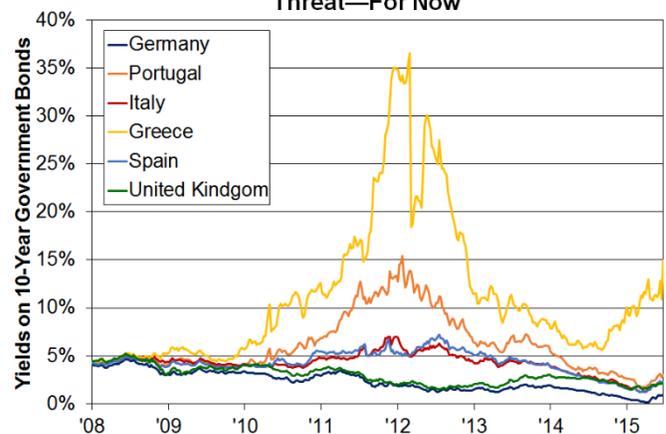


Building Momentum into the Second Half

We believe that second quarter economic growth likely came in slightly stronger than we expected in the prior forecast, boosted by strengthening consumer spending and residential and nonresidential investment. Meanwhile, net exports, which were the largest drag on first quarter gross domestic product (GDP) since 1985, likely were close to neutral in the second quarter. We now estimate that economic growth picked up to 2.8 percent annualized in the second quarter, 0.4 percentage points stronger than in the June forecast, and expect that it will accelerate further in the second half of the year to an average of approximately 3.0 percent. Our forecast for the second half is little changed; however, because of the government's upward revision to GDP in the first quarter as well as our more optimistic view for the second quarter, we upgraded our full-year 2015 economic growth outlook to 2.1 percent from 1.9 percent in the June forecast. Consumer spending is expected to be the biggest driver of growth, with housing and government spending also contributing. Due to the strong dollar and weak economies abroad, we expect net exports to be a drag on growth this year. The decline in oil prices over the past year will likely continue to hurt nonresidential investment in structures, while business investment in equipment and inventory should be neutral to growth.

While incoming domestic data over the past month largely beat our expectations, conditions abroad have deteriorated, posing downside risks to our forecast. The debt crisis in Greece is now front and center as the country is facing a choice between implementing harsh austerity and exiting the Eurozone, going into uncharted territory. So far, the Greek crisis has not ignited a run on sovereign debt of other weaker European economies, such as Italy, Portugal, and Spain. Bond yields in these countries have remained low. Investors may be expecting Greece to strike a deal with its creditors to avoid default, or they might have confidence that the European Central Bank (ECB) will intervene with several initiatives, including accelerating its Quantitative Easing (QE) program, to avoid contagion across the rest of Europe. Depending on how events unfold over the next month, the Greek debt crisis and the potential Greek exit could have significant implications for the future of the Eurozone.

European Yields Show Limited Contagion Threat—For Now



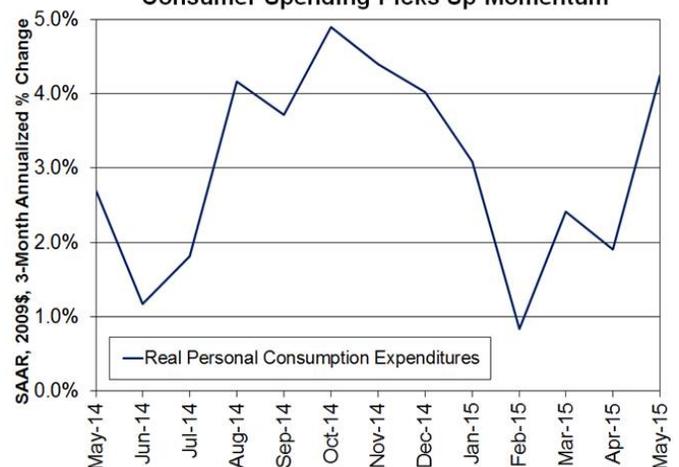
Trouble is also brewing in China. The Chinese government announced several measures to stem the spectacular dive in its stock market, including suspending trading of one-third of the companies listed on the Shanghai and Shenzhen exchanges and ramping up state investments in stocks. Despite these efforts, China's major indices remain a third off their highs as this article goes to print. Meanwhile, China's auto sales fell in June for the first time in two years, triggering concerns of a further downshift in its economic activity. Downside risks to our forecast include challenges associated with the debt crisis in Greece, the economic slowdown and stock market swoon in China, the deepening recessions in some emerging markets, and renewed appreciation in the dollar.

