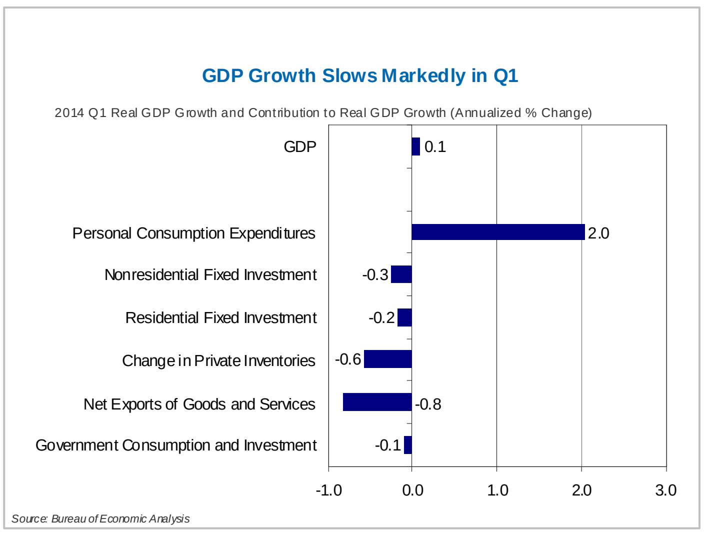
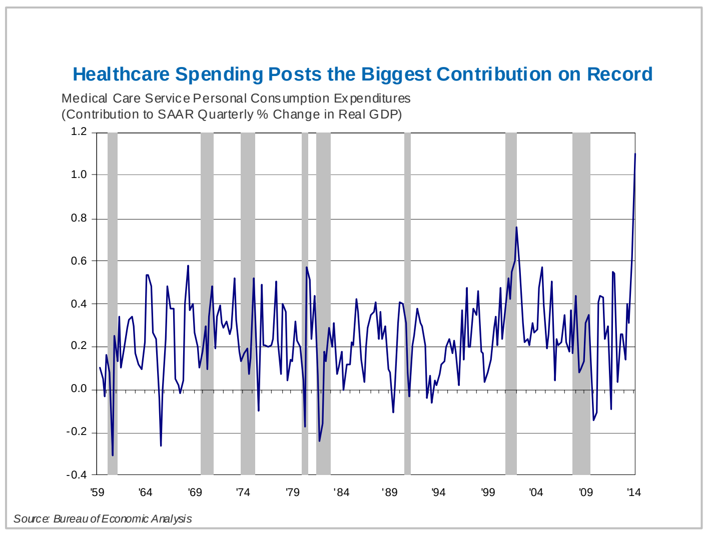
Housing Caught a Winter Cold and the Economy Sneezed

The economy stalled in the first quarter of this year, against our expectations of a weak growth pace, and there is a lot of concern over the near-term health of the housing sector. However, incoming data for March and April suggest that the economy is picking up momentum heading into spring, supporting our belief that the first quarter performance was an aberration. We expect growth to accelerate to slightly more than 3.0 percent on an annualized basis in the current quarter, due in part to a weather-related bounce. Housing is also entering the peak buying season and we expect a pickup in activity. Economic growth should remain firm during the second half of this year, given our expectations of reduced drag from government spending and fiscal policy uncertainty as well as improving financial and labor market conditions. However, concerns over the Federal Reserve's withdrawal of monetary stimulus could weigh on the already fragile housing market. Because of the lackluster start, we expect growth to come in at 2.4 percent for all of 2014, slightly slower than the 2.6 percent pace in 2013 and the 2.7 percent rate in our prior forecast.

Gloomy Picture in the Rearview Mirror…

Real (inflation-adjusted) gross domestic product (GDP) edged up just 0.1 percent annualized in the first quarter of 2014, according to the Bureau of the Economic Analysis' advance estimate. Consumer spending was the only major component that contributed to GDP, adding two percentage points to economic growth.

