# Businesses and Consumers Say “Eh!” to Fiscal Drag

The February jobs report surprised on the upside as businesses shrugged off fiscal drag and political stalemate. Consumers also appear to be desensitized to fiscal events, as reflected by the rebound in consumer confidence in February, ahead of the looming sequestration deadline. Stock markets continued to rally, with the Dow Jones Industrial Average cruising to a record high at the time of this writing. Manufacturing and service activity also expanded at a faster pace during the month, according to surveys of purchase managers. A gauge for future business capital investment indicates a pickup in activity in coming quarters, and both the stock and housing markets continue to act as a tailwind to economic growth, as they help boost household net worth.

Not all is rosy, however. Income and consumer spending took a hit at the start of the year, and it is possible that a delayed impact of the tax hike, coupled with a recent spike in gasoline prices, could slow spending again. Developments in Europe over the past month, in particular Italy’s inconclusive election results that are not conducive for the country’s fiscal austerity program, reminded the financial markets of the ongoing sovereign debt crisis that will occasionally flare up across the Atlantic.

Economic growth in the fourth quarter received an upgrade to a slight positive from a slight negative in the second estimate of gross domestic product (GDP). The improvement came largely from more favorable net exports and investment in nonresidential structures than initially reported. The revisions also showed a more severe decline in inventory investment, which is a positive for the current quarter as it implies more inventory accumulation as firms restock. Thus, we expect the inventory swing to boost headline economic growth in the first quarter. However, while overall economic growth is poised to strengthen, growth in private sector demand may weaken, dampened by the tax increases that came into effect at the beginning of the year.

We expect economic growth to come in at 2.1 percent in 2013, as strength in the housing market and business investment will help to offset fiscal tightening. Tax increases will restrain activity in the first half of the year, but we expect growth to pick up in the second half. Yet downside risks remain, as the actual fiscal tightening may be more severe than we currently assume (see more below). As we mentioned in last month’s commentary, several factors could cause growth to come in faster than we project, including stronger home price appreciation, which could result in a virtuous cycle that feeds into more favorable housing activity, consumer sentiment, and consumer spending.

## Fiscal and Monetary Policy: No Change In Our Assumptions – For Now

We retain our assumptions of fiscal and monetary policy, at least for this month. Since Congress could not agree on a compromise, the delayed sequestration took effect on March 1. We estimate that a full sequestration would lead to about one-half of a percentage point drag to economic growth this year. Our previous forecast built in approximately half of the currently slated sequester, and we continue to assume so in the current forecast as there is some chance that Congress could agree on a deal around the continuing resolution (the temporary spending authority scheduled to expire on March 27) that would dampen the fiscal drag to some degree.

The monetary policy front does not seem to be as eventful. The minutes of both the December and January meetings of the Federal Open Market Committee (FOMC) showed that the Fed is concerned about potential costs and risks stemming from additional asset purchases, leading market participants to price in a tapering or an end to the open-ended asset purchase program before the end of the year. In his testimony to Congress in late February, Fed Chairman Ben Bernanke reiterated that the benefits of the program continue to outweigh the potential risks. He also said that the Fed will review its exit strategy soon, which could involve a gradual sale of assets with plenty of notice. Alternatively, he said the Fed could exit without selling at all. We expect the asset purchase program to continue through the end of 2013 and the funds rate target to remain unchanged until the second half of 2015 – the same view we held in the prior forecast.

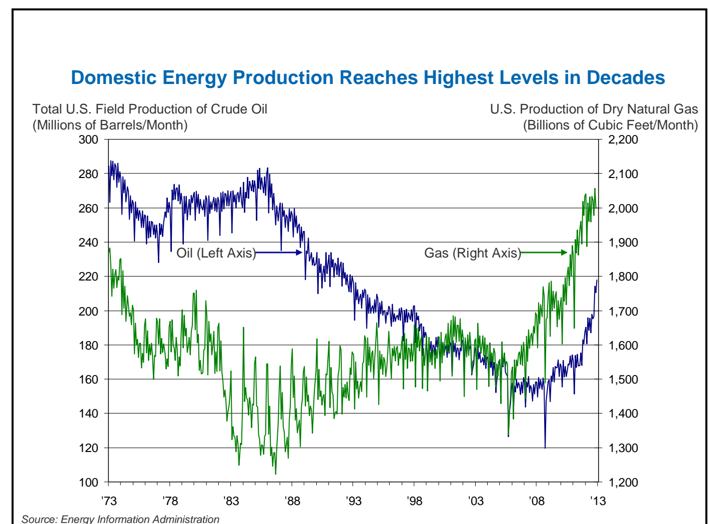
## Manufacturing: Encouraging Trend Continues