Consumers Poised to Bounce Back...

The third print of first quarter GDP showed that the economy contracted by 0.2 percent annualized, compared with a decline of 0.7 percent in the second estimate. Following the poorest showing in a year during the first quarter, consumer spending showed signs of a turnaround amid rising consumer confidence, expanding household net worth, healthy job gains, and improved income growth prospects. We estimate that real consumer spending growth accelerated to 2.9 percent annualized in the second quarter from 2.1 percent in the first quarter, and expect some additional acceleration in the second half of the year.

Monthly data showed that, after no change in April, real consumer spending was upbeat in May, jumping 0.6 percent. The increase for the prior three months ending in May

Consumer Spending Picks Up Momentum



accelerated to 4.2 percent annualized, compared with a paltry gain of 0.8 percent in the three months ending in February. Meanwhile, real personal income rose 0.2 percent during May following a 0.4 percent gain in April. With annual growth in real income accelerating one-tenth of a percentage point to 4.2 percent, it is the strongest year-over-year gain since February. While auto sales declined in June, the drop was from a near-decade-high pace in May. For the second quarter, auto sales averaged 17.1 million units annualized, the strongest pace since the third quarter of 2005.

...Amid Improving Consumer Confidence...

Consumer moods improved substantially in June. The Conference Board's Consumer Confidence Index® jumped 6.8 points from May, tying the March level at the second highest reading in the expansion. Both current assessments and expectations regarding the labor market improved in June. Income expectations, as measured by the share of households expecting their income to rise over the next six months minus the share expecting it to fall, ticked up in June for a second consecutive month after reaching an expansion-best in March.

The University of Michigan's consumer sentiment index also jumped in June, rising 5.4 points to the highest reading since the expansion-best reached in January. Consistent with the Conference Board results, consumers' view of the labor market improved and expectations for income growth firmed.

...Rising Net Worth...

Household net worth—assets minus liabilities—set a fresh record high in the first quarter amid rising home values and equity prices. The ratio of household net worth to personal disposable income increased to 639 percent for the quarter, the best showing since the third quarter of 2007, right before the economy slipped into recession. Households continued to be reluctant to incur more debt, however, as overall borrowing grew only 2.2 percent annualized in the first quarter—the slowest pace since the fourth quarter of 2013. The ratio of household debt to personal disposable income fell to 106.5 percent in the first quarter, the lowest level in more than a decade. The resulting decline in debt burden is a positive for consumers in the longer term, as it creates a support for future borrowing and spending.

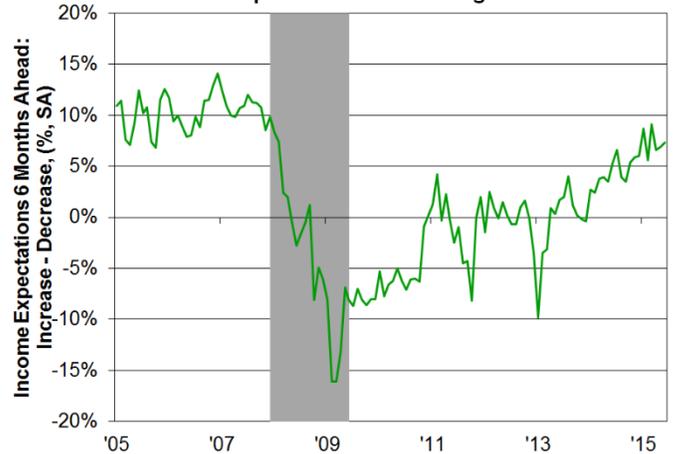
...And Solid Job Growth

The June jobs report showed healthy hiring, with total nonfarm employment rising 223,000. Given downward revisions for April and May, the average monthly job gain through the first six months was 208,000, implying 2.5 million jobs for the year—not as great as last year but still a solid number. Details were soft, however, as both average hourly earnings and the length of the average workweek were unchanged. For the second quarter, average hourly earnings increased 2.2 percent annualized, moderating from 2.7 percent in the first quarter but somewhat better than the trend over the prior few years.

