Moderating Growth into 2015

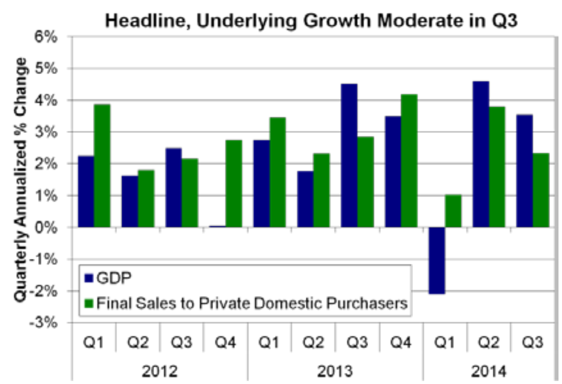
The strong growth in mid-2014 is slowing to a pace closer to our expectations for trend growth in 2015. Our current forecast puts full-year 2015 growth at 2.5 percent. We see full-year growth of 2.1 percent when the books are closed on 2014, which suggests that 2015 will be an improvement. We expect continued growth in employment, some improvement in incomes, gradually improving consumer purchase behavior, and increased business investment to be significant drivers. We believe the risk of recession is low.

The slowdown in global economic growth, including the Euro area, China, and Japan, and geopolitical events in Russia, Ukraine, and the Middle East remain the largest downside risks to the forecast. The sluggish global growth outlook has prompted long-term interest rates to move markedly lower. The ongoing decline in oil prices has helped to bring down headline inflation. This leaves more cash in consumer pockets but prompts concern at some central banks that the inflation rate may continue to decline from levels that are already below central bank targets. For example, in response, the Bank of Japan unexpectedly announced additional easing measures last month in an attempt to bring the inflation rate up to its 2.0 percent target.

Economic Growth is Slowing but Remains above Trend

The advance estimate of third quarter gross domestic product (GDP) showed real growth at an above-forecast 3.5 percent annualized pace, which followed a robust rebound gain of 4.5 percent annualized in the second quarter.

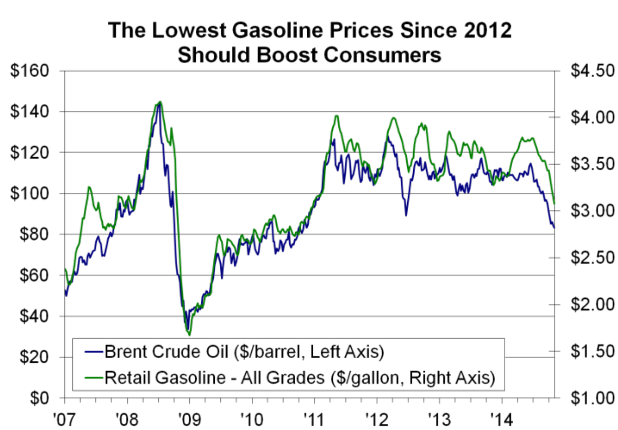
The details were less encouraging than the headline growth, however. A key indicator of underlying growth for the private sector—real final sales to private domestic purchasers (which includes domestic spending by consumers and businesses and excludes inventories)—grew 2.3 percent, slowing from 3.8 percent in the second quarter. Also, third quarter growth may be subsequently downgraded. The Bureau of Economic Analysis assumed a 1.3 percentage point contribution to third quarter GDP from net exports in its advance estimate, though the September trade report released after the GDP report suggests the contribution likely will be revised lower to roughly one percentage point.