Manufacturing activity started 2013 on a stronger footing, and conditions continued to improve in February, according to a survey of purchase managers from the Institute for Supply Management (ISM). The survey showed that, after contracting

for the first time during the current expansion last November, manufacturing has resumed its expansion at a healthy pace. Activity continued to expand in February at the fastest pace since June 2011, signaling that manufacturing will be a positive contributor to growth this quarter, serving as a counterbalance at a time when consumer spending growth is expected to weaken.

The recent trend in the ISM survey is consistent with positive developments in durable goods orders. January durable goods orders fell sharply due to a collapse in the volatile aircraft orders, but orders excluding transportation posted the biggest gain in nearly a year. Construction equipment picked up sharply, supporting the notion that homebuilding activity will continue to strengthen. Orders for mining equipment took a breather following several months of strong growth. However, we expect the pause to be temporary and domestic energy extraction industries should remain vibrant as U.S. energy production is at levels not seen in decades.

The mining sector likely will not act as a major driver of growth as it still accounts for a small share of the U.S. economy. However, growing domestic energy production will reduce the country's reliance on imported oil and help narrow the trade deficit, almost half of which is due to energy.




## Business Investment: Capital Investment Will be a Driver of Economic Growth

After an impressive performance during the final quarter of last year, we expect business investment in equipment and software to soften somewhat in the current quarter before strengthening in coming quarters. Core capital goods orders – a leading indicator for business capital investment – surged 7.2 percent in January, the biggest one-month rise since September 2004. For the three months ending in January, core capital goods orders grew 45.6 percent annualized, the second strongest pace since the inception of the series in 1992. Given improving business balance sheets, low borrowing costs, and the extension of the temporary 50 percent bonus depreciation through the end of this year, business investment will likely carry the momentum seen during the final quarter of 2012 into 2013.

By contrast, following four quarters of solid increases, investment in nonresidential structures contracted in the second half of 2012. We expect it to stabilize in the first half of this year, with weak growth for all of 2013.

## Trade: Neither a Contributor nor a Drag

Net exports were neutral to GDP in 2012, and more of the same is likely this year. The trade deficit widened substantially in January, partially reversing a substantial improvement seen in December. The worsening trade gap reflected rising imported oil prices as well as lackluster growth among many of the primary U.S. trading partners. We expect that net exports will be relatively flat in 2013, as the global backdrop is likely to remain weak amid moderate growth domestically, and will not be a meaningful driver or a drag this year.

## Employment: Healing at a Faster Pace

The February jobs report from the establishment survey was upbeat. The 236,000 increase in total nonfarm payrolls is the biggest one-month gain since last November, and both average hourly earnings and average weekly hours moved higher. Revisions over the prior two months showed a net job loss of 15,000, not enough to temper the positives of the report.