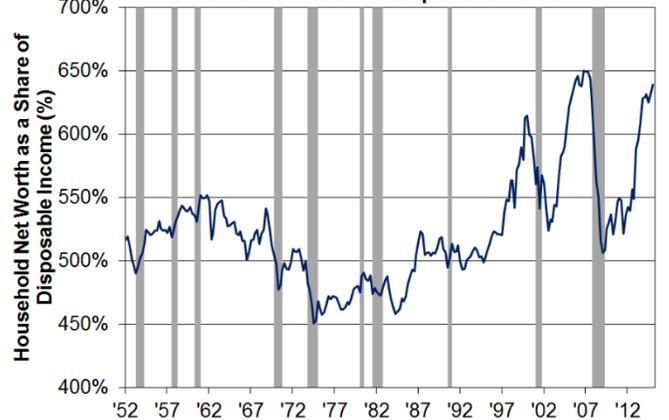
Q2 Auto Sales Reach Strongest Quarterly Pace in a Decade



Income Expectations Trend Higher in 2015



Household Net Worth as a Share of Disposable Income Rises to Expansion-Best

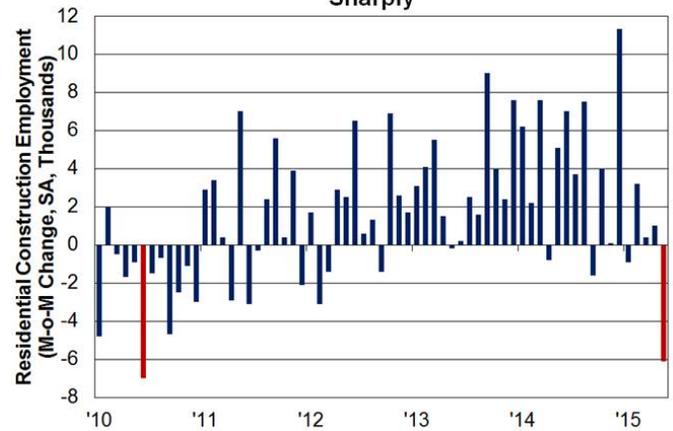


Employment growth by industry varied substantially. Healthcare and social assistance continues to be the bright spot, with a 53,000 job gain over the month and a record 539,000 increase over the past year. Manufacturing jobs were up a modest 4,000. Mining employment, which includes oil and gas extraction, dropped for the sixth consecutive month, though job losses moderated to 3,600 from 17,000 in May. Total construction employment was unchanged, weighed down by the largest drop in residential construction employment in nearly five years. Month-to-month changes could be volatile, and, as housing demand is heating up amid lean inventories, we expect home building activity and residential construction employment to pick up. One concern is that builders may find it increasingly difficult to hire skilled workers without substantially raising wages. Construction wage gains have accelerated this year after slowing sharply in 2014, in contrast to the overall wage growth, which has been moving sideways at approximately 2.0 percent over the past three years.

