



Economic Developments – March 2018

Growth Downshift Expected to Be Temporary

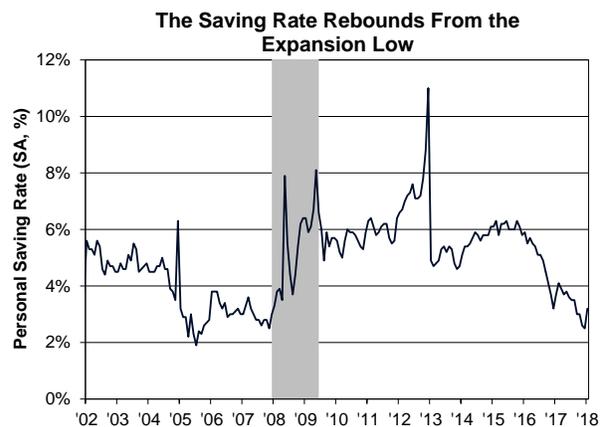
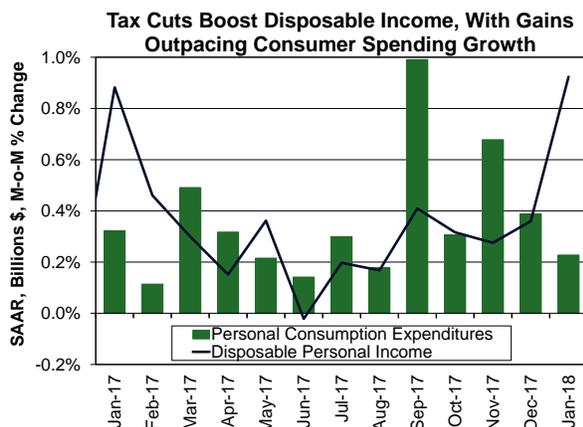
In our prior forecast we expected domestic demand growth would slow this quarter from last quarter’s unsustainable pace, but also that inventory investment would strengthen sufficiently to offset the decelerating domestic demand growth, leaving headline growth essentially unchanged. It now appears that first quarter economic growth will come in weaker than projected due to lackluster consumer spending and nonresidential and residential investment. Despite the first quarter markdown, we upgraded our full-year 2018 growth forecast one-tenth to 2.8 percent to reflect the impacts of new fiscal stimulus from the Bipartisan Budget Act of 2018, which will increase discretionary spending by nearly \$300 billion over the next two years. We also raised our forecast of 2019 growth by two-tenths to 2.5 percent. The more optimistic growth outlook lowered the trough of our projected unemployment rate one-tenth to 3.6 percent. Finally, our inflation forecast for next year is slightly higher.

More rapid wage and inflationary pressures, which would likely lead the Fed to tighten monetary policy more aggressively, pose downside risks to our growth forecast. A key downside risk for the forecast is a loss in business and consumer confidence in the face of a more assertive U.S. trade policy and retaliatory actions by our trading partners. Trade tensions are likely to intensify with the ongoing North American Free Trade Agreement (NAFTA) negotiations. Meanwhile, the United States is approaching the August deadline regarding the pending investigation into China’s intellectual property policies. Earlier this month, the Administration imposed another round of tariffs, this time on steel and aluminum imports (with exemptions for Canada and Mexico), following last April’s lumber and January’s solar panels and washing machines. On the same day of the latest tariffs’ imposition, 11 nations signed a revised Trans-Pacific Partnership, a sweeping trade agreement that excluded the United States because the Administration withdrew from the discussions in January 2017.

Consumer Spending Loses Steam

The second print of fourth quarter gross domestic product (GDP) downgraded real GDP growth by one-tenth to 2.5 percent annualized. Incoming data have shown weaker momentum in domestic demand, especially consumer spending. As a result, we have revised markedly lower our real consumer spending growth forecast for the first quarter to 2.2 percent annualized from 2.7 percent in the February forecast.

