent in the final quarter of 2017. We expect a pickup in growth during the rest of the year based on last December's Tax Cuts and Jobs Act and this February's Bipartisan Budget Act of 2018, which should boost consumer spending, business investment, and government outlays. Our full-year 2018 forecast remains at 2.7 percent, unchanged from our prior forecast. We lowered 2019 growth projections by two-tenths to 2.3 percent, as we now expect the stimulus from fiscal policy to fade and the labor market to tighten more than we did previously.

The mostly cheery first paragraph should not obscure the downside risks to our forecast, including the continued rise of oil prices. Declining global stocks of crude oil amid strong demand and rising geopolitical uncertainty have pushed crude prices higher by about $11 per barrel since December to reach $71 per barrel at the time of this writing. Rising gasoline prices decrease disposable income and are therefore likely to negate some of the increase in disposable income from the tax cuts. Furthermore, higher gasoline prices put upward pressure on headline inflation and could lead the Fed to raise interest rates more quickly than currently anticipated. Meanwhile, protectionist trade policy remains a headwind to growth.

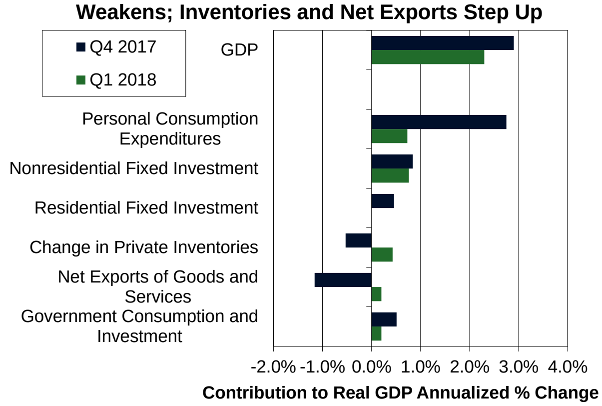
Rising Gasoline Prices Will Likely Temper Tax Cut Benefits



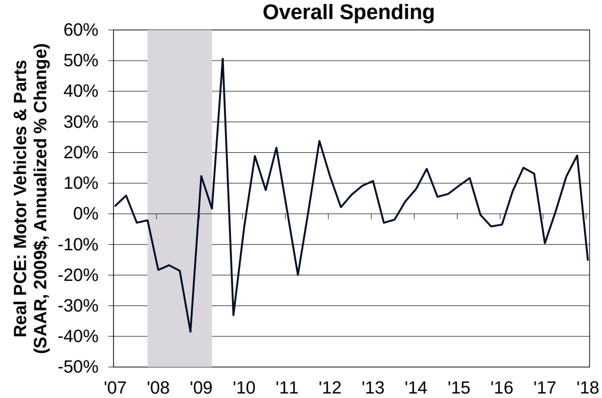
Despite Tax Cuts, Spending Falters in Early 2018

The main factor behind disappointing first quarter real gross domestic product (GDP) growth was consumer spending. After increasing 4.0 percent annualized in the prior quarter, real consumer spending grew just 1.1 percent in the first quarter, contributing only 0.7 percentage points to GDP growth, compared with a 2.8 percentage point contribution in the prior quarter. Spending on motor vehicles and parts was largely responsible for the marked slowdown. Following a fourth quarter surge as consumers replaced vehicles destroyed by the hurricanes, real spending on motor vehicles and parts posted the third largest drop of the expansion and subtracted 0.4 percentage points from first quarter growth, virtually offsetting its contribution to growth in the prior quarter.

