Economic Developments – January 2017

Will Policy Changes Extend the Expansion?

The recent election altered the landscape in terms of economic philosophy. How will that evolve into policy? We have limited information on the economic priorities of the incoming Administration, and priorities in the Senate and House are uncertain at this time, making establishing reasonable estimates of the nature and sequencing, much less the magnitude, of policy changes unusually challenging.

Thus our theme for 2017: "Will Policy Changes Extend the Expansion?" The economy has been growing below potential at about 2 percent in real terms, and we expect this to continue in 2017. If this trend continues, in March it will become the third longest, and weakest, expansion since World War II. The economy is late in the business cycle. There are minor signs of inflation that have the Federal Reserve reevaluating short-term interest rate expectations. Consumer debt is rising and business investment languishes.

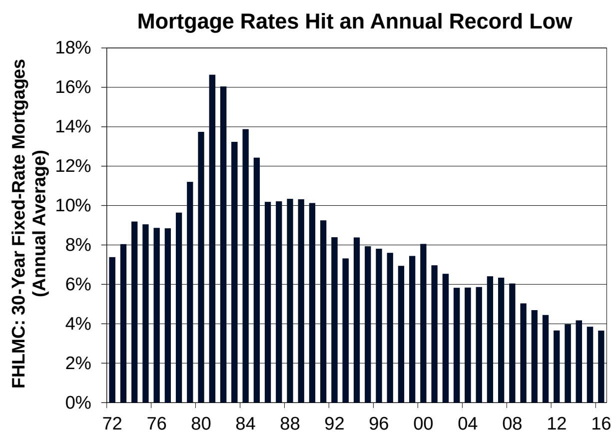
Will the Administration effectively advance priorities that extend the expansion? Many nominees for the new Administration have made statements in support of tax reduction and regulatory relief for businesses and households. Simultaneously, there are general comments about tightening the terms of trade, which in the presence of higher interest rates and a stronger dollar may work against that improved business environment.

How long will the expansion last? As we outline below, we have not changed the baseline forecast to reflect the uncertain nature of policy actions. The timing and content of policy changes could make the difference between an accelerating economy and a recession, which is common in the first term following a two-term presidency. In either scenario our expectation is that housing will cope reasonably well.

Affordability Constrains as the Expansion Matures: a Review

Our theme last year posited that as the expansion moved into late cycle the housing market would face affordability challenges, particularly for first-time homebuyers. These constraints included strong home price gains outpacing income growth, rising mortgage rates, and elevated rental cost burdens inhibiting renters' ability to save for down payments.

Influenced by these affordability challenges, we predicted in the January 2016 forecast that the pace of growth in total home sales would moderate from the 7.0 percent increase in 2015 to 3.7 percent in 2016. Mortgage rates surged after the Presidential election but posted the lowest annual average since Freddie Mac began its record keeping in 1972. We also underestimated the strength of home price appreciation.



New home construction was lackluster, and the inventory of existing homes for sale remained historically low. Both factors placed upward pressure on home prices (see the housing section below). The bottom line is that affordability appears to have constrained home sales last year, and our current estimate of home sales growth of 4.2 percent for all of 2016 is close to our prediction a year ago. With the Fed expected to continue raising short-term rates in coming years and construction lagging demand growth, affordability will remain a key issue for the housing market.

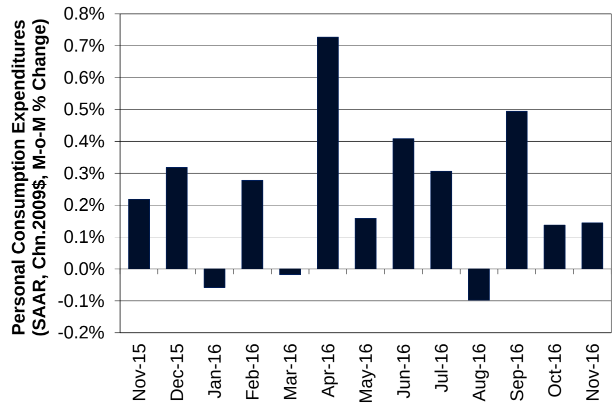
Moderate Growth Continues

We estimate that economic growth moderated to 2.0 percent annualized during the final quarter of 2016 from 3.5 percent in the third quarter. Full-year 2016 growth should come in at 1.9 percent, followed by expected 2.0 percent growth for 2017 (absent effective stimulus), one-tenth and two-tenths stronger, respectively, than in the prior forecast, largely from improving consumer spending. While we believe that some form of fiscal stimulus and deregulation might happen later this year or next year that could boost growth, we have included no new federal policies in our baseline forecast.