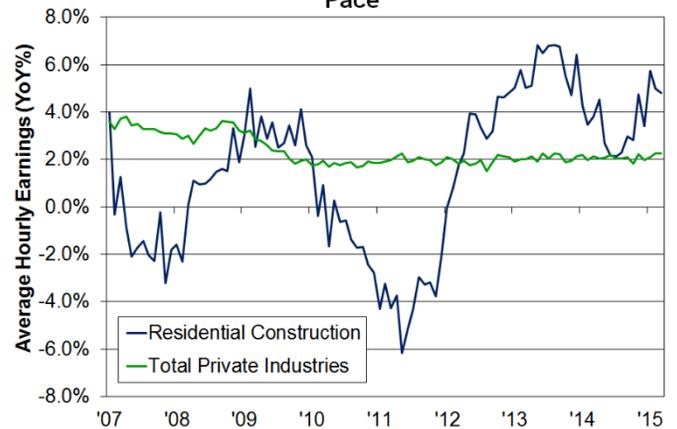
A survey of single-family builders conducted by the National Association of Home Builders (NAHB) in June 2015 showed that labor shortages have become even more widespread during the past year, especially for workers with basic skills. For example, 69 percent of builders reported a shortage of workers to do rough carpentry and 67 percent reported difficulties finding framing crews. The NAHB noted that the shortage of workers this year is substantially more severe than at the peak of the housing boom and rivals the widespread shortage just before the start of the expansion in 2001.

The employment report's household survey showed a 0.2 percentage point decline in the unemployment rate to a seven-year low of 5.3 percent. However, this positive headline masked the bleak news that the labor force participation rate fell three-tenths to 62.6 percent, the lowest reading since October 1977. The broadest measure of underemployment (U6), which includes those who are not in the labor force but want jobs as well part-time workers who prefer full-time jobs, fell 0.3 percentage points to 10.5 percent and is down 1.5 percentage points over the past year. Another gauge of labor market slack is the ratio of unemployed persons to job openings. The Job Openings and Labor Market Turnover Survey (JOLTS), which is released with a one-month lag to the jobs report, showed that job openings edged up to a fresh record high of 5.36 million in May. The ratio of unemployed persons to job openings remains at 1.6, well below its average of 2.1 during the 2001-07 expansion. Even if we add marginally unemployed persons—those who are not in the labor force but want a job—the ratio remains below the prior expansion average of 3.3. Overall, these indicators suggest that labor market slack has diminished meaningfully over the past year.

Residential Construction Employment Drops Sharply



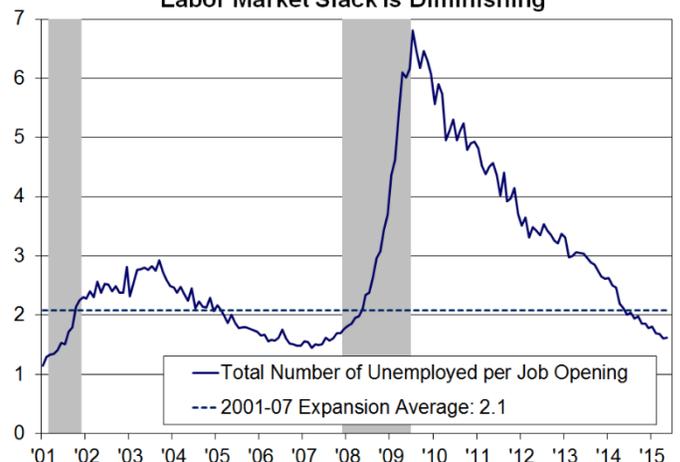
Construction Wages Are Rising at a Strong Pace



Unemployment Continues to Decline as Participation Falls to 38-Year Low



Labor Market Slack Is Diminishing



International Developments May Push Rate Lift-off Past September

The Federal Open Market Committee (FOMC) has emphasized that the timing of the lift-off in the target fed funds rate will be data-dependent, with the Committee continually assessing incoming information on both the labor and inflation fronts. The minutes of the June FOMC meeting released on July 8th showed that the Committee discussed the risks associated with waiting too long to begin normalizing interest rates. The Committee also discussed uncertainty about Greece as one of "a number of reasons to be cautious."

We believe our call for the first rate hike to occur in September remains viable given incoming data. On the labor market front, the June unemployment rate falls within the middle of the Committee's central tendency forecast (which excludes the three highest and three lowest projections) for the fourth quarter of this year. Other broader indicators of labor market slack have also shown improvements in recent months. On the inflation front, the minutes showed some members noted that recent underlying inflation has firmed and that stabilization in the dollar and oil prices supports the Fed's inflation outlook. However, the Fed could err on the side of caution and delay the liftoff to later this year, or even in early 2016. At the time of this writing, the market is pricing the start of the rate hike close to March 2016.

