



Economic Developments – August 2018

Growth Picks Up as Expected, No Thanks to Housing

Headline economic growth accelerated substantially in the second quarter, as predicted in our July forecast. However, the details underlying last quarter’s growth suggest an upgrade to our outlook for this quarter. As anticipated, consumer spending and net exports drove second quarter activity, but, contrary to our expectations, business inventories declined and dragged sizably on growth. While incoming data support our view that consumer spending growth will slow and net exports will detract from growth in the current quarter, a swing from an inventory drawdown to restocking should outweigh weaknesses elsewhere. Thus, we upgraded our third quarter outlook and now expect full-year 2018 growth of 3.0 percent, compared with 2.8 percent in the prior forecast. As fiscal policy impacts fade and monetary policy continues to tighten, we project that growth will slow to 2.3 percent in 2019.

Trade policy remains a key source of downside risk to our forecast. Trade tensions between the U.S. and the European Union appear to be de-escalating, but tensions with China have intensified. If proposed U.S. tariffs, including a 25 percent levy on \$200 billion in imported Chinese goods, take effect over the next several months, China will likely retaliate with tariffs and other measures that restrict trade. Although the direct cost of the already-imposed tariffs is small at the national level, indirect costs from uncertain trade policy are probably mounting. Uncertainty about access to imported inputs and foreign markets, as well as negative impacts from supply chain disruptions, are likely weighing on businesses’ decisions to invest and hire.

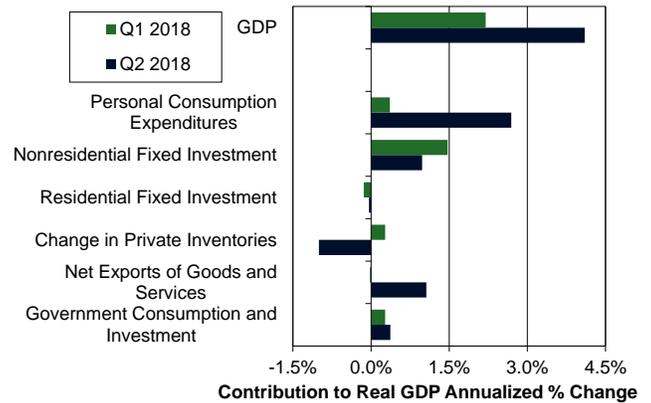
Consumer Spending Underpins Strong Growth

According to the Bureau of Economic Analysis’ advance estimate, real gross domestic product (GDP) grew 4.1 percent annualized in the second quarter, the best showing since the third quarter of 2014. The GDP report included annual benchmark revisions for the past five years that put real GDP growth between 2012 and 2017 at an average of 2.2 percent, unchanged from earlier releases.

Real consumer spending surged 4.0 percent annualized in the second quarter after a paltry 0.5 percent gain in the first quarter. Consumer spending added 2.7 percentage points to second-quarter growth, the biggest contribution since the end of 2014. The gains were solid across durables, nondurables, and services. Notably, durable goods spending rebounded strongly from the payback in the first quarter following a hurricane-induced surge in the fourth quarter of 2017. While quarter-to-quarter growth in real consumer spending has been quite volatile of late, year-over-year growth registered 2.7 percent last quarter, remaining within the narrow range of 2.4 percent to 2.8 percent since 2016.

As part of the benchmark revision, nominal personal income was revised higher, resulting in a significant upward adjustment to the personal saving rate. For example, the saving rate was revised to 7.2 percent in the first quarter of this year, more than doubling the initial estimate of 3.3 percent. Much of the upward revision to personal income was due to higher investment income, as proprietors’ income was upgraded significantly. However, over the last 18 months, changes to wages and salaries accounted for

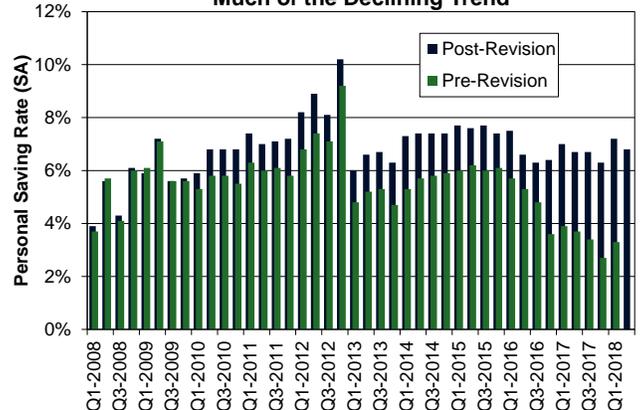
Consumer Spending and Net Exports Propel Growth as Inventories Drag



Annual Growth in Consumer Spending Holds Within a Tight Range



Revisions to the Personal Saving Rate Remove Much of the Declining Trend





most of the upward revision to income, essentially revising away the initially reported sharp decline in the saving rate. Thus, the recent upgrade in the saving rate suggests that consumers have a better cushion to support future spending than previously believed.

