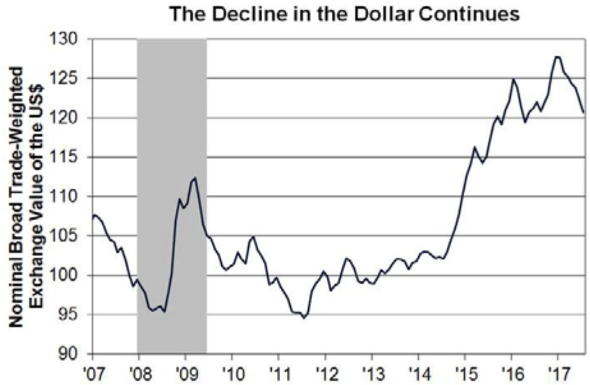
Economic Developments – August 2017

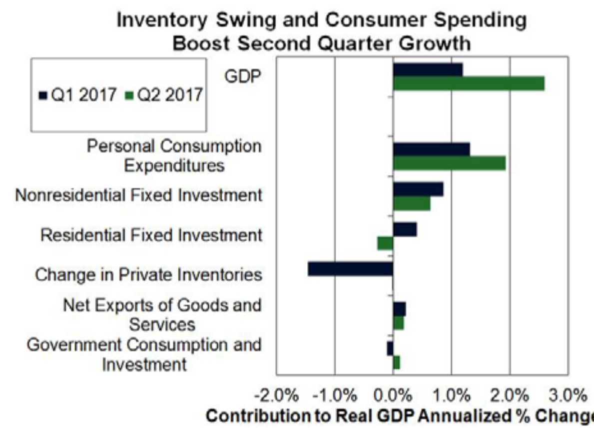
Still on Pace for a Two-Percent Economy

The economy grew 1.9 percent on an annualized basis during the first half of the year, compared with our expectation of 2.1 percent in the prior forecast. Our forecast for the second half of the year is slightly stronger, keeping our outlook for full-year 2017 growth at 2.0 percent. Risks to our forecast are roughly balanced. On the upside, consumer spending growth may not moderate as much as we expect. In addition, the sharp decline in the dollar during the first seven months of the year could boost exports more than we anticipate, although the outlook for the trade sector is clouded by uncertainty surrounding trade policy. Downside risks include a technical default due to a failure to raise the debt ceiling and a partial U.S. government shutdown if Congress cannot pass a spending bill before September 30. In addition, geopolitical tension has also increased.



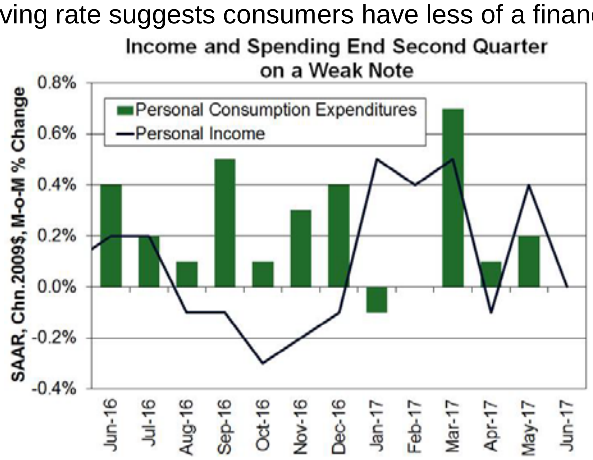
Growth Picks Up in Second Quarter as Expected

