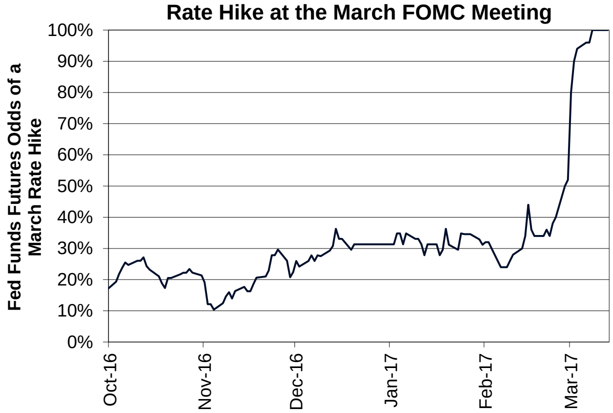
Economic Developments – March 2017

Fed Signals It Won't be Behind the Curve

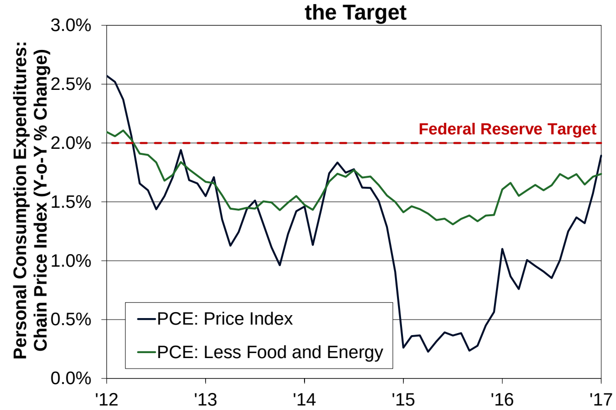
Our growth forecast has remained unchanged over the past month, with full-year growth of 2.0 percent still expected for 2017. Given current developments, we're comfortable with our assumption that materially positive impacts from any new fiscal stimulus will be limited in 2017. We are also aware that some potential new policies could be detrimental to growth. Our view is consistent with the Fed's discussion in the minutes of the January 31-February 1 Federal Open Market Committee (FOMC) meeting. FOMC participants view potential expansionary fiscal policy as presenting upside risks to their forecasts, with some noting that several potential policy changes could pose downside risks. Thus, we note both downside and upside risks to our two-percent growth forecast this year.

Between the release of the FOMC meeting minutes on February 22 and the end of the month, fed funds futures' odds of a March rate hike was a tossup. However, subsequent hawkish remarks from Fed officials, including those by Fed Chair Janet Yellen on March 3, led the futures market to quickly reprice its expectations, with odds of a March hike reaching 100 percent on March 8. Yellen noted that if the Fed waits too long to withdraw monetary stimulus, it runs the risk of having to raise rates more rapidly down the road. Overall, Fed officials' remarks suggest that employment and inflation environments have recently evolved in a way that supports a rate hike. Even without more clarity on fiscal policy, the Fed appears ready to continue monetary normalization this month. Meanwhile, the Fed's favored measure of inflation—the Personal Consumption Expenditures (PCE) deflator—jumped 0.4 percent in January from the prior month and 1.9 percent from last January, the strongest annual rise since October 2012 and just one-tenth below the Fed's target. Excluding food and energy items, core inflation was relatively stable, rising 1.7 percent from a year ago for the fifth time in six months.

Futures Market Fully Prices in a Fed Funds Rate Hike at the March FOMC Meeting



Fed's Favored Inflation Measure Approaches the Target

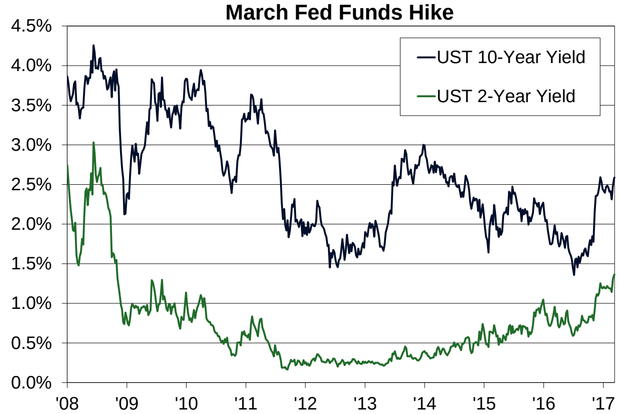


Measures of inflation expectations have also risen over the past month. For example, the 5-year Breakeven Rate trended up to around a two-year high at the time of this writing. Treasury yields have also moved higher, with the yield on 2-year Treasuries rising to an expansion high. Overall, we see developments in the job market and inflation consistent with hawkish remarks from the Fed, and we expect to see a rate hike next week followed by two additional rate increases this year.

