

Growth Stalls as Underlying Demand Stumbles

Consumer and business spending as well as net exports came in below expectations in the first quarter of 2016, causing us to lower our economic growth estimate to 1.2 percent annualized. In recent years, the first quarter appears to have suffered from residual seasonality issues—the display of seasonal patterns in data that have already been seasonally adjusted. We do not view weakness in the first quarter as the start of deteriorating economic activity and expect slightly better growth this quarter. Our view for growth for the rest of the year is little changed, as we expect full-year 2016 growth to register 1.9 percent.

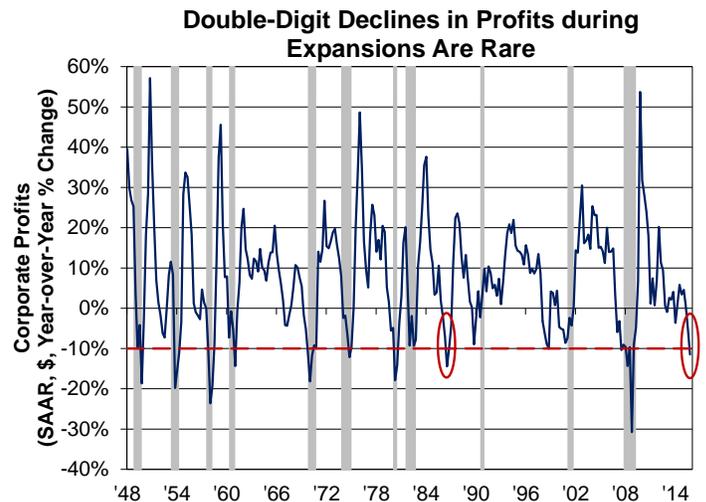
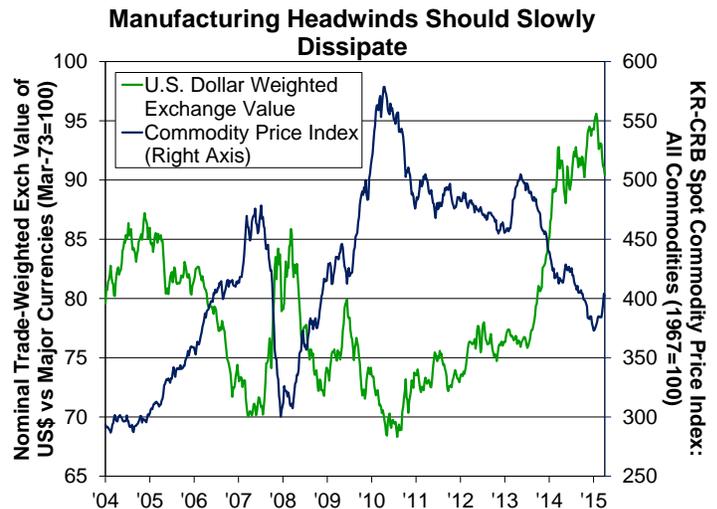
Financial conditions, which deteriorated earlier in the year, have largely reversed course, with rebounds in major stock indices and commodity prices, narrowing risk spreads, and a decline in the trade-weighted value of the dollar. Because weakness in manufacturing largely reflects the impacts of the stronger dollar and declining energy prices, these improvements, if sustained, should help turn the factory sector around. However, because of the lagged impact of the dollar on trade, even if the dollar were to continue weakening, net exports should still subtract from growth through the rest of the year.

Growth Weakens Despite a Resilient Labor Market

Fourth quarter annualized gross domestic product (GDP) grew at a 1.4 percent pace. Thus, over the past two quarters, the economy grew at just above stall speed. Corporate profits dropped for the second consecutive quarter, and fell 11.5 percent from the fourth quarter of 2014. Profits from domestic industries posted the largest quarterly drop since early 2011, which bodes poorly for business spending and the hiring outlook. So far this year, hiring has been solid despite weak economic activity, which underscores the ongoing problem of lackluster productivity growth. During the current expansion, annual productivity growth has averaged less than 1.0 percent, the worst performance for any expansion in the past 60 years.

