



Economic Developments – September 2018

Consumer and Business Demand Growth Poised to Slow; Housing Remains a Wet Blanket

The second quarter's robust economic growth of 4.2 percent annualized will likely mark the expansion's final peak. Incoming data are consistent with a growth slowdown to 3.2 percent annualized in the third quarter, the same pace projected in our August forecast. We expect consumer spending and business fixed investment growth to moderate but remain at a solid pace, and we believe that trade will drag on the economy after adding substantially to growth last quarter due to the frontloading of exports ahead of tariffs implemented in July. The July trade data showed that imports rose to a record high amid a marked drop in agricultural exports. Further declines in exports, especially for soybeans, likely occurred in August. We also expect that residential investment will continue to detach from consumer and other business demand, declining slightly this quarter and marking the third consecutive quarter in which housing subtracts from growth, the first such occurrence of this expansion. In the positive column, a swing from an inventory drawdown to restocking will help boost growth, and increased government spending should add even more fiscal stimulus. All factors considered, our overall growth outlook remains unchanged from the August forecast. We expect full-year 2018 growth of 3.0 percent before a slowdown to 2.3 percent in 2019 as the fiscal stimulus runs its course.

Trade tensions remain a key downside risk to growth. The U.S. and Mexico struck a tentative trade agreement that included higher local content for autos and wage requirements. However, Canada has not signed on to this agreement. Furthermore, while the Administration can implement tariffs, Congress must approve any new trade agreement among the U.S., Canada, and Mexico, and thus it is possible that any such agreement would not take effect until next year. Meanwhile, trade conflict between the U.S. and China is escalating, as the Administration has threatened to implement tariffs on another \$200 billion of imports from China, and China has pledged to retaliate. The Chinese economy has recently weakened, and additional U.S. tariffs would likely worsen its growth prospects. Earlier this month, anticipation of additional tariffs on Chinese imports boosted the U.S. dollar vis-à-vis the yuan, sending the yuan near its low for the year.

Even if the Administration's new tariff threats turn out to be a bargaining chip to achieve a better outcome through negotiation, the rising dollar will continue to weigh on the U.S. trade deficit this year. Since January, the value of the dollar has risen more than 6 percent, making American-made goods more expensive to our trading partners and imported goods less expensive for American consumers.

Financial stress in emerging markets has flared up as another downside risk. Emerging markets tend to suffer capital outflows during periods of U.S. monetary tightening, as rising returns and lower risk in the U.S. lure investors. The currencies of many countries, including Argentina and Turkey, have depreciated significantly, triggering rising inflation and interest rate hikes by their central banks. Elsewhere, the South African currency plunged to a two-year low as the country reeled from recession news, while the Indonesian currency plummeted to a two-decade low as the stock market came under severe pressure. Our base case anticipates limited contagion from the emerging-market turmoil, but developments bear close watching. Broad-based strength in the U.S. dollar versus currencies from both developed and emerging economies presents downside risk to trade and economic growth.