Consumer Spending's Contribution to Growth Weakens; Inventories and Net Exports Step Up



Motor Vehicles and Parts Drag on Overall Spending



Monthly data show that real consumer spending increased 0.4 percent in March, the first rise in three months, as tax refunds caught up to historical norms and most households realized lower withholdings due to the Tax Act. Disposable income gains lagged behind spending increases, pushing the saving rate two-tenths lower to 3.1 percent, the first drop this year, although the rate remains well above the expansion low of 2.4 percent reached last December. Meanwhile, consumers remained cautious with their credit card usage. While growth in nonrevolving debt (largely auto and student loans) held steady in March for the third straight month, revolving credit posted back-to-back drops for the first time in almost five years. Lending standards for credit card debt also tightened further. The Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices for the three months ending in April showed that banks tightened lending standards for credit card loans as they increased minimum required credit scores.

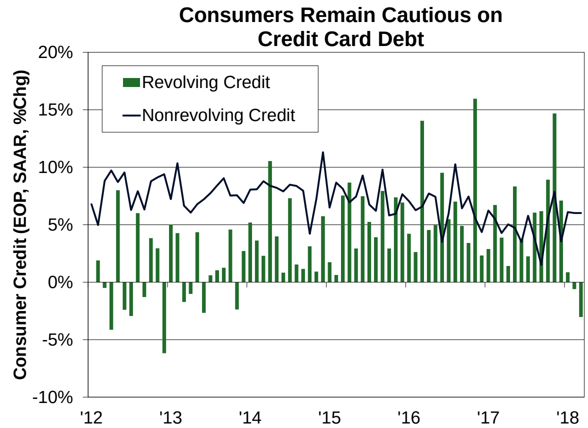
The rebound in real consumer spending in March suggests increased momentum heading into this quarter, setting the stage for a sizable pickup in spending and thus GDP growth. However, higher gasoline prices, which have risen nearly 40 cents per gallon so far this year, when combined with declining equity values since late January, could lead consumers to be more cautious. Thus, we revised lower our prediction for real consumer spending growth in 2018 by three-tenths to 2.1 percent.

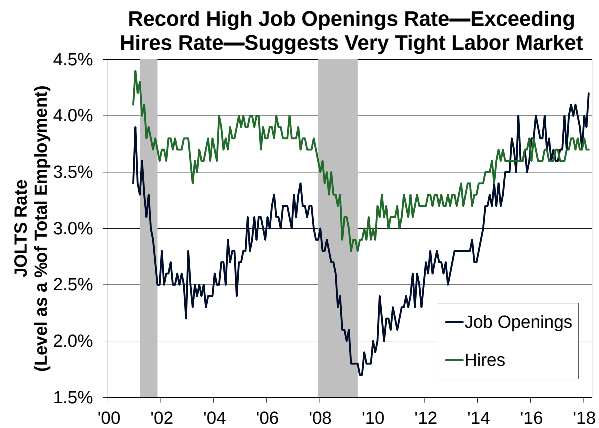
Measures of consumer confidence are at historically high levels amid healthy labor market conditions. The April jobs gain came in on the soft side, with nonfarm payrolls increasing 164,000. However, a net upward revision of 30,000 in the prior two months helped to keep the three-month average gain at more than 200,000. Wage pressures continued to be muted, as the annual rise in average hourly earnings held at 2.6 percent for the third consecutive month following a downward revision the prior month.

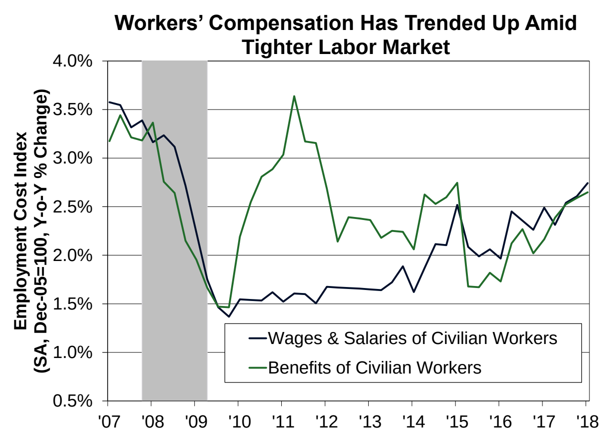
The household survey showed that the unemployment rate fell for the first time in six months to 3.9 percent from 4.1 percent as a result of the second straight drop in the labor force participation rate. One bright spot from the survey was the decrease in the broadest measure of labor underutilization (U-6 unemployment rate) to 7.8 percent, the lowest level in nearly 17 years.