Our material downward revision for first quarter real GDP growth largely stemmed from a sizable downward revision in consumer spending. Real consumer spending increased 0.2 percent in February as expected, but the January figure was revised lower to unchanged from an initially reported 0.4 percent increase. Income growth was higher than spending growth, pushing the saving rate up to 5.4 percent, the highest reading in a year. Incoming data for March were bearish, as auto sales dropped sharply to the weakest pace in more than a year. These developments led us to downgrade our estimate for real consumer spending for the first quarter to 1.7 percent annualized from 3.0 percent in the March forecast. However, we look for consumer spending growth to pick up somewhat over the rest of the year given healthy labor market conditions and an elevated saving rate. Full-year real spending growth is expected to moderate to 2.2 percent from 2.7 percent in 2015.

Payroll employment increased by a solid 215,000 in March, despite weakness in the manufacturing and mining industries. The most positive aspect of the jobs report came from the household survey, which showed the labor force participation rate reached 63 percent after the fourth consecutive monthly increase. Since last September, the participation rate has risen 0.6 percentage points, the largest six-month increase since the early 1990s, as 2.4 million people on net joined the labor force. Most of the increase in the participation rate has occurred among prime age workers, those between 25 and 54 years old, who saw a 0.7 percentage point gain over the past six months. At the same time, the unemployment rate

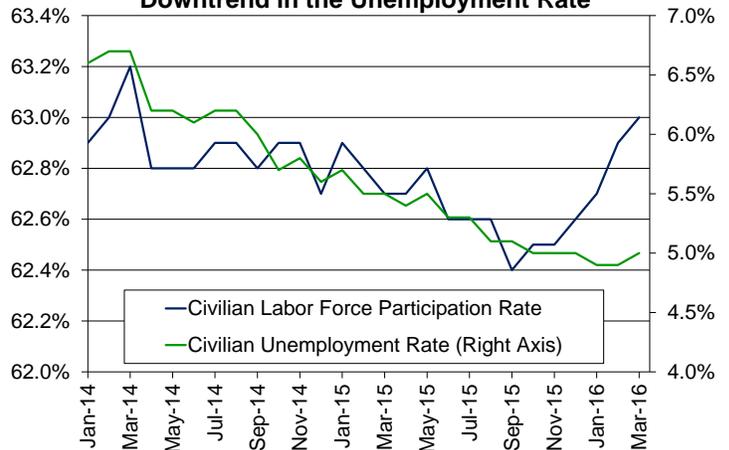


was just 0.1 percentage points higher. Expansion of the labor force amid solid job growth has helped arrest the decline in the unemployment rate, and, combined with anemic productivity growth, may help explain the failure of wages to accelerate more rapidly. The rise in the participation rate is consistent with Fed Chair Yellen's view that meaningful slack remains in the labor market. This view suggests the normalization of monetary policy will be gradual.

The February factory orders report included a downward revision and argued for a lower estimate for first quarter economic growth. Core capital goods shipments — a proxy for the business equipment spending component in GDP — fell more than previously estimated. The leading indicator for shipments, core capital goods orders, also received a downgrade. Since reaching an expansion high in September 2014, when crude oil prices began their descent and the dollar started to surge, core capital goods orders have fallen by 9.5 percent, sending a gloomy signal regarding the outlook for business capital spending. Recent trends in core orders suggest that business equipment spending likely declined in the first quarter for a second consecutive quarter, which would mark the first back-to-back drops since mid-2013.

Results from purchasing manager surveys were more upbeat, however. The Institute for Supply Management manufacturing survey showed activity moved into expansionary territory in March for the first time in six months. The new orders component posted the biggest jump since August 2009. Despite the survey's improving outlook, we believe that it is premature to declare that manufacturing has turned the corner.

