



### Economic Developments – April 2018

## Outlook Remains Firm, But With Rising Downside Risks

We previously forecasted that economic growth would slow moderately in the first quarter before picking up during the rest of the year, resulting in full-year 2018 growth of 2.8 percent. However, we now estimate that first quarter growth slowed to 1.7 percent annualized compared to our previous forecast of 2.1 percent. At the same time, the government revised higher its final estimate of fourth quarter real gross domestic product (GDP) growth four-tenths to 2.9 percent. Despite the marked deceleration in first quarter economic growth, we still expect activity to pick up substantially during the rest of the year, and thus have lowered our projected GDP growth for all of 2018 by just one tick to 2.7 percent.

Fundamentals support our strong outlook. Income growth remains healthy, consumers and businesses are optimistic, and fiscal stimulus from the tax cut and new federal budget should help boost demand through the rest of the year. While our 2018 growth forecast is little changed, downside risks are rising. The Administration has pledged to cut the U.S. trade deficit, which widened sharply in recent months to the worst showing since October 2008 in February and likely dragged on first quarter economic growth for the second consecutive quarter. Earlier this month, the Administration announced a 25 percent tariff on \$46 billion of Chinese imports, on top of the steel and aluminum tariffs imposed in March. After China announced retaliatory tariffs of equal size, the Administration raised the possibility of levying tariffs on another \$100 billion of Chinese imports.

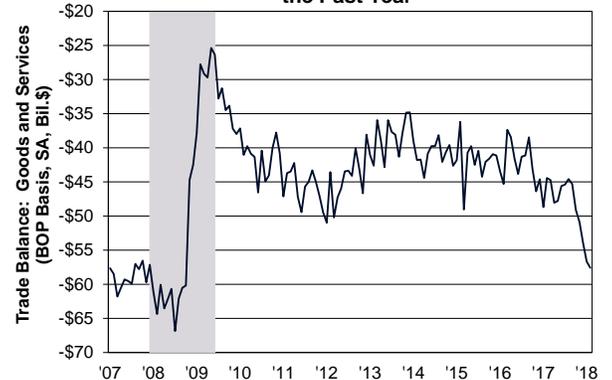
It is uncertain how much of the proposed tariffs are simply a negotiating tool and how much will actually go into effect. Negotiations might result in an agreement that preempts tariff imposition by either country; however, even Treasury Secretary Mnuchin conceded that there is the “potential of a trade war.” The increasingly heated rhetoric on trade has already led to volatile movements in stock prices over the past month. If the threats and counter-threats on trade continue, they could also lead to a significant loss in consumer and business confidence. If the United States actually deploys trade restrictions and China responds with aggressive retaliations (e.g., reciprocal tariffs, a reduction in Treasury bond holdings, restrictions on services trade and market access for U.S. companies), the trade war could reverse much of the positive impacts of the fiscal stimulus or could trigger an even worse outcome—recession.

The marked growth slowdown during the first quarter was not alarming per se. Since the end of the recession, economic growth has usually slowed between the fourth and first quarters because of lingering seasonality issues, before strengthening during the remainder of the year. Between 2010 and 2017, the average increase in real GDP in the first quarter was 1.2 percent annualized, at least one percentage point below the average growth during the other three quarters of the year. We expect this pattern to continue this year.

### Consumer Spending Is Poised to Rebound

We had expected first quarter real consumer spending growth to slow from an unsustainable pace in the fourth quarter, which was partly boosted by replacement demand for vehicles damaged by the hurricanes. However, actual spending was even worse than expected. Real consumer spending was flat in February, and January’s data were revised lower by one-tenth to show a 0.2 percent decline. Meanwhile, real personal income rose 0.2 percent in February, and the nominal disposable personal income gain outpaced the nominal consumer spending increase for the second consecutive month, pushing the saving rate up two-tenths to 3.4 percent—a six-month

