Housing Setback Underscores Fragile Recovery

Severe weather was disruptive to economic activity during the first two months of the year. If economic fundamentals have not deteriorated, the weather impact will likely fully reverse at some point, and we expect most economic indicators affected adversely by the weather to rebound in the months ahead. Unfortunately, despite the high hopes associated with the extended and expanded homebuyer tax credit, housing activity appears to have faced a setback that went beyond the impact of adverse weather conditions. Continued recovery in housing is the key to a durable economic recovery, and a renewed decline in activity adds downside risks to that outlook.

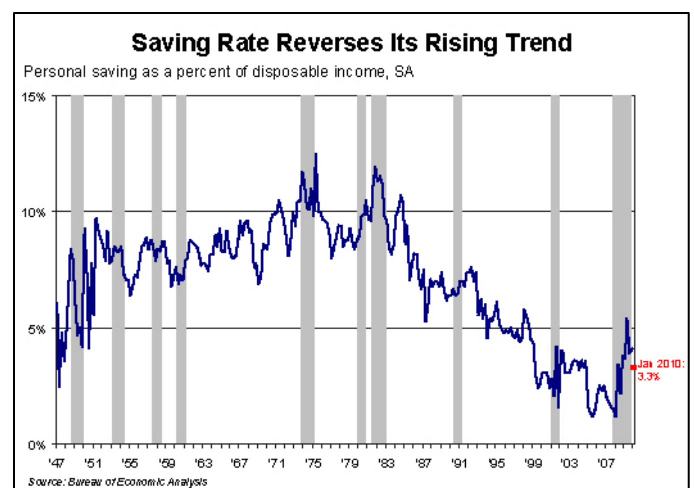
We currently view the housing setback to be a temporary one, and continue to expect activity to rebound later in the year but at a lower trajectory than previously projected. We also lowered our projection of export growth, given expected slower growth abroad, especially in Europe. These adjustments were quite modest, however. Overall, our outlook calls for moderate growth of 3.0 percent in 2010, compared with 3.2 percent in the previous forecast. Despite a surge in growth to an annualized pace of 5.9 percent in the fourth quarter of 2009, a slight upward revision from the Bureau of Economic Analysis' (BEA) initial estimate of gross domestic product (GDP), the recovery remains fragile, influenced by a rocky housing recovery. We believe that the fourth quarter growth pace, boosted by the temporary inventory swing, will be as good as it gets for quite some time.

Consumer Spending: Robust Start

While consumer spending growth was revised slightly lower in the fourth quarter of 2009, the picture is improving for the current quarter. Real (inflation-adjusted) consumer spending grew a solid 0.3 percent in January, suggesting a pickup in the first quarter even if growth slowed somewhat in February, which appears likely. Auto sales declined in February, and so far the average pace of the first quarter is slightly below the fourth quarter sales pace. Unusually harsh winter weather typically has an impact on non-auto retail sales, but an early indicator of retail sales appears to be holding up quite well. February chain store sales posted another sizable gain from a year ago, the fifth time in the last six months.

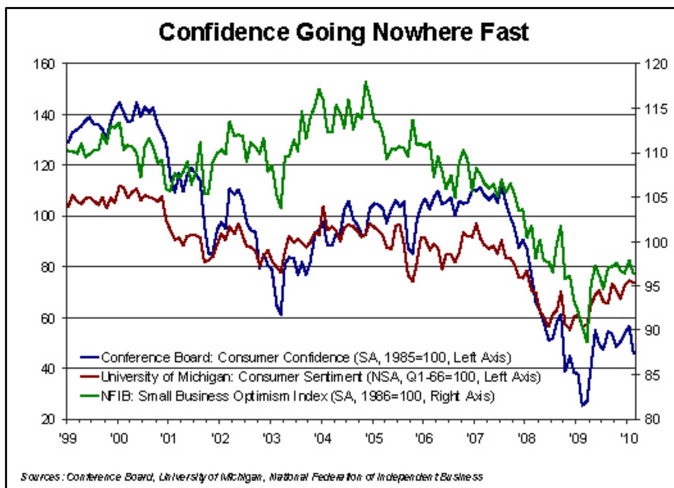
While consumers appeared to be off to a good start, we believe a strong pickup for the year is unlikely. Fundamentals supporting consumers remain soft, including weak labor market and compensation growth, low consumer and business confidence, and continued fragile household balance sheets. These factors suggest moderate spending growth in the coming quarters.

