Our Three-Handle Near-Term Growth Outlook Remains Intact

The Fed is completing its move away from "forward guidance" to being "data dependent" as incoming data support the view that economic growth in the second half of 2014 will average a solid 3.0 percent. The robust headline growth in the second quarter was slightly upgraded from 4.0 to 4.2 percent in the government's second estimate and more than offset the weak first quarter. Recent data through June showed upward revisions on net, suggesting that second quarter growth will likely be revised higher. The strength in growth appears to be broad-based, with all major components of gross domestic product (GDP) contributing, except the change in inventories. We expect growth to moderate from the above-par pace of the second half of this year and average 2.5 percent for all of 2015, an acceleration from a projected 2.0 percent in 2014. However, given the strength expected going into next year, the 2.5 percent pace may be more of a lower bound on growth expectations.

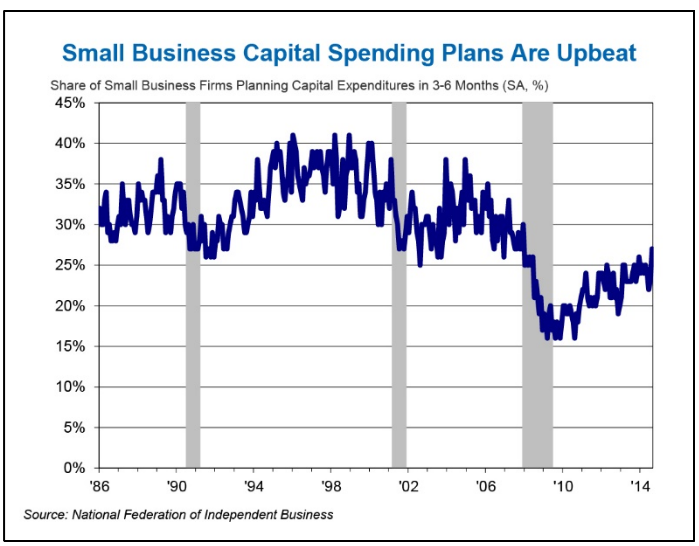
Economics: Solid Conditions…

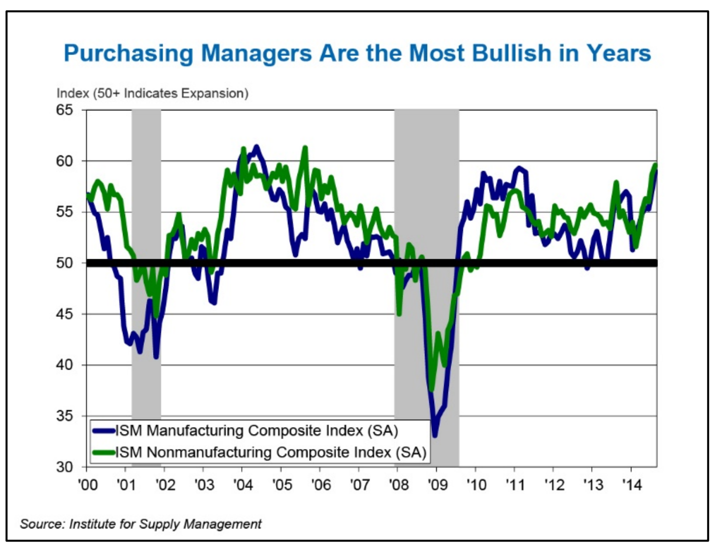
Economic reports for July and August 2014 were encouraging particularly in the area of business investment, which has been a missing ingredient for stronger growth for much of the recovery. Factory orders posted the biggest surge on record in July 2014 and the details were encouraging. Core capital shipments jumped in July, suggesting a healthy increase in business capital investment in the current quarter following a double-digit annualized gain in the second quarter. A survey of small businesses indicates that businesses are upbeat about capital expenditures in the near term. The August National Federation of Independent Business (NFIB) survey showed that the share of businesses planning capital expenditures over the next three to six months jumped four percentage points to the highest reading since the onset of the recession in December 2007.

The Institute for Supply Management (ISM) manufacturing survey points to a strengthening expansion with the August manufacturing index rising to a three-year high. Details were even more impressive, as the forward-looking new orders component increased to the highest reading since April 2004.

Business spending on structures also improved over the past year, benefitting from the gradual improvement in commercial real estate markets and increased energy production in the U.S. Because business spending on structures includes oil and gas exploration, extraction, and mining structures, the growth in "fracking," which adds to spending on mining and exploration, has helped boost business spending on structures. We expect spending on business structures to contribute more to GDP in the second half of this year than during the first half.