Nonetheless, we expect real consumer spending growth to moderate to 2.6 percent annualized this quarter. An early consumer spending-related report for July supports this view, as auto sales fell 2.7 percent to a 16.8 million annualized pace, the first time sales have fallen below 17 million units since last August.

Other Growth Drivers Will Likely Show Mixed Results This Quarter

Net exports were the second largest contributor to growth last quarter, adding 1.1 percentage points to GDP growth and marking the second largest contribution from trade in the expansion. Exports grew strongly, partly because businesses abroad rushed to import U.S. agricultural products, especially soybeans, ahead of recently implemented tariffs, while import growth decelerated. We expect the large contribution from trade to be a “one-off.” Monthly data already showed evidence of a deteriorating trade balance, with the June deficit widening for the first time in four months as imports rose while exports fell. Exports of petroleum goods rose to an all-time high, but nonpetroleum goods exports weakened almost across the board. We project that trade will revert to be a drag on growth in the third quarter as exports fall, reflecting both the expected reversal of a surge in soybean and other exports, as well as the negative effects of a rising dollar.

Government spending also posted a strong increase in the second quarter, boosted by an especially large gain in outlays on national defense. The government spending increase reflected the impact of this year’s budget act, which should continue to boost government expenditures through early next year before its effects start to fade.

Nonresidential investment also helped spur growth, though its contribution was less than in the first quarter. Mining structure investment surged in the second quarter, thanks to the highest crude prices since the fourth quarter of 2014, and drilling activity should remain a tailwind for growth this year. However, business equipment investment, the expected prime beneficiary of the tax act’s enhanced depreciation allowances and the repatriation of profits, disappointed, rising at the slowest pace since the fourth quarter of 2016. Downward revisions in June core capital goods shipments (nondefense excluding aircraft), which are used to estimate business equipment investment, put equipment investment on a weaker trajectory heading into this quarter. Core capital goods orders, a forward-looking indicator, were also revised lower, suggesting no meaningful near-term pickup in growth in equipment investment, a key to improving productivity growth in the longer term.

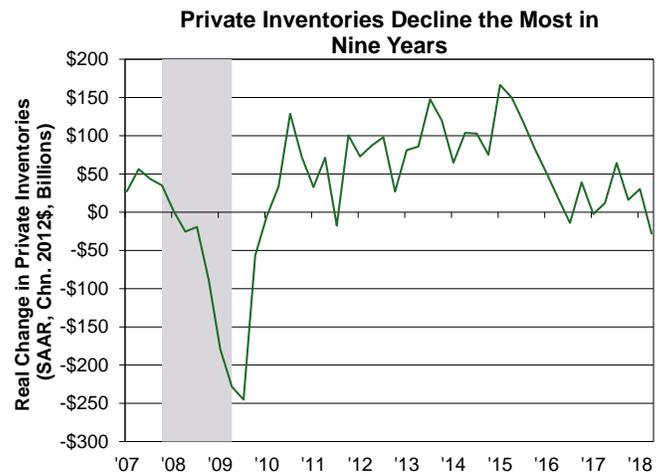
Inventory Swing Should Help Boost Growth

The biggest drag on second quarter growth was inventories, which fell the most since 2009 and subtracted 1 percentage point from growth. The drawdown in inventories and the need for restocking bodes well for the near-term outlook. The only other drag on growth was residential investment (see more details in the housing section).

The Labor Market Remains Solid

Despite the weakening hiring headline in the July jobs report to 157,000, upward revisions in the prior two months put the 3-month average job gain at 224,000, near the upper end of the range seen so far this year. Furthermore, July’s job gain was weighed down by a drop in employment in sporting goods and hobby stores of 31,800 related to the bankruptcy of Toys R Us, which closed all of its remaining stores at the end of June.