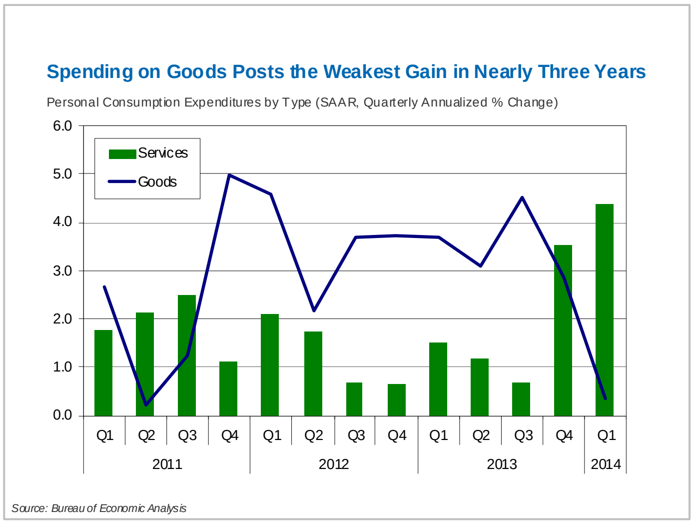


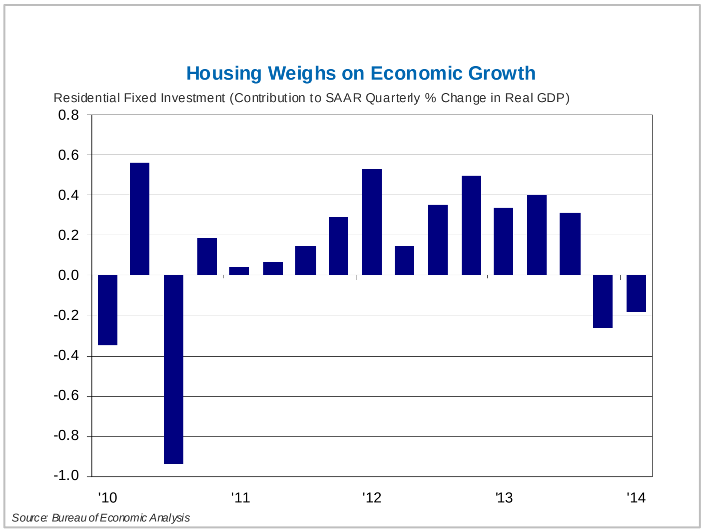


The solid 3.0 percent gain in real consumer spending was driven by a weather-related jump in spending on utilities and a surge in health care service spending reflecting enrollments under the Affordable Care Act. The latter grew 10.0 percent and contributed 1.1 percentage points to economic growth, by far the largest on record.

Spending on goods posted anemic growth of 0.4 percent during the quarter—the weakest in nearly three years. The harsh weather and the expiration of the extended unemployment benefits may have weighed on consumer spending. We also expect the outsized contribution from spending on utilities and on healthcare, which we believe partially crowded out spending on goods during the quarter, to subside in coming quarters while the contribution from goods spending rebounds.

The rest of the major GDP components were drags to growth in the first quarter. While we had expected residential investment to decline for the second consecutive quarter, the magnitude of the drop was much larger than we anticipated, resulting in a drag of nearly 0.2 percentage points to GDP.





Meanwhile, the 2.0 percent decline in nonresidential investment was due to a surprisingly sharp pullback in business investment in equipment spending—the first drop since the third quarter of 2012 and only the second decline witnessed in the current economic expansion. In addition, after plunging in the fourth quarter partly because of the government shutdown, total government spending fell against our expectation of a rise, as a result of weaker-than-expected state and local government spending—the first drop in a year. While federal government spending increased after five consecutive quarterly declines as expected, the gain was modest due to the sixth consecutive quarterly reduction in defense spending. It is possible that uncertainty among agencies in their allocation of spending authority under the recent budget act resulted in restrained spending growth, and thus we expect total government spending to post a rebound in the current quarter and maintain positive growth through the rest of this year and next year.