The improvement in activity was not limited to manufacturing. The ISM nonmanufacturing survey pointed to a strong pickup in momentum in the service industry, as the index climbed to a nine-year high.





The trade deficit narrowed slightly in July 2014, as a solid gain in exports – half of which came from petroleum products – just outpaced a gain in imports. Although imports of petroleum products rose during the month, they have been trending down over the past year. The declining petroleum trade deficit has helped to contain the overall trade deficit, and we expect the trade sector to help boost growth in the current quarter after acting as a drag in the prior two quarters.

…With A Few Cautionary Notes

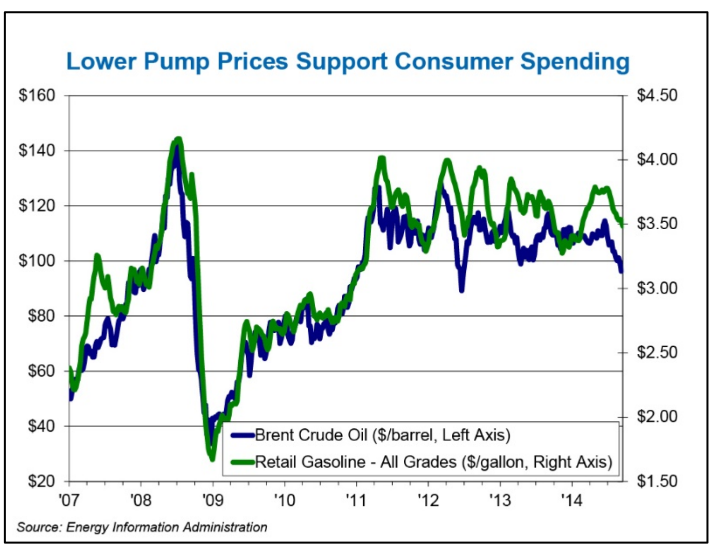
Not all incoming data were rosy. Consumer spending unexpectedly fell in July, driven by broad-based declines. The drop led us to downgrade our forecast for real consumer spending in the third quarter of 2014 by about one percentage point from the prior forecast to 1.6 percent annualized. Healthcare remained a major weakness for spending on services. The Bureau of Economic Analysis assumed a small rebound in healthcare spending in the second quarter and essentially flat spending at the start of the third quarter. However, we continue to expect volatility in the healthcare data as government statisticians wrestle with measurement of a large sector that has yet to see full implementation of major legislated changes.

The saving rate climbed to 5.7 percent despite slowing income growth in July. This was the highest rate since December 2012, when income was pulled into 2012 to avoid the federal tax hike enacted at the outset of 2013. Consumers appear to have slowed spending this year in favor of building savings, as the saving rate has increased 1.6 percentage points from its recent low of 4.1 percent at the end of 2013.

There are a few positive developments for consumers. Crude oil prices declined in August for the second consecutive month, and gasoline prices have followed suit. An analysis from the Fed indicates that a dollar increase in retail gasoline prices reduces real household disposable income by nearly one percent and hence tends to exert a significant drag on consumer spending. Thus, we expect that declining retail gasoline prices will provide support to consumer spending in the current quarter through a boost to disposable income.

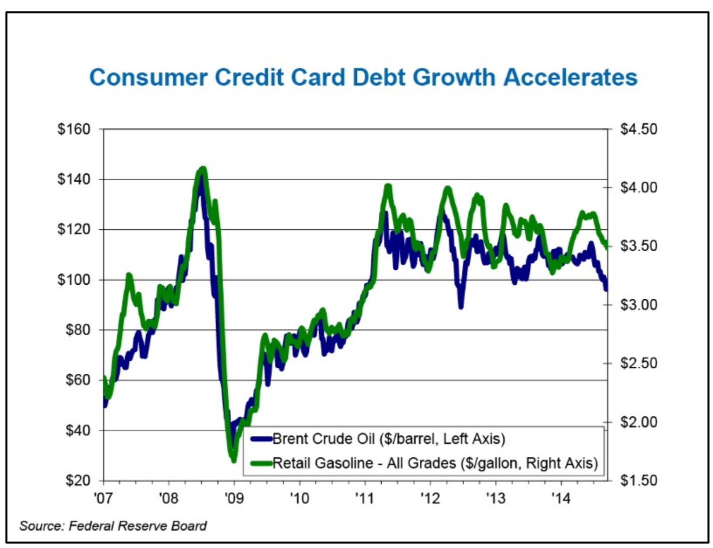
In addition, the Conference Board consumer confidence index increased to the highest level since October 2007, driven by a surge in the present situation component that outpaced a slight decline in the expectations component. Despite an improving assessment of current labor market conditions, consumer expectations of their income weakened. The Reuters/University of Michigan headline consumer sentiment index also improved in August from July but to a much lesser extent. Similar to the Conference Board's measure, the decline in the expectations component—likely a reflection of current geopolitical strife in Ukraine and the Middle East—tempered the improvement in the overall index.

