Economic Developments – November 2018

Despite Strong Job Growth, Housing Continues to Lag

The economy is projected to expand by 3.1 percent this year, up slightly from our prior projection, and post solid gains in employment and hourly wages. We forecast growth to slow to 2.3 percent in 2019 as the economy contends with further increases in short-term interest rates and the waning effect of the fiscal stimulus enacted in February. Key downside risks to our economic forecast include a further slowing in business investment or a loss in consumer confidence, whether due to the Federal Reserve increasing rates too aggressively, a further rise in trade tensions or a decline in equity markets.

The housing sector has continued to struggle despite the strong economy and job market. In the third quarter, existing home sales fell for the third consecutive quarter, while new home sales posted the sharpest quarterly drop in five years. Rising mortgage rates and home prices along with the low inventory of existing homes for sale has discouraged buyers, as confirmed by our consumer survey.

Our housing and mortgage market outlook for 2019 is premised on the view that mortgage rates will recede as a headwind. When combined with our overall outlook for the economy, this leads us to expect that existing and new home sales will stabilize in 2019, aided in part by a moderation in home price appreciation. The operating environment for mortgage lenders will remain challenging. Given weak housing data over the past month, we lowered our 2018 originations forecast by $11 billion to $1.624 trillion and our 2019 forecast by $21 billion to $1.603 trillion.

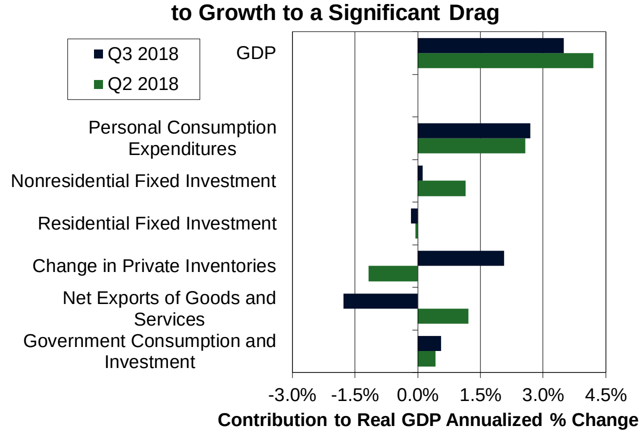
Headline Growth Remains Strong but News on Investment is Discouraging

The first estimate of third quarter growth came in at a 3.5 percent annualized rate, a modest decline from 4.2 percent in the second quarter, but still a respectable pace given the length of the current expansion. Consumer and government spending as well as a build-up in private inventories contributed to growth in the third quarter. In contrast, business fixed investment was soft and residential fixed investment fell for the third consecutive quarter. The trade deficit widened during the quarter, partially in response to a reversal in the tariff-induced export surge over the second quarter, and subtracted sizably from growth. As noted in prior commentary, trade remains a downside risk to the economy.

We expect economic growth to slow in the fourth quarter, but to remain solid at 2.6 percent. A strong dollar will contribute to a widening trade deficit, and therefore subtract from growth. Consumer spending growth is expected to moderate from the robust rates recorded over the second and third quarters of the year. The economy should continue to receive support from government spending, and business fixed investment is expected to pick up. Residential fixed investment is expected to grow modestly as the industry recovers from weather-related disruptions – hurricanes in the Southeast and wildfires in California – and the impact of rising mortgage rates over the past year.

Finally, we expect full-year growth in 2018 to come in at 3.1 percent. We also expect growth to slow to 2.3 percent in 2019 as the economy adjusts to higher interest rates and slower growth in federal government outlays.

