Economy Picks Up Steam

Economic growth got off to a slow start in 2013 but is validating our expectation of a pickup in growth in the second half of the year. Fiscal drag is waning, the housing recovery continues, and a rebound in manufacturing and business investment are helping boost growth. We expect economic growth to average 2.5 percent in the second half of the year, after lackluster first and second quarter growth of just 1.1 percent and 1.7 percent, respectively. We expect the economy to grow at the same 2.0 percent pace projected in our prior forecast for all of 2013.

Risks to this forecast would seem to be on the downside. The Federal Reserve leadership has been signaling their intention to alter their securities purchase program by slowing purchases. The market awaits details including timing, but this would likely put additional upward pressure on interest rates. Additionally, the debate over federal expenditures and the related debt ceiling will be carried out in the fall with the potential for additional fiscal tightening.

However, consensus has the economy strengthening in spite of these two exogenous macroeconomic factors. The view is that consumer spending is strengthening sustainably and many forecasters have rued the day they bet against the American consumer. Also, manufacturing and nonmanufacturing production indicators have been picking up steadily, which the consensus believes will move the economy ahead in spite of the monetary and fiscal headwinds.

Expectation of Tapering of Federal Reserve's Securities Purchases

The mixed jobs report (details below) does not change our expectation of a reduction in the amount of Fed asset purchases. We continue to expect an announcement at the September Federal Open Market Committee (FOMC) meeting that the Fed will begin to scale back its asset purchases and end the program by the spring. This is consistent with our forecast of declines in the unemployment rate and a comment from the Fed Chairman Bernanke that the program will end when the unemployment rate trends down to around 7.0 percent.

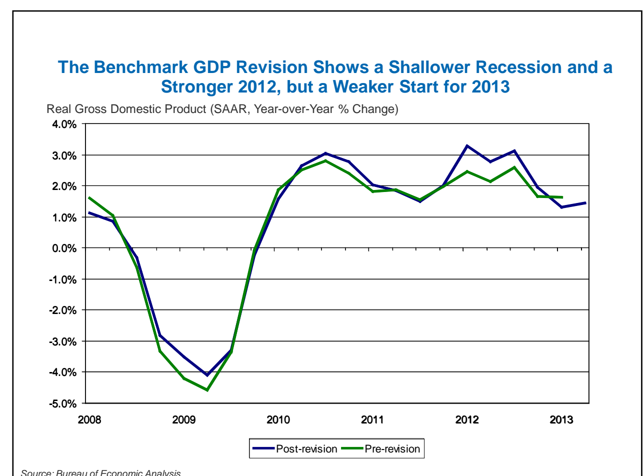
We expect that the Fed will keep the fed funds rate on hold for some time, with the first rate hikes occurring late in the first half of 2015. Our expectation is based on our forecast and the Fed's rate guidance, which calls for no rate hikes at least as long as the unemployment rate remains above 6.5 percent and one-year inflation expectation remains below 2.5 percent.

Fiscal Policy Issues Will Heat Up in the Fall

The forthcoming budget negotiations and the debt ceiling could potentially have adverse impact on the financial market and the economy, but that will not come until the fall. Congress went on recess the week of August 5 after the House passed only a portion of the necessary 12 appropriation bills. There is no budget yet for fiscal year 2014. The continuing resolution to fund the government will expire at the end of September, and unless there is a new resolution—or a budget is passed—the government will shut down on October 1. Lawmakers will return from their summer recess the week of September 9. The debt limit will not have an impact until later, as extraordinary measures are likely to last until late October.