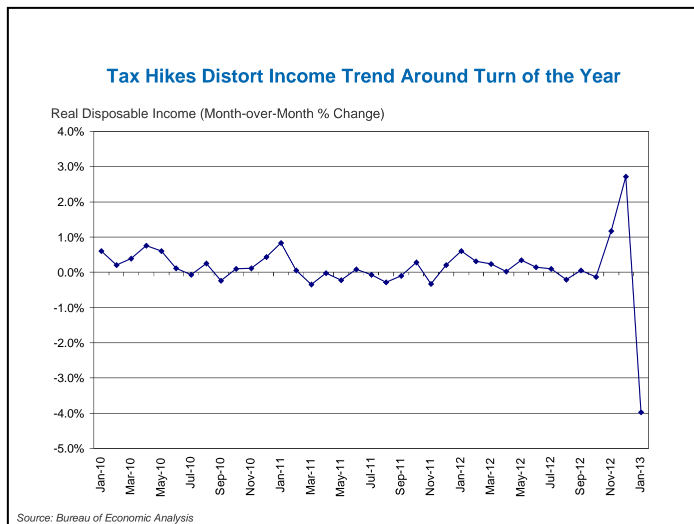
Job gains were broad-based, suggesting that the recovery is widening across the economy. Construction employment increased a robust 48,000, the largest monthly gain witnessed in nearly six years following a string of decent gains during the past several months. Construction employment has lagged homebuilding activity during the current housing recovery, but now is building momentum, confirming our view that the housing recovery will continue to gather strength this year.

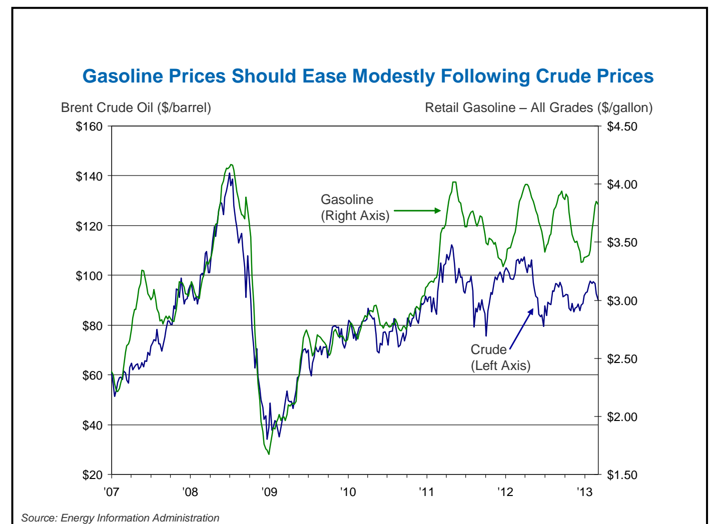
During the three months ending in February, the economy added an average of 191,000 jobs per month, compared with 182,000 in September through November. While labor market conditions are gradually improving, we may see some impact from sequestration begin to seep into the employment data in coming months, especially if the full sequester prevails. However, the trend in hiring over the past six months provides some comfort that the economy will be resilient enough to withstand additional headwinds that may lie ahead.

The household survey was less encouraging as it showed a decline of 130,000 in the number of people joining the labor force against a 170,000 gain in household employment, which pushed the unemployment rate down 0.2 percentage points to 7.7 percent, the lowest rate since December 2008. The labor force participation rate ticked down to 63.5 percent, matching the cycle low reached last August.

## Income: Volatile from Tax Law Changes

Nominal personal income fell 3.6 percent in January, driven by a plunge in dividend income, reversing the surges reported for the prior two months due to efforts to pull forward bonus and dividend income into 2012 ahead of the anticipated tax increases. The weakness in income also reflected the tax hike for social security withholding due to the expiration of the payroll tax holiday at the start of 2013. Taking into account the impact of taxes and inflation, real (inflation-adjusted) disposable income sank 4.0 percent following the prior two months' spikes. Aside from the volatility in those months, the trend in real disposable income had been relatively flat since April, underpinning the ongoing modest recovery.