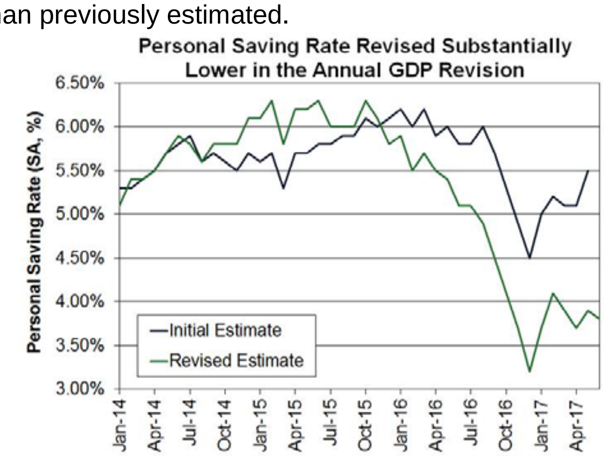
The first print of second quarter real gross domestic product (GDP) growth came in at 2.6 percent annualized, a touch lower than our expectation of 2.7 percent in the July forecast. The acceleration in growth was largely attributable to inventory investment, which pulled back substantially and subtracted 1.5 percentage points from growth in the first quarter but stabilized and was neutral to growth in the second quarter. A strong increase in consumer spending and a healthy rise in nonresidential investment also helped boost growth. Encouragingly, business equipment investment posted the strongest gain since the third quarter of 2015. However, residential investment fell sharply, subtracting 0.3 percentage points from growth, a payback from the weather-induced surge in the first quarter. The second quarter GDP report included annual revision back to 2014. The revision did not substantially change the economy's trajectory. Real GDP growth was revised higher in 2014 and 2015, but lower in 2016. Growth for the first quarter of 2017 was revised two-tenths lower to 1.2 percent.



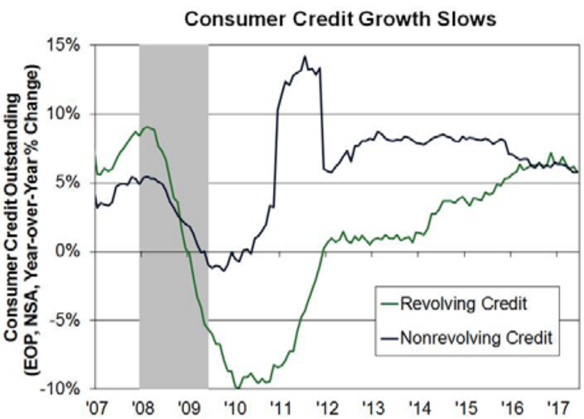
Consumers Save Less Than Initially Believed

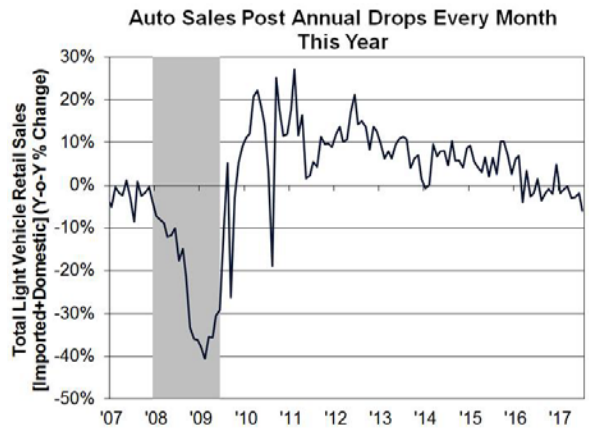
While real consumer spending growth was solid in the second quarter, monthly data revealed weakening momentum heading into this quarter. Both real consumer spending and personal income were unchanged in June. The annual revision to GDP showed a marked downgrade of the personal saving rate, largely the result of downward revisions to personal income. The saving rate for the first quarter of this year was revised lower to 3.9 percent from an originally reported 5.1 percent, and it edged down further to 3.8 percent in the second quarter. The marked downward revision in the saving rate suggests consumers have less of a financial cushion than previously estimated.