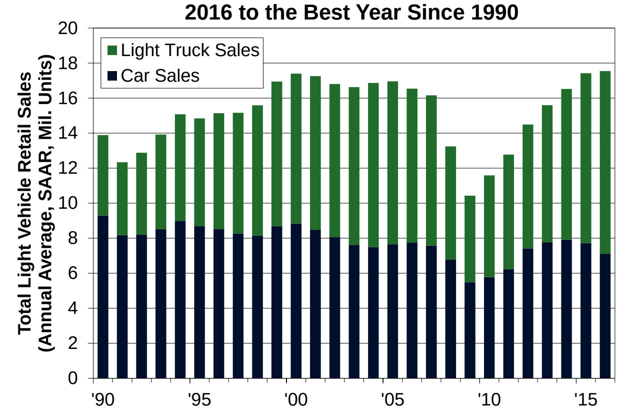
Incoming data support our expectations that the strong growth in the third quarter was unsustainable. Much of the strength came from a temporary surge in agricultural exports. The trade deficit widened significantly in November for a second straight month, and we expect net exports to subtract one percentage point from growth in the fourth quarter. Given the strong dollar, net exports should subtract from growth over the next two years.

Consumer-related data came in better than we expected. The final estimate of third quarter gross domestic product (GDP) showed a slight upgrade in real consumer spending growth to 3.0 percent annualized. This put spending on a better trajectory for the fourth quarter despite anemic 0.1 percent real consumer spending growth in November for the second consecutive month. In addition, auto sales increased 3.1 percent in December, likely boosted by strong incentives at the end of the year to reduce inventory. While car sales slowed in 2016, light truck sales improved, helping total auto sales to cap the best annual sales pace since 1990.

Consumers Spending Growth Is Anemic Again



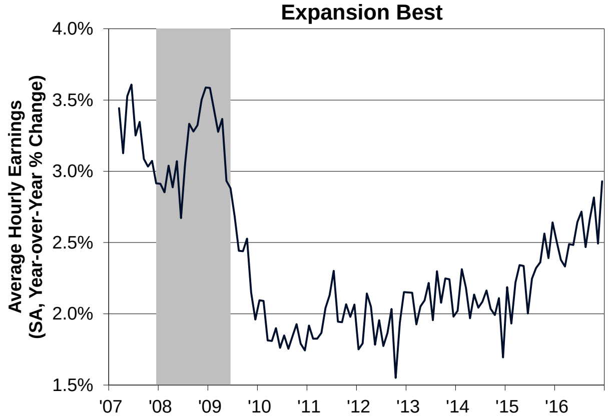
Rising Light Truck Sales Push Auto Sales in 2016 to the Best Year Since 1990



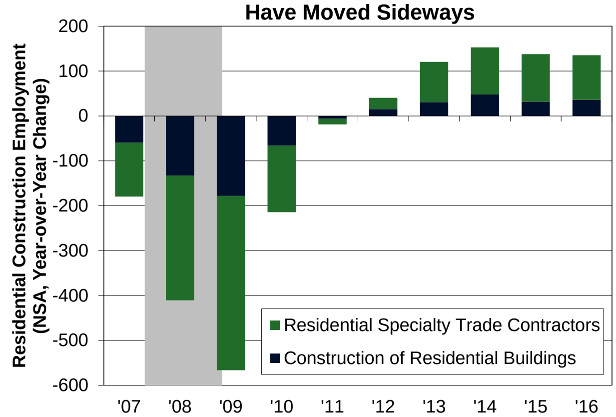
Labor market conditions should help support consumers. The job gain of 156,000 in December and the net positive revision in the prior two months put the average monthly gain over the past three months at a solid 165,000. This is a slowdown from the prior three months and, with increased wage gains, is consistent with a late-cycle economy. Other details of the jobs report were largely positive, including an uptick in the labor force participation rate and the third consecutive drop in the broadest measure of labor underutilization (the U-6 unemployment rate). In addition, average annual earnings rose to an expansion high of 2.9 percent, showing a visible uptrend in wage growth over the past two years.