Inflation Expectations Hover Near a Two-Year High

*The difference between the nominal yield on the 5-year Treasury and the yield on 5-year Treasury Inflation-Protected Securities.

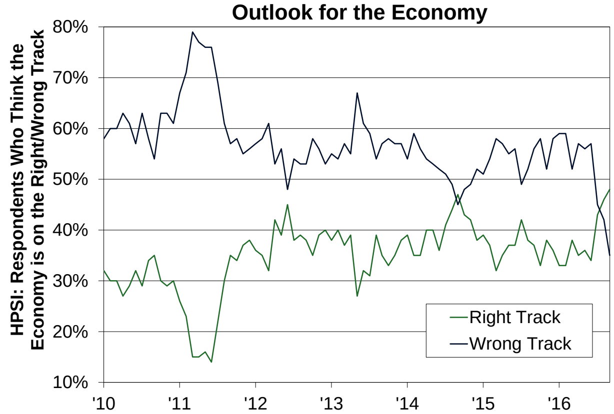
U.S.Treasury Yields Rise in Preparation for a March Fed Funds Hike



First Quarter Growth Poised to Slow Again

First quarter economic growth will likely slow from the final quarter of last year, marking the fourth consecutive time that growth has decelerated to start the new year. In the prior forecast, we expected real gross domestic product (GDP) growth this quarter to be little changed from last quarter, which remained at 1.9 percent annualized in the government's second estimate. However, incoming data suggest that our previous forecast was too optimistic, leading us to revise lower our current-quarter economic growth forecast to 1.6 percent. The main culprit was consumer spending. Despite half a percentage point upgrade in real consumer spending in the fourth quarter to 3.0 percent annualized in the second print of fourth quarter GDP, January real consumer spending fell 0.3 percent, the biggest drop in three years, amid flat real personal income. Some of the weakness came from a downturn in utility spending, which should reverse if more seasonable temperatures return. In addition, some analysts argued that later-than-usual tax refunds, due to additional vetting to prevent fraud, may have depressed consumer spending in January. February consumer-related data showed that auto sales edged down to a 17.6 million annualized pace. Given the drop in January consumer spending and flat February auto sales, we downgraded first quarter real consumer spending growth by half a percentage point to 1.9 percent.

Consumers Have a Change of Heart Over the Outlook for the Economy

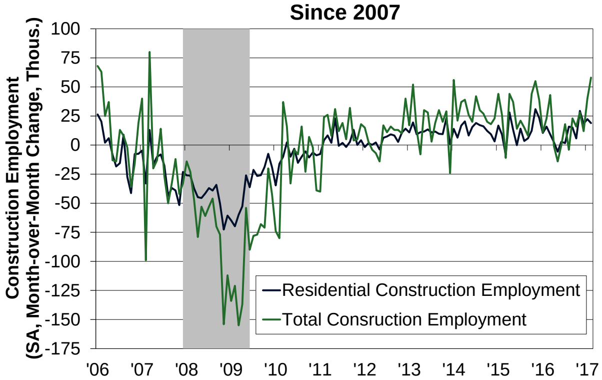


While hard data on consumer spending disappointed, surveys of consumer confidence remained upbeat. The Conference Board consumer confidence index rose in February to the highest level since July 2001. Meanwhile, the University of Michigan consumer sentiment index dropped only modestly in February from an expansion high in the prior month. The February Fannie Mae National Housing Survey® continued to show post-election bullishness, with the share of consumers saying the economy is on the right track rising for the third straight month to reach the highest level since the survey's inception in 2010. The share of consumers saying the economy is on the wrong track also fell for the third straight month to a fresh survey low.

Despite signs of a marked slowdown this quarter, consumer spending should continue to drive growth this year, supported by improving labor market conditions. The February jobs report showed back-to-back strong job gains, with nonfarm employment rising 235,000 on the heels of modest revisions to the prior two months. The three-month average job gain climbed to more than 200,000, the best showing since last September, and annual growth in earnings rebounded to 2.8 percent, just below the expansion high of 2.9 percent seen at the end of last year. The strong headline job gain in February was boosted by the largest monthly increase in total construction payrolls since 2007, thanks to the unseasonably warm weather during the month. Residential construction payrolls also posted a solid gain, extending a string of at least 18,000 jobs added per month since last November. The household survey showed the unemployment rate edged down to 4.7 percent despite a large jump in the labor force, and the broadest measure of the unemployment rate (U-6) fell two-tenths to 9.2 percent, tying an expansion low.

