Stronger Second Half Can't Save This Year

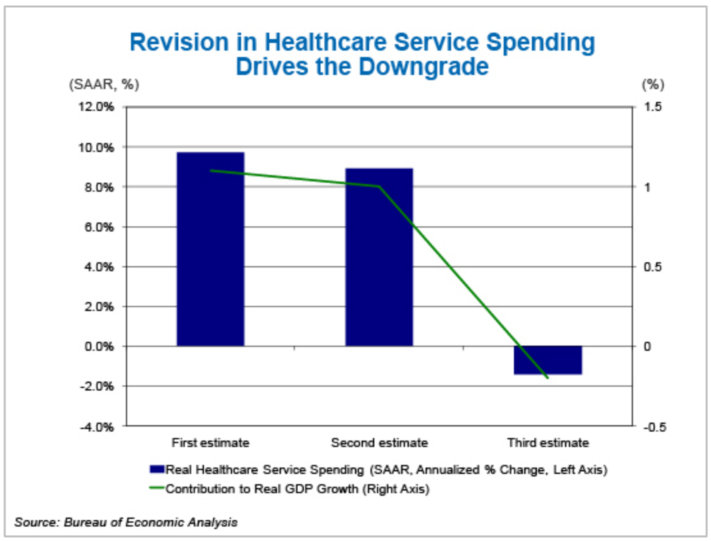
In our forecast, we expect the economy to grow 1.5 percent in 2014—a downgrade from 2.1 percent in the prior forecast and the worst performance of fourth quarter over fourth quarter growth in this now-longer-than-average expansion. The economy posted the worst performance in five years during the first quarter of 2014. While we anticipate the second quarter results will show a pickup in economic growth, the expected pace of growth is about one-half a percentage point below our prediction in the June forecast of 3.3 percent annualized growth. Thus, it appears that economic growth in the first half of this year was essentially flat. We expect the economy to grow approximately 3.0 percent in the second half, but given the government statisticians' difficulty in determining health care expenditures there is significant uncertainty around the forecast.

Other forecasters also have downgraded their expectations after the release of the third estimate of gross domestic product (GDP). For example, the July Blue Chip forecast showed that the consensus forecast for economic growth in 2014 was 1.6 percent versus 2.2 percent in the June forecast.

We expect consumer spending to be the biggest driver of growth, followed by business capital investment and residential investment. Government spending should contribute to growth for the first time in five years, while nonresidential investment should be neutral. We expect inventory investment and net exports to subtract from growth this year after adding to growth in 2013.

Healthcare Was the Culprit of the Downward Revision

Real (inflation-adjusted) GDP fell 2.9 percent annualized—a downgrade from a one percent drop in the second estimate. Sharp declines in the pace of inventory building and net exports as well the harsh weather effects helped drag down first quarter GDP. However, the surprising drop in spending on healthcare services—the biggest in more than three decades—was the cause for the rare outsized downward revision. Based on its estimates of healthcare utilization, the government had assumed that the rollout of the Affordable Care Act led to a surge in medical spending. Healthcare spending, which was previously estimated to have grown at an 8.9 percent annualized rate, was revised to show a 1.4 percent drop, subtracting 0.2 percentage points from GDP.