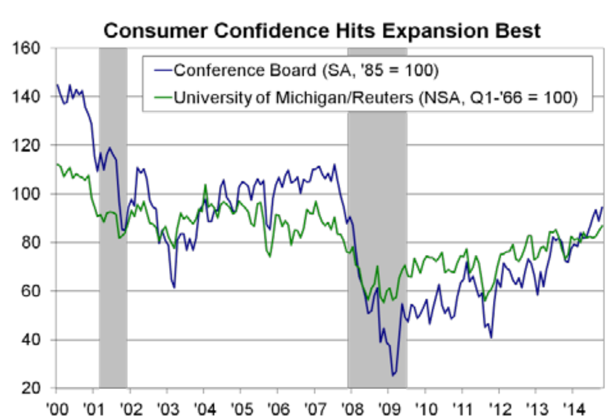


Manufacturing Expansion Remains in Place

Besides the drop in consumer spending in September, another disappointing piece of news came from the durable goods orders report, as September core durable goods orders—a leading indicator for business capital investment—posted the largest drop since January. However, other factory-related news was positive. Manufacturing output rebounded in September, offsetting the drop in the prior month, and the Institute for Supply Management (ISM) manufacturing index rebounded sharply in October, suggesting that the expansion in the sector will remain in place despite slowing demand abroad.

Consumers Remain Cautious…

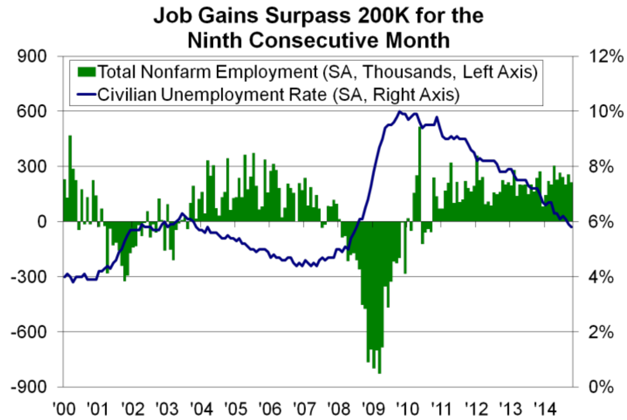




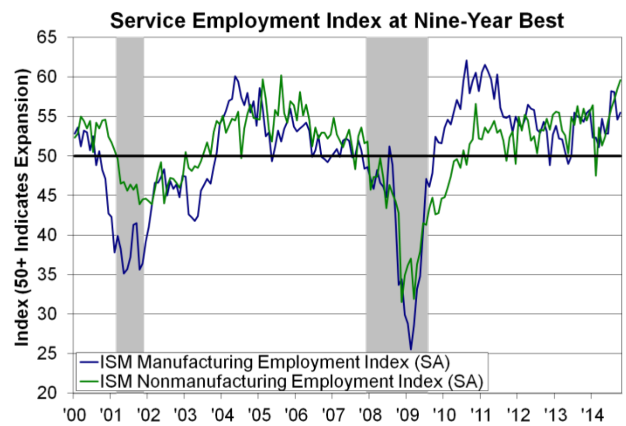
Cautious consumers cut back spending at the end of the third quarter, pushing the saving rate up to 5.6 percent, matching the level in July, which was the highest since 2012. The drop in September real consumer spending lowered the trajectory for the fourth quarter. However, October vehicle sales were solid, and measures of consumer confidence moved higher at the outset of the fourth quarter. The final reading of the Reuters/University of Michigan Consumer Sentiment Index ticked up to the highest reading since July 2007, while the Conference Board Consumer Confidence Index rose to a seven-year high. Despite the impressive headline in the Conference Board's measure, buying plans for autos, major appliances, and homes failed to improve, suggesting a high level of consumer caution. Looking ahead, we expect declining gasoline prices, presaged by continued declining oil futures prices, will add to disposable income and help to support consumer spending.

…Amid Steady Improvement in Job Creation

The October employment report showed a healthy pace of hiring with nonfarm payrolls rising by 214,000. With the upward revisions to the prior two months, job gains have exceeded 200,000 for nine consecutive months, the first time since 1995. The unemployment rate, calculated from the separate survey of households, ticked down to 5.8 percent, a more than six-year low, as a large gain in household employment outpaced the sizable increase in the labor force. An acceleration in wage gains remains elusive, however. Average hourly earnings edged up just 0.1 percent in October with a three-month annualized gain of 1.8 percent. Year-over-year growth came in at 2.0 percent—holding within the tight range witnessed during the last couple of years. However, the average work week rose to the best showing since May 2008, pointing to a pickup in aggregate labor income during the month.