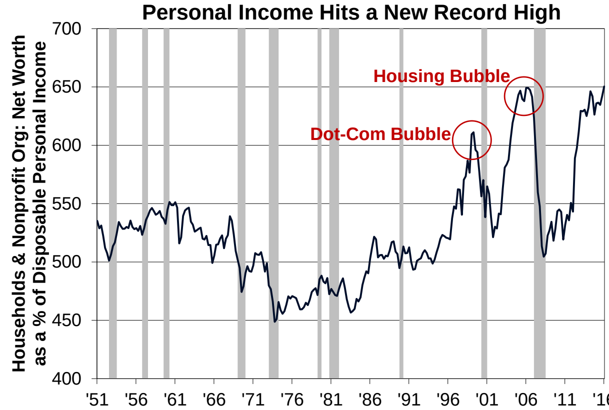
In addition to improving labor market conditions, rising household net worth should help support consumers. According to the Fed's Financial Accounts of the U.S., household and nonprofit organization net worth—the value of assets minus liabilities—increased $2.0 trillion in the fourth quarter of 2016 to a record high of $92.8 trillion, boosted by gains in both housing and stocks. Notably, net worth as a share of disposable income rose to 650 percent, also a record high.

Construction Sector Sees Largest Payroll Gain Since 2007



Note: Residential Construction Employment combines construction of buildings and specialty trade contractors

Household Net Worth as a Percentage of Personal Income Hits a New Record High

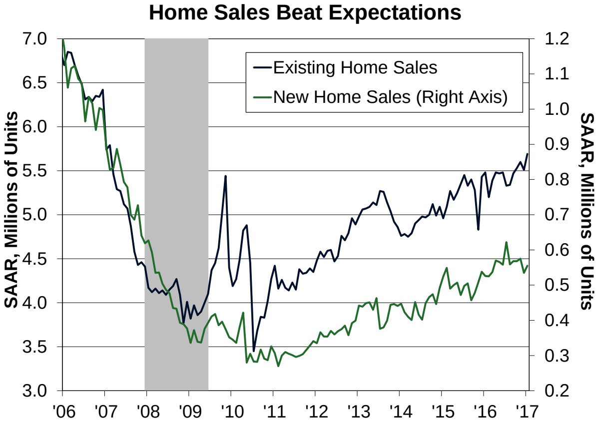


Incoming data on factory orders and manufacturing surveys suggest continued improving manufacturing activity and business investment in equipment. Residential construction spending data point to a second consecutive quarter of solid growth in residential investment. The trade sector is likely to remain the only drag on growth this quarter and will likely remain a headwind for the rest of the year. Inventory investment should add to GDP this quarter but should be neutral for all of 2017.

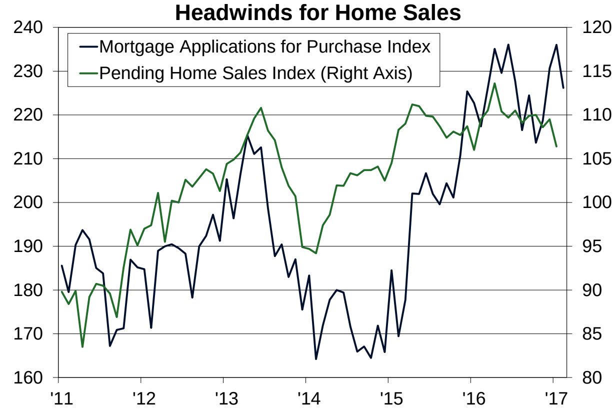
Housing Roundup

After declining during December, home sales beat expectations in January, with existing sales showing a sizable gain to the strongest pace since 2007 and new home sales partially recapturing ground lost in the prior month. However, leading indicators point to near-term weakness. Pending home sales, which record contract signings of existing homes and typically lead closings by one to two months, declined in January for the second time in three months to reach a 12-month low. Furthermore, purchase mortgage applications dropped on average during February, ending a stretch of three consecutive monthly gains.