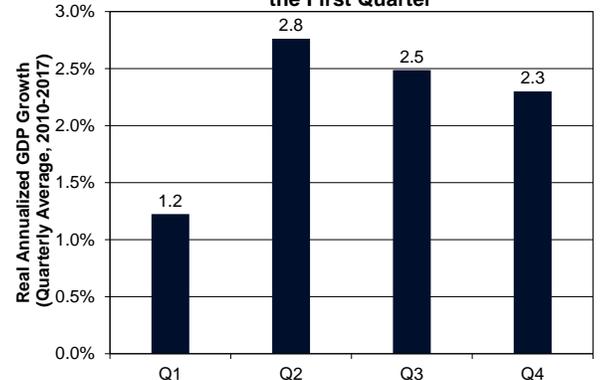
The Trade Deficit Widens Substantially Over the Past Year



Dow Jones Industrial Average Index Shows Heightened Volatility

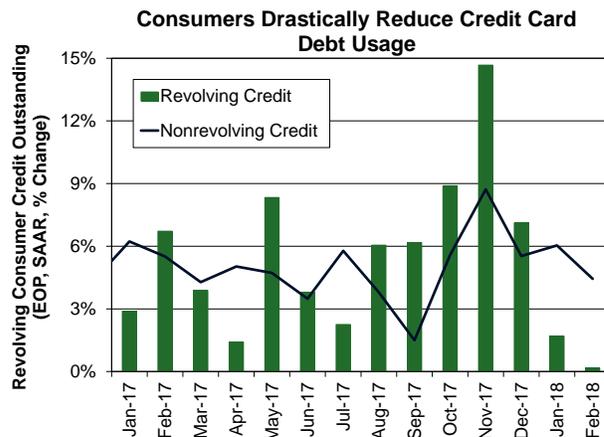
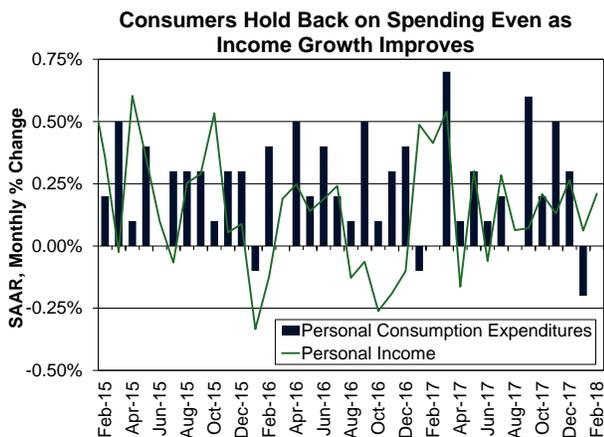


Economic Growth Tends to Decelerate During the First Quarter

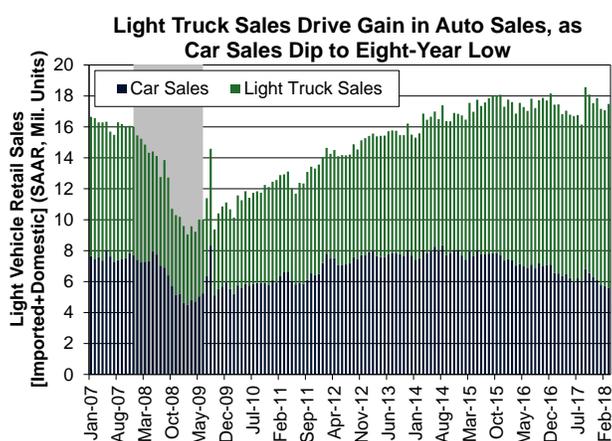




high. Consumer credit data were consistent with the cautious consumer theme, showing essentially unchanged revolving credit (largely credit card debt) in February following an anemic gain in January.

