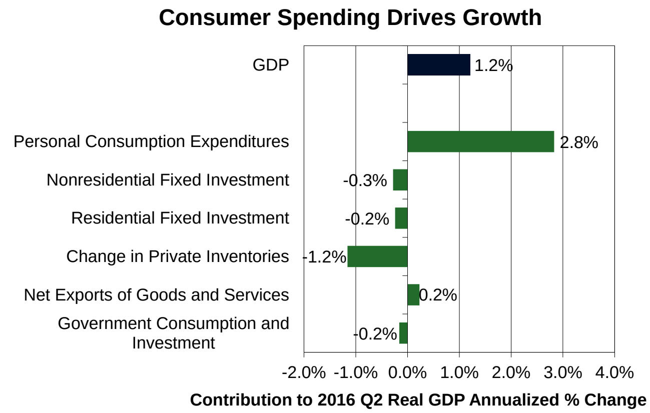
Economic Developments – August 2016

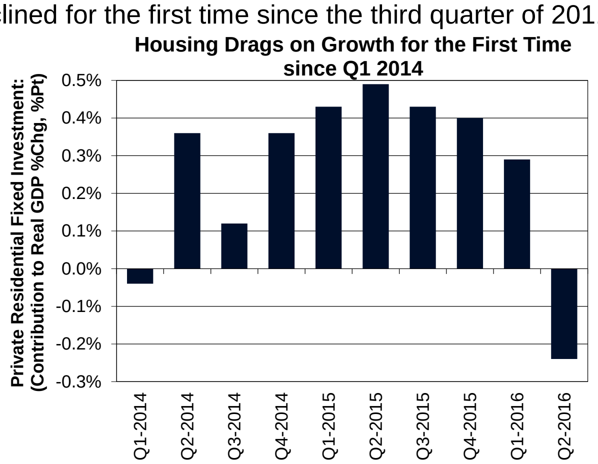
Consumers Should Carry Growth Again in the Second Half

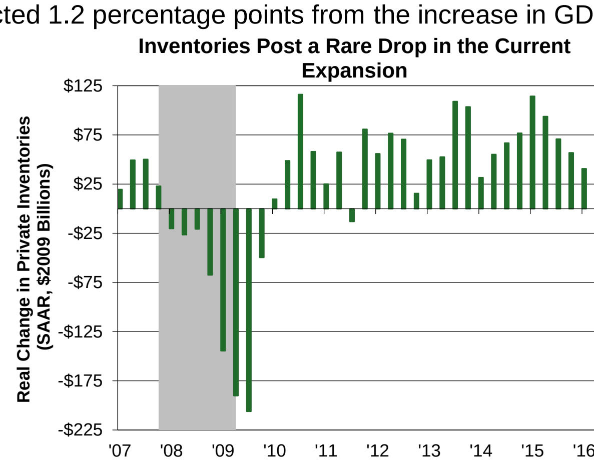
Our full-year 2016 real gross domestic product (GDP) growth forecast remains at 1.8 percent, despite underwhelming average annualized growth of just 1.0 percent during the first half. Second quarter growth disappointed, but the silver lining was that much of the unexpected weakness came from a surprising inventory drawdown, which we believe will change to a sustainable pace of inventory accumulation in coming quarters if incomes and consumer spending grow. Incoming data have largely been positive, reinforcing our expectation of a rebound in second half economic growth to a pace roughly 0.5 percentage points greater than we predicted in the prior forecast, keeping economic growth for all of 2016 the same.

Second Quarter Growth Disappoints…

Economic growth came in at 1.2 percent annualized in the second quarter, more than 1.0 percentage point weaker than we had expected in the July forecast. While real consumer spending growth picked up strongly to 4.2 percent annualized, as we projected, and contributed 2.8 percentage points to GDP growth, the rest of the GDP components disappointed. Residential, nonresidential, and inventory investment, as well as government spending, slowed growth, with net exports the only other main category besides consumer spending adding to growth. Notably, business capital expenditures declined for the third consecutive quarter — a rare occurrence outside of a recession. Residential investment also fell during the quarter, largely due to weakness in single-family home building, subtracting 0.2 percentage points from growth. This marks the first time housing subtracted from growth since the first quarter of 2014. The biggest drag on growth in the second quarter was inventories, which declined for the first time since the third quarter of 2011 and subtracted 1.2 percentage points from the increase in GDP.



