Waning Momentum Reinforces Forecast of Growth Slowdown

The first quarter's robust economic growth of 3.1 percent annualized is likely to be the fastest quarterly growth this year. Incoming data are consistent with a marked slowdown to 1.7 percent in the second quarter, the same pace projected in our May forecast. While we maintained our expectation that relative strength in consumer spending and labor productivity will support growth, we now expect weakness in fixed investment to weigh more heavily on macro conditions during the latter part of 2019 and through 2020. Thus, we have revised downward our full-year gross domestic product (GDP) forecasts from 2.3 percent to 2.1 percent in 2019 and from 1.8 percent to 1.5 percent in 2020.

Sluggish manufacturing activity, slowing global growth, an escalation of U.S.-China trade tensions, and the possibility of a resurgence of U.S.-Mexico trade tensions all reinforce downside risks to our forecast. Additionally, equity valuations fell in May for the first time this year, increasing the risks associated with company-level borrowing and threatening to deplete the stimulus provided by the Tax Cuts and Jobs Act of 2017. The yield curve inverted at the end of May and has remained inverted as of the time of this writing, suggesting that market participants believe monetary stimulus will be necessary to forestall a recession. In response to these signs of actual or potential downside, we are now forecasting that the Federal Open Market Committee (FOMC) will cut the federal funds rate by 25 basis points at its September meeting.

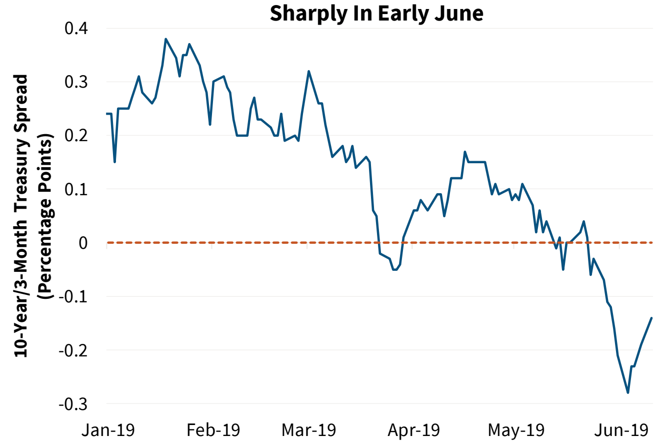
Both existing and pending home sales disappointed slightly in April; moreover, upward revisions to new home sales in the first quarter imply that the inventory of new homes available for sale is smaller than we previously thought. However, we expect the remainder of the second quarter to make up for April's softness as mortgage rates stabilize at new lows for the year and home price appreciation continues to moderate. We maintain our forecast of a modest 1.0 percent gain in home sales during 2019, but the slow early pace implies more of that growth will occur during the latter half of the year. Conversely, our forecast of housing starts relative to last month is stronger during the second quarter but slightly weaker during the rest of 2019 and 2020, reflecting our expectation of a gradual weakening in macroeconomic conditions.

Yield Curve Inversion Spurs Rate Cut Predictions

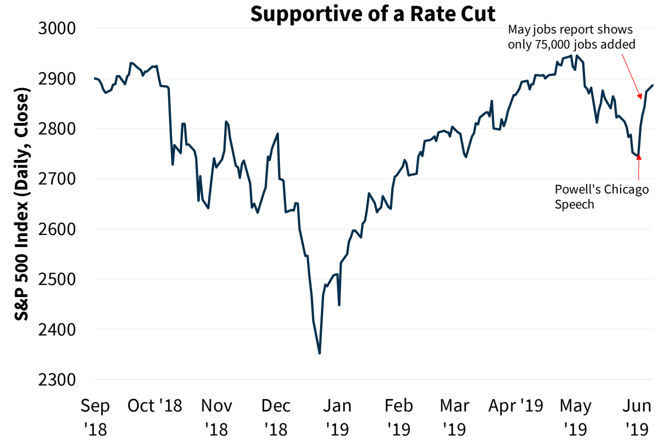
In late May the spread between the yields on 10-year and 3-month Treasuries inverted, with 3-month yields eventually exceeding 10-year yields by as much as 28 basis points in early June. The 10-year yield plummeted 45 basis points between the beginning of May and the beginning of June to the lowest level since September 2017, while the 3-month yield declined a modest 8 basis points. An inversion is regarded by many as a sign of overly tight U.S. monetary policy and harbinger of recession, but it may also reflect global capital flows into the country driven by the fact that U.S. yields remain attractive relative to those elsewhere. With the long end of the curve falling below the short end, the futures market turned bearish and, as of this writing, are implying a cut in the fed funds rate by July's FOMC meeting and a second cut by December.