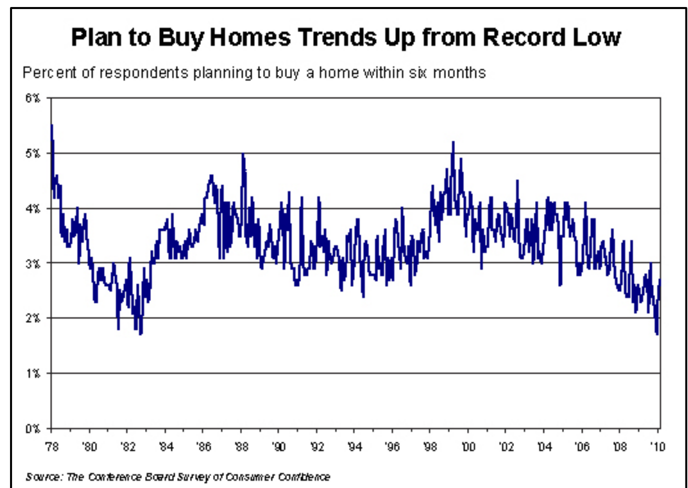
Besides a downward revision on consumer spending, the BEA also downwardly revised disposable personal income. A combination of lower personal income and larger tax payments in the third and fourth quarters pushed disposable income substantially lower than previously reported. The result was a 0.5 percentage point downward revision in the saving rate in the second half of 2009, with the rate reaching 4.1 percent in the fourth quarter. This was discouraging, as it implies that consumers have been less successful in rebuilding their fragile balance sheets than previously believed. Conditions worsened in January, as disposable personal income fell for the first time in six months, pushing down the saving rate from 4.2 percent in December to 3.3 percent—the lowest reading since October 2008.



Consumer Confidence: Jobs Wanted

Despite the surge in economic growth in the fourth quarter of 2009, real wages and salaries continued to drop further, weighing on consumer confidence. Both the Reuters/University of Michigan Consumer Sentiment Index and the Conference Board Consumer Confidence Index fell in February but by varying degrees. The drop in the Consumer Confidence Index to the lowest reading since April 2009 was much more pronounced than the Reuters/University of Michigan's measure as consumers were substantially more pessimistic about their job and income prospects than they were the prior month. One bright spot in the Conference Board survey was the share of those who plan to buy a home within six months, which rose from a record low in December to the highest reading since August 2009. While both measures of consumer moods have trended up from their record lows, they continued to stay near or below levels seen during previous recessions. It appears that consumers refuse to believe the notion that the recession is over, and it will likely take sustained job growth to convince them otherwise.





Given the severe winter weather in February, the financial markets were bracing for bad news from the labor market. The news turned out to be better than expected. Payrolls fell 36,000 during the month, and there was an upward revision of 35,000 jobs to previous months, according to the Establishment Survey. Construction payrolls dropped sharply as expected but manufacturing payrolls eked out a gain for the second consecutive month, the first time that has happened since 2006. The weather did have a material impact on labor market conditions. According to the Household Survey, about one million workers reported that bad weather prevented them from getting to work this February, compared with an average of about 300,000 each February previously, a record since tracking began in 1976. We cannot precisely remove the weather-related noise from the overall figures, but it is safe to say that the storms masked a marked improvement in labor market conditions.