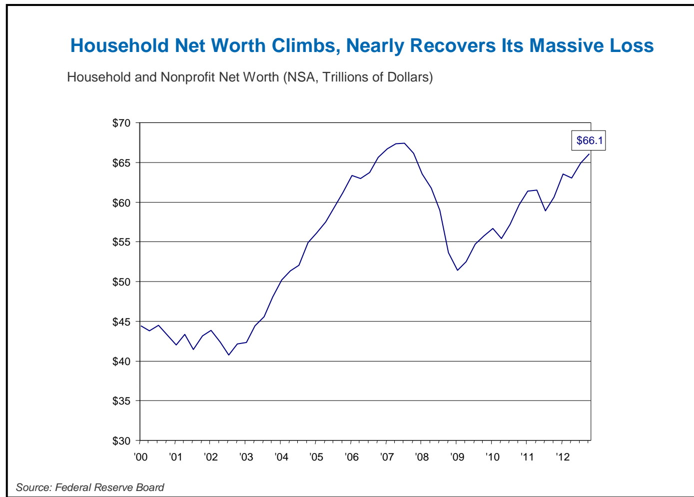

## Consumer Spending: Signs of Slowdown Have Arrived

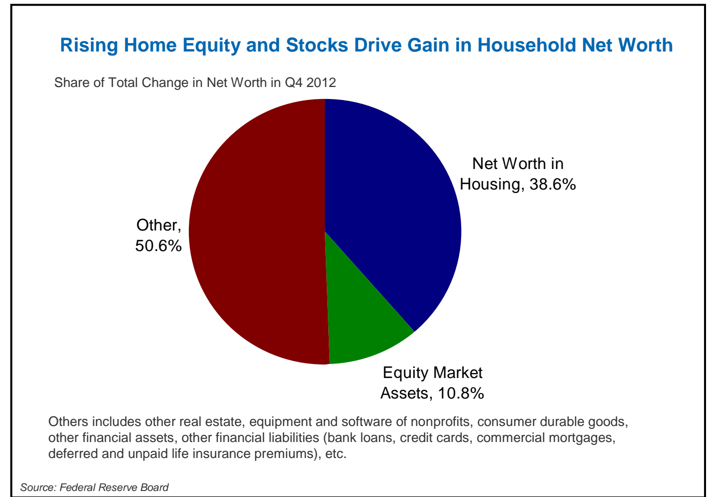
The large drop in disposable income at the start of the year restrained real consumer spending growth, which posted an anemic gain of 0.1 percent in January. February auto sales rose for the first time in three months, which should help support nominal consumer spending, but rising energy prices during the month will likely depress real consumer spending growth.

Gasoline prices rallied between mid-January and mid-February, driven by a combination of unexpected refinery closures and low inventories amid the refinery maintenance season. These supply-related issues have been resolved and it appears that gasoline prices may have peaked.

Even with declining gasoline prices following a recent spike, consumers will continue to face headwinds in coming months from the delayed impact of higher social security taxes and potentially from sequestration. One positive factor that could provide a buffer against rising taxes is improving net worth (household assets minus liabilities). The latest Flow of Funds data showed that household net worth increased by $1.17 trillion in the fourth quarter, reaching the highest level in five years. Households have now recovered 90.0 percent of the cumulative $16 trillion lost in net worth recorded between the third quarter of 2007 and the first quarter of 2009 in nominal terms.

The increase in net worth came from gains from both housing wealth, thanks to robust home price appreciation, and rising financial wealth stemming from rising stock values.