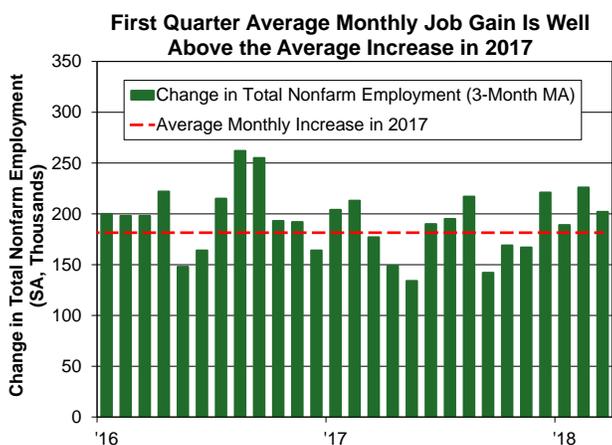


We expect consumer spending to improve in March and in coming months. By March, tax refunds had caught up to historical norms and most households had realized lower withholdings due to the Tax Act. Consumers also appeared to loosen their purse strings in March, as auto sales rose 2.4 percent, marking the first rise in three months from February's six-month low. Sales of light trucks, which include sport utility vehicles, were solely responsible for the gain, as they rose to a 12-year high amid a sixth consecutive monthly drop in car sales to an eight-year low. Even with a rebound in spending in March, we expect real consumer spending growth to moderate to just 1.1 percent annualized in the first quarter from 4.0 percent in the fourth quarter before strengthening to nearly 3.0 percent in the second quarter.



### Labor Market Is Not Immune to Volatility

The March jobs report stepped back from many of the strengths of the prior month, showing that labor market conditions were not immune to the volatility seen lately in other sectors. Nonfarm payrolls increased 103,000, the worst showing since last September, following an upwardly revised gain of 326,000 in February, the biggest monthly rise since October 2015. However, job gains were revised sharply lower for January, resulting in a downward revision for the prior two months of 50,000, on net. Despite the net downgrade, the monthly gain during the first quarter averaged 202,000, well above the average monthly gain of 182,000 in 2017.

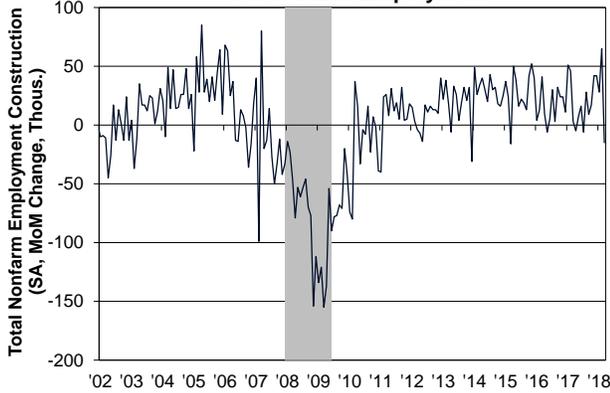


Weather may have played a role in the February-March hiring swing, as evidenced by weather-sensitive industries. For example, after increasing by a decade-best 65,000 in February, construction employment fell in March by 15,000, the largest drop in three years. Retail trade payrolls also swung substantially, declining 4,000 in March following a gain of 47,000 in February. Weather didn't tell the whole story, however. Generally, the average workweek drops during a period with significant weather disruptions, but the March workweek held on to February's increase, remaining at 34.5 hours.

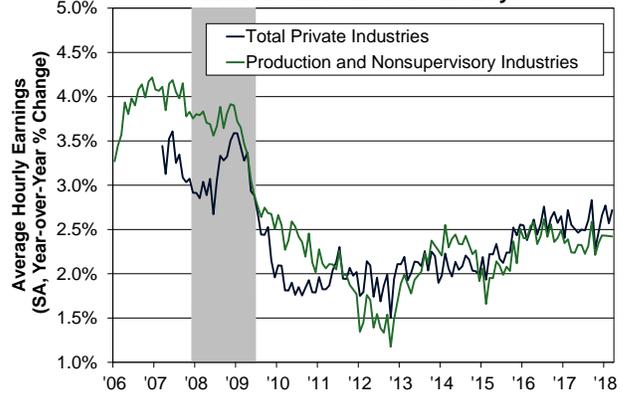
Average hourly earnings, which is closely watched as an indicator of wage inflation, picked up 0.3 percent from February, while the annual increase of 2.7 percent remained within the narrow band seen since late 2017. However, the annual wage increase for nonsupervisory workers, who account for roughly 80 percent of the private workforce, remained unchanged at 2.4 percent for the fourth consecutive month.



**Weather Likely Caused Recent Wild Swings in Construction Employment**



**Annual Wage Gains for Nonsupervisory Workers Have Moved Sideways**



Without broad-based increases, wage gains are unlikely to surge in the near term. In addition, the National Federation of Independent Business (NFIB) Small Business Economic Trends Survey showed that the net share of small business owners planning to raise worker compensation fell in March for the second consecutive month to the lowest reading since last November, although the level remains elevated.

