



### Economic Developments – October 2016

## A decent but not great second half

We expect economic growth to average 2.4 percent in the second half of the year, up from 1.1 percent in the first half, but at a slightly slower pace of growth than we predicted in our prior forecast. However, because of a modest upgrade to second quarter growth in the government’s final estimate, our full-year 2016 growth forecast remains at 1.8 percent. Economic growth appears to have picked up in the third quarter as we expected, though not all data are in yet. Much of the improvement came from a swing in inventory investment and from trade. Inventory building resumed in the third quarter following the drawdown in the second quarter. We estimate that the change in inventories added about half a percentage point to third quarter gross domestic product (GDP), reversing some of the 1.2 percentage point drag in the second quarter. Net exports provided a bigger boost to growth last quarter, following a positive contribution in the second quarter. However, domestic demand, including consumer spending and residential investment, appears to have weakened last quarter more than we had anticipated.

Despite signs of weakening private domestic demand, long-term Treasury yields have moved higher recently. Long-term sovereign yields in the U.S. and other developed markets have increased as investors perceive that global central banks, including the European Central Bank and the Bank of Japan, are tapering their quantitative easing (QE) programs. Meanwhile, financial markets are convinced, at the moment, that incoming data in the U.S. support an increase in the Fed’s target rate this year. Fed funds futures odds of a December rate hike hovered around 65 percent at the time of this writing. However, a lot of key data, including two jobs reports, will be released between now and the Federal Open Market Committee meeting on December 13-14. Thus, we continue to hold our call of no rate hike this year.

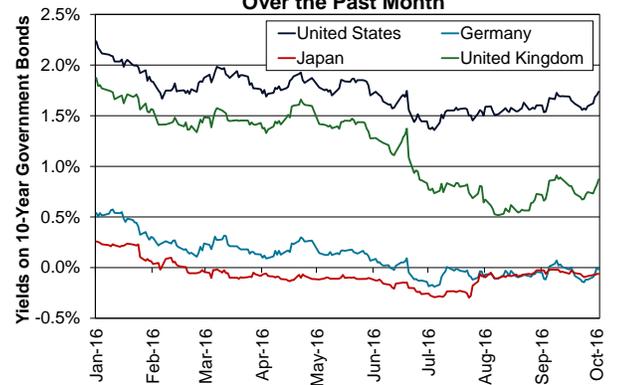
### The good, the bad, and the steady

Recent economic data have been mixed. Good news came from the third print of second quarter GDP, which showed that the economy grew 1.4 percent annualized, three-tenths higher than in the second estimate. One key upward revision came from nonresidential fixed investment, as both business investment in structures and in equipment were revised to show smaller declines. Growth in intellectual property investment outweighed the drops in the other two components, leading overall business fixed investment to contribute slightly to growth in the third estimate, whereas it had subtracted from growth in prior estimates.

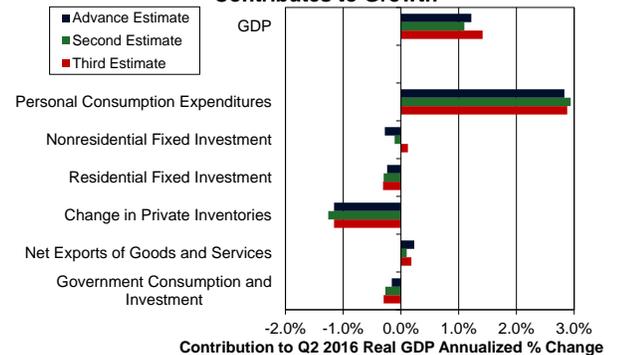
Incoming data on the trade deficit have also been positive. The real goods deficit, which is used in the calculation of net exports in the GDP estimate, narrowed in August for the second consecutive month, suggesting that net exports likely contributed to growth in the third quarter after adding 0.2 percentage points to second quarter GDP. In addition, the Institute for Survey Management (ISM) surveys of manufacturing and service sectors also rebounded in September. The Manufacturing Index indicated expansion after dipping into contraction territory in August, while the Service Index jumped to an 11-month high. Lastly, auto sales also bounced back in September, nearly reversing the drop in the prior month, though fleet sales and heavy end of year discounts bumped numbers up and we expect flat to lower sales in the months ahead.

