Lower Mortgage Rates and Continued Wage Growth Provide Some Stability for Housing

U.S. economic growth is expected to slow from 3.0 percent in 2018 to 2.2 percent in 2019. The boost from the Tax Cuts and Jobs Act, which pushed economic growth to an expansion best in 2018, is expected to fade over 2019. Business investment and consumer spending are expected to slow, but residential fixed investment is expected to rebound in 2019 following a decline in 2018.

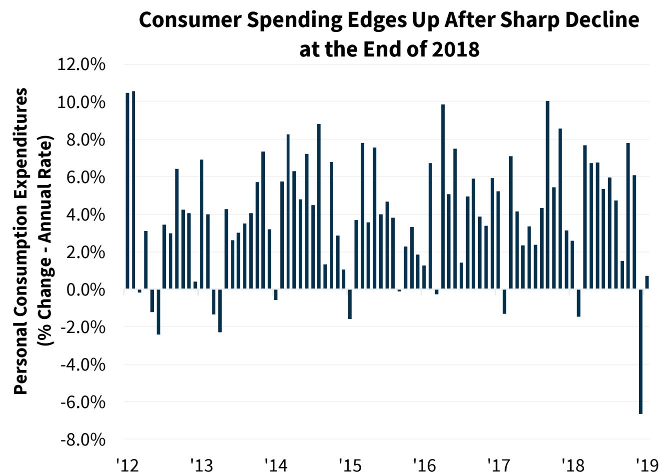
Incoming data indicate that domestic demand growth is slowing, which is consistent with our expectation of a deceleration in economic growth in 2019. We project economic growth to slow to 2.0 percent over the first half of 2019 from 2.8 percent over the second half of 2018. Economic growth in the second half of the year is expected to strengthen to 2.3 percent amid a patient Federal Reserve ("Fed") and easing financial conditions. Amid prospects for stronger economic growth over the second half of this year, we continue to expect the Fed to raise the federal funds rate once more this year in December, but we pushed our rate hike call back from October to December due to the Fed's plans to cease balance sheet reduction in September.

The risks to our macroeconomic forecast are currently balanced. The potential effects from the U.S.-China trade dispute and slowing global growth remain key downside risks, and while we assume that the federal government's debt ceiling will ultimately be raised in a manner that does not permanently erode economic activity, any flare-up in political tension associated with the process of raising the debt ceiling could weigh on business and consumer sentiment. Meanwhile, the recent rebound in the stock market, the reversal of the tightening of financial conditions since the beginning of the year, and the "patient" stance by the Fed are key upside risks to our forecast, along with a rebound in growth outside the U.S. if trade disputes and Brexit are resolved in a manner more favorable for business investment than is generally expected.

We expect healthy labor market conditions, slowing house price appreciation, and lower mortgage rates will support home sales, which we expect to fully recover in the first half of the year from the declines witnessed over the second half of 2018. However, a low supply of housing could derail our expectations. Amid projections of stable home sales and slower house price appreciation in 2019, we expect purchase mortgage originations to climb modestly. Due to falling rates, our projection of refinance originations improved from a steep year-over-year decline in our previous forecast to a more modest one. However, resolution of key downside risks to our macroeconomic forecast or faster domestic demand growth due to a patient Fed would likely push longer-term interest rates higher, which in turn could reduce housing affordability. Stronger economic growth prospects may also result in better than expected labor market conditions.

Consumer Spending Growth Remains Modest

Personal consumption expenditures (PCE) rose in January following a sharp decline in December. However, the annualized pace of growth was the slowest since December 2012, supporting our prediction of a significant slowdown in consumer spending in the first quarter. While spending edged up, personal income fell for the first time since November 2015. This dynamic pushed down the saving rate to 7.5 percent, though it remained near the three-year high reached in December. Also concerning was a decline in retail sales in February amid reports of tax return delays. Finally, while light vehicle sales in March grew at the fastest pace since September 2017, the month after Hurricane Harvey's landfall, declines in the prior two months caused quarterly sales to post the largest drop in two years.