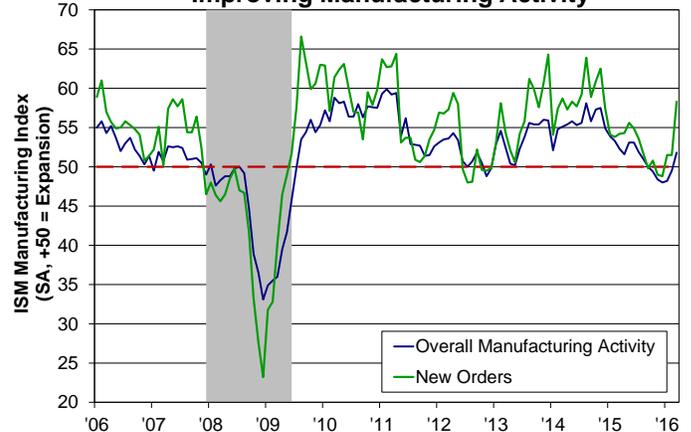
Participation Rate Spike Helps Arrest the Downtrend in the Unemployment Rate



Oil Price Collapse and Rising Dollar Trigger Downtrend in Core Durable Goods Orders



Purchasing Manager Survey Points to Improving Manufacturing Activity



In addition to weakening consumer and business capital spending, trade, inventory, and business investment in structures likely weighed sizably on first quarter GDP. The February trade deficit was wider than anticipated, and the January figure was revised to be wider than previously reported. Incoming data on inventory investment also underscored the painful correction process from last year's unsustainable inventory accumulation, but less inventory build in the first quarter also suggests better prospects for growth in the second quarter. While crude oil prices are off their lows, with West Texas Intermediate oil prices hovering near \$40 per barrel at the time of this writing, non-residential investment in mining exploration, shafts, and wells will likely remain a drag on growth for some time through lingering pass-through from still low oil prices. The number of active rotary rigs fell 60.8 percent at an annual rate in the first quarter, and more declines are expected in the current quarter, albeit at a more modest pace. Combined, net exports, inventory investment, and non-residential investment in structures should shave more than 1.0 percentage point from real GDP in the first quarter.

The Fed Proceeds Slowly

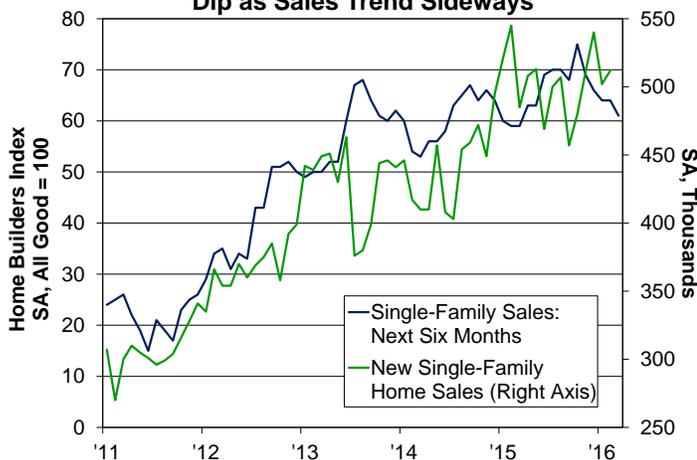
The minutes from the March 15-16 Federal Open Market Committee meeting highlighted downside risks to global economic and financial developments as well as lower inflation expectations as reasons for a cautious approach to rate hikes. An April rate hike is off the table as several members were concerned that it would convey an inappropriate "sense of urgency." Recent speeches by Fed officials, including the Chair and New York Fed President William Dudley, struck a

dovish tone, noting that the risks to the outlooks for growth and inflation are tilted to the downside. The uptrend in the labor force participation rate and subdued wage pressure suggest Fed leadership feels less urgency for the second fed funds rate hike. While core inflation has picked up recently, the Fed will look for more concrete evidence that such firming will be sustained. The downward pressure on inflation from commodity prices is fading. However, the increase in the rent components of consumer prices, which were the single-biggest contributors to accelerating core inflation in the past year, should moderate going forward as new supply mitigates a shortage of rental housing. We now expect only one rate hike in 2016, most likely in September, compared with an expectation of two hikes in our March forecast. The vote on the U.K. referendum to leave the European Union, which will occur only a week after the June 14-15 Federal Open Market Committee meeting, presents meaningful event risk. Thus, we believe a June rate hike is highly unlikely given the Fed's emphasis on global stability. Fed funds futures do not price in a 25 basis point hike until the second half of 2017.

