



Economic Developments – May 2017

It's Déjà Vu All Over (and Over) Again

For the fourth consecutive year, first quarter economic growth slowed from the fourth quarter. We expect history to also repeat itself with a second quarter growth rebound, which occurred in the last three years. Thus, we are keeping our full-year 2017 growth projection at 2.0 percent. Health care and tax legislation may be enacted in late 2017 or early 2018, but we will await the details before incorporating their impact on growth.

“Special Factors” Weighed on First Quarter Growth

Real gross domestic product (GDP) grew 0.7 percent annualized in the first quarter in the Bureau of Economic Analysis' (BEA) first estimate, slowing from 2.1 percent in the fourth quarter. Since the last recession, first quarter growth has tended to be understated due to residual seasonality, which the BEA defines as lingering seasonality in data that have already been adjusted to remove seasonal effects. Over the past two years, the BEA attempted to address the issue, but it appears that seasonal biases remain. An alternative way to assess the well-being of the economy in the first quarter is to look at year-over-year growth, which showed a 1.9 percent increase, in line with trend growth in the current expansion and our forecast.

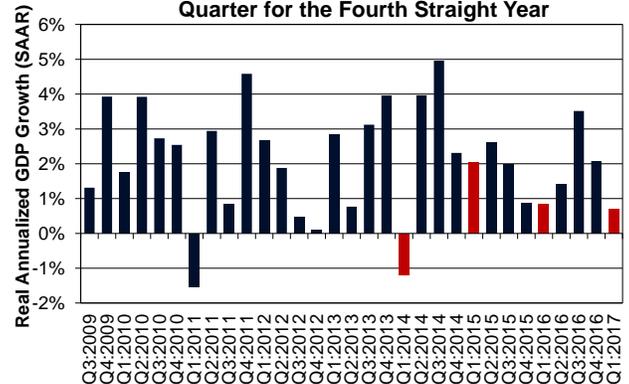
The two main components of GDP that subtracted from first quarter growth were the change in private inventories and government consumption and investment. While the decline in inventory investment to just \$10 billion subtracted nearly one percentage point from first quarter GDP, it has a positive implication for this quarter because businesses will need to increase production to build up inventory from an unsustainably low level.

However, the main culprit for the slowdown in first quarter growth was consumer spending, which has typically been the biggest driver of growth during this expansion. Real consumer spending grew 0.3 percent annualized and added only 0.2 percentage points to GDP, the smallest contribution since the end of 2009. A pullback in motor vehicle sales from an expansion high at the end of 2016 and the unseasonably warm winter weather, which depressed utilities spending, weighed heavily on overall spending last quarter.

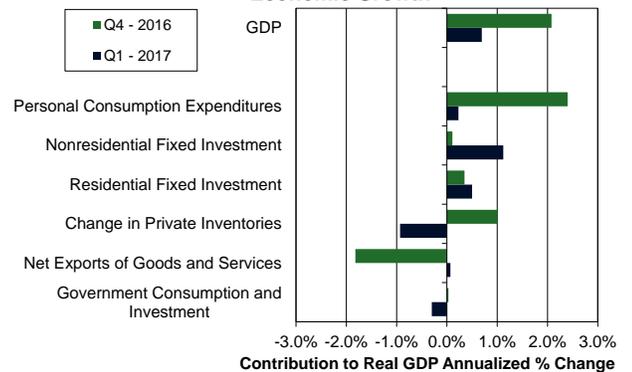
Monthly data showed that nominal consumer spending was flat in March as personal income rose 0.2 percent. As a result, the saving rate rose for the third consecutive month to a seven-month high. However, the personal consumption expenditures (PCE) deflator fell in March for the first time in more than a year, largely driven by an outsized drop in wireless telephone services. After adjusting for inflation, real consumer spending rose 0.3 percent in March following back-to-back drops in the prior months, implying strong momentum for real consumer spending this quarter. We expect real consumer spending growth to accelerate to 3.0 percent annualized this quarter, but then slow modestly in the second half of the year. While auto sales increased in April for the first time in four months, they remained 1.5 million units below the level in December 2016, which likely marked the peak for the current expansion. The Senior Loan Officer Opinion

Survey for the three months ending in April showed that banks continued to tighten lending standards on auto loans, a

