

# Growth Exceeds Expectations, but a Slowdown Is Likely

First quarter growth in real gross domestic product (GDP) surprised to the upside at 3.2 percent annualized, accelerating from the fourth quarter pace of 2.2 percent. While this was the strongest first quarter growth in four years, details showed deceleration in both household and business spending growth. Half of the headline growth was due to increases in net exports and business inventories, which we believe are unsustainable. Thus, despite the strong first quarter pace, we expect full-year 2019 growth at 2.3 percent, just one-tenth higher than forecasted previously. For 2020, we believe growth should revert closer to trend at about 1.8 percent as fiscal policy impacts fade, with government spending no longer boosting growth in the second half of the year.

Risks to our forecast are roughly balanced. U.S.-China trade tensions will likely continue to be a headwind, while elevated corporate debt with lower credit quality remains a concern as it makes nonfinancial corporations more susceptible to external shocks. Offsetting these downside risks are slightly more sanguine prospects for global demand, stronger productivity growth, and an improved investment climate due partly to a now firmly “patient” Fed and equity valuations holding near all-time highs.

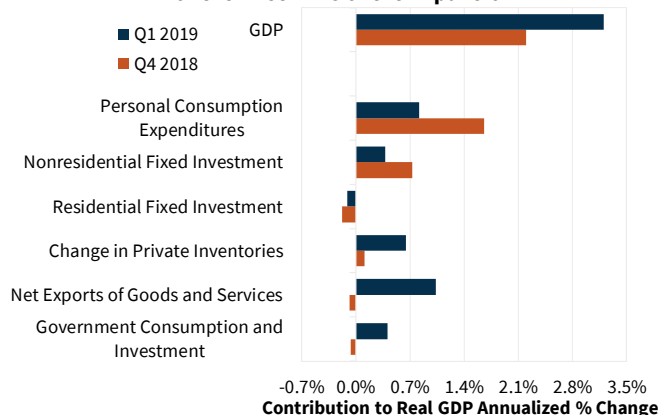
While residential investment dragged on growth for the fifth consecutive quarter to start the year, we expect to see an improvement this quarter. The spring home-buying season has been stronger than we expected, thanks to lower mortgage rates, and thus we revised higher our 2019 total home sales forecast from flat to a modest gain of 1.0 percent.

## Temporary Strength: Trade and Inventories

For the first time in this expansion, the largest contributor to first quarter growth was net exports, which contributed 1.0 percentage point to real GDP. Even though exports rose for the eighth time in nine quarters, much of the net gain in trade was due to the largest decline in imports since 2009. This could be a symptom of weakening domestic demand. Our forecast calls for net exports to drag on growth during the second half of the year.

Inventories were another contributor to first quarter growth that we expect to reverse for the rest of the year. Business inventories increased at the fastest pace in nearly four years, adding to growth for the third straight quarter. As with net exports, however, we expect inventories to turn into a drag on growth as businesses bring the pace of inventory building more in line with growth in final sales. Supporting that view, the National Federation of Independent Businesses reported in March that small businesses were concerned about excess inventories due to weaker sales. The net share of businesses planning to add to inventories turned negative for the first time since December 2017.

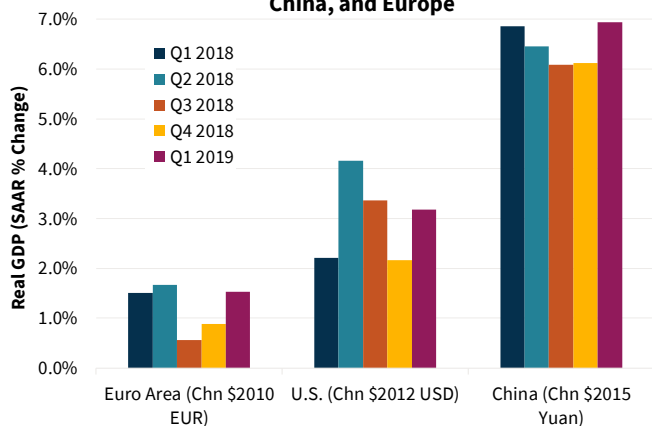
## Net Exports Are the Largest Contributor to Growth for the First Time of the Expansion



Final sales to domestic purchasers, a better gauge of the strength of domestic demand than headline GDP, rose 1.4 percent annualized in the first quarter, the slowest pace in more than three years. While we expect the measure to pick up this quarter,

the expected drags on growth from trade and inventories should lead to moderating growth in the coming quarters.