The March Job Openings and Labor Turnover Survey (JOLTS) pointed to an extremely tight labor market. The job openings rate (as a share of total employment) jumped three-tenths in March for the second time in three months to 4.2 percent, the highest level since the series began in December 2000. The hires rate remained slightly below its expansion high. The quits rate, a gauge of workers' confidence in the labor market, ticked up to 2.3 percent, tying the expansion high.

The JOLTS results were consistent with the National Association of Independent Business Small Business Economic Trends Report, which showed that the Small Business Optimism Index rose slightly in April. The share of firms with job openings held steady at the expansion high of 35 percent. Labor quality remains the top concern, cited by 22 percent of small business owners, tying an expansion high.



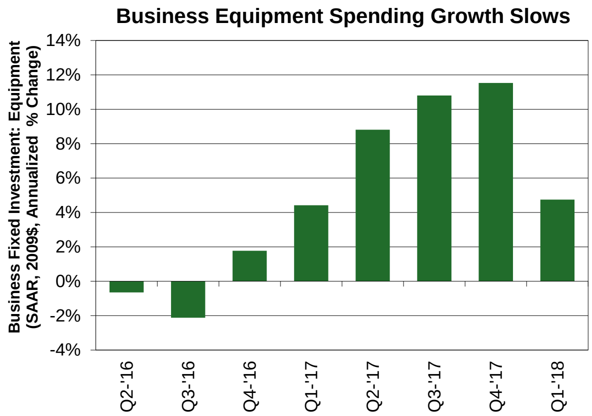


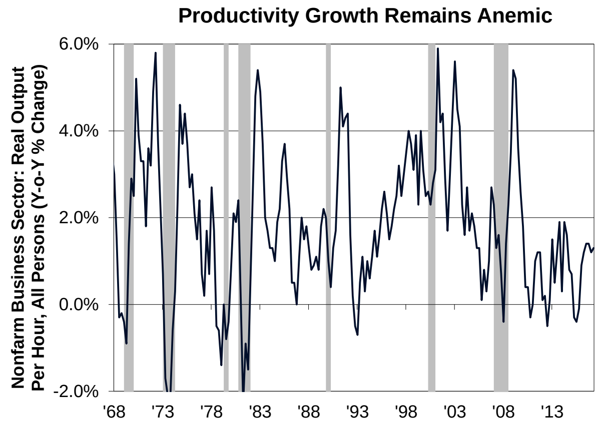


Although steady wage growth amid a tight labor market should ease concerns of runaway inflation, the Fed will watch other measures of rising labor costs, such as the Employment Cost Index (ECI). Unlike the average hourly earnings data of the monthly jobs report, the ECI is free from the influence of employment shifts across occupations and industries. The year-over-year rise in the ECI reached an expansion high in the first quarter, thanks to the biggest annual increase in wages and salaries of the expansion amid an accelerating annual rise in benefit costs.