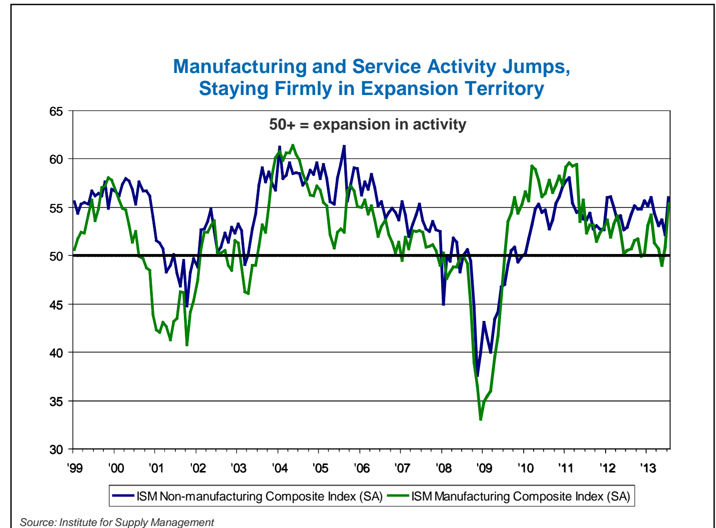
GDP revisions were relatively minor

The latest release on economic growth reflected the Bureau of Economic Analysis' comprehensive revision of gross domestic product (GDP) data going back to 1929, which raised the level of GDP as more items, including intellectual property production (software, research and development and entertainment), are now measured as part of GDP. The new data show no significant changes in the growth trend and continue to confirm a modest recovery. Four years into an economic expansion, economic growth has averaged 2.2 percent a year. For the most recent history, growth was upgraded in 2012 but downgraded in the first quarter of this year.



Manufacturing and Service Activity Signals Improvement in GDP Growth

Economic data during the past month were largely positive. The industrial production report suggests that manufacturing gained momentum toward the end of the second quarter, with manufacturing production up during the month, following upward revisions to the figures reported for the prior two months.



Several regional manufacturing surveys signaled a substantial improvement in manufacturing production in the third quarter. The Institute for Supply Management (ISM) manufacturing index jumped in July, sending the index to the highest level since June 2011, with the important production component surging to the highest reading since 2004.

There was good news from the service industry as well. Service activity rebounded in July after dipping in June with the ISM nonmanufacturing index jumping to the highest reading since February. Both indices indicated that manufacturing and service activity was firmly in expansion territory at the start of the third quarter.

Hiring Slowed as Earnings Pulled Back, but the Unemployment Rate Improved

The July employment report showed a gain in nonfarm payrolls of 162,000—the weakest since March—on the back of downward revisions in the prior two months, signaling a loss of momentum. The average monthly gain over the three months ending in July moderated to 175,000 from 224,000, the monthly average gain in the three months ending in April. In addition, both the average workweek and average hourly earnings fell, which bodes poorly for labor income in July. This development is discouraging following the release of June personal income, which contracted after adjusting for inflation for the first time since the start of the year.

The Household Survey fared better, showing a two-tenths decline in the unemployment rate to 7.4 percent. Household employment posted a large gain amid a moderate decline in the number of people joining the labor force, indicating that hiring was the main driver of the improvement in the rate. Nonetheless, the labor force participation rate edged down to 63.4 percent, just above its cyclical low of 63.3 percent recorded earlier this year.

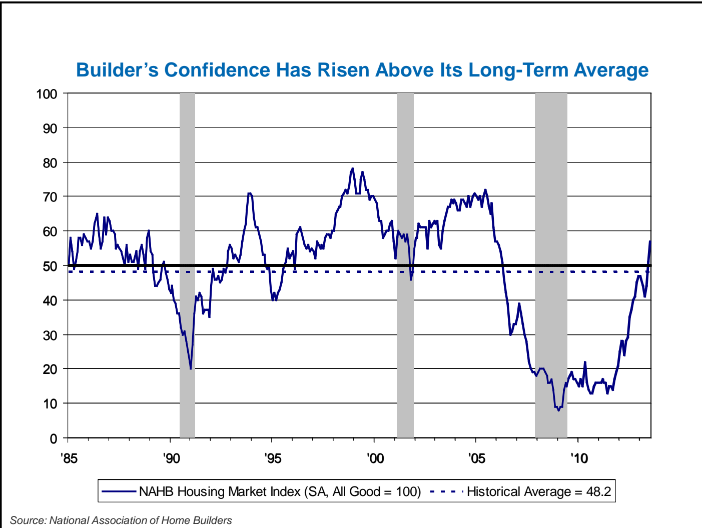
We expect that the unemployment rate will continue to move lower amid a steady labor force participation rate over the next couple of years, averaging 7.3 percent in the second half of this year, before declining to below 7.0 percent by next spring and reaching 6.5 percent around mid-2015.

