



Economic Developments – December 2016

Growth May Slow to End 2016 But Sentiment Brightens

We expect economic growth to moderate to less than two percent this quarter, with full-year 2016 growth at 1.8 percent. We have not included the effects of any new federal policies in this forecast, due to considerable uncertainty about the President-elect’s policy agenda and the extent of support he will receive from the new Congress. The risks to our 2017 growth forecast of 1.8 percent are balanced between upside and downside.

The economy expanded 3.2 percent annualized in the third quarter, a sizable pickup from average growth of only about one percent in the prior three quarters. However, the strong pace appears unsustainable, as temporary support from agricultural exports generated much of the growth, helping net exports add nearly one percentage point to growth. As such exports receded, the trade deficit widened significantly in October, and we expect net exports to subtract about one percentage point from growth this quarter. As the trade deficit widened to start the fourth quarter, consumer spending growth also slowed.

Long-term interest rates have risen significantly over the past month, with the 10-year Treasury yield touching 2.60 percent at the time of this writing, the highest rate since July 2015, presenting headwinds for housing. At the same time the dollar is approaching a 14-year high, which could weigh on manufacturing and other exports, as well as U.S. profits overseas.

Mortgage Rates and 10-Year Treasury Yields Rise After the Election



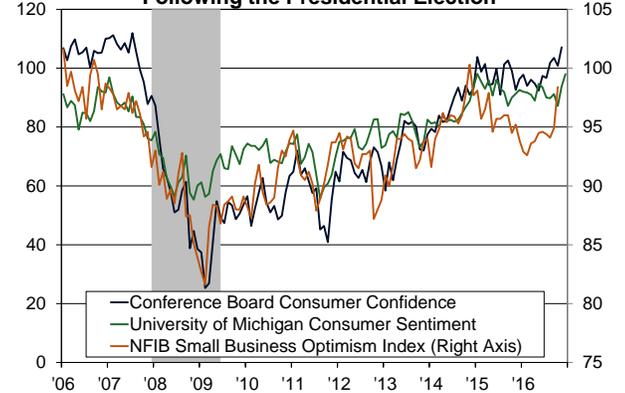
U.S. Dollar Strengthens to a 14-Year High



Confidence Improves Across the Board

Investors are bullish, with major U.S. stock market indices reaching record highs in early December. Consumer and business confidence improved following the election. The Conference Board confidence index jumped to an expansion high in November, and the preliminary estimate of the University of Michigan sentiment index rose in December to just one-tenth below the expansion best in January 2015, which was the highest reading since the start of 2004. Strong equity markets and continued solid job gains have helped improve sentiment, and the election results also helped boost sentiment as consumers believe that the incoming Administration will adopt pro-growth policies. For example, a press release from the University of Michigan consumer sentiment survey noted that a jump in sentiment in early December was “largely due to” Presidential-elect Trump’s victory, as more consumers noted the potential positive impact of new economic policies “than ever before recorded in the long history of the survey.”

Consumers and Businesses Are Upbeat Following the Presidential Election



Business confidence has also risen, as made evident by the Business Roundtable’s survey of CEOs and comments from earnings calls. Meanwhile, small business sentiment improved significantly in November, with the National Federation of Independent Business (NFIB) Optimism Index jumping to the best showing in nearly two years, driven by increased



optimism in the economic outlook. The election seemed to have helped boost confidence, as the NFIB noted a sharp increase in optimism in responses received after the election.

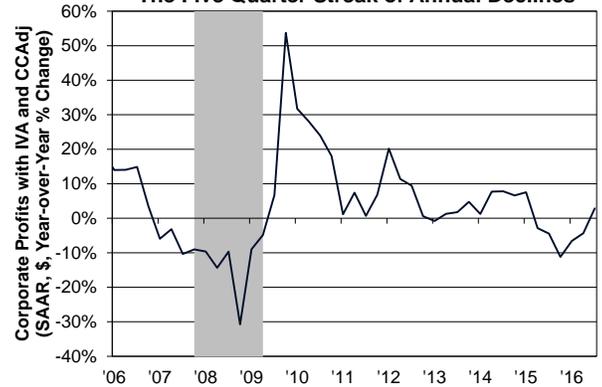
Furthermore, economists are also generally more upbeat following the election. According to the December Blue Chip Economic Indicator Survey, the consensus forecast of economic growth next year rose slightly from the prior month. About 47 percent of respondents reported that they had raised their forecasts of real gross domestic (GDP) growth in 2017 as a direct result of the election outcome. Consistent with the notion that an increase in aggregate demand (e.g., from fiscal stimulus) late in the business cycle – at a time when the labor market is at or near full employment – would add to wage and inflationary pressure, about 44 percent of Blue Chip respondents said that they had raised their inflation forecasts due to the election results. Our economic growth forecast is below the Blue-Chip consensus. We were among the bottom ten forecasts both before and after the election as we remain in wait-and-see mode.

