Hopeful Signs Emerge

The Federal Reserve finally unveiled the details of the long-awaited resumption of its asset purchase program, known as quantitative easing, at the Federal Open Market Committee (FOMC) meeting in early November. The market's anticipation of a second round of quantitative easing, following Fed Chairman Ben Bernanke's speech at Jackson Hole in late August, helped boost equities, lower long-term interest rates, narrow risk spreads, and weaken the dollar. The Fed actions—the amount, the type, and the timing of the assets to be purchased—were broadly in line with market expectations, and it appears that much of the impact of the program is already priced in.

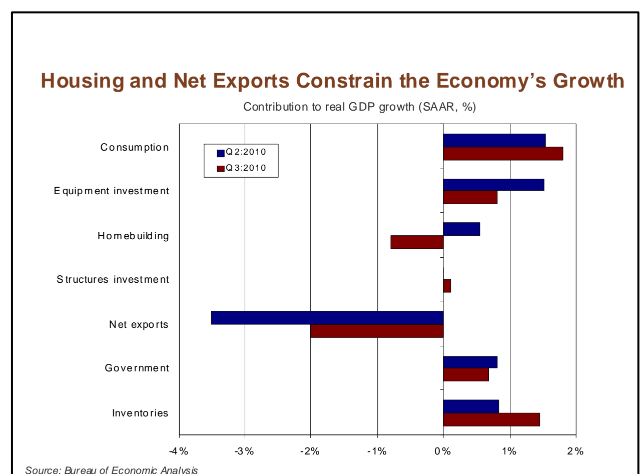
The October employment report, which provided surprising upside news, came out on the same week as the FOMC meeting. By the end of that week, major stock market indices reached their highest levels since September 2008. Improving financial conditions during the past two months and recent encouraging signs from the labor market, if they persist, should combine to support consumption and investment demand, setting the stage for an above-par growth trend by mid 2011. Despite recent positive developments, many challenges remain, including those from domestic fiscal policy and actions from abroad. Improvement in economic activity will likely occur at a gradual pace, and subpar growth is still in the cards in the near term.

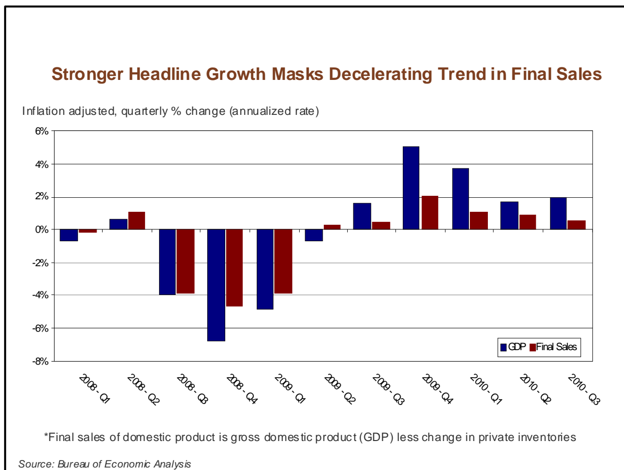
The Economy: Sluggish Growth Through at Least Early Next Year

Looking back, the tepid recovery continued in the third quarter. The first estimate of gross domestic product (GDP) showed a slight pickup in growth to 2.0 percent at an annualized pace from 1.7 percent in the second quarter. Consumer spending posted the best showing since the end of 2006, while business investment slowed markedly, albeit to a still solid pace. Housing plummeted following a tax-credit boost in the second quarter. In contrast, nonresidential investment in structures increased for the first time since the second quarter of 2008; however, the improvement came entirely from energy drilling and not building structures.

In terms of contributions to GDP, consumer spending was the biggest driver in the third quarter, adding 1.8 percentage points to growth. Changes in inventories, which were supposed to be fading, were surprisingly strong, coming in second as a source of growth. Business investment in equipment and software, a reliable driver of the recovery, continued to add to growth, although its contribution was just slightly more than half of what it was in the second quarter. After supporting economic growth in the second quarter for the first time in three quarters, housing resumed its subtraction from growth. Trade was still a large drag, albeit improving during the third quarter.