Other results from the establishment survey were largely unremarkable. The average workweek ticked down one-tenth to 34.5 hours. Average hourly earnings increased 0.3 percent from June, but the annual gain showed no signs of breaking out of the tight range seen so far this year, remaining at 2.7 percent for a second consecutive month, one-tenth below the expansion best. Separately, the Employment Cost Index, which is considered a better measure of labor compensation, pointed to stable annual wage gains. While the annual increase in total compensation rose to an expansion high of 2.8 percent in the second quarter, the acceleration was solely because of a rise in the benefit component. The annual

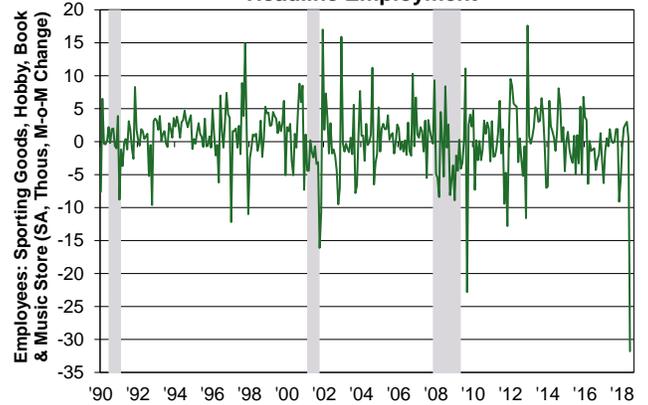




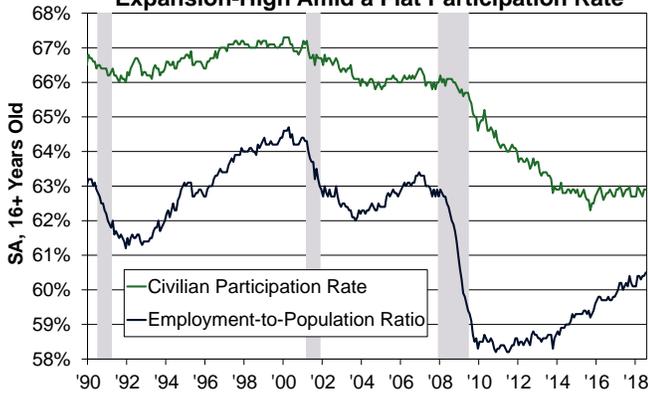
increase in the wage and salary component was unchanged at an expansion best of 2.7 percent. Overall, incoming data painted a picture of muted wage pressures.

The jobs report's household survey offered upbeat news, however. The unemployment rate ticked down one-tenth to 3.9 percent as the gain in employment outpaced the increase in the labor force. The broadest measure of labor underutilization (U6) fell three-tenths to 7.5 percent, the lowest level in more than 17 years. While the labor force participation rate remained flat at 62.9 percent, the employment-to-population ratio rose to 60.5 percent, an expansion high. The continued strong job market has also benefited those workers with less than a high school degree, as their unemployment rate fell to a record low since the series began in 1992, while their employment-to-population ratio rose to tie the record high reached in 2007.

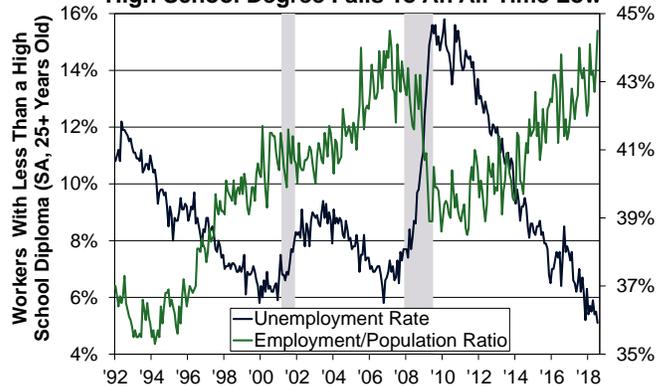
Toy Store Bankruptcy Weighs on July's Headline Employment



Employment/Population Ratio Hits An Expansion-High Amid a Flat Participation Rate



Unemployment Rate of Workers Without a High School Diploma Falls To An All-Time Low

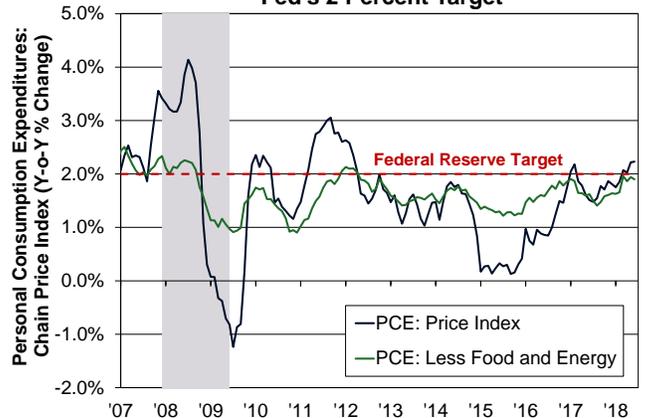


September Rate Hike Likely

Although annual wage growth has shown no signs of accelerating this year, inflation has picked up recently. The annual gain in the personal consumption expenditures (PCE) deflator—the Fed's preferred measure of inflation—remained at 2.2 percent in June, the fourth straight month at or above the Fed's 2-percent target. The annual increase in the core (excluding food and energy) PCE deflator remained at 1.9 percent for the third consecutive month. In July, the core Consumer Price Index posted the biggest annual increase in this expansion of 2.4 percent.