Some Encouraging News in the Third Quarter

The second print of third quarter real GDP showed that corporate profits rose 6.6 percent (not annualized) from the second quarter. Corporate profits increased 2.8 percent from a year ago, ending a string of five consecutive annual declines, which has occurred only one other time during an expansion. The annual rise in the third quarter was solely because of a rebound in financial sector profits; annual profits in nonfinancial sectors continued to drop for the sixth consecutive quarter.

Another notable detail from the second estimate of third quarter GDP was a sizable upgrade in real consumer spending growth to 2.8 percent annualized from 2.1 percent in the prior estimate. However, incoming data suggest that spending growth will moderate sizably this quarter as real consumer spending edged up just 0.1 percent in October, retail sales ticked up 0.1 percent in November, and November auto sales ticked down, albeit from a strong pace in the prior month.

Corporate Profits Rise from a Year Ago, Ending The Five Quarter Streak of Annual Declines

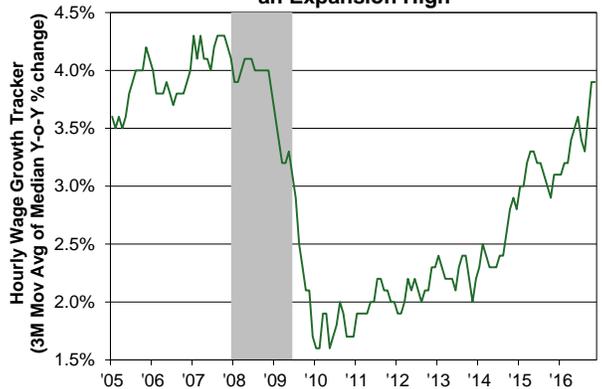


Consumer Fundamentals Are Positive

Despite signs of a slowdown this quarter, we expect consumer spending to continue to drive growth. The November employment report showed a decent job gain of 178,000. It also showed a three-tenths percentage point drop in the unemployment rate to an expansion low of 4.6 percent; although the drop was driven more by a decline in the labor force than by job growth. The labor force participation rate ticked down for the second consecutive month to 62.7 percent, the lowest reading since June. Annual earnings growth moderated three-tenths of a percentage point to 2.5 percent from an expansion high in the prior month. This measure of earnings growth is not adjusted for compositional shifts in employment, however. For example, an influx of new workers into lower-paying positions can drag on overall earnings growth.

An alternative earnings measure not influenced by these compositional shifts is the Atlanta Fed's Wage Growth Tracker. It showed that annual wage growth remained at an expansion high of 3.9 percent in November. It is likely that some slack remains in the labor market. The broadest measure of labor market underutilization, which includes part-timers who want full-time jobs and discouraged workers who want a job but are no longer looking for one, continued to slide, falling to 9.3 percent. While the rate has trended down to the lowest level since April 2008, it remains elevated relative to levels in the previous expansion, when it troughed at 7.9 percent.

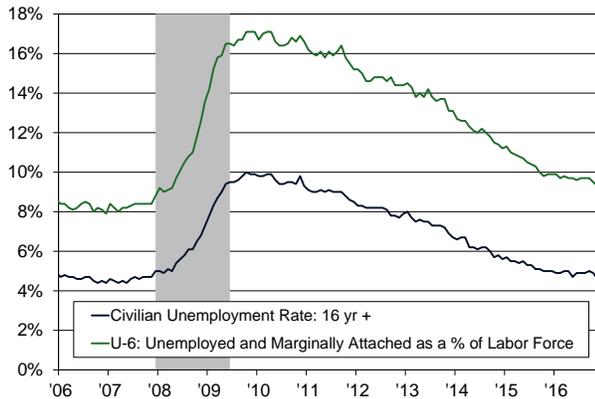
Atlanta Fed Wage Growth Measure Remains at an Expansion High



