Economic Developments – June 2018

Growth Poised to Pick Up Firmly

Economic growth slowed to 2.2 percent annualized in the first quarter from 2.9 percent in the final quarter of 2017. We forecast a pickup in economic activity during the rest of the year, boosted by stimulative fiscal policies, including accelerating growth in spending appropriations. Our full-year growth forecasts over the next two years remain unchanged, with real gross domestic product (GDP) expected to expand by 2.7 percent in 2018 and then increase at a slower pace of 2.3 percent in 2019 as fiscal impacts fade.

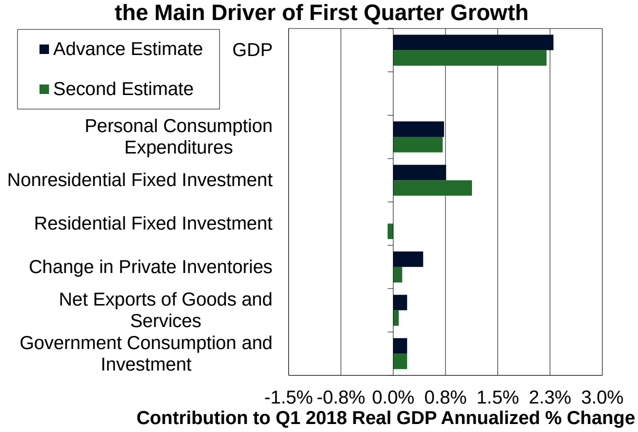
We see a balance of risks to our forecast. Upside risks include a potential acceleration of business investment and a reduction in household conservatism resulting in a stronger pickup of consumption than we are currently expecting. The upward revisions to business investment in structures, equipment, and intellectual property products in the second estimate of GDP is the basis for the investment component of the upside risk. Downside risks include a faster pace of interest rate increases than currently anticipated and uncertainty from trade policy.

Tensions with our trading partners are intensifying. Earlier this month the administration allowed exemptions from steel and aluminum tariffs for Canada, Mexico, and the European Union to expire, effectively imposing 25 percent and 10 percent tariffs on steel and aluminum imports, respectively. The three trading partners quickly retaliated by imposing tariffs on U.S. products. The Administration also announced plans to move forward with impending tariffs on Chinese imports. While the impact of proposed tariffs on the overall economy may be modest, escalating trade rhetoric could drag on equity markets and business and consumer confidence. Political uncertainty in Italy, the third largest economy in the Euro zone, and shocks to emerging markets bear close monitoring, although the impact on U.S. financial conditions has been limited thus far.

Second Print of GDP Shows Positive Details for Domestic Demand

Headline growth for the first quarter was downgraded slightly in the second GDP estimate but the details were positive, on net, for domestic demand. The one-tenth downgrade in real GDP growth resulted from small downward revisions in inventory accumulation, consumer spending on services, government spending, residential investment, and net exports, which outweighed an upward revision to nonresidential investment.

After Revision, Nonresidential Investment Is the Main Driver of First Quarter Growth