The more cautious consumer behavior can likely be attributed to wariness after the fourth quarter's steep losses in equity markets. While the Standard and Poor's 500 Composite Index (S&P 500) rose 9.2 percent over the first quarter, it still did not fully recover from the large declines at the end of 2018. This caution should be temporary, however, and we predict a rebound in spending this quarter.

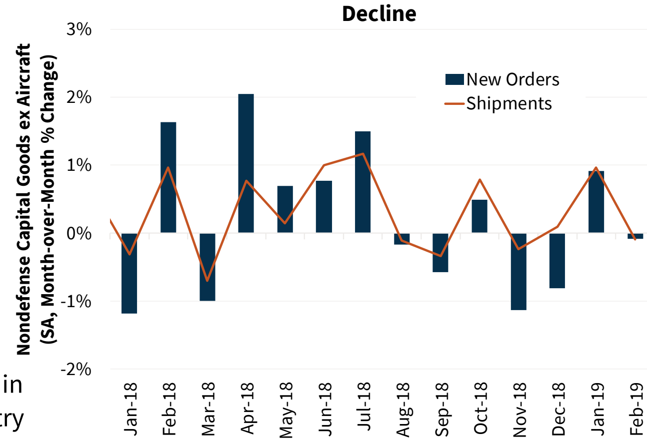
Business Investment Growth Moderates

Private non-residential construction spending fell in February but was likely due to below-average temperatures experienced over the month. The continued upward trajectory in employment growth suggests that non-residential construction spending should return to growth.

Shipments of non-defense capital goods excluding aircraft fell 0.1 percent in February and new orders, a forward-looking indicator of equipment spending, fell by the same amount. Weakness in shipments and new orders of non-defense capital goods suggests that equipment spending growth in the first quarter will moderate.

Looking past the first quarter, tariff hikes and trade policy tensions may continue to limit growth in business investment. According to estimates by the Federal Reserve Bank of Atlanta, tariff hikes and trade policy tensions lowered U.S. private sector gross capital investment expenditures by 1.2 percent over 2018, while 20 percent of surveyed businesses are reassessing their capital expenditure plans in 2019, signaling that the trade conflict may continue to weigh on industry growth.

Core Capital Goods Orders and Shipments Both Decline



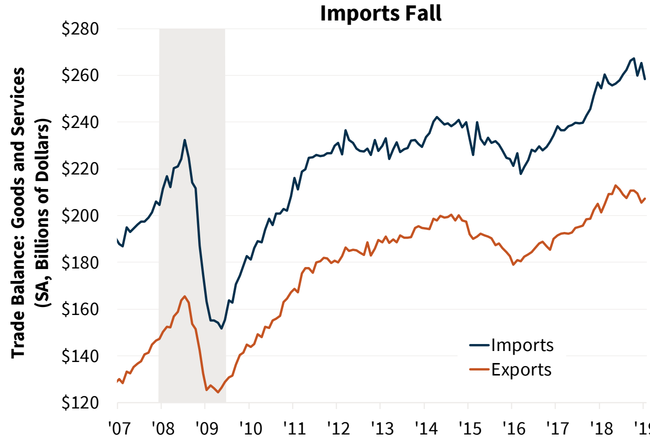
The recent news that Boeing intends to cut production of its 737 Max 8 aircraft by 19 percent contributed to the downward revision to our business investment forecast in the second quarter. We now expect nonresidential investment to grow 2.4 percent annualized in the second quarter, which would be the weakest growth rate in over two years.

Trade Deficit Narrows as Imports Fall

The U.S. trade deficit narrowed in January to $51.1 billion from $59.9 billion in December, which should support broader economic growth. However, the underlying details added to concerns that domestic demand growth is slowing. Although exports rose by 1.0 percent, the first increase since September, imports fell by 2.6 percent, the second large decline in three months.