Outside of the jobs report, other labor market indicators also are positive. The four-week moving average for initial unemployment claims has remained below 300,000 since mid-September, declining in early November to the lowest level since mid-2000. Notably, as a share of the labor force, the current level of initial jobless claims is at a record low. In addition, both employment subcomponents of the ISM manufacturing and nonmanufacturing indices rose in October, with the latter surging to a nine-year best.

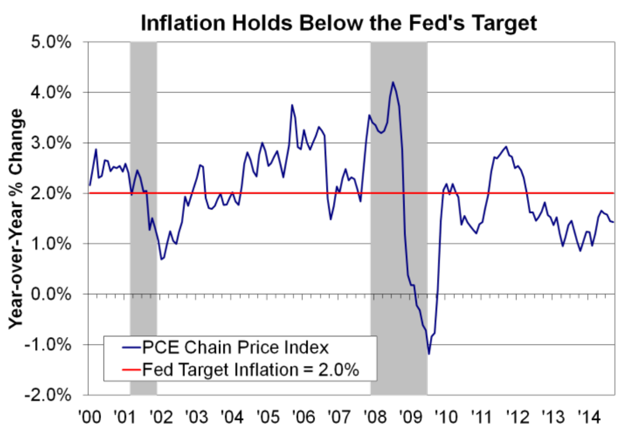


Fiscal Policy Braces for Potential Battle Next Year

Following the midterm election, a few important fiscal events have yet to be resolved. The lame duck Congress must extend the continuing resolution to fund the government by its December 11 expiration or face another government shutdown. We view a shutdown as unlikely, but nonetheless a downside risk to this outlook. The Congress must also decide whether to act to pass tax extenders that are scheduled to expire at year-end. The debt ceiling also will need to be raised approximately next March. The best-case scenario, and an assumption underlying this forecast, is for Congress to strike a deal before the March 15, 2015 deadline. If gridlock drags negotiations, raising the default concerns, both consumer and investor will yet again suffer.

Fed Indicates No Change in Expected "Lift Off" Schedule

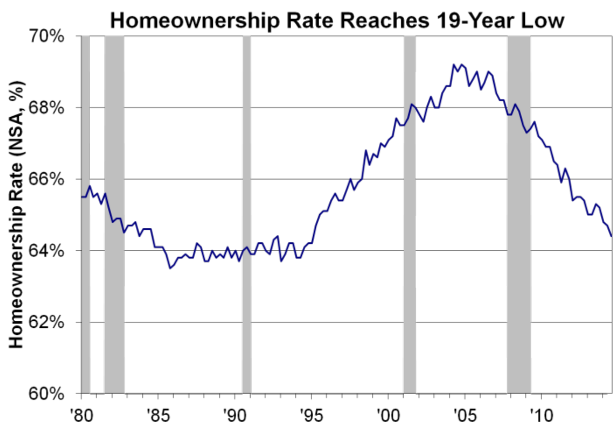
The Fed announced at its October Federal Open Market Committee (FOMC) meeting an end to its large-scale asset-purchase program, accounting for about $1.6 trillion over a span of two years. The Fed stated that it will now maintain the current size of its balance sheet at approximately $4.5 trillion at least until after its first increase in the fed funds target rate.

