Economy Hits an Air Pocket

The global economy has faced a pair of major shocks—the ongoing political turmoil in the Middle East and North Africa, and the catastrophe in Japan and its aftermath. The European sovereign debt crisis continues to brew, with a steady deterioration in neighboring economies. Portugal has become the third country in the European Union (EU) to seek a bailout.

The U.S. economy continues to face multiple cross-currents. U.S. fiscal austerity at the federal, state, and local levels in the form of increased taxes or sharp cutbacks in spending poses a short-term risk to economic activity, while the long-term challenges stemming from the looming federal budget deficit are increasingly a concern. There also is a great deal of uncertainty surrounding monetary policy, as the Fed's second round of quantitative easing is expected to end as scheduled in June. This opens debates about the Fed's next move in the face of a tenuous recovery, the prospect of fiscal restraint, and rising headline inflation. Its counterpart in the EU, the European Central Bank, just implemented its first rate hike this month since 2008 to combat rising inflation.

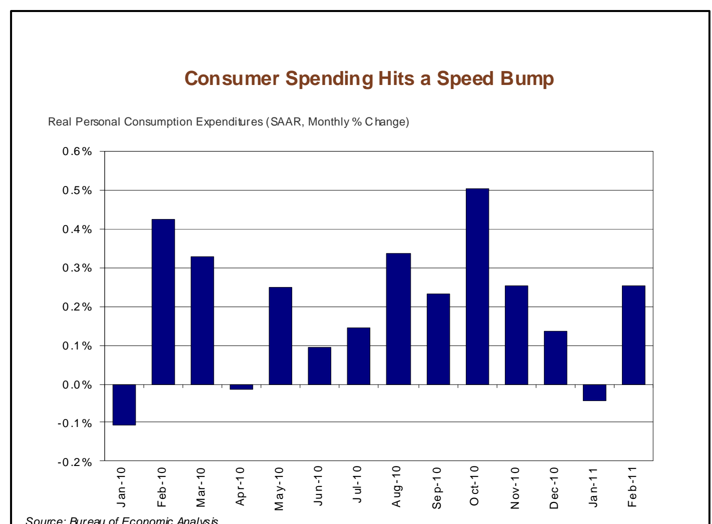
Meanwhile, economic data in the U.S. strongly indicate a slowdown in economic activity in the first quarter of this year. Specifically, consumer spending growth is poised to come in well short of the robust gain of the fourth quarter. Both business investment and nonresidential investment in structures also slowed markedly, and housing has shown some renewed softness.

There is some silver lining, however. The economy continued to create jobs in March, pushing the unemployment rate to its lowest level in two years. Despite the volatility during the quarter, the stock markets appear to be shrugging off the headwinds at least for now, with the Dow Jones Industrial Average posting its best first quarter in 12 years. We believe that the stronger signs of improvement in hiring are providing support for a self-sustaining expansion.

However, it is clear that those headwinds, including the surge in oil prices and supply disruptions from the tragedy in Japan (as Japanese-made parts supplied to the U.S. have become scarce), are causing sufficient damage to dampen economic growth in the first half of the year. We expect the slowdown to be temporary, and our outlook calls for a modest acceleration in the second half of the year, with economic growth averaging 3.1 percent for all of 2011, a downgrade from 3.5 percent projected in the prior forecast. The key to this outlook is continued improvement in the labor market and moderating oil prices in the second half of the year. However, significant challenges lie ahead, which could potentially lower growth this year by much more than we project.

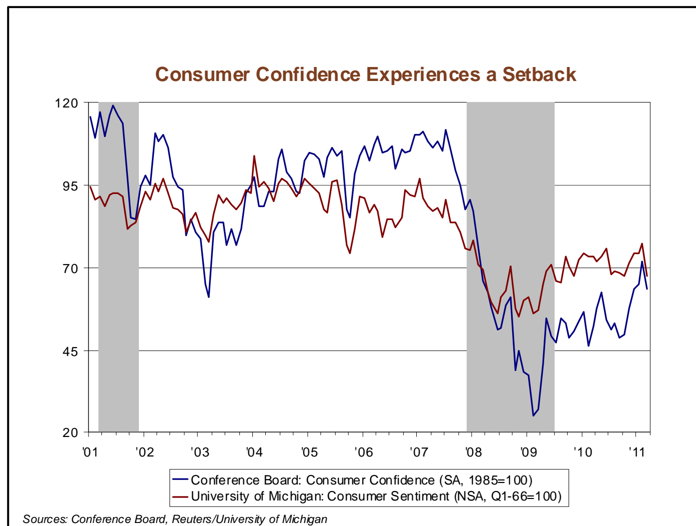
Overall Economy: Another Rough Patch to Overcome