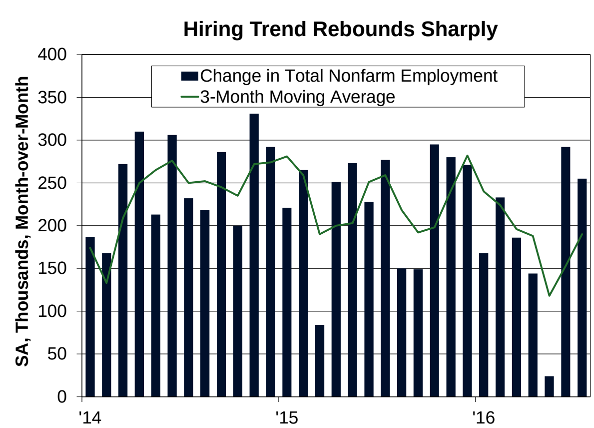




…But the Upbeat July Jobs Report Helps Soothe Concern

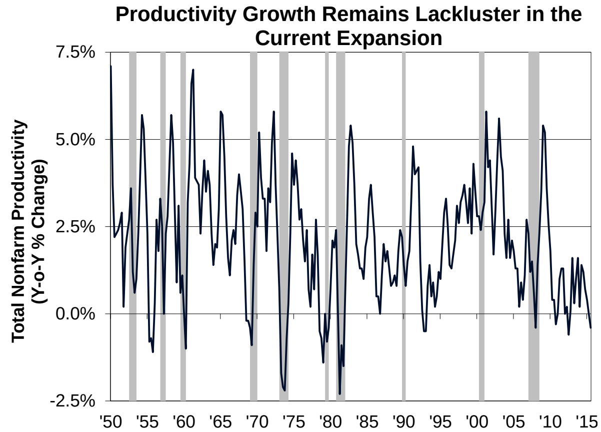
The July jobs report also supports a pickup in economic growth in the second half of the year. The 255,000 payroll gain and upward revisions in the prior two months put the average monthly job increase over the past three months at 190,000, a vast improvement in the hiring trend from just 118,000 in May.

The report also points to improving income prospects for consumers in the near term. Annual growth in average hourly earnings remains at a seven-year best of 2.6 percent amid a longer workweek. The index of aggregate hours, which reflects the increases in both hours worked and the number of payrolls, rose 0.5 percent, the largest gain in a year. Combined with a pickup in



average earnings, the report bodes well for gains in wage and salary income at the start of the third quarter. The household survey was also positive. The unemployment rate was unchanged because a strong employment gain offset a robust increase in the labor force. The labor force participation rate increased for the second consecutive month.

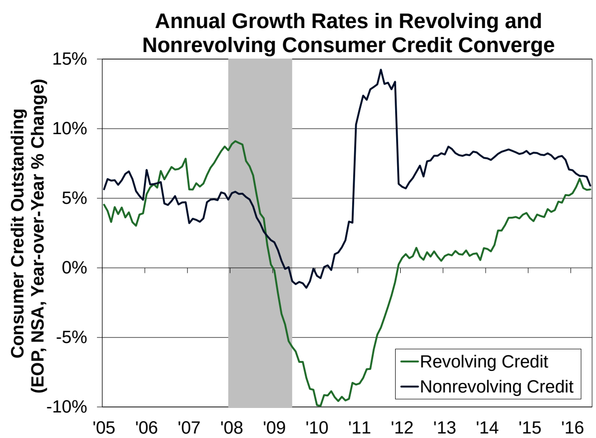
The strengthening hiring trend should also help soothe concerns over the health of businesses, which have faced a lot of headwinds from lackluster profits and productivity and have been pulling back on capital expenditures. Given the acceleration in hours worked, productivity growth in the third quarter will likely remain weak. Productivity declined during the second quarter for the third consecutive quarter, marking the longest stretch of declines since 1979. Over the past year, productivity fell 0.4 percent, the first drop in three years. Since the recession, the underlying trend in productivity growth has been at historically low levels. The annual benchmark revisions showed that the productivity numbers over the past year were even worse than previously reported. This could be the dark cloud in the silver lining of the recent acceleration in wage growth as productivity gains drive real income gains and are themselves driven by business investment, which has been falling.



Consumer Spending Momentum Continues into the Third Quarter

Momentum in consumer spending appears to be carrying into the third quarter. July auto sales picked up to the strongest pace since last November, putting sales 4.1 percent above their second quarter average, suggesting that durable goods spending is off to a strong start this quarter. The positive income picture from the July jobs report also points to future consumer strength. While we still expect a sizable moderation of real consumer spending growth to just 2.7 percent annualized this quarter, we did upgrade our forecast slightly due to the solid trajectory of spending through June.