While economic growth in the third quarter was stronger than we expected, the performance for the current quarter is likely to be more of the same tepid growth we saw during the third quarter. The modest strengthening in headline economic growth, by itself, did not translate into a buildup in momentum into the fourth quarter. Much of the pickup in growth came from an inventory accumulation, which suggests less new production to meet demand in the current quarter. In other words, the positive impact of inventory investment could potentially reverse and turn into a drag on growth. Final sales (GDP minus the change in inventories and considered a measure of underlying demand) grew only 0.6 percent, and have been slowing steadily from more than 2 percent in the final quarter of 2009. The deceleration in final sales underscores the fragile underlying trend of economic activity.





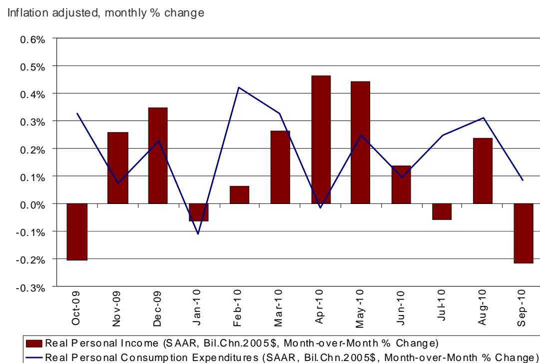
We expect continued sluggish growth at least through the first quarter of next year. While housing and trade are likely to improve going forward, the economy will receive less support from inventory investment and government spending. We expect business investment to remain solid next year, given an extremely low cost of capital and stellar profits, but nonresidential investment in structures is expected to decline throughout next year. Finally, we expect that consumer spending will continue to be a main support of growth next year, although with a modest contribution by normal recovery standards.

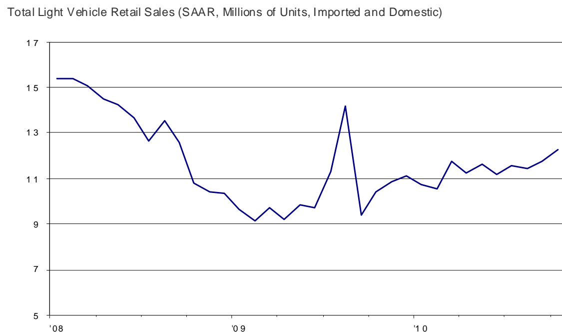
The strength in consumer spending will be determined largely by labor market conditions and income trends, as households will continue to pare their debt usage, voluntarily or otherwise, repairing their damaged balance sheets. The October employment report from a survey of establishments was upbeat, showing that hiring is slowly rebounding from a setback witnessed when the European sovereign debt crisis emerged in the spring of 2010. Total nonfarm payrolls posted a gain of 151,000, with private payrolls rising by 159,000. In addition, the prior two months' private payrolls were revised upwardly by a combined 93,000, sending the average monthly gain during the last three months to 136,000, compared with just 91,000 before the October report. Other very encouraging signs were increasing average hourly earnings, an increased average workweek, and higher temporary services payrolls. These aspects signal further improvement in hiring ahead.