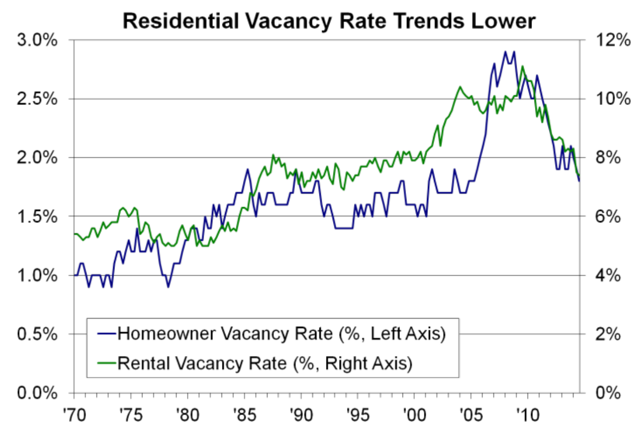


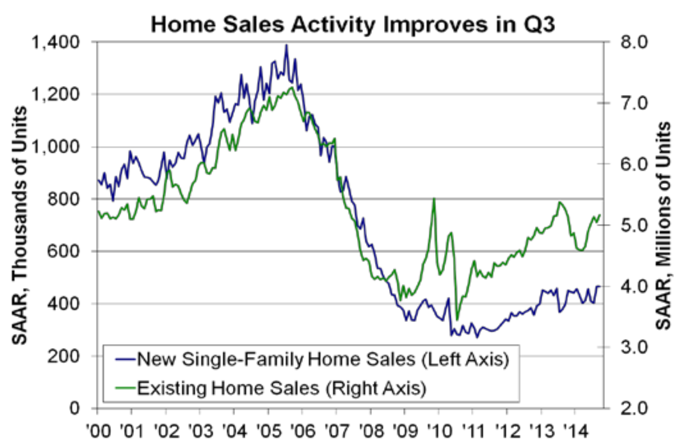
The statement following the meeting suggested no heightened concerns among the Fed officials regarding the current low rate of inflation as they continued to note that the odds of inflation running persistently below 2.0 percent have receded since earlier in the year. The Fed's favored inflation target—the personal consumption expenditures deflator—edged up 0.1 percent in September, and 1.4 percent year over year. While the current inflation rate was lower earlier in the year when it touched 1.0 percent, it remains well below the Fed's long-run 2.0 percent target. Inflation expectations in the U.S. also have moved lower, reflecting the decline in energy prices and a strengthening in the dollar. This has been made evident by a sharp reduction in the spread between nominal U.S. Treasury yields and the yields of inflation protected Treasuries in the second half of this year. We expect the further strengthening in the dollar amid an end to the asset-purchase program, expectations of rate hikes in the U.S., and expanding balance sheets abroad to keep inflationary pressure in check. Oil prices are likely to trend lower in the near term as it appears that OPEC is unlikely to cut back its production. Fed officials also acknowledged in the statement that underutilization of labor resources has gradually diminished. However, they retained the assurance that the target rate will remain near zero for a "considerable time" while noting that Fed policy is data-dependent, not calendar-dependent. We maintain our expectation that the Fed will raise the target interest rate in the third quarter of 2015.

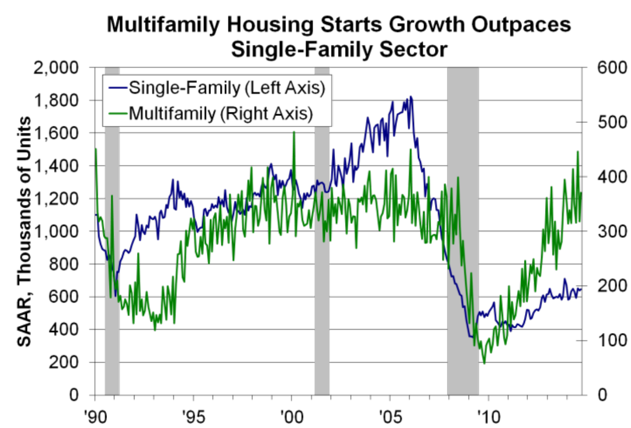
Housing Activity Grinds Higher but Fundamentals Remains Weak…

The housing recovery remains uneven so far this year. With little growth in household income, household formation continues to be weak, rising roughly 500,000 during the third quarter from a year ago, little changed from the pace witnessed in the first two quarters of the year, according to the Housing Vacancy Survey. The survey showed that housing demand continues to tilt toward rentals, made evident by declines in both the rental vacancy and homeownership rates to the lowest levels since 1995.





