AIER’s Business Cycle Conditions Leading Indicators index eased back in July, registering a 79 following a 92. The Roughly Coincident Indicators index returned to a perfect 100 reading while the Lagging Indicators index fell to 83 (see chart below). Despite the mixed results, the AIER business cycle indicators signal continued economic expansion and support a positive outlook with a low probability of recession.

The advance (first) estimate of real GDP growth for the second quarter shows a significant reacceleration after a weak first quarter. Most areas of the economy saw solid growth, though housing remained weak. Rising interest rates may further restrain housing, but some of the headwind may be offset by the strong labor market. Overall, economic conditions are positive, though federal debt and ongoing trade disputes including escalating tariffs remain major sources of concern. More recently, economic activity continued at a robust pace, providing further evidence that real GDP growth is maintaining solid momentum.

**Chart 1. Indicators at a glance**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of AIER leading indicators expanding</th>
<th>Percentage of AIER roughly coincident indicators expanding</th>
<th>Percentage of AIER lagging indicators expanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985-1990</td>
<td>79</td>
<td>100</td>
<td>83</td>
</tr>
</tbody>
</table>

Notes: Shaded areas denote recessions. A score above 50 indicates expansion. Source: AIER.
Leading indicators pulled back in July, but economic conditions remain favorable

In last month’s update, two leading indicators—housing permits and real stock prices—turned from positive trends to neutral trends, pushing the index from 100 to 92. This month, three more indicators—consumer expectations, real new orders for consumer goods, and debit balances in brokerage margin accounts—turned to flat trends as well. That brings the total to five indicators now trending flat, leaving seven indicators trending higher. Notably, none of the leading indicators were in a downward trend. The last time a leading indicator was in a downward trend was February 2018. With a reading of 79 in the latest month, the leading index remains well above the neutral 50 threshold, suggesting continued economic expansion in the months ahead.

The Roughly Coincident Indicators index returned to a perfect 100 in July after posting a 92 in June. The index has hit perfect 100s in 13 of the past 17 months. The strong performance of the index is consistent with the majority of economic data, from both public and private sources, that suggest the economy is performing well more than nine years into the current expansion.

AIER’s Lagging Indicators index fell to 83 in July following three months at 92. Overall, four indicators are trending higher, none are trending lower, and two are neutral. Real manufacturing and trade inventories and real nonresidential construction were neutral indicators in the latest month.

The three AIER business cycle indicator indexes showed mixed results in July. However, all three are well into favorable territory, suggesting a continued positive economic outlook with a low probability of recession in the coming months.

Real GDP growth reaccelerated sharply in the second quarter

Real gross domestic product rose at a 4.1 percent annualized rate in the second quarter, up from a revised 2.2 percent pace in the first quarter of 2018. Growth was driven by strong gains in consumer spending, business investment, exports, and government spending.

Consumer spending accelerated sharply in the second quarter, rising at a robust 4.0 percent pace compared to a 0.5 percent growth rate in the first quarter. Business fixed investment rose at a 7.3 percent annualized rate in the second quarter of 2018, slower than the 11.5 percent pace of the first quarter. Residential investment, or housing, fell at a 1.1 percent pace in the second quarter compared to a 3.4 percent decline in the prior quarter.

Together, business and residential investment grew at a 5.4 percent pace in the first quarter, contributing 0.9 percentage points to total GDP growth compared to a 1.3 percentage-point contribution in the first quarter. Inventory liquidation by businesses subtracted 1.0 percentage points from second-quarter growth after inventory accumulation added 0.3 percentage points to growth in the prior quarter.

Net exports had a positive impact on overall GDP growth in the second quarter, adding 1.1 percentage points. Exports rose at a robust 9.3 percent pace while imports grew at a substantially slower 0.5 percent rate, below the 3.0 percent pace in the prior quarter. It is unclear at this point whether trade patterns are being impacted by the ongoing trade disputes.