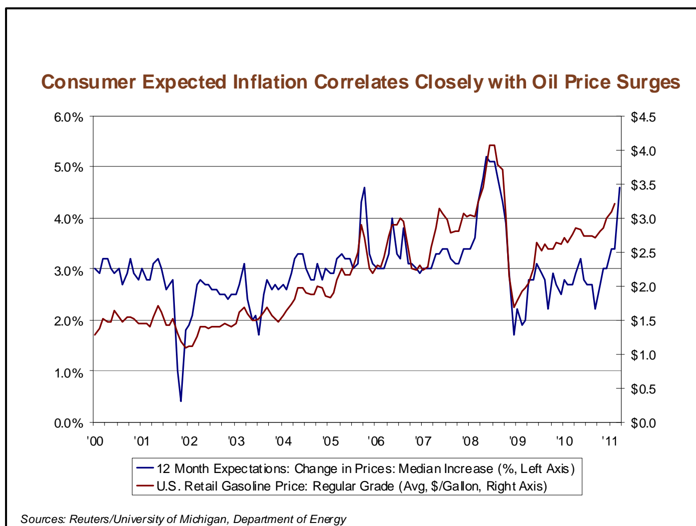
Real (inflation-adjusted) consumer spending disappointed at the start of the year, posting a decline in January for the first time in nine months. This weakness came before the surge in crude oil prices, and may have been influenced by severe winter weather. Spending rebounded in February, but warmer temperatures also dragged down consumption of utilities during the month. Despite a partial reversal in February, the average level of consumer spending in January and February was just slightly above the fourth quarter level.



The near-term outlook for consumer spending looks subdued, as confidence has recently turned sour. Gasoline

prices were up by 80 percent at an annualized rate over the three month period through February, and this apparently took a toll on confidence in March. The Conference Board consumer confidence index fell to 63.4 from the recovery high of 72.0 in February. The Reuters/University of Michigan consumer sentiment index plummeted ten points to 67.5. Such a decline was notable, as it was the biggest monthly drop since October 2008, following the bankruptcy of Lehman.





Surveys of consumers show that consumers' expected inflation, especially their short-term expectation, generally spikes higher in response to a surge in gasoline prices. For example, the Reuters/University of Michigan survey of consumer sentiment shows that the expectation of price changes during the next 12 months is closely correlated to the change in gasoline prices. The one-year expectation jumped to 4.6 percent in March from 3.4 percent in February and from just 3.0 percent at the end of 2010. A similar surge was witnessed during mid-2008.

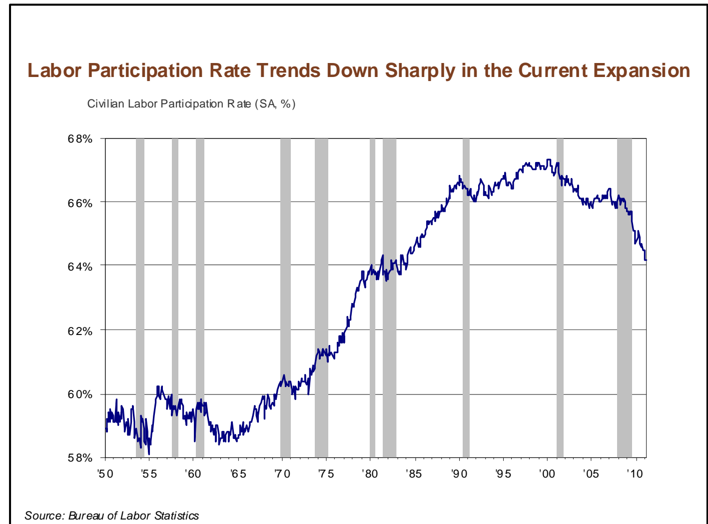
However, it appears that measures of market-based expected inflation, such as the yield spread between 10-year maturity Treasury issues and those of Treasury Inflation-Protected Securities (TIPS), have been much less sensitive to oil prices than the inflation expectations from the consumer survey. According to the minutes of the March Federal Open Market Committee released earlier this month, members had mixed opinions on the inflation outlook. Some noted that businesses were preparing to pass on higher input costs to customers, although the success of such efforts was uncertain. Others noted that commodity and energy costs accounted for a relatively small share of production costs for most firms, while labor costs, which have been subdued, are more important in influencing underlying inflation.