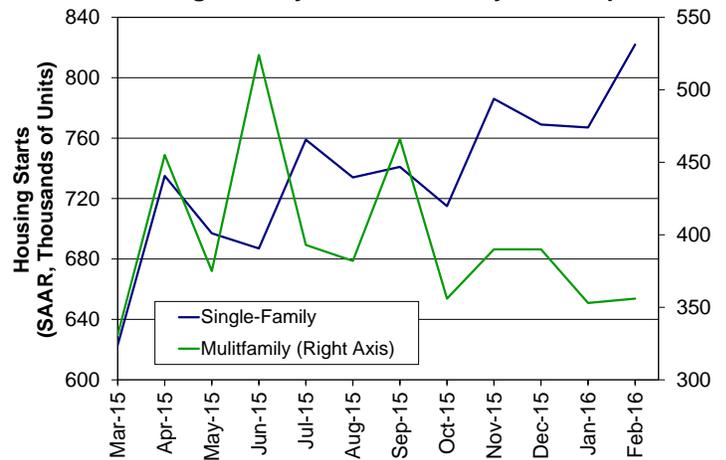
Housing Affordability Constrains

Housing indicators continue to be mixed. On the negative side, existing home sales dropped sharply in February, and new home sales rebounded only modestly following a steep decline in January. Over the past year, new home sales have moved sideways after gradually trending up in the prior years. Home builders' sentiment, which has declined from a recent peak last October, held steady in March at the lowest reading since May 2015. The forward-looking component, sales expectations over the next six months, fell sharply in March to the lowest reading in a year.

Builders' Outlook for Home Sales Continues to Dip as Sales Trend Sideways



Single-family Starts Gradually Trend Up

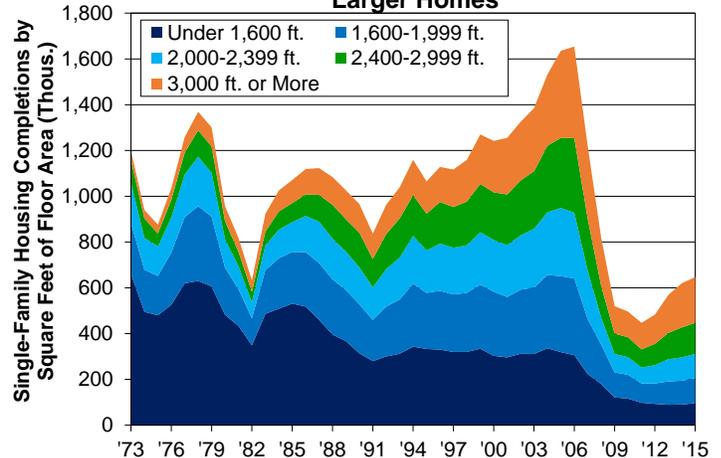


On the positive side, housing starts rose in February for the first time in three months, driven by strength in the single-family segment, which has been trending up over the past year. Meanwhile, multifamily starts have been moving lower since reaching an expansion high in June 2015. Overall, the trend in the multifamily segment remains positive, especially in some of the energy-dependent metropolitan areas, which have seen elevated levels of new supply complete and come online just as some of these local economies are getting hit by lingering low oil prices. (For more information on rental market conditions, read the [April 2016 Multifamily Market Commentary](#)).

Some of the softness in home sales likely reflects the lack of supply of homes for sale, especially in the lower-priced segment. The inventory of completed new homes remains extremely low by historical standards, which may have restrained buyer traffic. While single-family housing completions have gradually trended up since reaching their lows in 2010, the increase has been concentrated in large, less affordable homes.