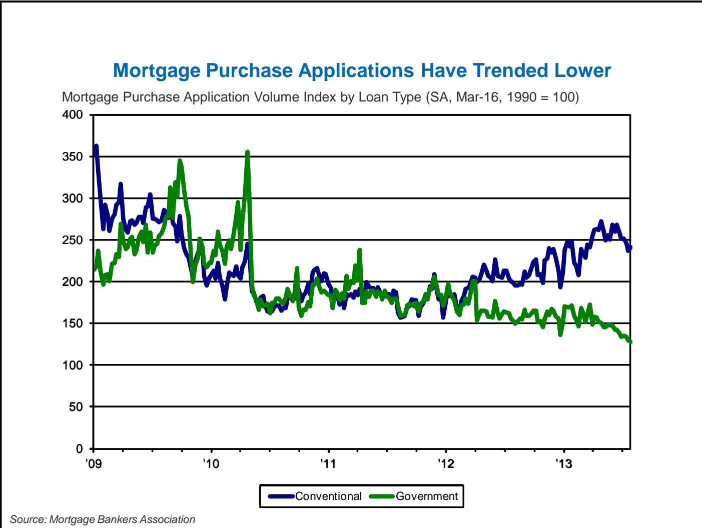
Consumer Spending Outperformed Expectations During the First Half

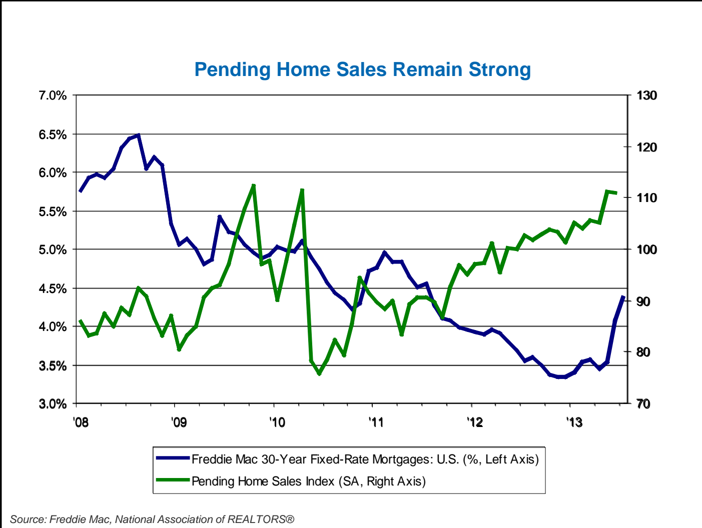
Despite tax hikes amounting to 1.6 percent of disposable income in the first half of 2013, consumer spending provided an upside surprise, rising 2.3 percent annualized in the first quarter and 1.8 percent in the second quarter, against our expectation in our January 2013 forecast of an average growth rate of 1.4 percent for the first half of this year. One factor that helped offset the impact of the tax hikes was rising household wealth through both equity and home prices.

Going forward, we expect continued rising household wealth, albeit at a more moderate pace than in the first half. Given the fading impact of fiscal drag, we expect consumer spending growth to strengthen, averaging about 2.5 percent in the second half of 2013 and to continue to pick up further in 2014 as the income growth trend improves.

Measures of consumer confidence showed mixed results in July. The Conference Board's consumer confidence index slipped, marking its first decline in four months, driven solely by the drop in the expectations component as the present situation component rose to a new recovery high. The Reuters/University of Michigan consumer sentiment index improved modestly, reaching the highest level for the expansion.







Overall, we expect the economy to strengthen in the second half of the year, driven by consumer spending, business capital investment, and housing. Trade should add slightly to GDP in the second half of the year, while nonresidential investment in structures will likely be neutral. Meanwhile, both government spending and the change in business inventories will act as a drag.