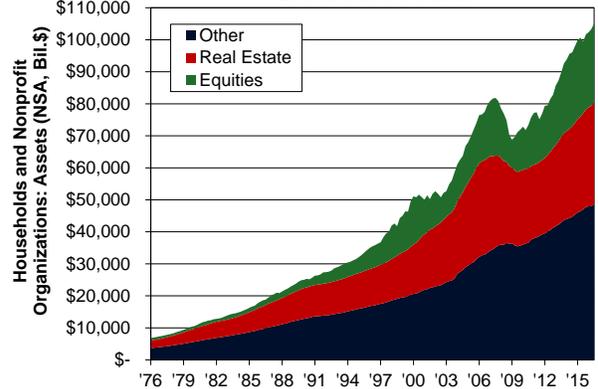
In addition to improving labor market conditions, rising household net worth should help support consumers. The net worth of households and nonprofit organizations—the value of assets minus liabilities—increased \$1.6 trillion to \$90.2 trillion in the third quarter of 2016, boosted by gains in both housing and stocks.



Unemployment Rates Dip to Expansion Lows



Household Net Worth Shows Broad-based Gains



Overall, we expect consumer spending to be the biggest driver of growth in 2017. Nonresidential investment should also add to growth, as investment in structures should be less of a drag due to the rebound in oil prices amid modestly improving business investment in equipment. The only major drag to growth next year should be net exports.

The Fed Should Exercise Caution Amid Heightened Uncertainty

The Fed raised the fed funds rate at the December Federal Open Market Committee (FOMC) meeting as universally expected. The “dot plot,” which showed each member’s expected fed fund rate in coming years, implies three rate hikes next year compared with two in September. The additional expected hike could be viewed as a sign of a more hawkish stance. However, we shouldn’t give this projection too much weight, given that, at one point, the dot plot signaled four rate increases in 2016 versus the one that actually materialized. We believe that the Fed will likely be in wait-and-see mode given this substantial policy uncertainty and anticipate two hikes each in 2017 and 2018. However, the Fed will be vigilant in monitoring wage pressure, as further tightening in the labor market should lead to a pickup in compensation growth. If the productivity growth trend remains anemic, rising worker compensation will lead to increasing unit labor costs, which will compress profit margins unless businesses pass the higher costs on to consumers through higher prices. During her testimony before the Joint Economic Committee in November, Fed Chair Janet Yellen observed that changes in the fiscal outlook, to the extent that they influence economic growth, labor markets, and inflation forecasts, could alter the course of interest rates. She noted that fiscal stimulus that does not spur faster productivity and labor force growth could result in more upward pressure on inflation and higher interest rates.

Housing Roundup

Housing data point to a double-digit gain in residential investment this quarter, consistent with our view that residential investment will add to economic growth after subtracting from growth in the second and third quarters. Both single-family and multifamily starts jumped in October. However, home sales were mixed, with existing home sales rising to an expansion high amid declining new home sales. (For more information on multifamily market conditions, read the [December 2016 Multifamily Market Commentary](#).)

Pending home sales, which typically lead existing home sales by one to two months, were little changed in October, signaling that existing home sales should remain strong in the near term. Another leading indicator of home sales, purchase mortgage applications, has been mixed of late. They declined in October through mid-November but then surged during the third week as the post-election spike in mortgage rates prompted some potential homebuyers to act before rates rose further.

Existing Home Sales Reach New Expansion Best, As New Home Sales Falter

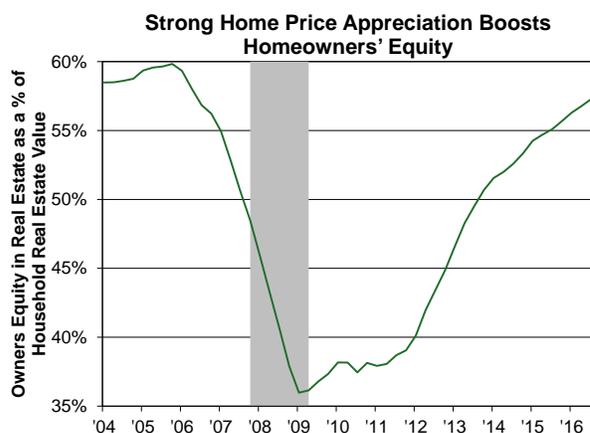
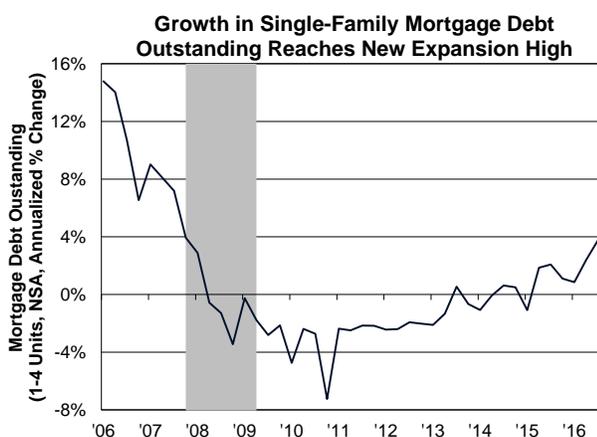