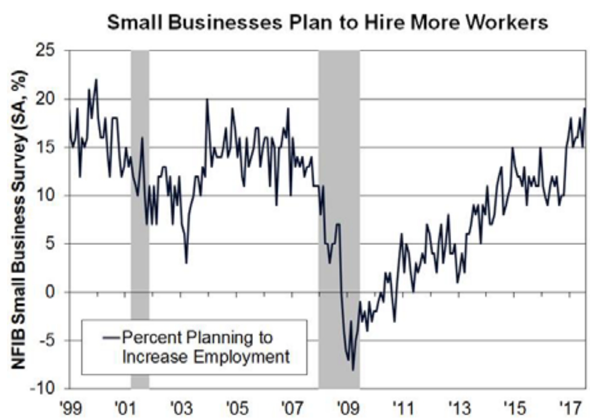


Growth of both revolving (largely credit card) and nonrevolving (largely auto and student loans) consumer credit slowed in June, partly due to banks tightening their lending standards. Weakness in vehicle sales contributed to the slowdown in nonrevolving credit growth. In July, auto and truck sales edged up 0.4 percent, but they have been below year-ago levels every month this year. While auto sales have posted annual declines since October 2015, truck sales fell year-over-year for the first time since 2010. Moderating auto sales and credit growth support our forecast of a slowdown in consumer spending growth in the second half of this year.

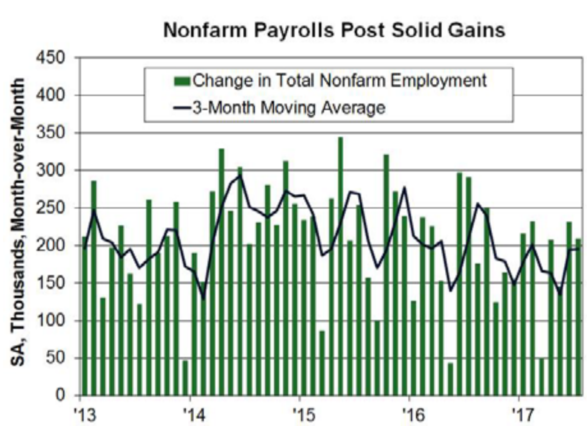


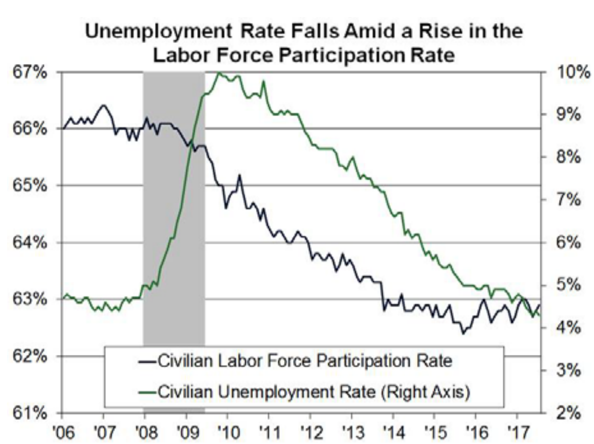


On a supportive note for consumers, labor market conditions are positive. The Job Openings and Labor Turnover Survey showed that the job openings as a share of total employment rose in June to match the expansion high of 4.0 percent. Furthermore, details from the National Federation of Independent Business survey, which showed that small business optimism improved in July for the first time in six months, also suggest a shortage of qualified workers. The share of firms reporting unfilled job openings rose to an expansion high of 35 percent, while the share with few or no qualified job applicants jumped six percentage points to 52 percent, matching an expansion high. The survey also points to improving hiring outlook as the proportion of firms with plans to hire rose to 19 percent, the highest level since the end of 2006.



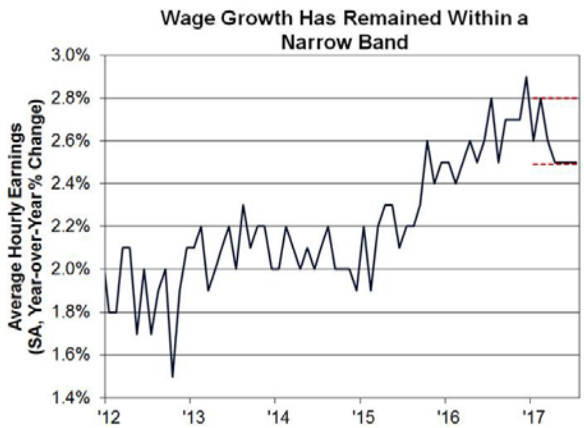
The July jobs report showed that payroll gains were solid and broad-based, and a slight upward revision put average monthly hiring over the past three months at 195,000, the strongest pace since February. The unemployment rate ticked down one-tenth to 4.3 percent, while the labor force participation rate ticked up by the same amount to 62.9 percent.