Business Equipment Investment Growth Slows

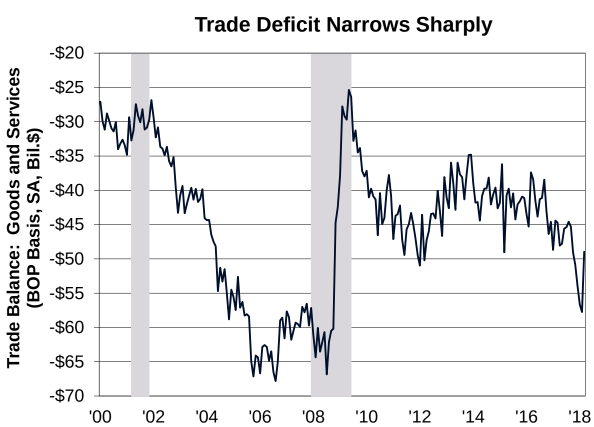
Real nonresidential investment grew during the first quarter at a pace in line with the quarterly gains seen throughout 2017, driven by the strongest growth in real investment in structures in a year. However, real investment in equipment disappointed, growing at less than half the pace of the prior two quarters, despite the Tax Act's full expensing provision. In addition, core (nondefense excluding aircraft) capital goods orders, a forward-looking indicator of equipment investment, fell in March for the third time in four months, suggesting that equipment spending growth could slow further this quarter. Our expectation for improving GDP growth this year depends, in part, on a pickup in business equipment investment, which could help spur productivity growth from the current anemic pace. During the first quarter, nonfarm productivity rose just 1.3 percent from a year ago, roughly the same pace seen over the past year. An acceleration in productivity growth is needed to help keep unit labor costs contained amid late cycle fiscal stimulus. This would help businesses maintain profit margins, allowing them to continue to invest and hire.

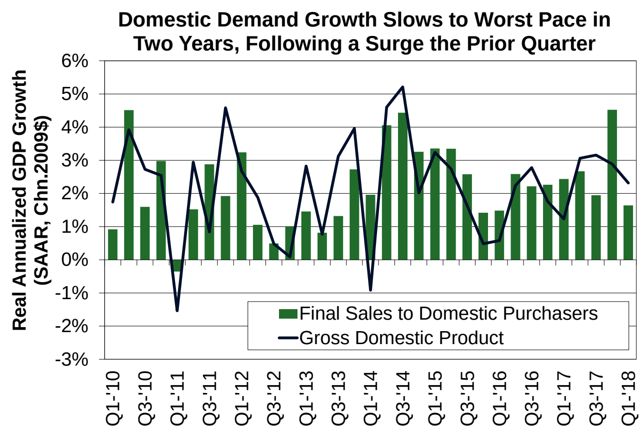




Domestic Demand Growth Moderates

As expected, inventory investment and government spending contributed to first quarter GDP growth. One surprising driver of first quarter growth was trade. The nominal trade deficit narrowed in March for the first time since August 2017, falling by the largest amount since February 2009, as exports rose and imports declined. The overall decline in imports reflected a sharp reversal in imports of services following a spike in February related to spending on broadcasting rights for the Winter Olympics. Imports of goods also declined in March, but reversed only a fraction of a large run-up since August 2017. We expect the marked improvement in March to be an aberration, with net exports dragging on growth during the rest of the year. A gauge of strength in domestic demand and a better measure of the underlying growth—final sales to domestic purchasers (GDP minus trade and inventories)—grew at the slowest pace in two years, after surging at the end of 2017 to the fastest growth since 2010.

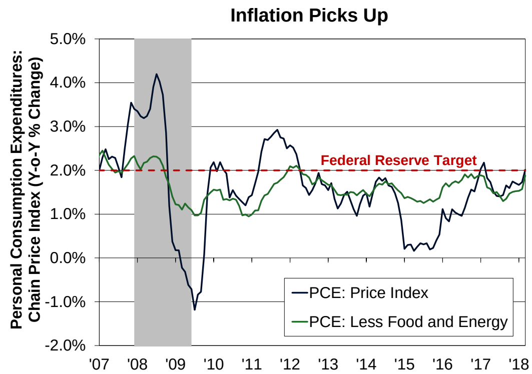




The Fed May Temporarily Tolerate Above-Target Inflation

Inflation picked up in March. The Fed's preferred measure of inflation, the personal consumption expenditures (PCE) deflator, rose 2.0 percent annually in March after four consecutive months of 1.7 percent gains, as core PCE posted a 1.9 percent year-over-year rise.