Real consumer spending growth in the first quarter is likely to moderate to below 2 percent from over 4 percent in the prior quarter. Fortunately, the primary support for consumer spending—the labor market—has shown further signs of improvement. Nonfarm payrolls rose 216,000 in March. The private sector added 230,000 jobs, which followed a 240,000 gain in February, marking the best back-to-back gains in five years. The gain in nonfarm payrolls in February was largely a result of a rebound from January's weather-related weakness, while the solid gain in March appeared to be free from any distortion from the weather. Government jobs were down 14,000, as local governments shed 15,000 jobs, continuing their downtrend that started in late 2008.

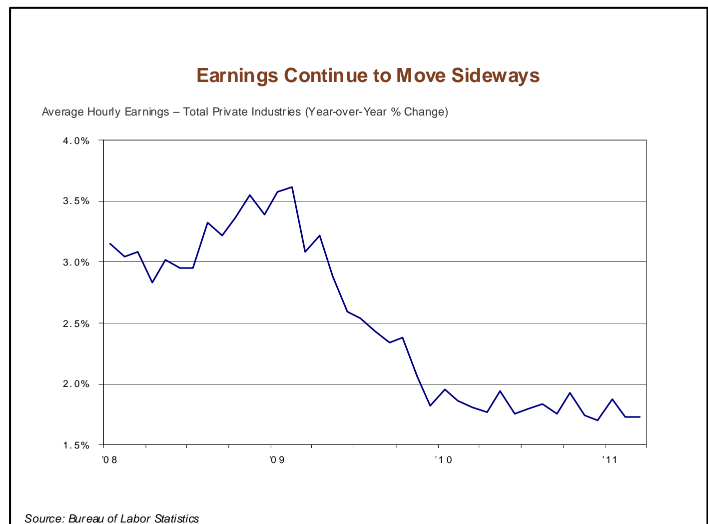
The unemployment rate, which is derived from a separate household survey, edged down to 8.8 percent in March. This is the fourth consecutive monthly drop to the lowest rate since March 2009, standing one percentage point below the level recorded in November 2010. For the first quarter of 2011, the unemployment rate fell 0.7 percentage points to 8.9 percent, the steepest quarterly drop since 1984.

The vast improvement in the unemployment rate in December and January was due to a huge drop in the labor force (nearly 800,000 during the two month period). However, the dip in the rate in February and March indicated a genuine improvement as gains in household employment substantially outweighed the increase in the labor force. The

participation rate, which had been falling almost continuously since April of last year, has shown signs of stabilization. The rate remained unchanged in March for the second consecutive month at an historically low level of 64.2 percent, half a percentage point below that of six months ago. A declining participation rate is historically quite unusual during economic expansions with the notable exception of the jobless recovery following the 2001 recession.



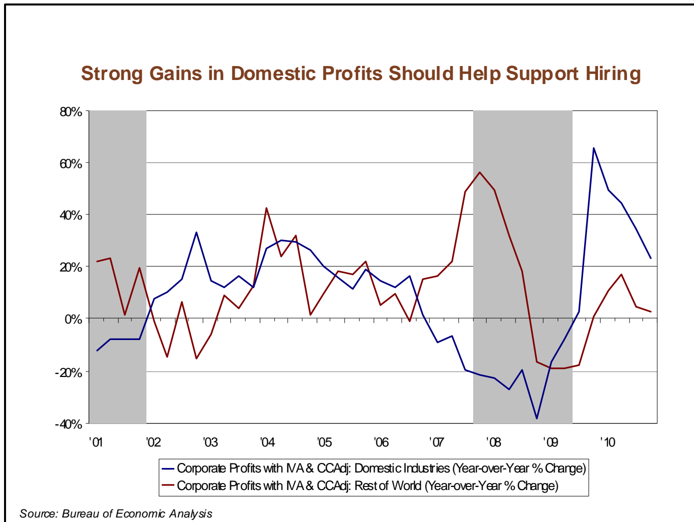
Not every aspect of the employment report was upbeat. The average workweek for all employees on private payrolls was unchanged at 34.3 hours in March. In addition, the average hourly earnings of all employees also were unchanged for the fourth time during the last five months. During the past year, wages have risen just 1.7 percent, which will provide little help for consumers to combat higher gasoline prices. However, soft wage trends appear to give the Fed some comfort, in that underlying inflation will likely be benign in the face of rising energy and commodity prices.