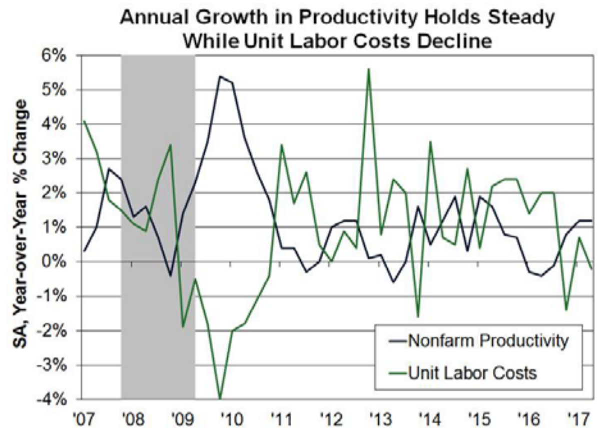




Despite strong hiring trends, wage pressure remains muted. Average hourly earnings rose a strong 0.3 percent from June, but the annual wage increase remained unchanged at 2.5 percent, staying within the narrow range of 2.5 percent to 2.8 percent witnessed so far this year.

Consistently subdued wage growth seems justified given labor productivity trends. Nonfarm business sector productivity firmed modestly in the second quarter, increasing 0.9 percent annualized. Because compensation rose moderately, unit labor costs – a measure of how fast compensation is growing relative to output – increased only 0.6 percent annualized during the quarter. On a year-over-year basis, productivity was up 1.2 percent, the same as the prior quarter but still low by historical standards, while unit labor costs fell 0.2 percent, the second annual decline in three quarters.



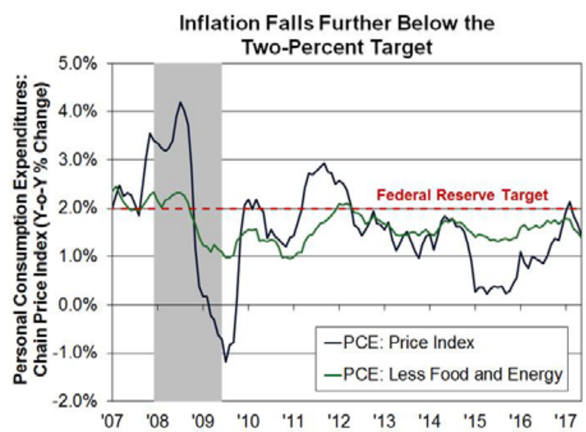


Another measure of labor compensation, the Employment Cost Index (ECI), underscored the lack of wage pressure, as both wages and benefits posted only modest increases of 0.5 percent (not annualized) and 0.6 percent, respectively, in the second quarter. From a year ago, the ECI rose 2.4 percent, unchanged from the prior quarter. Weak labor cost growth takes pressure off businesses to pass higher input costs on to consumers, which should keep inflation contained.

We expect real GDP growth to moderate to 2.3 percent annualized in the third quarter, as consumer spending growth is projected to slow to 2.5 percent from 2.8 percent in the second quarter. Outside of consumer spending, an inventory build should be a positive for growth this quarter. We expect real residential investment to turn from a sharp drop to a modest gain, as homebuilding and home sales should gradually improve in the second half of the year, with the latter boosting brokers' commissions. As oil prices stabilize, nonresidential investment in structures should improve further. Lastly, the decline in the dollar and a pickup in global growth should support manufacturing and exports, providing a tailwind for the second half of the year. However, uncertain tax policy could delay businesses' investment plans.