Recent trends in consumer (non-mortgage) credit outstanding suggest that consumers appear to be less reluctant to take on credit card debt amid a stronger job market. Consumer credit balances posted a 9.7 percent annualized gain in July, which matched the gain in April as the biggest rise since July 2011. The gain in non-revolving credit (largely auto and student loans) drove the overall increase in consumer debt outstanding. However, revolving loan balances (largely credit card loans) advanced for the fifth consecutive month, marking the longest streak since prior to the recession and posting



Lower Pump Prices Support Consumer Spending

Source: Energy Information Administration



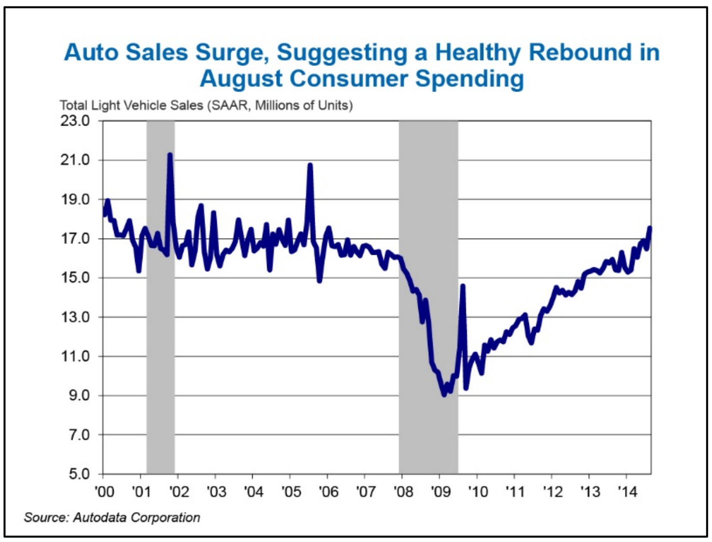
Consumer Credit Card Debt Growth Accelerates

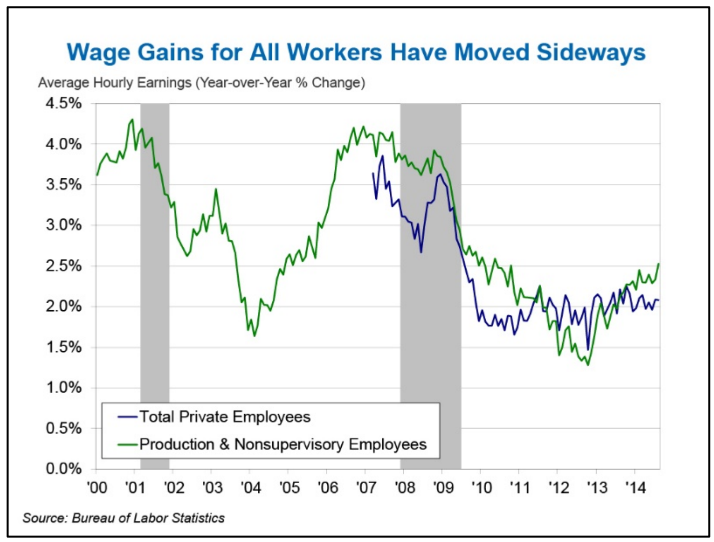
Source: Federal Reserve Board

the biggest year-over-year gain since October 2008. If the labor market continues to improve over time, we expect that consumers will be more willing to take on additional credit card debt to support stronger spending growth.
The surge in vehicle sales in August to 17.5 million annualized, the fastest monthly sales pace in more than eight years, signaled that the drop in spending in July will likely reverse in August. It is possible that an early Labor Day may have boosted sales, and if that is the case some payback will likely occur in September.