The Household Survey also showed that the unemployment rate held steady at 9.7 percent, reflecting an increase of 308,000 in civilian employment—a figure that just kept pace with growth of the labor force. During the last two months, civilian employment has risen by more than 800,000, a huge divergence from the Establishment Survey showing continued payroll losses during those months. Large divergences between the two surveys are not unusual, especially when the labor market is on the cusp of creating jobs. In 2003, household employment rose substantially on a sustained basis well before payrolls. Thus the strong gains seen in household employment may presage sustained increases in payroll employment.

Leading indicators of the labor market were mixed: the length of the workweek edged down, likely reflecting the weather; while temporary employment continued to post healthy gains for the fifth consecutive month. The figure on temp employment excludes temporary census hiring, which accounted for about a 15,000 government payroll gain during the month. Overall, labor market conditions suggest that the market is poised to create jobs, and we expect a substantial payroll gain in March, as the weather effect unwinds and census hiring is scheduled to pick up substantially.

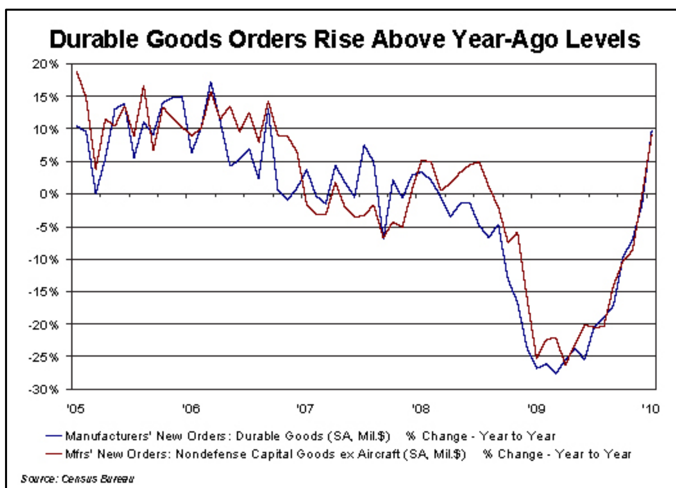
Business Confidence: Customers Wanted

Recent movements in small business sentiment have mirrored that of consumers, according to the National Federation of Independent Business (NFIB) Index of Small Business Optimism. While the index has climbed from its low in March 2009, it has stalled in recent months, remaining way below the levels seen during the 2001 recession, despite the improvement in economic activity in the second half of 2009 (*also see Chart 2 above: Confidence Going Nowhere Fast*). The survey suggested that an improvement in the labor market will likely be gradual. A record high share of businesses cited "poor sales" as their top problem in the February survey. More firms reported that they planned to cut workers than those planning to add. Small businesses, which have been a great source of job creation in the past, are facing a tremendous challenge. Without sustained increases in consumer demand, they are unlikely to add workers. However, without meaningful job creation, consumers will likely remain cautious, keeping spending growth moderate.

Nonresidential Investment: Continued Expansion at a Slower Pace

The most encouraging part of the revision in GDP was a sizable upward revision to nonresidential business investment in equipment and software, or CapEx, which posted the fastest pace of increase since the first quarter of 2000. Its contribution to GDP was 1.1 percentage points in the fourth quarter of 2009, rivaling the contribution from consumer spending. Some of the gain was likely influenced by expiring tax breaks at the end of 2009, however.

Incoming data suggest a slowdown in CapEx in the first half of this year. Durable goods orders increased strongly in January, driven by a jump in the volatile aircraft sector. However, nondefense durable goods orders excluding aircraft—a proxy for CapEx in coming quarters—fell sharply after two large consecutive gains. One noteworthy aspect was that, after an extended period of decline that started in 2008, durable goods orders increased from a year ago for the first time since the start of the recession. Nondefense durable goods orders excluding aircraft also posted a double-digit percentage gain from a year ago.