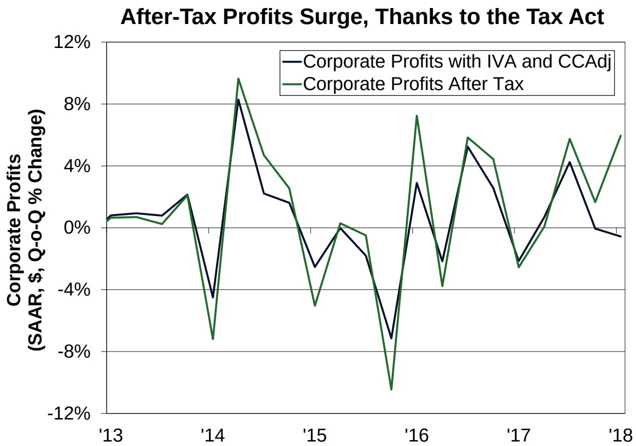


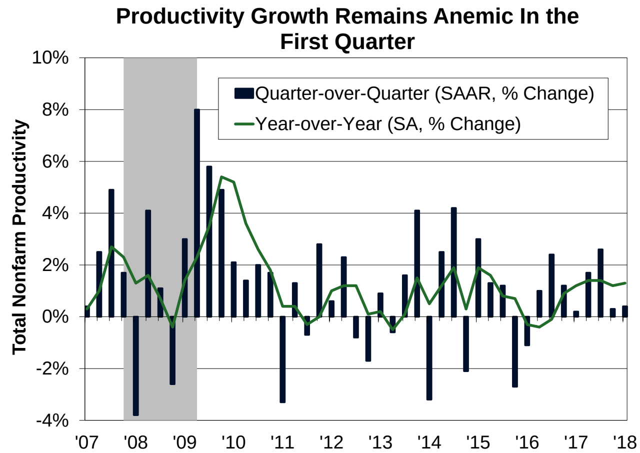
Nonresidential investment was the only component of GDP that was revised higher. The upgrade in real nonresidential investment growth, from 6.1 percent annualized to 9.2 percent, was large enough to push final sales to domestic purchasers (GDP minus trade and inventories)—a gauge of strength in domestic demand and a better measure of underlying growth—three-tenths higher than the prior estimate, to 1.9 percent annualized. However, the increase was still a drastic deceleration from 4.5 percent during the fourth quarter.

Real residential investment was revised lower from a flat reading to a decline. This marks the third time in four quarters that housing subtracted from GDP growth.

Corporate profits, the new piece of data in the second print of GDP, showed that before-tax profits fell in the first quarter for the second consecutive quarter. However, after taxes, profits surged during the quarter, thanks to the cut in corporate taxes from the Tax Cut and Jobs Act.

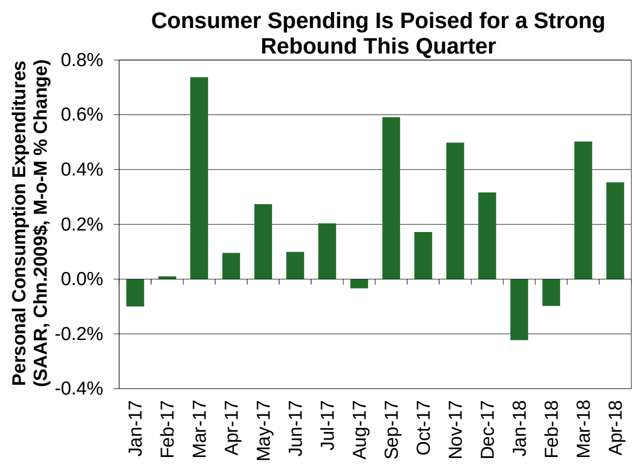
A meaningful acceleration in productivity growth has remained elusive but often lags a pickup in business investment. Nonfarm productivity grew just 0.4 percent annualized during the first quarter, three-tenths slower than in the prior estimate. The year-over-year increase in productivity remained within the narrow range of 1.2 percent to 1.4 percent seen over the past year. Meanwhile, unit labor cost growth was revised higher by two-tenths to 2.9 percent annualized during the quarter, the biggest quarterly rise in a year. However, the annual increase remained subdued, rising just 1.3 percent from a year ago, decelerating from 1.8 percent in the prior quarter.





