



Economic Developments – January 2019

The Economy's Slowing, the Fed Slows, Housing Plateaus

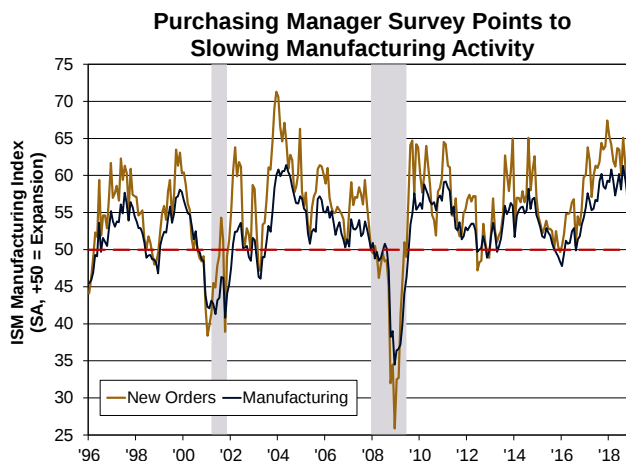
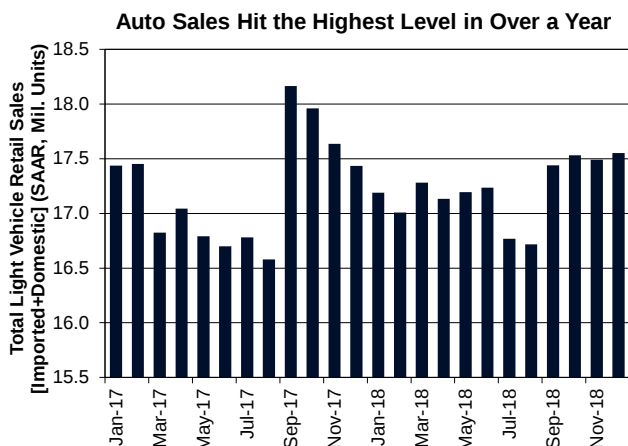
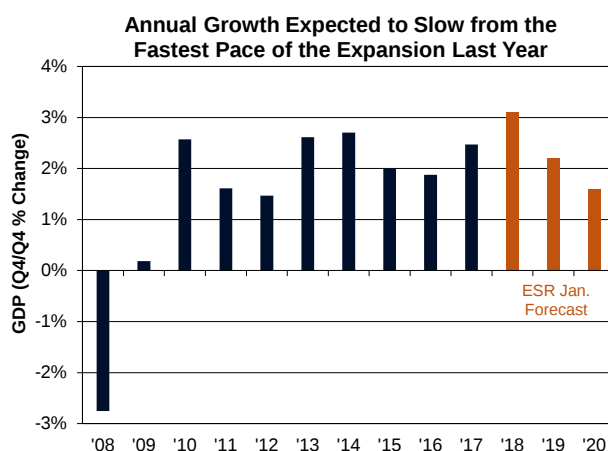
We expect economic growth to decelerate this year to 2.2 percent, down from last year's estimated pace of 3.1 percent, which we believe will turn out to have been the strongest pace of the current expansion. The projected moderation is based on our expectation that the impact of the fiscal stimulus will fade and that financial conditions will continue to tighten this year. Despite the slowdown, with the economy continuing to grow, the expansion will become the longest on record.

While overall growth shined last year, details showed some troublesome spots. This was particularly true in the housing sector, in which lackluster single-family homebuilding and declining home sales were evident. Economic momentum slowed as financial conditions deteriorated toward year-end. The stock market fell sharply, volatility spiked, corporate credit spreads widened, and the yield curve flattened. In addition, a late-year budgetary impasse led to a partial federal government shutdown as a Continuing Resolution affecting approximately 25 percent of discretionary outlays expired. The shutdown is now the longest on record. There are potential upside offsets in the form of consumers and businesses: In the event they look past the domestic and international policy uncertainty and instead focus on strong employment and wage growth in recent U.S. economic data, growth could exceed expectations. These are data the Fed will be watching as it continues to be "data dependent."