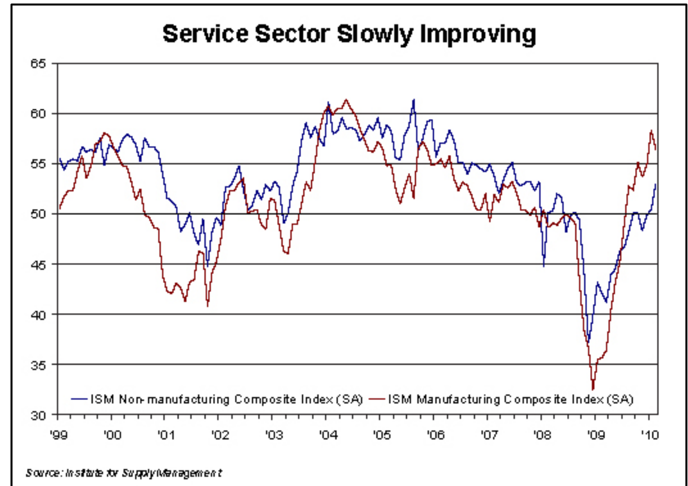


We continue to expect that the recovery in business investment will continue. Industrial production, which measures the nation's output in manufacturing, mining, and utilities showed a strong gain in January, led by a rise in manufacturing output. Improving corporate profits have allowed businesses to increase capital expenditures, especially toward high-tech equipment.

With seven consecutive increases in industrial production, the rate of capacity utilization has trended up gradually to 72.6 from its record low of 68.3 in June 2009. Still, the current capacity utilization rate continues to remain below the rates seen during previous recessions with the exception of the 1980-82 recession, where the cycle low was 70.9. Both the unemployment rate and the capacity utilization rate indicate substantial slack in the economy.

Another manufacturing report indicated an on-going solid recovery in manufacturing. The Institute for Supply Management (ISM) Manufacturing Index showed expanding manufacturing activity in February for the seventh consecutive month. While the slight drop in the index indicated a more moderate pace of expansion during the month, the index has remained in strong growth territory.

A more balanced picture of manufacturing and services growth has emerged, according to the ISM Non-Manufacturing Survey. The Non-Manufacturing Index rose to the highest reading since December 2007, showing strengthening growth in the service industry, which covers nearly 90 percent of the economy. Since the second half of 2009, the service industry has lagged behind manufacturing, as evidenced by the gap between the two indices. The jump in the Non-Manufacturing Index and the drop in the Manufacturing Index narrowed that gap, suggesting a broadening economic recovery.

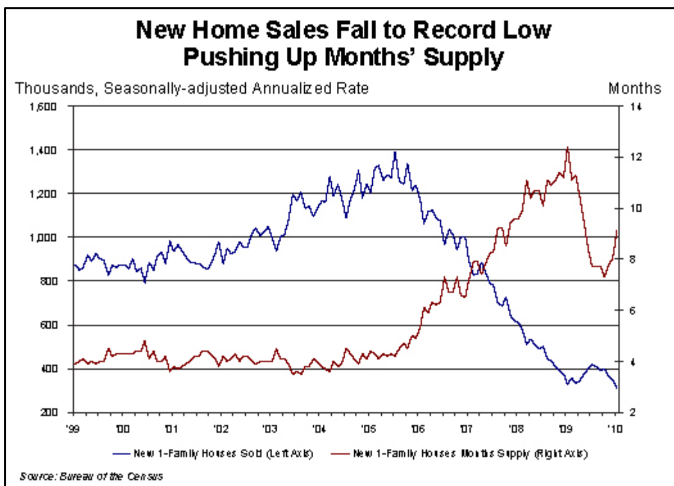


There is no end in sight for the commercial real estate downturn. Real nonresidential investment in structures fell 13.9 percent in 2009 and we expect the decline to continue this year. We expect that this sector will be the last to recover.