Manufacturing Is Still In a Rut Despite More Optimistic Purchasing Managers

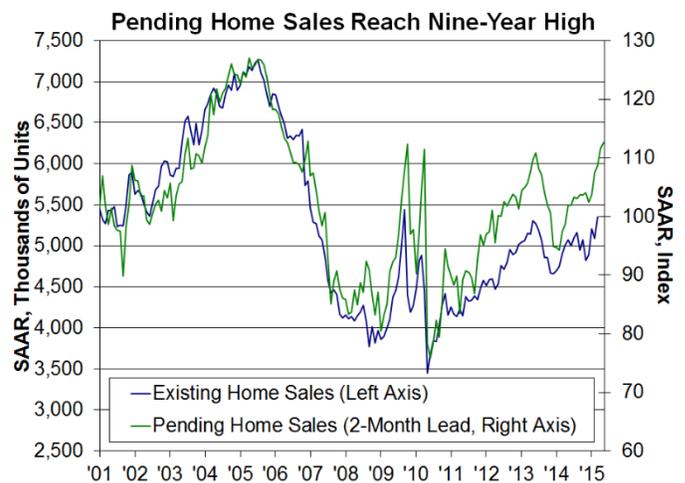
The industrial production report showed that the mining sector continues to drag on the economy, with mining output falling in May for the fifth consecutive month and the seventh time over the last eight months. The continued drop in mining output was expected; the decline in manufacturing output was the downside surprise in the industrial production report, given that the May Institute for Supply Management (ISM) manufacturing index rose for the first time in seven months.

The factory orders report reinforced the view that the recovery in the sector will be very slow, as orders fell in May for the second consecutive month and for the ninth time over the last 10 months. Details were disappointing as core capital goods shipments—an input used to estimate business equipment spending—were revised lower. In addition, core capital goods orders, a leading indicator for shipments, were downgraded from a 0.4 percent gain to a 0.4 percent loss, marking the fourth drop in the last five months. Overall, data on core shipments and core orders suggest weak business equipment spending in the second quarter as well as in coming quarters.

The Institute of Supply Management (ISM) manufacturing index improved further in June to the highest reading since January. Despite improvement in the ISM manufacturing index at the end of the quarter, the average for the second quarter was unchanged from the first quarter. A turnaround in manufacturing will likely be gradual given the soft demand abroad and strength of the U.S. dollar.

Housing Expected to Provide a Tailwind to Growth

Home sales were notably stronger in May and are poised to post a sizable increase in the second quarter. Existing home sales rebounded 5.1 percent to the strongest pace since November 2009, when sales spiked ahead of the expiry of the first-time home buyers tax credit. New home sales increased 2.2 percent following an 8.1 percent rebound in April. Combined, total annualized home sales of 5.9 million units in May mark the strongest pace since June 2007.



Leading indicators point to continued improvement going into the summer months. Pending home sales rose for the fifth consecutive month to a nine-year high, and purchase mortgage applications rose in early July to the second highest level since June 2013. Meanwhile, mortgage lending standards are easing on the margin, although they remain tight by historical standards. According to Fannie Mae's [second quarter 2015 Mortgage Lender Sentiment Survey™](#), more lenders have continued to report credit loosening rather than tightening.

