



Economic Developments – June 2017

Monetary Policy Tightens; Fiscal Policy Languishes; Yield Curve Flattens

This month marks the eighth anniversary of the U.S. economic expansion, the third-longest of the post-World War II era. We expect the expansion to continue, with GDP growth at 2.0 percent for all of 2017. Moderate growth should continue next year, but the potential for fiscal stimulus remains a wild card for the 2018 outlook. The odds that Congress will enact major pieces of legislation, including health care, tax reforms, and infrastructure investment, by the end of this year have diminished, and thus meaningful impacts from fiscal stimulus appear to be unlikely before 2018. The economy also faces another fiscal policy uncertainty later this year, perhaps in November, as Congress will have to raise the debt ceiling to avoid a government shutdown and a technical default. The Congressional Budget Office estimates that tax revenue for the first eight months of Fiscal Year 2017 missed projections by as much as \$70 billion. If budget deficits deteriorate significantly in coming months, the Treasury could run out of money sooner than November. Meanwhile, the Fed continues to normalize monetary policy, raising the fed funds rate at the June 13-14 Federal Open Market Committee (FOMC) meeting by 25 basis points. In the Q&A session following her press conference, Chair Yellen said balance sheet normalization could occur “relatively soon.”

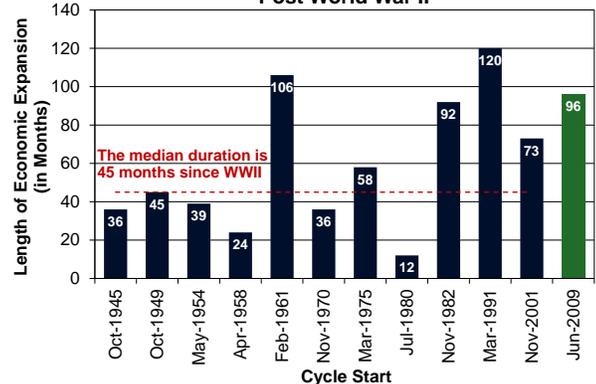
Following the FOMC meeting, long-term yields declined and the yield curve flattened further. The yield on 10-year Treasuries reached a three-year high of 2.63 percent on March 13, two days before the Fed raised the fed funds rate. The yield has trended down since then, reaching 2.13 percent on June 14. Mortgage rates have moved lower in tandem, with the average rate on 30-year fixed mortgages declining to below 4.0 percent during late May and early June. The spread between 10- and 2-year Treasury notes narrowed from a post-election high of 135.5 basis points in late December to below 80 basis points for the first time since early September.

Global uncertainty has mounted as the U.K. election resulted in a hung Parliament in which the Conservative party came in first but failed to achieve an outright majority. Formal Brexit talks, which were due to start this month, are likely to be delayed, and the future of the British exit from the European Union in March 2019 is more uncertain. However, Euro Zone economic activity, including industrial production, has recently picked up, boosted by strength in Germany. At its meeting earlier this month, the European Central Bank raised its growth forecast and changed its forward guidance, dropping the easing bias on interest rates.

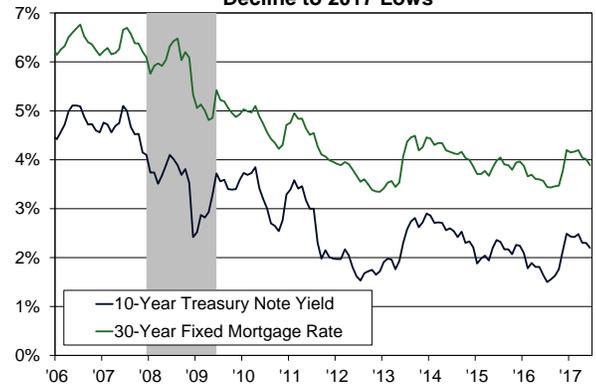
A Meaningful Growth Rebound Is in the Cards, But Is Likely Unsustainable

First quarter economic growth was revised higher by 0.5 percentage points to 1.2 percent annualized in the second estimate of gross domestic product (GDP). The upward revision largely reflected stronger consumer spending and nonresidential investment growth than initially reported. The second print of GDP provided the first glimpse of corporate profits, which fell 1.9 percent (not annualized) in the first quarter—the first drop in three quarters. Profits of domestic financial and nonfinancial corporations fell, offsetting a rise in profits from the rest of the world.

