



Economic Developments - May 2016

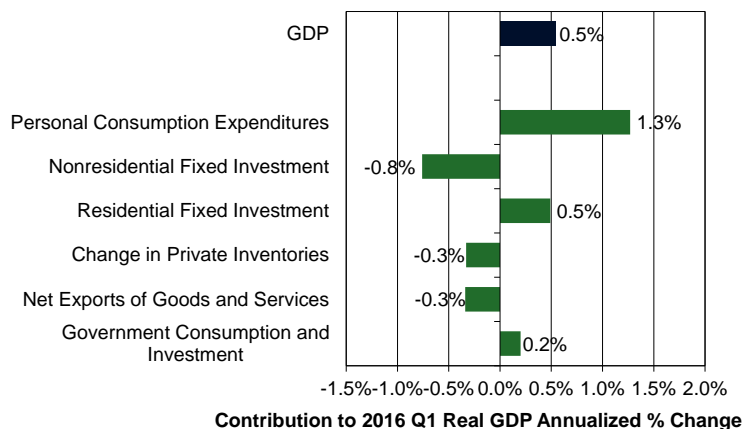
Full-Year Growth Downgraded Again

The economy posted the weakest growth rate in two years of 0.5 percent annualized in the first quarter versus our expectation of 1.2 percent. This marks the third year in a row that first quarter growth came in below 1.0 percent, although part of the weakness might result from measurement errors. In the past two years, economic growth bounced back in the second quarter, and we expect that this year will be no different. Financial conditions have improved over the past few months, with a weaker dollar, narrowing risk spreads, and rising equities supporting our forecast for a rebound in growth this quarter. We continue to expect growth to pick up during the last three quarters of the year, averaging about 2.0 percent. Full year 2016 growth should come in at 1.7 percent, a downgrade from 1.9 percent in the April forecast and from 2.2 percent projected at the start of the year. A sharp slowdown in China, dollar appreciation, and an intensified conflict in the Middle East are among the downside risks to the forecast.

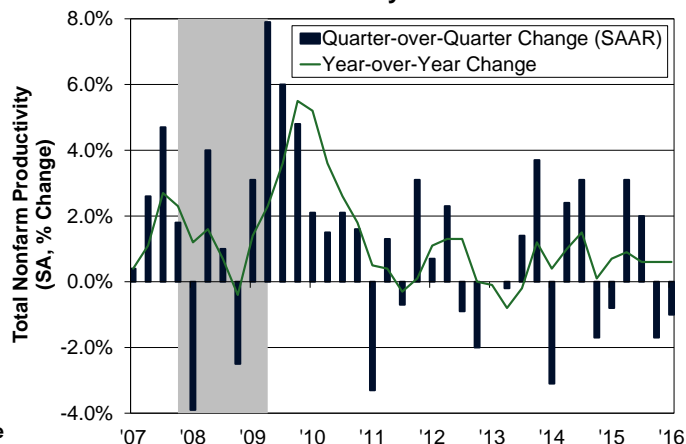
The first quarter slowdown in real gross domestic product (GDP) growth was broad-based across components of private domestic demand. Real consumer spending grew 1.9 percent annualized, the slowest pace in a year, weighed down by a contraction in durable goods consumption, especially in motor vehicles and parts. Business investment in equipment showed the largest decline of the current expansion, partly reflecting weak global growth, the strong dollar, and a domestic profit squeeze. The drop in investment in structures was the worst since the first quarter of 2011 due to a plunge in oil and gas drilling. Net exports and inventories also dragged on growth. One bright spot was residential investment, which added 0.5 percentage points to growth, the largest contribution since the fourth quarter of 2012. The recent budget deal also provided modest stimulus from the government sector. We expect both the housing and government sectors to contribute to growth for all of this year.

Given the weak economic output, nonfarm labor productivity fell at a 1.0 percent annual rate in the first quarter and has grown at just a 0.6 percent rate over the last year. Unit labor costs accelerated during the quarter, and weak productivity growth and rising unit labor costs, if sustained, will continue to weigh on profits.

