Despite a Weak First Quarter, Economic Growth Expectations Remain in Place

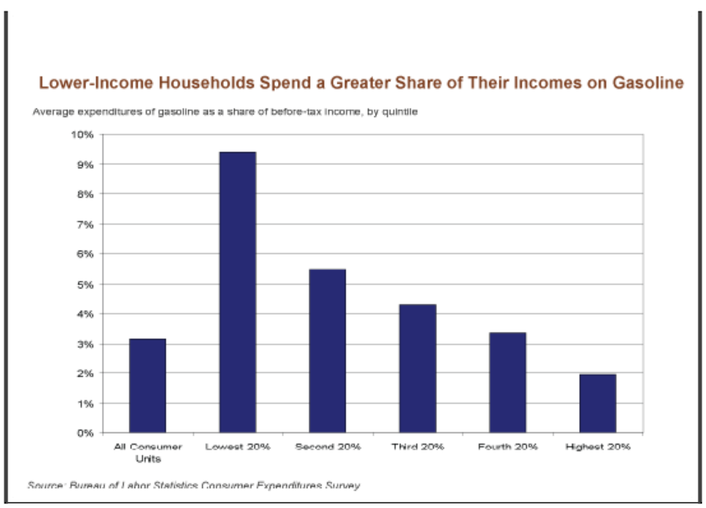
Economic growth slowed sharply to a 1.8 percent annualized pace in the first quarter of 2011 from 3.1 percent in the prior quarter. Part of the marked slowdown was due to temporary factors. Factors include the severe winter weather early in the year, which served to depress both residential investment and nonresidential investment in structures, and the largest drop in government spending since 1983, driven by a double-digit decline in national defense spending during the quarter.

Construction spending should rebound from the weather-related hit, and while softness in government spending will remain a drag to growth during the coming year, we expect the collapse in defense spending will prove to be an aberration. Consumer spending growth held up quite well despite the sharp rise in gasoline prices, and spending appears to be tracking firmly into the second quarter. While trade subtracted slightly from growth during the first quarter, the weaker dollar should help improve net exports going forward. The durable goods report at the end of the first quarter bodes well for business investment in equipment and software in coming quarters. Most importantly, the strength of April job gains showed that the labor market is gaining momentum, supporting the notion that the slowdown in the first quarter was transitory and that growth is poised to pick up to over 3 percent in the current quarter on an annualized basis.

For now, we appear to be moving past the soft patch. The plunge in crude oil prices in early May underscored their volatile nature. If oil prices trend down in the face of a continued improving labor market going forward, economic growth should remain over 3 percent for the rest of the year. While weakness in housing in the first quarter may have been exaggerated by the weather, a meaningful housing recovery this year is not expected. After being a drag on growth for five consecutive years, we expect residential investment to add just slightly to growth this year. With very little help from housing, the economy will likely grow at a modest pace again this year, similar to the 2.8 percent pace seen in 2010. Our projected 2011 growth is 2.9 percent—below the 3.1 percent to 3.3 percent range of the Fed April forecast, which was downgraded from the previous forecast of 3.3 percent to 3.9 percent released in January.

Economy: Above-Trend Growth Should Resume After the Temporary Downshift

Despite harsh weather and rising gasoline prices, real (inflation-adjusted) consumer spending slowed to a decent 2.7 percent annualized pace during the first quarter from 4.0 percent in the fourth quarter. This is still the second strongest performance since the start of the economic recovery. Consumers have received some support from the payroll tax holiday, which amounts to an extra $110 billion of cash this year. However, through April, higher gasoline prices have more than offset the impact of the payroll tax cut on incomes.