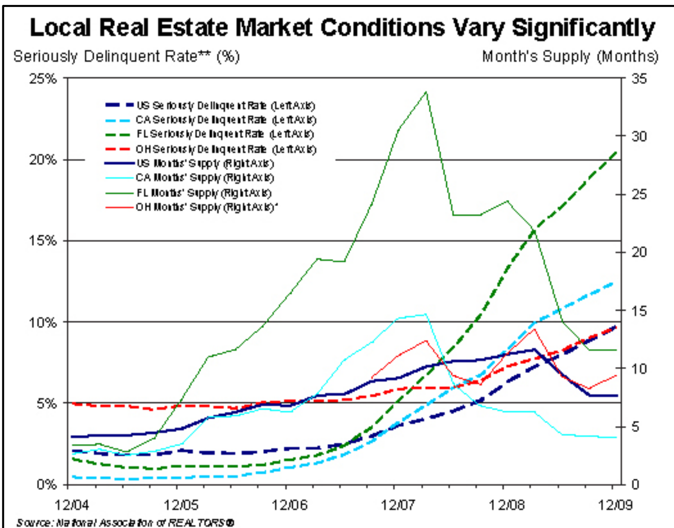
Residential Investment: Dimmer Near-Term Outlook

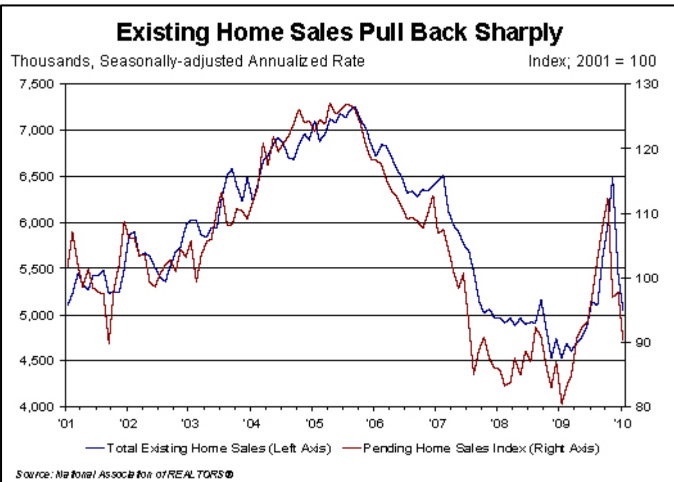
Construction spending fell in January, with the decrease driven by nonresidential construction spending and public construction spending. While residential construction spending increased, the gain was entirely due to expenditures on home improvement. Spending on new construction fell despite a modest increase in units of housing starts during the month, as the average cost per unit declined sharply. Homebuilding activity has improved substantially from its depressed level a year ago, with single-family starts reaching 33 percent above their level in January 2009. A leading indicator of starts pointed to continued increase in the near term, as single-family permits rose for the third consecutive month.

In contrast, both new and existing home sales disappointed, dropping sharply in January. The tax credit was extended and expanded in November to cover current homebuyers and we had expected it to spur housing demand by January. New home sales fell for the third consecutive month in January to a level that surpassed the previous low recorded a year ago. A string of declines in new home sales caused the months' supply to increase in each of the past three months, reaching the highest level since May 2009. Existing home sales have fared better. Despite two consecutive sharp drops, January sales remained nearly 12 percent above their record low.



The national average months' supply masks significant regional variation. Some regions, such as Florida, continue to struggle with historically high months' supply while others, such as California, are experiencing lower than average months' supply. Loan performance also varies significantly around the country. At the end of 2009, the seriously delinquent rate for the nation rose to a record high 9.7 percent, according to the Mortgage Bankers Association National Delinquency Survey. However, the rate was more than double that in Florida, where the months' supply has remained at a double-digit level.





Home sales will likely fall further in February, suggested by a sharp decline in the pending home sales index in January. Furthermore, mortgage applications to purchase homes have remained near their lowest level since 1997, according to the four-week moving average of the Purchase Index in the Mortgage Bankers Association Weekly Applications Survey. Weak housing demand bodes poorly for the housing starts outlook. As a result, we revised downward our projected housing starts for the first half of this year.