Housing Supports Growth



Productivity Growth Is Dismal



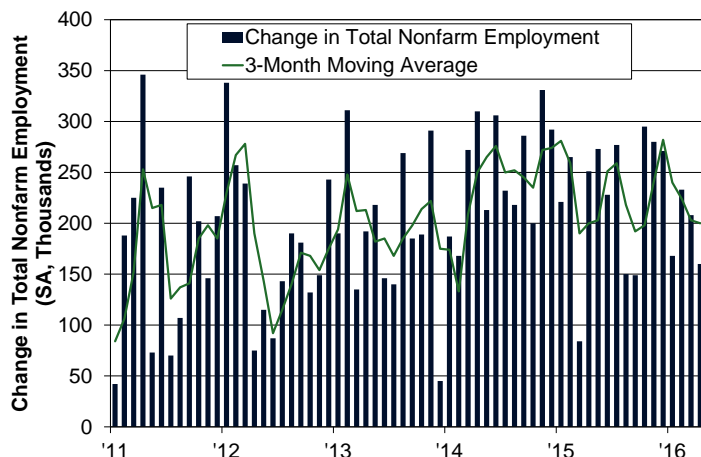
Labor Market Loses Some Momentum

April brought a slower pace of job creation, as nonfarm payrolls increased 160,000, compared with the 203,000 average over the prior three months. However, the average workweek ticked up, and average hourly earnings increased 0.3 percent from March and 2.5 percent from April 2015. While the pickup in wage gains is encouraging, the gains remain within the narrow range of 2.0 percent to 2.6 percent witnessed over the past year. Both the pickup in hours worked and in wage gains suggest an acceleration in labor income in April, which should help support consumer spending.

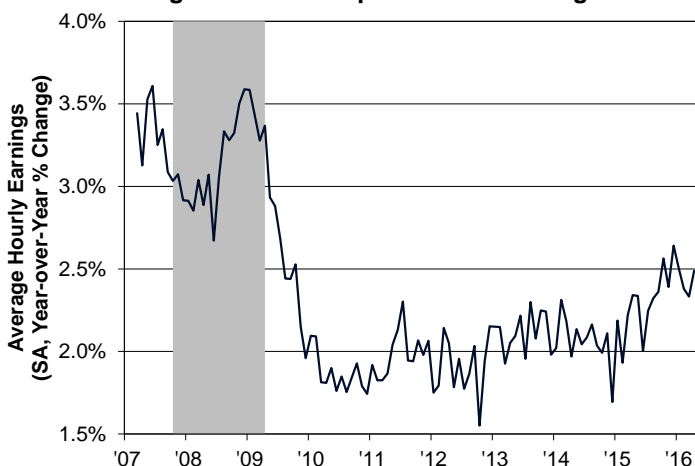
The household survey component of the jobs report also disappointed. The labor force participation rate gave back some of the increases of the past six months, dipping two-tenths to 62.8 percent. The unemployment rate remained at 5.0 percent for the fifth time over the past seven months, but a modest decline in part-time workers who want a full-time job helped push the broadest measure of the unemployment rate (U-6) to 9.7 percent, tying the expansion low.



Job Creation Has Slowed



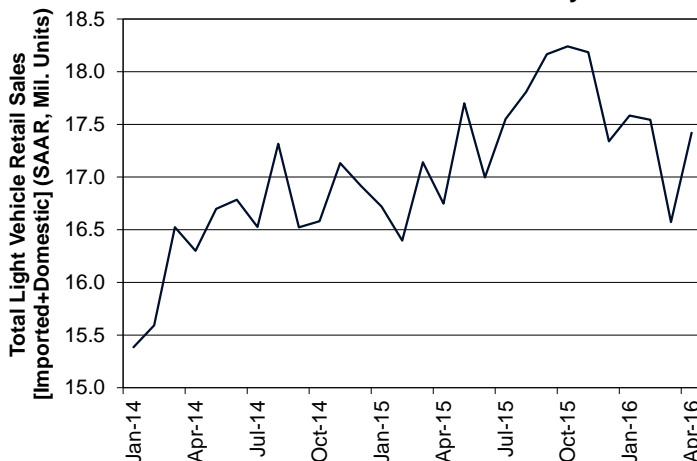
Wage Gains Pick Up But Remain Range-Bound