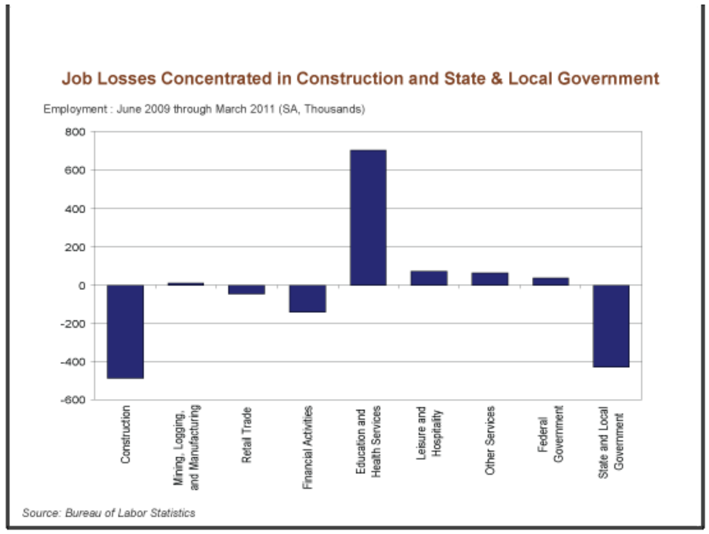


Rising gasoline prices have a disproportional impact on households. The share for lower-income households is much higher than that for upper-income households. For example, in 2009 (the most recent year that data are available), the households in the lowest income quintile spent more than 9 percent of their annual income on gasoline, compared with just about 2 percent for households in the highest income quintile.

It appears that persistently higher gasoline prices also are having a larger impact on confidence for lower-income consumers than higher-income groups. After plummeting in March, measures of consumer confidence rebounded modestly in April. For example, the Conference Board consumer confidence index rose by less than two points after dropping by more than eight points in March. Confidence increased for all income groups except for the lowest one (those making $25,000 or less), whose confidence fell in April for the second consecutive month. Rising equity markets appeared to have lifted confidence for higher-income groups, outweighing the impact of rising gasoline prices.

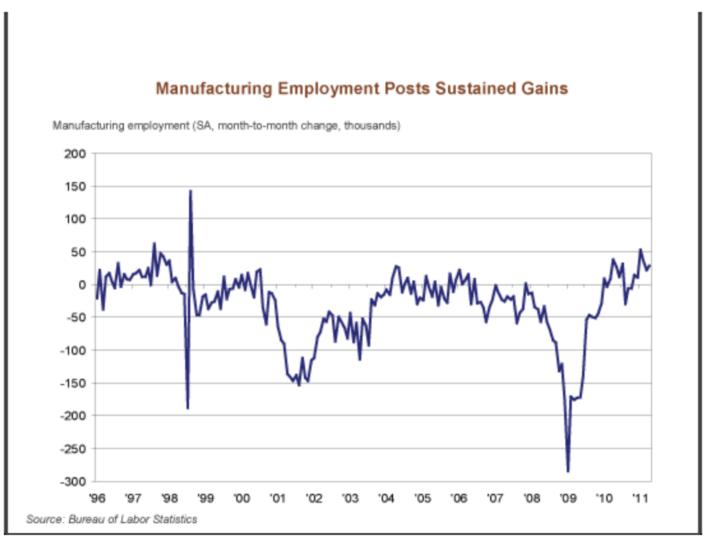
Consumers have some positives that will help sustain the ongoing economic recovery. The labor market appeared to have absorbed the twin shocks from the Middle East/North Africa and Japan without too much damage. Nonfarm payrolls from a survey of establishments rose 244,000 in April, marking the third consecutive month of solid gains. Subtracting a 24,000 decline in government employment, mainly because of declines in state and local government workers, private payrolls rose 268,000, the biggest gain in more than five years. March and February payrolls were revised higher by 46,000, putting the average gain in the past three months to 233,000, more than doubling the gain of the prior three months.

However, some negatives in the labor market tempered the upbeat news. State and local governments continued to be a drag on overall employment. The drag will likely persist before abating later in the year; however, risks remain that a recovery in this sector will be delayed given ongoing fiscal challenges. While employment gains were broad-based, construction employment continued to be subdued. In fact, since the start of the economic recovery, job losses have been concentrated in construction and state and local government.



In addition, the average workweek held steady at 34.3 hours in April for the third consecutive month. Average hourly earnings edged up just 0.1 percent and have risen a modest 1.9 percent during the past year. The bottom line is that there is a part of the labor market that will not benefit from the economic recovery for some time, and despite the improving employment picture, meaningful income gains have yet to materialize.