Nonetheless, given growing downside risks, the Federal Reserve has turned more dovish, communicating its willingness to be "patient" in raising rates and to be flexible in response to incoming economic data. We believe that the slower pace of rate hikes this year will help to stabilize home sales. Thus, our theme for 2019 is "The Economy's Slowing, the Fed Slows, Housing Plateaus."

Economic Growth Shows Signs of Slowing...

The primary reason for our expected slowdown in growth going forward is consumer spending, which was the biggest driver of growth last year. In our December forecast, we expected annual growth in gross domestic product (GDP) in 2019 to decelerate to 2.3 percent; but, in light of continued stock market volatility and the government shutdown, we marked down our forecast for economic growth by one-tenth of a percentage point. This largely reflects a downgrade of real consumer spending growth in the first quarter to 1.9 percent annualized from 2.1 percent in the prior forecast. For all of 2019, consumer spending growth should slow to 2.3 percent from an estimated pace of 2.8 percent in 2018, as the boost in household incomes from the Tax Cuts and Jobs Act wanes. Auto sales, which exceeded 17.5 million units annualized in December for only the second time last year, will likely decline this year.



Incoming data suggest that business investment growth this quarter will remain below its performance during the first half of 2018. The Institute for Supply Management (ISM) Manufacturing Index fell further from the August 2018 peak to 54.1 in



December, indicating the slowest pace of growth in the sector since November 2016. The slowdown was driven by an 11 point decrease in the forward-looking new orders subcomponent. The durable goods orders report corroborated the ISM survey, as core (nondefense excluding aircraft) capital goods orders, which is a leading indicator of business investment in equipment, fell in November for the third time in four months.

The labor market ended the year on a high note. An impressive 312,000 jobs were added in December, the annual increase in average hourly earnings ticked up to tie the expansion best of 3.2 percent, and the labor force participation rate reached 63.1 percent, the highest level in over a year. Over the full year of 2018, the economy added 2.6 million jobs – the eighth consecutive year of job growth above 2.0 million and the biggest rise in three years.

The labor market should remain solid in 2019, although the pace of job growth is expected to slow as labor slack continues to diminish. As of November, the Job Openings and Labor Turnover Survey (JOLTS) showed that the number of job openings exceeded the number of people unemployed, corroborating reports of worker shortages. The December reading of the National Federation of Independent Businesses (NFIB) Small Business Optimism Index fell for the fourth straight month to 104.4, primarily because the net share of firms expecting the economy to improve plummeted to the lowest level since the Presidential election. Quality of labor remained the single most important problem for firms.

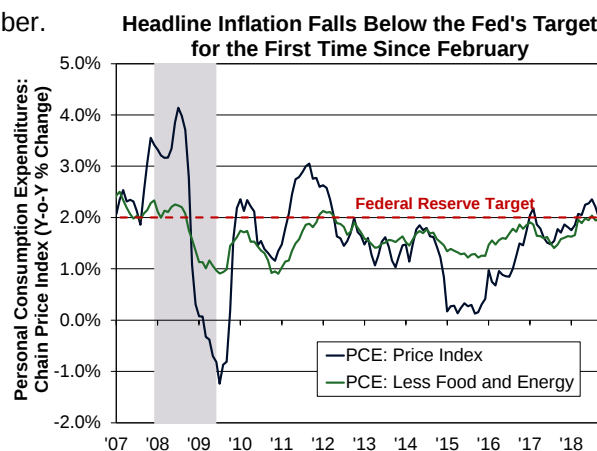
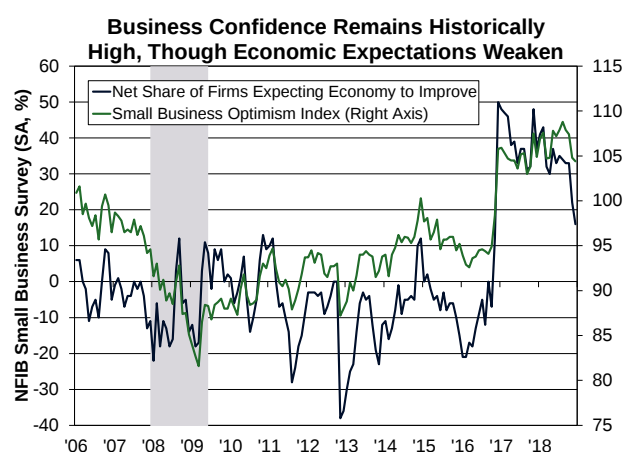
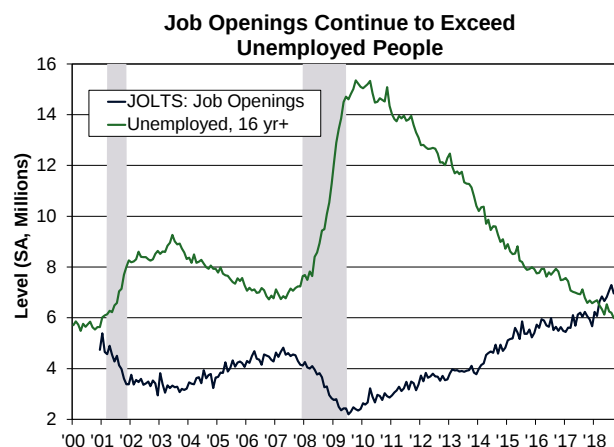
Although the labor market is tight, inflation remains contained. Annual growth in the personal consumption expenditures (PCE) deflator, the Fed's preferred measure of inflation, reached its recent peak at 2.4 percent in July 2018 and steadily decelerated to 1.8 percent in November. Annual growth in the core PCE deflator, which excludes volatile food and energy prices, ticked up to 1.9 percent in November, but remained below the levels seen during the summer.