As expected, the Fed held the fed funds rate steady at 1.75 percent to 2.00 percent at the August Federal Open Market Committee meeting. However, the statement following the meeting reflected the recent firming in inflation, noting that inflation has remained "near 2 percent," a change from "moved close to 2 percent" in the June statement. Our forecast continues to call for rate increases in September and December of this year. However, if trade tensions intensify, weighing on consumer and business confidences and the equity market, the Fed could turn to a wait-and-see mode for the rest of the year.

Headline Inflation Remains Above the Fed's 2 Percent Target



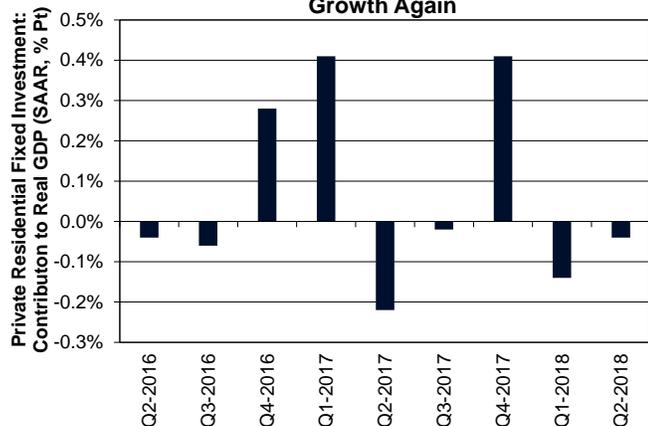
Housing Roundup

While strong domestic demand from consumers and businesses helped drive second quarter GDP growth, residential investment dragged on growth for the fourth time in five quarters, subtracting 0.04 percentage points, due to lackluster homebuilding activity and home sales and, thus, brokers' commissions. Housing activity weakened across the board at

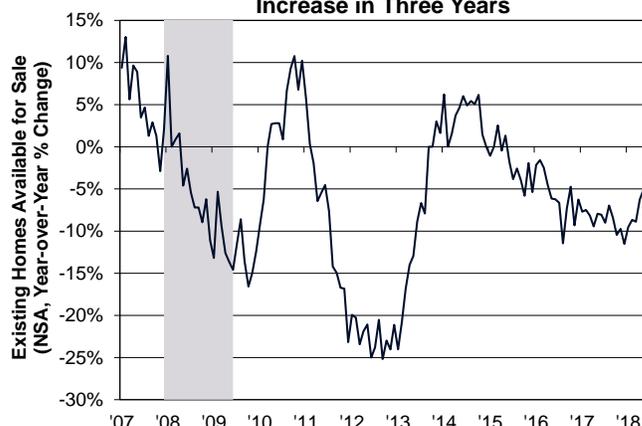


the end of the second quarter. Total housing starts posted the largest monthly decline in June since November 2016, as both multifamily starts and single-family starts fell sharply, and new home sales fell to the lowest level since last October.

Residential Investment Subtracts from Growth Again



Existing Home Inventory Posts First Annual Increase in Three Years



Existing home sales fell for the third straight month in June. The for-sale inventory of existing homes posted a year-over-year increase, ending three years of annual declines and pushing the months' supply to the highest level in almost a year. However, tight inventory, rather than weakening demand, likely remains the primary factor restraining sales. According to the National Association of REALTORS®, homes for sale are going under contract very quickly, as properties typically stayed on the market for a record low 26 days for the third consecutive month. Tight supply continued to support an annual home price gain of more than 6 percent in May, according to the main measures of home prices.