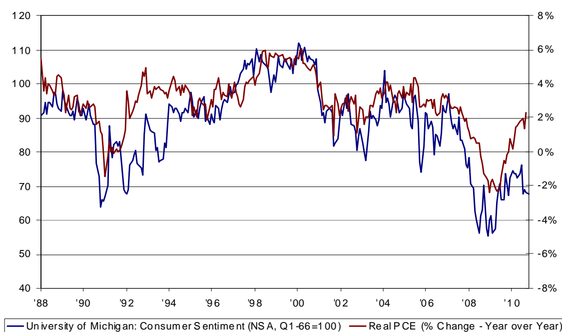
Tempering the positive news was the stubbornly elevated unemployment rate from a survey of households. The rate remained at 9.6 percent for a third consecutive month as household employment showed a large drop that was roughly offset by the decline in the labor force. Unfortunately, we expect the unemployment rate to get worse before it gets better as discouraged workers who had given up looking for jobs rejoin the labor force when the market shows consistent signs of improvement. It will take an average monthly gain in household employment of more than 150,000 on a sustained basis to bring down the unemployment rate. Counting those who gave up looking for jobs and those part-timers who prefer full-time jobs, the slack in the labor market in October was 17.0 percent, much higher than suggested by the headline unemployment rate.

We expect the unemployment rate to remain above 9 percent through most of 2012. The change in the policy toward emergency unemployment benefits could have some impact on the unemployment rate going forward. Unless Congress extends emergency unemployment benefits, they will expire at the end of November. After that, a few hundred thousand people will lose benefits each week until eligibility expires entirely around February 2011. If the emergency unemployment benefits are allowed to expire or if the eligibility period is shortened from the current 99 weeks, the unemployment rate could potentially decline faster than projected, as some unemployed people will be more likely to take a job they would not take if they could still collect benefits. Work by various researchers (e.g., the Federal Reserve Bank of San Francisco) suggests that this disincentive impact is approximately 0.5 percent.

Rising average hourly earnings and the lengthening average workweek in October were positive for consumer spending at the start of the fourth quarter. The pickup in real (inflation-adjusted) consumer spending in the third quarter was encouraging. However, without strong income support and less appetite for consumer credit, it is unlikely that the strength in consumer spending will be sustainable. Monthly data indicated that consumer spending weakened late in the third quarter as real income turned negative after rising strongly in August, boosted by the renewal of emergency unemployment benefits.







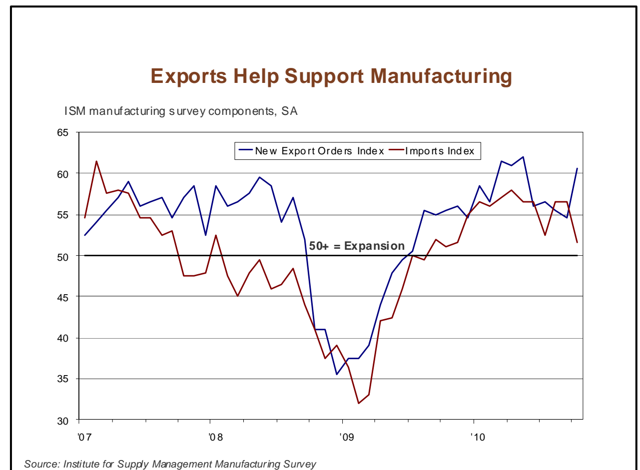
Leading indicators for consumer spending were mixed in October. While chain store sales weakened, vehicle sales started the fourth quarter on a strong note, rising to the strongest pace since September 2008, excluding sales in August 2009, which were boosted by the "cash for clunkers" program.

While measures of consumer confidence do not necessarily move in tandem with consumer spending, it appears that, lately, the improvement in spending has outpaced confidence. For example, while consumer spending has increased steadily during the past year, the Reuters/University of Michigan consumer sentiment index has recently fallen below its level from a year ago.

Confidence may soon get a lift from the recent improvements in the labor and equity markets. However, commodity prices have moved higher amid the declining dollar since late August, with crude-oil futures prices rising by 15 percent, reaching $85 per barrel after the FOMC meeting. Disposable income also will take a hit from fading government support. The payroll tax credit enacted in 2009 is scheduled to expire at the end of the year. As mentioned above, emergency unemployment benefits also are set to expire, if Congress lets them lapse as scheduled. Furthermore, it is uncertain whether the expiring tax cuts under the Bush administration will be extended across the board, including those for upper-income taxpayers. Despite a gain in household financial wealth during the past two months, rising energy prices and uncertainty surrounding future tax liabilities pose a challenge for the outlook for consumer spending.