For all of 2016, the economy created 2.0 million jobs, marking six consecutive years of annual job gains of at least two million – the best record since 1999. However, the employment to population ratio remains low at 59.7 percent. For residential construction employment, job creation was the weakest in three years, consistent with the lackluster housing starts.

Annual Wage Gains Climb to an Expansion Best

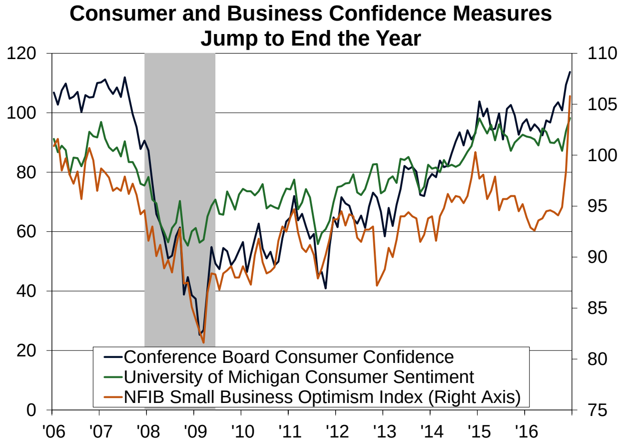


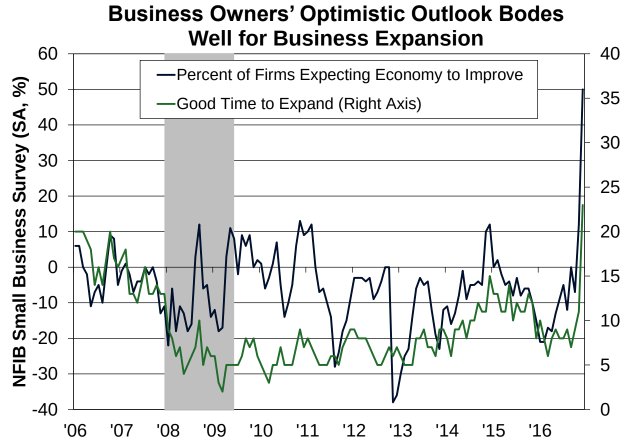
Residential Construction Employment Gains Have Moved Sideways



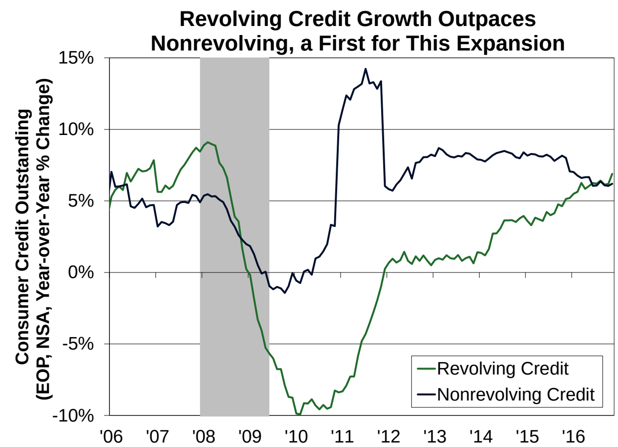
In addition to improving overall labor market conditions, the continued rise in household net worth, boosted by gains in housing wealth and stocks, will help support consumers. Major U.S. stock market indices finished 2016 with one of their best performances in years, and home price appreciation remained strong. Consumer and business confidence improved further in December: The Conference Board confidence index jumped to the highest level since August 2001, and the University of Michigan sentiment index rose to the highest reading since January 2004.

After a rise in November, the National Federation of Independent Business (NFIB) Optimism Index surged in December. The two-month gain of 10.9 points marks a record back-to-back increases since the monthly survey began in 1986. A more optimistic economic outlook drove the gain in the overall index, with the net share of firms expecting the economy to improve rising 38 points to 50 percent, a 14-year high. The share of firms saying it is a good time to expand business jumped 12 points, the largest one-month gain on record, to 23 percent, the highest level since 2005. The NFIB notes that much of the increase was due to a change in the political environment. Prospects for tax cuts and deregulation are potentially a game changer for small business owners, as they have cited taxes and government regulations as their top two concerns throughout the expansion. We must note, however, that a post-presidential election rise in confidence is not unusual, and it is also not unusual for such measures to give back gains soon thereafter.