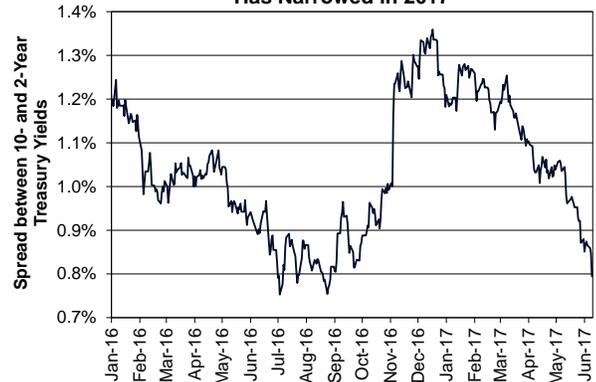
Current Expansion is the Third Longest Post World War II



Mortgage Rates and 10-Year Treasury Yields Decline to 2017 Lows

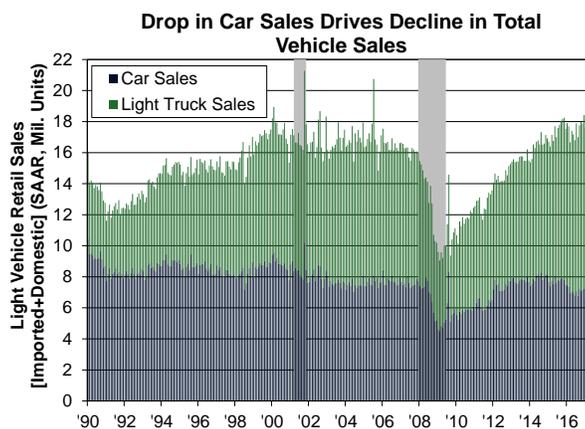


10-Year to 2-Year Treasury Spread Has Narrowed in 2017





Incoming data support our prior forecast that economic growth will rebound to 2.9 percent annualized in the second quarter. Real personal income and real consumer spending both grew 0.2 percent in April. Furthermore, an upward revision to first quarter consumer spending pushed March's gain higher to a strong 0.5 percent. The trend in consumer spending last quarter was consistent with our belief that unseasonably warm weather, which reduced demand for utilities, and delays in tax refunds temporarily restrained spending growth. By March, however, tax refunds appeared to have caught up with year-to-date disbursements of recent years, providing a boost for consumer spending moving into the second quarter. However, auto sales fell in May for the fourth time in five months, supporting our view that sales likely peaked last year, and retail sales dropped in May, though prior months' data were revised higher. All factors considered, we expect consumer spending growth to rebound to 3.1 percent annualized this quarter from 0.6 percent in the prior quarter. However, this quarter's strong rebound is unlikely to be sustainable, and consumer spending growth should moderate during the second half of the year, weighed down by durable goods spending.

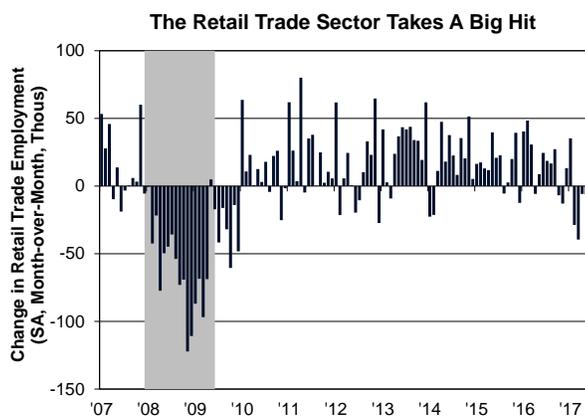


For the current quarter, an inventory investment swing should also support growth. After subtracting more than one percentage point from growth during the first quarter, we expect inventory investment to contribute to growth as businesses increase production to build stockpiles to more sustainable levels. Nonresidential and residential investment growth will likely slow from the stellar performance in the prior quarter. Government spending is expected to add to growth, boosted by a rise in defense spending, but net exports should drag on growth.