Government spending rose at a 2.1 percent annualized rate in the second quarter compared to a 1.5 percent increase in the first quarter, contributing 0.4 percentage points to growth versus a 0.3 point contribution in the prior quarter.
Real final sales to private domestic purchasers, a key measure of private domestic demand, rose at a very impressive 4.3 percent annualized rate in the second quarter, up from a 2.0 percent pace in the first quarter. The second-quarter gain was the second time in the past three quarters that growth exceeded 4 percent and the fifth time over the past nine quarters that growth exceeded 3 percent. Over the past four quarters, real private domestic demand is up at a healthy 3.2 percent rate, slightly above the 2.9 percent gain for the four quarters ending with first-quarter 2018.

The underlying trend in real private domestic demand remains well-supported by continued job creation, rising wages, healthy corporate and consumer balance sheets, solid corporate-sales and corporate-earnings growth, and high levels of business and consumer confidence. The virtuous cycle between the consumer and corporate sectors is likely to provide ongoing support for further gains in real private domestic demand.

**Housing market facing headwinds**

With another round of weak results in June, the broad trend in housing construction and permits appears to be plateauing. For the single-family segment, the plateau is well below peak levels of activity achieved during previous economic expansions. For multifamily housing, the plateau is about in line with sustained levels in the prior two expansions.

Housing construction fell in June as single-family and multifamily starts declined. Total housing starts fell 12.3 percent in June to a 1.173 million annual rate. The dominant single-family segment, which accounts for about three-fourths of new home construction, fell 9.1 percent for the month to a rate of 858,000 units. Starts of multifamily structures with five or more units plunged 20.2 percent to 304,000.

Housing permits, an indicator of future activity, also fell in the latest month, pulled down by a drop in multifamily permits. Total permits fell 2.2 percent to 1.273 million from 1.301 million in May. Single-family permits rose 0.8 percent to 850,000 while permits for two- to four-family units were up 5.9 percent and permits for five or more units dropped 8.7 percent to 387,000.

Sales of new and existing single-family homes also fell in June, dropping 5.3 percent and 0.6 percent, respectively. For new single-family homes, sales came in at 631,000, down from 666,000 in May. Despite the drop, sales are still up 2.4 percent from a year ago.

Total inventory of homes for sale rose 1.7 percent to 301,000 in June, pushing the months’ supply (12 times the inventory divided by the annual selling rate) to 5.7 months, up from 5.3 months in May. Months’ supply has been holding relatively steady in the five- to six-month range since the end of 2013.

The combination of rising home prices and higher interest rates is likely weighing on housing activity. Home affordability has been trending lower after surging in 2009–12 because a combination of extraordinarily low interest rates and falling home prices made for a buyer’s market. Declining affordability due to rising home prices and rising interest rates is likely to continue weighing on housing activity. Sales are unlikely to move significantly higher in the coming months, and new-home construction is unlikely to contribute significantly to growth in gross domestic product in coming quarters.
Labor market remains the foundation of the expansion

On the labor front, the July jobs report was upbeat despite a weak headline. Nonfarm payrolls added 157,000 jobs in July, below the consensus expectation of 190,000. However, the prior two months were revised upward by a combined 59,000, putting the June gain at 248,000 and the May increase at 268,000. Private payrolls added 170,000 in July following upwardly revised gains of 234,000 in June and 260,000 in May. Monthly payroll estimates tend to be somewhat volatile.

Job creation appears to have reaccelerated since private payrolls posted a weak gain of just 16,000 new jobs in September 2017. Over the six months ending in September, private payrolls added an average of 162,000 per month, the second-slowest pace since 2012. Since September 2017, the six-month average has been trending higher, posting a 219,000 mark in July. Those gains have helped drive the unemployment rate down to 3.9 percent and boost wage growth to 2.7 percent. Though the pace of acceleration in wage growth has been slow by historical measures, the combination of increasing payrolls, accelerating wages, and a relatively long workweek has provided ample support for income growth, which in turn has helped support consumer confidence and consumer spending.

The unemployment rate fell 0.1 percentage points in July to 3.9 percent after ticking up to 4.0 percent in June on a surge of 601,000 entrants into the labor force. The labor force increased by an additional 105,000 in July, while the labor force participation rate held steady in July at 62.9 percent. The participation rate remains well below the 66.0 percent rate that prevailed from 2004 through mid-2008.