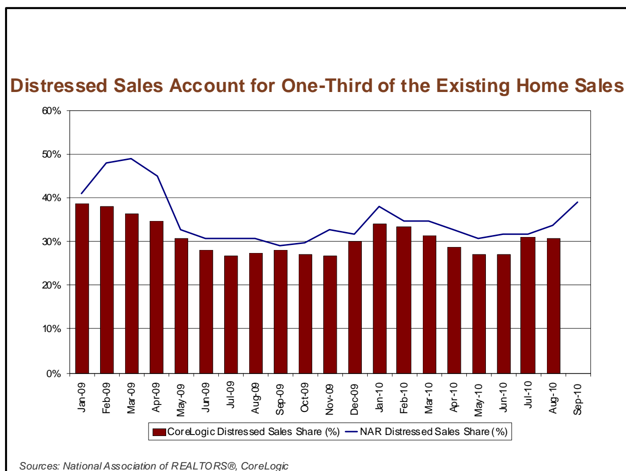
There are signs of healing across the economy. Surveys of broad economic activity suggest that both manufacturing and service activity expanded at a faster pace in October, according to the Institute for Supply Management (ISM) manufacturing and non-manufacturing surveys, both of which advanced during the month.

The increase in the ISM manufacturing index after four drops in the last five months was somewhat surprising, suggesting that the anticipated slowdown in manufacturing activity likely will be less severe than previously believed. Details in the ISM manufacturing survey showed improvement across the board, with new orders and export orders surging and employment and production rising from already elevated levels. The combination of an increase in export orders while import orders decline is particularly encouraging. The gap between the export and import orders components was the largest since June 2008. The large, positive gap suggests that, after subtracting from growth for three consecutive quarters, trade may soon add to growth. The ongoing decline in the dollar should help improve exports and support manufacturing activity amid fading supports from inventory investment.



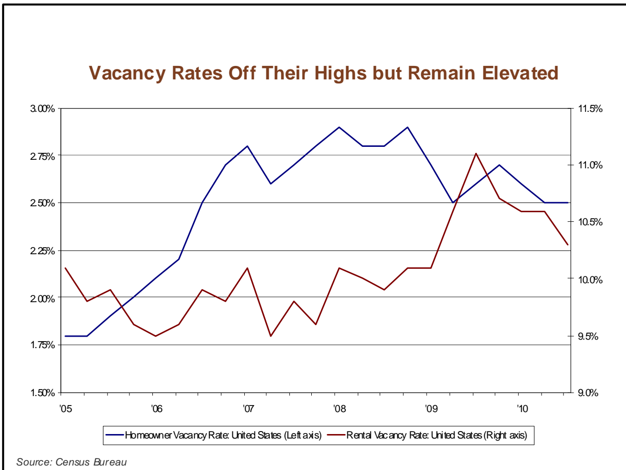
Housing: Near-Term Outlook Remains Bearish

Although both existing and new home sales rose in September, total home sales likely will soften in coming months. Existing home sales jumped 10.0 percent in September, but the impressive gain did not yet reflect the suspensions of some foreclosure sales. The foreclosure problems, which could cause some potential buyers to question the integrity of these transactions, add a layer of risk to the housing market. The magnitude of the potential damage to the housing market is difficult to assess, given the uncertainty surrounding the extent and the timing of foreclosure moratoriums. Distressed sales (foreclosures and short sales) have been an integral part of the housing market during the housing downturn. There are many surveys that track the share of distressed sales with varying results. However, they generally show that distressed sales still account for about one-third of existing home transactions at present.