The trade deficit is expected to widen this quarter, but the pace of growth in total trade may slow. Manufacturers responding to the March Institute for Supply Management survey indicated that while the pace of new export orders and imports are still expanding, growth in both fell to the lowest levels in over two years.

The Trade Deficit Narrows as Exports Rise and Imports Fall



Government Spending Growth Slowed by Shutdown, Expected to Recover

Government spending subtracted from GDP growth in the fourth quarter of 2018, partly reflecting a 6.0 percent decline in non-defense federal spending. Weakness likely continued in January due to the partial government shutdown. However, federal spending growth likely surged over the rest of the quarter following the government's reopening. Although the recovery from the shutdown should raise economic growth in the first quarter, federal spending is expected to wane later in the year as the effects of the Bipartisan Budget Act passed in early 2018 subside.

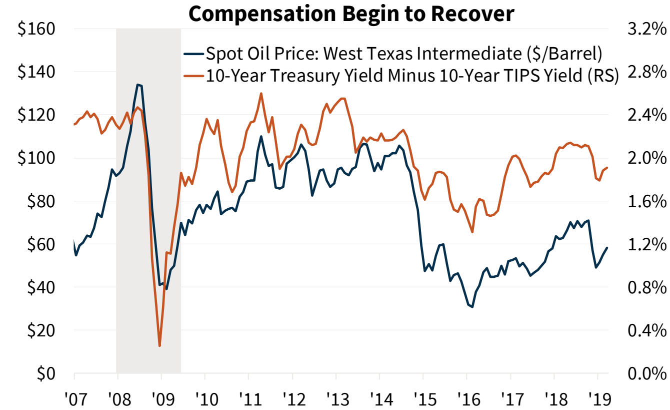
Inventories Climb

Amid signs of a slowdown in domestic demand growth, private inventories have picked up strongly. Largely in response to a significant upward revision in inventory investment, we raised our first quarter GDP forecast by five-tenths to 1.8 percent annualized. However, firms are expected to draw down inventories in lieu of additional spending and investment, which would likely weigh on economic growth in the second quarter.

Upside Inflationary Pressures Remain Muted

The Consumer Price Index (CPI) accelerated to 1.9 percent on an annual basis in March following four consecutive months of decelerating growth. Over the month, the CPI climbed 0.4 percent, double the rate of growth in February and the largest monthly gain in over a year. The spike in CPI was due to energy prices jumping 3.5 percent in March, the largest increase since September 2017, the month after Hurricane Harvey made landfall.

Energy Prices and Long-Term Inflation Compensation Begin to Recover

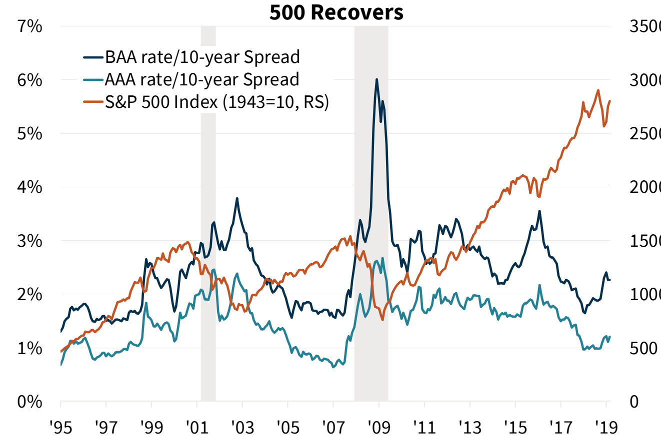


Crude oil prices have been recovering since the start of 2019 after declining over the fourth quarter of 2018. The increase in energy prices comes amid reports of large supply cuts in Saudi Arabia's production, which may be boosting longer-term inflation expectations, measured as the spread between the 10-year Treasury rate and the rate on 10-year Treasury Inflation Protected Securities (TIPS). However, core inflation, which excludes more volatile food and energy prices slowed to 2.0 percent, in line with the Fed's inflation target but the slowest pace of growth since February 2018.