## First Quarter Growth Accelerates Across the U.S., China, and Europe



Abroad, first-quarter growth also beat expectations. The Euro Area grew at a 1.5 percent annualized pace, accelerating from the fourth quarter and above the European Central Bank (ECB)’s projected growth of 1.1 percent for all of 2019. While manufacturing activity shrank in the Euro Area and uncertainty over Brexit continues to loom over the continent, fiscal policy should help boost growth in the near term. France has pledged tax cuts in response to widespread protests, Germany has announced tax cuts and expenditure increases, and Italy is spending heavily on infrastructure.



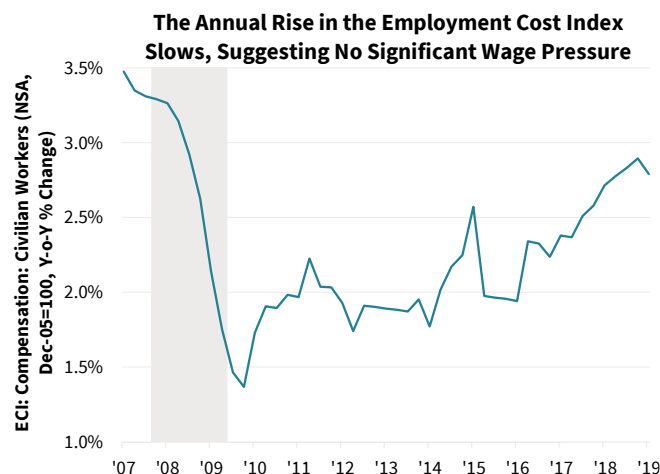
Meanwhile, China grew at 6.9 percent in the first quarter, significantly above its 2019 target of 6.0 to 6.5 percent. Despite a variety of stimuli, including tax cuts, increased government spending, and relaxed bank reserve requirements, downside risks to Chinese manufacturing have emerged and a gauge of Chinese factory activity fell sharply in April, suggesting the policies may not be enough to ensure sustained growth. Additionally, U.S.-China trade tensions escalated in early May when the U.S. unexpectedly hiked an existing 10 percent tariff on \$200 billion of Chinese goods to 25 percent and threatened to impose the same tariff on an additional \$325 billion in Chinese goods. Equity markets pulled back sharply in response not merely to the U.S.-China disagreement but also out of concern that it might portend a similar escalation in U.S.-Europe trade tensions.

## Consumer Spending Growth Poised to Pick Up

Personal consumption expenditures (PCE) grew just 1.2 percent annualized in the first quarter, the weakest pace in a year. Monthly data, however, showed that real consumer spending ended the quarter on a strong note, posting the largest monthly gain in two years in March. Strong PCE increases amid flat personal income pushed the saving rate eight-tenths lower to 6.5 percent, well below the nearly three-year high of 7.7 percent seen in December. However, consumers were cautious with credit card usage in March: while growth in nonrevolving credit (largely auto and student loans) held steady, revolving credit (largely credit card debt) declined for the first time in three months. Meanwhile, the Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices for the three months ending in April showed that the net share of banks tightening lending standards for credit card loans rose to the highest level since the end of 2009.

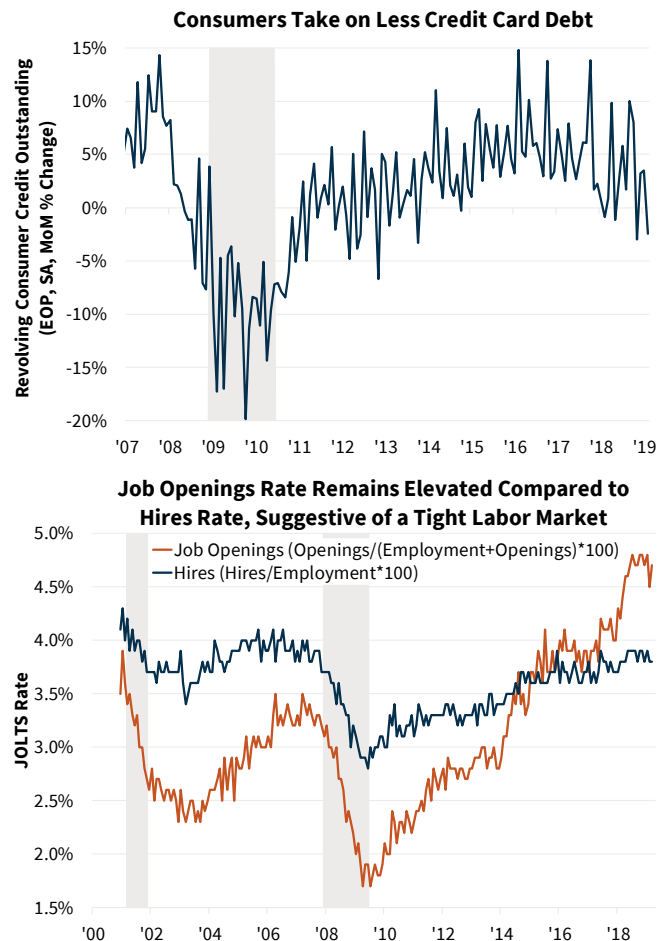
The March Job Openings and Labor Turnover Survey pointed to an extremely tight labor market, which should support continued strength in consumer spending. The job openings rate rose to 4.7 percent, just shy of January's all-time high, while the hires rate remained at 3.8 percent. The job openings rate has exceeded the hires rate for more than two years, and the number of openings has exceeded the number of unemployed persons for 12 straight months. The quits rate, a gauge of workers' confidence in the labor market, held steady at an expansion best of 2.3 percent for the tenth straight month.