While we had expected sales to pull back from an unsustainable pace in the fourth quarter, as homebuyers rushed to buy homes before the tax credit was tentatively set to expire, the drop in the current quarter will likely turn out to be larger than we had anticipated. There are many reasons why we believe the second tax credit will be much less effective than the first. The 2009 first-time homebuyer tax credit may have dried up the pool of qualified first-time homebuyers. In addition, while the tax credit was extended to cover repeat buyers, the amount of the credit was smaller than that for first-time homebuyers. The tax incentives may not be enough to induce many homeowners to move, given that current homeowners generally must incur commission costs to sell their current homes, a cost not incurred by first-time homebuyers.

We continue to expect home sales to rebound in the second quarter, as homebuyers rush to close sales before the expiration of the second tax credit in June. In the third quarter, we expect a payback as the tax credit will likely pull some of the demand forward. By the end of the year, if the labor market improves as expected, sales should start to trend up on a sustainable basis. For all of 2010, we project a nine percent increase in total home sales, compared with an increase of 12 percent in the previous forecast. Home price declines moderated in 2009 and we expect the trend to continue this year.

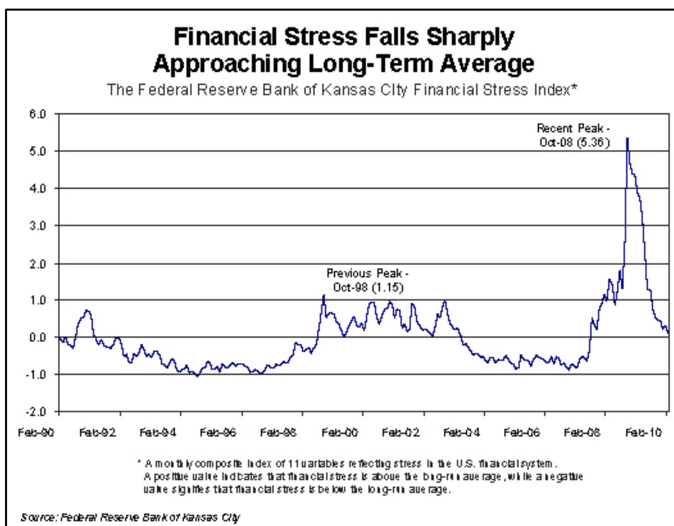
With projected lower housing starts, lower home sales, and, by extension, lower sales commissions in the near term, we lowered significantly our projection of real residential investment in the first quarter. We forecast a double-digit drop in the first quarter, rather than a slight increase as noted in the previous forecast. We expect a strong rebound in the second half of the year, and thus, for all of 2010, real residential investment is expected to grow about 10 percent, just slightly lower than in the previous forecast.

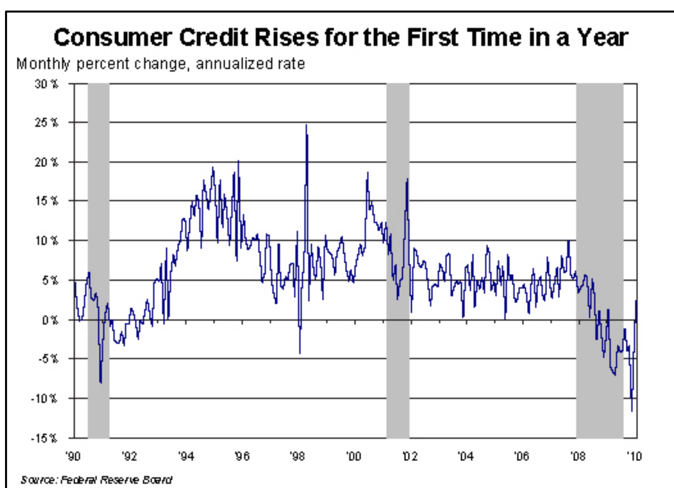
Mortgage Market: Declining from 2009 Policy-Boosted Volume

Due to lower projected home sales, we lowered purchase mortgage originations somewhat to $716 billion. Still, the purchase market should dominate production volume. For all of 2010, total mortgage originations are projected to decline to $1.31 trillion from a projected $1.97 trillion in 2009, with a refinance share of 44 percent. We expect the decline in mortgage debt outstanding to accelerate to 2.6 percent, compared with an estimated drop of 1.7 percent in 2009.

