



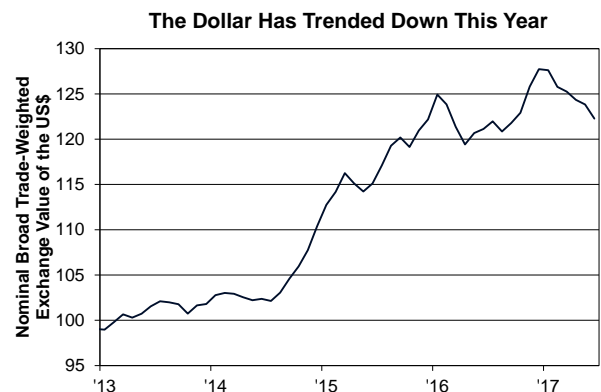
### Economic Developments – July 2017

## Moderating Growth Expected in the Second Half; Housing Supply Still Lagging

Incoming data continue to suggest a rebound in economic growth in the second quarter from first quarter growth, but somewhat weaker than we anticipated in the prior forecast. We expect growth to slow to an average of 1.9 percent for the second half of the year, compared with an estimate of 2.1 percent for the first half. Overall, our projected full-year growth remains at 2.0 percent, the same view we have held since February. We expect housing won't be a drag this year but won't make a huge contribution either as supply remains a problem.

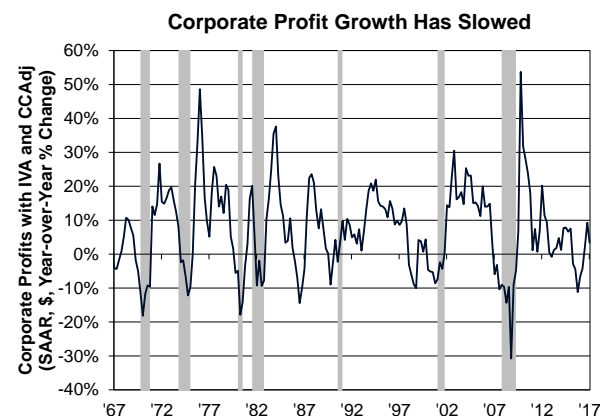
The global economic growth outlook has improved, as reflected in communications from several major central banks. Late last month, European Central Bank (ECB) President Draghi delivered a bullish assessment of the growth and inflation outlook in the Euro area. The financial markets viewed this as groundwork for the ECB to taper quantitative easing later this year. Bank of England Governor Carney stated that monetary stimulus could be removed if business investment and net exports strengthen enough to offset weakness in consumer spending and if wage growth picks up.

These bullish outlooks moved Treasury yields higher, with the 10-year Treasury rising about 25 basis points over the past two weeks to 2.39 percent at the time of this writing. Improving growth abroad, combined with a decline in the dollar of about 4 percent so far this year, should help improve U.S. manufacturing and exports, which deteriorated substantially after the dollar started to strengthen in 2014.



### Growth in the Rearview Mirror Improves

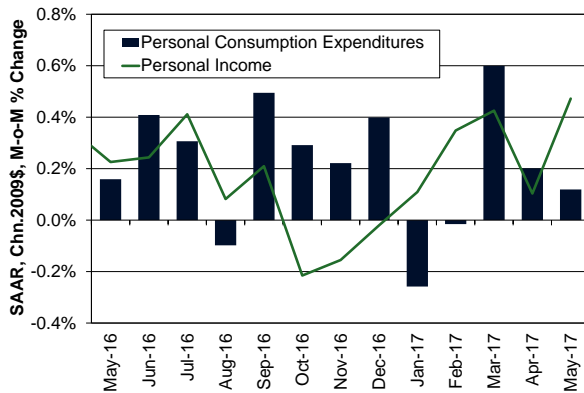
First quarter economic growth was revised higher to 1.4 percent annualized in the third estimate of gross domestic product (GDP). The latest upgrade reflected stronger consumer and government spending and more favorable net exports than initially reported, which offset downward revisions in residential and nonresidential investment and inventories. Corporate profits, which fell for the first time in three quarters, were revised lower to show a bigger drop. The quarter-to-quarter decline was broad-based. Profits in the domestic financial sector posted a drop for the first time in five quarters, while those in the nonfinancial sector fell for the second consecutive quarter. Overseas profits were revised from an increase in the initial estimate to a decline, the first drop in four quarters. While year-over-year changes in overall corporate profits remained positive for the third consecutive quarter following five straight quarters of declining annual profits, the rate of increase has slowed markedly to 3.3 percent. Declining profits or modest growth are generally seen late in the business cycle.