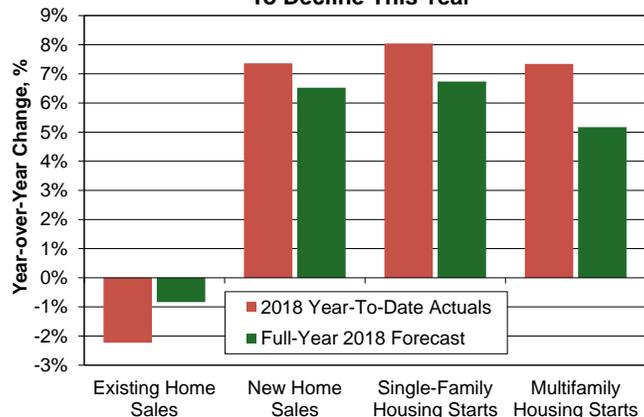
In contrast to a mostly contracting supply in the existing market, the new home inventory has increased on an annual basis every month for over five years, although it remains below historical norms seen during prior expansions. More new homes are being sold without yet being started. The share of new homes sold that are not yet started rose to 31 percent in June, the highest share since last November, underscoring the headwinds facing homebuilders from rapidly rising costs and shortages of skilled labor. The Job Openings and Labor Turnover Survey provided additional evidence of shortages of qualified construction workers, as construction job openings rose in June for the fourth consecutive month to reach an expansion best, but hiring fell for the first time in three months.

The Share of Homes Sold Not Yet Started Rises to Highest Level in Seven Months



Through the first half of the year, existing home sales were about 2.2 percent below the year-ago level, compared with an increase of 7.4 percent for new home sales. Leading indicators of home sales suggest little improvement in the near term. Pending home sales rose in June for the first time in 3 months, but purchase mortgage applications fell in July for the second time in 3 months. For all of 2018, we expect existing home sales to fall nearly 1 percent, the first annual drop in 4 years, versus an increase of 6.5 percent for new home sales. Because new home sales account for a very small share of total home sales, overall home sales should be little changed this year.

Existing Home Sales Expected To Decline This Year

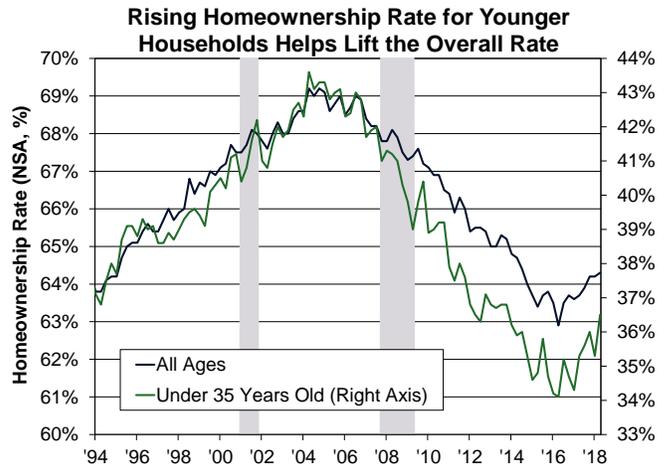
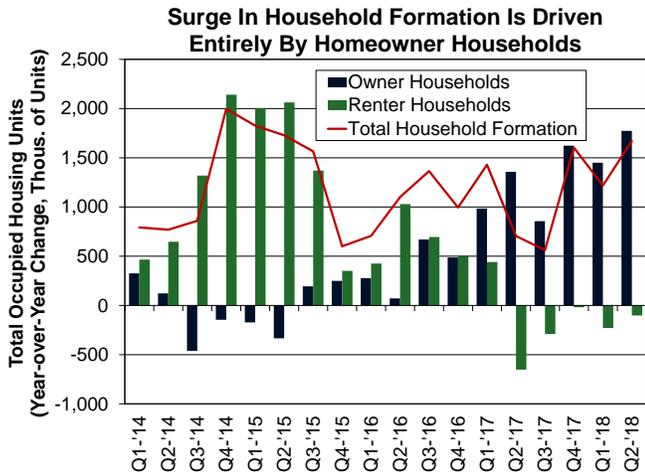


The Housing Vacancy Survey (HVS) offered some good news for the housing sector, particularly for owner-occupancy, during the second quarter. Household growth is running well in excess



of 1 million units per year, with continued rapid growth in owner households and modest declines in renters. The homeownership rate (not seasonally adjusted) rose on an annual basis for the sixth consecutive quarter, increasing 0.6 percentage points to 64.3 percent, the highest second quarter rate since 2014. The rate for households 35 years old or younger rose 1.2 percentage points from a year ago, marking the third straight quarter of annual increases at or exceeding 1 percentage point. In addition, both homeowner and rental vacancy rates remain at or near multi-decade lows.

Despite the positive news from the HVS, the general weakening of housing conditions in the second quarter led us to lower slightly our projected mortgage purchase and refinance originations for this year. Total mortgage originations are expected to fall about 9 percent to \$1.67 trillion in 2018, as a 28 percent drop in refinance originations swamps a 2 percent increase in purchase originations. The refinance share is expected to decline to 28 percent this year from 36 percent in 2017.



For information on multifamily market conditions, read the [August 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: Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, National Association of REALTORS®, and Fannie Mae ESR

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