Real consumer spending fell 0.1 percent in January, the biggest monthly drop in a year. The Bureau of Economic Analysis (BEA) added an adjustment to wage and salary income to reflect one-time bonuses reported by many businesses in response to the corporate tax cuts in the Tax Cuts and Jobs Act; however, soft dividend and interest income largely offset gains elsewhere, resulting in flat real personal income. The BEA estimated a decline in personal taxes of 3.3 percent (regardless of whether employees adjusted their withholding schedules), the biggest drop since the recession, which boosted disposable personal income the most in a year. With the nominal disposable personal income gain significantly outpacing the nominal consumer spending increase, the saving rate surged seventh-tenths from an expansion low of 2.5 percent in December. We expect the saving rate to continue to trend higher, as we expect a large share of income gains will likely be saved rather than consumed.

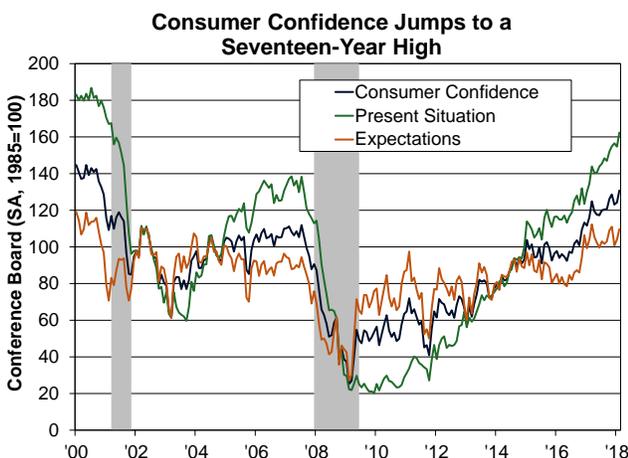
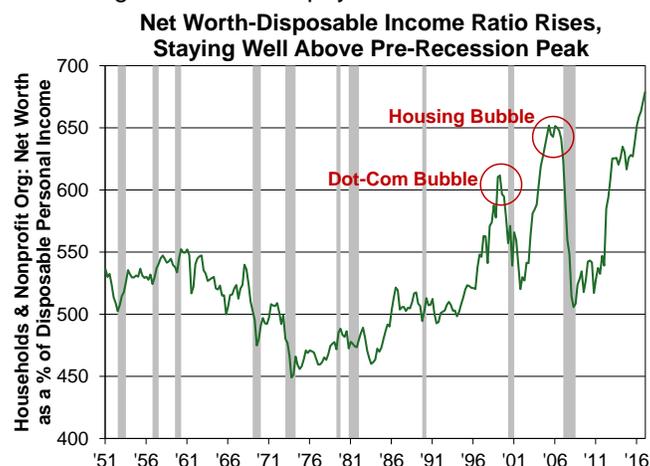




January consumer credit data pointed to cautious consumers, with credit growth slowing for the second consecutive month. Revolving credit (largely credit card debt) was the culprit, rising just 0.8 percent, the smallest monthly gain since February 2015. February auto sales, which fell for the fourth time in five months, were consistent with soft consumer spending in the current quarter. However, we expect the lull in consumer spending to be transitory. The weakness early in the quarter was likely attributable to delayed issuance of income tax refunds through February, but incoming data showed that issuance has now caught up with historical norms. Thus, we expect consumer spending growth in coming months as workers receive their 2017 tax refunds and also have a better idea of their higher take-home pay as a result of the tax cut.

Other consumer fundamentals remained more positive over the past month. Household net worth—the value of assets minus liabilities—rose \$2.1 trillion in the fourth quarter to another record high of \$98.7 trillion, thanks to both stocks and real estate. The ratio of net worth to disposable income rose to a record high of 679 percent, well above the peak prior to the 2007-09 recession triggered by the housing boom.