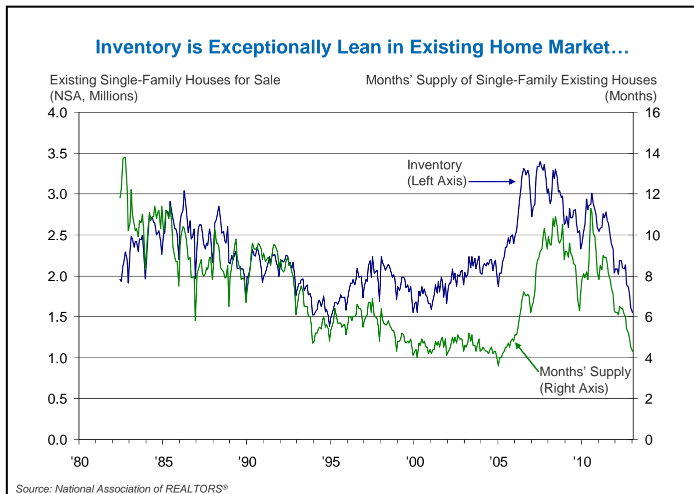


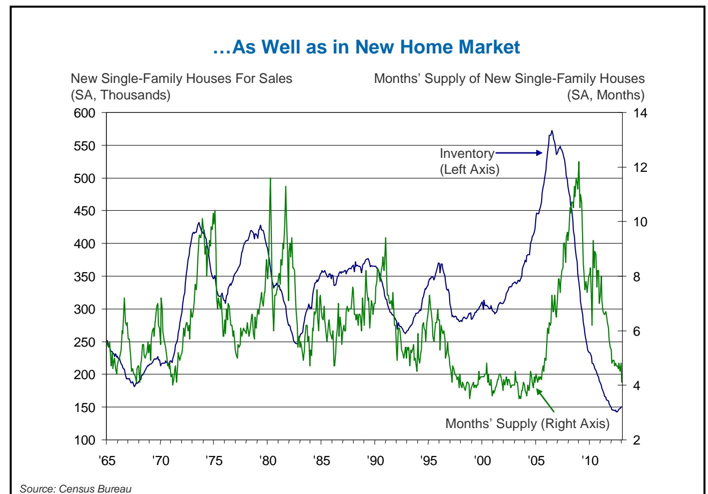




## Housing: Upturn is Intact

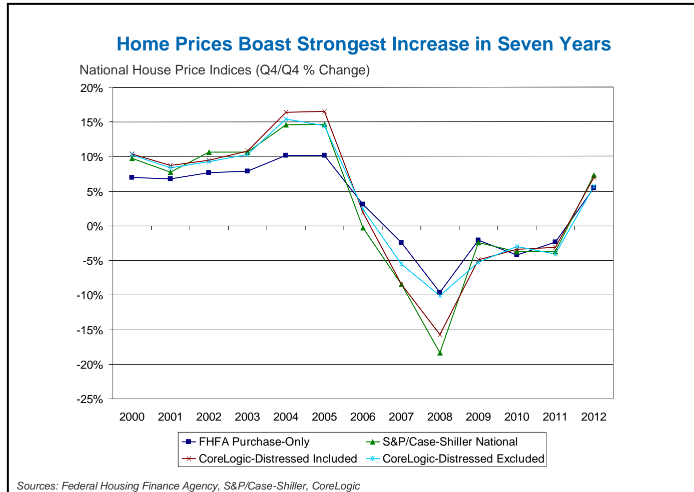
Housing indicators showed mixed performance in early 2013. On the soft side, housing starts tumbled in January on the volatile multifamily sector's weakness following a surge in the prior month, and builders' confidence slipped in February as buyer traffic pulled back. Tempering the negative news for the construction industry was the steady improvement in single-family permits, which rose in January for the fifth consecutive month and have not posted a decline since March 2012. (For more information on multifamily market conditions, including recent trends in rents, read the *March 2013 Multifamily Market Commentary*.)

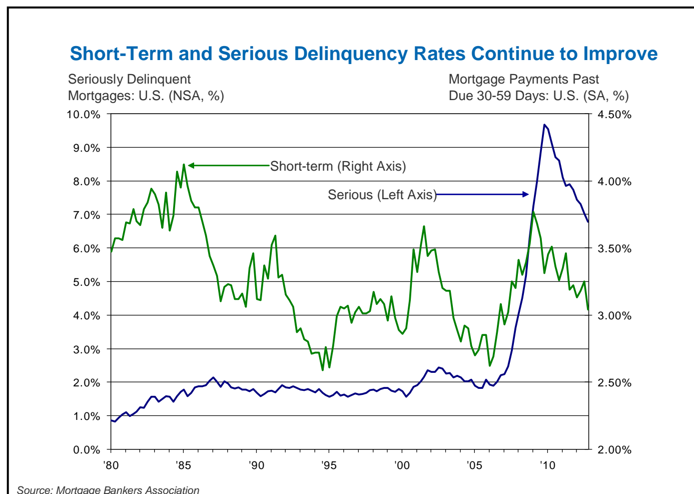
Following a slight drop in December, existing home sales were little changed in January. The National Association of REALTORS® pointed to a shortage of homes for sale, especially in the lower-end price range, as a factor for sluggish sales in recent months. The inventory of homes available for sale is at the lowest level since the end of 1999. Despite the slow sales pace, the months' supply continued to decline for the ninth consecutive month to 4.2 months.