The suspension of foreclosure and REO sales translates to a decline in the supply of homes available for sale in the near term but adds to the shadow inventory of homes. While the housing market still suffers from a large amount of excess supply for housing, it appears that conditions are slowly improving, according to the Bureau of the Census' Housing Vacancy Survey, which offers the most comprehensive gauge of vacant homes available for sale and for rent. The homeowner vacancy rate, which measures the share of housing units that are typically owner-occupied but are vacant and for sale, remained unchanged at 2.5 percent during the third quarter of this year. While the rate is much higher than its long-term average of about 1.7 percent, it has fallen from the record high of 2.9 percent recorded at the end of 2008.

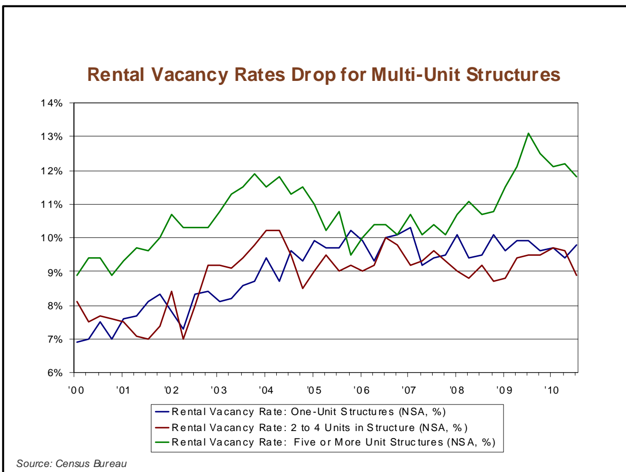
In contrast, the rental vacancy rate (the share of rental housing units that are vacant and available for rent) fell to 10.3 percent in the third quarter from 10.6 percent in the prior quarter. The rate has improved steadily after reaching a record high of 11.1 percent in the third quarter of 2009, though it remains historically high. Throughout the history of the series, the rental vacancy rate has been much more volatile than the homeowner vacancy rate, making it much more difficult to estimate what the normal rate is. Before the rental vacancy rate started to trend up sharply in 2001, the rate averaged 7.7 percent for about a decade, suggesting a still-significant excess supply of rental units.



Details of the rental vacancy rates by the size of the structure showed that only the rental vacancy rate for one-unit structures rose during the quarter while the rates for multi-unit structures improved.

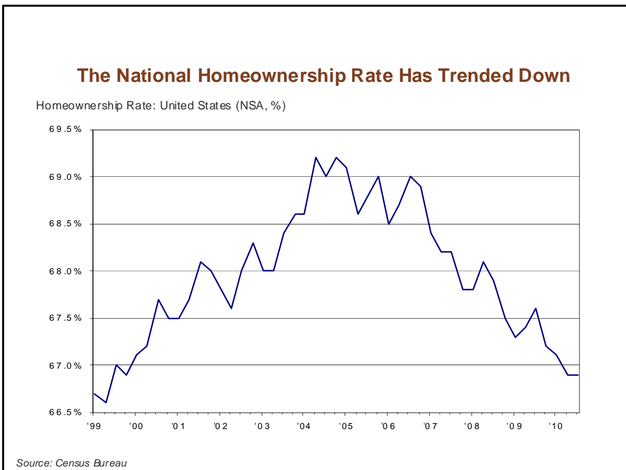
Insert Slide 11: Rental Vacancy Rates Drop for Multi-Unit Structures

The decline in rental vacancy rates for large structures is consistent with private surveys of apartment vacancies, showing improving multifamily fundamentals during the third quarter. (For more information on current multifamily market conditions, read the *November 2010 Multifamily Market Commentary*).



The Census also released data on homeownership for the third quarter showing that the homeownership rate (not seasonally adjusted) remained at the second quarter rate of 66.9 percent, which was the lowest reading since the end of 1999. The rate has been trending down from its peak of 69.2 percent in 2004.

Despite historically high housing affordability, tight lending standards and the weak labor market have made homeownership prohibitive for many households. These conditions will likely continue to be a barrier to homeownership for some time. Declining home prices also have also made households more cautious about purchasing a residence. These factors will likely depress homeownership further in coming quarters.