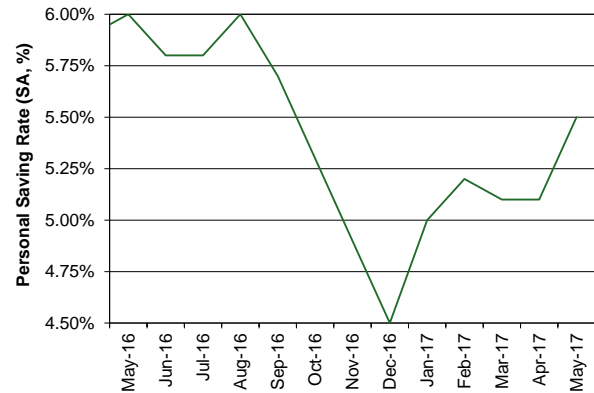
We expect second quarter economic growth to rebound to 2.7 percent annualized, supported by a pickup in consumer spending growth to 2.9 percent, a slight downgrade from the previous forecast. While real consumer spending picked up strongly in March following back-to-back drops, building momentum into the second quarter, it grew only modestly in April and May. May real consumer spending edged up just 0.1 percent despite a 0.5 percent jump in real personal income. As a result, the personal saving rate rose four-tenths to 5.5 percent. Between December and May, the saving rate rose a full percentage point, suggesting increasing caution among consumers. In addition, vehicle sales declined in June for the fifth time this year to the slowest sales pace since February 2015, despite lower gasoline prices and sizeable dealer incentives. However, lending standards for auto loans have tightened in recent quarters in response to deteriorating loan performance. We expect that vehicle sales and production will be a drag on the economy this year after sales peaked in 2016.



**Consumers Are Cautious**

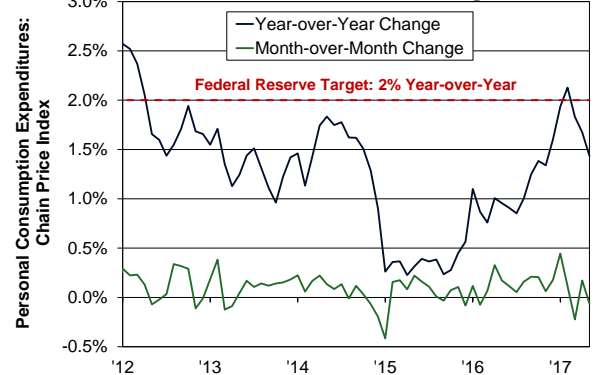


**The Saving Rate Has Climbed This Year**



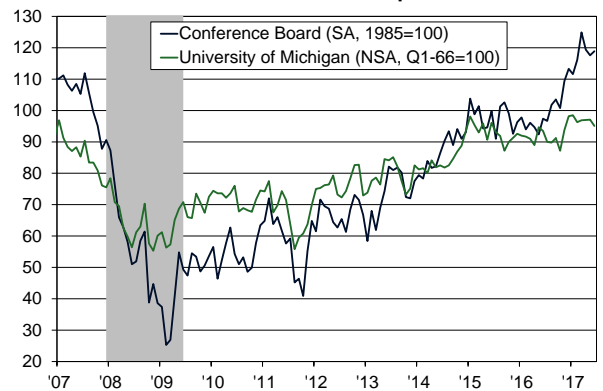
Meanwhile, the Fed's favored measure of inflation, which is tied to consumer spending, has moved further below the two-percent target. The Personal Consumption Expenditures (PCE) deflator fell 0.1 percent in May, the second decline in the past three months, pushing annual inflation lower to 1.4 percent. Excluding food and energy, the core PCE deflator increased 0.1 percent from April and 1.4 percent from last May. Declining inflation in healthcare expenditures, which account for nearly one-fourth of core PCE, has partly restrained core inflation. So far, Fed officials have attributed the recent weakness in inflation to transitory factors. The minutes to the June Federal Open Market Committee (FOMC) meeting note that, "most participants" felt that softness in inflation was driven by "idiosyncratic factors, including sharp declines in prices of wireless telephone services and prescription drugs."