Home Sales Beat Expectations



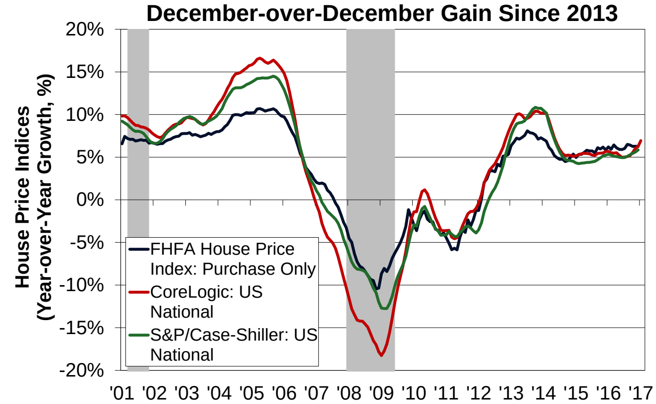
Leading Indicators Point to Near-Term Headwinds for Home Sales



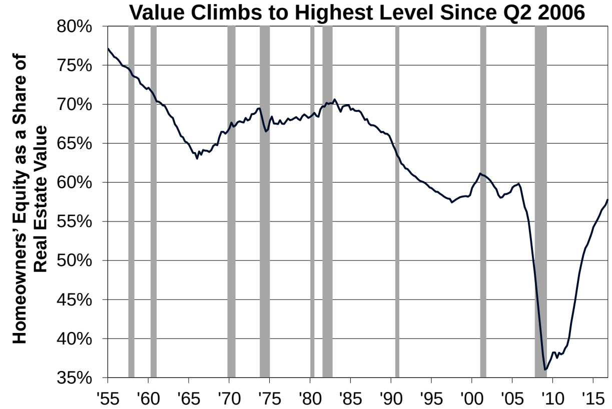
The weakness in these leading indicators supports our view that some of the improvement in home sales at the start of the year was likely the result of a rush to enter the market before mortgage rates could rise further. One positive piece of forward-looking news is that housing sentiment moved higher in February along with sentiment regarding the economy. The Fannie Mae Home Purchase Sentiment Index® increased in February for the second consecutive month, reaching the highest level since data collection began in 2010.

Inventory remains very tight, especially in the existing home market, as the number of homes for sale has fallen year-over-year for nearly two years. In January, the existing homes inventory reached the lowest level for any January since the inception of the series in 1999.

Home Price Indices Post Strongest December-over-December Gain Since 2013



Homeowners' Equity Share of Real Estate Value Climbs to Highest Level Since Q2 2006

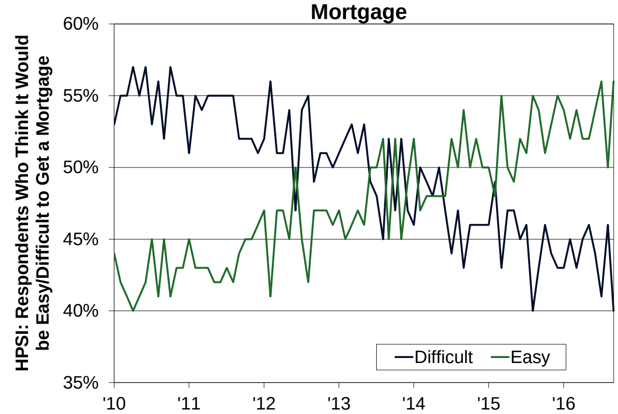


Scarce inventory has maintained upward pressure on home prices. At the end of last year, the principal measures of house prices recorded the strongest annual appreciation since 2013. The CoreLogic house price index strengthened further in January, with year-over-year growth of 6.9 percent compared with 6.3 percent in December. The Fed uses this measure of home prices to estimate the value of household real estate in the Financial Accounts of the U.S. For the fourth quarter, household net equity in residential real estate increased $0.5 trillion, resulting in a cumulative increase of $7.1 trillion over the past five years. Home equity as a percent of real estate value increased to 57.8 percent last quarter from a record low of 36.0 percent in the first quarter of 2009. Meanwhile, the share of residential properties with negative equity continued to trend down, reaching 6.2 percent in the fourth quarter of 2016, compared with a peak of 26.0 percent seven years earlier, according to CoreLogic.

While strong home price gains are a positive for existing home owners, they create a challenge for potential first-time homebuyers. However, demographics should be a positive factor for the first-time homebuyer market: the large Millennial generation is moving full-force into the age groups (late twenties through mid-30s) where first-time home buying is common; the most recent data from the Census Bureau show strong real income gains for households in the prime ages for first-time home purchase; and our research indicates that homeownership rate gains have accelerated in recent years for young adults aging through their late twenties and early thirties.