Consumer Spending Poised for a Rebound…

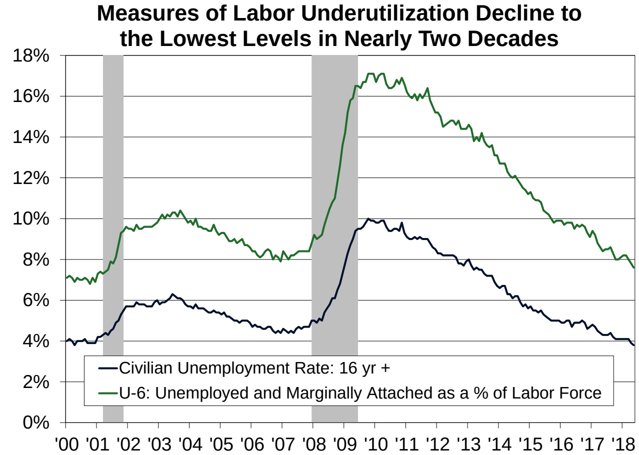
Incoming data are reinforcing our expectation for strengthening economic growth this quarter. Real consumer spending started the second quarter on a strong note, rising 0.4 percent in April following a 0.5 percent rise in March. Given the first quarter's strong finish and the second quarter's solid start, we expect real consumer spending growth to pick up to 3.0 percent annualized this quarter from 1.0 percent last quarter. Our expectation for accelerated spending is bolstered by continued improving labor conditions.

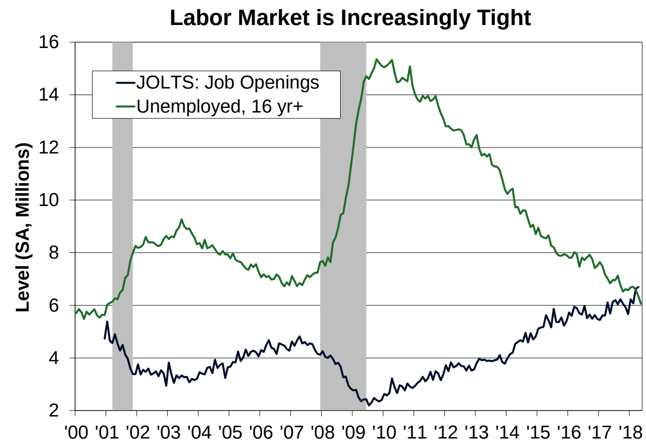


…Amid a Tighter Labor Market

Hiring picked up in May, with nonfarm payrolls posting a strong, broad-based increase of 223,000 following a net upward revision for the prior two months. Wages grew 0.3 percent, the biggest monthly gain since January. However, the annual increase showed no signs of breaking out, staying within the tight range between 2.6 percent and 2.8 percent seen since December. The unemployment rate edged down to 3.8 percent, the lowest level in 18 years, with a record-low rate for African Americans, while the broadest measure of labor underutilization (U-6) declined to 7.6 percent, the best showing in 17 years. One weakness was the third consecutive drop in the labor force participation rate to 62.7 percent.

Other labor market reports also point to continued reduced slack in the market. For example, the Job Openings and Labor Turnover Survey (JOLTS), which lags the monthly employment report by one month, showed that job openings rose in April to a record high of 6.7 million, which exceeded the number of unemployed persons (6.3 million) for the first time since record keeping on job openings began in 2000. At the onset of the current expansion, there were 14.7 million unemployed people and 2.4 million job openings.





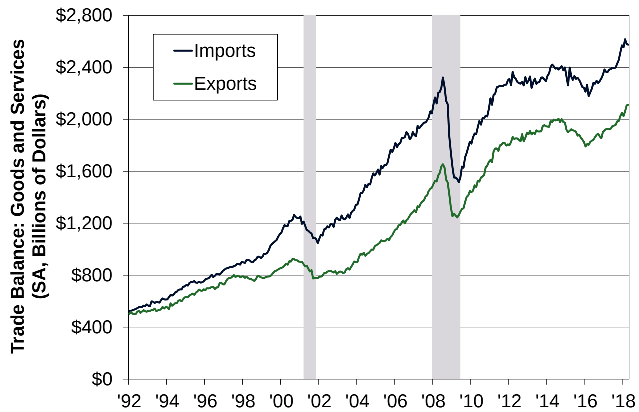
Business Equipment Investment Disappoints

We had expected a boom in business investment in equipment this year in response to the full expensing provision of the Tax Act. So far, actual investment has fallen short of expectations. Real business equipment investment grew 5.5 percent annualized during the first quarter, decelerating from double-digit gains during the second half of 2017. Lackluster data from the transportation sector suggest that real equipment spending is poised to decline this quarter for the first time since the third quarter of 2016. If realized, this quarter's decline should be a one-off, given the generous tax provisions. However, protectionist trade policy could increase uncertainty, leading businesses to delay spending decisions. Strong equipment spending growth is important to boost productivity growth and keep labor costs contained.