...And Downside Risks to the Outlook Mount

Several downside risks could undermine our forecast for 2019. Stock market volatility continues, which could lower confidence and curtail spending. The Conference Board's consumer confidence index posted the largest monthly decline in three years in December as the expectations component plunged the most in five years.

Another dark cloud comes in the form of slower growth abroad, which could limit foreign demand for U.S. goods and services, adversely impacting U.S. exports and slowing domestic growth. Trade issues also present uncertainty to our forecast. The U.S. and China agreed to a 90-day truce beginning on December 1, which will freeze the tariff rate on \$200 billion in Chinese imports at 10 percent instead of increasing it to 25 percent on January 1 as planned. In light of the truce, the downside risks from trade frictions with China are temporarily removed, but uncertain prospects for a final resolution may derail some spending and investment activity.

The deceleration of global growth, particularly in China and Europe, as well as prospects for slower growth in the U.S. and trade tensions likely contributed to recent declines in business confidence. In addition to the downtrend in the NFIB Small Business Optimism Index late last year, the Conference Board's Measure of CEO Confidence fell from 55 in the third quarter of 2018 to 42 in the fourth quarter (readings below 50 indicate more negative responses than positive ones). Growing business pessimism could weigh on private investment and hiring.





The partial government shutdown, if persistent, also poses downside risks to our forecast. Economic analysis from Bank of America Merrill Lynch suggests that 0.1 percentage point will be shaved off of first quarter growth for every two weeks of the partial shutdown. Unpaid workers could delay spending, which could temporarily reduce consumer spending. In addition, businesses may temporarily forego investment given rising uncertainty. Economic data releases, most notably by the Bureau of Economic Analysis and the Census Bureau, will be delayed, eroding the base of information needed to assess the economy. Financial market stresses will likely worsen if the shutdown extends into the debate on the debt ceiling, which is due to be reviewed on March 2.

The partial shutdown will also have ramifications for housing. First, homeowners affected by the shutdown may find it increasingly difficult to meet their monthly mortgage payments. Absent intervention, such as forbearance, rising delinquencies and foreclosures could occur. Second, prospective homebuyers affected by the shutdown may delay a home purchase. While the direct impact on home sales is likely to be small, the effects could deepen if the government shutdown undermines broader homebuyer confidence. Fannie Mae's [Home Purchase Sentiment Index®](#) declined in December, but the drop did not reflect the government shutdown as responses were collected prior to its start. Results from the January release may reflect impacts from the shutdown. Third, the partial shutdown may disrupt some federal mortgage programs. The closure of the U.S. Department of Agriculture has halted activity under its Direct and Guaranteed Loan programs. While the Federal Housing Administration is open, it is operating with reduced staff, which may delay endorsements.