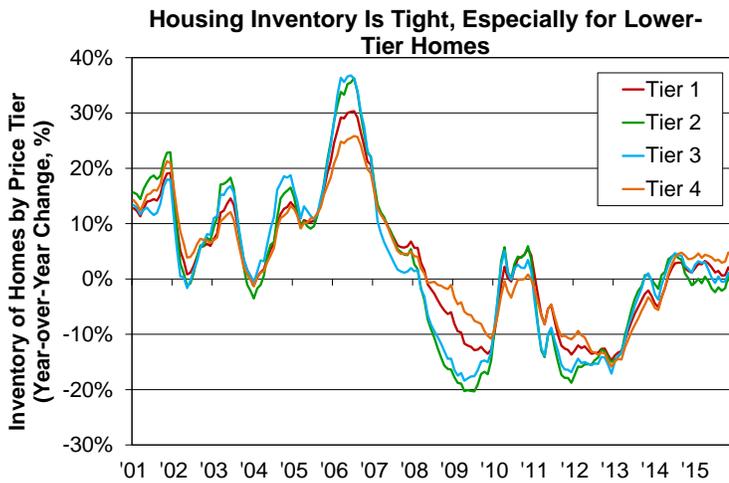
For existing homes, inventory at the lower end is also quite lean. Listings are not keeping pace with demand, which has boosted lower-tier home prices by more than for higher-end homes, according to data from CoreLogic and Case-Shiller.

New Home Construction Is Skewed towards Larger Homes

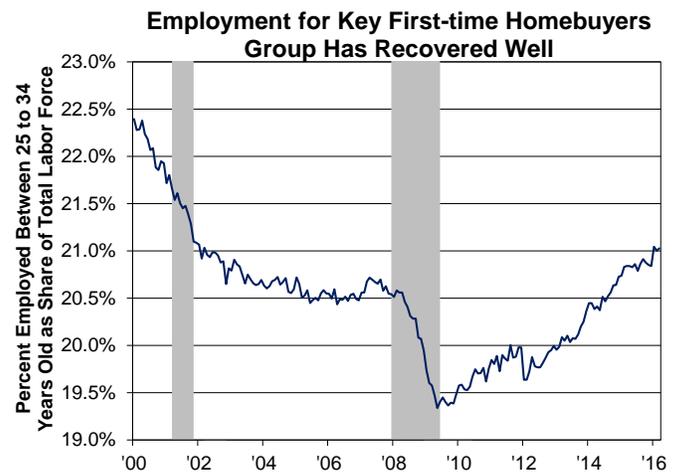


Despite historically low mortgage rates, strong home price appreciation is eroding home purchase affordability for potential first-time homebuyers, whose income gains lag behind home price appreciation. A great deal of pent-up housing demand exists among young adults, many of whom still live with their parents. These young adults will likely rent rather than buy when they can afford to establish their own households. We noted earlier that rent increases are poised to moderate going forward, taking some pressure out of core inflation. This is especially true for rents in Class A properties, which have a substantial supply pipeline. However, supply is tighter for more affordable Class B and Class C properties, which will likely command higher rent increases than Class A properties, especially for new tenants. Elevated rental cost burdens will hurt purchase affordability by inhibiting renters' abilities to save for down payments.

Labor market news has been positive for potential first-time homebuyers. Employment among those aged 25 to 34 years old has increased at a healthy pace, and their employment as a share of total labor force has risen to the highest reading since 2002, though part of the increase is attributable to the large number of young adults as a share of the population. A sustained increase in income among young adults, more construction of starter homes, and continued introduction of new loan products geared towards those with low down payments would go a long way toward bringing more potential homebuyers into the housing market. More first-time homebuyers should lead to more trade-up buyers, spurring organic housing demand amid declining investor and international demand.



Note: Tier 1: 0-75% of median, Tier 2: 75%-100% of median, Tier 3: 100%-125% of median, Tier 4: 125%+ of median



Our forecasts for mortgage rates, housing activity, and mortgage originations are little changed. We expect total mortgage originations to decline about 9.0 percent in 2016 to \$1.56 trillion, with a refinance share of 40 percent. We expect total originations to decline further in 2017, as a drop in refinance originations should outpace an increase in purchase originations. We project total production volume to be \$1.43 trillion in 2017 with the refinance share dropping to 31 percent.

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Economic & Strategic Research (ESR) Group

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 Board, Commodity Research Bureau, Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, The Institute for Supply Management, National Association of Home Builders, Lawler Associate and Housing Consulting, National Association of REALTORS®, Mortgage Bankers Association, CoreLogic

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