**Fed's Favored Inflation Measure Falls Further Below the Two-Percent Target**



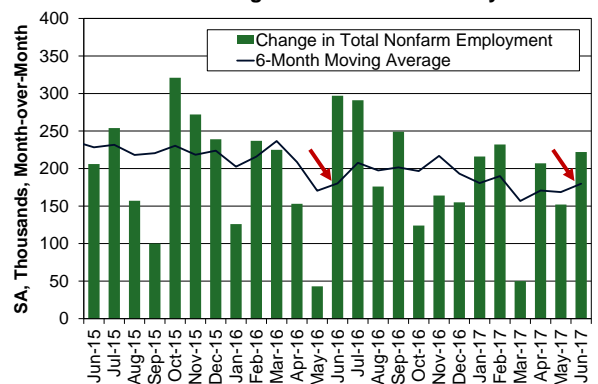
Sluggish consumer spending growth has occurred amid historically high consumer confidence, but even that has pulled back somewhat from the recent peaks witnessed after the Presidential election. Declining gasoline prices and rising stock prices have likely helped support confidence.

**Consumers Remain Optimistic**



Positive labor market conditions have also supported the consumer. According to the most recent jobs report, nonfarm payrolls increased 222,000 in June and gains in the prior two months were revised higher by 47,000. The monthly job gain during the first half of this year averaged 180,000, the same as registered during the first six months of 2016. The average workweek edged up one-tenth in June to 34.5 hours.

**Hiring Trend Remains Healthy**

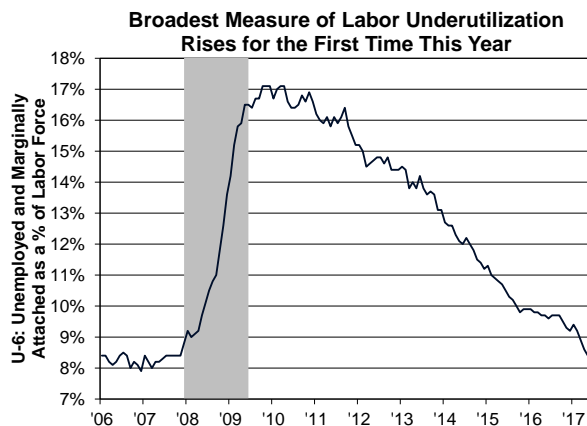
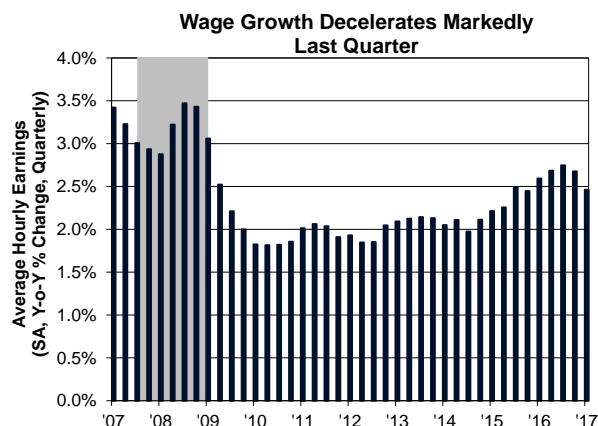


Despite solid job growth, accelerating wage gains remain elusive. Average hourly earnings rose 0.2 percent from May and 2.5 percent from a year ago, where it has hovered for most of the year. Earnings growth can be volatile from month to month. On a quarterly basis, annual growth for the second quarter moderated to the slowest pace since the first quarter of 2016.

Other news from the June jobs report was mixed. While the unemployment rate edged up one-tenth to 4.4 percent, it was due to labor force growth outpacing employment gains and pushing the labor force participation rate up one tick to 62.8 percent. On a disappointing note, the broadest measure of labor underutilization (the U-6 rate),



which includes discouraged workers and part-time workers who prefer full-time jobs, rose two-tenths to 8.6 percent after declining for four consecutive months.



## The Fed Stays the Course

The June jobs report should create no sense of urgency and allow the Fed to stay the course of gradual monetary policy normalization. The minutes of the June FOMC meeting showed no consensus on when the Fed should begin to wind down its \$4.5 trillion balance sheet. “Several” participants preferred to announce the policy change “within a couple of months.” Others wanted to defer until later in the year to allow the Fed more time to assess the economic and inflation outlook. We now expect the Fed to announce its policy to taper the balance sheet in September and hike the fed funds rate once more this year in December.