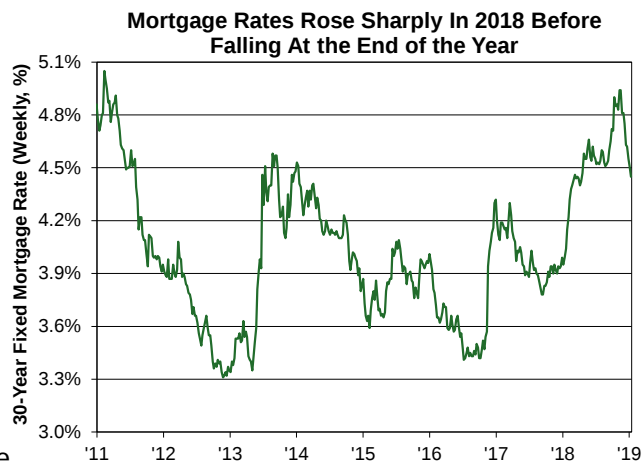
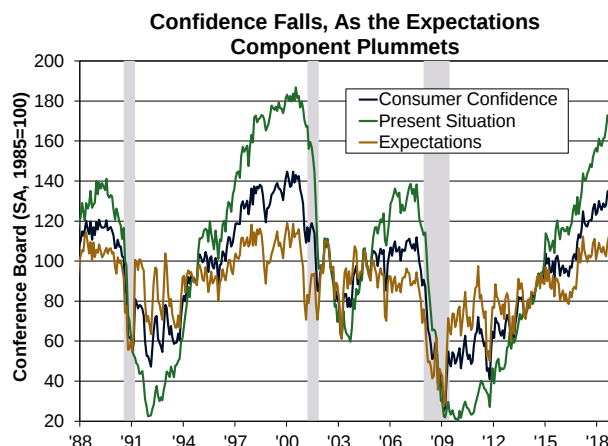
The Pace of Fed Tightening Should Slow...

The Fed expects economic growth to slow during 2019. The Summary of Economic Projections (SEP) released at the December 2018 Federal Open Market Committee (FOMC) meeting showed that the Fed expects economic growth of 2.3 percent in 2019, modestly slower than the 2.5 percent rate projected in September. The Fed also anticipates fewer rate hikes. The median federal funds rate projection in December implied two rate hikes in 2019, compared with the September projection of three hikes.

As of this writing, federal funds futures contracts that trade on the Chicago Mercantile Exchange imply no Fed rate increases in 2019. In addition, the minutes of the December FOMC meeting showed a dovish shift in the Fed's thinking. The Fed still expects "further gradual increases" in the federal funds rate, but acknowledged that it can "afford to be patient about further policy firming." In addition, Fed Chairman Powell remarked that the shutdown will postpone data releases, making it difficult for the Fed to assess the economy. We now expect the Fed to raise rates only once in 2019, in June, compared with two hikes in our December forecast, due to deteriorating financial market conditions, the Fed's increasingly dovish commentary, and muted inflationary pressure.

...Helping Housing to Plateau

We expect home sales to stabilize in 2019 after falling in 2018. Mortgage rates are expected to change little in 2019 from their level late last year of around 4.5 percent, allowing potential homebuyers time to adjust to the rate environment after the volatility experienced in 2018. When combined with our forecast of a slower pace of house price appreciation (4.2 percent in 2019 from 5.5 percent in 2018, according to the FHFA purchase-only Home Price Index), stable rates should support affordability and buyer confidence. At the same time, our forecast for continued job growth implies that the unemployment rate will remain near historic lows – a positive for wage growth and affordability. We expect single-family starts to grow modestly in 2019 as home buying firms. Although labor shortages will likely continue to frustrate builders, lower interest rates should help contain their borrowing costs. Multifamily construction, which has had a solid run since 2010, is expected to move down in 2019. However, solid labor market conditions and favorable demographic trends,





including household formations by Millennials, are expected to provide support to the multifamily sector in 2019. (For additional information on multifamily market conditions, please see the [January 2019 Multifamily Market Commentary](#).) Total residential investment, which includes new construction and home improvement spending as well as brokerage fees, is projected to rebound this year after contracting last year for the first time in seven years.