The April jobs report confirmed the strength in the labor market, with nonfarm payrolls increasing by 263,000 jobs to continue its rebound from February's anemic gain. The stronger-than-expected gain helped boost the average monthly job gain for this year to 205,000, though this remains slightly below the average 2018 gain of 223,000. The U-6 rate, a broad measure of labor market



slack, held steady for the third straight month at 7.3 percent, the lowest level in 18 years. Other details of the April jobs report, however, were less rosy. The average workweek fell while the annual change in average hourly earnings has moved sideways in recent months after climbing steadily over 2018. The household survey results were mixed: the drop in the unemployment rate to its lowest level since 1969 came only because a drop in household employment was outpaced by a decline in the civilian labor force, pushing the labor force participation rate down to a seven-month low.

The first quarter Employment Cost Index, a measure of labor compensation that is free from the influence of employment shifts across occupations and industries, edged down one-tenth of a percent on an annual basis from the expansion high of 2.8 percent as





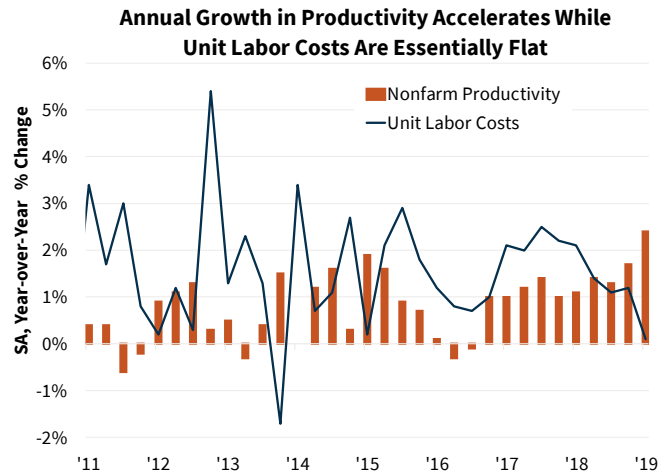
growth of the wages and salaries component as well as the benefits component slowed, indicating no significant wage pressure despite the tight labor market.

Consumers appear to remain upbeat. The University of Michigan Consumer Sentiment index declined modestly in April but has essentially moved sideways at elevated levels since the presidential election. When asked about financial prospects for the year ahead, 44 percent of surveyed consumers anticipated improvements compared with just 8 percent who expected worsening finances, marking the best net improvement share since 2004.

The jump in March consumer spending suggests increased momentum heading into the second quarter. Recognizing this strength combined with historically elevated consumer confidence levels and healthy labor market conditions, we expect real consumer spending growth to pick up noticeably this quarter.

## Business Fixed Investment and Productivity Growth

While trade and inventories exceeded our expectations, nonresidential fixed investment disappointed. Nonresidential fixed investment grew at a modest 2.7 percent annualized in the first quarter, driven almost entirely by investment in intellectual property products. Structures spending fell for the third straight quarter and equipment spending was essentially flat, edging up only two-tenths, the slowest pace in more than two years. While incoming data were mixed, we believe business investment growth will accelerate this quarter due to improved financial conditions and corporations' desire to increase productivity in response to tight labor market conditions.



