ESR Economic and Housing Weekly Note | *February 26, 2016*

Economics: Consumer Spending Picks Up Along with Inflation

This week's reports indicated that economic growth for Q4 2015 went from bad to slightly less bad in the second print of gross domestic product. However, details have some negative implications for Q1 2016 growth because the upward revisions were mainly because of an upgrade in inventory build. As a result, inventory accumulation in the prior quarter remained unsustainably high, suggesting a bigger decline in inventory investment in this quarter. January data for consumer and business spending are more upbeat, however. Consumer spending posted the biggest gain since last May, pointing to a slight upside risk to our forecast for Q1 2016 real consumer spending growth of 2.7 percent annualized. In addition, the first increase in three months in core capital goods orders, a leading indicator of business investment in equipment, sets up for a modest rebound for capital investment after a decline in the last quarter. On the labor market front, while weekly initial jobless claims rose last week for the first time in three weeks, the underlying trend continues to move lower. Meanwhile, deteriorating financial conditions, including selloffs in the global equity markets, appear to be weighing on consumer moods, with two measures of consumer confidence eroding in February. Last but not least, the Fed's favored measure of inflation, the personal consumption expenditure deflator, moved up sizably in January, sending the year-over-year gain toward the Fed's 2.0 percent target. Overall, we believe that this week's news supports our expectation that the Fed will remain on the sidelines at its March meeting before raising the fed funds rate twice this year.

➢ **Gross domestic product (GDP)**, adjusted for inflation, grew 1.0 percent annualized in Q4 2015, according to the second estimate from the Bureau of Economic Analysis (BEA). The 0.3 percentage point upward revision was mainly due to more modest drags from inventory investment and net exports, which more than offset a downward revision to consumer spending and government spending.

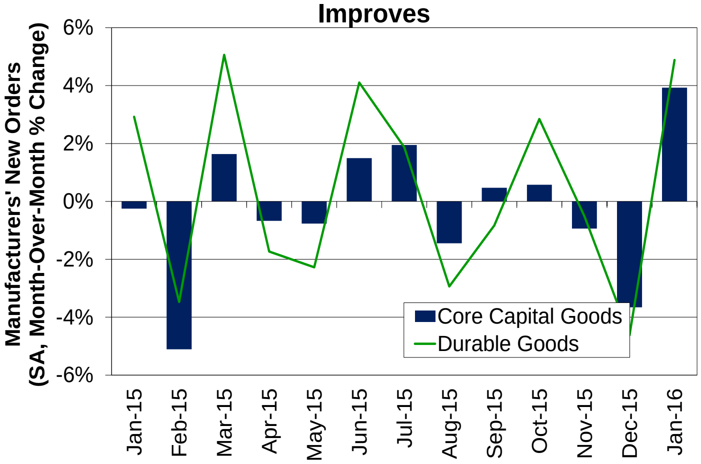
➢ **Personal consumption expenditures (PCE)**, adjusted for inflation, rose 0.4 percent in January, according to the BEA. Real personal income also increased 0.4 percent. The PCE deflator edged up 0.1 percent from December and 1.3 percent from a year ago. The core PCE deflator (excluding food and energy items) increased 0.3 percent, pushing the annual core inflation rate up from 1.5 percent to 1.7 percent, the biggest gain since July 2014.

➢ **The University of Michigan Consumer Sentiment Index** fell 0.3 points to 91.7 in the final February reading. **The Conference Board Consumer Confidence Index** fell 5.6 points to 92.2 in February. Both the present situation and expectations components declined. Details showed that the labor market assessment deteriorated, income expectations ticked down, and the share of consumers planning to buy homes and major appliances fell.

➢ **Durable goods orders** rose 4.9 percent in January, driven in part by a surge in the volatile civilian aircraft category, according to the Census Bureau. Core capital goods shipments — which are used to estimate business investment in equipment in GDP calculation — declined 0.4 percent. Core capital goods orders increased 3.9 percent.

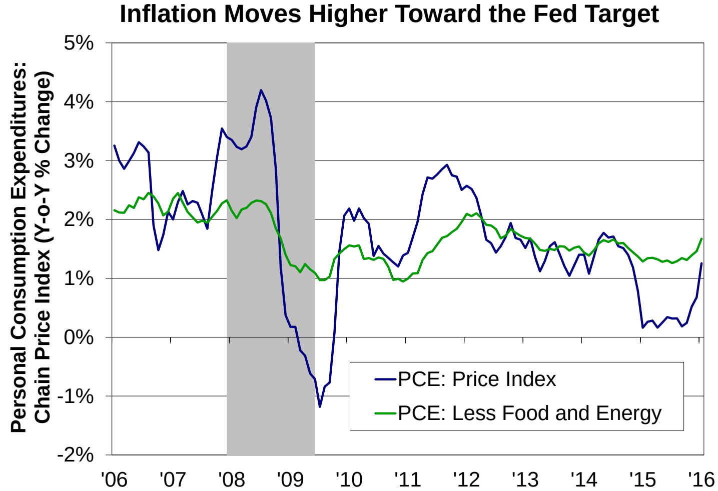
➢ **Initial claims for unemployment insurance** increased by 10,000 to 272,000 in the week ending February 19, according to the Department of Labor. The four-week moving average decreased 1,300 to 272,000, marking the third straight drop.