Corporate Profits Decline in the Fourth Quarter

The final release of fourth quarter GDP included information on corporate profits, which fell 1.7 percent annualized, the first quarterly decline since the first quarter of 2017. Corporate risk premiums rose amid the decline in corporate profits in the fourth quarter. Despite a 17-basis point decline in the 10-year Treasury rate over the final three months of the year, the spread between the rate on AAA-rated corporate debt and the 10-year Treasury rate rose by 21 basis points, and the spread between the rate on BAA-rated corporate debt and the 10-year Treasury rate rose by 42 basis points. Over the same period, the stock market fell by 11.5 percent.

Corporate Risk Premiums Edge Down as the S&P 500 Recovers



Corporate earnings growth continues to be pressured by the effects of U.S.-China trade conflict, slower foreign economic growth, and tight labor market conditions. As of this writing, corporate risk premiums have not fully receded from the highs, although the stock market has rebounded from its decline.

Risks to Our Forecast Are Balanced

The rise in the stock market over the first quarter of this year presents upside risk to our forecast of economic growth. An increase in the stock market raises the value of household's financial assets and boosts consumer spending. The recent broad move upward in equity valuations comes amid easing financial conditions and a "patient" Fed, a dovish pivot following the rate hike and a call for "further gradual increases in the target range of the federal funds rate" at its December meeting. However, amid weaker corporate earnings, a rising stock market, and easing financial conditions, there is a risk of inflating asset bubbles.

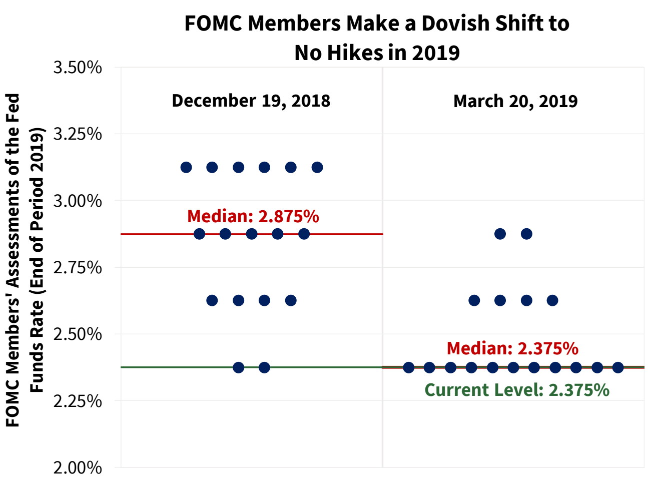
Several key risks could undermine our projection for economic growth. The U.S. and China have not resolved their trade conflict. Outstanding issues include protection for American intellectual property and an enforcement mechanism for the trade deal, such as the ability to impose tariffs on China with no threat of countering if China fails to honor the agreement.