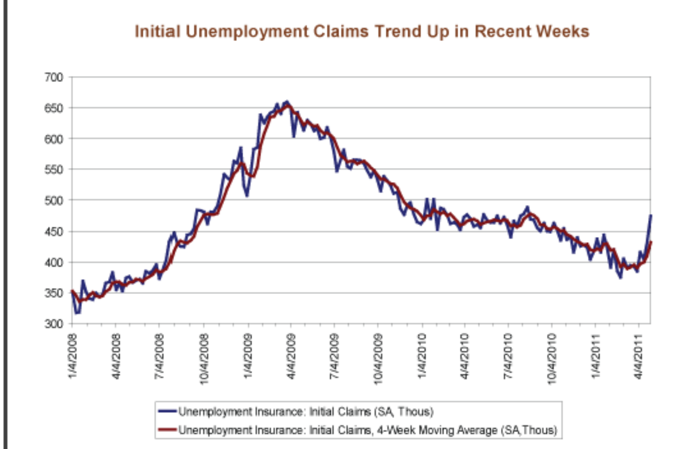
Another sobering picture of the labor market is that the unemployment rate, calculated from a separate survey of households, rose to 9.0 percent from 8.8 percent in March. An uptick in the unemployment rate is not uncommon during a period of improving labor market conditions, as brighter job prospects usually bring previously discouraged people (who had stopped looking for work) back into the labor force for another try. That was not the case for April, however. Household employment fell for the first time in five months, while the number of people looking for jobs stayed relatively flat during the month. After declining steadily from April 2010 to the end of last year, the labor force participation rate has stabilized, remaining at 64.2 percent, the lowest rate since the mid-1980s, for four consecutive months. The participation rate is likely to rebound modestly in coming months, as millions of people who lost their jobs during the recession are poised to re-join the job market as conditions improve further. That will present a challenge for bringing the unemployment rate down to levels seen prior to the recession.



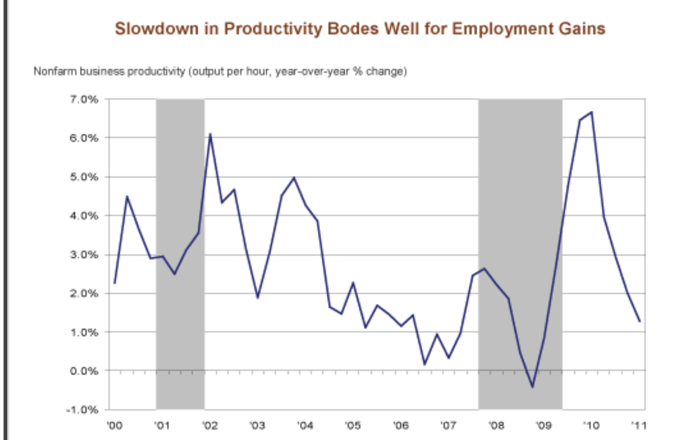
While service industry employment enjoyed a large increase in April, manufacturing employment continued to be impressive, showing an increase in jobs in this sector for six straight months, the first time that has happened since 1997.

This is by no means the glory days for the sector, as manufacturing employment has fallen 40 percent from its 1979 peak, a result of improving productivity and globalization. However, manufacturing has fared much better than construction—another goods-producing industry. Since its cycle trough in December 2009, manufacturers added 250,000 jobs. By contrast, it is unclear that construction employment has bottomed. Since its peak in April 2006, construction has been trending down, reaching the lowest level since April 1996 at the beginning of this year.

There are reasons to be cautious about the sustainability of the strength in job growth, including the recent uptrend in initial jobless claims**.** Data from April 12 (the most recent data available as of this writing), shows that jobless claims have trended up, raising some questions about the durability of hiring strength.



Source: Department of Labor



Source: Bureau of Labor Statistics

However, we appear to be in the midst of a transition from productivity-led growth to an expansion supported by sustainable job gains. Nonfarm productivity or output per hour slowed as the economy hit a speed bump in the first quarter, increasing 1.6 percent (annualized rate) compared with a gain of 2.9 percent in the prior quarter. Hourly compensation outpaced productivity, and, consequently, unit labor costs—compensation costs adjusted for labor productivity, a key gauge of wage pressure—rose 1.0 percent, following a 1.0 percent decline in the prior quarter. The modest rise in unit labor costs indicates little wage pressure for now, which helps alleviate the Fed's worries that core inflation and inflation expectations will spiral out of control.