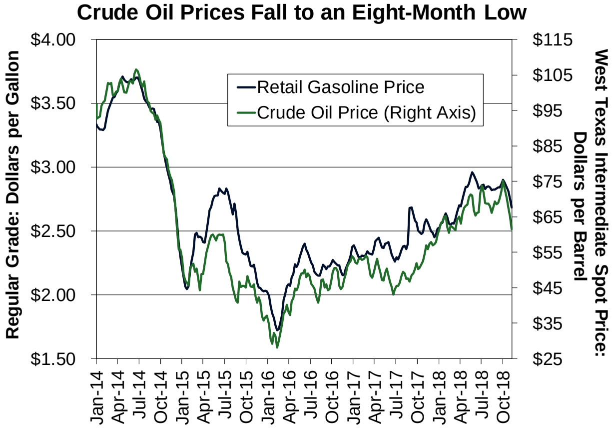
Net Exports Switch From a Major Contributor to Growth to a Significant Drag

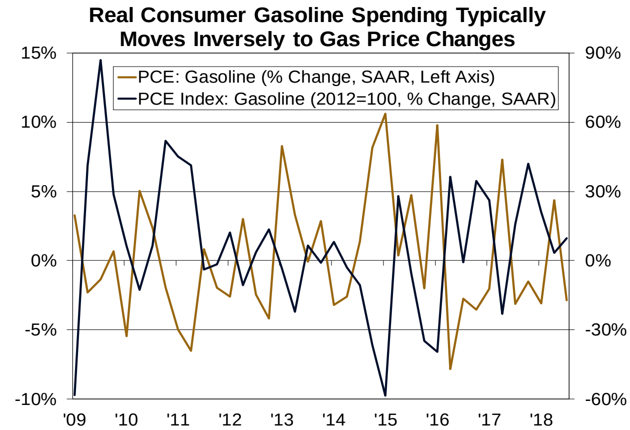


Consumer Spending Growth Strengthens Amid a Healthy Labor Market

Personal consumption expenditures grew by a 4.0 percent annualized rate in the third quarter, its fastest pace of growth in nearly four years, with growth across all major categories. While spending growth on durable goods was not as high in the third quarter relative to the second, spending on non-durable goods posted the fastest quarterly increase since the first quarter of 2013. However, spending growth on gasoline, a component of non-durable goods, fell over the quarter as gasoline price inflation quickened. The decline in gasoline spending was likely attributable to rising oil prices in response to production disruptions in Venezuela and the prospect of sanctions on Iran.

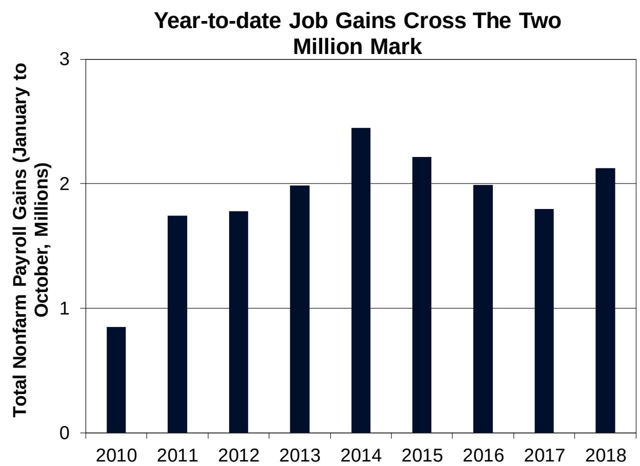
After increasing during the third quarter, crude oil prices have fallen in early November and represent one tailwind for consumer spending. Although the Administration re-imposed sanctions on Iran on November 5, it has issued waivers to eight countries so far, allowing them access to Iranian oil supplies and making the decline in the oil supply from Iran more gradual. Additionally, the lost barrels of oil from Iran and Venezuela have been replaced by greater output from the U.S., Russia, and Saudi Arabia, putting downward pressure on oil prices. Lower oil prices should lead to declining gasoline prices and help support consumer spending.