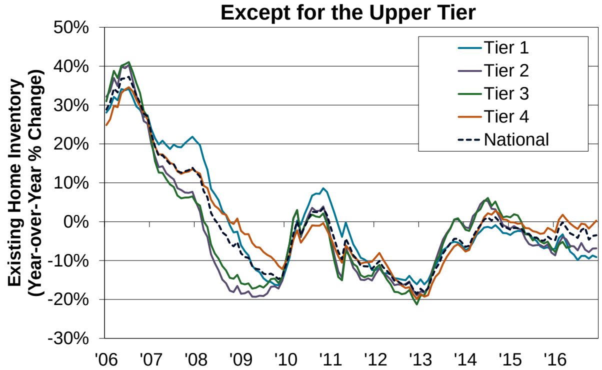
Another positive for the mortgage market is that consumers believe that it's easier to get a mortgage than in the past. The February Fannie Mae National Housing Survey® showed that the share of consumers who believe that it is easier now to get a mortgage exceeded those who believe it is more difficult by the greatest margin in six years.

Consumers Believe It Is Easier to Get a Mortgage



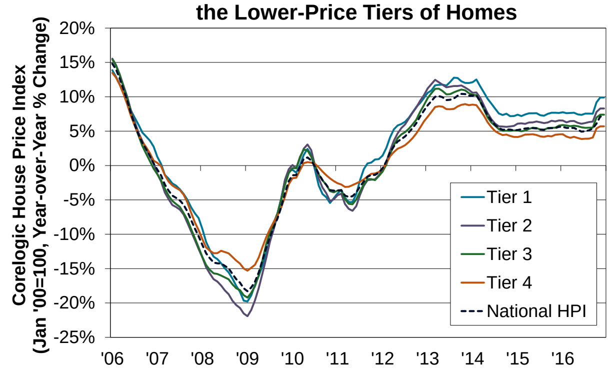
However, very tight starter home supply is weighing against first-time homebuyers. CoreLogic data show that for-sale inventory in the lowest tier of the home price distribution is extremely lean. Because listings are not keeping pace with demand for starter homes, prices for lower-tier homes have appreciated at a much faster pace than prices for higher-end homes.

Inventory of Homes for Sale Falls Annually, Except for the Upper Tier



Note: Tier 1: 0-75% of median, **Tier 2:** 75%-100% of median, **Tier 3:** 100%-125% of median, **Tier 4:** 125% + of median

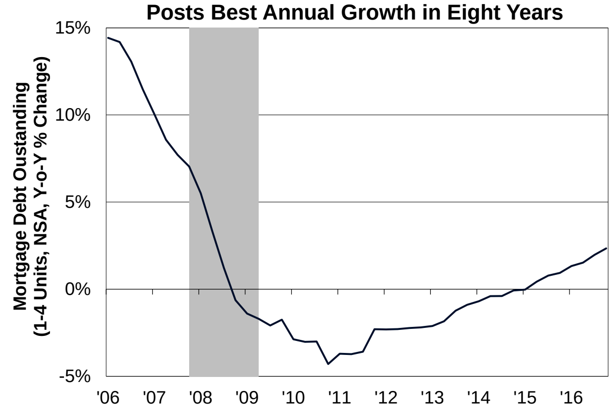
Home Price Growth Accelerates, Especially for the Lower-Price Tiers of Homes



Tight inventory and strong home price appreciation bode well for homebuilding activity. In January, single-family starts rose modestly as multifamily activity fell sharply. Homebuilders remained optimistic in February, with confidence just four points below the eleven-year high reached in December.

Our outlook for mortgage rates, housing activity, and mortgage originations is little changed from the prior forecast. Total mortgage originations should drop about 19 percent this year to $1.57 trillion, as a decline in refinance originations outpaces a rise in purchase originations. The refinance share should decline 15 percentage points from 2016 to 33 percent. Single-family mortgage debt outstanding continued to heal from the massive decline stemming from the housing crisis, rising 2.7 percent annualized in the fourth quarter from the prior quarter and 2.3 percent from a year ago.

Single-Family Mortgage Debt Outstanding Posts Best Annual Growth in Eight Years



Economic & Strategic Research (ESR) Group

March 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: *Bloomberg, Bureau of Economic Analysis, Federal Reserve Board, Fannie Mae, National Association of REALTORS®, Census Bureau, Mortgage Bankers Association, CoreLogic.*

ESR Macroeconomic Forecast Team

Doug Duncan, SVP and Chief Economist
Orawin T. Velz, Director
Hamilton Fout, Director
Mark Palim, VP and Deputy Chief Economist
Frank Shaw, Economist
Michael T. Vangeloff, Strategic Planning Analyst III