Other reports suggest that the labor market is strengthening. Most notable is the visible downtrend in initial unemployment claims, with the four-week moving average for claims remaining below 400,000 for the past six weeks. Business surveys of optimism and hiring intentions also have shown improvement. For example, optimism among U.S. CEOs in the first quarter surpassed the highest level reached before the recession, according to a survey by the Business Roundtable, as more business leaders projected increased sales, investment, and hiring. Fifty-two percent of CEOs said they intend to add to payrolls, up from 45 percent in the fourth quarter.

Corporate profits trends should support hiring. The final print of the GDP report for the fourth quarter showed that profits rose to a record high. While the year-over-year gain has moderated substantially from the end of 2009, it has remained robust. A large portion of the growth was from domestic industries; profits from the rest of the world were slim. Historically, domestic profits are a leading indicator of hiring.

Consumer spending is not the only segment of economic activity that has witnessed a significant slowdown. The durable goods orders report suggests that business investment in equipment and software appeared to hit the brakes during the first quarter. Core capital goods shipments which are an input in estimating GDP during the quarter,

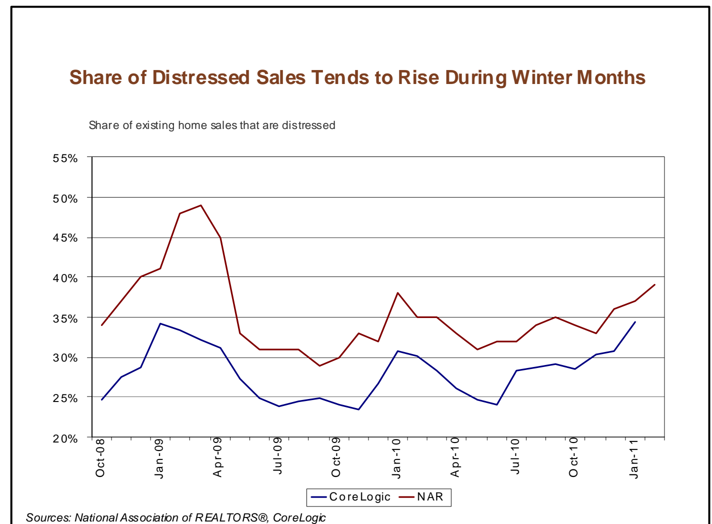


increased only 0.5 percent in February after declining 2.5 percent in January. Core capital goods orders, a leading indicator of business investment in equipment and software, fell in February for a second consecutive month. However, we are not overly concerned at this point. Durable goods orders tend to be volatile and are often subject to large revisions. Furthermore, weak core capital goods activity looks contrary to the Institute for Supply Management (ISM) manufacturing survey, which edged lower in March but still remains elevated, hovering around the highest level reached since 1983.

Other components of nonresidential investment—nonresidential construction expenditures in structures—in the first two months of the year also were below the fourth quarter level. With consumer spending, nonresidential investment, and residential investment all showing signs of deceleration, economic growth likely moderated substantially to just slightly more than two percent from a 3.1 percent annualized pace in the fourth quarter of 2010.

Housing: Achilles Heel of the Expansion

Housing activity weakened across the board in February. Following three months of gains, existing home sales fell nearly 10 percent. The extent of the decline in existing home sales may have been exaggerated by severe winter weather. Because existing home sales are recorded at closing, February home sales likely reflected market conditions in December and January, which were marked by harsh winter weather, preventing many potential homebuyers from looking for homes. Despite the sharp drop in February, existing home sales remained about 26 percent above their cycle's low witnessed in July 2010. Distressed sales (foreclosure and short sales) continue to account for more than a third of the total existing home sales. The latest data from various sources, e.g., the National Association of REALTORS® survey of practitioners and CoreLogic transaction data, show that the share of distressed sales rose to the highest levels reached since early 2009. The share of distressed sales tends to rise at year end and carry on through the first couple of months of the following year. This is because distressed sales, such as REOs, do not display the same seasonal variations as those of arms-length transactions, which generally weaken during the winter months.