Another piece of slightly disappointing news over the past month came from the August jobs report, which ended the streak of six monthly job gains of more than 200,000, the longest such stretch since 1997. Nonfarm payrolls rose 142,000 while downward revisions to the prior two months totaling 28,000 jobs pushed the average monthly gain over the last three months down to 207,000 from 245,000 in the prior three month period. So far in 2014, the economy has gained an average of 215,000 jobs per month, up from 194,000 in 2013. The breadth of job growth also deteriorated. The diffusion index, a measure of how many industries are adding jobs, fell to 59.1, the lowest level since December 2013.

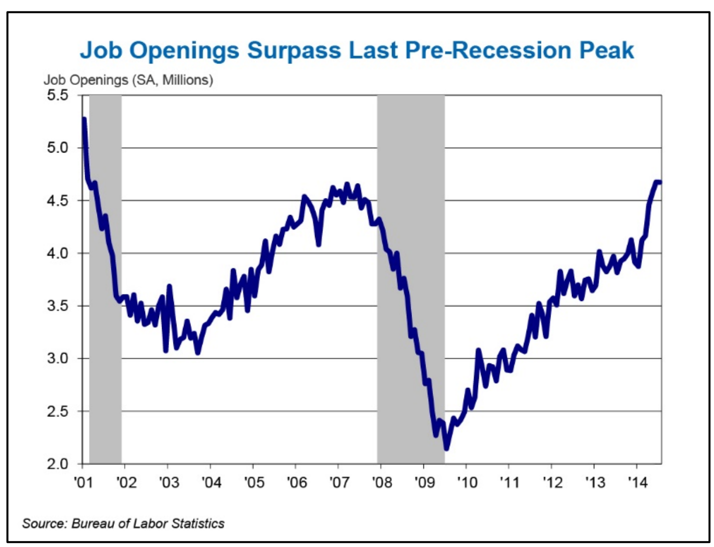
The report also showed that average hours worked remained flat for the sixth consecutive month. Average hourly earnings for all workers ticked up 0.2 percent from July and 2.1 percent from a year ago, maintaining the subdued trend witnessed during the past several years. Earnings for the sub category of non-supervisory workers, which have longer history, fared better: They rose 0.3 percent in August and were up 2.5 percent over the past year, the biggest year-over-year gain since October 201





The separate household survey showed a 0.1 percentage point drop in the unemployment rate to 6.1 percent, while the labor force participation rate edged down a tick to 62.8 percent, matching its lowest reading since the 1970s.

Our view of the underlying trend in the jobs market has not changed as the report was at odds with other recent reports. For example, initial jobless claims continue to hover at very low levels, matching readings witnessed prior to the recession, and consumer assessments and perceptions of job prospects from the Conference Board consumer confidence survey remain at multi-year highs. Furthermore, July's Job Opening and Labor Turnover survey showed that job openings stayed near their 13-year high reached in June, indicating a healthy demand for labor.



Fed Faces Less Pressure to Alter Its Statement

We continue to expect the Fed to end its asset purchase program at the October meeting but continue to reinvest the proceeds of its maturing asset holdings until a later date. The Fed continues to focus its attention on the labor market as the inflation picture remains subdued. The overall price index tied to personal consumption spending edged up 0.1 percent in July from June and rose 1.6 percent from July 2013, remaining well below the Fed's target of 2.0 percent. The minutes from the July Federal Open Market Committee (FOMC) meeting showed that Fed officials believe that employment and inflation have moved closer to levels consistent with their dual mandate. The August jobs report has not changed our call regarding the "lift-off" for the target fed funds rate expected around mid-2015.

