Economics: A Solid Ending to the First Half

This week’s economic data support our expectation announced in last week’s note that the economy likely grew approximately 3.0 percent annualized in Q2 2014. The June jobs report showed that the pace of hiring continues on a solid upward trajectory, and the string of five consecutive monthly gains averaging more than 200,000 was the best performance since late 1999. The narrowing in the trade deficit suggests that trade was a smaller drag on the economy in Q2 2014 than in Q1. While both the ISM manufacturing and service indices slipped in June 2014, the Q2 average improved sizably from Q1 2014. Weak top-line factory orders in May 2014 mask positive details, as solid core shipments and core orders indicate a rebound in business capital spending following the rare drop in Q1 2014. Overall, this week’s strong data support our view that the economy will build momentum in the second half of 2014. However, not all is rosy, especially from the Federal Reserve’s perspective. The labor force participation rate remains at depressed levels last witnessed during the 1970s. In addition, despite the improved pace of hiring, wage gains remain weak, implying the persistence of considerable slack in the labor market. The question of whether labor market data indicate significant slack is a source of debate among Federal Reserve Board members and others. The decline in the unemployment rate, combined with a recent uptick in the inflation rate, has raised market speculation that the Fed will start increasing the target interest rate sooner than prior consensus expectation. We believe this presents a downside risk to housing activity, which has just begun to regain its footing after the rate rise in the middle of last year.

- **Nonfarm payrolls** rose 288,000 while upward revisions to the prior two months totaling 29,000 jobs pushed the average monthly gain over the second quarter to 272,000—a substantial pickup from the 190,000 average over the first quarter. Average hourly earnings ticked up 0.2 percent from May 2014 and 2.0 percent from June 2013. The separate household survey showed a 0.2 percentage point drop in the unemployment rate to 6.1 percent—a near six-year low—against the backdrop of a stabilizing labor force participation rate, which remained at 62.8 percent three straight months.

- **The Institute for Supply Management (ISM) manufacturing index** edged down to 55.3 in June from 55.4 in May 2014 (any reading above 50 indicates expanding activity). The ISM nonmanufacturing index also ticked down from 56.3 in May to 56.0 in June. Despite the slight drops in the headline indices, the details were positive and are consistent with a pickup in overall economic growth in Q2 2014.

- **Factory orders** fell for the first time in four months in May 2014, dropping 0.5 percent, dragged down by defense orders. The previously released durable goods orders were revised higher to show a 0.9 percent decline from an advance report of a 1.0 percent drop. Orders for nondurable goods rose 1.1 percent, marking the third consecutive monthly gain. We believe the recent trend in core capital goods orders (nondefense orders excluding aircraft) shows that momentum in business capital spending is picking up.

- **Vehicle sales** rose in June 2014 to 16.9 million units annualized—the fastest clip in more than eight years. We believe the strength in June auto sales likely bodes well for consumer spending and industrial production at the end of Q2 2014.

- **The trade deficit** narrowed to $44.4 billion in May 2014 from a downwardly revised $47 billion in April 2014. Exports rose 1.0 percent while imports edged down 0.3 percent.
Housing: Home Sales Poised to Continue Growth

Continued good news in the housing market supports our expectation of a housing rebound during the second half of this year. May’s home sales reports were strong, as both new and existing home sales surged, and the pending home sales index, which tends to lead closed home sales by two to three months, jumped to its highest level since September 2013. Home prices continued to increase across the country, but the pace of year-over-year growth is slowing, in line with the corporate home price forecast. Private residential construction spending unexpectedly contracted in May 2014, but spending growth remains healthy on a year-over-year basis.

- The National Association of REALTORS® pending home sales index increased 6.1 percent in May 2014 on an annualized basis, marking the third straight month of gains. Pending sales were up across all four regions, led by the Northeast and West, which grew 8.8 percent and 7.6 percent, respectively. Compared to a year ago, however, the index was down 5.2 percent. Aside from the Northeast, pending home sales were down across all regions, with the West suffering the largest decline, 11.1 percent from May 2013.

- The CoreLogic National House Price Index (not seasonally adjusted) increased 1.4 percent in May 2014 and was up 8.8 percent from May 2013. The index, excluding distressed sales, increased 1.2 percent in May 2014 and 8.1 percent year over year, suggesting that investors continue to fuel some of the price gains. All states and the District of Columbia experienced year-over-year gains, with 10 states reaching new highs. The pace of home price appreciation is slowing, however, as year-over-year gains in the index ticked down for the third straight month.

- Total construction spending edged down 0.1 percent in May 2014, driven by a 1.5 percent decline in private residential construction spending that outpaced a 1.1 percent increase in private nonresidential construction spending and a 1.0 percent gain in public spending. The drop in private residential construction spending was broad-based, with outlays on single-family, multifamily, and home improvement falling during the month. On a year-over-year basis, however, private residential construction spending was up 10.6 percent for single-family and 30.7 percent for multifamily.

Sources: National Association of REALTORS®, Census Bureau

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