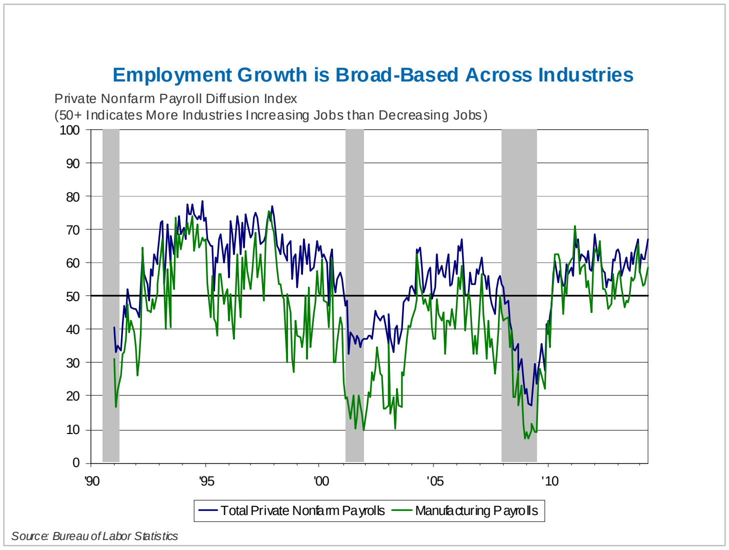
Data for March net exports released after the first estimate of GDP suggest that GDP is likely to be revised lower. Other potential sources of revisions are forthcoming, which add significant uncertainty to the final reading of first quarter economic growth.

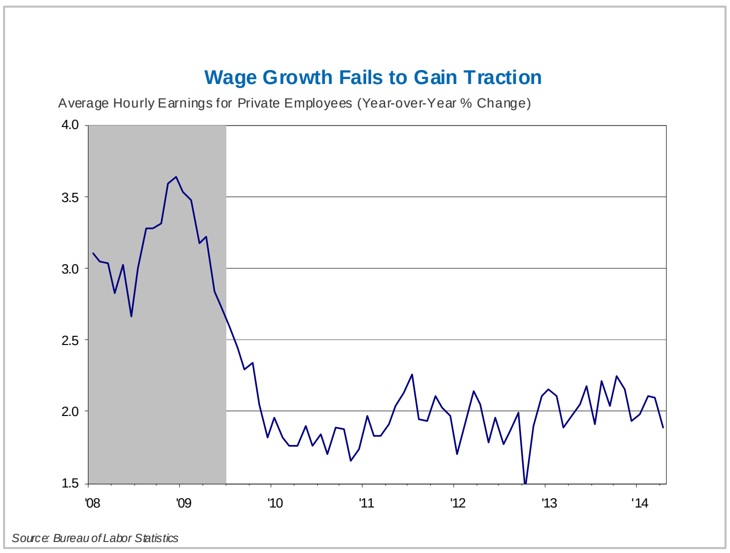
…But Near-Term Outlook Is Positive

Despite the disappointing performance earlier in the year, we remain optimistic that the stumble in growth was temporary and the economy is poised to accelerate. Evidence that growth will pick up includes strong consumer spending in both goods and services in March, which set up a trajectory for more solid spending growth in the current quarter. While auto sales declined modestly in April to 16.0 million annualized units from 16.3 million in March, the two consecutive months of at least 16 million annualized units was the first since 2007.

The outlook for business capital spending has also improved. Core capital goods orders (nondefense durable goods orders excluding aircraft)—a leading indicator of business investment in equipment—jumped 3.5 percent in March to the highest nominal reading on record, suggesting that business capital spending will likely rebound in the second quarter.

The industrial production report indicated that manufacturing output—which accounts for three-quarters of all industrial output—improved further at the end of the first quarter, rising 0.5 percent in March after a 1.4 percent increase in February. Its performance over the last two months of the first quarter gives evidence that momentum in manufacturing continued to build heading into the second quarter.