The biggest dose of bad news came from consumer spending, the linchpin of economic growth. After a solid increase of 0.3 percent in

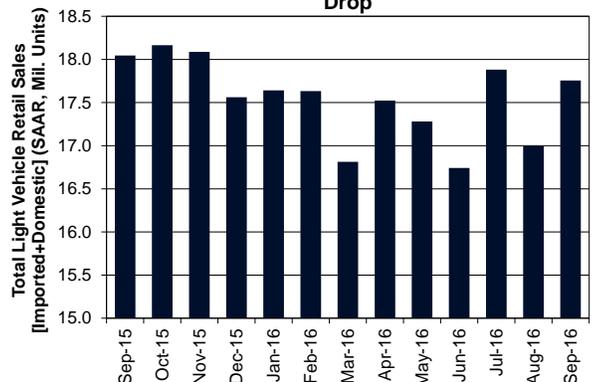
#### Yields on 10-Year Government Bonds Rise Over the Past Month



#### In Final Estimate, Business Investment Contributes to Growth



#### Auto Sales Nearly Reverse the Prior Month's Drop

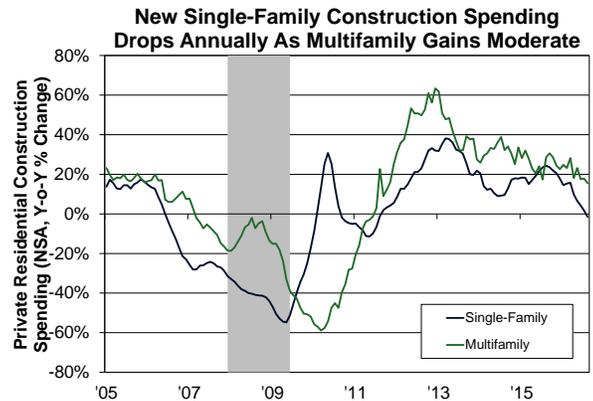




July, real consumer spending pulled back in August, edging down 0.1 percent, marking the first drop since January. The saving rate edged up for the second consecutive month, suggesting increased caution among consumers. While we expect that real consumer spending growth moderated in the third quarter from an unsustainable pace of 4.3 percent annualized in the second quarter, the expected downshift to a still solid 2.7 percent was slightly less than we anticipated in the September forecast. We expect a further softening in consumer spending growth this quarter, which is a main reason we expect moderating economic growth from the third quarter.

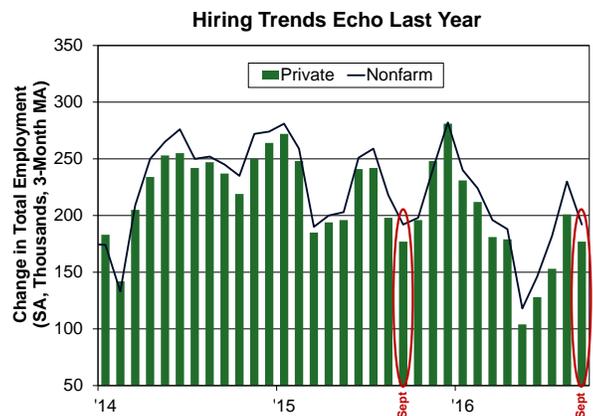
Bad news also came from the report on construction spending, which weakened more than expected in August on the heels of downward revisions for July. Private nonresidential construction spending, which had been upbeat recently, fell in August for the first time in four months. Despite the August decline, the report supported our expectation that nonresidential investment in structures likely increased in the third quarter, partly because of some improvement in the depressed energy extraction sector. Separately, the increase in weekly rig counts in the third quarter also supported a mild turnaround in the sector.

Spending on new private residential construction continued to be lackluster, driven by the ongoing decline in new single-family construction spending, which dropped in August for the sixth consecutive month and fell from a year ago for the first time in five years. Meanwhile, new multifamily construction spending continued to post annual gains, but the increase has moderated to the weakest pace since October 2011. (For more information on multifamily market conditions, read the [October 2016 Multifamily Market Commentary](#).)