Headline inflation has risen as a result of higher prices of energy and other commodities. Thus far, there has been relatively little spillover into core inflation. Fed Chairman Ben Bernanke stated in his first press conference following the April Federal Open Market Committee meeting that the Fed viewed the increase in headline inflation to be transitory and that it will moderate once the energy price run-up is over. The slack in the labor market will keep wage increases tranquil. Bernanke assured the market that the Fed has the will and the tools to keep inflation contained, and that inflation expectations and the strength of job creation will determine the stance of monetary policy.

Productivity growth is clearly slowing from the strong pace of the last two years, rising just 1.3 percent in the first quarter of 2011 from a year ago. This is compared to more than 6 percent growth during the cycle's peak at the end of 2009 and early 2010, when businesses continued to layoff workers even after the economy expanded.

As the expansion continues amid rising demand, firms are finding it increasingly difficult to get more out of their existing workers. While strong productivity growth is important for long-term economic growth, slowing productivity bodes well for the job market this year. We expect to see continued gains in payroll employment, albeit moderating from the pace during the past three months, averaging 180,000 a month for the remainder of the year before strengthening to about 200,000 jobs gained per month in 2012. The unemployment rate should trend down only gradually, remaining at about 8 percent by the end of 2012.

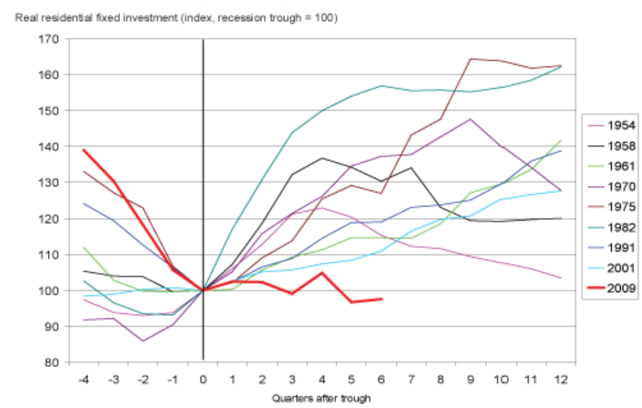
Besides stronger job gains, other consumer fundamentals also are improving. Household balance sheets have strengthened substantially during the past couple of years. Household net worth has increased, as debt has been pared down and the value of financial assets has rebounded. The saving rate has gradually trended up from just over 1 percent in 2005, remaining at 5.6 percent during the first three months of this year.

Financial conditions also have improved for corporations. Corporate profits have remained solid, and big businesses are awash with cash. Interest rates have remained at historically low levels, and credit spreads have declined to normal levels.

Anecdotal evidence suggests that lending conditions have been more favorable during the past several months. The April Federal Reserve Senior Loan Officer Survey showed that, during the three months ending in April, banks continued to ease lending standards for most types of loans, including commercial real estate loans, whose lending standards eased for the first time since the fourth quarter of 2005. Demand also generally improved for most types of loans. The exception was residential mortgage loans, for which demand continued to weaken and lending standards were little changed.

The bright spot for the current economy—manufacturing—continues to experience a strong expansion. The supply-chain disruption from the tragedy in Japan will likely cause a temporary decline in auto and other manufacturing output in the current quarter. However, the declining dollar should help spur exports, which will continue to support manufacturing this year. The April factory orders report also showed a robust increase in core capital goods—a leading indicator of business investment in equipment and software. This suggests strong growth for investment spending in the current quarter, benefitting manufacturing activity. Besides housing, nonresidential investment in structures took a large hit during the first quarter. We expect nonresidential investment in structures to be a slight drag on economic growth this year.