The Institute for Supply Management (ISM) manufacturing survey provided additional reason for optimism of a rebound in manufacturing activity and business capital investment in the current quarter. The ISM manufacturing index rose in April to the highest reading this year, indicating the sector is likely to see a rebound in the spring. The employment component posted a healthy increase and was consistent with the solid April jobs report.

The April jobs report was largely upbeat, showing a pickup in hiring to the fastest pace in more than two years, and corroborated other recent economic indicators that the economy is picking up momentum heading into spring. Nonfarm payrolls rose 288,000 coupled with upward revisions of 36,000 jobs for March and February, pushing the average monthly gain for the past three months to 238,000—a substantial pickup from the 167,000 average gain during the prior three month period. The job gain was broad-based across industries, with the diffusion index rising to the highest level since early 2012.

Other details were soft, including flat hourly earnings and average weekly hours worked. Average hourly earnings growth slowed to 1.9 percent from a year ago, compared with a recent peak of 2.3 percent in October 2013. The separate household survey showed a 0.4 percentage point drop in the unemployment rate to 6.3 percent—the lowest since 2008. However, the drop was due to a 0.4 percentage point decline in the labor force participation rate to 62.8 percent, which erased the rise in the participation rate witnessed during the first three months of the year.

Though total private payroll employment from the establishment survey surpassed the pre-recession peak in March with total nonfarm payrolls expected to do the same over the next month or two, total household employment from the separate survey of households is still nearly 1 million jobs below its November 2007 peak. Furthermore, as firms shifted toward part-time workers during the height of the recession in 2008 and 2009, part-time employment jumped by roughly 3 million jobs at the expense of full-time workers. During the ongoing economic expansion, while part-time employment has moved sideways near all-time highs, full-time employment has witnessed a sluggish—albeit strengthening—recovery, and still remains roughly 3.5 million below pre-recession levels.

The sharp drop in the unemployment rate amid uninspiring growth supports the Fed's messaging that any future interest rate hike decision—which we believe is still at least a year away—will not be associated with a specific unemployment rate target. The April Federal Open Market Committee (FOMC) meeting was uneventful as the Fed reduced the monthly pace of asset purchases another $10 billion to $45 billion as expected, with no change to forward guidance. As long as inflation remains below the Fed's stated target of 2.0 percent, held down by only modest wage growth, the Fed will have significant room to maneuver.

Housing Remains the Weakest Link

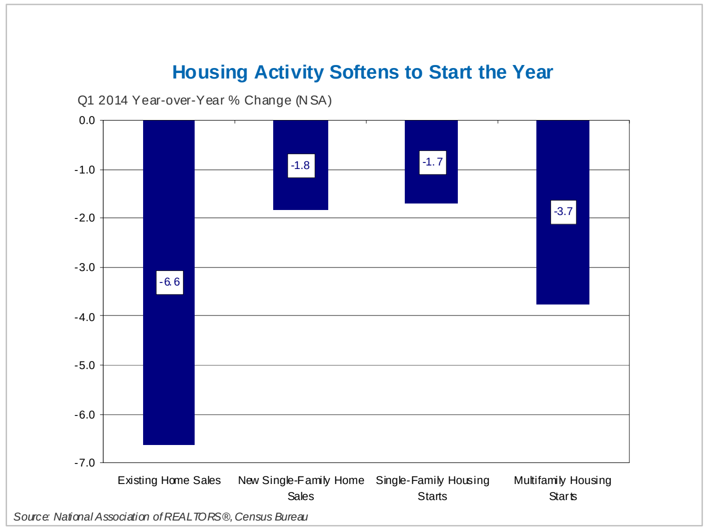
Housing activity disappointed in the first quarter of this year. Through the first three months of 2014, existing home sales, new single-family home sales, single-family housing starts, and multifamily housing starts all experienced year-over-year declines. Though it is likely that extreme winter weather and supply constraints played a significant role in the slowdown of both sales and homebuilding activity, we believe faltering demand in the wake of reduced affordability and more general consumer conservatism about taking on a mortgage are the primary culprits. However, we continue to expect a modest rebound in activity from depressed levels as the spring and summer selling and building seasons approach.