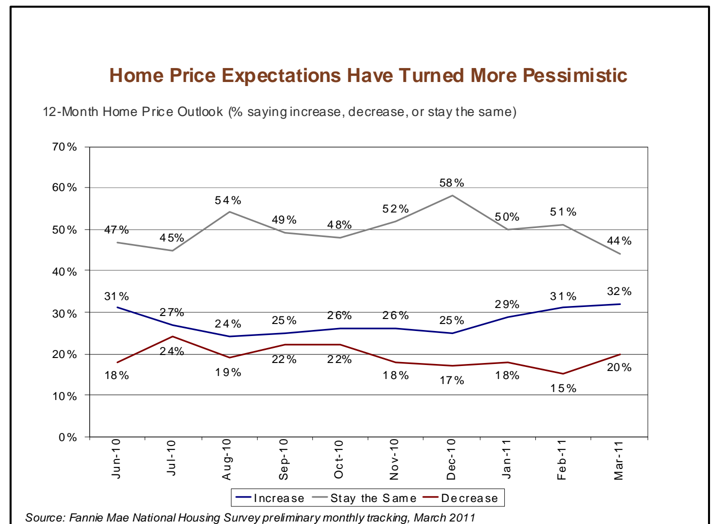
The abundant availability of distressed sales remains a particular hurdle for the new home market, which has been persistently depressed since the end of the homebuyer tax credit. New home sales plunged in February, setting a fresh record low since the inception of the data in 1963 and are now nearly 9 percent below the previous record low set in August 2010. The number of new homes available for sale was flat in February, remaining near record lows. The inventory of new homes has not posted a monthly increase since January 2010. Despite the historically low inventory, the new home market continues to face a significant imbalance amid sluggish demand. With the slowest pace of sales on record in February, the months' supply rose to 8.9 months, the highest reading since August 2010. While the months'

supply has improved substantially from a record high of more than 12 months at the start of 2009, it remains much higher than its long-term average of about six months.

Given dismal new home sales, homebuilding activity also is languishing. Both single-family and multifamily starts fell sharply in February. Single-family starts are now only about four percent above their record lows reached in January 2009, and the second consecutive sharp drop in single-family permits suggests continued sluggish single-family homebuilding activity in the near term.

With a rising share of distressed sales and a winding down of various programs to support the housing market, measures of home prices have shown persistent declines. The FHFA purchase-only house price index, seasonally adjusted, fell in January, marking the seventh drop in the last eight months. The index, which measures prices of properties whose mortgages have been purchased or securitized by Fannie Mae and Freddie Mac, has shown year-over-year declines for a number of years. Since September 2007, the index has posted only one positive reading. Other seasonally adjusted house price measures, such as the CoreLogic and the Case-Shiller indices, showed year-over-year home price appreciation during the first half of 2010 then posted renewed declines after the expiration of the tax credit. The Case-Shiller index dropped in January for the seventh consecutive month, while the CoreLogic home price index fell sharply in February, marking the ninth consecutive decline. Not all the data are negative, however, as CoreLogic also offers an index that excludes distressed sales, and, notably, this index rose in February for a second consecutive month. From a year ago, the index, excluding distressed sales, was essentially flat.

One should exercise appropriate caution in using seasonally adjusted home price indices due to the rise in the share of distressed sales during winter months, which leads to more pronounced seasonal fluctuations in home prices. This phenomenon should be reversed when non-distressed sales are stronger, e.g., during the summer months. Nonetheless, market expectations of home price performance have deteriorated somewhat over the past several months, according to various surveys. For example, the most recent MacroMarket Survey of more than one hundred economists released in March showed that the consensus expected prices to fall 1.4 percent in 2011, compared with an expected drop of just 0.2 percent in the December survey. More survey participants expect declines in home prices and no participant expects gains of more than 3 percent. The Fannie Mae National Housing Survey preliminary monthly tracking data also showed that consumers' home price expectations for this year have deteriorated materially during the past several months. In March, about 44 percent of respondents expected home prices to rise in 2011, a drop of 7 percentage points from the prior month. The share was as high as 58 percent at the end of 2010. Overall, survey respondents still expect a slight rise in home prices.