Trade Boosts Near-Term Growth

The nominal trade deficit narrowed in April for the second consecutive month, as exports increased to a fresh record high while imports fell. At $46.2 billion in April, the trade deficit has narrowed more than $9 billion from its level just two months prior, when it reached its widest level since 2008. We expect net exports to add to growth this quarter.

Exports Rise to a Fresh Record High



However, going forward, trade will likely face headwinds. Recent tariff actions increased the odds of a negative conclusion to the North American Free Trade Agreement (NAFTA) negotiations. The importance of trade with Canada and Mexico varies significantly among states. For example, in 2017, exports to Canada accounted for about 8 percent of North Dakota's GDP, and exports to Mexico made up more than 5 percent of Texas' state product. Thus, while the impact on the nation might be modest, trade restrictions would likely hurt some states much more than others.

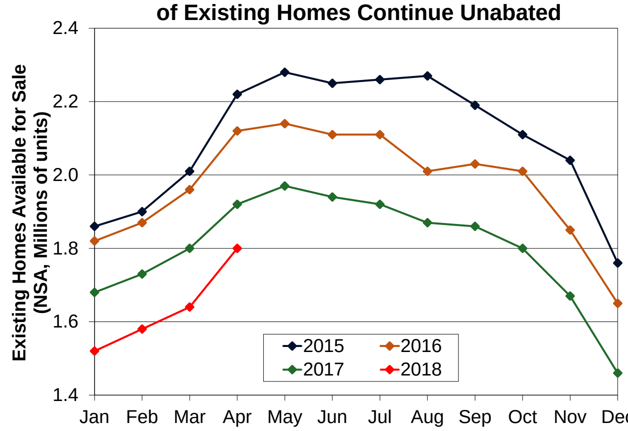
Fed Signals More Aggressive Tightening

Annual inflation held steady in April after accelerating in March amid reduced labor market slack. The Fed's favored measure of inflation—the Personal Consumption Expenditures (PCE) deflator—rose 0.2 percent from March but the year-over-year increase remained at 2.0 percent. The core PCE deflator (excluding food and energy) also rose 0.2 percent during the month, leaving the annual increase unchanged at 1.8 percent.

At the June Federal Open Market Committee (FOMC) meeting, the Fed raised the federal funds rate by 25 basis points, to a range of 1.75 percent to 2.00 percent, as universally expected. In the post-meeting statement, the FOMC discontinued forward guidance, dropping language indicating that "the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

The Fed's updated economic projections indicate slightly stronger growth, lower unemployment rates, and higher inflation rates for 2018 than in the March projections. In addition, the dot plot, which shows members' federal funds rate projections, implies a total of four rate increases in 2018, one hike more than was projected in March. With inflation expectations expected to remain well-anchored around the Fed's inflation target, we continue to forecast only one more rate increase this year, but with the risk skewed toward two hikes.

Year-over-Year Declines in For-Sale Inventories of Existing Homes Continue Unabated