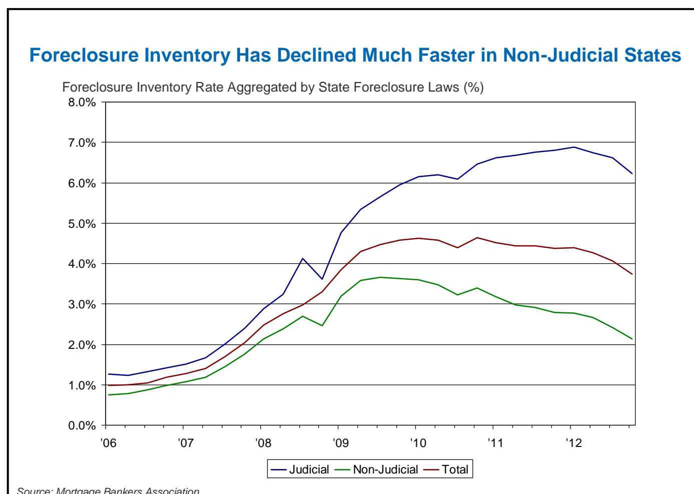


On the upside, new home sales jumped 15.6 percent in January – the biggest monthly gain in nearly two decades – sending the sales pace to the highest level since July 2008 and 35.0 percent above last year's level. The strong sales pace and the historically low level of inventory pushed the months' supply down to 4.1 months, the lowest since March 2005 and well below its highest level of 12.2 months witnessed three years ago.




Leading indicators of home sales – purchase mortgage applications and pending home sales – picked up in January, with pending sales rising to the highest level since April 2010, just before the contract signing deadline for the homebuyer tax credit. However, purchase mortgage applications, the more timely of the two indicators, fell in three out of four weeks in February and then rebounded strongly in early March, suggesting that the ongoing recovery in home sales could be bumpy during the first half of this year.

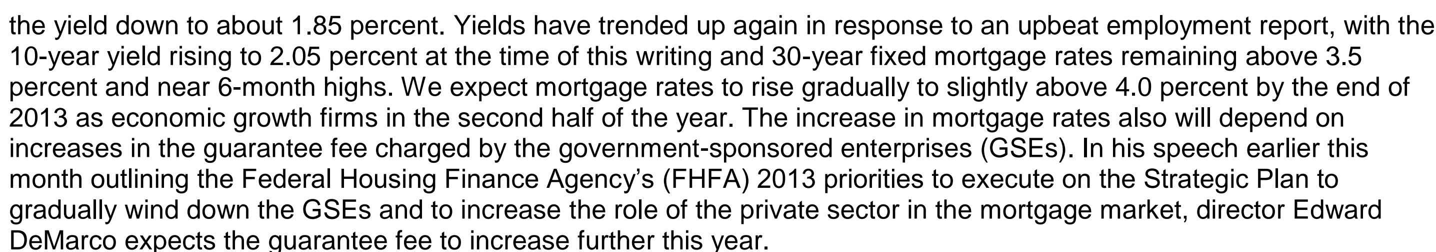
Lean inventory and declining share of distressed sales over the past year helped to propel home prices. Main measures of home prices posted solid gains in 2012, showing the strongest rate of appreciation since 2005.

Home prices (not seasonally adjusted) grew further in January, rising 0.7 percent, according to the CoreLogic home price index. From a year ago, prices rose 9.7 percent, marking the 11th consecutive year-over-year increase and the largest since April 2006. We expect home prices to firm further amid a durable housing recovery, continuing to boost household net worth, gradually diminishing the population of underwater borrowers, and reducing incentive for strategic defaults.

Other housing fundamentals, including household formation and loan performance, are also improving. The short-term delinquency rate dropped during the fourth quarter to its lowest level since mid-2007, helped by the improving job market. With fewer new delinquencies, the foreclosure start and foreclosure inventory rates continued to fall to their lowest levels since 2007 and 2008, respectively. The shadow supply of housing, as gauged by the share of seriously delinquent mortgages – those that are more than 90 days past due or in the foreclosure process – also have trended down roughly 3 percentage points below its peak of 9.7 percent at the end of 2009.