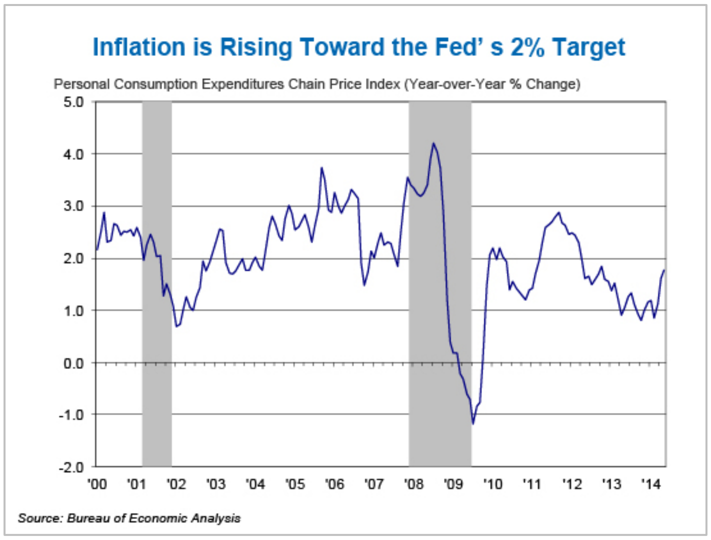


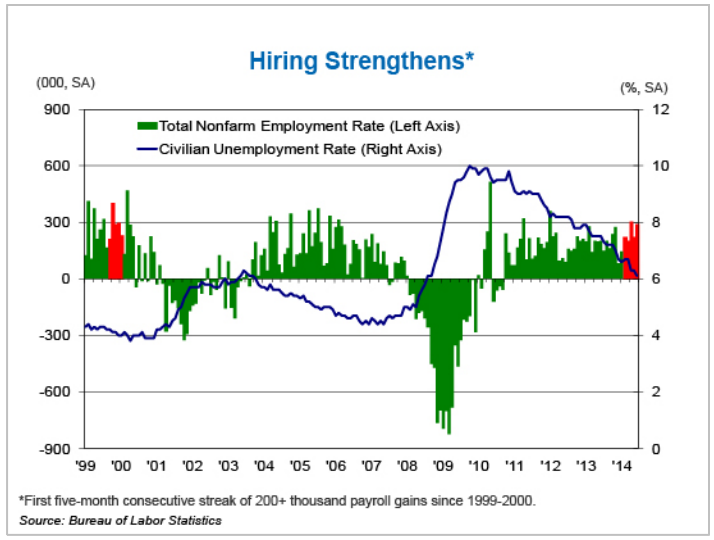
As a result, top-line real consumer spending increased at just 1.0 percent annualized, compared with the previous estimate of 3.1 percent. The resulting paltry 0.7 percentage point contribution to GDP from consumer spending—the only driver of growth—was substantially outweighed by drags from all other GDP components.

Consumer Spending Momentum Slows

Incoming data continue to suggest that economic activity picked up momentum during the second quarter of 2014 but consumer spending disappointed. Monthly data showed that real consumer spending fell 0.1 percent in May after a 0.2 percent drop in the prior month. The weak May data suggest that real consumer spending in the second quarter likely grew approximately half the pace we projected in the prior forecast of 3.3 percent annualized when combined with a significant revision in consumer spending earlier in the year.

Real personal income grew for the fifth consecutive month in May, increasing 0.2 percent against a backdrop of weak consumer spending. The saving rate rose to 4.8 percent, the highest reading since last September. The personal consumption expenditure price index, the Federal Reserve's preferred measure of inflation, increased 0.2 percent from April 2014 and 1.8 percent from May 2013, the biggest year-over-year rise since October 2012.