Several FOMC members have expressed a more dovish position on rate movements recently. In early June, Federal Reserve Board Chairman Powell gave a speech in Chicago in which he emphasized that the central bank is closely monitoring the recent escalation in trade tensions and "will act as appropriate to sustain the expansion." The market posted an immediate positive reaction to the comments, with both the S&P 500 Stock Index and the Dow Jones Industrial Average ending the day up more than 2 percent. Market participants seem to have interpreted Chairman Powell's

The 10-Year/3-Month Treasury Spread Inverts Sharply In Early June



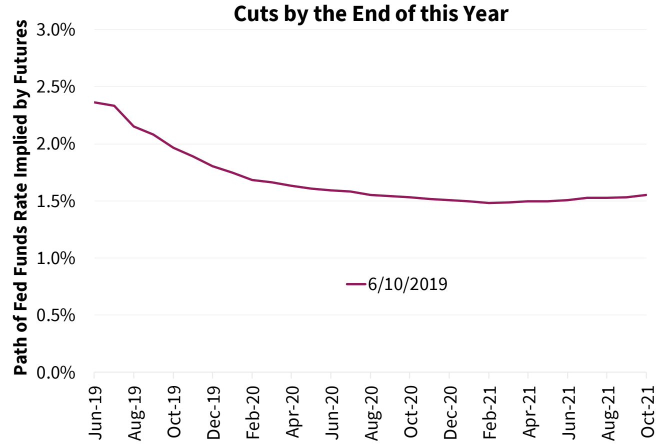
Stock Market Reacts Positively to Reports that are Supportive of a Rate Cut



remarks as confirmation that the Fed would provide an implicit backstop to declines in equities, and since then have reacted counterintuitively to new indicators of macroeconomic conditions on the theory that negative data increases the chance of a Fed rate cut, which would be a positive for "risk-on" assets. This was demonstrated most clearly after the unexpectedly weak May jobs report triggered a 1.4 percent gain in the S&P 500 during the hours after the release.

Inflation has continued to drift below the Fed's 2.0 percent target, increasing concerns that inflation expectations may adjust to a lower level that would make it difficult to achieve the Fed's goal of promoting "maximum sustainable employment" along with stable prices, defined by the Fed as an annual inflation rate of 2.0 percent. The Fed attributed muted inflationary pressures during the first quarter to "transitory factors," but in more recent comments several FOMC members have expressed greater concern, with New York Fed Chairman Williams noting that "inflation that's too low is now a more pressing problem." In response to the persistence of inflation on the lower side of the Fed's target, along with downside risks including trade tensions and slowing global growth, we are now forecasting that the FOMC will reduce its target for the federal funds rate by 25 basis points at its September meeting.

The Fed Funds Futures Market Expects Two Rate Cuts by the End of this Year



International Trade Tensions Exacerbate Global Manufacturing Weakness

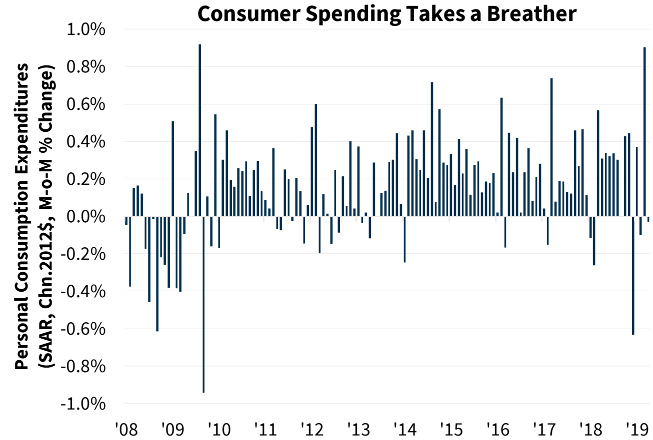
In response to reported Chinese backtracking on concessions in ongoing trade negotiations in early May, the U.S. unexpectedly hiked tariffs on Chinese goods. International trade tensions have since escalated, with tit-for-tat retaliations in the U.S.-China relationship along with a recent U.S. threat to impose new tariffs on Mexico until the flow of illegal migrants to the U.S. moderated. While participants on both sides of the U.S.-Mexico border worked to head off that threat, hopes of a U.S.-China breakthrough during or leading up to the G20 meeting at the end of June are looking less realistic. We expect further tariffs to be implemented before a trade deal is reached, which will likely result in higher prices for consumer products and production inputs, and we have adjusted upward our forecast for inflation in 2019. Moreover, the uncertainty regarding future trade policy is likely to reduce confidence among businesses and consumers, causing them to scale back on investments and major purchases.