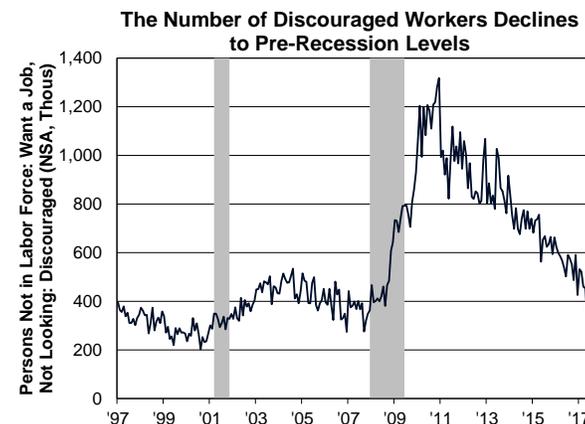
Consumer Fundamentals Are Mixed

The second estimate of GDP showed a sizable downward revision in wage and salary income for the fourth quarter. Real disposable personal income increased 1.7 percent annualized in the first quarter, but the 2.0 percent increase for the fourth quarter was revised sharply lower to show a 0.3 percent drop. The personal saving rate for the first quarter rose to 5.2 percent, up from 4.9 percent in the prior quarter, which received a 0.6 percentage point downgrade.

The May jobs report also suggested that hiring and wage growth have lost some steam. Nonfarm payrolls rose 138,000 on the heels of downward revisions of 66,000 jobs for the prior two months. The three-month moving average gain has steadily declined from 201,000 in February to 121,000 in May. Retail trade was hit particularly hard, losing over 80,000 jobs between February and May—the first time the sector experienced such losses since 2009. Meanwhile, wages have shown no signs of heating up amid reduced slack in the labor market, with average hourly earnings posting an annual gain of just 2.5 percent for the second straight month—the weakest gain since August.



While a separate household survey showed that the unemployment rate ticked down to 4.3 percent, a 16-year low, the decline was caused by a large decrease in the labor force that outpaced a decline in household employment. The labor force participation rate fell 0.2 percentage points to 62.7 percent, the lowest reading this year.



One silver lining is the ongoing decline in the broadest measure of labor underutilization, the U-6 unemployment rate, which includes



discouraged workers and part-time workers who prefer full-time jobs. The rate fell two ticks to 8.4 percent, the lowest level since November 2007. Notably, the number of discouraged workers fell to just 355,000, the lowest reading since November 2007. The number of part-time workers who want full-time jobs has declined steadily since August 2016, but remains well above pre-recession levels.