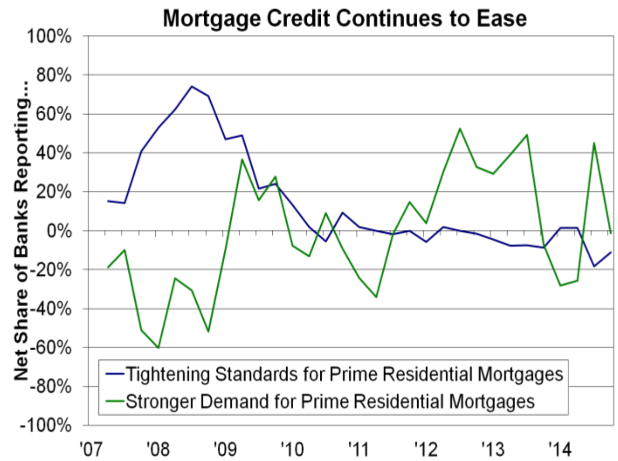




Homebuilding activity improved during the third quarter, driven by the multifamily segment, which we expect to rise 18 percent in 2014. (For more information on multifamily market conditions, read the November 2014 Multifamily Market Commentary.) The outlook for single-family homebuilding is less rosy, however, as single-family permits, a leading indicator of activity, edged up in September but has trended sideways for the better part of two years. In addition, home builders' confidence dropped in October to its lowest reading since July. Following double-digit gains in 2012 and 2013, single-family starts will likely increase less than 3.0 percent in 2014, leaving total housing starts slightly shy of one million units.

On a positive note, existing home sales rose in September to the strongest pace in a year, and their leading indicator, pending home sales, also edged up during the month. Total home sales for the third quarter increased 5.2 percent from the prior quarter. New home sales rose slightly in September, leaving the September sales pace at the highest level since July 2008. New home sales have bounced around from month to month this year without showing a meaningful upward trend. Despite the downward revisions, average sales for the third quarter rose 4.5 percent—the first quarterly gain this year. Existing home sales through the first three quarters of 2014 were 4.8 percent below the level during the same period last year, compared with a 2.4 percent gain for new home sales.

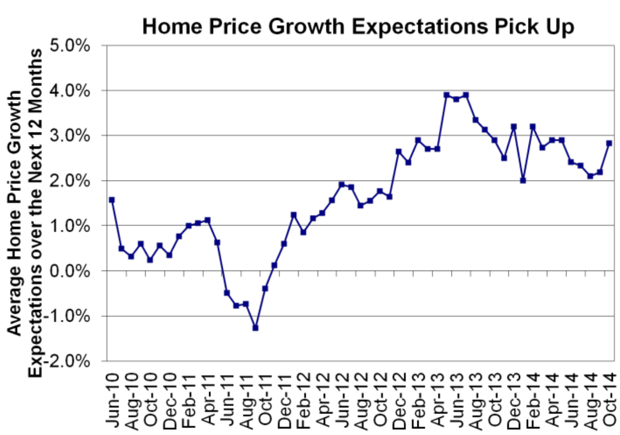
Continued improving labor market conditions, relatively low mortgage rates, and rising inventories should help boost housing demand going forward. While we believe that demand weakness trumps credit tightness in today's market, given underwhelming trends in household formation, income, and sentiment, we expect that an easing lending standards environment, even if only around the edges, should combine with other factors to boost home sales next year.

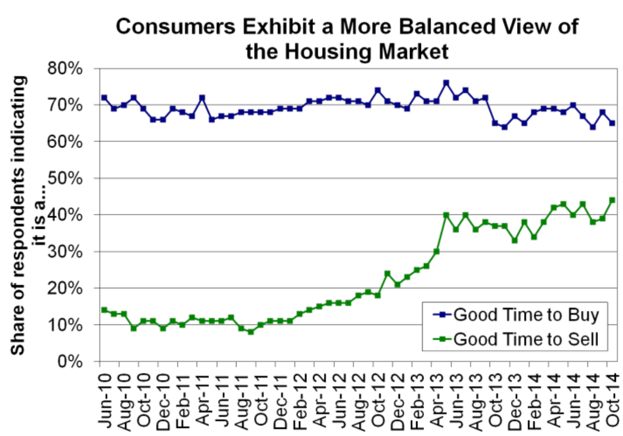


One measure to track lending conditions in the mortgage market on a quarterly basis is the Federal Reserve Senior Loan Officer Opinion Survey (SLOOS). The October survey showed that, on net, banks have eased standards for prime mortgages in the three months ending in October, the second consecutive period of easing. Unfortunately, the SLOOS also showed that a net share of banks reported weaker demand for mortgage loans following a rebound in demand reported in the July survey.