Homebuilders’ confidence surged in December, with the National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index jumping seven points to 70, the highest reading since July 2005. (A reading of 50 or higher indicates more builders view the single-family market conditions as “good” rather than “poor”). The NAHB attributed the

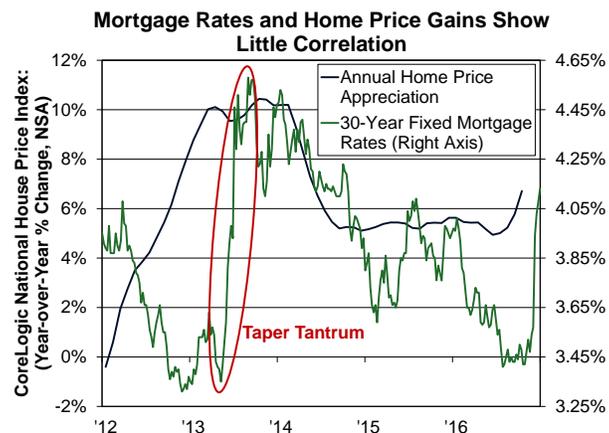


jump to the election results, noting that builders are hopeful that President-elect Trump will cut burdensome regulations as pledged during the campaign. Overall consumer housing sentiment declined in November, however. The Fannie Mae Home Purchase Sentiment Index® (HPSI) decreased for the fourth consecutive month. The results are fairly evenly split between responses collected before and after the election, and there is evidence of an increase in consumer optimism in the immediate aftermath of the election.

Home price appreciation remains strong. The CoreLogic Home Price Index, the measure used by the Fed to estimate the value of household real estate assets, showed that home price appreciation strengthened in October, rising 6.7 percent from a year ago. For the third quarter, the Index appreciated a strong 6.5 percent annualized, helping to boost the value of household real estate holdings and net worth. Housing wealth, which is strongly influenced by home values, rose \$554 billion from the second quarter. Meanwhile, single-family mortgage debt outstanding increased \$93.5 billion — a 3.7 percent annualized rate — the fastest pace since the end of 2007. Owners' home equity as a percentage of the value of household real estate increased to 57.3 percent, up substantially from the trough of 36.0 percent in the first quarter of 2009 but below the previous peak of 59.8 percent reached in the fourth quarter of 2006.



While strong home price appreciation benefits homeowners, it presents an affordability challenge to potential first-time homebuyers, especially given recent increases in mortgage rates. Freddie Mac's survey showed that mortgage rates continued to rise in early December to 4.13 percent, the highest reading since early October 2014. The rise in mortgage rates of about 60 basis points since before the election suggests some headwinds to home sales. However, if long-term interest rates increase along with stronger economic growth, rising incomes could help support housing affordability and home sales. History suggests a weak correlation between mortgage rates and house prices. For example, home prices continued to rise during the 2013 "taper tantrum," defying the spike in mortgage rates and declining housing demand.



We expect mortgage rates to rise gradually, from an average of 3.8 percent this quarter to 4.2 percent a year from now, about 50 basis points higher than the previous forecast. We project an increase in total home sales of nearly three percent in 2017, little changed from the prior forecast. Our 2017 sales outlook hinges on our expectations of a slow rise in interest rates, continued improving household income, and a positive household formation outlook.

We revised higher our forecast of refinance originations this year due to stronger volume through October than anticipated, but we downgraded next year's forecast in response to higher mortgage rates. For all of 2016, we expect total mortgage originations to increase 10.0 percent from 2015 to \$1.90 trillion with a refinance share remaining at 47 percent. Mortgage originations should decline about 17 percent in 2017 to \$1.57 trillion, as a result of a drop in refinance originations, sending the refinance share lower to 33 percent.



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: Bloomberg, Federal Reserve Board, Bureau of Economic Analysis, Conference Board, University of Michigan, National Federation of Independent Business, Federal Reserve Bank of Atlanta, Bureau of Labor Statistics, National Association of REALTORS®, Census Bureau, CoreLogic, and Freddie Mac.

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