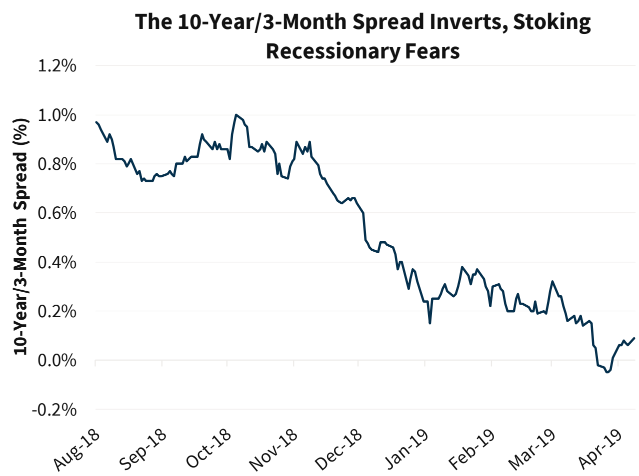
Foreign economic growth is slowing beyond the negative effects caused by U.S.-China trade tensions. A slowdown in global growth would likely drag on U.S. output partly due to reduced demand for U.S. goods and services. A decline in U.S. exports resulting from weaker demand would likely weigh on corporate earnings, which could heighten corporate risk premiums and increase financial market volatility, adversely affecting consumer spending. If foreign growth improved in response to policy measures announced across major foreign economies, including the Euro Area and China, U.S. economic growth could ultimately strengthen, and the 10-year Treasury yield would likely rise. Our forecast of slower U.S. growth this year along with a slowdown in global economic growth would likely lessen demand for crude oil, slowing headline inflation further. However, lower oil prices would also likely boost gasoline spending.

Recent European data have been particularly weak. A measure of industrial production in Germany showed annual declines in February, and Italy posted the second consecutive quarter of GDP contraction in the fourth quarter. Economic weakness prompted the European Central Bank (ECB) to announce in March that it will hold interest rates steady through the end of the year, as well as offer a series of cheap long-term loans to the region's banks. Growth slowed across the Chinese economy, driven by a multi-year deleveraging campaign in addition to tariffs placed on exports to the U.S. On a more encouraging note, policymakers in China implemented assorted monetary and fiscal stimuli earlier this year. The March reading of China's Purchase Managers Index, which measures manufacturing activity, rose unexpectedly from the prior month's three-year low, but the full effects of new economic policies will take some time to appear.

Healthy Labor Market Lowers Prospects of a Federal Reserve Rate Cut

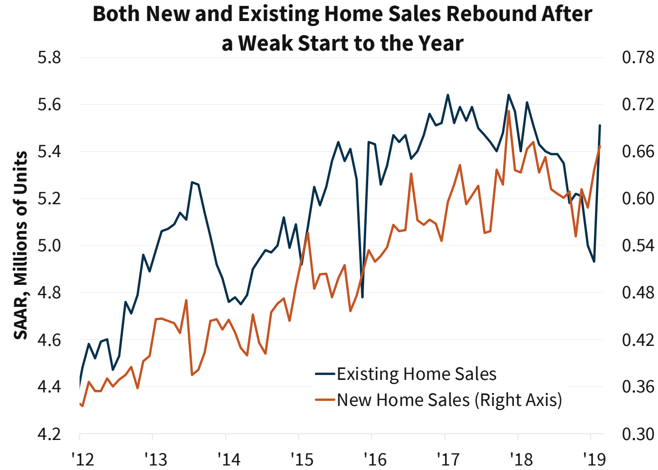
The Fed held its key policy rate steady at a range of 2.25 to 2.50 percent and reiterated its "patient" stance on monetary policy at its March meeting. The Fed also revealed its intention to slow the runoff of assets in May and cease the reduction entirely in September. The Summary of Economic Projections (SEP) showed no rate hikes in 2019, down from two hikes in the December SEP. These changes come amid an average expectation by Committee members of slower economic growth, higher unemployment, and softer inflation in 2019.





In the days following the meeting, the yield curve flattened and ultimately inverted for a short period of time. The yield curve inversion sparked recession fears because historically an inversion of the 10-year/3-month spread has preceded a recession by approximately 8 to 12 months. As of this writing, market participants expect a rate cut in 2019, but the March employment report helped calm recessionary fears. In March, the U.S. economy created 196,000 jobs, a strong rebound from the 33,000 jobs gained in February. In addition, the unemployment rate remained low at 3.8 percent. Amid tight labor market conditions, annual average hourly earnings growth slipped but remained near the expansion peak of 3.4 percent set in February.