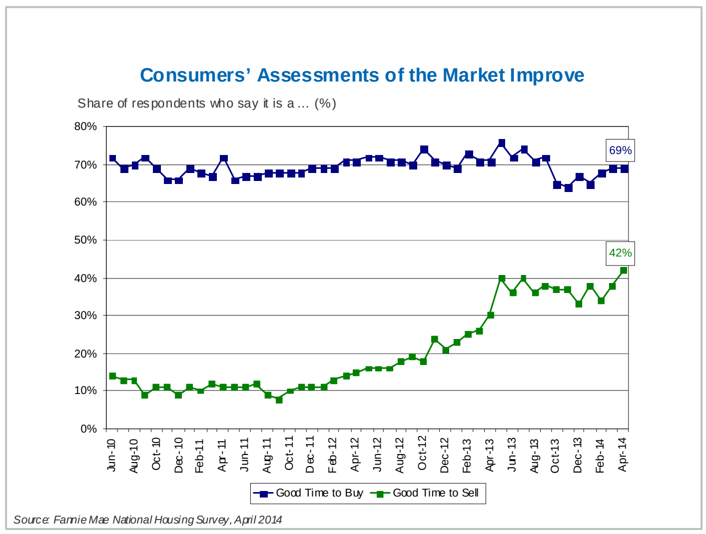
Existing home sales, which comprised roughly 90 percent of sales activity in March, edged down 0.2 percent to 4.59 million annualized units—the slowest sales pace since July 2012. Non-seasonally adjusted sales through the first quarter of this year were down 6.6 percent from a year ago. The composition of sales activity shows a dramatic year-over-year decline in lower-priced units, a result of an affordability-induced reduction in consumer housing demand combined with continued tapering of investor demand.

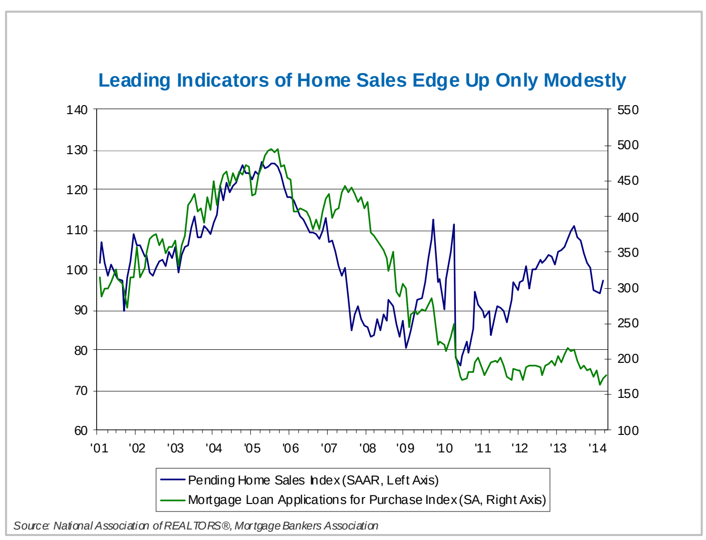
Lean supply also is a factor weighing on sales activity. Despite monthly declines in resales in seven of the last eight months, the months' supply, or inventory/sales ratio, has edged up only 0.2 to 5.2 months during that span. One bright spot on the supply side is the growing number of consumers indicating that it is a good time to sell a home in our Fannie Mae National Housing Survey—up 4 percentage points in April to a survey-high 42 percent. As consumers become more confident in the selling environment and more supply enters the market, it will help to boost housing turnover.