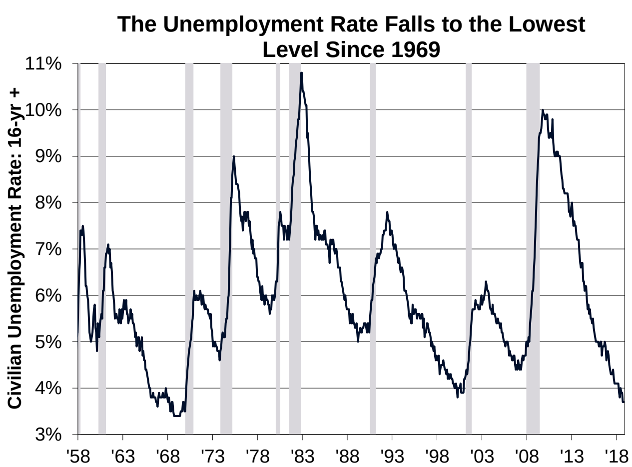


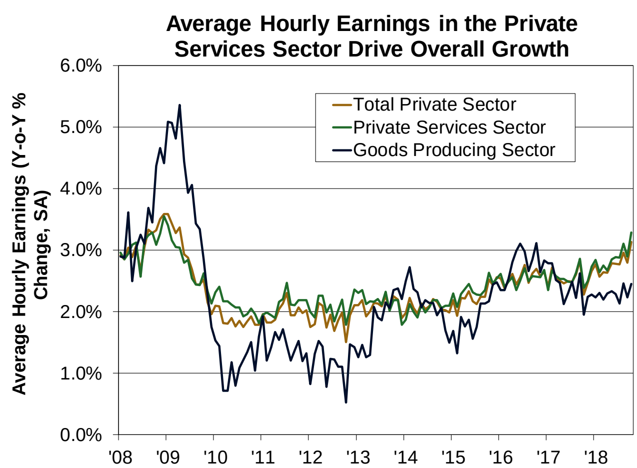
The U.S. economy created 250,000 jobs in October, a pickup from the September increase of 118,000 jobs, which were revised lower by 16,000. The level of job creation in October partly reflected a rebound from Hurricane Florence as weather-sensitive industries, such as leisure and hospitality, registered job gains in October following a September decline.

The brisk pace of job creation in October contributed to the impressive strength of the labor market this year. The number of jobs added last month pushed total job growth year-to-date above 2.1 million. By comparison, the U.S. economy added 1.8 million and 2.0 million jobs over the first 10 months of 2017 and 2016, respectively.



The unemployment rate held steady in October at 3.7 percent, a level last recorded in 1969. Amid a low unemployment rate, annual average hourly earnings across the private sector rose by 3.1 percent, an expansion high. Earnings growth in the private services-producing sector, which accounted for 84 percent of all private-sector jobs in October, rose by 3.3 percent, a new expansion high. By contrast, earnings growth across the private goods-producing industries has held relatively steady over the past two years, reflecting an offsetting deceleration in average hourly earnings growth in the manufacturing sector that has largely offset the broad acceleration in the construction, mining, and logging industries.





Government Spending and Inventories Also Contribute to Growth

Government spending and investment accelerated in the third quarter, boosted by faster growth in federal nondefense and state and local spending as well as solid growth in federal defense spending. The contribution of government spending to broader economic growth is supported by the Bipartisan Budget Act of 2018, which we expect will continue to boost growth through the first half of next year before it begins to fade and turns to a drag on economic growth in the second half of 2020.

Inventories lifted growth in the third quarter as businesses replenished the net drawdown from the second quarter, contributing 2.1 percentage points to growth after subtracting 1.2 percentage points in the previous quarter. The third quarter contribution was its largest since the first quarter of 2015. We expect inventory investment to slow in the fourth quarter, dragging moderately on growth.

Weakness in Business Investment May Limit Future Productivity Gains

Business fixed investment grew at a 0.8 percent annualized rate in the third quarter, the slowest pace in nearly two years. Equipment spending growth slowed to a near standstill despite the full expensing provision from the 2017 Tax Cuts and Jobs Act. Business spending on industrial equipment represented the lone bright spot, growing by a 10.2 percent annual rate in the third quarter after falling by 3.1 percent in the second quarter. The gains in industrial spending were countered by a slowdown in the growth of information processing equipment and declines in transportation and other business equipment spending. Anecdotal reports contained in the minutes of the Federal Open Market Committee (FOMC) September meeting were encouraging, as FOMC members noted that their contacts remained optimistic about their business prospects. However, they did acknowledge that labor shortages and uncertainty regarding trade policy were causing them to forego business fixed investment opportunities in some cases.