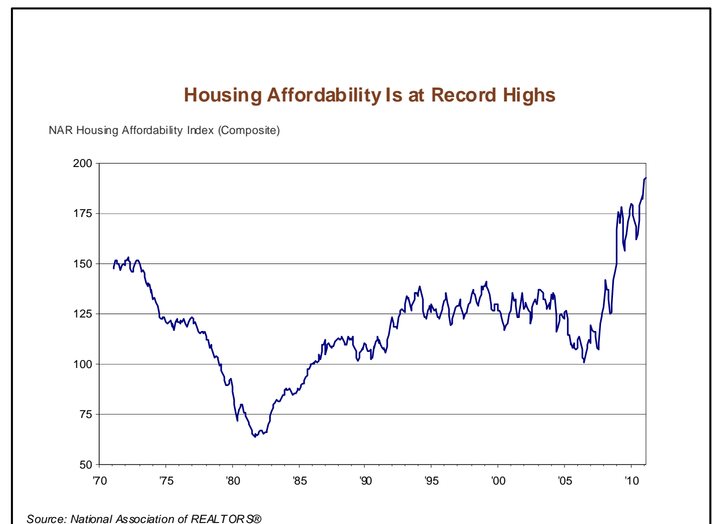
Continued deteriorating home price expectations could cause some potential homebuyers to remain on the sidelines, and further sharp cutbacks in housing demand would pose a risk to the fragile housing recovery. However, leading indicators suggest that home sales will likely rebound in the near term. After falling in January and February, purchase mortgage applications rose 6 percent in March. Purchase applications continued to rise in early April, boosted by applications for government loans as some borrowers attempted to get mortgages before a scheduled increase in FHA insurance premiums later this month.

The purchase mortgage applications data will not capture homes sold using cash. Many distressed sales are cash transactions and thus the rising share of distressed sales also pushed the share of homes sold for cash to about one-third of the existing home market, according to the survey of practitioners from the National Association of REALTORS®. A leading indicator of home sales that captures homes sold using cash is pending home sales (measuring contract signings of existing homes), which rose 2.1 percent in February following drops in the prior two months. While fundamentals do not suggest a robust spring season in housing activity, the odds of another outsized drop in activity have declined.

While home prices at the national level are likely to decline further before stabilizing later this year, price trends will vary by region and prices are likely to have troughed in some local markets. One upside for home prices is that rents are rising amid increasing rental demand, which has substantially absorbed the excess supply of vacant homes, as is evident in the plunge in the rental vacancy rate in the second half of 2010.

Declining home prices, low mortgage rates, and stabilizing incomes after the massive drop experienced during the recession have combined to propel affordability higher, reaching a new record in February according to the National Association of REALTORS®.

Record high affordability has not stimulated housing demand as much as it did in the past. The job market is healing, but a significant number of people remain unemployed. While there are signs that household formation has rebounded with an improving labor market, new households that are being formed are more likely to be renters than owners. In addition, lending standards for mortgages have remained tight relative to non-mortgage consumer loans.



As a result of further weakening housing starts trends, we downgraded our housing starts and new home sales projections. We expect housing starts to rise by about 4 percent this year, with stronger growth in multifamily starts. New home sales should manage to eke out a slight rise from last year's record lows, and existing home sales are projected to increase by about 6 percent. While we expect mortgage rates to rise modestly to about 5.5 percent by the end of 2011, expected stronger employment gains and continued soft home prices should help maintain historically high levels of housing affordability. For all of 2011, total mortgage originations are projected to decline to $1.04 trillion from an estimated $1.53 trillion in 2010. The refinance share should fall to 40 percent from an estimated 69 percent in 2010. We expect total single-family mortgage debt outstanding to fall by 2.6 percent, compared with a drop of 2.9 percent in 2010. While multifamily activity performance improved in 2009, multifamily mortgage debt outstanding posted a slight drop of 0.9 percent in 2010. (For more details on multifamily mortgage debt outstanding, read the *April 2011 Multifamily Market Commentary*).

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