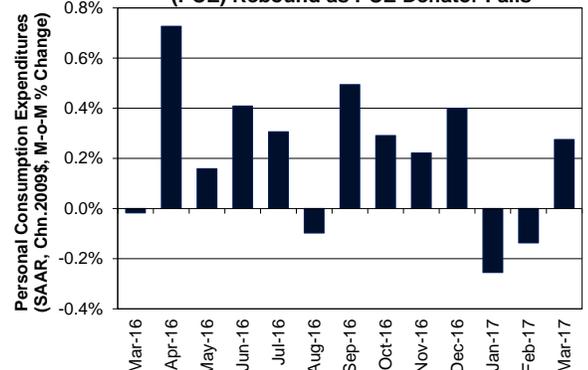
Q1 Economic Growth Slows From Prior Quarter for the Fourth Straight Year



Sluggish Consumer Spending Growth Hampers Economic Growth



Real Personal Consumption Expenditures (PCE) Rebound as PCE Deflator Falls

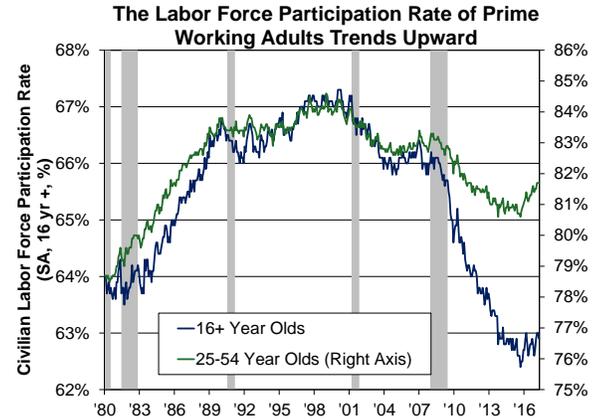




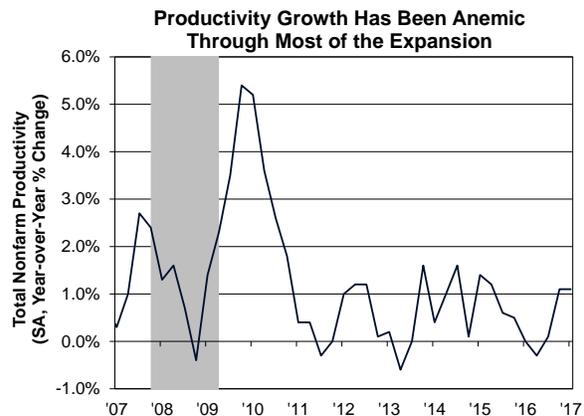
reasonable response to other sources of data showing rising auto delinquency rates, which could further weigh on sales. Used car prices are also in decline and days of inventory are lengthening.

The bright spot for first quarter GDP was a broad-based improvement in private fixed investment across structure, equipment, and residential components. Notably, the biggest contribution to growth came from nonresidential investment in structures, which contributed 0.6 percentage points to growth, thanks to a 450 percent annualized surge in oil and gas well drilling. Housing was another bright spot in first quarter GDP. Real residential investment posted the first double-digit gain since the end of 2015 and added 0.5 percentage points to growth, the most in nearly two years. We expect the outsized contributions to growth from nonresidential and residential investment to moderate this quarter. We also expect trade, which added slightly to first quarter GDP, to drag on growth this quarter and the rest of the year.

Recent developments in the labor market displayed late-cycle characteristics. The April jobs report showed that nonfarm payrolls increased 211,000, supporting our view that March's paltry gain of 79,000 was a weather-related blip. So far this year, payroll growth has averaged 185,000 a month, helping to propel the labor market further into full employment territory. The unemployment rate dipped to an expansion low of 4.4 percent, the lowest reading since May 2007. More importantly, the broadest measure of labor underutilization, which includes discouraged workers and part-timers who prefer full-time jobs, fell for the sixth time in the past seven months to 8.6 percent, the lowest level since November 2007. While the labor force participation rate ticked down to 62.9 percent, part of the decline is driven by demographics, as older baby boomers are retiring. The rate for prime working-age adults (25-54 year olds) has trended up since its recent trough in September 2015, which matched the expansion low in October 2013.



The jobs report showed that the average workweek edged up one-tenth and average hourly earnings increased 0.3 percent from March, suggesting a solid start for wage and salary income gains this quarter. Over the past year, average hourly earnings rose 2.5 percent, four-tenths below the expansion best reached at the end of 2016. While it appears that the low unemployment rate hasn't led to increased wage pressures, other labor cost indicators have recently picked up. For example, the Employment Cost Index rose 0.8 percent in the first quarter (not annualized), the biggest rise of the expansion. The index rose 2.4 percent from a year ago, the biggest annual increase in two years. In addition, the productivity report for the first quarter showed that hourly compensation grew 3.9 percent from a year ago, the strongest rise in three years. We believe that the message is clear: The labor market is extremely tight. Unless productivity growth breaks out from its average annual pace of only about 0.5 percent over the past six years, labor costs will continue to trend upward.