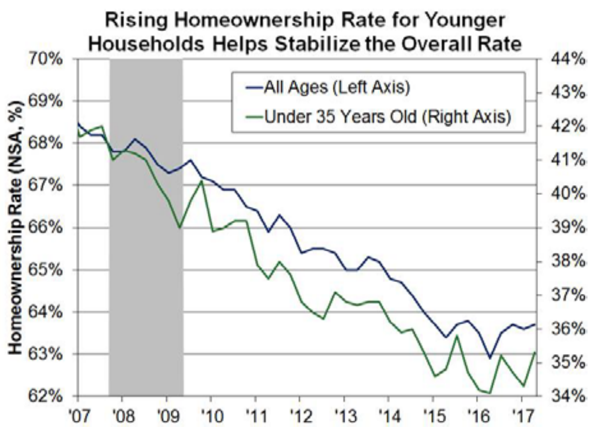
No Sense of Urgency for the Fed to Raise Rates

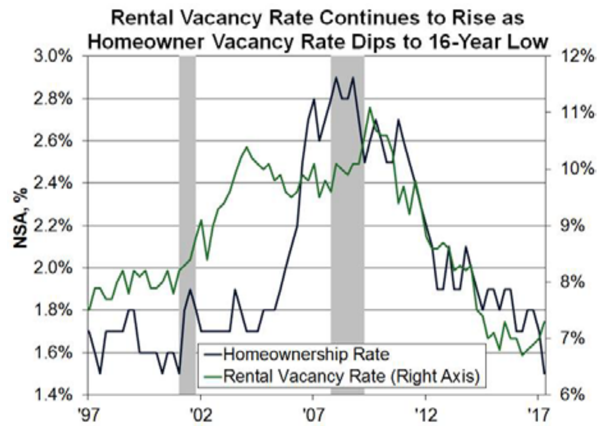
The Federal Reserve held the fed funds rate steady at the July Federal Open Market Committee meeting and stated that it expected to begin implementing its balance sheet normalization program "relatively soon." It also acknowledged that annual inflation has declined recently and is running below its two-percent target. The Fed's favored measure of inflation – the Personal Consumption Expenditures Deflator – was flat in June, and the annual increase slowed to 1.4 percent from 1.5 percent in the prior month and as high as 2.2 percent in February. Given muted wage and inflation pressure, we continue to expect balance-sheet tapering to begin in September and a December rate hike.



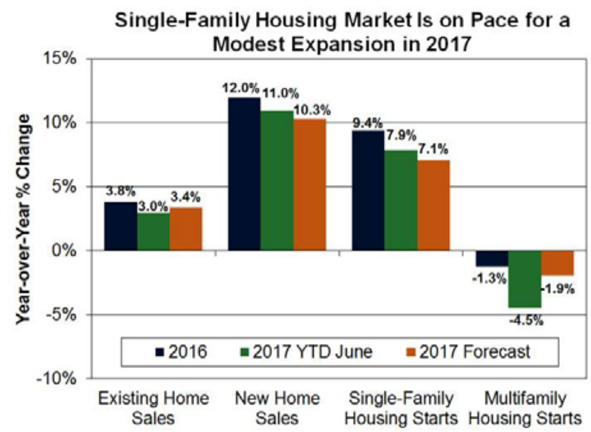
Housing Roundup

Real residential investment fell 6.8 percent annualized in the second quarter and subtracted the most from growth since the third quarter of 2010. As we mentioned earlier, we expect a moderate rebound this quarter. One piece of good news for owner-occupied housing came from the second quarter Housing Vacancy Survey, which supported our view that the homeownership rate has stabilized after an extended downturn. The homeownership rate (not seasonally adjusted) came in at 63.7 percent, 0.8 percentage points higher than the level a year ago. This marks the second consecutive quarter that the rate posted an annual gain. A 1.2 percentage point year-over-year increase for households under age 35 helped stabilize the overall homeownership rate, supporting our view that Millennials have begun to mount a homeownership recovery and close the homeownership attainment gap with their predecessors. (Read "Millennials Have Begun to Play Homeownership Catch-Up," Fannie Mae *Housing Insights*, August 10, 2016). Meanwhile, the rental vacancy rate rose for the fourth consecutive quarter to 7.3 percent, the highest reading since the third quarter of 2015, amid a drop in the homeowner vacancy rate to 1.5 percent, the lowest level since the first quarter of 2001.