The household survey component of the March jobs report showed that the unemployment rate remained at 4.1 percent for the sixth straight month as the labor force participation rate fell one tick to 62.9 percent, the first drop since last October. The broadest measure of labor underutilization, the U-6 unemployment rate, fell two-tenths and returned to its expansion low of 8.0 percent, thanks to a decline in the number of discouraged workers and others marginally attached to the labor force.

**The Net Share of Small Businesses Planning to Raise Worker Compensation Declined Sharply**



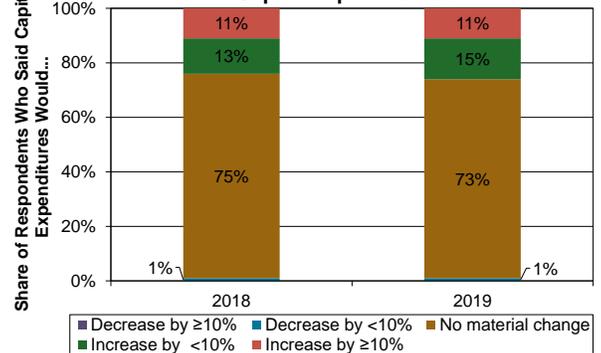
**Business Investment Remains Key to the Outlook**

One key factor underlying our outlook is strong business equipment investment growth, which would help spur productivity growth and keep unit labor costs and inflation contained amid ongoing fiscal stimulus. Recent trends in core (nondefense excluding aircraft) capital goods shipments, a proxy for capital investment, and core orders, a forward-looking indicator, suggested a slowdown in business capital investment growth in the first quarter, albeit from a strong average pace of roughly 11 percent annualized during the second half of 2017.

Recent business surveys have raised concerns over whether robust capital expenditures growth will continue this year. The Survey of Business Executives (SBE) conducted in February by the Atlanta Fed in conjunction with academics showed that roughly three-quarters of executives made no changes to their capital expenditures plans in either 2018 or 2019 in response to the passage of the Tax Act. Comparing results from the February 2018 survey for 218 firms that also responded to a similar survey in November 2017, it appears that firms have revised lower their capital expenditures plans for 2018.

Results from the March NFIB survey were in line with the SBE survey. The share of small businesses planning capital expenditures fell in March, erasing the improvement seen since November 2017.

**How Has the Recently Enacted Tax Cuts and Jobs Act Led You to Revise Your Plans for Capital Expenditures?**



**Share of Small Businesses Planning Capital Expenditures Falls**



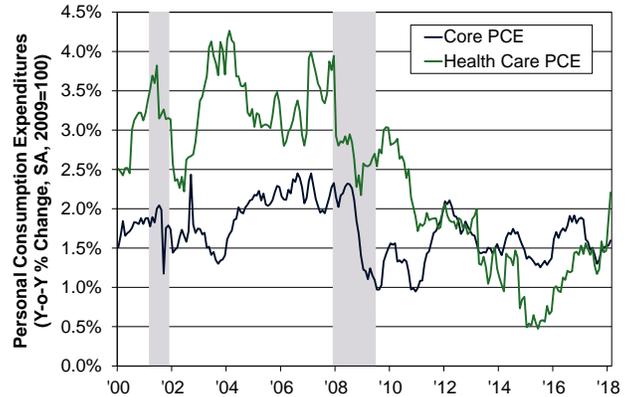


## The Fed Expected to Raise Rates in June

The Summary of Economic Projections released at the March Federal Open Market Committee (FOMC) meeting indicates that the Fed is more optimistic about economic growth and employment in 2018 while its view on inflation is unchanged. However, the statement following the meeting shows that the Fed appears more confident that inflation will move toward the 2-percent target, noting that members expect that annual inflation will move up “in coming months,” as opposed to “this year” in the prior statement.