We have left our purchase mortgage originations forecasts for both 2018 and 2019 largely unchanged from the December forecast. However, we upgraded our 2020 purchase originations outlook slightly based on a more optimistic view of home price growth than in December. While a lower mortgage rate forecast led us to increase projected refinance originations in 2019 and 2020 by approximately \$10 billion and \$6 billion, respectively, we continue to expect refinance volumes to decline over the next two years.

Year in Review

Our 2018 theme, “Fiscal Policy and the Fed: Stimulus/Response,” underscored the crosswinds between fiscal and monetary policies that played out during the year. Fiscal boosts came from the Tax Cuts and Jobs Act and the Bipartisan Budget Act. Meanwhile, the Fed continued to normalize monetary policy by raising the federal funds rate four times in 2018, the most in the post-recession period. It also continued the process of shrinking its balance sheet, which started in October 2017, by letting Treasuries and agency debt and mortgage-backed securities mature and run off naturally.

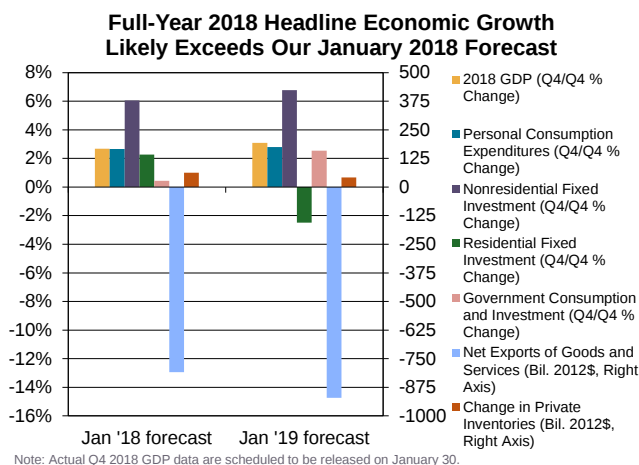
Our current estimate of headline 2018 real GDP growth of 3.1 percent exceeds our forecast from the beginning of last year by 0.4 percentage points. While consumer spending and overall nonresidential and inventory investment likely grew in 2018 roughly in line with our expectations, we made several misjudgments in forecasting other GDP components.

First, we did not account for impacts of the Budget Act, which was enacted in February 2018, when we prepared our forecast last January because of considerable uncertainty regarding its passage. This led to an underestimate of government spending in 2018 and contributed to the shortfall in our overall economic growth forecast.

Second, and related to the first point, U.S. economic strength prompted the Fed to raise rates two more times than we initially anticipated. In addition, the strong economy pushed long-term Treasury yields higher. As the Fed tightened monetary policy at a faster pace than our trading partners, who experienced weaker economic growth, the dollar kept strengthening. The real trade-weighted value of the U.S. dollar against other major currencies rose about 4 percent for the year. In addition, trade tensions intensified. The combination of tariffs, a stronger dollar, and slowing global growth resulted in a much larger trade gap than we had expected. Capital expenditures also disappointed as business investment in equipment growth slowed substantially from the pace in 2017. Anecdotal evidence from business surveys and the Fed’s beige book suggested that trade uncertainty may have caused some firms to delay investment.