Survey data offered evidence that businesses are having a difficult time finding workers, which could put additional upward pressure on compensation. The National Federation of Independent Business' small business survey showed that the share of firms saying it's hard to fill job openings rose to 33 percent in April, the highest reading since November 2000.



In addition, the share reporting that finding qualified labor was their most important problem held at 16 percent for the second consecutive month, near its expansion high of 17 percent. Taxes remained the most important issue for small businesses, followed by government requirements, cited by 21 percent and 17 percent of firms, respectively.

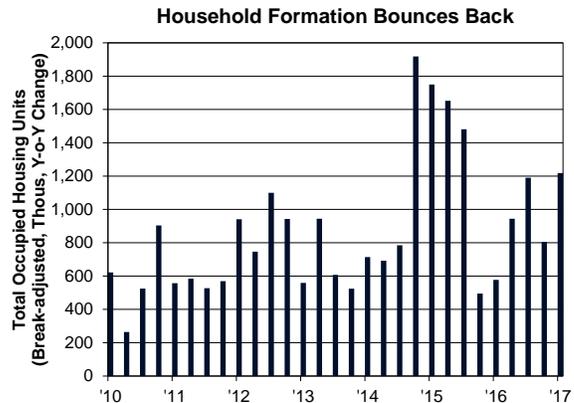
Fed Is On Track for Monetary Policy Normalization

As universally expected, the Fed held the fed funds rate steady at the May Federal Open Market Committee meeting. The statement following the meeting indicated that the committee downplayed the first quarter growth slowdown, viewing it as transitory. Tight labor market conditions and recent communications from Fed officials support our expectation for rate hikes in June and September and for a change in the Fed's reinvestment policy to start shrinking the balance sheet in December.

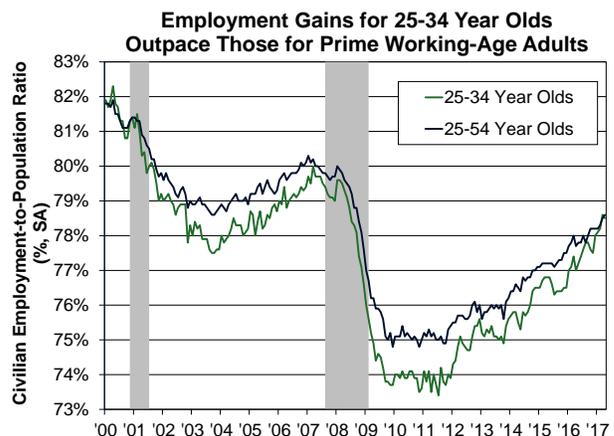
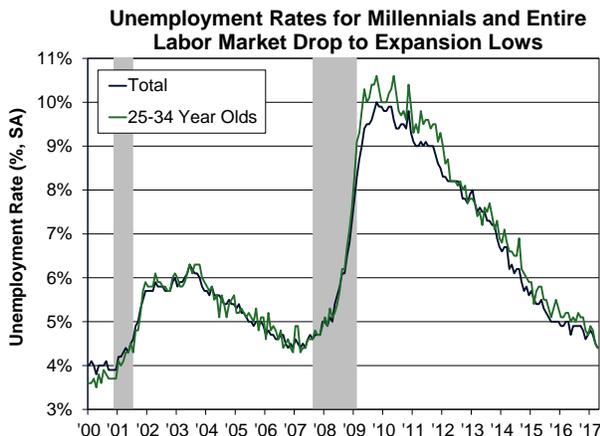


Housing Roundup

Household formation has gradually improved since the recession, with the number of households increasing by 1.2 million in the first quarter from a year ago. The homeownership rate showed signs of stabilization, ticking up 0.1 percentage points from a year ago to 63.6 percent in the first quarter.



One likely reason for the improving homeownership rate trend is that young adults finally appear to be releasing some of their pent-up housing demand as their employment situation brightens. During early stages of the recovery, the unemployment rate for 25-34 year-olds, a prime age group for first-time homebuyers, substantially exceeded the rate for all workers. However, over the past year, the 25-34 year-old rate has fallen to match the overall rate, with both dropping to levels last seen prior to the recession. Notably, the employment-to-population ratio for the 25-34 year-olds has also improved significantly, rivalling that of all prime working-age adults (25-54 year olds) so far this year for the first time since the early 2000s. While the rate has ascended rapidly over the past year, it remains below pre-recession levels.