Two factors are driving the downward trend in new single-family construction spending this year: lackluster single-family starts (see the housing section below) and a continuation of the decline in the average cost per single-family start that began late last year. While we had expected in the prior forecast that residential investment fell in the third quarter, the August construction spending report suggests that the drop was steeper than previously believed. State and local government construction spending was also another weak spot, decreasing during the month and leading us to lower our estimate of government consumption and gross investment growth in the third quarter.

The factory orders report was also negative, showing that core (nondefense excluding aircraft) capital goods shipments, a proxy for business investment in equipment, declined in August for the fourth consecutive month, albeit at a more moderate pace. Meanwhile, core capital goods orders, a forward-looking indicator, increased during the month for the third straight month. We now expect that business investment in equipment fell in the third quarter for the fourth consecutive quarter, but the improving trend in core capital goods orders suggests business capital investment should edge higher this quarter.



The steady news comes from the labor market. Nonfarm payrolls rose 156,000 in September, slightly below consensus. Notably, the three-month average gains in both nonfarm payrolls and private payrolls were exactly the same as in September 2015, a couple of months before the first rate hike this cycle.

Goods-producing industries added 10,000 jobs on net, thanks to the increase of 23,000 in construction payrolls. This included a 15,700 gain in residential construction employment, the biggest increase since January, which suggests a near-term improvement in housing supply. Mining and logging payrolls were flat during the month, ending a streak of 23 consecutive monthly declines, supporting our view that the energy sector is regaining its footing.



Other details conveyed decent labor market conditions. Average hourly earnings rose 0.2 percent on a monthly basis and were up 2.6 percent from last September, a pick-up from 2.4 percent in the prior month but slightly below the expansion best. Meanwhile, the average workweek rebounded from the drop the prior month. The unemployment rate edged up one-tenth to 5.0 percent, but for a good reason – a large number of people joined the labor force, slightly outweighing a solid gain in household employment. Overall, labor market conditions by themselves are not a hurdle for the Fed to raise the fed funds rate this year, although our forecast points to a slowdown in economic growth to just about 2.0 percent this quarter.

## Housing roundup

One positive housing news item was emerging signs of improvement in homeownership demand in 2015. According to American Community Survey data released last month, owner household growth exceeded renter household growth in 2015 for the first time since the onset of the 2007-09 recession. In another encouraging sign for owner-occupancy, and in particular for the first-time buyer market, the same survey showed that the homeownership rate for households under age 35, which declined substantially and relentlessly between 2006 and 2014, finally stabilized in 2015.

However, in recent months, housing activity has clearly lost momentum. Existing home sales fell in August for the second consecutive month, reaching the lowest level since February. Their forward-looking indicator – pending home sales, or contract signings on existing homes – dropped in August for the third time over the last four months, sending pending sales to the lowest level since January.

New home sales declined sharply in August, but from an expansion best in the prior month. Single-family housing starts also decreased sizably during the month. The recovery in single-family homebuilding has been very gradual, partly because of land and labor constraints. The shortage of skilled labor is reflected in the Job Openings and Labor Turnover Survey, which showed that the construction job openings rate jumped in July to tie an expansion best, while the rate of hiring remained low for an expansion.

On a positive note for young homebuyers, builders appear to be increasing their focus on the entry-level market. After rising sharply at the end of the recession, the typical size of new single-family homes stabilized in 2014 and 2015 and began to decline in the fourth quarter of 2015, according to data from the Census Bureau. The median square footage of new single-family homes continued to shrink in the second quarter. As builders adjust their production in response to rising demand for entry-level homes, typical new home size is likely to trend lower going forward, which should help to sustain the fledgling recovery in homeownership.

Another leading indicator of home sales – purchase mortgage applications – dropped in August for the second consecutive month, suggesting continued weakness in existing home sales in the near term. However, purchase applications rebounded in September, giving some hope that home sales would recover in late 2016. Meanwhile, refinance mortgage applications moved lower in September for the second consecutive month after a surge in July.