The Dollar Has Strengthened This Year



Some Emerging Market Currencies Have Weakened Against The Dollar Recently

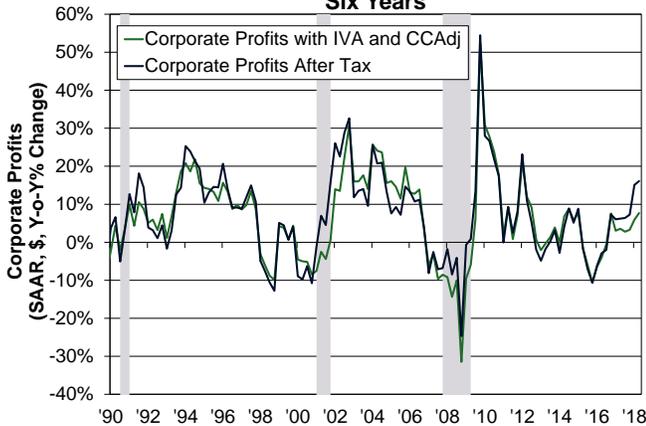




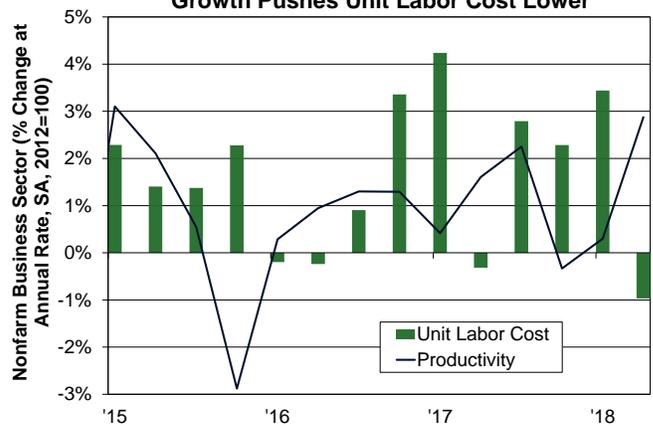
The Tax Act Boosts Corporate Profits

Revisions to gross domestic product (GDP) for the second quarter were uneventful. However, corporate profits, a new piece of data, revealed the improving underlying health of businesses, even absent the recent tax benefits and despite tightening labor markets. Pre-tax profits grew 3.3 percent in the second quarter (not annualized), accelerating from a 1.2 percent gain in the first quarter and marking the strongest quarterly pace in four years. Domestic profits from both the financial and nonfinancial sectors outweighed a decline in overseas profits. On an annual basis, after-tax profits spiked during the first half of this year, a testament to the impact of the large corporate tax rate cut included in last year's tax act.

After-Tax Profits Surge To Largest Gain in Six Years



A Pickup in Second Quarter Productivity Growth Pushes Unit Labor Cost Lower



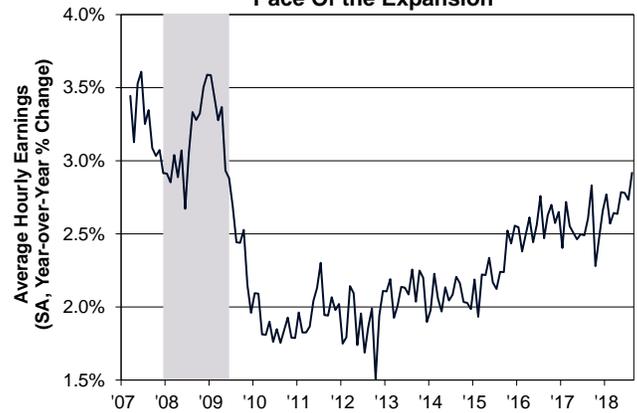
The biggest quarterly increase in productivity growth in three years of 2.9 percent annualized helped keep unit labor costs contained during the second quarter. However, productivity growth tends to be volatile from quarter to quarter. On an annual basis, productivity grew 1.3 percent during the second quarter, remaining within the tight range of 1.0 percent to 1.4 percent seen since the end of 2016. Going forward, rising labor and material costs, increasing interest rates, and a flattening yield curve will likely compress domestic profit margins. At the same time, a strengthening dollar and moderating global growth should weigh on overseas profits.

Strong Labor Market Continues to Support Consumers

Hiring improved in August, with nonfarm payrolls increasing 201,000. Despite downward revisions totaling 50,000 in the prior two months, the three-month average job gain came in at a solid 185,000. The big news in the jobs report was the 0.4 percent jump in average hourly earnings from July and 2.9 percent from last August, the biggest annual rise since June 2009.

The household survey showed a flat unemployment rate at 3.9 percent, but the broadest measure of labor underutilization (U6), which includes discouraged workers and those working part-time for economic reasons, fell one-tenth to 7.4 percent, the lowest level since April 2001. Part-time workers for economic reasons as a share of total employment fell to 2.8 percent, below the average of the prior expansion. In a slight setback, the household survey revealed a two-tenths decline in the labor force participation rate, which fell to the bottom of the narrow range of 62.7 percent to 63.0 percent registered since May 2016. While the teenage participation rate, which tends to be volatile during the summer months, pulled down the overall rate, the rate for prime-age workers (25- to 54-year olds) dropped for the first time in three months. Overall, the household survey suggests ongoing diminished labor market slack.

Annual Wage Growth Jumps to the Fastest Pace Of the Expansion



Share of Workers Who Are Part-Time for Economic Reasons Returns to Pre-Crisis Level