Current Housing Recovery Underperforms Previous Recoveries

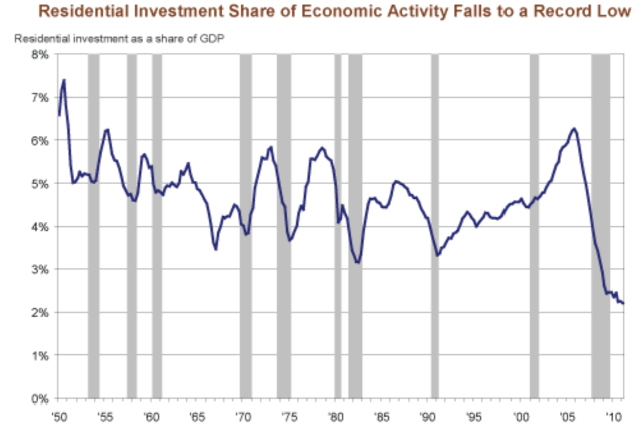


Source: Bureau of Economic Analysis

Housing: Sustained Improvement Remains Elusive

As the economic recovery approaches its two-year anniversary in June, housing has not yet contributed to economic growth in any meaningful way. Since the start of the current recovery, real residential investment growth has been relatively week, compared to those in previous recoveries. After the boost from the homebuyer tax credit in the second quarter of 2010, real residential investment dropped below the level observed at the start of the recovery.

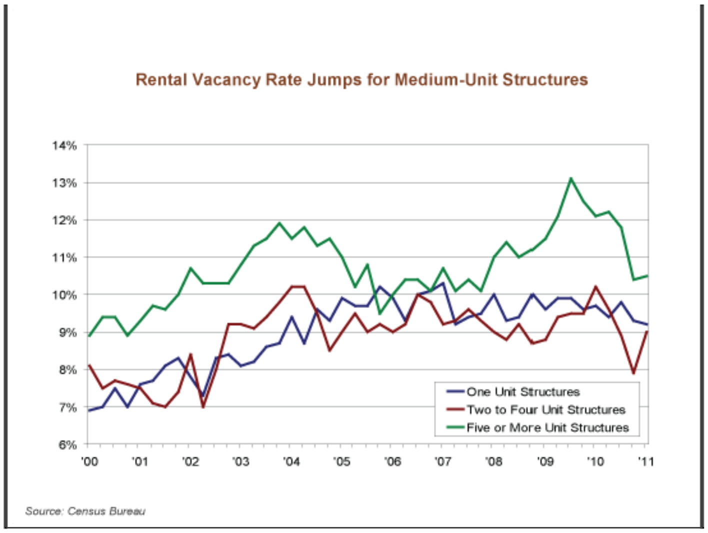
Residential Investment Share of Economic Activity Falls to a Record Low



Source: Bureau of Economic Analysis

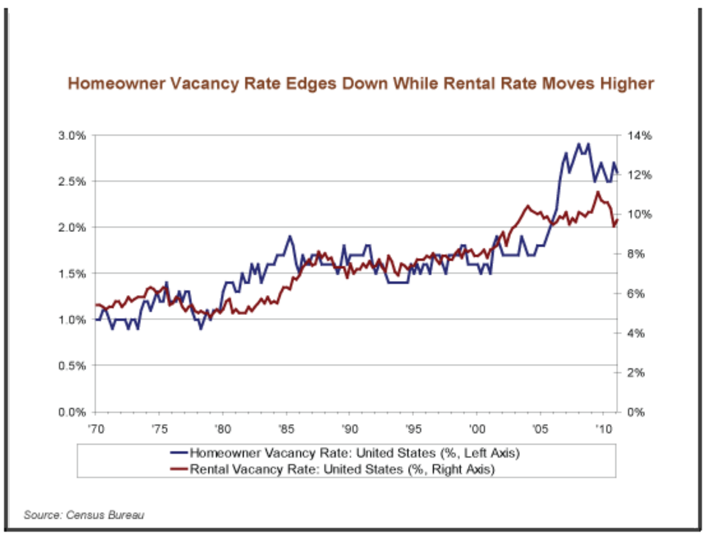
Real residential investment contracted at a 4.1 percent annualized rate in the first quarter, and as a share of GDP, residential investment fell to a record low of 2.2 percent, declining from its recent peak of more than 6 percent at the end of 2005.

Homebuilding activity remained very weak, especially for single-family structures, given a significant excess supply of homes, as well as an elevated shadow supply. Single-family housing starts and new home sales have been flat at depressed levels after the temporary and small lift obtained from the tax credit around the middle of last year.