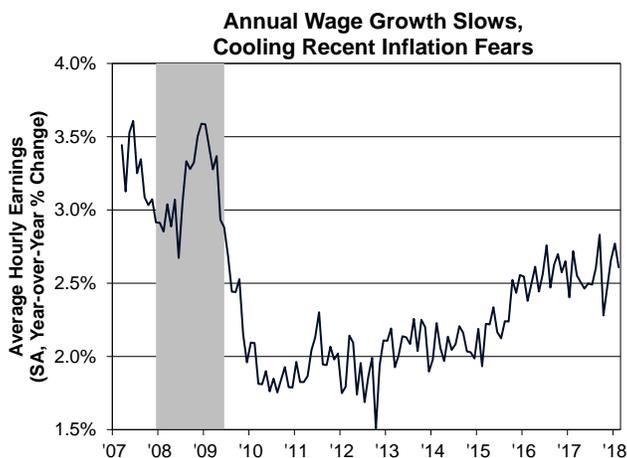
Consumers also turned more upbeat. The Conference Board Consumer Confidence Index jumped in February to the highest reading since November 2000, boosted by both the present situation and expectations components. Notably, income expectations improved substantially, with the share expecting rising income over the next six months jumping to the highest level since 2001.



As-Good-as-It-Gets Jobs Report

Nonfarm payrolls increased 313,000 in February, the largest monthly job gain since July 2016. With upward revisions to the prior two months of 54,000 jobs, the average increase over the past three months rose to 242,000, the best showing since September 2016. In addition, the average workweek rebounded, rising one-tenth to 34.5 hours.

The most highly anticipated aspect of the February jobs report was wages, following January's jump in the year-over-year increase, which spooked markets and led to a spike in stock market volatility, rising inflation expectations and long-term interest rates, and a stock market correction. The markets breathed a sigh of relief, however, as average hourly earnings edged up just 0.1 percent from January and 2.6 percent from a year ago. In addition, January's reading on annual growth was revised down one-tenth

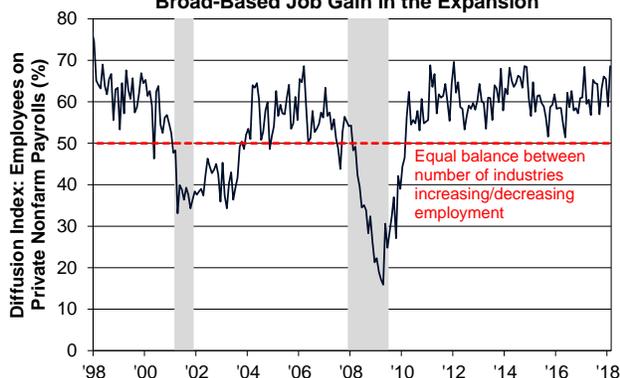




to 2.8 percent. Despite the slowing wage gain in February, the pickup in job gains and the average workweek, as well as continued rising wages, translated into an improvement in labor income, a positive for consumer spending in February.

The breadth of employment gains in the February's report was impressive. The diffusion index jumped to 68.6 percent, just 1 point below the expansion high reached at the beginning of 2012. A diffusion index reading of 50 indicates an equal balance between industries with increasing and decreasing employment. At the industry level, employment in goods-producing industries (manufacturing, mining, and construction) rose 100,000 in February, the biggest gain since August 1998. Of those, 61,000 were in the construction industry, the largest gain since March 2007. Residential construction payrolls increased 25,400, the best performance in more than a year. Since last October, residential construction employment has increased by more than 100,000 jobs, which bodes well for the future supply of housing. In the service sector, payrolls also remained healthy. Notably, retail trade added the most jobs in two years, and temporary help services, which tend to be a leading indicator of hiring, registered the biggest gain since September 2016.