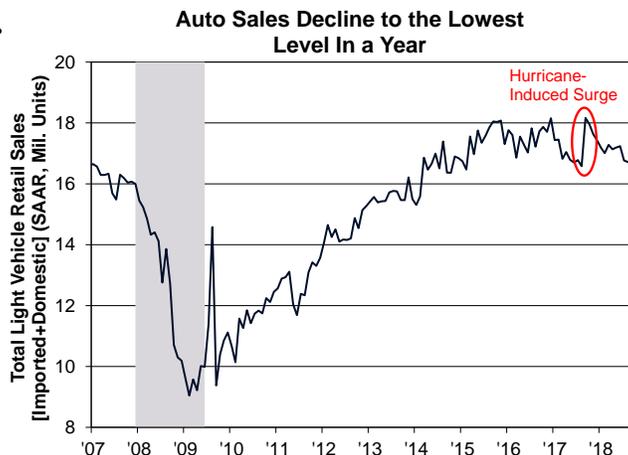




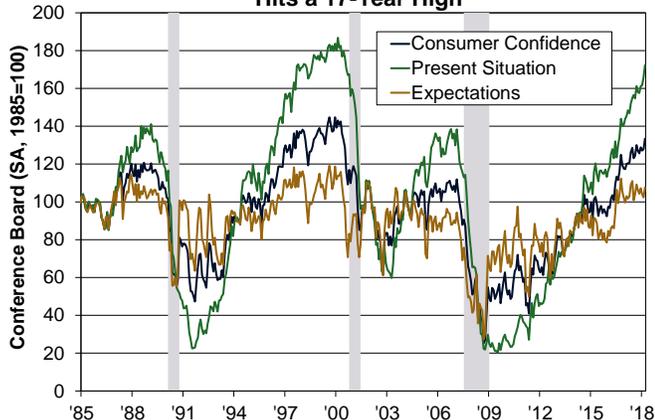
Consumer Spending Growth Is Set to Moderate...

We expect real consumer spending growth to slow to 2.9 percent annualized this quarter from 3.8 percent in the second quarter. Both real consumer spending and real personal income rose 0.2 percent in July. The rise in nominal spending slightly outpaced the increase in nominal disposable income, pushing the saving rate down to 6.7 percent, the lowest level this year. August consumer spending likely remained soft, as auto sales fell for the second consecutive month to the slowest pace since last August, just prior to a hurricane-induced surge in replacement demand. Rising interest rates and uncertainty regarding auto tariffs present headwinds for the sector.

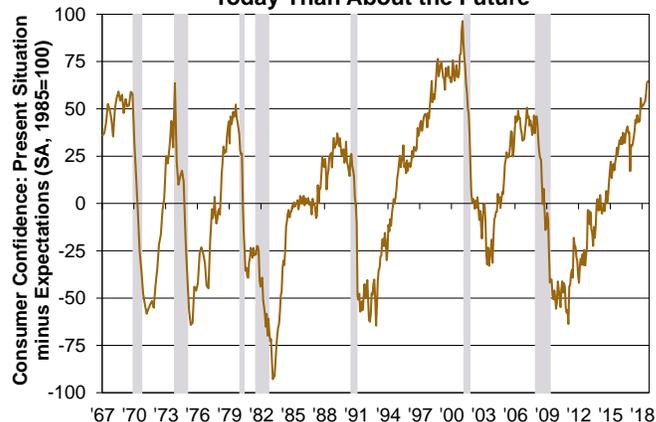
Consumer sentiment was mixed in August. The Conference Board Consumer Confidence Index jumped to the highest level since October 2000. Both the present situation and expectations components improved but consumers were much more optimistic about the former, which rose to an expansion best while the latter remained well below its recovery high reached last March. Notably, the long history of the Conference Board's survey suggests that a substantial divergence between the present situation and the expectations components is a warning sign of a forthcoming slowdown in economic activity. The gap between the two components has risen toward its all-time high, reached just before the 2000-01 recession.



Happy Days Are Here Again, As Confidence Hits a 17-Year High



Consumers Are Much More Optimistic About Today Than About the Future



In contrast to the rising Conference Board measure, the University of Michigan's consumer sentiment index fell in August for the fourth time in five months to the lowest level since January. A divergence between the two measures is not uncommon. The University of Michigan's measure is more sensitive to financial conditions, which have been volatile, while the Conference Board's metric is closely tied to labor market conditions, which have improved over time.

...Along with Business Investment Growth

The pickup in corporate profits this year should provide support for increased business capital expenditures. However, growth in business equipment spending decelerated in the second quarter to the slowest pace since the final quarter of 2016, and incoming data on factory orders suggest a further slowdown this quarter. In contrast to the slowdown in equipment spending, investment in nonresidential structures was stellar during the first half of the year, with two straight quarters of double-digit annualized increases, thanks in part to the rebound in oil prices. In July, the first drop in four months in private nonresidential construction spending points to a marked slowdown in nonresidential investment in structures this quarter.

Rate Increases Appear Consistent with This Year's Dot Plot—Next Year Uncertain

The pop in annual wage gains in the August jobs report came on the heels of recent increases in broader measures of inflation. The headline personal consumption expenditures (PCE) deflator—the Fed's preferred measure of inflation—rose 0.1 percent in July, pushing it up to 2.3 percent on a year-ago basis. Since March, the annual increase in the PCE deflator has equaled or exceeded the Fed's 2-percent target. The annual rise in the core PCE deflator (excluding food and energy)



accelerated one-tenth to 2.0 percent in July. Recent trends in wage gains and overall inflation seem to support Fed Chair Powell's argument in Jackson Hole that raising interest rates too slowly could risk overheating, and are consistent with our call for September and December rate hikes. Such moves would bring the rate hikes total for the year to four, the same as the pace implied in the "dot plot," which shows fed funds rate projections by members of the Federal Open Market Committee (FOMC). While the dot plot implies three rate increases in 2019, we believe such a pace would be too aggressive given our expectation of a growth slowdown next year. Over the past several months, the fed funds futures market has turned more bearish regarding the path of monetary policy, and now implies the last rate hike for the cycle will occur in 2019.