Housing is Resilient Despite the Backup in Interest Rates

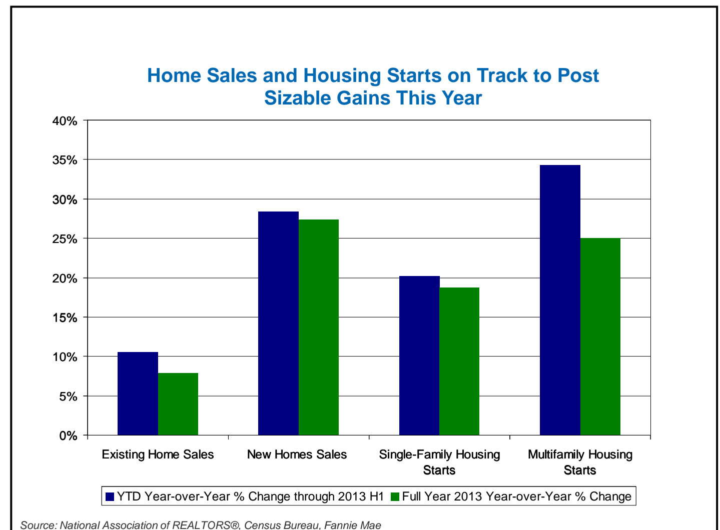
Recent housing and economic indicators have been mixed. Single-family starts dipped slightly in June, marking the third decline during the past four months. The volatile multifamily starts fell sharply, erasing a surge in May. (For more information on multifamily market conditions, read the August 2013 Multifamily Market Commentary). However, the outlook for single-family homebuilding remains positive as its leading indicators, permits, moved higher in June for the third consecutive month. The weak trend in single-family starts so far may have reflected shortages in labor and developed lots as well as spikes in costs of some building materials—factors mentioned by several surveys from the National Association of Home Builders. Some of these issues have been alleviated in recent months, however.

Meanwhile, new home sales jumped in June for the third straight month as inventory gradually trended up since reaching its trough last July. The number of completed new homes for sale remains at a record low, however. The months' supply of new homes fell to 3.9 months, matching the level at the start of the year, which was the lowest reading since mid-2004. Combined with a rising trend in permits, tight inventory will be supportive for single-family home building activity in the second half of the year. Rising mortgage rates have not yet eroded homebuilders' confidence, which jumped in July to its highest level since January 2006. This was the second consecutive month that confidence was above 50, which indicates that builders seeing a better market outnumber those judging it as poor. The surge in July puts confidence slightly above its long-term average.

Following two consecutive monthly gains, existing home sales dipped in June. Leading indicators of home sales suggest some pullback in the current quarter, likely reflecting the increase in mortgage rates since early May. Mortgage purchase applications have trended lower from their recent peak in early May, with the decline coming from both the conventional and government segments.

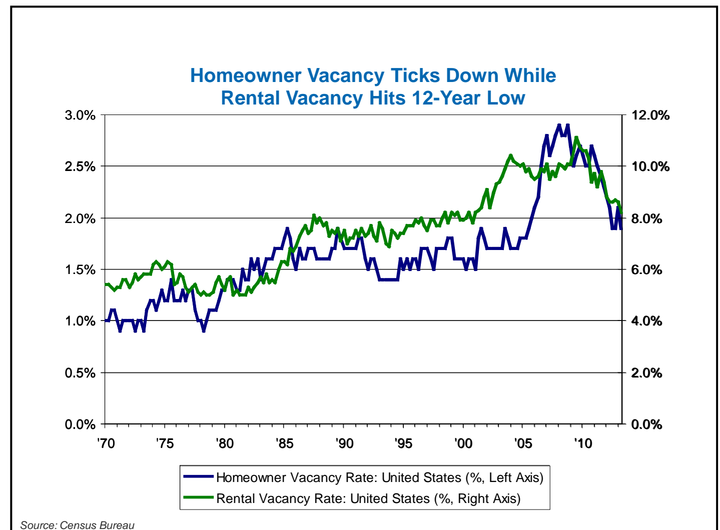
However, pending home sales, which measure contract signing of existing homes, have held up well as the pending sales index slipped slightly in June but still remains near recovery highs.

Mortgage rates appear to be stabilizing, with the yield on 30-year fixed-rate mortgages from the Freddie Mac weekly survey hovering around 4.4 percent at the time of this writing, about 10 basis points below its recent peak about a month ago and slightly more than about 100 basis points above the rate at the start of May. Despite rising mortgage rates, other fundamentals of the housing market remain supportive to housing demand: Labor market conditions continue to improve and consumer attitudes toward the housing market are increasingly positive. Results from the [Fannie Mae July 2013 National Housing Survey] showed that consumers expect home prices to rise 3.9 percent, on average, during the next 12 months, little changed from expectations recorded in the prior two months. The share of consumers believing it is a good time to buy increased to 74 percent, compared with 40 percent for the share of consumers who say it is a good time to sell, which matched the survey high recorded in May when rates started to rise.