February Jobs Report Shows Nearly the Most Broad-Based Job Gain in the Expansion

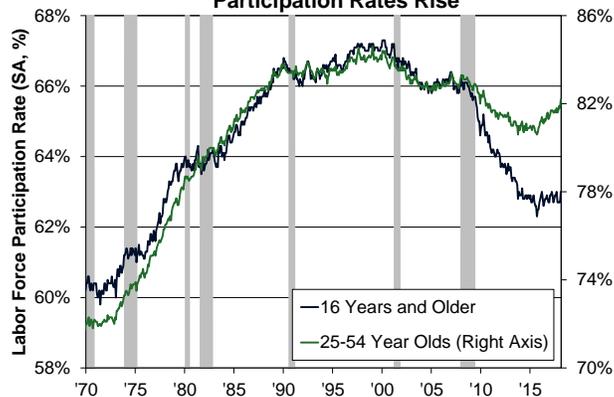


Goods-Producing Sector Employment Performs the Best in Decades



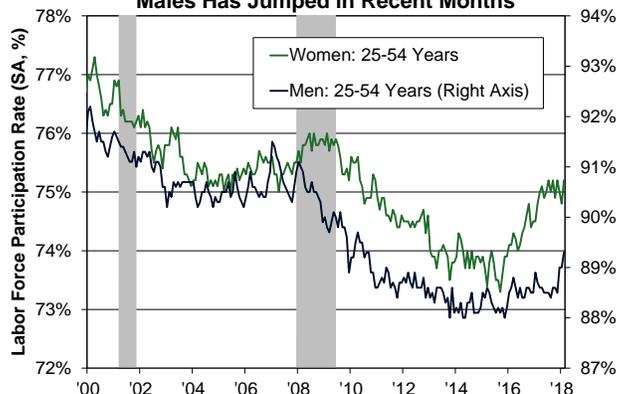
The household survey component of the February jobs report also registered a stellar performance, showing a massive gain in employment amid a three-tenths rise in the labor force participation rate, the biggest one-month jump since April 2010. As a result of the strong employment and labor participation increases, the unemployment rate remained unchanged at 4.1 percent for the fifth consecutive month. The net growth in the labor force, not seasonally adjusted, jumped to 1.457 million, compared with an average of only 500,000 for the last five Februaries. This February's gain set a record for the month since the inception of the series in 1948. Despite the February improvement, the overall labor force participation rate reached just 63.0 percent and has largely trended sideways over the past two years, weighed down by retiring baby boomers. However, the prime age (25-54 years old) labor force participation rate has visibly trended up during the same period, with the rate rising four-tenths in February to the highest level in seven years.

Prime-Age and Overall Labor Force Participation Rates Rise



At his inaugural semi-annual monetary policy testimony before Congress earlier this month, Fed Chair Powell said he believes slack remains in the labor market, which should allow the Fed to gradually raise interest rates even though the unemployment rate is at a 17-year low. He noted that the labor force participation rate for prime-age males is well below the level at the onset of the recession. However, the rate has jumped sharply over the past several months, which supports the view that the labor market is not yet at full employment and there is more room to improve without overheating the economy.

Labor Force Participation Rate of Prime-Age Males Has Jumped in Recent Months





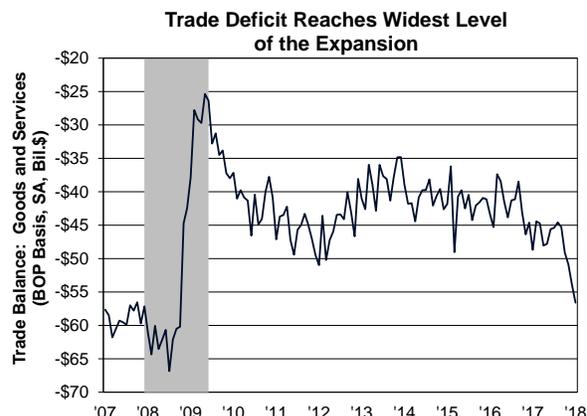
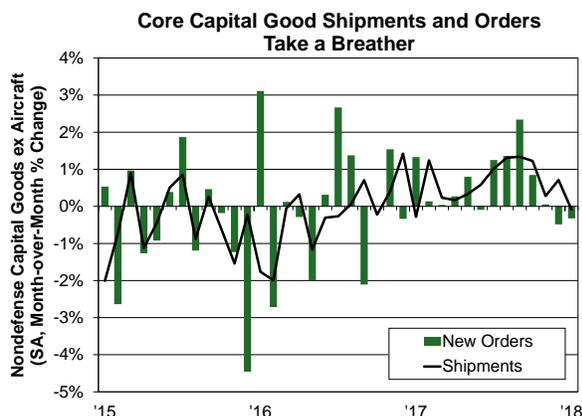
The Fed Has Reasons to Be Patient