One of the biggest challenges for housing remains the extremely lean inventory of homes for sale. The number of existing homes for sale declined 10.1 percent in August from a year ago, marking the largest annual drop since 2013. The lean inventory for the existing home market is partly attributable to the fact that homeowners are remaining in their homes longer. Data from CoreLogic showed that the median

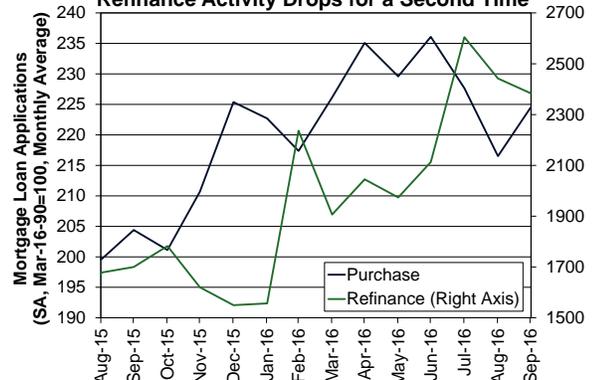
**Pending and Existing Home Sales Retreat From Recent Expansion Highs**



**New Single-Family Starts and Home Sales Fall**



**Purchase Applications Bounce Back While Refinance Activity Drops for a Second Time**

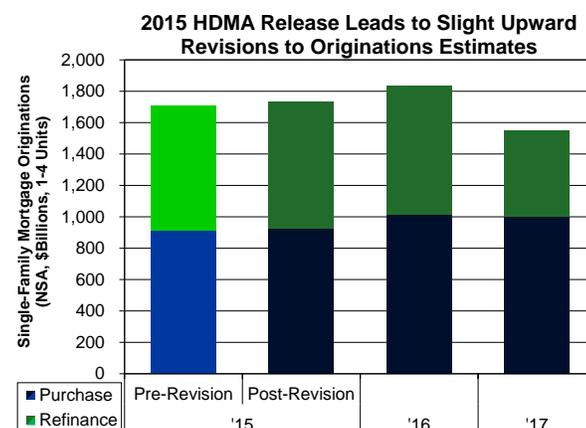
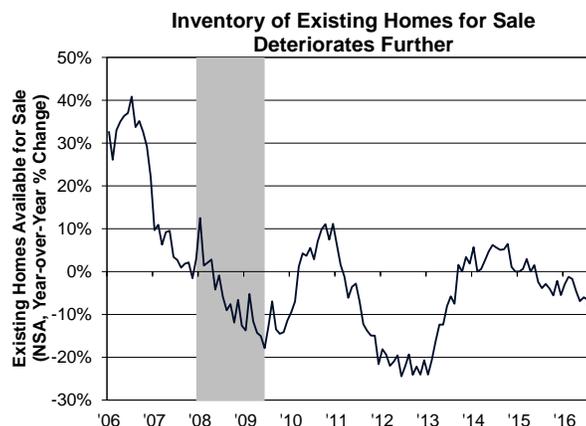




number of years that home sellers had owned their home roughly doubled between 2007 and 2015, from five years to 10 years. Separately, data from government surveys show that mobility rates have been declining. If these trends continue, we should expect a lower rate of housing turnover, and thus home sales, than in the past. This will be challenging for the housing and mortgage market, especially in a rising mortgage rate environment where lenders have to rely more on purchase mortgage originations. Tight supply and rapid price gains in the lower tiers of the home sales market are increasingly hampering first-time home buyer affordability and endangering the budding recovery in young-adult home buying demand.

Our mortgage rate forecast hasn't changed as we don't expect the recent rise in long-term interest rates to be sustainable. Our forecast of a 3.6 percent increase in total home sales for this year is also little changed from the September forecast, but it includes weaker existing home sales and stronger new home sales.

In October of each year, we update our estimate of single-family (1-4 unit properties) mortgage originations for the prior year as a result of our annual benchmark to the newly released Home Mortgage Disclosure Act (HMDA) data. We revised slightly higher our estimated purchase and refinance originations by \$6 billion and \$13 billion, respectively, putting total 2015 mortgage originations at \$1.73 trillion. The refinance share edged up one percentage point higher than the prior estimate to 47 percent. We also upgraded our projected mortgage originations for 2016 by \$30 billion to \$1.83 trillion, with refinancing accounting for much of the upgrade. This marks an increase of about 6.0 percent in total expected originations in 2016 from 2015. For 2017, we expect total originations to decline by approximately 15 percent due to a sizable decline in refinance originations.



## Economic & Strategic Research (ESR) Group

October 10, 2016

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, Bureau of Economic Analysis, Autodata, Census Data, Bureau of Labor Statistics, National Association of REALTORS®, Mortgage Bankers Association, and ESR forecast.

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