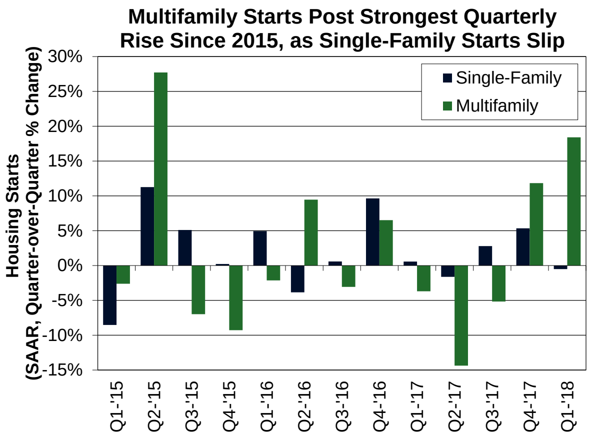
As universally expected, the Federal Open Market Committee (FOMC) voted at its May meeting to hold rates at 1.50 percent to 1.75 percent. The statement following the meeting reflected the acceleration in inflation, as the FOMC noted that headline and core inflation "moved close to" the 2 percent target, a change from "continued to run below" in the prior statement. Another notable

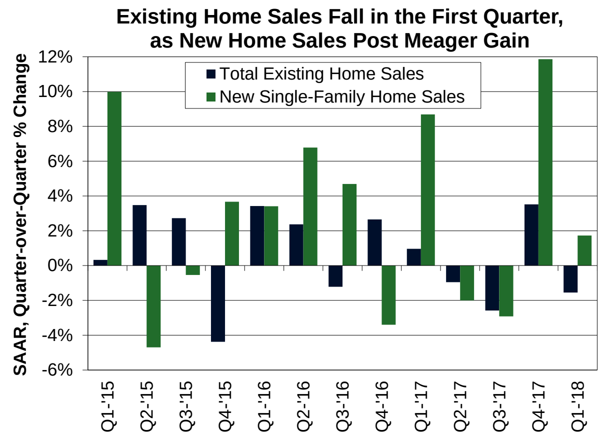


modification in the statement was that inflation is “expected to run near the Committee’s symmetric 2 percent objective over the medium term.” The introduction of the word “symmetric” could be a signal that the Fed will tolerate inflation temporarily overshooting the target. The FOMC also dropped the language that it is “monitoring inflation developments closely,” hinting that it is more confident in the near-term inflation outlook. The statement’s somewhat dovish tone and the April jobs report support our view of a June rate hike followed by only one more increase this year.

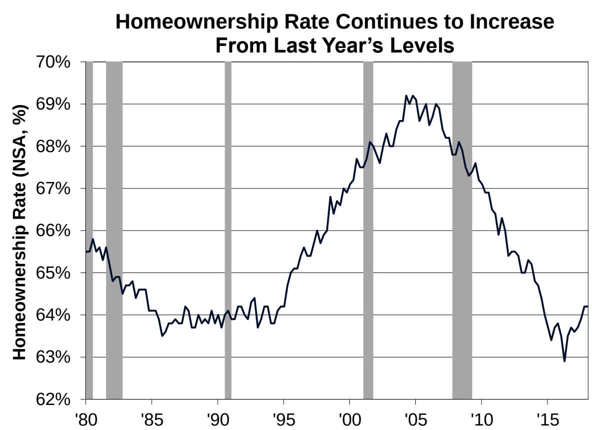
Housing Roundup

First quarter housing activity was lackluster, and as a result real residential investment made no contribution to growth in the first estimate of GDP. Homebuilding activity was mixed during the quarter, with multifamily starts posting the largest quarterly increase since the second quarter of 2015 amid a slight decline in single-family starts. Meanwhile, new home sales increased while existing home sales, which account for nearly 90 percent of total home sales, fell during the quarter.