## Housing Roundup

Recent housing data, especially those related to homebuilding, have come in soft. Single-family starts fell in May for the second time in three months and permits dropped for the third consecutive month. Similarly, multifamily starts decreased for the fifth straight month to the slowest pace since last September and permits also fell. The declining trend in multifamily construction reflects the mature state of the sector’s expansion. Recent declines in the single-family sector might reflect payback from the boost caused by unseasonably warm weather earlier in the year. In addition, a shortage of workers likely remains a constraint on construction activity because new homes have been selling well and the number of single-family homes authorized but not started has climbed significantly this year from a year ago.

Through the first five months of this year, single-family starts were about 7 percent higher than the same period last year, compared with a decline of about 5 percent for multifamily starts. Because of the unexpected weakness in single-family construction, we revised lower our full-year projection of single-family starts to a gain of about 6 percent, versus approximately 9 percent growth in the May forecast. We expect multifamily starts to decline slightly this year from last year, the same view expressed in the prior forecast.

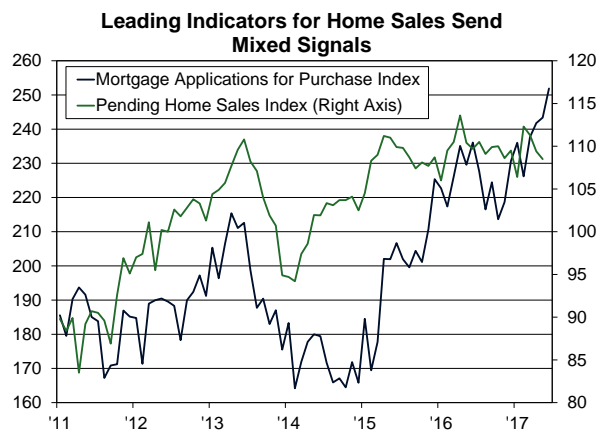
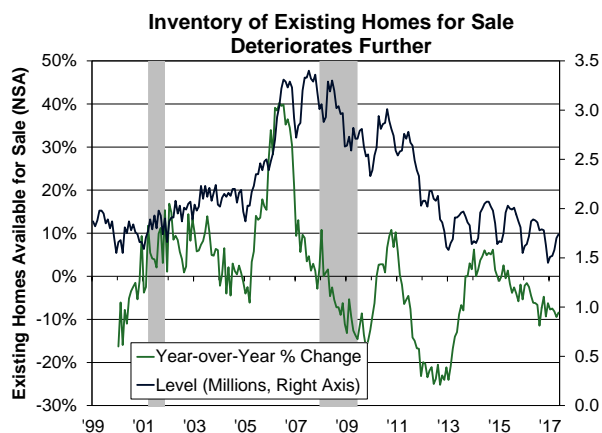
Private residential construction spending also fell in May for the first time in more than a year, reflecting a pullback in both units built and average construction cost per unit. After rising at a double-digit annualized pace in the first quarter, real residential investment likely fell modestly in the second quarter, dragging on GDP for the first time in three quarters.

Home sales have been more encouraging than housing starts. New home sales rose in May on the heels of sizable upward revisions. Existing home sales also rose during the month, reversing some of the decline in April. Year-to-date through May, total home sales increased 3.9 percent from the same period a year ago, roughly tracking with our forecast for a 3.3 percent rise for all of 2017.

The lack of inventory continues to constrain sales. For-sale inventory of existing homes fell 8.4 percent from last May’s level and has been posting year-over-year declines since June 2015. The months’ supply declined to 4.2 months from 4.7 months last May. The average time on the market fell to a fresh record low of 27 days, down from 29 days in April and 32 days a year earlier.



Recent trends in leading indicators of home sales are mixed. On a positive note, average purchase mortgage applications rose in June for the fourth consecutive month amid a decline in average fixed mortgage rates to the lowest level since November. By contrast, pending home sales fell in May for the third consecutive month.