The average length of the workweek decreased by 0.1 hours to 34.5 hours in July. Average weekly hours have been bouncing around between 34.3 and 34.6 hours since 2012.

Combining payrolls with hourly earnings and hours worked, the index of aggregate weekly payrolls rose 0.1 percent in July and is up 5.0 percent from a year ago. This aggregate measure has posted relatively steady year-over-year gains in the 3 to 5 percent range since 2010 and provides a strong foundation for income gains, high levels of consumer confidence, and continued growth in consumer spending.

Interest rates moving higher

Though economic activity remains robust and pressures on prices remain, both are moderate enough that it is unlikely the Federal Open Market Committee will retreat from its path of normalization. The likely action by the committee will be to implement a total of four quarter-point rate increases in 2018 (with two already implemented) and continue the process of slowly shrinking the Fed’s balance sheet.

The 10-year Treasury note yield has already risen to just under 3 percent from less than 1.5 percent in 2016. Rising short-term rates, solid growth, and moderate price pressures are likely to push longer-term rates even higher in coming quarters. Rising federal deficits may exacerbate the upward pressure on bond yields as the supply of new issuance is expected to accelerate in the second half of 2018.

Some of these pressures may be offset by increases in global demand created by extraordinarily low yields in Europe and Japan, and bouts of uncertainty from trade wars.
## CAPITAL MARKET PERFORMANCE
(Percent change)

<table>
<thead>
<tr>
<th></th>
<th>July 2018</th>
<th>Latest 3M</th>
<th>Latest 12M</th>
<th>Calendar Year 2015</th>
<th>Calendar Year 2016</th>
<th>Calendar Year 2017</th>
<th>Annualized 3-year</th>
<th>Annualized 5-year</th>
<th>Annualized 10-year</th>
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<td><strong>Equity Markets</strong></td>
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<td>-1.6</td>
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## CONSUMER FINANCE RATES
(Percent)

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<tr>
<th></th>
<th>July 2018</th>
<th>Latest 3M</th>
<th>Latest 12M</th>
<th>Average for Year 2017</th>
<th>Average for Year 2016</th>
<th>Average for Year 2015</th>
<th>Average over Period 3-year</th>
<th>Average over Period 5-year</th>
<th>Average over Period 10-year</th>
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<tr>
<td>30-yr. fixed mortgage</td>
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<td>4.0</td>
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<td>15-yr. fixed mortgage</td>
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<td>5-yr. adjustable mortgage</td>
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<td>4.5</td>
<td>4.4</td>
<td>5.1</td>
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</tbody>
</table>

Sources for tables on this page: Bankrate, Barron’s, Commodity Research Bureau, Dow Jones, Federal Reserve, Frank Russell, iShares, Standard & Poor’s, STOXX Europe 600, Thomson Reuters.
LEADING INDICATORS (2000 – 2018)

New orders for consumer goods (constant dollars, billions)

New orders for core capital goods (constant dollars, billions)

Retail sales and food services (constant dollars, billions)

Consumer sentiment (expectations) (index)

Heavy truck unit sales (thousands)

New housing permits (thousands)

Initial claims for unemployment insurance (thousands, inverted)

Index of common stock prices (constant purchasing power)

Average workweek in manufacturing (hours)

Debit balances in margin accounts at broker/dealers (constant dollars, billions)

Ratio of manufacturing and trade sales to inventories (ratio)

10-year–1-year Treasury spread (percentage points, inverted)


Note: Shaded areas denote recessions.
ROUGHLY COINCIDENT INDICATORS (2000–2018)

- Nonagricultural employment (millions)
- Industrial Production Index (2012=100)
- Personal income less transfer payments (constant dollars, trillions)
- Civilian employment as a % of the working-age population (percent)
- Manufacturing and trade sales (constant dollars, billions)
- Consumer confidence (present situation) (index)

LAGGING INDICATORS (2000–2018)

- Average duration of unemployment (weeks, inverted)
- Manufacturing and trade inventories (constant dollars, billions)
- Commercial and industrial loans outstanding (constant dollars, billions)
- Consumer Price Index excl. food and energy (year-over-year percent change)
- Private nonresidential construction (constant dollars, billions)
- Composite of short-term interest rates (percent)
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