During his Congressional testimony, Fed Chair Powell was upbeat about the economy and noted that recent data increased his confidence that inflation will move toward the two-percent target. When asked whether the median fed funds rate forecast in December (which implied three hikes in 2018) was still appropriate, Powell said that his “personal outlook” for the economy has strengthened since December, partly because of more stimulative fiscal policy and continued strong global growth. He noted further that he would be “taking into account everything that’s happened since December” when he submits his updated projections at the next Federal Open Market Committee (FOMC) meeting on March 20-21.

So far, inflation has not flashed any warning signs. The Fed’s favored measure of inflation, the Personal Consumption Expenditures (PCE) deflator, jumped 0.4 percent in January; however, the 12-month increase was unchanged at 1.7 percent for the third consecutive month. Core PCE (excluding food and energy) rose 1.5 percent from a year ago for four straight months. Regarding the other Fed mandate on full employment, we view the cooling of February’s wage gains and the pickup in the labor force participation rate consistent with three rate increases this year. We continue to expect the first rate increase of the year in March, with risks to the forecast tilted toward four hikes this year.

Business Investment Turns Bearish Amid Worsening Trade

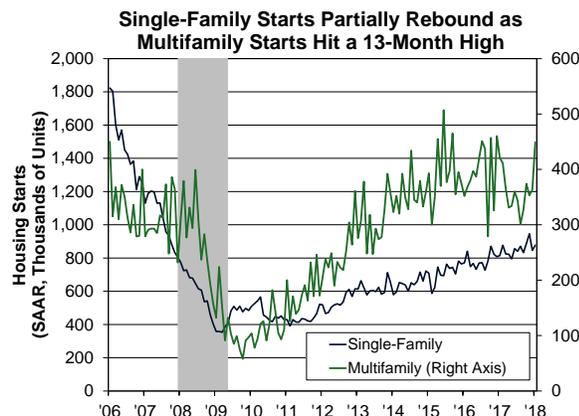
Business investment in equipment has cooled following robust growth in the third and fourth quarters. The factory orders report showed that core (nondefense excluding aircraft orders) capital goods shipments, an input to estimate the business equipment spending component in GDP, fell in January for the first time in a year, and core capital goods orders, a forward-looking indicator, registered back-to-back drops for the first time since May 2016. Another source of weakness this quarter is trade. The trade deficit widened in January, reaching the biggest trade gap of the expansion. The real goods deficit, used in the calculation of net exports in GDP, widened to the largest level in 11 years, suggesting trade will drag on GDP for the second consecutive quarter. Residential investment should also act as a drag on economic growth (see the housing section). The main GDP components offsetting those weaknesses include inventory investment and government spending, which has been boosted by the Budget Act. Considering the overall impacts of these components, we revised lower our forecast of first quarter GDP growth by six-tenths to 2.1 percent annualized. We expect the slowdown in economic growth to be transitory and expect a pickup in growth to at least 3.0 percent annualized over the next three quarters.



Housing Roundup

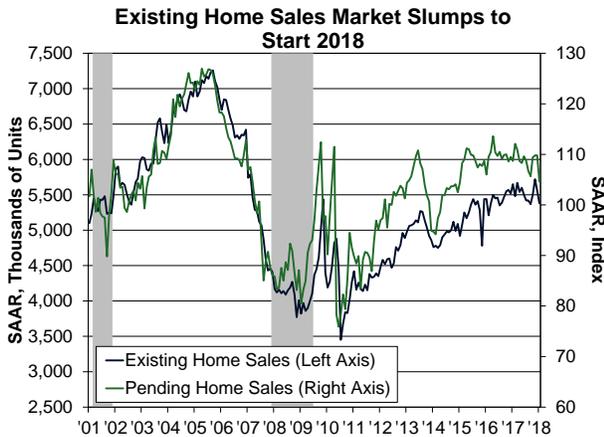
Homebuilding activity was mixed at the start of 2018. Single-family starts partially recovered from the double-digit percent drop in December, while multifamily starts surprised to the upside, surging to the highest level since the end of 2016, with permits rising for the first time in three months. The marked improvement led us to revise higher our forecast for multifamily starts to a slight gain this year from the modest drop predicted in our prior forecast.