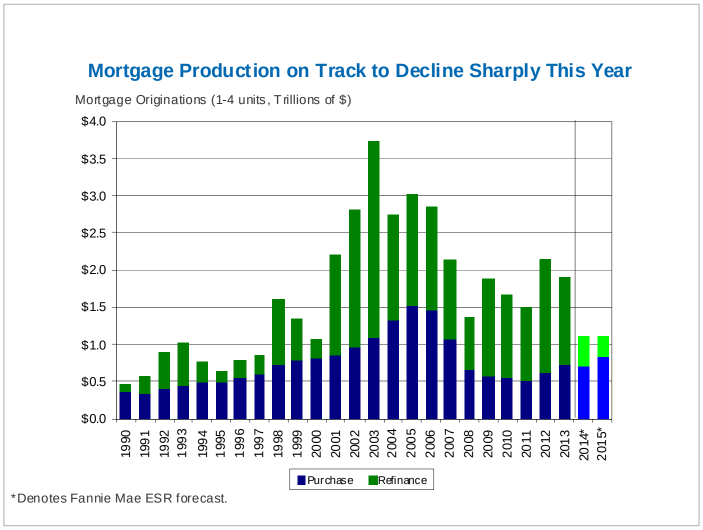
Leading indicators of home sales point to cautious optimism in the near-term outlook. Pending home sales, which record contract signings on existing home sales and typically lead closings by one to two months, broke a streak of eight consecutive monthly declines in March, rising 3.4 percent to the highest level since November. In addition, purchase mortgage applications continued to trend up modestly from the nearly two-decade low reached in February. However, at the end of April, purchase applications were down more than 20 percent from a year ago.

First-time homebuyers remain an integral piece of housing demand, and although their share of home sales has risen in recent months according to the National Association of REALTORS®, it has merely recovered from the decline witnessed over the past year as mortgage rates spiked, disproportionally affecting first-time buyers who are typically more price sensitive, especially when compared to institutional investors who often pay cash.









In our recently released National Housing Survey Topic Analysis of younger renters aged 18 to 39, we found that although a majority of them would prefer to own for both financial and lifestyle reasons, they remain more concerned about their ability to obtain a mortgage than both younger owners and the general population, citing insufficient credit history and difficulty with affording a down payment as their biggest obstacles. Those with student loan balances were more likely to cite affording the down payment or closing costs as a primary obstacle than those without student loans, indicating the rising cost of secondary education could significantly delay homeownership for current and future graduates. (For more details on the attitudes and constraints of younger renters, see Sarah Shahdad, "What Younger Renters Want and the Financial Constraints They See," FM Commentary, May 6, 2014.)

The first-quarter Housing Vacancy Survey showed a 0.1 percentage point decline in the homeownership rate to a nearly two-decade low of 65 percent. Since peaking at 69.4 percent in 2004, the homeownership rate has persistently trended down with younger cohorts suffering the largest decline relative to other groups. Questions remain regarding the extent of their credit damage and the time they will need to repair it, though our survey consistently shows a fundamental desire to own a home at some future point, though it may be later rather than sooner.

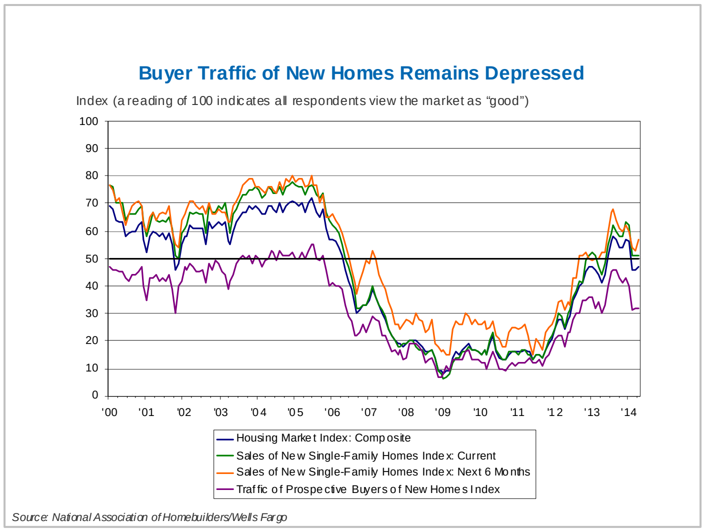
Another constraint for potential homebuyers remains banks' willingness to lend. The Federal Reserve Board Senior Loan Officer Opinion Survey has continually shown tightening underwriting of subprime and nontraditional mortgages, though the tentative Q2 survey showed that on net, banks tightened lending standards for traditional prime mortgages for a second consecutive quarter, reversing the five-quarter trend of modestly easing standards. Given the current regulatory landscape, we believe rising employment and income are more likely to bolster housing demand rather than easing credit conditions.