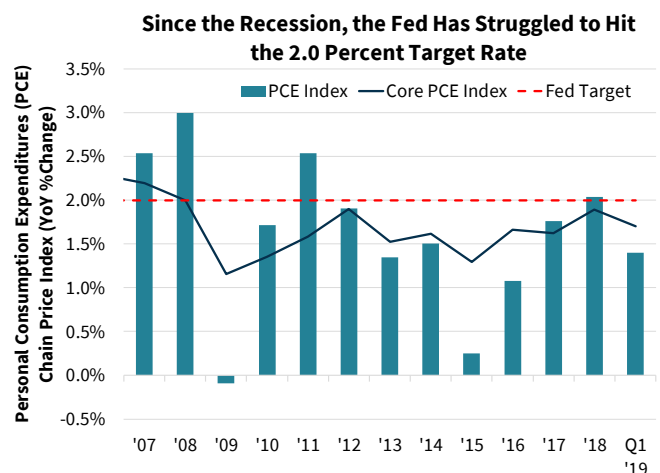
Productivity growth has helped to keep per unit labor costs contained. Productivity jumped 3.6 percent annualized over the first quarter, the biggest gain since the third quarter of 2014, and registered more than 2.0 percent annual growth for the first time since 2010. The rise in productivity during the first quarter applied downward pressure on the growth in unit labor costs, pushing down its annual growth to the slowest pace since the end of 2013.

We remain cognizant of several downside risks to nonresidential investment. The most prominent is the continuation of U.S.-China trade tensions, which may lead businesses to defer capital investments. Elevated levels of riskier corporate debt are also a concern as they make corporations more vulnerable to market shocks. The ratio of outstanding debt to GDP among nonfinancial firms is now near its all-time high. Not only is the nonfinancial corporate sector highly leveraged by historical standards, but credit quality in this space is also riskier than during past cycles. About half of outstanding bonds in 2018 were rated BBB, the lowest investment grade tier, up from one-third in 2000. As a result, a historically large portion of corporate borrowers may be susceptible to interest rate or liquidity shocks due to rising risk premiums or downgrades, potentially harming real economic activity.

## The Fed Struggles to Hit Its 2.0 Percent Inflation Target

Inflation pressures remain muted, thanks in part to productivity gains balancing out wage growth. The annual gain in the PCE deflator, the Fed's preferred measure of inflation, accelerated in March for the first time in eight months, though it remains one-half percentage point below the Fed's 2.0 percent target, and well below the six-year high reached last July. First quarter headline PCE averaged 1.4 percent, the slowest pace since the third quarter of 2016.

The statement following the May Federal Open Market Committee (FOMC) meeting acknowledged that both headline and core inflation "have declined and are running below 2 percent." In the post-meeting press conference, Fed Chair Powell attributed the recent slowdown in inflation to "transitory factors," such as portfolio management





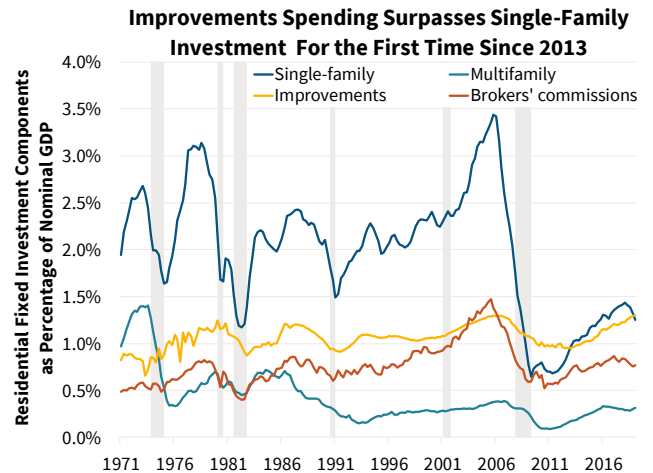
service fees and apparel prices, but inflation below 2.0 percent has been more of a norm than an exception in the current expansion. Since the expansion began, headline PCE averaged above or at 2 percent twice, while core PCE has always averaged below the 2.0 percent target.

Sustained below-target inflation will likely make it difficult for the Fed to raise the federal funds rate any further this year. Additionally, while we had been hopeful for a U.S.-China trade deal to boost growth in the second half of the year, that hope appears less likely, suggesting that the Fed will not see the substantial pickup in growth needed to justify a rate hike. Thus, we changed our call from a rate hike in December to no more hikes expected within our forecast horizon. This is consistent with statements from the Fed, such as Powell reiterating that the FOMC is comfortable with its patient stance and does not “see a strong case for moving in either direction.”

## Housing Drags, but We Expect a Rebound

Residential fixed investment fell during the first quarter for the fifth straight quarter, driven by the decline in spending on new single-family structures. While single-family starts increased during the first quarter, the spending on the construction of these structures fell as the average price declined. Improvement spending rose during the quarter and exceeded investment in single-family structures for the first time since 2013.