Recent consumer credit data indicate a trend of increasing consumer debt. Revolving credit (largely credit card debt) annual growth has gradually trended up over the past two years and finally surpassed the annual growth rate for nonrevolving credit (largely auto and student loans) in November for the first time since 2008. Continued improving debt usage, especially for revolving debt, suggests that consumers are more confident in their finances and are more willing to incur debt to support their spending.



Data on nonresidential construction spending and durable goods orders suggest that business investment in structures rose last quarter, and business investment in equipment posted a gain after declining for four consecutive quarters. We expect business fixed investment to improve this year as the drag from declining oil prices has faded. There appears to be significant pent-up demand for business equipment, and recent improvement in business sentiment is encouraging for capital expenditures this year. We also expect government spending and inventory investment to add to growth in 2017.

Alternative Scenarios

We ran a scenario assuming moderate tax cuts totaling $100 billion ($70 billion personal; $30 billion business) and a minor reduction in business costs through deregulation enacted in the second quarter of 2017. This scenario resulted in GDP increase roughly half a percentage point in 2017 and about a full percentage point in 2018 before slowing. We believe that reasonable growth expectations without significant inflation expectations are built into market rates. In this environment we expect little impact on the growth path of housing as income growth offsets the modest increase in interest rates.

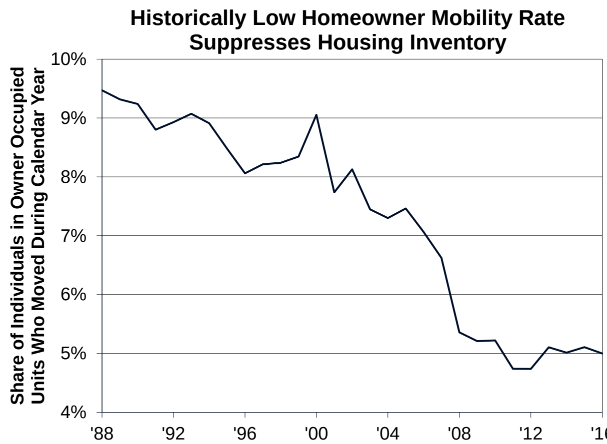
Under a mild recessionary scenario, home sales may not suffer much, as interest rates would likely fall, a modest rise in unemployment would ease the rate of price appreciation, and supply would continue to grind upward. We view this as similar to the past experience of the 2000 recession.

Monetary Policy Suggests Modest Interest Rate Increases

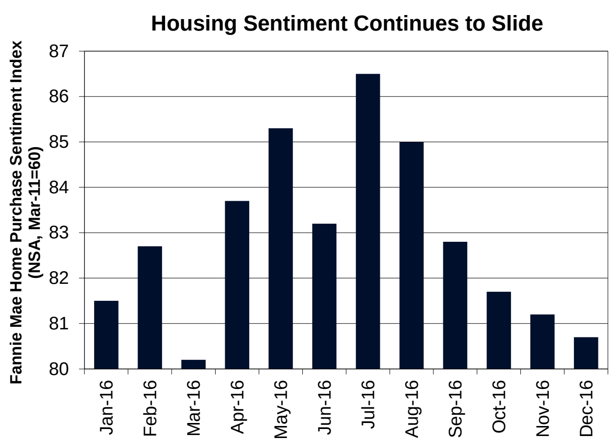
The word uncertainty appeared 15 times throughout the minutes of the Federal Open Market Committee (FOMC) December meeting. We believe that the Fed will exercise caution given substantial policy uncertainty in the U.S., as well as risks from national elections in Europe; banking stress in the European Union, especially Italy; and financial turmoil in China. We anticipate two rate hikes in 2017. The recent Fed minutes also revealed that half of the FOMC members priced some form of a fiscal stimulus into their forecast, and the median forecasts for both economic growth and the number of expected fed funds rate hikes increased compared with the September forecast. This suggests that if and when it becomes apparent that a fiscal stimulus will be enacted, rate hike expectations from both the market and the Fed will likely be faster than at the present time. Policy maker deflation fears appear to have receded, turning the attention toward reflation.

Housing Grinds Upward

Home sales increased at a slower pace in 2016 than in 2015. Existing home sales rose in November to an expansion high while new home sales rebounded. However, pending home sales, which typically lead existing home sales by one to two months, fell substantially during the month, suggesting that rising mortgage rates caused a setback in home sales at the end of 2016.