Credit expansion should continue to support consumer spending during the rest of year, when combined with improving labor market conditions and strengthening household balance sheets. Revolving consumer credit (largely credit card debt) jumped $7.7 billion in June from May, the second best monthly increase of the recovery. On a year-over-year basis, revolving credit growth has increased since mid-2015 while nonrevolving credit (largely auto and student loans) growth has been moderating. The year-over-year growth rate in revolving credit should soon outpace that of nonrevolving credit, which has not yet happened in the current expansion.



Strong consumer spending growth is crucial given that business investment is struggling. As oil prices stabilize, nonresidential investment in structures should begin to recover. However, the sustained decline in business investment in equipment over the past three quarters, which has been driven by the strong dollar, low energy prices and weak corporate profits, is worrisome as it has implications for labor productivity and the economy's near-term potential growth. Core capital goods orders (excluding defense and aircraft), which are a leading indicator of business capital expenditures, rose 0.4 percent in June. The puny gain marks the first rise in three months, underscoring that the weakness in business equipment investment will persist.

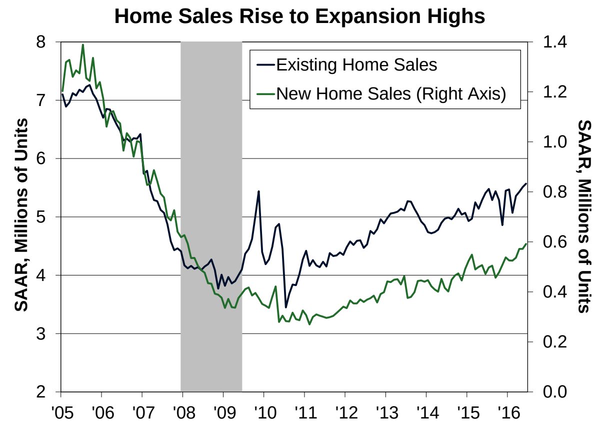
Stellar Jobs Report Supports Fed Officials Hoping to Raise Rates This Year

We expect that a few Federal Open Market Committee (FOMC) members will use the strong July jobs report to argue that the Fed should hike rates in September. However, most Committee members have expressed a desire to proceed cautiously and gradually with monetary policy. News on the inflation front tends to support those favoring patience, as the Fed's favored measure of inflation – the Personal Consumption Expenditures (PCE) price index – continues to run below the 2.0 percent target. The annual change in the PCE deflator has trended down from 1.1 percent in January to 0.9 percent in June, despite rising gasoline prices. Excluding food and energy items, the core PCE rose 1.6 percent in June from a year ago for the fourth consecutive month. Global uncertainties and anemic output growth also suggest no change in policy at the September FOMC meeting.

While many of the financial impacts of Brexit have unwound, some, including the downward pressure on long-term Treasury yields, persist. Earlier this month, the Bank of England cut its key policy rate, expanded its quantitative easing program, and created a Term Funding Scheme aimed at providing up to £100 billion of additional funding to banks to help ease the strain of lower short-term rates. Given investors' search for yield amid low or negative rates on sovereign debt elsewhere, we expect long-term Treasury yields to remain low. One concern that arises if the Fed raises interest rates when other major central banks are easing monetary policy is that the U.S. dollar could appreciate significantly, which could weigh on growth and delay inflation from returning to the Fed's target in the medium turn as the Fed expects. We remain convinced that the Fed will hold the target rate steady this year.