Housing Roundup

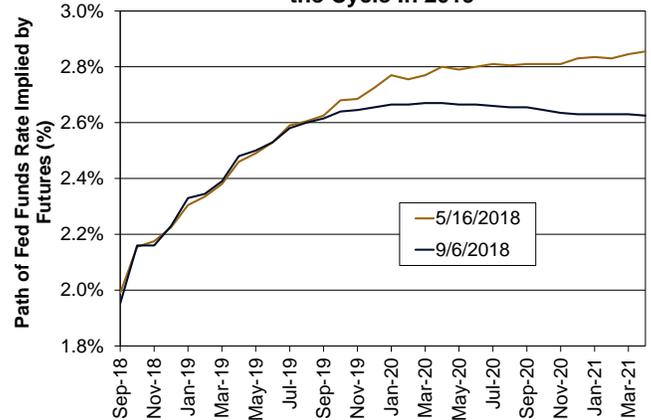
While the overall economy continues to grow at a solid pace, the housing sector has been soft across the board. Single-family housing starts increased only slightly in July following a 9.0 percent drop the prior month, the largest decline this year. Multifamily starts also disappointed, eking out only a small gain after a double-digit drop in June. One positive development is that home builders appear to be responding to strong first-time buyer demand by constructing smaller homes. The typical new single-family home size has been falling since peaking in 2015, with the median square footage dropping sharply in the second quarter to the smallest reading since the end of 2012.

New home sales declined in July for the third time in four months to the slowest pace since last October. Over two-thirds of new home sales were either under construction or not yet started, the highest share since the end of 2015, underscoring the need for increased building activity. According to the National Association of Home Builders Housing Market Index, builders face headwinds from softening demand, especially in the sales expectation and traffic of prospective buyers components. In addition, pricing to cover material and labor cost increases has been challenging. Fortunately, some building material prices, such as lumber, have started to ease, which should allow builders to offer more favorable pricing, hopefully leading to an improvement in building and sales activity going into the fall.

Total existing home sales fared even worse than new sales, falling in July for the fourth consecutive month to the worst showing since February 2016. While the for-sale inventory of existing homes finally ended three years of annual declines, inventories are still at historic lows. Leading indicators suggest no meaningful improvement in the near term, as pending home sales fell in July for the third time in four months, and purchase mortgage applications dropped in August for the second straight month.

Home prices have held up well. Continued strong price appreciation that has outpaced income growth, along with a rise in mortgage rates of nearly 60 basis points since the start of the year, have weighed on home purchase affordability and depressed home buying sentiment. The Fannie Mae Home Purchase Sentiment Index[®] has trended lower from its record high in May, with the net share of consumers saying now is a good time to buy a home sliding further in August to the second lowest reading in the survey's eight-year history.

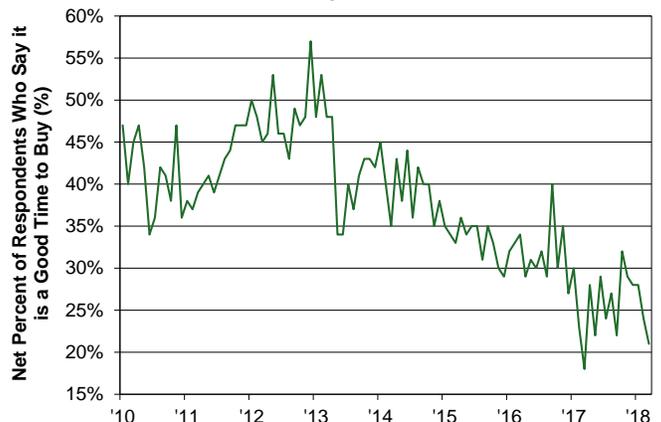
Fed Funds Futures Imply Last Rate Hike For the Cycle In 2019



Typical Single-Family Housing Start Size Continues to Shrink



Good Time to Buy Sentiment Slides Further





We lowered our near-term projection of housing starts in 2018, while keeping our home sales forecast essentially unchanged from the prior forecast, showing a 6 percent increase in new home sales and a nearly 1 percent drop in existing home sales. Our forecasts of purchase and refinance mortgage originations are little changed from August, with total single-family mortgage originations projected to fall about 9 percent to \$1.67 trillion in 2018 and a refinance share of 28 percent.

For information on multifamily market conditions, read the [September 2018 Multifamily Market Commentary](#).

Economic & Strategic Research (ESR) Group

September 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: Federal Reserve Board, Bloomberg, Bureau of Economic Analysis, Bureau of Labor Statistics, AutoData, the Conference Board, Census Bureau, Fannie Mae ESR

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