The new homes market suffered a setback in March as new single-family home sales plunged 14.5 percent to an eight-month low. The sharp decline in sales amid slowly growing supply pushed the months' supply up to six months, in line with the historical average. The composition of new home sales has skewed toward higher priced units in similar fashion to the existing homes market, with the median sales price of new single-family homes jumping at the fastest rate on record in March to a nominal high of $290,000.

Homebuilding activity was a bit more upbeat in March despite a decline in activity during the first quarter. Housing starts edged up for the second consecutive month, following two sharp declines in December and January. A bounce in single-family starts outweighed the fourth consecutive month with no improvement in multifamily housing starts. (For information on multifamily market conditions, read the May 2014 Multifamily Market Commentary.) Mixed building permits in March and flat builder confidence in April provide little confidence in a robust near-term pickup. Though more builders expect a pickup in single-family home sales over the next six months, their assessments of current sales and demand were flat.

The National Association of Homebuilders/Wells Fargo (NAHB) housing market index showed that traffic of prospective buyers of new homes held relatively steady in April at a level below any month in 2013. The index has remained below the break-even value of 50—when the number of survey respondents indicating buyer traffic is good is equal to those indicating that buyer traffic is poor—since October 2005.

In addition to the demand side, builders also face constraints on the supply side. In a recent survey conducted by the NAHB, builders cited materials prices, the cost and availability of labor, and the cost and availability of land as the three most significant problems they expect to face this year, in that order. Since retreating rapidly during the crisis, residential construction employment, which includes residential construction workers and residential specialty trade contractors, has seen steady gains over the past year despite remaining significantly below pre-crisis levels. Even as wage growth in the sector, which fell much faster than overall wage growth during the crisis, converges with the general economy, the



diverging trend between rising construction job openings and sluggish construction hiring suggest those wages will have to increase further to attract qualified workers back into the market.

Despite the significant weakness across nearly all housing data, home price appreciation remained robust in March according to the CoreLogic home price index—the measure used by the Fed to estimate the value of housing units and housing wealth in the Financial Accounts of the U.S. The index was up 11.1 percent from a year ago in March, the 14th consecutive month of double-digit annual gains. Though we expect these price gains to moderate this year in line with reduced affordability and sluggish demand, continued tight housing supply suggests home price appreciation will continue.

The disappointing stream of housing data so far this year has caused us to push lower our 2014 projections of sales activity. Though we continue to expect existing home sales to decline modestly this year from 2013 amid a double-digit annual gain in new home sales, both of these figures are below our prior forecast estimates. We estimate that mortgage production will fall more than 40 percent in 2014 to $1.12 trillion from $1.91 trillion in 2013, led by a sharp decline in refinance originations. Indeed, our preliminary estimate of $237 billion first-quarter mortgage originations, subject to revisions, is the lowest quarterly total since the first quarter of 2000. After declining for six consecutive years, we expect single-family mortgage debt outstanding to rise modestly in 2014.

Doug Duncan, Brian Hughes-Cromwick, and Orawin T. Velz
Economic and Strategic Research
May 12, 2014