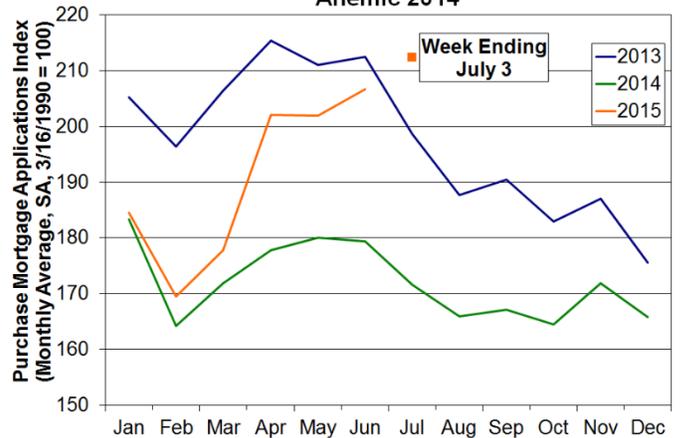
The back-to-back increase in new home sales brought the months' supply (seasonally-adjusted) down to 4.5 months from 5.1 months a year ago and from an average of 5.5 months for all of 2014. With improving sales, homebuilders' confidence jumped five points in June to its highest level since last September. We expect the combination of strong sales, lean inventories, and rising confidence to lead to increased home building activity this year.

Following a surge in April to the strongest pace since July 2007, both single-family and multifamily housing starts fell sharply in May. Meanwhile, building permits, a leading indicator of starts, surged to the highest level since September 2007. We expect housing starts to average 1.12 million units in 2015, a slight upgrade from the June forecast solely from the multifamily segment. As we mentioned earlier, shortages of labor likely will play a role in restricting construction activity this year. (For more information on multifamily market conditions, read the [July 2015 Multifamily Market Commentary](#).)

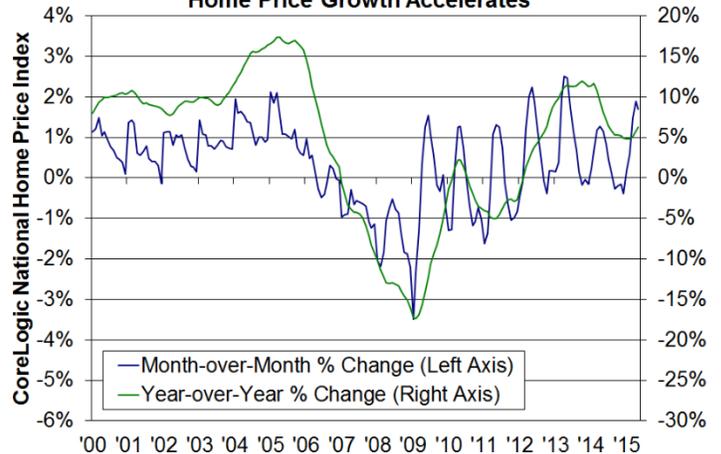
Rising home sales amid tight inventories are putting upward pressure on home prices. The CoreLogic Home Price Index, the measure used by the Fed to estimate real estate value in the Financial Accounts of the U.S., posted a robust 6.3 percent year-over-year gain in May, the strongest pace since last July. While other home price measures such as the Case-Shiller and the FHFA house price indices also showed healthy home price gains this year, the CoreLogic index has been relatively more bullish than other measures.

While strong home price appreciation has helped boost household net worth and reduced the number of underwater properties, it presents a challenge to potential first-time buyers. With strong home price gains amid continued strong job and income growth, consumers are looking more favorably on the current selling climate. [Fannie Mae's June 2015 National Housing Survey™ \(NHS\)](#) showed that the share of consumers who believe now is a good time to sell a home reached a new survey high, increasing three percentage points to 52 percent and crossing the 50-percent threshold for the first time in the survey's five-year history.