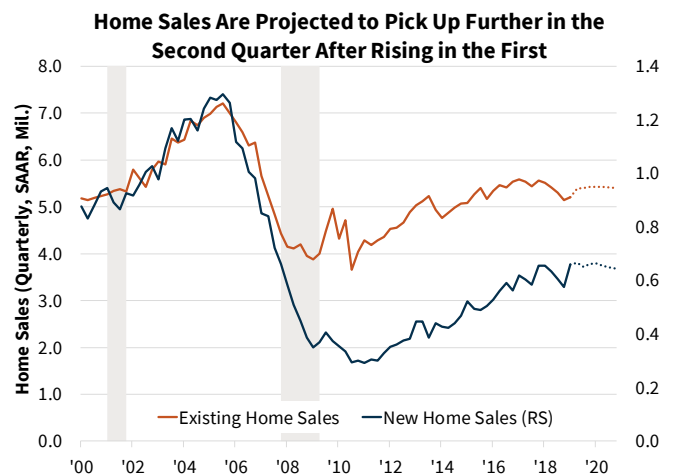
Brokers’ commissions, a part of residential investment, rose in the first quarter, thanks to a jump in new home sales and the first rise in existing home sales in five quarters. New single-family sales rose almost 15 percent over the quarter and were up slightly on an annual basis. The strong pace of new home sales was supported by drawing down inventories of already-started homes that had built up as sales slowed in 2018 in the face of higher mortgage rates. However, after peaking last November at an average of 4.87 percent, the 30-year, fixed mortgage rate has pulled back, falling about 70 basis points to 4.14 percent in April. The full effect of declining mortgage rates is likely still working its way through the market, adding further support for buyers. Builders likely still have a few months to go before inventories are back to their pre-slowdown trend, which should support new home sales in the second quarter, even if starts remain lackluster.



Another positive development for affordability and good news for entry-level homes is that builders are increasingly focused on more modest-sized homes. After peaking at more than 2,500 square feet in the first quarter of 2015, the median size of single-family starts trended down to about 2,300 square feet at the end of 2018. As the share of low- and moderate-priced new homes sold in the first quarter increased, the median price for new home sales fell 7.1 percent.

For existing homes, annual home price gains continued to moderate, with the CoreLogic National House Price Index rising 3.7 percent in March, the slowest pace since May 2012.

Overall, leading indicators suggest that the spring home-buying season will be solid, as we expected. Pending sales, a leading indicator of existing sales, jumped 3.8 percent in March, suggesting continued strength into April. Purchase mortgage applications have also been on the rise, increasing strongly in March and April. Thus, we revised upward our home sales forecast for the second quarter to show a solid rebound from the first quarter. When combined with our more optimistic view of new home sales for the year, total sales for 2019 were also revised upward seven-tenths from our prior forecast to a modest gain of 1.0 percent from 2018.



According to the Fannie Mae Home Purchase Sentiment Index, April survey respondents walked back some of their buying optimism from March, as an increasing share of respondents reported it was a bad time to buy (due largely to high home prices).



This mixed housing sentiment, the continued tightness in housing inventories, and elevated home prices relative to incomes will likely weaken sales momentum in the latter half of this year. Thus, after a solid rebound in the first half, total home sales are expected to moderate and level out by the end of the year, especially as economic growth slows heading into 2020.

The Housing Vacancy and Homeownership Survey showed a three-tenths decline in the homeownership rate in the first quarter to a seasonally-adjusted rate of 64.3 percent, the first quarterly decline since 2016. The annual pace of total household formation growth remained steady at 1.3 percent, bolstered by renter households that grew at the fastest pace since the end of 2016. Vacancy rates for multifamily rental units in the first quarter were unchanged from the year prior, indicating that supply growth matched demand growth.

For more information on multifamily market conditions, please see the [May 2019 Multifamily Market Commentary](#).

To be consistent with incoming applications data, we revised upward both our purchase and refinance mortgage originations forecasts for 2019, pushing expected total originations volume from \$1.62 trillion to \$1.66 trillion. We continue to expect purchase originations to rise given modest increases in home sales and continued, but slowing, home price growth. With mortgage rates beginning to stabilize at much lower levels than in 2018, we expect less of a decline in refinance volumes and have revised our forecast for 2019 refinance mortgage originations from a 2.2 percent annual decline to a 1.2 percent decline.

## 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:** Bureau of Economic Analysis, Statistical Office of the European Communities, China National Bureau of Statistics, Federal Reserve, Bureau of Labor Statistics, National Association of REALTORS®, Census Bureau, Fannie Mae ESR Group.

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