The share of loans in the foreclosure process has gradually declined from its peak, but the improvement is significantly different between judicial and non-judicial states. Improving loan performance overall amid rising home prices should encourage lenders to loosen lending standards, which have been little-changed over the last three years.

Long-term interest rates have trended up since the beginning of 2013, sending the 10-year Treasury yield to above 2.0 percent for the first time since April of last year. The rising trend paused in late February following the election in Italy, which resulted in a flight-to-quality, bringing



the yield down to about 1.85 percent. Yields have trended up again in response to an upbeat employment report, with the 10-year yield rising to 2.05 percent at the time of this writing and 30-year fixed mortgage rates remaining above 3.5 percent and near 6-month highs. We expect mortgage rates to rise gradually to slightly above 4.0 percent by the end of 2013 as economic growth firms in the second half of the year. The increase in mortgage rates also will depend on increases in the guarantee fee charged by the government-sponsored enterprises (GSEs). In his speech earlier this month outlining the Federal Housing Finance Agency's (FHFA) 2013 priorities to execute on the Strategic Plan to gradually wind down the GSEs and to increase the role of the private sector in the mortgage market, director Edward DeMarco expects the guarantee fee to increase further this year.

Consumer expectations of mortgage rates have been on the rise, according to the Fannie Mae February National Housing Survey. Since reaching its trough last September, the share of consumers expecting mortgage rates to go up increased by 4 percentage points to 45.0 percent, the highest level since August 2011, while those who think they will go down held steady at 7.0 percent. The survey also showed that, despite historically low mortgage rates, nearly half of all borrowers have never refinanced their mortgage. Our forecast of mortgage originations assumes that the Home Affordable Refinance Program (HARP) will expire at the end of 2013 as scheduled. Thus, rising rate expectations and the looming HARP deadline should prompt some borrowers to refinance soon to take advantage of more favorable mortgage terms and add to their disposable incomes, helping to offset ongoing fiscal drag.

HARP reached a milestone of 2 million borrowers in November. We do not expect that rising rates will reduce HARP volumes substantially since most HARP borrowers have mortgage rates well above 5.0 percent, still providing ample incentive for those eligible borrowers with good credit history to refinance.

Our forecast of housing activity is little changed from the prior forecast, with total home sales projected to rise by about 11.0 percent, supported by a rebound in household formation, historically high housing affordability, improving sentiment toward the housing market, and continued strong demand from investors. We expect home prices to increase further this year and next, but at a more moderate pace than in 2012. As a result, purchase mortgage originations should rise to $619 billion in 2013 from an estimated $530 billion in 2012. However, expected rising mortgage rates should sharply reduce organic (non-HARP) refinance originations. We project that refinance originations will decline to about $1 trillion from an estimated $1.4 trillion in 2012, resulting in a refinance share of 62.0 percent in 2013.

The Flow of Funds data showed that 1-4 unit single-family mortgage debt outstanding fell at a 0.3 percent annualized rate in the fourth quarter. This marks the 19th consecutive quarter of declines, as well as the slowest pace of contraction during that time. We expect that single-family mortgage debt outstanding will be flat in 2013, as home prices continue to rise amid the slowing pace of both charge-offs and household deleveraging.

---

Doug Duncan, Orawin T. Velz, and Brian Hughes-Cromwick
Economic and Strategic Research
March 11, 2013

*Opinions, analyses, estimates, forecasts and other views of Fannie Mae's Economic and Strategic Research (ESR) group included in these materials should not be construed as indicating Fannie Mae's business prospects or expected results, are based on a number of assumptions, and are subject to change without notice. How this information affects Fannie Mae will depend on many factors. Although the ESR group bases its opinions, analyses, estimates, forecasts and other views on information it considers reliable, it does not guarantee that the information provided in these materials is accurate, current or suitable for any particular purpose. Changes in the assumptions or the information underlying these views could produce materially different results. The analyses, opinions, estimates, forecasts and other views published by the ESR group represent the views of that group as of the date indicated and do not necessarily represent the views of Fannie Mae or its management.*