Existing home sales have posted modest rebounds since the end of the tax credit. However, distressed sales continue to account for a large share of sales and the share has risen in recent months. Builder sentiment remains pessimistic as new homes continue to face competition from distressed sales, and home prices are showing renewed signs of weakness, amid the rising share of distressed home sales. For example, the CoreLogic House Price Index, which is used by the Federal Reserve in estimating the value of owner-occupied housing in the Flows of Funds data, fell for the eighth month in a row in March, with most of the decline resulting from distressed sales. From a year ago, home prices, including distressed sales, declined 7.5 percent. Excluding distressed sales, prices performed much better. Month-over-month, prices, excluding distressed sales, rose in March for the third consecutive month and were only less than 1 percent below the level in place a year ago.

The large price discounts associated with the rising distressed share also serve to depress appraisal values, adding difficulties to the underwriting process. Deteriorating expectations of home prices also act to persuade increasing numbers of potential homebuyers of non-distressed properties to remain on the sidelines.

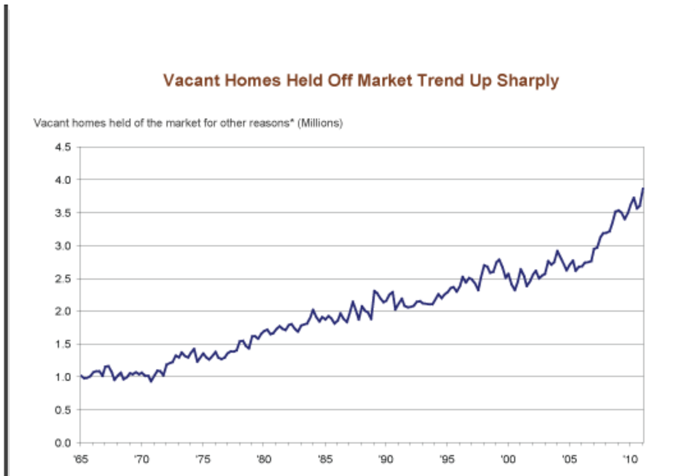


One positive aspect stemming from very little homebuilding activity is that the inventory of new homes is quite lean, with the number of new homes available for sale hovering near record lows that go back to 1963.

However, other indicators of housing supply suggest that the excess supply of the overall housing market has not yet declined on a sustained basis. One source that offers indicators of the supply of vacant homes for sale and for rent is the Census Bureau Housing Vacancy Survey, which showed mixed results in the first quarter of 2011. The homeowner vacancy rate or the share of owner-occupied housing stock that are vacant and for sale edged down in the first quarter of 2011 to 2.6 percent. After peaking at 2.9 percent in the fourth quarter of 2008, the rate has moved within a narrow range of 2.5 to 2.7 percent during the last nine quarters.

The improvement in the homeowner vacancy rate was tempered by a development in the rental vacancy rate. Prior to the first quarter of 2011, the rental vacancy rate declined steadily from its peak of 11.1 percent in the third quarter of 2009 to 9.4 percent in the fourth quarter of 2010, offering a rare green shoot for the housing market. However, the rate picked up in the first quarter to 9.7 percent; the reversal was disappointing and surprising as it contradicted other reports showing declining apartment vacancies. For example, private data showed that the national vacancy rate for institutional investment-type apartment properties fell during the first quarter. (For more information on multifamily market conditions, read the *May 2011 Multifamily Market Commentary*).

Details in the Census Bureau rental vacancy rate showed that the increase was largely because of a jump in the vacancy rate in structures with two to four units, which accounted for only 18 percent of the total vacant for-rent units during the quarter.



*Held off the market for reasons other than occasional use or temporarily occupied by persons with usual residence elsewhere.
Source: Census Bureau

The Housing Vacancy Survey also shows a category of vacant homes that can offer some insight on the shadow supply of housing—vacant homes that are held off market for unspecified reasons, which rose sharply during the first quarter.

This category of vacant homes also includes homes in the foreclosure process. Thus, the jump may have been attributable to the large number of homes stuck in the foreclosure process due to servicer foreclosure problems. Some of these vacant homes may be dilapidated properties or in undesirable locations and therefore they are not likely to add to the supply of housing because they will be destroyed.