International trade tensions have ratcheted up along with increased signals of slowing global growth. The World Bank revised downward its 2019 global macroeconomic growth forecast from 2.9 percent in January to 2.6 percent in June, citing trade barriers and lackluster investment flows as the main drags. Slower growth in China, the U.S., and the Euro Area present major obstacles for growth in emerging economies. Mirroring data from the U.S., global manufacturing has been particularly weak with more countries showing contractions in manufacturing activity (as measured by Purchasing Managers' Indices) than at any time since April 2015. Global manufacturing activity is at its lowest level since October 2012 and is almost 2 points below its long-term average.

Confident Consumers Are Reluctant to Spend

Growth in personal consumption expenditures (PCE) was revised up one-tenth in the second estimate of first quarter real GDP to 1.3 percent, the second largest contributor to GDP growth behind net exports. This upward revision was largely due to the March increase in real consumer spending being revised higher by two-tenths to the largest monthly increase since 2009, indicating an improved starting point for the second quarter. However, this source of support took a breather in April as real consumer spending was flat due to weakness in durable goods purchases and, to a lesser extent, spending on services.

After Posting the Largest Gain Since 2009 in March, Consumer Spending Takes a Breather



The loss of momentum on consumer spending during April seemed at odds with two surveys showing continued consumer optimism in May. The Conference Board's measure of consumer confidence rose, moving close to the expansion highs reached late last year, driven primarily by strength in the present situation component, which rose to the highest level in more than 18 years. The University of Michigan Consumer Sentiment Index likewise improved to just shy of expansion highs, but its increase was driven entirely by a jump in the consumer expectations component to the highest level since January 2004, while the current economic conditions component continued to trend down from a peak in March 2018.

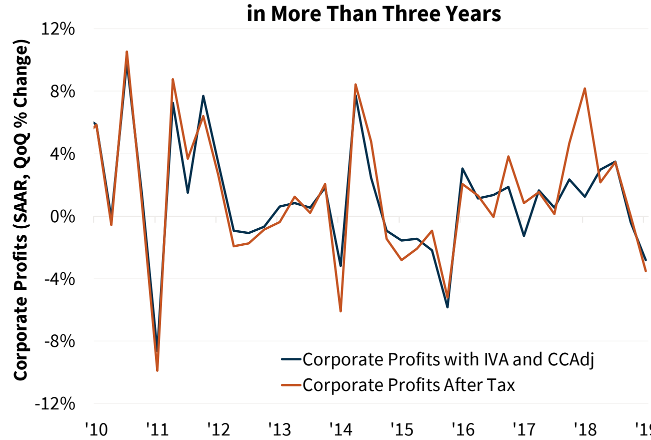
The earliest read on consumer spending in May came from sales of light vehicles, which showed the strongest gain since September 2017 at 6.2 percent, the second surprisingly strong sales figure in the past three months. With auto sales trending down since the end of 2017, light truck sales (which includes SUVs) as a share of total sales rose to a record high of 71 percent in May. Drivers have been helped by a sharp drop in crude oil prices since their most recent peak of $63 per barrel at the end of April; this should also boost real disposable income as the decline in oil prices translates to lower prices at gas stations.

We continue to regard consumer fundamentals as an important source of stability in what is otherwise an uncertain macroeconomic environment. However, in light of the April pause in retail sales and consumption expenditures, we revised down our forecast for second quarter growth in consumer spending. We consider it likely that the recent increases in trade tensions and equity market volatility will prompt consumers to adopt a more guarded outlook and revise downward their still-strong expressions of optimism.

Businesses Also Confident, But Investment Likely to Remain Weak Amid Increased Uncertainty

Nonresidential fixed investment now seems unlikely to pick up in the second quarter, as we had predicted a month ago, and we revised downward our forecast for that component of GDP growth from 3.4 percent annualized to 2.0 percent, with similar reductions in 2020. Businesses had a slow start to the year as corporate profits not only fell during the first quarter—the second straight quarter of decline—but posted the largest drop since the end of 2015. Similarly, annual growth in after-tax profits decelerated to 1.9 percent, the slowest pace since the third quarter of 2016. The decline in business profits, coupled with the increased uncertainty surrounding trade and economic conditions abroad, are likely to cool business sentiment even though the National Federation of Independent Business reported historically high levels of small business optimism in May.