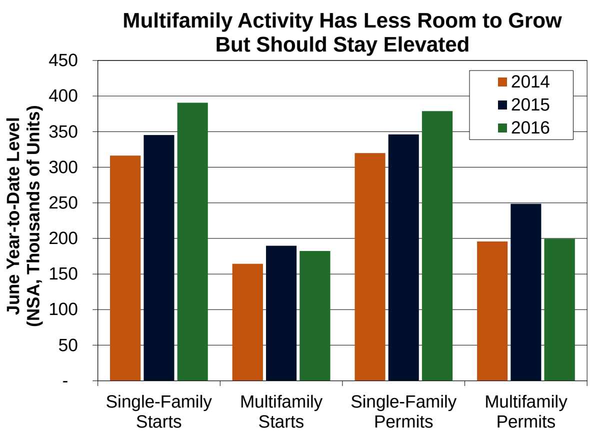
Housing Roundup

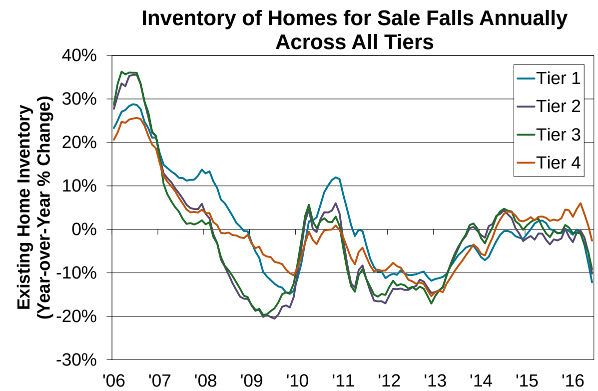
Mortgage rates will likely remain supportive for the housing market this year, with projected 30-year fixed mortgage rates averaging just 3.4 percent during the fourth quarter of 2016, slightly lower than the prior forecast. Lending standards should also help marginally, with the Fed's Senior Loan Officer Opinion Survey showing that banks loosened standards for residential mortgages in the three months ending in July.



Home sales performed well during the second quarter. Both new and existing home sales rose in June to the highest levels of the expansion. Through the first six months of this year, new and existing home sales were nearly 11 percent and 5.0 percent, respectively, more than sales during the same period in 2015. Leading indicators suggest some near-term pullbacks, however, with pending home sales (contract signings of existing homes) little changed in June. After a surge in the first week of June, purchase mortgage applications rose in only one additional week through the end of July.

Strengthening job and wage growth are positives for the demand side of the housing market, but weak single-family home building and soft construction hiring are worrisome from a supply perspective. Unlike home sales, which rose in the second quarter from the first quarter, single-family starts fell for the first time since the first quarter of 2015. Without relief from new construction, housing inventory will likely remain tight, continuing to boost home prices, especially at the lower end of the market.



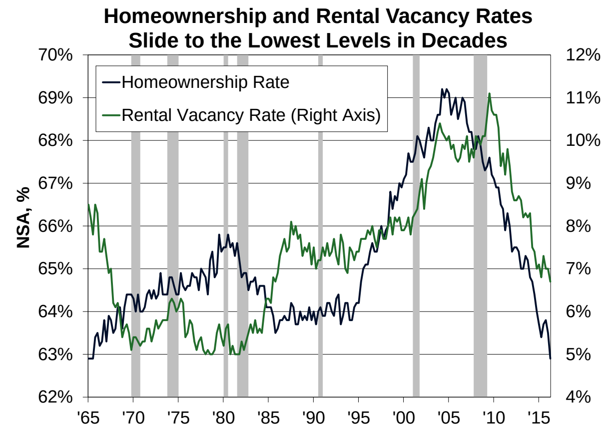


Note: Tier 1: 0-75% of median, **Tier 2:** 75%-100% of median, **Tier 3:** 100%-125% of median, **Tier 4:** 125% + of median

The rental market fared better during the second quarter, with multifamily starts in buildings of five or more units posting an increase for the first time in four quarters. However, year-to-date through June, multifamily activity has declined from its elevated levels during the same period last year. This reflects a mature stage of the multifamily expansion as a result of its rapid, V-shape recovery that has lifted activity above its prerecession levels. (For more information on rental market conditions, read the August 2016 Multifamily Market Commentary). By contrast, single-family starts and permits have improved only gradually, remaining historically low for an expansion.

Meanwhile, demographic factors are positive, with household growth on a path to recovery following the severe downturn. Rental demand was robust in the second quarter, sending the rental vacancy rate to the lowest level in decades. While the homeownership rate dropped to 62.9 percent in the second quarter of 2016, the lowest level since 1965 when the Census Bureau began tracking the quarterly rate, we are finally seeing some tentative signs of a move by older millennials in the direction of homeownership. (See Fannie Mae's Economic & Strategic Research Group's *Housing Insights* from August 10 titled, Millennials Have Begun to Play Homeownership Catch-up).

Given weaker-than-expected single-family homebuilding activity in the second quarter, we revised lower single-family starts over the next four quarters. Meanwhile, existing home sales came in slightly stronger than expected and thus we revised higher the projected sales for the rest of this year. Projected mortgage originations are little changed from the July forecast. For all of 2016, we expect total mortgage originations to rise 3.0 percent from 2015 to $1.76 trillion, as the increase in purchase originations more than offsets the drop in refinance originations. The refinance share should drop 4.0 percentage points from 2015 to 42 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, Census Bureau, Federal Reserve, National Association of REALTORS®, and CoreLogic*

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