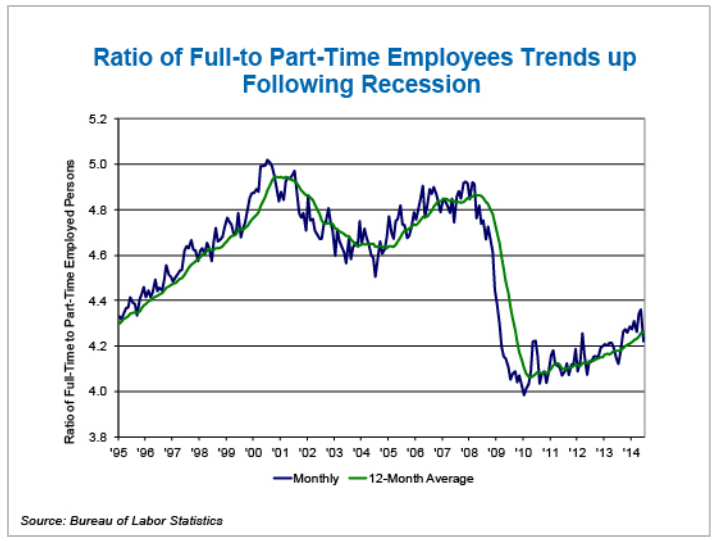


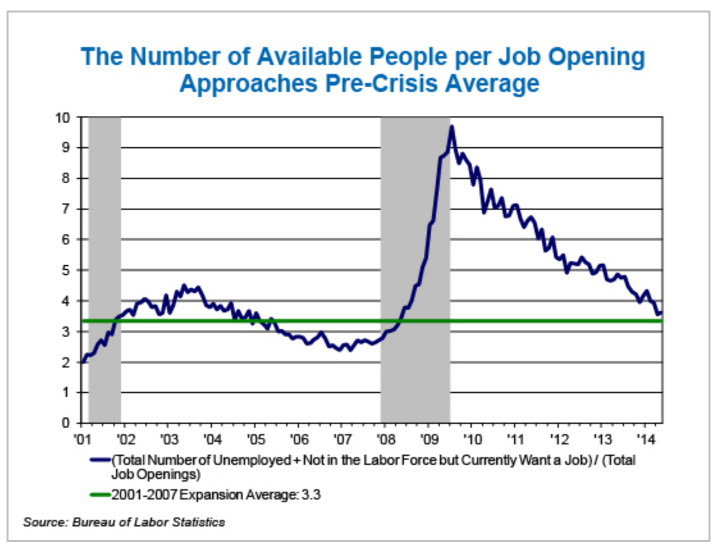
Hiring Strengthens

Consumer fundamentals are improving as hiring continued on an upward trajectory. The June jobs report was positive overall. Nonfarm payrolls rose 288,000 in June while upward revisions to the prior two months totaling 29,000 jobs pushed the average monthly gain over the second quarter to 272,000—a substantial pickup from the 190,000 average over the first quarter and the biggest since the first quarter of 2012. The string of five consecutive monthly gains above 200,000 was the best performance since late 1999.

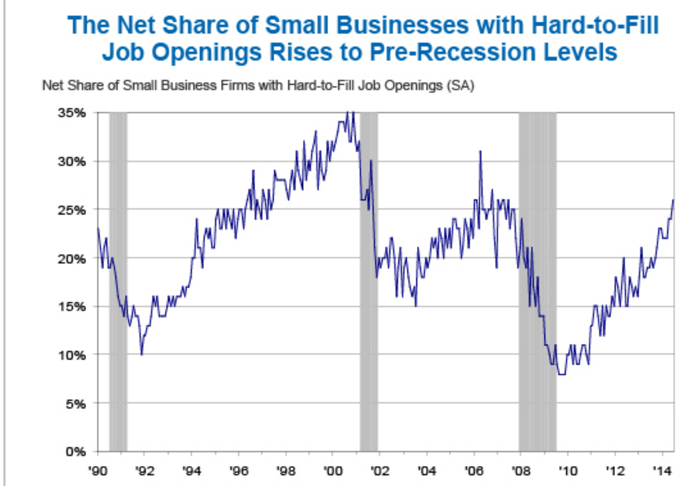
The separate household survey showed a 0.2 percentage point drop in the unemployment rate to 6.1 percent—a near six-year low—against the backdrop of a stabilizing labor force participation rate, which remains at 62.8 percent for the third consecutive month. It also showed that part-time employment posted the biggest jump in June since 1993 while full-time employment fell, causing the ratio of full-time to part-time employment to plunge during the month. However, despite the month-to-month volatility in the nature of the household survey, the ratio has trended up gradually since the end of the recession.

In another sign of a strengthening labor market, job openings rose in May to the highest level since June 2007, according to the Job Openings and Labor Turnover Survey, which provides labor market indicators with a one-month lag to the jobs report. The number of available people per job opening has trended down substantially, approaching the average witnessed during the 2001-07 expansion.





The survey of small businesses from the National Federation of Independent Business (NFIB) showed continued optimism for hiring. While the headline index ticked down for the first time in four months from a seven-year high, the net percent of firms planning to hire rose for the third straight month, matching January's recovery-high. Furthermore, a net share of 26 percent of firms indicated they have open positions that they are unable to fill, reaching a recovery high. Since the inception of the monthly series in 1986, the share has averaged approximately 21 percent.