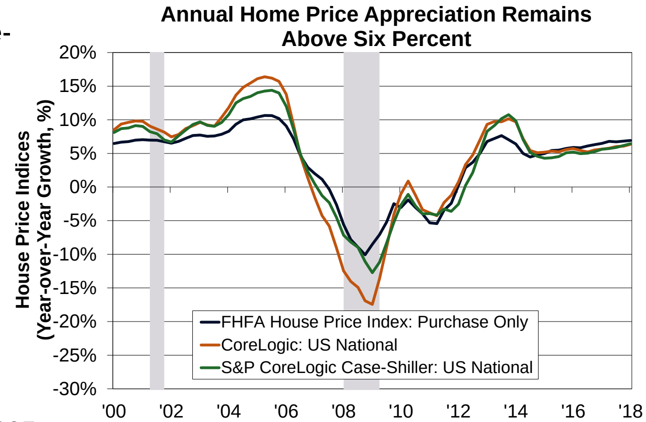
Housing Roundup

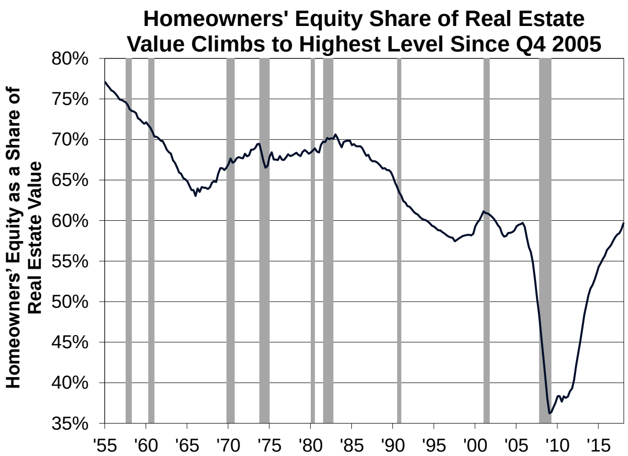
Housing activity was downbeat in April, with declining housing starts, new home sales, and existing home sales. The for-sale inventory of existing homes has remained below year-ago levels for nearly three years. Inventory shortages are impeding sales, but demand appears to be strong as homes are selling fast, with properties typically staying on the market for only 26 days in April, the shortest duration since the series began in 2011.

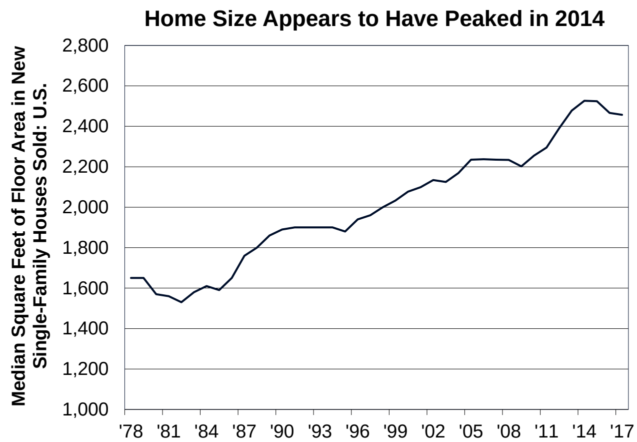
Tight inventory continues to boost prices in the presence of strong demand. Main measures of home prices—the S&P CoreLogic Case-Shiller, CoreLogic, and FHFA home price indices—showed strong increases in the first quarter, pushing annual gains to between 6.4 percent and 6.9 percent for the nation.

While the strength in home prices has restrained home purchase affordability and sales, it helped increase household net worth (assets minus liabilities) during the first quarter to $100 trillion for the first time, as gains in real estate wealth and other components outweighed the first drop in stock market wealth in 10 quarters.

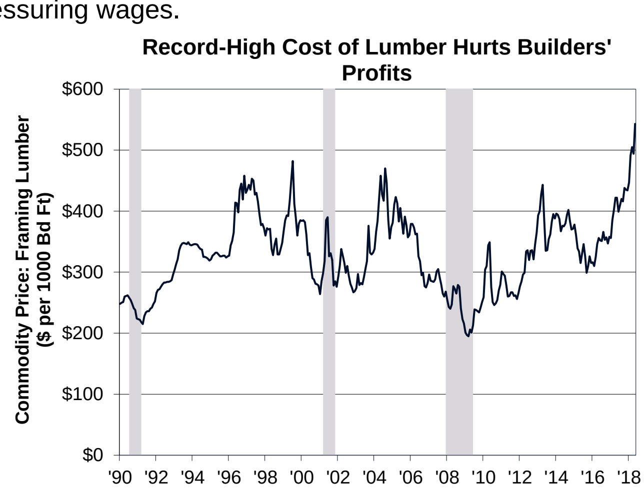
For the first quarter, homeowners' equity in real estate posted the largest gain in almost five years, pushing the equity share of real estate value to 59.7 percent, the highest reading since the end of 2005 and a significant rebound from the trough of 36.2 percent witnessed 9 years go.