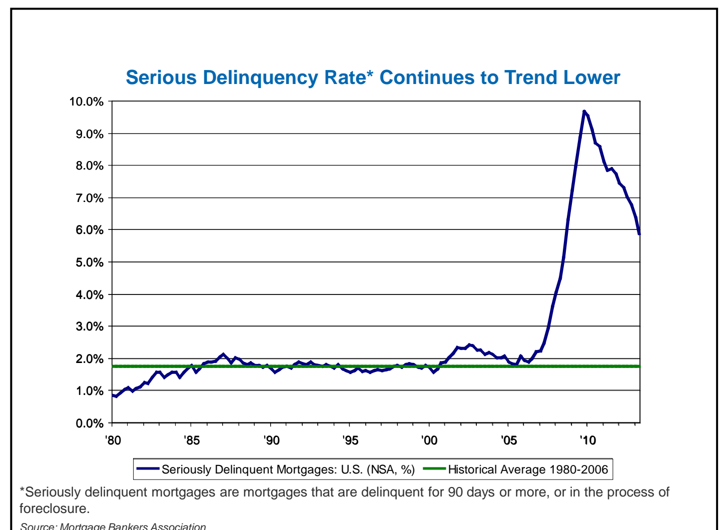
Source: National Association of REALTORS®, Census Bureau, Fannie Mae

Other surveys corroborated improving housing sentiment. The Conference Board survey showed that plans to purchase a home rose in July. Consumer sentiment on homebuying conditions from the Reuters/University of Michigan survey edged down slightly in June from May but still remained the second highest since 2003. Details showed that rising mortgage rates may induce some potential homebuyers to act sooner rather than later—the share of respondents reporting it was a good time to buy because of rising interest rates increased from 3.0 percent in May to 5.0 percent in June and to 10.0 percent in July, the highest reading since 2006.



Source: Census Bureau

Expansion of credit may also modestly offset the negative impact of rising rates. The Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices showed a solid increase in mortgage demand in the third quarter despite the increase in mortgage rates, marking the eighth consecutive rise and the second highest reading for the expansion. The survey also showed that lending standards for mortgages eased further, albeit gradually.



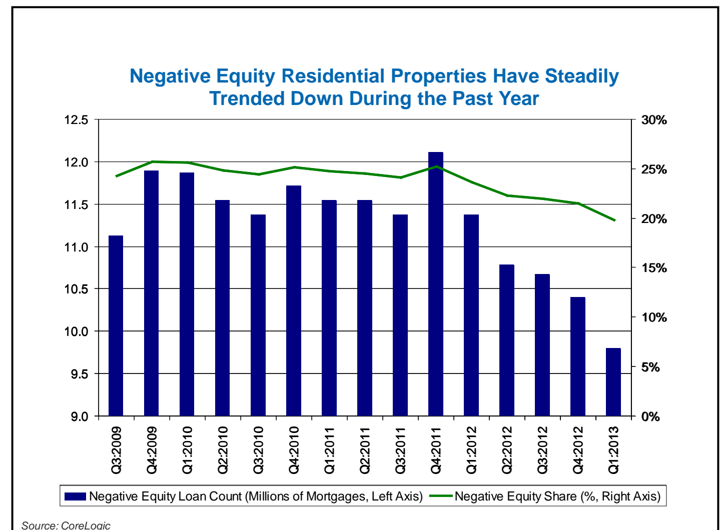
*Seriously delinquent mortgages are mortgages that are delinquent for 90 days or more, or in the process of foreclosure.
Source: Mortgage Bankers Association

Overall, during the first half of 2013, housing starts and home sales posted significant gains over the same period last year, ranging from a gain of 10.0 percent for existing home sales to 34.0 percent for multifamily housing starts. We expect that positive fundamentals of housing demand will offset the impact of rising interest rates, helping to support activity during the rest of the year and producing healthy increases in sales and starts for all of 2013.