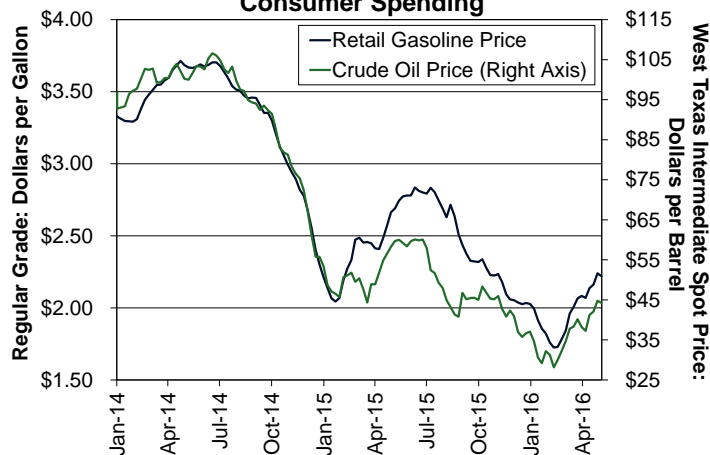
Consumers Are Cautious...

Consumers appeared to exercise a great deal of caution at the end of the first quarter. Real consumer spending was flat in March despite a 0.3 percent rise in real income, resulting in a three-tenth gain in the saving rate to 5.4 percent, the highest level in over a year. Greater consumer caution might be partly due to rising gasoline prices, which have rebounded somewhat since crude oil prices bottomed in February. While it is possible that consumers will remain cautious and continue to build up savings, especially with gasoline prices rising further in April, we expect a moderate rebound in consumer spending growth in the current quarter. April auto sales rose 5.1 percent, largely reversing the drop in March. Through the first four months of this year, sales have averaged about 17.3 million vehicles annualized, about 3.2 percent above sales during the same period in 2015. Given that full-year 2015 sales totaled 17.4 million units, the best year since 2000, the trend in auto sales so far this year remains healthy. In addition, revolving consumer credit (largely credit card debt) rose at a healthy clip in March, and the Fed's Senior Loan Officer Opinion Survey for the three months ending in April showed that banks reported an increased willingness to lend to consumers amid stronger demand for consumer loans.

Vehicle Sales Remain at a Healthy Pace



Rising Energy Prices Could Suppress Future Consumer Spending



...And So Are Businesses

Factory goods orders increased in March, but the gain was largely driven by defense orders and price-related increases in energy items for nondurables. Core capital goods orders — a leading indicator of business capital investment — were upwardly revised to 0.1 percent from unchanged, suggesting continued lackluster capital expenditures. Business capital investment declined sharply during the first quarter in response to compressed profit margins. Political uncertainty stemming from the upcoming presidential election may also be weighing on businesses' plans to invest in coming months.

The sharp decline in non-residential investment in structures in the first quarter largely reflected slumping investment in oil drilling structures and oilfield machinery stemming from the collapse of oil prices since mid-2014. Outside of drilling, growth of business fixed investment has been reasonably healthy. We expect the drag on structures investment from the



energy sector to dissipate over time because oil prices have rebounded and because the sector has become smaller over the past two years. Meanwhile, we expect the inventory correction to continue through 2016 in response to an unsustainably high pace of accumulation in the first half of 2015. After 2016, we expect inventory investment to stabilize and remain roughly neutral for economic growth.

Net Exports Will Continue to Subtract from Growth

Net exports subtracted 0.3 percentage points from growth in the first quarter, marking the third consecutive quarter that the sector has subtracted from growth and the biggest drag in a year. The main driver for this trend is the jump in the trade-weighted value of the dollar since summer 2014 in both nominal and real terms. While the dollar has reversed some of that gain more recently, it remains well above mid-2014 levels. We expect trade to drag on growth this year and next year.