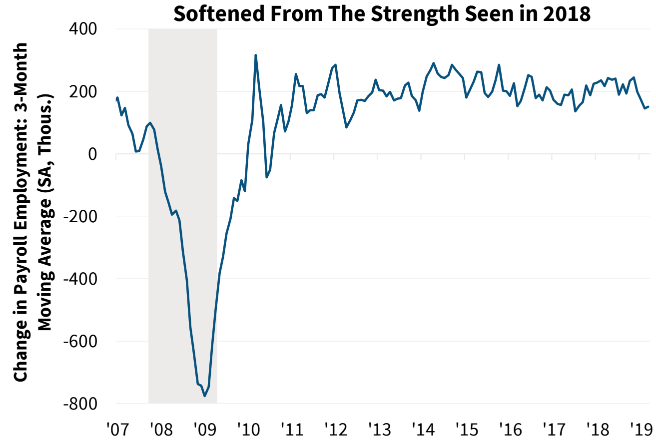
After-Tax Profits Decline for the First Time in More Than Three Years



Uncertainty over the expiration of the debt ceiling also poses risks to business investment this year. When the debt ceiling was reinstated at the beginning of March, the U.S. Treasury began employing "extraordinary measures" to avoid defaulting on the government's obligations. These measures, however, will be exhausted sometime in the third quarter and another increase in the federal debt ceiling will be required. While we assume that the federal government debt ceiling will be raised in a manner that does not permanently erode economic activity, the potential for a lengthy Congressional debate may push businesses to delay investment until the issue has been resolved.

Government outlays during the early part of this year were boosted by a large increase in state and local spending on highways and other infrastructure, and we believe some of that spending will flow into the second quarter. We increased our government consumption and investment forecast this quarter by 1.7 percentage points, in large part making up for the decline in business fixed investment.

The 3-Month Moving Average for Job Gains Has Softened From The Strength Seen in 2018



Employers Hesitant to Hire

The heightened uncertainty that seems to be inhibiting business fixed investment may be causing a similar loss of momentum in the job market, which we had hitherto seen as a source of stability and optimism. Nonfarm payrolls increased by only 75,000 in May, and downward revisions totaling the same number to March and April data implied that May's weak gain represented zero net additional job growth. Accordingly, we have revised downward our forecast for growth in total employment through 2020. The unemployment rate held steady at a historically low level, but we expect to see it start to increase later this year as anticipated growth in employment falls short of moderate growth in the labor force participation rate.

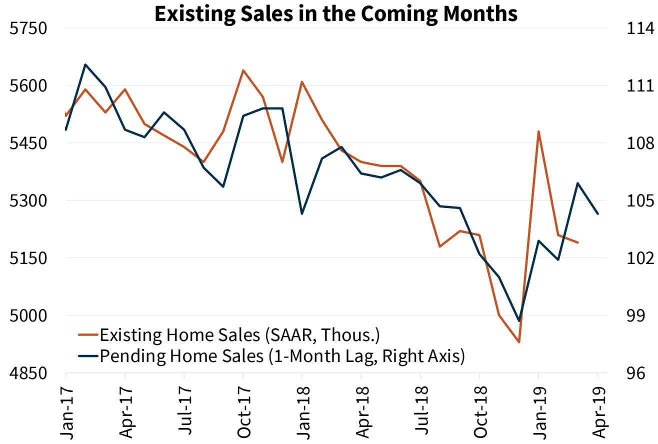
Despite continued tightness in the labor market, we have yet to see evidence of wage pressure that would contribute to an increase in inflation, as annual growth in hourly earnings declined to an eight-month low of 3.1 percent. On a more positive note, productivity increased 3.4 percent annualized during the first quarter, boosting the productivity growth rate to an average of 1.7 percent over the past two years. Moreover, even though business fixed investment has disappointed, investment in research and development and software has been very strong over the past year, averaging between 6 and 16 percent annualized for the past five quarters. These investments should help spur productivity and minimize increases in unit labor costs, and we continue to believe they will come in strong for the remainder of the year.