Source: National Federation of Independent Business

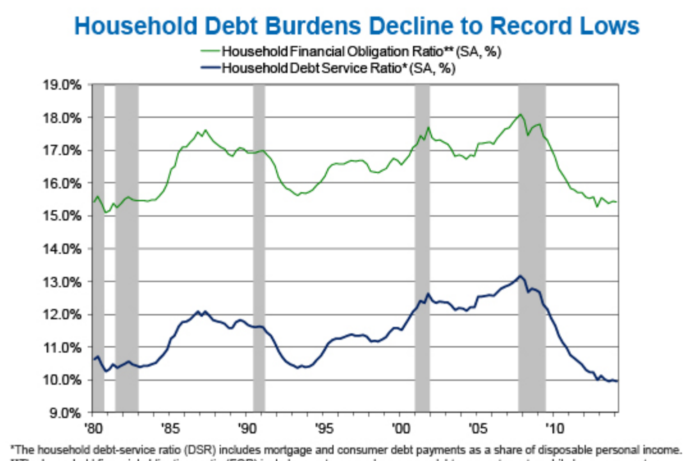
Our Fed Call Still Holds

However, not all appears rosy for the labor market, especially from the Federal Reserve's perspective. The labor force participation rate remains at depressed levels last witnessed during the 1970s. In addition, despite the improved pace of hiring, wage gains remain weak, with average hourly earnings ticking up 0.2 percent from May 2014 and 2.0 percent from June 2013. In her news conference in May, Fed Chair Janet Yellen noted that an important signal of a tightening labor market will be an increase in wages. However, the decline in the unemployment rate, combined with a recent uptick in the inflation rate, has raised market speculation that the Fed will start increasing the target rate sooner than previously expected. This presents a downside risk to housing activity that has just begun to regain its footing after the spike in mortgage rates last summer. Our call for the first rate hike remains unchanged at the third quarter of 2015, but the hike could come sooner if labor market conditions continue to improve while inflation expectations start to unhinge.

Given a balance sheet of more than $4 trillion—representing approximately 25.0 percent of GDP compared with the traditional ratio of less than 6.0 percent historically—it was no surprise that Fed officials discussed at length how to normalize monetary policy at the June Federal Open Market Committee (FOMC) meeting, according to the meeting minutes. While the Fed has not made any decisions regarding the eventual exit strategy, it appears that it will continue to invest the proceeds of its maturing asset holdings until some point after the first rate hike. Fed officials did not specifically mention outright asset sales, so if they occur at all, it will most likely be after 2015 rather than before. They did convey that the tapering of asset purchases will likely be complete by the October FOMC meeting.

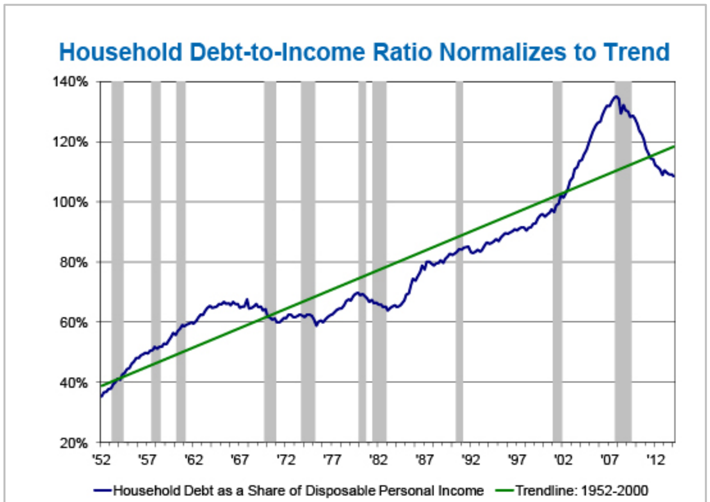
Households Are in Better Shape

Amid rising household net worth—to a record all-time high, even after adjusting for inflation and for number of households—debt burdens also dropped to record lows. While some of the decline in debt service reflects default or debt forgiveness, it also reflects the pay-down of debt, record-low interest rates, and rising income. The Fed's debt service



*The household debt-service ratio (DSR) includes mortgage and consumer debt payments as a share of disposable personal income.
**The household financial obligations ratio (FOR) includes mortgage and consumer debt payments, automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax payments.