Nonresidential spending on structures declined outright as most categories recorded quarterly declines. Most notably, spending related to petroleum and natural gas fell for the first time since the fourth quarter of 2016, following surges in the prior two quarters. Growth in spending on nonresidential structures may be limited if oil prices continue to fall.

Over the third quarter productivity rose at a healthy 2.2 percent annualized rate, perhaps reflecting last year's rebound in capital investment. However, from a year ago, productivity grew 1.3 percent, remaining within the 1.0 percent to 1.4 percent range that has prevailed since the end of 2016. The recent slowdown in business fixed investment growth diminishes the likelihood that productivity will accelerate further.

Inflation Remains Manageable

Despite the broad acceleration in average hourly earnings, annual growth in the price index associated with personal consumption expenditures (PCE) offered some evidence that inflation pressures remain contained. This is likely due in part to continued productivity gains. The annual growth in the PCE index slowed in September for the second consecutive month to 2.0 percent, while core PCE inflation remained stable at 2.0 percent for the fifth consecutive month.

The recent decline in oil prices and the rise in the dollar puts downward pressure on inflation, but escalating tariffs, most notably on imports from China, represents an upside risk for inflation. However, that risk is partly reduced by gains in the U.S. dollar relative to the Chinese yuan over the past year. The minutes from the Federal Reserve's September FOMC meeting indicate that firms were attempting to diversify the set of countries with which they trade as a result of uncertainty over tariff policy and to limit their impact on input costs.

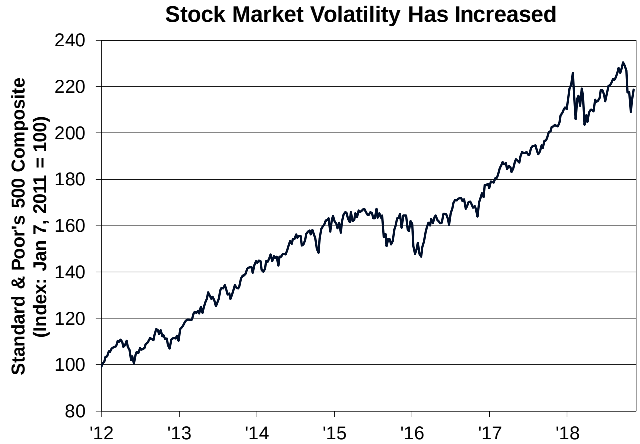
Fed Pauses in November

The Fed kept the target federal funds rate at a range of 2.0 to 2.25 percent at the November FOMC meeting, as widely expected. The statement accompanying the meeting noted that the pace of broader economic growth was strong, but it acknowledged that growth of business fixed investment had "moderated." The statement recognized that job gains have also been strong and the unemployment rate has declined, while inflation remains near 2.0 percent. The Fed considers the risks to its economic outlook to be "roughly balanced," and still expects "further gradual increases in the target range for the federal funds rate." We anticipate that the Fed will raise the federal funds rate in December and two more times in 2019, reflecting our forecast of a solid labor market and inflation near the Fed's 2.0 percent objective.

Stock Market Volatility and Trade Tensions Pose Downside Risks to Forecast

Volatility in the stock market intensified since our last forecast. Moves at or above 1.0 percent up or down in the S&P 500 Index occurred on 10 trading days in October compared with none in September. For all of October, the S&P 500 Index fell 6.9 percent, largely reversing its 2018 gains.