Housing Is Expected to Support Growth

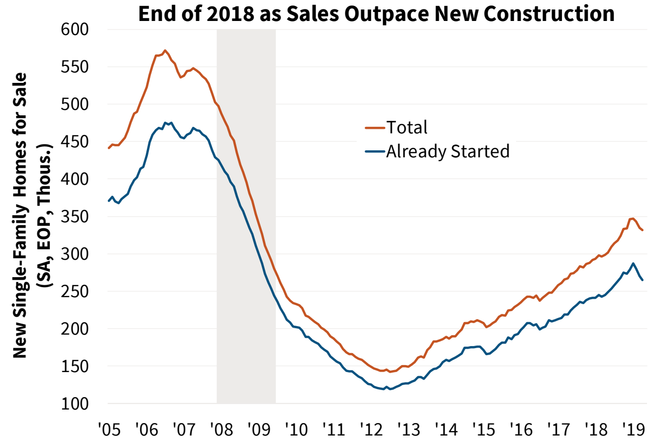
Housing activity was mixed in April, with single-family starts moving higher along with solid new home sales, while existing sales fell modestly and came in weaker than we had expected on the basis of the previous month's jump in pending sales and mortgage applications. However, it is likely that some of March's increase in pending sales will contribute to stronger May sales as it can take six weeks for a signed contract to result in a closed sale. While we revised our second quarter existing sales forecast modestly downward, our overall view of an improving second quarter pace of sales remains intact and we expect an increase of 2.2 percent from the first quarter on a seasonally-adjusted basis. Going forward, stabilizing mortgage rates and a modest rise in the inventory of homes available for sale should help support growth in sales of existing homes in the latter half of the year.

Revisions to February and March new home sales data showed a considerably stronger winter sales pace than previously reported, with March sales hitting a new cyclical high at a seasonally-adjusted annualized pace of 723,000 units. This implies that the inventory of previously started homes for sale accumulated by homebuilders at the end of the last year was sold off at a considerably faster pace than we previously thought, leaving fewer new homes available for sale as of the end of April. Thus, despite momentum in April new sales, we have revised our forecast for second quarter new home sales modestly downward while also bumping up starts to reflect the diminished inventory of new homes available for sale.

Pending Home Sales Suggest a Possible Increase in Existing Sales in the Coming Months



Inventories of New Single-Family Homes Fall From End of 2018 as Sales Outpace New Construction



Single-family permits declined by 3.7 percent in April, tempering optimism for a robust near-term jump in starts. However, continued demand for new homes driven by sustained consumer confidence and low unemployment, coupled with the limited inventory of new homes available for sale, is expected to lead to an upward trend in permits in coming months. Supporting this view is a continued improvement in May of the Home Builders Housing Market Index, a measure of homebuilder expectations.

Currently more than 640,000 multifamily rental units are under construction with more than 400,000 expected to deliver this year. Since only 85,000 units were completed from January through May of this year, an acceleration in completions is expected to occur over the rest of the year. Also consistent with this view, new permits for multifamily construction rose in May to the second highest level in the past two years. While a sizeable portion of this supply is located in the nation's top metro areas, there is continued demand for multifamily units across the country.

For more information on multifamily market conditions, please see the [June 2019 Multifamily Market Commentary].

The CoreLogic National House Price Index accelerated on an annual basis in April for the first time in 13 months but remained near the slowest pace in 7 years reached in March. Also supporting affordability, mortgage rates, sitting at 3.82 percent in the first week of June as reported by Freddie Mac, have declined over a full percentage point from last fall's highs and are helping to bolster homebuyer purchasing power. The headline value for Fannie Mae's Home Purchase Sentiment Index rose solidly in May to levels last seen in the spring of 2018, even though the share of respondents reporting income growth over the past year moderated. Similarly, Fannie Mae's Mortgage Lender Sentiment Survey for the second quarter showed a large increase in the share of lenders reporting expectations of growing purchase mortgage demand over the next three months. While tight home inventories and a legacy of sustained home price appreciation will limit the robustness of the total sales pace recovery, we expect moderate growth in home purchases through the remainder of the year.

In response to the decline in mortgage rates, we increased our forecast for mortgage originations over the remainder of the year, with total originations now expected to rise 2.6 percent from 2018 to $1.68 trillion. We expect the refinance share of total mortgage originations to be unchanged from 2018 at 29 percent, but the decline in rates has increased the upside risk to that forecast as the refinance option is in the money for an increasing share of recent-vintage mortgages. Single-family (1-4 unit properties) mortgage debt outstanding rose to the highest level since the end of 2009 during the first quarter of 2019, increasing 0.2 percent from the prior quarter to $10.9 trillion. However, this was the smallest pace of growth since the start of 2016 and was consistent with decelerating home price appreciation over the quarter.

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: *Federal Reserve, Standard & Poor's, Bloomberg, Bureau of Economic Analysis, Bureau of Labor Statistics, National Association of REALTORS®, Census Bureau, Fannie Mae ESR Group.*

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