While the Housing Vacancy Survey generally indicated the lack of improvement in the excess supply and the shadow supply of housing in early 2011, we caution in reading too much into these results, which can be volatile due to small sample sizes for some states and outdated housing stock estimates. The Census Bureau announced that it will soon release demographic profiles by state from the decennial Census data, including data on housing tenure and occupancy/vacancy status. These releases will help analysts derive a more accurate view regarding the extent of the excess supply of housing.

Recent strong employment gains provide an upside for the housing market, as it should help increase household formation, which has been depressed in recent years. In the current environment, newly formed households are more likely to be renters than owners. The homeownership rate or the share of households who own their homes, peaked at 69.2 percent in the fourth quarter of 2004 and has trended down to 66.4 percent in the first quarter of this year, the lowest rate since the fourth quarter of 1998.

It is likely that the homeownership rate will continue to decline further, given that lending standards are not likely to return to conditions seen during the housing boom anytime soon and that the cost of obtaining a mortgage is likely to increase further going forward. In addition, the number of mortgages 90 days or more past due or in the process of foreclosure has remained elevated, and a significant share of these borrowers will not be able to maintain their homeowner status and will likely convert into renters over time. Lastly, the historic housing downturn and declining home prices appears to have convinced many consumers that housing may not be as great an investment vehicle as had been the case in the past.

Our forecast continues to call for a modest improvement in housing activity this year. Near-term leading indicators point to improving home sales in coming months: pending home sales (contract signings of existing homes) rose in March, while purchase mortgage applications increased in March through mid-April. However, it is likely that some of the increased activity reflected a pull-forward of housing demand ahead of the increase in the FHA mortgage insurance premium that took effect on April 18. Purchase mortgage applications plummeted in the following week but have shown signs of stabilization in recent weeks.

The Fed will conclude its Treasury purchase program at the end of June, and short-term interest rates are likely to remain low, as the Fed is largely expected to remain on hold at least through early next year. Long-term interest rates have moved lower in recent weeks, with the yield on the 10-year Treasuries declining to a six month low at the time of this writing. We expect mortgage rates to move up just slightly over the course of the year amid modest economic growth, rising to about 5.2 percent by the end of the year. High housing affordability and a continued improvement in the labor market should help lift housing activity in the second half of the year.

Our forecasts of housing starts and home sales are little changed from the prior month. Both single-family starts and new home sales are expected to post slight gains, with multifamily starts showing a stronger increase from last year, supported by the ongoing decline in the homeownership rate and rising demand for rental properties. Home prices are expected to decline further before stabilizing late this year. Existing home sales are projected to increase by about 6 percent. However, we lowered our projected forecast of purchase mortgage originations for 2011 due to higher than expected shares of cash sales and distressed sales. The distressed share was 40 percent in March, while the cash share rose to 35 percent during the month, according to the National Association of REALTORS®. The decline in projected purchase mortgage originations is expected to be offset by higher projected refinance originations, which appeared to have been more front-loaded than previously projected.

For all of 2011, total mortgage originations are projected to decline to $1.04 trillion from an estimated $1.51 trillion in 2010. As a result of a downgrade in purchase mortgage originations and an upgrade in refinance mortgage originations, the refinance share is expected to reach 45 percent, compared with 40 percent projected in the previous forecast and 69 percent in 2010. We expect total single-family mortgage debt outstanding to fall an additional 2.7 percent this year, moderating slightly from a drop of 2.9 percent in 2010. This will mark the fourth straight annual decline. Some of the reduction in the mortgage debt outstanding reflects charge-offs but some reflects a conscious decision on the part of households to pare down their debt holdings. According to Freddie Mac's Refinance Activity Report for the first quarter of 2011, 75 percent of homeowners who refinanced their first-lien home mortgage either maintained about the same loan amount or reduced their principal balance by coming up with additional money at closing. That left the share of cash-out refinances at 25 percent, compared with the average cash-out share over the past 25 years of 62 percent. Our forecast calls for continued deleveraging in mortgage debt through 2013.

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Economics and Mortgage Market Analysis
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