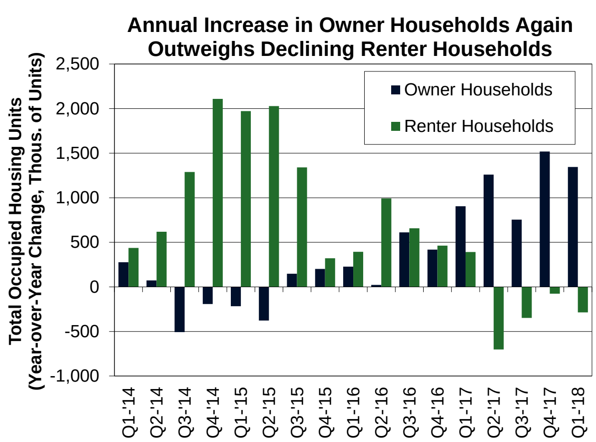


The for-sale inventory of existing homes has remained below year-ago levels for nearly three years, thereby restraining sales and boosting prices. Main measures of home prices—the S&P CoreLogic Case-Shiller, CoreLogic, and FHFA Purchase-Only home price indices—showed strong annual home price gains between 6.3 percent and 7.2 percent for the nation in February.



Leading indicators suggest an improving outlook for home sales going into the spring selling season: pending home sales rose in March for the second consecutive month and purchase applications increased in April for the second straight month. We continue to expect total home sales to rise about 2.5 percent this year.

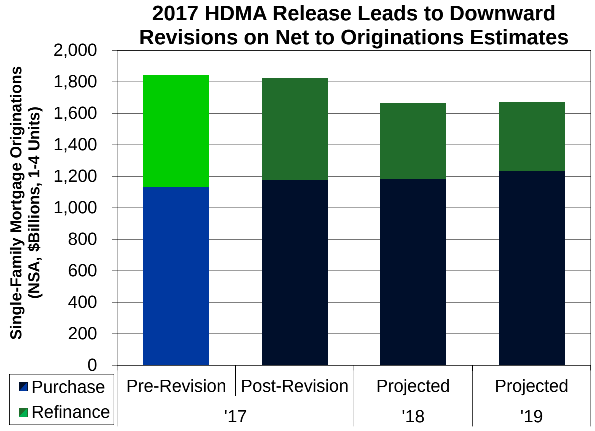
The Housing Vacancy Survey (HVS) offered some good news in the owner-occupied sector for the first quarter. While the homeownership rate (not seasonally adjusted) stayed flat at 64.2 percent, it increased on an annual basis for the fifth consecutive quarter. In addition, the annual increase in owner households exceeded one million for the third time in four quarters and significantly outpaced the drop in renter households, which posted a year-over-year decline for the fourth consecutive quarter.



Meanwhile, in another sign of constrained supply in the for-sale market, the HVS homeowner vacancy rate fell two-tenths from the level a year ago to 1.5 percent, the lowest for the first quarter reading since 2001. The rental vacancy rate was unchanged from a year ago, remaining at 7.0 percent.

We have updated our estimate of single-family (1-4 unit properties) mortgage originations for the prior year based on our annual benchmarking to the newly released Home Mortgage Disclosure Act (HMDA) data. We revised higher our estimated purchase originations by $42 billion and revised lower our estimate of refinance originations by $58 billion, which resulted in a net decline in total mortgage originations of $16 billion to $1.83 trillion in 2017. As a result of the benchmarking, the refinance share was revised lower by 2 percentage points from the prior estimate to 36 percent.

For 2018, we expect total mortgage originations to decline approximately 9 percent from 2017 to $1.67 trillion, as a 26 percent drop in refinance originations outpaces a 1 percent rise in purchase originations. We expect the refinance share to fall 7 percentage points from 2017 to 29 percent.



For information on multifamily market conditions, read the [May 2018 Multifamily Market Commentary].

Economic & Strategic Research (ESR) Group

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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: *Bloomberg, Energy Information Administration, Bureau of Economic Analysis, Federal Reserve Board, Bureau of Labor Statistics, Census Bureau, National Association of REALTORS®, ESR Group*

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