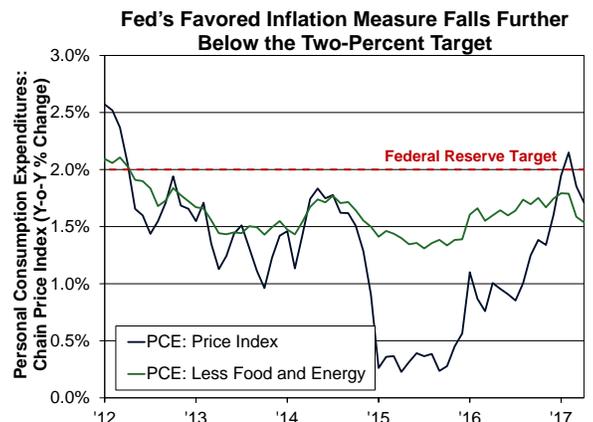
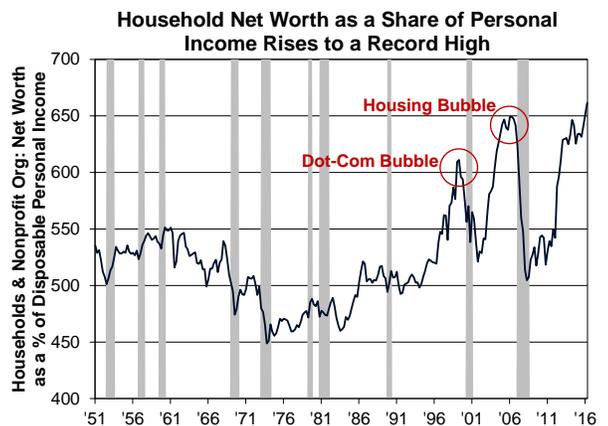
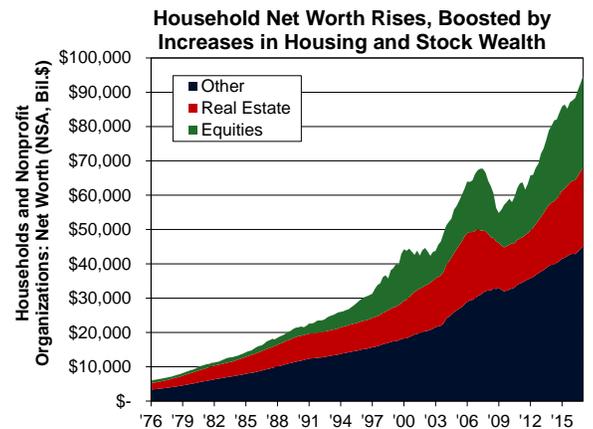
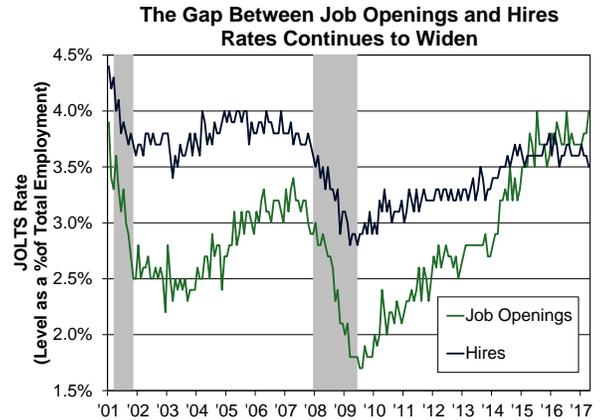
The Job Openings and Labor Turnover Survey (JOLTS), which is released with a one-month lag to the jobs report, suggests a shortage of skilled labor may have partly restrained hiring. Since February, the job openings rate has exceeded the hires rate. In April, the jobs openings rate rose two-tenths to 4.0 percent, tying an all-time high, while the hires rate fell one-tenth to 3.5 percent, marking a one-year low. The 0.5 percentage point gap between the job openings and hires rates is the largest since the survey's inception in 2000. The growing gap between job openings and hires rates suggests firms are having a difficult time finding qualified workers to fill open positions.

While the trends in hiring and wages disappointed, data from the Financial Accounts of the United States were upbeat, as household (including nonprofit organizations) net worth—assets minus liabilities—grew \$2.35 trillion to \$94.8 billion during the first quarter, boosted by gains from both stocks and home equity. Net worth as a share of disposable personal income rose to a record high. While research suggests that the propensity to consume from an increase in wealth is smaller than from a similar increase in income, improving household balance sheets are a positive for consumers.