Our research shows that millennials are starting to leave the parental home and are advancing into homeownership more quickly. (Read [Starting to Launch: Millennials Are Leaving Mom and Dad's Basement](#), Fannie Mae Housing Insights, April 27, 2017, and [Millennials Have Begun to Play Homeownership Catch-Up](#), Fannie Mae Housing Insights, August 10, 2016.) However, extremely lean inventory and rapid home price appreciation in the lower-end of the market remain challenges for potential first-time homebuyers.

Single-family construction took a step back at the end of the first quarter, as starts declined from an expansion high reached during the unusually warm February. Permits also fell in March from an expansion best the prior month. Multifamily starts dropped during the month but permits rebounded. Through the first quarter of the year, single-family starts are 6.0 percent higher than during the same period last year. However, the level of single-family construction has remained historically low for an expansion. Surveys of home builders continue to indicate that access to labor remains a top business challenge, in line with government surveys suggesting a competitive market for construction workers. The Job Openings and Labor Turnover Survey showed that the quits rate, which is a gauge of workers' confidence in the jobs market, has been trending up over the past year for construction workers, compared with a relatively stable rate for all workers. The quits rate for the construction industry rose in March to an expansion high of 2.5 percent.

Meanwhile, home sales performed quite well in March. New home sales climbed for the third straight month to a level just shy of the expansion best, while existing sales jumped to a decade-high. Notably, the months' supply of existing homes for sale has been below four months since last December. The dearth of existing homes for sale acts as a tailwind for home prices. The FHFA and the Case-Shiller home price indices showed a pickup in annual appreciation in February, and the CoreLogic annual home price gain accelerated further in March.

Whereas tight inventory has supported robust price gains, it remains a headwind for sales. Leading indicators of home sales were mixed. Pending home sales pulled back in March, but the average number of purchase applications rose in April for the second consecutive month, thanks in part to the decline in mortgage rates between mid-March and mid-April. The average 30-year fixed mortgage rate hovered around four percent during the first week of May. We expect mortgage rates to rise very modestly during the remainder of the year, averaging 4.10 percent in the fourth quarter. We anticipate about a three percent increase in total home sales for all of 2017.

We revised higher our estimate of 2016 total mortgage originations by about \$90 billion to \$2.05 trillion, reflecting our ongoing benchmarking process to internal and external data, which will conclude with the expected release of the 2016 Home Mortgage Disclosure Act data this September. For 2017, we upwardly revised our forecast for purchase mortgage originations slightly in response to stronger home sales data and increased near-term momentum. Total mortgage originations should drop about 22 percent this year to \$1.59 trillion as a decline in refinance originations outpaces an increase in purchase originations, driving the refinance share lower from 48 percent in 2016 to 32 percent in 2017.

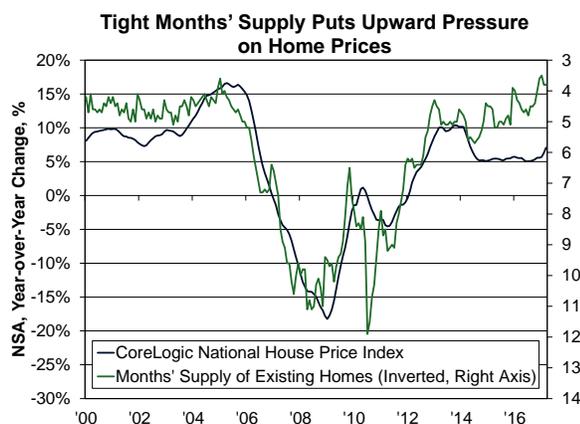
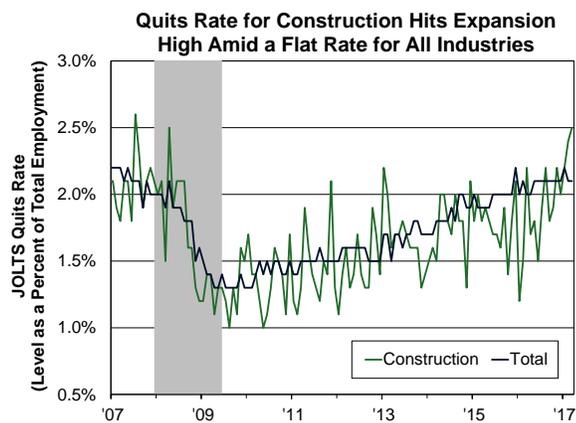
Economic & Strategic Research (ESR) Group

May 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: Bureau of Economic Analysis, Bureau of Labor Statistics, The National Federal of Independent Business, Census Bureau, The National Association of REALTORS®, CoreLogic.

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