In February, the annual increase in the Fed’s favored measure of inflation—the Personal Consumption Expenditures (PCE) deflator—picked up to 1.8 percent after holding at 1.7 percent for three consecutive months. Following an increase of 1.5 percent for four straight months, the annual rise in Core PCE (excluding food and energy) accelerated one tick to 1.6 percent, boosted by health care service prices, which jumped 2.2 percent from last February, the biggest annual gain since 2010. Annual PCE inflation likely strengthened in March, as a result of the base effect. That is the plunge in communication services prices (i.e., cellphone contracts) last March is no longer weighing down the change in the index. With inflation trending up toward the target amid continued labor market improvements, we expect the Fed to raise interest rates for the second time this year in June before hiking once more later this year. In the prior forecast, we noted that risks tilted toward four rate increases this year. However, with headwinds from trade protectionism emerging over the past month, we can’t rule out that the Fed may ultimately raise rates only twice this year. At his first press conference, Fed Chair Powell said that several FOMC members had voiced concerns over trade policy, and he noted that trade has become a bigger downside risk to the outlook.

Health Care Inflation Accelerates

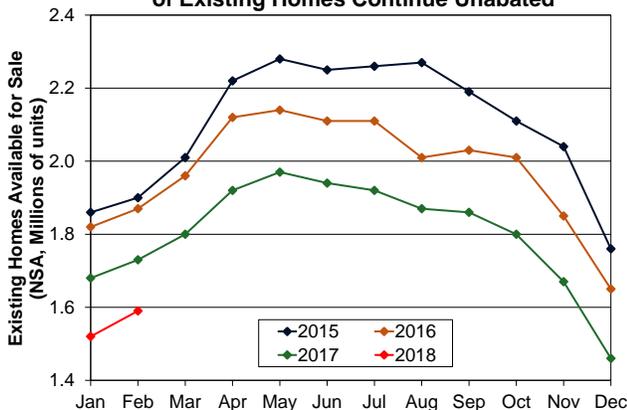


## Housing Roundup

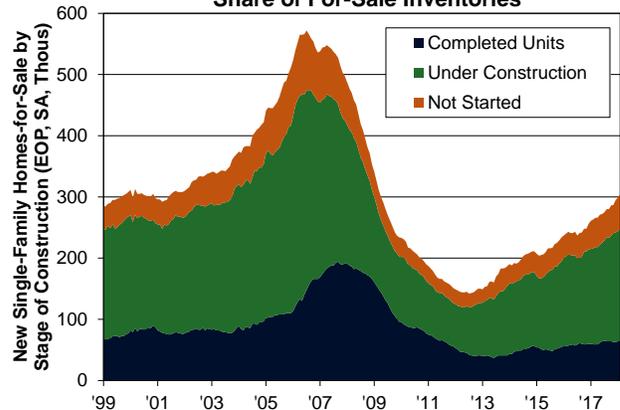
Incoming data support our view that real residential investment declined during the first quarter following strong 12.8 percent annualized growth in the fourth quarter. New home sales fell in February for the third consecutive month, while existing home sales partially recovered from January’s drop. Total home sales during the first two months of the year were flat compared with the same period last year. Total housing starts fell in February, while nominal residential construction spending posted an anemic gain in February for the second consecutive month. Main measures of home prices—the S&P CoreLogic Case-Shiller, CoreLogic, and Federal Housing Finance Agency home price indices—continued to show strong annual home price gains of 6.1 percent to 7.3 percent for the nation in January.

The near-term outlook for home sales is mixed. While pending home sales rebounded in February, partly regaining the sharp drop in January, purchase mortgage applications fell sizably in February and only partially recovered in March. We continue to expect total home sales to rise nearly three percent in 2018 amid increasing household income, a gradual rise in mortgage rates, and continued lean inventory. The for-sale inventory of existing homes continued to decline from year-ago levels. While the number of new homes for sale has continued to trend up, the increase has been concentrated in incomplete units. Ongoing tightness in the inventory of completed new homes for sale should continue to restrain sales.

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



Incomplete Units Account for an Increasing Share of For-Sale Inventories





Our mortgage rate and mortgage volume forecasts for 2018 are essentially the same as in our March forecast. We expect total mortgage originations to fall about 8 percent from 2017 to \$1.69 trillion in 2018, with a refinance share of 29 percent, nearly 10 percentage points below the share in 2017.

## **Economic & Strategic Research (ESR) Group**

April 10, 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:** Census Bureau, Bloomberg, Bureau of Economic Analysis, Federal Reserve Board, AutoData, Bureau of Labor Statistics, National Federation of Independent Business, Federal Reserve of Atlanta, National Association of REALTORS®

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