Even with some improvement in the broad measures of housing inventory, near-term leading indicators of housing activity point to continued weakness. After rebounding modestly in August and September from the post-tax-credit plunge, purchase applications in the Mortgage Bankers Association Weekly Survey of Mortgage Applications were relatively flat in October. Pending home sales, which measure contract signings of existing home sales, posted a modest drop in September. The decline was somewhat unexpected, given that the foreclosure problems did not start until late in the month.

Home building activity was mixed in September, with single-family starts rising for the second consecutive month while multifamily starts fell after back-to-back surges. For the third quarter, single-family starts declined at a nearly 37 percent annualized rate. By contrast, volatile multifamily starts surged 247 percent, although from near record low levels.

Permits, an indicator of future homebuilding activity, fell during the month, driven entirely by a drop in multifamily permits. Single-family permits eked out a small gain, the first in six months. The downward trend in single-family permits suggests that a rebound in single-family starts in the fourth quarter, if it occurs at all, will be modest. We also revised lower single-

family starts in coming years. For multifamily, the third quarter's strong performance prompted us to revise our near-term projection higher. Home builders' confidence edged up in October from a 17-month low level, according to the National Association of Home Builders' Housing Market Index. Home builders saw improvement in all three components: current sales, expectations of sales during the next six months, and traffic of prospective buyers.

The foreclosure issues are expected to keep home sales subdued in the final quarter of this year but we expect to see a gradual improvement in 2011. For all of 2010, total home sales are projected to decline by about 8 percent from 2009 to 5.13 million units, marking the bottom of annual total home sales in this cycle. We expect home sales to increase by about 3 percent in 2011. However, the pace of recovery will largely be determined by labor conditions. If hiring improves at a faster pace than expected, home sales will likely see a stronger gain in 2011 and vice versa.

After declining for four consecutive years to the lowest annual pace on record in 2009, homebuilding activity is expected to recover this year and improve further going forward. For 2011, single-family housing starts are projected to triple the 6-percent gain expected this year. Multifamily starts should see stronger gains than single-family starts both in 2010 and 2011.

The Fed's announcement on quantitative easing changed our forecast of short-term interest rates but left our projected path for long-term rates relatively unchanged. We believe that the impact on interest rates is largely priced in, resulting in a rate path close to what we projected in the prior forecast. The Fed announced that it will purchase $600 billion of long-term Treasuries by the end of the second quarter of 2011, leaving open the possibility of doing more if growth and inflation do not pick up by then. The $75 billion per month in new purchases of Treasury debt will be on top of $35 billion per month the Fed is expected to purchase to replace retired agency mortgage-backed securities in its portfolio.

We now expect the Fed to keep the zero fed funds rate policy through all of 2011. The first tightening will likely occur by mid-2012, compared with late 2011 expected in the prior forecast. For long-term interest rates, yields on 10-year Treasuries have fallen from just under 3 percent in early August to around 2.5 percent after the Fed meeting. We expect the 10-year Treasury yield to move up gradually during the course of next year, reaching about 3 percent by the end of 2011. We also expect mortgage spreads to tighten during the same period, with the spread between the 30-year fixed mortgage rate and the 10-year Treasury yield narrowing from the range of 160-170 basis points in the third quarter to below 150 by the end of next year. As a result, mortgage rates are expected to remain close to the current level of about 4.3 percent in the coming year.

Given our projected mortgage rates, the Fed's quantitative easing is not expected to refuel refinance activity, which is now fading. Refinance applications fell during the last week of October for the seventh time during the last nine weeks. For 2010, we expect that refinance originations will account for about 65 percent of the projected $1.50 trillion in total mortgage originations. The refinance share is expected to drop to 46 percent of the projected $1.18 trillion mortgage originations in 2011. We expect the deleveraging process of mortgage debt to continue, with total single-family mortgage debt outstanding falling 3.2 percent in 2010, followed by a 3.0 percent drop in 2011.

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Economics and Mortgage Market Analysis
November 10, 2010

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