Monetary Policy Uncertainty Beyond June Has Increased

Although hiring has slowed markedly, the labor market appears to be at or near full employment. At the same time, inflation pressure has cooled. After exceeding the Fed's 2.0 percent target in February, the annual rise in the Fed's favored measure of inflation—the personal consumption expenditures (PCE) deflator—moderated for the second consecutive month in April, dropping to 1.7 percent. Since the March FOMC meeting, the unemployment rate has fallen 0.4 percentage points while the annual growth in PCE moved 0.2 percentage points farther away from the target, providing mixed signals for the Fed. Another measure of inflation, the Consumer Price Index, moderated further in May, with the annual inflation slowing to 1.9 percent—the smallest gain since November. The annual increase in core prices also moderated to 1.7 percent, the slowest pace in two years.

The statement following the June meeting noted that annual inflation has declined recently to below 2.0 percent, and the committee expects it to remain below the target in the near term. The statement offered new detail on how the Fed will taper reinvestment of principal payments from its securities holdings, although it provided no specifics on when the process balance sheet normalization would begin, other than "this year." Our forecast calls for another rate hike





in September and a start of reinvestment tapering in December. However, the slowdown in hiring and muted inflation and wage pressures could delay the Fed's intended path of monetary policy normalization.

For Housing, the Song Remains the Same

The narrative for the housing market has not changed over the past year: labor shortage continues to restrain homebuilding, and tight inventory constrains sales and boosts home prices. Year to date through April, single-family starts were up 7.0 percent, significantly greater than a 1.9 percent gain for multifamily starts. The small gain in year-to-date multifamily starts reflects the maturity of that sector's expansion, which we believe peaked last year. Single-family starts remain near levels witnessed in a typical recession prior to the last downturn. Labor shortage remains a lingering issue for the residential construction industry, according to various private surveys of home builders. The JOLTS survey corroborates those results. The April survey showed that the job openings rate for the construction industry jumped to the highest reading since September, while the quits rate—a gauge of workers' confidence—remained at an expansion high for the third consecutive month.

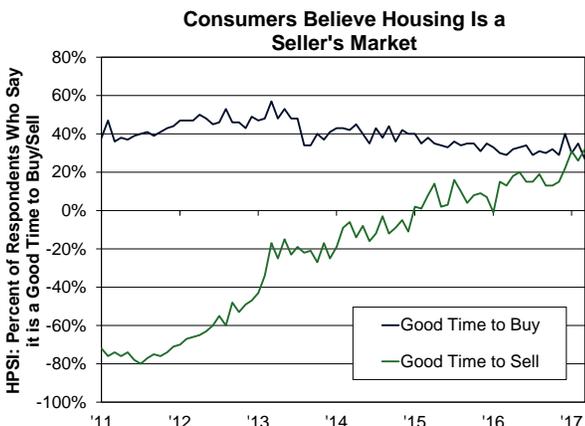
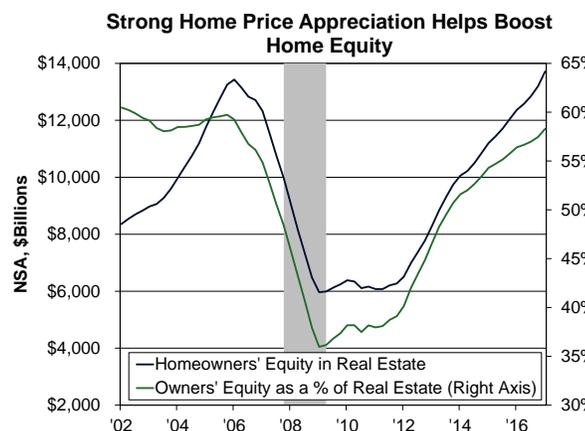
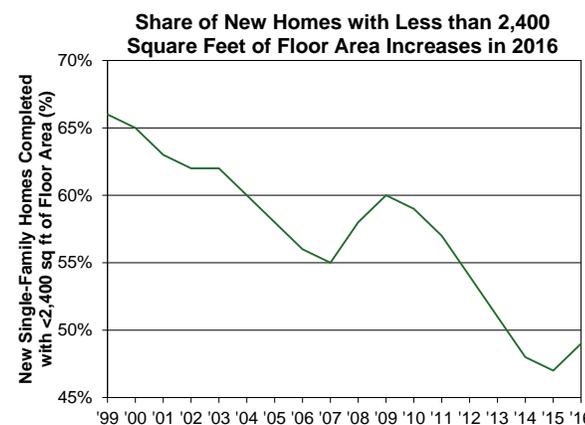
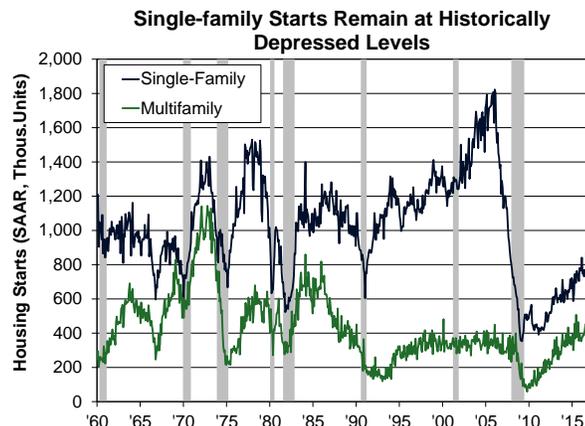
One piece of encouraging news is that builders appear to be responding to demand for smaller homes. The share of completed new single-family homes with less than 2,400 square feet of floor area rose in 2016 for the first time since 2009. If this trend continues, it could help alleviate the critically tight supply in the lower end of the market.