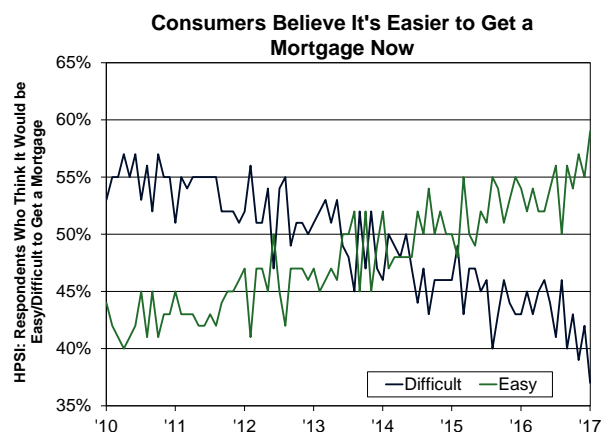
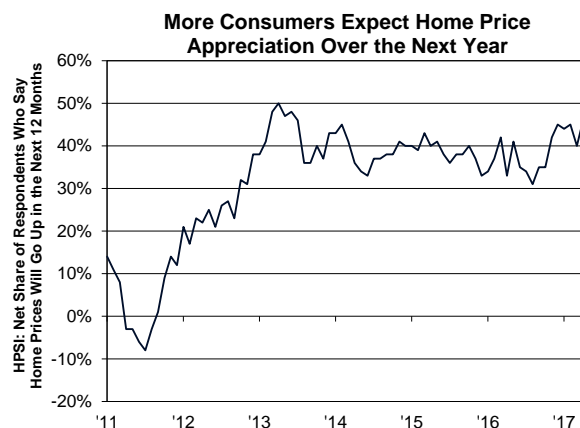


An extremely tight inventory of homes for sale continues to support home prices, with main measures of home prices posting an annual gain of between 5.5 percent (S&P Case-Shiller) and 6.9 percent (Federal Housing Finance Agency) in April. In May, the CoreLogic Home Price Index rose 6.6 percent from a year ago, with lower-priced homes experiencing significantly stronger appreciation. For example, prices in the lowest tier (75 percent or less of the median) rose 9.4 percent from a year ago, while prices for the low-to-middle tier (between 100 and 125 percent of the median) posted an 8.1 percent year-over-year gain. With the continued robust pace of home price appreciation, we revised higher our projected home price forecast for the rest of this year.

Consumers are also more optimistic regarding the home price outlook, according to the Fannie Mae [National Housing Survey](#). The June survey showed that the net share of consumers expecting home prices to go up over the next year jumped 6 percentage points to 46 percent, the highest reading since September 2013. The survey also showed that more consumers believe it is easy to get a mortgage and fewer think it is difficult to obtain one. The gap between the share of consumers saying it is easy to get a mortgage and the share believing it is difficult widened to 22 percentage points, the biggest difference since the survey's inception in 2010.

Consumers' view of mortgage credit accessibility is consistent with results from surveys of lenders, including the Federal Reserve Board Senior Loan Officer Opinion Survey in Bank Lending Practices and Fannie Mae's [Mortgage Lender Sentiment Survey](#), both of which showed that lenders continued to ease lending standards during the second quarter. The latter survey indicated that lenders also expected credit standards to ease further in the current quarter. By easing credit standards lenders attempt to increase access to homeownership; however, given the extremely lean supply, they may also put additional upward pressure on home prices and reduce home purchase affordability. Resulting affordability challenges might be especially pressing for potential first-time home buyers who, unlike trade-up buyers, are unable to reap the benefit of rapid home price appreciation in their existing properties.

Mortgage rates have supported housing demand and should continue to do so through the rest of the year. We expect 30-year fixed mortgage rates to average 4.1 percent in the fourth quarter, compared with 4.0 percent last quarter. Given our lower projected single-family starts but higher projected home price trends, we revised slightly higher our purchase mortgage originations forecast for





this year. For refinance originations, our forecast for the first half of the year was little changed, but we increased moderately our projection for the current quarter. As a result, we expect total single-family mortgage originations to drop about 20 percent in 2017 to \$1.65 trillion, with a large decline in the refinance share from 48 percent in 2016 to 34 percent in 2017.

For information on multifamily market conditions, read the [July 2017 Multifamily Market Commentary](#).

## **Economic & Strategic Research (ESR) Group**

July 10, 2017

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:** Federal Reserve Board, Bureau of Economic Analysis, Conference Board, University of Michigan, Bureau of Labor Statistics, National Association of REALTORS®, Mortgage Bankers Association, Fannie Mae.

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