Financial Conditions: Turning More Favorable

Financial conditions have generally eased during the past month. The yield curve has remained steep and risk spreads in the corporate bond market have declined. Mortgage spreads have narrowed, with the spread between the yields on agency mortgage securities and 10-year Treasuries hovering near record lows by early March, even as the scheduled end of Fed purchases approaches. The S&P 500 was up more than 60 percent year-over-year on March 9, the one year anniversary of the date when the market hit a 12-year low. Fear over a Greek default has ebbed. Investors have been encouraged by measures taken by Greece to reduce its budget deficit and by expectations that Germany and France would ultimately come to Greece's assistance to prevent a default, and Greece succeeded in selling bonds at its last auction.





Measures of financial stress have trended down during the past year. For example, an index measuring financial stress produced by the Kansas City Federal Reserve Bank showed that financial stress has steadily declined from its peak in October 2008. In February, the index continued to move closer to its long-term average, although it has remained above the level seen at the start of the financial crisis in August 2007.

According to the Beige Book, a summary of regional conditions across the 12 Fed districts, the credit crunch continued to be widespread during the first two months of this year, with strains coming from both the demand and supply sides. Most districts reported weak demand for loans, as well as continued caution about lending on the part of banks. These conditions are unlikely to improve anytime soon and should continue to constrain consumer spending growth going forward.

There was one noteworthy development for consumer debt. After declining for eleven consecutive months, consumer credit outstanding (excluding mortgages) increased in January. Revolving credit (credit card debt) continued to decline, while non-revolving credit increased, driven by the jump in federal government lending (i.e., student loans from the Department of Education). The decline in consumer credit during the past year reflects both the decline in demand from consumers to incur new debt and the drop in the supply through tighter lending standards, as well as charge-offs. The increase during January was boosted by temporary factors and we believe consumer credit will likely resume its decline going forward.

Inflation and Monetary Policy: No Pressure

Retail inflation has abated. The Core Consumer Price Index (excluding food and energy items) declined 0.1 percent in January—the first drop since 1982. From a year ago, core inflation rose 1.6 percent, slowing modestly from the previous month. A broader measure tied to personal consumption expenditures excluding food and energy, the Fed's preferred inflation measure, showed a flat reading in January. We expect core inflation to moderate going forward.

The projection of moderating inflation is supported by labor cost trends. The BEA's downward revision in income in the second half of 2009 had a large impact on unit labor costs, especially in the third quarter. In the third quarter unit labor costs fell at an annualized pace of 7.6 percent (revised from 1.5 percent initially), the biggest drop since 1949. In the fourth quarter, unit labor costs posted the largest year-over-year decline since the inception of the series in 1948. This provides another piece of evidence of tame core inflation, as there is no cost pressure coming from the labor market.

With the surge in the Fed's balance sheet since late 2008, many analysts have focused on measures of expected inflation, such as the spread between the 10-year Treasury note yield and the 10-year TIPS (Treasury Inflation Protected Securities) yield. The spread rose significantly from its low in mid-2008 but has declined from its recent high in early February, suggesting contained inflation expectations for the time being.

While inflation appears to pose no risk in the near term, the economy has gained more traction, prompting the Fed to address the issue of an exit strategy to preempt higher inflation once the economy gains more momentum. The Fed raised its discount rate, one of the first steps in the process of unwinding the stimulus measures, although this action should not be seen as a signal of Fed tightening, according to its official announcement. We expect that the Fed will keep the federal funds rate unchanged through the rest of this year.

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Economics and Mortgage Market Analysis

March 10, 2010

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