The main measures of home prices pointed to stronger gains in 2016 than in 2015. All through last year we emphasized tight inventory. The existing home market witnessed continued annual drops in the number of homes for sale since the summer of 2015. One reason was that the number of distressed sales dwindled as loan performance improved with the economy. Another reason was the continued downtrend in mobility rates. Census data showed that the share of Americans moving fell to an all-time low in 2016. For those living in owner-occupied units, about five percent moved between 2015 and 2016, the same share seen in recent years, compared with at least eight percent prior to 2000. We believe it is unlikely that the declining trend observed over the past 15 years will reverse any time soon, suggesting that the turnover rate will likely remain historically low for some time.

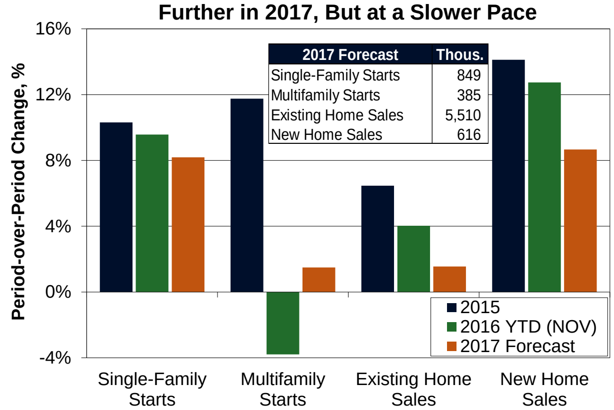


The November residential construction spending report confirmed our expectation of a strong rebound in residential investment last quarter after two straight quarterly drops. However, for all of 2016, homebuilding activity was a disappointment, with total housing starts growing at just half the pace of the 10.8 percent gain in 2015, contrary to our expectation at the start of 2016 of a similar gain. We noted throughout last year that a shortage of skilled labor and available lots contributed to the poor performance for homebuilding, along with the increased cost of mortgage lending. While home builders' confidence improved following the election due to expectations of deregulation under the Trump Administration, lender sentiment eroded during the fourth quarter. According to Fannie Mae's Mortgage Lender Sentiment Survey®, a majority of lenders cited "mortgage rates are not favorable" for their worsening near-term outlook. Meanwhile, the Fannie Mae Home Purchase Sentiment Index® (HPSI) showed that, after reaching a record high in July, consumer housing sentiment declined in December for the fifth consecutive month to the lowest level since March. Despite the post-election bump in general consumer attitudes, a rapid rise in mortgage rates has tamped down home purchase sentiment.

Mortgage rates took a breather during the last week of 2016. After rising for eight consecutive weeks following the election to the highest level since April 2014, mortgage rates fell 12 basis points to 4.20 percent according to Freddie Mac's survey. We expect mortgage rates to rise only gradually, from an average of 3.8 percent in the fourth quarter of 2016 to 4.3 percent during the fourth quarter of 2017. There is a risk that rates could rise faster than we expect, but if income growth also strengthens, then the housing recovery can continue as we expect. The cut in FHA premium this month should offset some of the increase in mortgage rates. Demographic factors are positive, with our research showing that the oldest Millennials have begun to buy homes, as we have been predicting, and are closing the homeownership attainment gap with their predecessors. We project further slowdowns in the pace of increase in home sales and single-family starts for 2017. We expect a slight gain for multifamily starts, following last year's pullback, which was the first decline in seven years. (For more information on multifamily market conditions, read the January 2017 Multifamily Market Commentary.)

We revised higher our estimate of refinance originations by about $30 billion during the fourth quarter of 2016 but modestly downgraded this year's forecast. We slightly upgraded our projected purchase originations through next year due to a combination of stronger existing home sales and home price gains but weaker housing starts and new home sales than in the prior forecast. For all of 2017, we expect total mortgage originations to drop about 19 percent from an estimated $1.94 trillion in 2016 to $1.57 trillion, as the decline in refinance originations outpaces the rise in purchase originations. We expect the refinance share to decline 15 percentage points from 2016 to 33 percent.

Single-Family Housing Market Should Expand Further in 2017, But at a Slower Pace



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: *Freddie Mac, Bureau of Economic Analysis, Auto Data Corporation, Bureau of Labor Statistics Conference Board, University of Michigan, National Federation of Independent Business, Federal Reserve Board, National Association of REALTORS®, Census Bureau, Fannie Mae.*

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