Home Sales Show Signs of Life

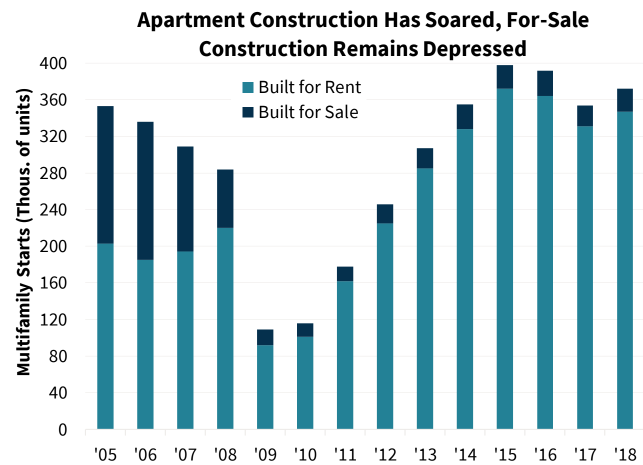


Home sales rose in February amid falling mortgage rates and slowing house price growth. Existing home sales rose 11.8 percent to 5.5 million in February, the largest monthly gain since December 2015 and the highest level since March 2018. Sales of new homes rose 4.9 percent to 667,000, also the highest level since March 2018.

Contract rates on the 30-year fixed-rate mortgage, reported by Freddie Mac, continued their descent, falling 10 basis points to 4.27 percent in March. Over the twelve months ending in February, the CoreLogic National House Price Index increased 4.0 percent, the slowest pace in over six years.

Fannie Mae's Home Purchase Sentiment Index (HPSI) jumped 5.5 points in March to 89.8, reversing last month's slight decline and reaching the highest point since June 2018. Housing demand should be further boosted by the rebound in job gains over March and relatively strong growth in average hourly earnings.

Low housing supply could derail the recovery in home sales. Despite a 2.5 percent increase in existing homes available for sale in February, the faster pace of sales pushed down the months' supply of homes to 3.5 months (not seasonally adjusted), its lowest level in a year. Strong sales of new homes helped lower the months' supply of new homes in February to 6.1 months (seasonally adjusted), the lowest level since last June.



Single-family starts fell 17.0 percent in February to a seasonally-adjusted annual rate of 805,000, offsetting the 19.2 percent increase in January. The near-term outlook for single-family construction remains modest as single-family permits, which take about a month to become starts, edged down 0.5 percent to 817,000. Although multifamily starts have recovered to their pre-recession levels, the number built for sale remains depressed, weighing on potential sales.

For more information on multifamily market conditions, please see the April 2019 Multifamily Market Commentary.

We continue to project home sales in 2019 will stabilize at their 2018 levels. The near-term outlook for home sales is mixed. Average monthly applications for purchase mortgages rose by 7.1 percent in March, but pending home sales fell 1.0 percent in February. However, lower mortgage rates, slowing house price growth, and strong job growth are reasons for optimism. While lower mortgage rates led us to raise our growth projection for the Federal Housing Finance Agency's Purchase-Only House Price Index in 2019 to 4.6 percent from 4.2 percent in our March forecast, we still expect house price growth to slow from 2018's 5.7 percent. If the economy strengthens as expected in the second half of the year, longer-term interest rates could rise, reducing affordability, but stronger economic growth would induce better than anticipated job gains, potentially boosting housing demand.

Given our forecast of stable home sales in 2019 and continued-but-slowing house price growth, purchase mortgage originations are expected to rise by 2.5 percent to $1.176 trillion. Amid the decline in mortgage rates, refinance originations are now projected to fall 2.2 percent to $446 billion. In our March forecast, refinance originations were forecasted to fall 8.6 percent to $417 billion.

Economic & Strategic Research (ESR) Group

April 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, Census Bureau, Energy Information Administration, Federal Reserve Board, Standard & Poor's, Moody's Analytics, National Association of REALTORS®*

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