For information on multifamily market conditions, read the [March 2018 Multifamily Market Commentary](#).

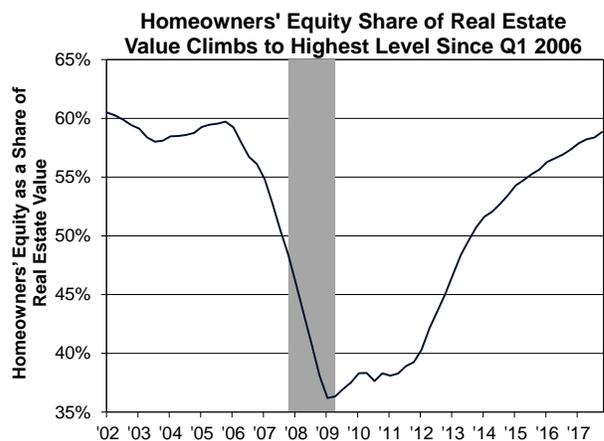
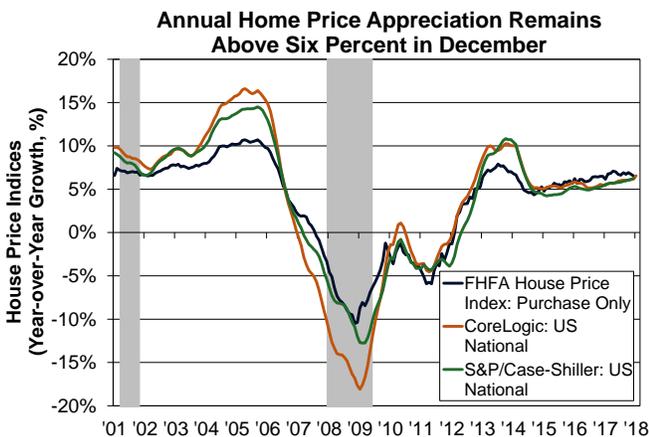




Home sales performed poorly to start the year. Existing home sales fell in January for the second consecutive month and posted the largest year-over-year drop in more than three years. Tight inventory continued to weigh on sales as real estate agents noted strengthening buyer traffic in most areas. The sharp drop in year-over-year inventory continued unabated. Pending home sales, a forward-looking indicator of existing home sales, declined sharply in January, suggesting sales will likely decrease further in the near term. New home sales tumbled in January, but sizable upward revisions to prior months tempered the weakening trend. While the for-sale inventory of new homes has fared better than that for existing homes, it remains near the levels generally seen during prior recessions. Overall, the slower pace of home building activity and declining home sales (and thus brokerages fees) in January should result in a decline in residential investment this quarter following a strong gain in the prior quarter.



Home price appreciation remained robust at the end of 2017, with the main price measures exhibiting more than 6 percent year-over-year gains in December. While strong home price appreciation impedes sales and erodes home purchase affordability, it helps boost homeowner equity. During the fourth quarter of 2017, homeowners' equity as a share of real estate value continued to rise, reaching the highest level in nearly 12 years.



Our housing activity and mortgage rate forecasts have not materially changed over the past month. We project that purchase mortgage originations will rise about 5 percent from 2017 to \$1.19 trillion in 2018, while refinance originations will drop about 30 percent to \$498 billion. Single-family mortgage debt outstanding grew 2.8 percent annualized during the fourth quarter, the slowest pace in three quarters, but for all of 2017, it increased 3.0 percent, the biggest annual gain since 2007.

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, Federal Reserve Board, Conference Board, Bureau of Labor Statistics, Census Bureau, National Association of REALTORS®, Federal Housing Finance Agency, Standard & Poors, and CoreLogic.

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