…Although Consumer Attitudes about Housing Improve…

The October 2014 Fannie Mae National Housing Survey results showed that consumers are growing more optimistic about the housing market. While recent actual home price measures have shown moderating annual gains, consumers' home price expectations rose significantly in October, largely reversing the dip witnessed during the past four months, and the share of consumers who think it's a good time to sell a home reached a fresh survey high. The narrowing gap between home buying and home selling sentiment in the survey may foreshadow increased housing inventory levels, bringing about a better balance of housing supply and demand and supporting the observed slowing of price appreciation nationally. Overall, the survey supports our forecast that a broad-based housing recovery will resume in 2015, with total home sales rising roughly 5.0 percent in 2015, more than offsetting the 3.0 percent drop expected in 2014.

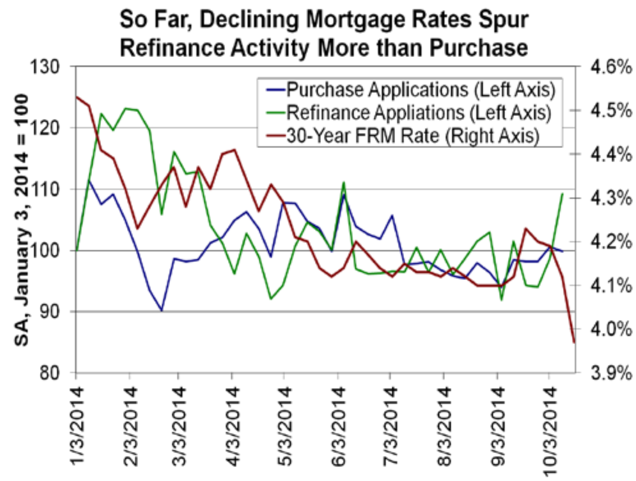




…While Mortgage Activity Pulls Back as Renewed Refinance Activity Fades

Our view of housing starts, home sales, and home price trends are largely unchanged from the prior forecast. Our projected purchase mortgage originations also are similar. However, mortgage rates moved lower in October, with the average yield on 30-year fixed-rate mortgages breaching 4.0 percent during the month, and settling at 4.02 percent in the first week of November, according to Freddie Mac.

Consequently, the drop in rates spurred a brief pickup in refinance mortgage applications, according to the Mortgage Bankers Association, which will translate into moderately more refinance originations late this year and early next year than we projected in the prior forecast. We don't expect the renewed increase in refinance demand to be sustainable. Data on refinance mortgage applications showed that even as rates have only gradually moved off a 16-month low, the recent resurgence in refinance demand is waning quickly, though activity still remains above mid-year levels. Should enhanced international economic turmoil spur additional flight to quality and provide greater downward pressure on interest rates (and subsequently mortgage rates), refinance volumes may come in stronger than in our forecast. The drop in mortgage rates has not spurred additional home purchase mortgage activity, as average monthly purchase mortgage applications edged down in October to the lowest monthly reading since February.



Our forecast looks for mortgage rates to trend up slowly as indicated by the forward curve at the end of October, reaching 4.4 percent by the end of 2015. For all of 2014, total mortgage originations should decline approximately 40 percent to $1.12 trillion and drop another 7.0 percent to $1.04 trillion in 2015. We expect the market will turn substantially more toward the purchase market, indicated by a sizable drop in the refinance share to just 32 percent in 2015 from our forecast of 40 percent this year. Total single-family (1- to 4-unit properties) mortgage debt outstanding is projected to remain relatively flat this year and strengthen modestly going forward.

November 10, 2014
Economic and Strategic Research (ESR)

For a more timely, detailed snapshot of macroeconomic and housing data, read ESR's Economic and Housing Weekly Notes.

Sources for chart data: Bureau of Labor Statistics, Energy Information Administration, Conference Board, University of Michigan/Reuters, Bureau of Labor Statistics, Institute for Supply Management, Census Bureau, National Association of REALTORS, Federal Reserve Board, Fannie Mae National Housing Survey, Mortgage Bankers Association, Freddie Mac

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