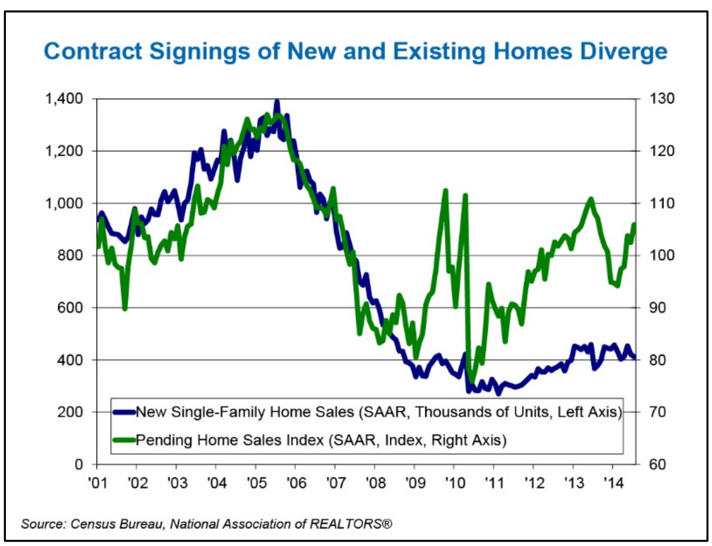
The European Community Bank (ECB) cut its interest rate targets and announced a private sector asset purchase program covering asset-backed securities and covered bonds starting next month against a backdrop of stagnant growth, high unemployment, essentially no inflation, and a shrinking ECB balance sheet. Meanwhile, the Bank of Japan continues to push toward further balance sheet expansion with asset purchase in its current "quantitative and qualitative easing" (QQE) policy, while the People's Bank of China pledged to inject liquidity through a standing lending facility to stimulate targeted sectors.

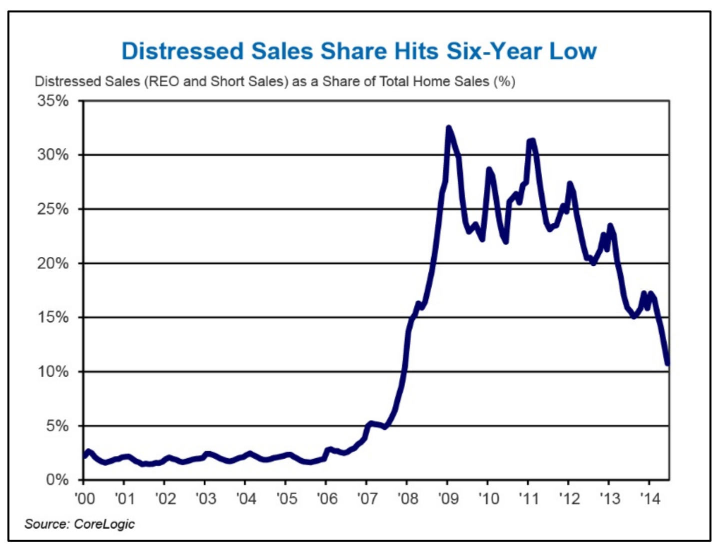
Housing: Struggling to Gain Traction

Housing activity improved at the beginning of the third quarter. Both single-family and multifamily starts rose in July for the first time in three months, but the improvement continued to favor the multifamily sector, which contributes less to GDP than does the single-family segment. Multifamily starts accounted for 40 percent of total housing starts—the highest share since the mid-1980s and double the share seen during the early 2000s. (For more information on multifamily market conditions, read the September 2014 Multifamily Market Commentary.)

Home sales were mixed in July. Existing home sales rose for the fourth consecutive month to a 10-month high, and pending home sales posted a sizable gain during the month, suggesting a decent increase in existing home sales for the current quarter. However, new home sales, which measure contract signings of new homes, moved lower in July to a level that is significantly below the second quarter average.

The trend in new home sales was at odds with homebuilders' confidence, which continued to improve, rising in August for the third consecutive month to the highest reading since January.





Home price gains have remained healthy, supported by limited inventory and declining distressed sales. According to the National Association of REALTORS® (NAR), the share of distressed sales fell sharply over the past year. In July, the share fell to 9.0 percent, marking the first single-digit reading since record-keeping began in October 2008, compared with an average share of more than one-third of total sales in 2009. The declining trend in the NAR survey is consistent with data from CoreLogic.

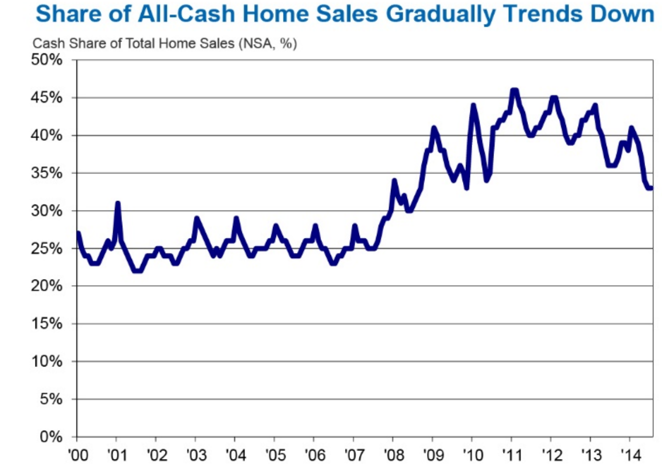
The trend in pending home sales contrasts with that for purchase mortgage originations, which remain a soft spot for the mortgage market. Purchase mortgage applications from the Mortgage Bankers Association have trended down over the past three months to the lowest reading since February despite the declining interest rate environment, suggesting that the pace of improvement in housing indicators for the rest of the year will likely be subdued.