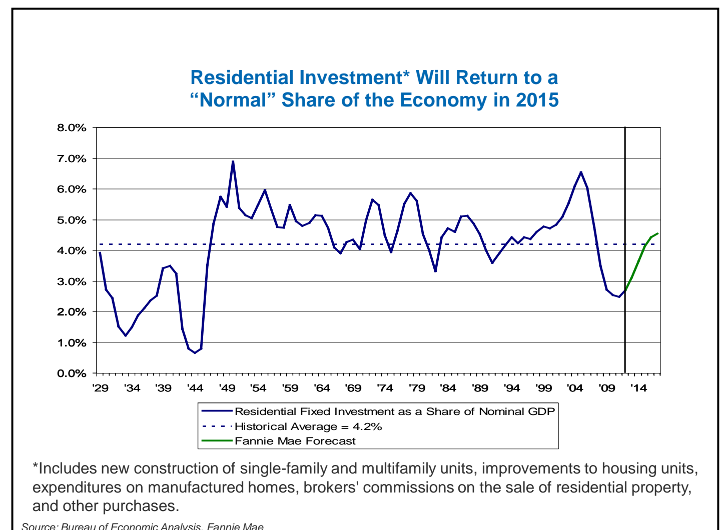
We expect that historically tight supply conditions will continue to support further home price gains. While the number of new and existing homes available for sale has risen over the past year, it has remained lean by historical standards. In addition, data from the Census Bureau's Housing Vacancy Survey showed that both the homeowner and rental vacancy rates fell in the second quarter of 2013 to the levels

close to their long-run average, indicating more balance in supply and demand conditions after suffering from significant excess supply during the housing downturn.

Another factor supporting home price trend is that shadow inventory has also gradually trended down. The declining unemployment rate has helped bring further drops in delinquencies and foreclosures. One proxy for shadow inventory, the Mortgage Bankers Association's serious delinquency rate (defined as the share of loans that are 90 days or more past due or in the foreclosure process), fell to 5.9 percent in the second quarter of 2013. While the rate remains substantially higher than its historical norm, it has fallen by nearly 4 percentage points from its peak at the end of 2009. As the stock of shadow inventory trends down, it will exert less downward pressure on home prices over time.



Main measures of home prices continued to show robust gains. For example, the June CoreLogic National House Price Index was nearly 12.0 percent above its year-ago level for the third consecutive month, which was the strongest gain since early 2006. Strong home price appreciation is also helping more and more properties with negative equity return to a state of positive equity. At the end of the first quarter of 2013, 9.7 million (or 19.8 percent) of all residential properties with a mortgage were in negative equity, according to CoreLogic.



*Includes new construction of single-family and multifamily units, improvements to housing units, expenditures on manufactured homes, brokers' commissions on the sale of residential property, and other purchases.

Source: Bureau of Economic Analysis, Fannie Mae

Of those negative equity properties, 3.4 percent are "near positive equity position," with a loan-to-value ratio between 100 percent and less than 105 percent. With another 5 percent home appreciation and continued amortization, these properties will move into positive equity position.

Housing has consistently contributed to GDP since the fourth quarter of 2010, and we expect it to gradually gain momentum. Residential investment as a share of GDP stood at 3.1 percent in the second quarter of 2013. Our forecast of continued housing recovery implies that, on an annual basis, residential investment as a share of GDP will steadily rise in coming years, reaching its "normal" share of GDP or its long-term average of more than eight decades of 4.2 percent by 2015.

Our projected mortgage rates and housing activity are little changed from our view in the prior month. In the July forecast, we downgraded our forecast of refinance originations for 2013 in response to higher mortgage rates. Over the past month, incoming data from Fannie Mae acquisition as well as from other data we use to benchmark total market mortgage originations showed that refi originations appear to be stronger than we had anticipated and thus we revised higher our projection by nearly $100 billion. For all of 2013, total mortgage originations should decline to $1.75 trillion from an estimated $2.03 trillion in 2012, with the refinance share dropping from an estimated 73.0 percent in 2012 to 64.0 percent in 2013. We expect total single-family mortgage debt outstanding to rise modestly in 2013, the first annual rise in six years.

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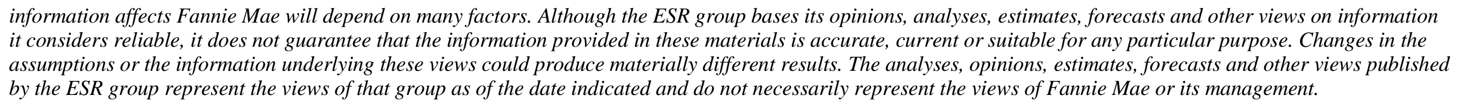

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