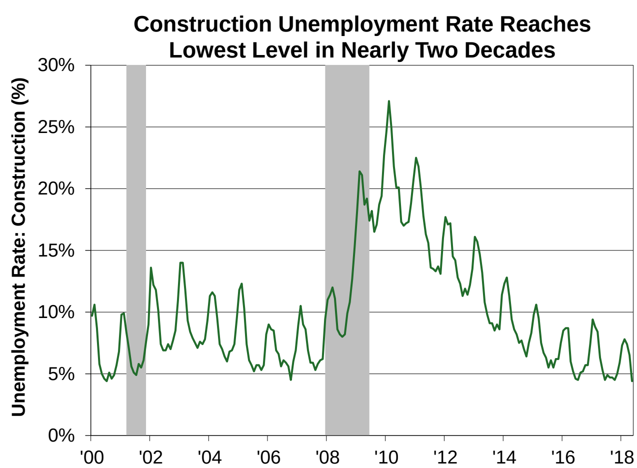






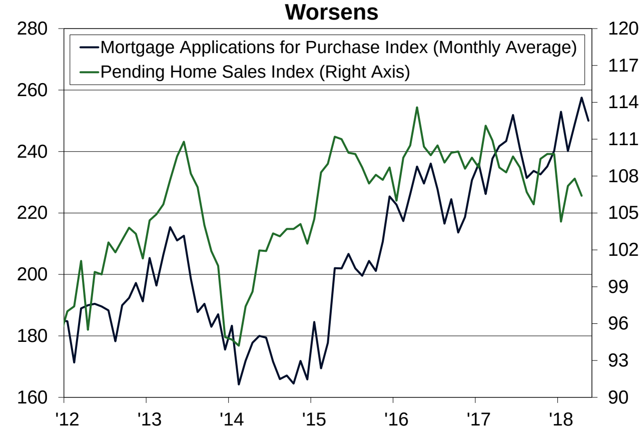
Lean inventory, a strong labor market, and positive demographics should support future single-family homebuilding. Home builders' confidence has remained historically high, but builders continue to face headwinds from rising costs. The median size of new homes sold has been declining in recent years, as builders have focused on smaller homes to meet rising demand from entry-level buyers. However, the record-high cost of lumber has pressured profit margins, making it more difficult to produce relatively modest-priced homes. In addition, shortages of available lots and skilled labor have remained primary concerns for builders. Finished lot price as a share of sales price has risen since 2015, and the construction industry unemployment rate fell in May to 4.4 percent, tying the lowest level since the inception of the series in 2000, pressuring wages.





The near-term outlook for home sales is bearish, as pending home sales fell in April and purchase mortgage applications dropped in May. Increasing mortgage rates are adding to affordability challenges. Mortgage rates rose in May for the eighth consecutive month, with the 30-year fixed mortgage rate averaging 4.59 percent, compared with 3.81 percent just last September. We lowered our forecast for existing home sales slightly, with total home sales rising about two percent this year compared with 2.5 percent in the prior forecast. However, we revised higher our purchase originations forecast for 2018 due to a downwardly revised share of homes sold for cash.

Near-Term Outlook for Home Sales Worsens



Total mortgage originations are expected to fall about 6 percent from 2017 to $1.71 trillion in 2018, with a refinance share of 28 percent, compared with 36 percent in 2017. Single-family (1-4 unit properties) mortgage debt outstanding in the first quarter of 2018 climbed to the highest level since the third quarter of 2010, but the quarterly increase was the smallest in two years.

Economic & Strategic Research (ESR) Group

June 13, 2018

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, Bureau of Labor Statistics, Census Bureau, Foundation for International Business and Economic Research, and National Association of REALTORS®, Mortgage Bankers Association*

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