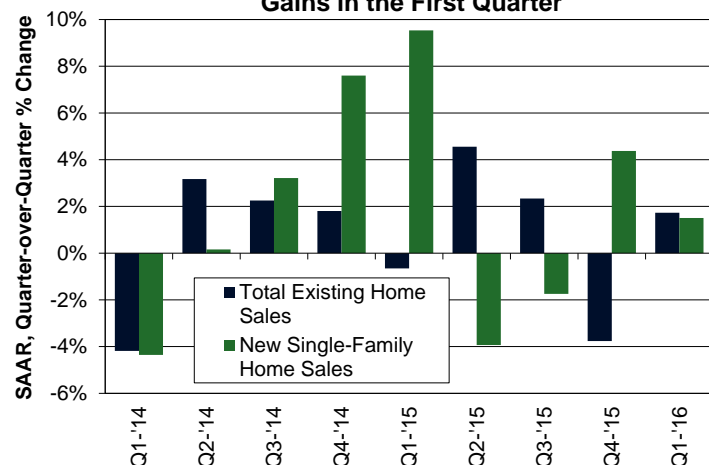
The Fed Will Likely Hold in June

The April Federal Open Market Committee (FOMC) post-meeting statement suggests that the Fed was less worried about financial turmoil abroad as it dropped the reference that “global economic and financial developments continue to pose risks.” However, it pledged to “closely monitor” those developments as well as inflation indicators. Overall, the statement suggests that a June rate hike remains on the table, though the fed funds futures put the odds of a June hike at just 6.0 percent. In the April forecast, we expected only one rate hike in 2016, with the timing likely to be during the second half of the year. We remain convinced that the vote on the U.K. referendum to leave the European Union, which will occur only about a week after the June 14-15 FOMC meeting, will likely keep the Fed from raising rates in June. In addition, the risk of a Greek default and exit from the Eurozone has been forestalled but not eliminated, with the influx of immigrants fleeing Syria and Iraq likely to weigh further on the government’s budget.

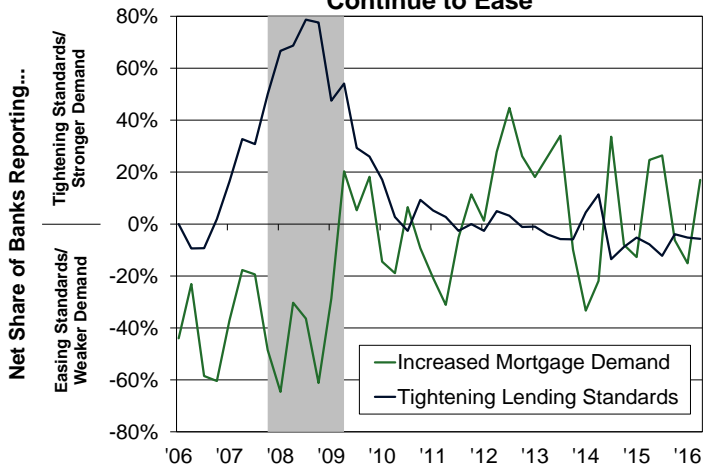
Housing Roundup

Home sales moved moderately higher in the first quarter of 2016 from the prior quarter despite lackluster month-to-month activity. New home sales fell in March for the third consecutive month, while total existing home sales rebounded in March but failed to completely reverse the sharp drop in February. Through the first three months of this year, existing home sales and new home sales were 5.6 percent and 1.5 percent higher, respectively, than sales during the same period last year. Leading indicators suggest that home sales will pick up going into the spring season. Pending home sales rose in March for a second consecutive month, and the average purchase mortgage application index picked up 4.0 percent in April for a second straight month, as the average 30-year fixed mortgage rate edged lower in April from March, according to Freddie Mac. In addition, the Fed’s Senior Loan Officer Opinion Survey for the three months ending in April showed that banks reported having eased lending standards on most types of residential mortgage loans amid firming demand.

New and Existing Home Sales Post Modest Gains in the First Quarter



Mortgage Demand Rises as Lending Standards Continue to Ease



Homebuilding activity disappointed in the first quarter. Both total housing starts and building permits declined from the prior quarter, with volatile multifamily (more than one unit structures) starts being the culprit, dropping for the third consecutive quarter after a surge in the second quarter of 2015, partly due to the sharp increase in the Northeast before construction tax incentives in New York State expired. One of the main headwinds for multifamily construction is excess supply of upper-end apartment buildings in the top ten most populous cities. However, affordable rental units have plenty of room for growth. (For more information on rental market conditions, read the [May 2016 Multifamily Market Commentary](#)). The financing environment for new multifamily construction has become more difficult, according to the



Fed's Senior Loan Officer Opinion Survey, as a net percentage of banks reported tightening lending standards for multifamily commercial real estate (CRE) loans over the past three months, a second consecutive quarter of tightening.

Year-over-year comparisons are positive for the single-family segment, with single-family starts about 22 percent above the level in 2015, compared with flat multifamily starts. Nonetheless, the trend in the single-family segment was still lackluster, as the double-digit gain was from still-depressed levels.