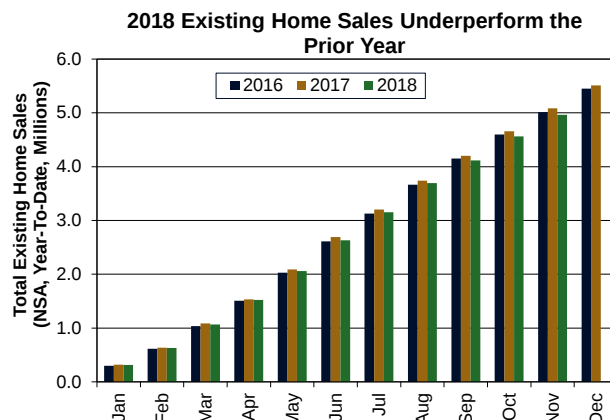
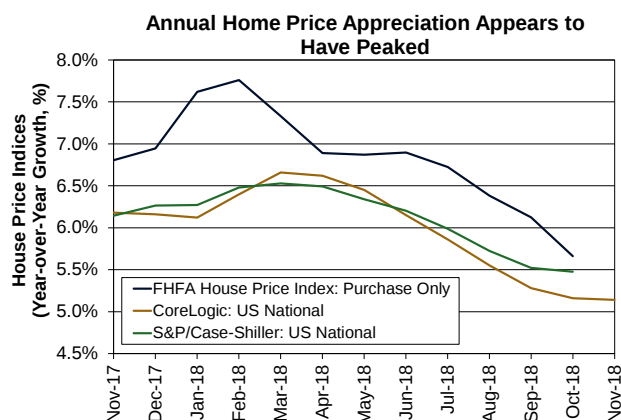
Third, we missed the mark on our forecasts of mortgage rates, housing activity, and residential investment. We had expected mortgage rates to rise gradually. At the same time, we had anticipated that the tax cut would help spur housing demand through increased disposable household income, despite some provisions that reduced the incentives for homeownership.

Throughout last year, concerns about housing affordability emerged as mortgage rates rose sharply, with the average yield on 30-year fixed-rate mortgages rising nearly 100 basis points between November 2017 and November 2018. For all of 2018, rates averaged 4.5 percent, 50 basis points higher than our forecast from last January. And while house price appreciation slowed in the second half of 2018, it remained strong. Shortages of skilled labor and rising input costs inhibited homebuilding activity amid tight inventory of existing homes for sale, resulting in home price appreciation that outpaced income growth, which in turn hurt affordability and home sales.





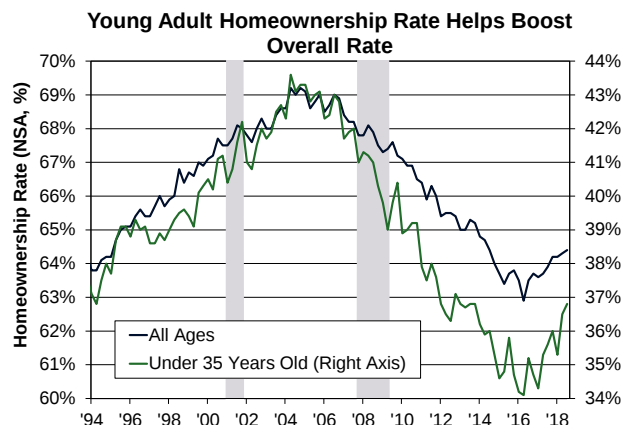
Existing home sales over the first 11 months of 2018 were 2.3 percent below their pace over the same period in 2017. Year-to-date new home sales through October 2018 were 2.9 percent higher than their level during the first 10 months of 2017. Total home sales are now estimated to have declined in 2018 for the first time in four years, dropping by about 2.0 percent rather than notching the 2.0-percent rise anticipated at the beginning of last year.



Single-family residential construction growth slowed in 2018. Single-family starts over the first 11 months of 2018 were approximately 4.0 percent ahead of their pace over the same period in 2017. Anecdotal reports collected as part of the National Association of Home Builders/Wells Fargo Housing Market Index indicate that builders responded to weaker demand stemming from reduced home buying affordability. However, multifamily starts were a bright spot, with activity through last November about 8.0 percent ahead of the pace during the same period in 2017.

Our current estimate for 2018 total mortgage originations falls short of the forecast at the start of the year by about \$100 billion, with more than 70 percent of the overly optimistic forecast stemming from the refinance segment.

Last year was not all bad for the housing market, however. Annual household growth was well above one million during each of the first three quarters of 2018, fueled by owner-occupants. The homeownership rate, which bottomed in 2016, continued to increase during 2018, with young adults faring particularly well throughout the year.



Economic & Strategic Research (ESR) Group

January 10, 2019

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: Bureau of Economic Analysis, Fannie Mae ESR, Autodata, Institute for Supply Management, Bureau of Labor Statistics, National Federation of Independent Business, The Conference Board, Freddie Mac, Federal Housing Finance Agency, CoreLogic, Standard & Poor's, National Association of REALTORS®, Census Bureau

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