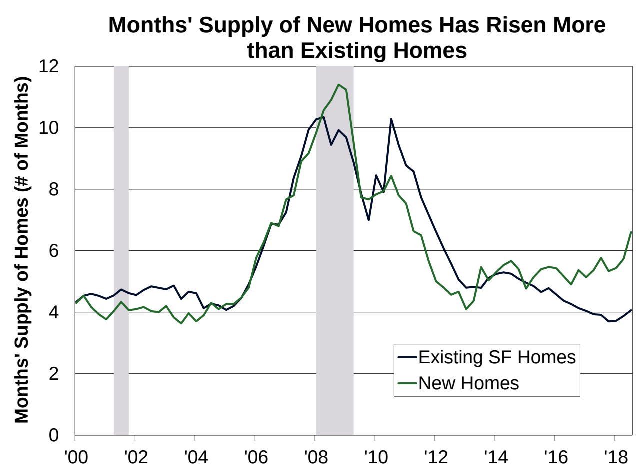
Consumer confidence remains elevated in spite of recent fluctuations in the stock market. The preliminary reading from the University of Michigan Consumer Sentiment Index indicates that consumers' confidence fell modestly in November to 98.3 from 98.6 in October, but remains at a historically high level, suggesting that recent stock market volatility did not significantly change consumers' views on the economy. However, there seems to be a divergence in sentiment by household income. Sentiment among households earning more than $75,000 a year fell, perhaps a reaction to October's stock-market decline, while those earning less than $75,000 saw a gain. Sustained declines in the stock market pose downside risks to our outlook as a contraction in households' financial wealth could lead consumers to be more cautious.



The U.S. trade deficit subtracted 1.8 percentage points from third quarter growth, reversing its positive contribution in the second quarter. Exports fell sharply, reversing the surge in the prior quarter, when shipments had been pulled forward to beat the effective date of announced tariffs. At the same time, imports rose the most in three quarters. Additionally, the rise in the dollar, which makes U.S. exports more expensive to foreign buyers and foreign goods and services less expensive to U.S. consumers, should lead to a widening in the deficit in coming quarters. Our forecast assumes that net exports will continue to fall, further subtracting from economic growth.

Housing Roundup

Widespread weaknesses in housing indicators occurred in the third quarter, as higher mortgage rates, continued house price appreciation, and low inventory further reduced affordability. In the third quarter, existing home sales fell for the third consecutive quarter, while new home sales posted the sharpest quarterly drop in five years. Mortgage rates averaged 4.57 percent in the third quarter, reaching the highest quarterly level in more than seven years. In addition, annual house price growth exceeded 6.0 percent in July and August (FHFA Purchase-Only Index). Although the inventory of homes for sale has shown evidence of growing, the increase has been concentrated in California and remains abnormally low in many markets. In the third quarter, it would take approximately 4.3 months to exhaust the inventory of existing homes at the current sales pace. A months' supply of inventory below six months typically signals a shortage. The months' supply of new homes reached 6.6 months in the third quarter, exceeding six months for the first time since the third quarter of 2011.



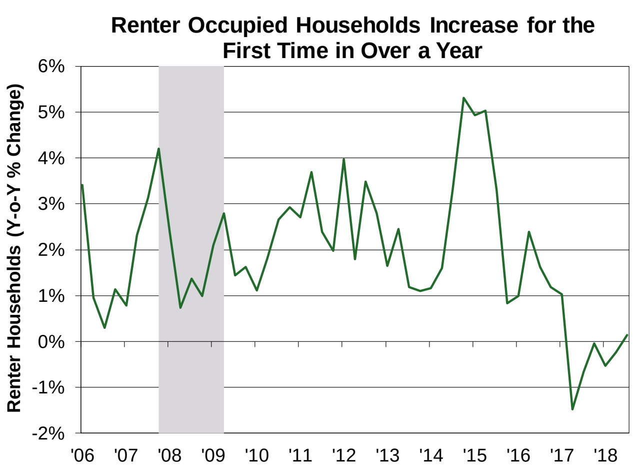
More recently, extreme weather during the month likely also contributed to the lackluster performance. Existing home sales fell by 3.4 percent in September, the sixth consecutive monthly decline, led by a 5.4 percent drop in the South and a 3.6 percent decrease in the West. Sales of new homes have fallen for four consecutive months, with a 5.5 percent decline in September that was partly attributable to a 1.5 percent decrease across the South and a 12.0 percent decline in the West. The wildfires have been tragic for all those affected. We expect that the impact of these natural disasters for residential construction activity will be transitory.