Business Capital Investment Outlook Improves



Source: Census Bureau

Inflation Moves Higher Toward the Fed Target



Source: Bureau of Economic Analysis

Housing: Prices End 2015 on a Strong Note; Sales Begin 2016 with Discord

Housing data released this week centered around home sales, which started the year on uneven footing. New home sales stumbled in January after three consecutive monthly gains, which sent sales to the second highest level of the expansion in December. Existing home sales, on the other hand, posted a small gain, solidifying the prior month's recovery from the steep drop in November and putting sales just below the expansion best set in July 2015. The wild swings in monthly sales stemmed in part from delays in closings due to new disclosure regulations implemented last October. The inventory of existing homes for sale, which has been a lingering constraint for the market, remains historically low, staying below its year-ago level for the eighth straight month. Lean inventories continue to put upward pressure on home prices, as evidenced by continued solid annual appreciation in December and the biggest year-over-year gain for the fourth quarter in nearly two years. On the other hand, the new home market has recorded consistent improvement in the inventory over the past six months, with the number of homes available for sale in January reaching the highest level since October 2009. Mortgage demand took a step back last week, as refinancing applications dropped for the first time this year, outweighing an increase in purchase applications. Mortgage rates resumed their decline this week, with Freddie Mac's survey showing that the 30-year fixed mortgage rate edged down three basis points to 3.62 percent.

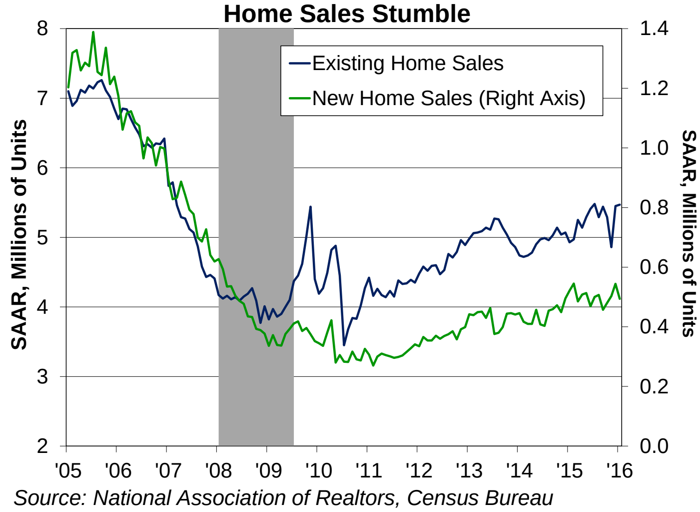
- **New single-family home sales** dropped 9.2 percent to 494,000 annualized units in January, driven by a large drop in the West, according to the Census Bureau. Sales also declined on a year-over-year basis for only the second time since mid-2014, falling 5.2 percent. The number of homes for sale, which is reported on a seasonally adjusted basis, increased 2.1 percent. The months' supply (inventory/sales ratio) rose seven-tenths to 5.8 months. The median sales price, which is not adjusted for the composition of sales, fell 4.5 percent from a year ago. This marked the first time since the beginning of 2012 that prices have declined on a year-over-year basis for two consecutive months.

- **Existing home sales** edged up 0.4 percent to 5.47 million annualized units in January after posting the largest monthly gain on record for a December, according to the National Association of REALTORS®. From a year ago, sales were up 11 percent, the largest increase since July 2013. The number of homes for sale, which is not seasonally adjusted, rose 3.4 percent from December, but fell 2.2 percent on an annual basis. The months' supply ticked up one-tenth from December to 4.0 months, compared to 4.5 months a year ago. The median sales price rose 8.2 percent from a year ago.

- **The FHFA Purchase-Only House Price Index**, reported on a seasonally adjusted basis, rose 5.7 percent in December from a year ago, slowing from a 5.9 percent increase in November. For the fourth quarter, prices increased 5.8 percent from Q4 2014, tying Q3 2015 for the strongest gain since Q1 2014. **The S&P/Case-Schiller National Home Price Index** (not seasonally adjusted) rose 5.4 percent in December from a year ago, the largest annual increase since July 2014. The year-over-year increase of 5.2 percent during the fourth quarter was the largest since Q1 2014.

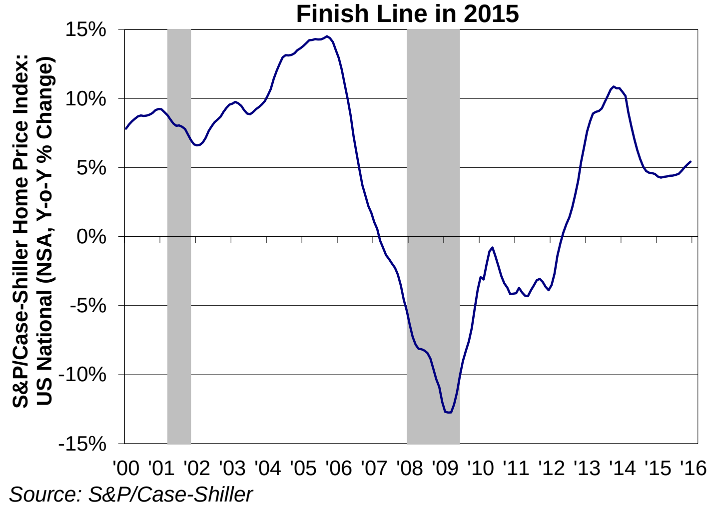
- **Mortgage applications** decreased 4.3 percent in the week ending February 19, according to the Mortgage Bankers Association. The 7.7 percent drop in refinancing applications drove the decline, coinciding with the first rise this year in the survey's average contract interest rate for 30-year fixed-rate mortgages, which edged up two basis points to 3.85 percent. Purchase applications improved 2.2 percent following a 3.7 percent fall the prior week.

Existing Home Sales Hold Steady While New Home Sales Stumble



Source: National Association of Realtors, Census Bureau

Home Price Growth Accelerates Across the Finish Line in 2015



Source: S&P/Case-Shiller

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