The share of home sales using cash is one of the major factors explaining the gap between home sales and mortgage applications. While the cash share has remained elevated, staying above the level prior to the recession, it has declined more than 10 percentage points from its peak.

The declining trend of the cash sales share is positive for first-time homebuyers, giving them more opportunities to bid on the homes they wish to purchase. Despite declining mortgage rates and moderating home price gains this year, the NAR first-time homebuyer affordability index edged down in the second quarter of this year to the lowest reading since the final quarter of 2008. The share of first-time homebuyers of total home sales has been well below average, hovering under 30 percent, according to NAR. Until we see signs that organic housing demand from first-time homebuyers and trade-up buyers can step up to replace investor demand, we remain cautious on the outlook for the housing market.

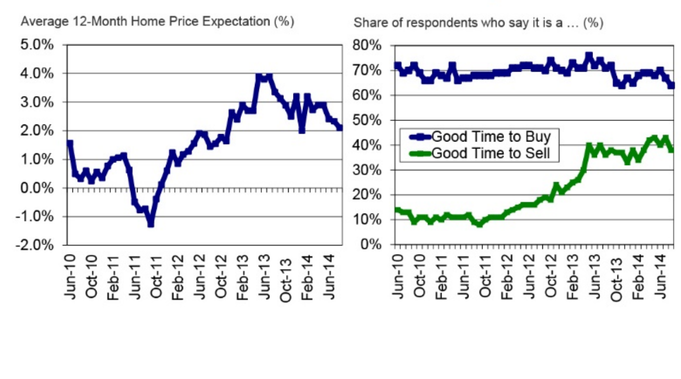
Results from Fannie Mae's [August 2014 National Housing Survey] showed more subdued consumer expectations regarding housing. The share of consumers who say it is a good time to buy a house fell to 64 percent, matching the all-time low, while those who say it is a good time to sell decreased to 38 percent. The average home price change expectation fell for the third consecutive month to 2.1 percent.

Share of All-Cash Home Sales Gradually Trends Down



Source: CoreLogic

Consumers Downgrade Their Assessment of the Housing Market



Source: Fannie Mae National Housing Survey, August 2014

We believe that the weakening sentiment was partly due to the lack of momentum on consumers' assessment of their household incomes. The share of consumers who report that their household income is significantly higher than it was 12 months ago dropped by five percentage points to 23 percent. These data, combined with results from other consumer surveys showing weakening income expectations, provide support for our view that the housing sector's growth for the remainder of 2014 and for 2015 will be modest.

One positive for the housing market this year is the declining trend in mortgage rates, which have recently stabilized near their lows for the year. Over the past month, rates on intermediate-term Treasuries have moved up. At the same time, the flight to safety due to geopolitical risks has kept rates on long-term Treasuries low.

At the time of this writing, the 10-year Treasury yield moved higher to 2.54 percent, the highest closing level since the end of July, remaining well below the rate at the start of the year of about 3.0 percent. Meanwhile, mortgage rates have moved in a very tight range, with the average yield on 30-year fixed mortgage rates staying between 4.10 percent and 4.12 percent over the past four weeks, according to Freddie Mac. We expect mortgage rates to hold relatively steady during the rest of this year before trending up to 4.5 percent by the end of 2015.

Our forecast of the housing and mortgage market is little changed from August.. We expect total mortgage originations to decline 42 percent from 2013 to $1.11 trillion in 2014 and drop another 5.0 percent to $1.05 trillion in 2015. We expect the mortgage market to skew more toward the purchase market, with the refinance share trending down to 26 percent in 2015 from a forecast of 39 percent in 2014. Our projections are subject to change in the next forecast, when we benchmark our 2013 estimates to data pursuant to the Home Mortgage Disclosure Act (HMDA). However, we expect the general market trends to remain valid. After posting six consecutive annual declines, we expect total single-family (1- to 4-unit properties) mortgage debt outstanding to increase slightly this year and strengthen modestly in 2015.

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