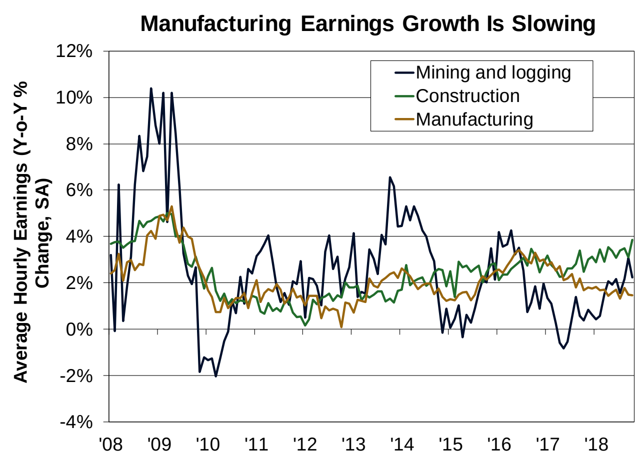
The increase in mortgage rates to date and ongoing home price appreciation should remain a headwind for home sales. Home prices are expected to rise by 5.4 percent in 2018 and by an additional 4.1 percent in 2019, decelerating from 6.9 percent appreciation in 2017 (FHFA Purchase-Only Index). Fannie Mae's Home Purchase Sentiment Index® (HPSI) fell modestly in October, partly reflecting an increase in the proportion of respondents expecting mortgage rates to go up over the next 12 months and a decline in the share expecting mortgage rates to go down.

The Census Bureau's Housing Vacancy Survey provided some good news for the longer-run drivers and health of the housing sector. Household growth remained robust in the third quarter, increasing by 1.56 million occupied households over the prior year. Renter-occupied households posted the first year-over-year increase since the first quarter of 2017. Over the past year, the count of owner occupied households increased by 1.5 million, the 13th consecutive quarter of annual gains. The homeownership rate has increased on an annual basis over seven consecutive quarters, reaching 64.4 percent in the third quarter. In addition, both the homeowner and rental vacancy rates remain at or near multi-decade lows. Over the longer-term, headship rates and household formation are key determinants of housing production. In the immediate term, market conditions are a challenge for the construction industry.

Single-family housing starts fell over the third quarter. Higher interest rates are raising builder's construction costs and average hourly earnings growth of residential construction workers has accelerated amid tight labor conditions. Prices of softwood lumber have offered relief, declining by approximately 27 percent since reaching a record high in June. Similar to home sales, weather may have also played a role in the recent decline in single-family housing starts as the 0.9 percent drop in September was driven by a 6.8 percent decrease in the South. Multifamily starts, which are notoriously volatile, also pulled back in the third quarter, with a drop in September thanks to sharp declines in the Midwest and the South.

We revised projected purchase mortgage volumes down slightly (approximately 1.0 percent for 2018 and around 2.0 percent for 2019) based on the downward revision to the forecast of single-family starts and incoming data indicating a continued softening in home price appreciation. We now have purchase originations declining slightly in 2018 relative to 2017 (down about 1.0 percent year over year), a change from last forecast, but recovering in 2019 (up almost 3.0 percent year over year) as existing home sales are projected to pick up. We left projected refinance volumes unchanged forecast over forecast despite the increase in mortgage rates over the last month, given our relatively large downward revision in the prior forecast, which was consistent with a more pessimistic outlook for rates.





For information on multifamily market conditions, please see the November 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: *Census Bureau, Bloomberg, Energy Information Administration, Chicago Mercantile Exchange, Department of Labor, FEMA, Bureau of Labor Statistics, Federal Reserve*

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