Meanwhile, the main measures of home prices, including the Case-Shiller, the FHFA purchase-only, and the CoreLogic indices, showed strong annual appreciation of 5.3 percent to 6.0 percent during the first two months of 2016. Lean inventory and declining distressed sales have continued to support home price gains.

The homeownership rate has shown tentative signs of stabilizing, according to the Census Bureau's Housing Vacancy Survey. The homeownership rate (not seasonally adjusted) for the first quarter of 2016 edged down 0.3 percentage points from the prior quarter and 0.2 percentage points from one year ago to 63.5 percent, a level around which the rate has hovered for the past four quarters. One factor helping to support the overall rate is that the large Baby Boom generation is still at a point in the life cycle with high homeownership rates, which has helped offset the low homeownership rates among the even larger Millennial generation in young adulthood.

Our forecast for mortgage rates is little changed from the prior forecast, with 30-year fixed mortgage rates at 3.7 percent during the fourth quarter of 2016. We raised our total home sales forecast in 2016, as the upward revision in existing home sales slightly outpaced the downward revision in new home sales. We revised lower our outlook for single-family and multifamily starts this year.

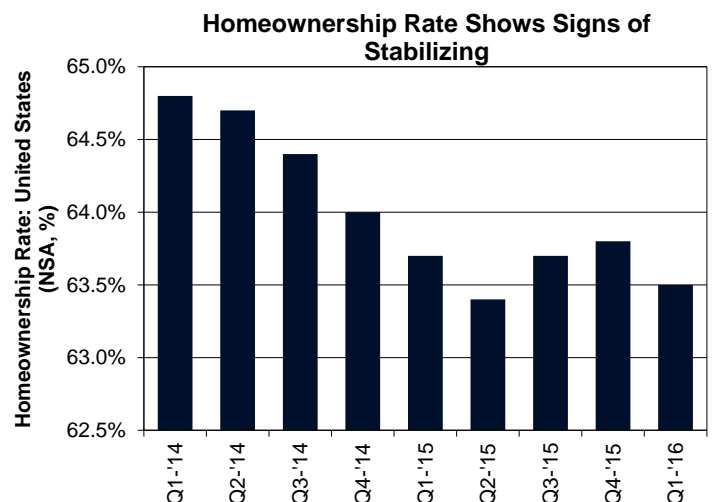
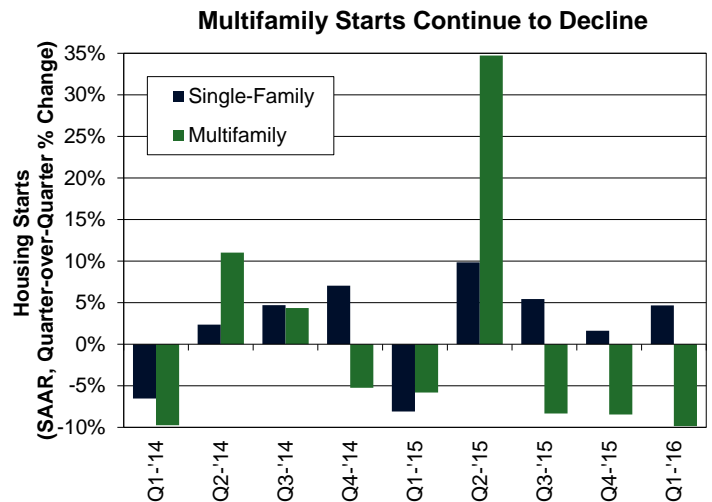
For mortgage originations, incoming data for 2016 for both purchase and refinance originations have been stronger than we expected, leading us to upgrade our estimates for the first quarter and for the rest of 2016. For purchase originations, we lowered our assumed share of home sales using cash through the first quarter of 2017. For all of 2016, we expect total mortgage originations to decline 3.7 percent from 2015 to \$1.65 trillion, as the 18.8 percent drop in refinance originations outpaces the 9.4 percent rise in purchase originations. The refinance share should decline to 39 percent in 2016 from 46 percent in 2015. Total originations should decline further in 2017, as a drop in refinance originations continues to outweigh an increase in purchase originations. We project total production volume to be \$1.45 trillion in 2017, with the refinance share sliding further to 30 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: Bureau of Economic Analysis, Bureau of Labor Statistics, Autodata Corporation, Energy Information Administration, Census Bureau, National Association of REALTORS®, Federal Reserve Board





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