Purchase Applications Improve From Anemic 2014



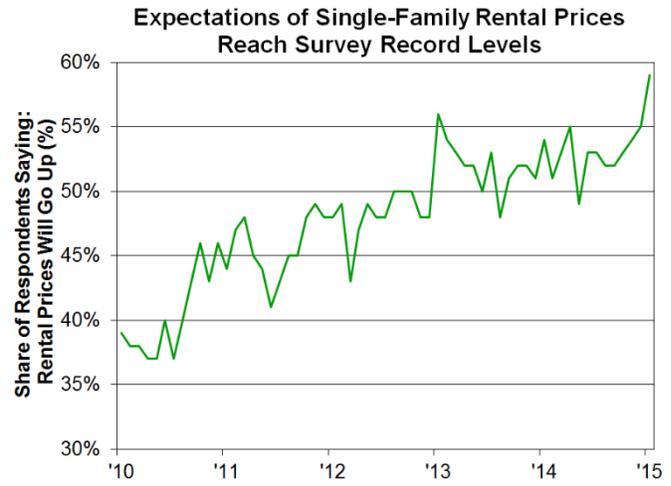
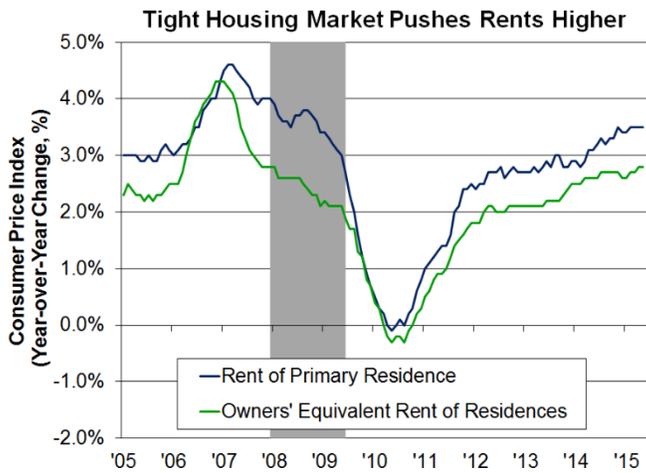
Home Price Growth Accelerates



For the First Time in Survey History, a Majority of Consumers Think It is a Good Time to Sell Their Home



The tight housing market also is putting upward pressure on rents, thanks to the jump in the number of renter households. After increasing just 0.5 percent on average during the first five years of the expansion, annual growth in household formation has surged since late 2014. Following a 1.4 percent rise in the fourth quarter of 2014, year-over-year growth in household formation slowed slightly to 1.3 percent in the first quarter of this year. Because the newly created households were renter households, increased rental demand has pushed the rental vacancy rate lower and driven rents higher. Details in the Consumer Price Index (CPI) showed that both tenant rent and owners' equivalent rent (a measure of the change in the shelter cost homeowners receive from their primary residences) have accelerated sizably over the past two years. In May, the CPI for tenant rent was up 3.5 percent from a year ago, compared with 2.8 percent for owners' equivalent rent. Rapidly rising rents have boosted consumer expectation for rent increases. The Fannie Mae NHS also showed that the share of consumers expecting rents to go up in the next 12 months rose four percentage points to 59 percent in June, an all-time survey high. These results from the Fannie Mae survey suggest that the home purchase market may improve in the near term, with more renters likely to find owning to be more cost-effective than renting and more sellers likely to put their homes on the market.



After reaching their recent trough in February, fixed mortgage rates have trended up, cooling refinance demand. During the last week of June, refinance mortgage applications fell to the lowest level this year, though they rebounded modestly in early July. Economic turmoil in Greece and China has renewed a flight to safety, which should help keep long-term interest rates low, supporting home sales in the crucial summer selling season. Given our expectation of stronger economic growth, mortgage rates should trend up going forward, though we expect a gradual rise from about 4.0 percent currently, according to Freddie Mac, to about 4.5 percent by the end of 2016. We modestly upgraded our projected home sales for 2015, with existing and new home sales rising by approximately 5 percent and 25 percent, respectively. Our forecast of mortgage originations is little changed, as an upward revision in projected purchase originations slightly outweighs a downward revision in projected refinance originations. For all of 2015, we expect total mortgage originations to rise approximately 24 percent to \$1.46 trillion, with a refinance share of 47 percent.

July 10, 2015
Economic & Strategic Research (ESR) Group

For a snapshot of macroeconomic and housing data between the monthly forecasts, please read ESR's [Economic and Housing Weekly Notes](#).

Sources for chart data: Bloomberg, Bureau of Economic Analysis, Autodata, the Conference Board, Federal Reserve Board, Census Bureau, Bureau of Labor Statistics, Fannie Mae National Housing Survey

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