After rising to expansion bests in March, both new and existing home sales pulled back in April. Unusually warm winter weather, combined with declining mortgage rates in January and February, likely pulled forward some sales into the first quarter.

Tight inventory in the existing home market continues to constrain sales. While the number of homes for sale saw a seasonal rise in April, it remains significantly below last year's level, continuing annual declines that extend back nearly two years. The number of days on the market fell to a fresh record low, and the months' supply remained historically tight at 4.2 months, versus 4.6 months last April.

Lean inventory is a boon for home prices. The CoreLogic House Price Index, the measure used by the Fed to estimate the value of real estate assets, posted a 6.9 percent annual gain in April—the strongest rise since May 2014. Strong home price appreciation during the first quarter helped boost homeowners' equity, which has now surpassed its previous peak recorded 11 years ago, according to the Financial Accounts of the United States. On the debt side, single-family (1-4 unit properties) mortgage debt outstanding rose 1.9 percent annualized, the weakest quarterly gain in a year.

While robust home price gains have helped spur increases in household wealth, they have restrained home purchase affordability. The [Fannie Mae National Housing Survey® for May](#) suggests that high and rising home prices continue to favor sellers. The net share of Americans who reported that now is a good time to buy a home, which





has moved in a tight range over time, dropped to a record low. On the other hand, the net share who reported that now is a good time to sell a home has trended up substantially since 2012 following a trough in home prices. The share rose to a record high in May, surpassing the good time to buy net share for only the second time since the survey's inception in 2011.

The near-term outlook for existing home sales remains bearish, as pending home sales fell in April for the second consecutive month. Mortgage rates should remain supportive for home sales, as we expect them to stay near current levels, averaging 4.0 percent in the fourth quarter. Our forecast for home sales and originations are little changed. We expect total home sales to rise 3.2 percent this year. Total single-family mortgage originations are projected to drop about 21 percent this year to \$1.62 trillion, with a large drop in refinance originations outweighing a modest rise in purchase originations. We expect the refinance share to move lower, from 48 percent in 2016 to 34 percent in 2017.

For information on multifamily market conditions, read the [June 2017 Multifamily Market Commentary](#).

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:** National Bureau of Economic Research, Federal Reserve Board, Freddie Mac, Bloomberg, AutoData Inc., Bureau of Labor Statistics, Bureau of Economic Analysis, Census Bureau, Fannie Mae.*

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