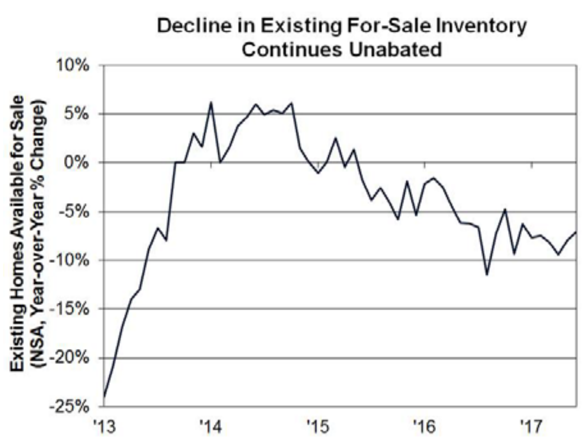


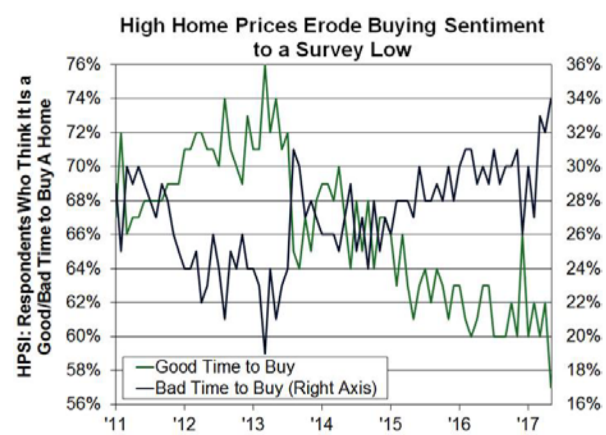


Housing activity was mixed at the end of the second quarter. Both single-family and multifamily starts rose in June, while existing home sales fell during the month and new home sales registered a slight increase. Activity through the first half of the year came in as expected, and thus our forecast for all of 2017 is largely the same as in the prior forecast.



The for-sale inventory of existing homes has been declining on an annual basis for more than two years. In turn, tight inventory has constrained sales and boosted home prices. The Fannie Mae Home Purchase Sentiment Index® (HPSI) decreased 1.5 percentage points in July from a survey high in June. Selling sentiment deteriorated sharply, weighed down by economic conditions. Among consumers who believe now is a bad time to sell a home, the share citing economic conditions as a primary reason posted a sharp rise. At the same time, high home prices helped send buying sentiment to a record low since the survey's inception in 2010, with the share saying now is a good time to buy dropping to a survey low and the share responding that now is a bad time to buy rising to a survey high. Nearly half of consumers who say now is a bad time to buy cited rising prices as a primary concern – a survey high.





The near-term outlook for home sales is mixed. Pending home sales rose in June, ending a streak of three monthly drops and posting an annual increase for the first time since March. The rise echoed an increase in average purchase mortgage applications during the month. However, average purchase applications fell in July, more than offsetting June's gain.

Mortgage rates should continue to support home sales, as we expect them to remain near current levels, averaging 4.0 percent in the fourth quarter. Our mortgage originations forecast is largely the same as in the prior forecast. We revised higher our forecast of refinance originations for this year and next year in response to stronger year-to-date data than anticipated. Total single-family mortgage originations are expected to drop about 19 percent this year to $1.67 trillion. The refinance share is forecasted to decline from 48 percent in 2016 to 35 percent in 2017. We project a further drop in overall originations of about six percent to $1.57 trillion in 2018 as a decline in refinance originations outweighs an increase in purchase originations, with the refinance share decreasing to 26 percent.

For information on multifamily market conditions, read the August 2017 Multifamily Market Commentary.

Economic & Strategic Research (ESR) Group

August 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: *Federal Reserve Board, Bureau of Economic Analysis, Autodata, National Federation of Independent Business, Bureau of Labor Statistics, Census Bureau, National Association of REALTORS®, Fannie Mae.*

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