Source: Federal Reserve Board

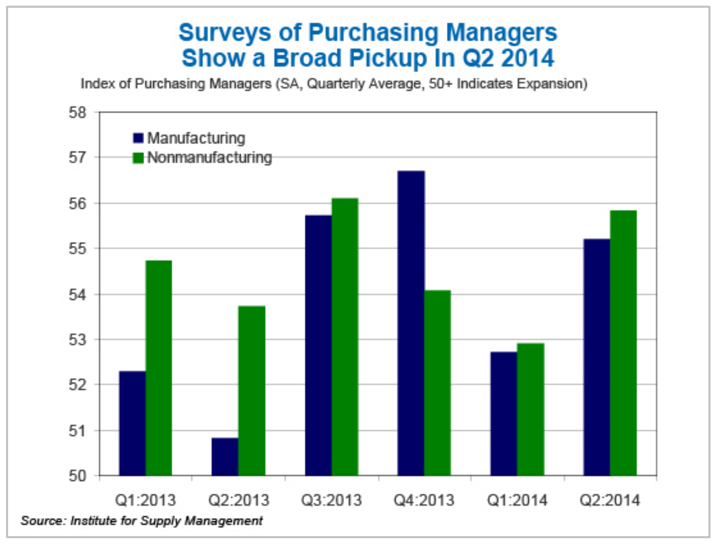


Source: Federal Reserve Board, Bureau of Economic Analysis ratio—a measure of debt burdens as a share of income—fell to 9.94 percent during the first quarter of 2014, standing slightly below the previous record low set in the third quarter of 2013. The household financial obligations ratio (FOR) (a broader measure of household debt burdens), which includes mortgage and consumer debt payments, automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax payments, also declined during the first quarter. Another measure to gauge household debt size is the debt-to-income ratio, which after rising to nearly 130 percent just before the recession has been normalizing toward its trend.

We expect that household debt burdens will likely increase again going forward, but this assumes that consumers' longer-term attitude about taking on debt was not substantially altered by the magnitude of the recession. As household financial conditions have improved, banks are becoming increasingly willing to extend credit for various types of borrowing. Consumer (non-mortgage) credit outstanding increased at a 7.4 percent annual rate in May, continuing a streak of 33 consecutive monthly gains. While non-revolving credit (composed primarily of auto and student loans and other financed big box purchases) continued to rise, revolving credit outstanding (mostly credit card debt) followed up the more than 10-year high jump in April with another gain in May. Revolving debt is up 2.2 percent from a year ago—the fastest annual gain since 2008.

Survey Says the Economy Is Accelerating…

Surveys of purchasing managers suggest that growth picked up in the second quarter of this year. The second quarter average for both manufacturing and service activity improved sizably from the prior quarter despite slight drops in the Institute for Supply Management (ISM) manufacturing and nonmanufacturing indices in the month of June.



…In Line with Other Economic Reports

Data related to manufacturing showed signs of strengthening as well. While factory orders fell for the first time in four months in May 2014, the recent trend in core capital goods orders (nondefense orders excluding aircraft)—a leading indicator of business capital investment—has improved, suggesting that momentum in business capital spending is picking up. Orders for motor vehicles and parts increased for the third time in four months in May, and June auto sales, which posted the fastest sales pace in nearly eight years, suggest another solid gain in June industrial production. For the second quarter, auto sales averaged 16.5 million annualized units, up from approximately 15.6 million in each of the past three quarters.

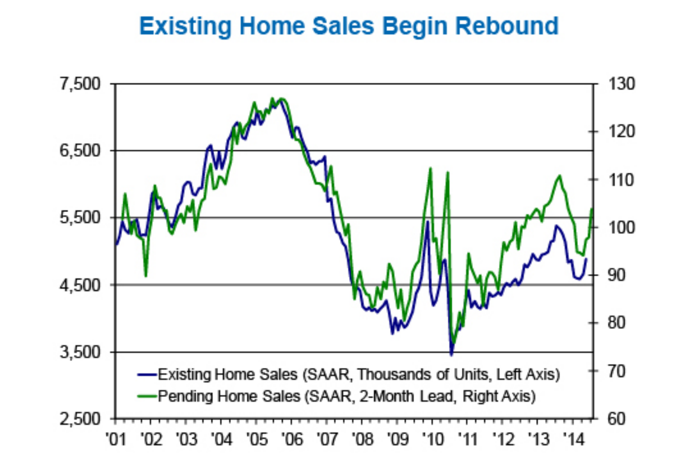
Housing Recovery Struggles to Gain Traction

Recent housing indicators point to a continued but modest rebound in the housing market. The elusive spring selling season finally arrived in May for both the existing and new home markets. After declining in seven of the last eight months through March, total existing home sales rose for the second consecutive month in May to the fastest sales pace since October. Despite a pickup in activity over the past two months, existing home sales through the first five months of 2014 remained more than 7.0 percent below levels for the same period last year. Following a 13.8 percent jump in April, the inventory of homes for sale (not seasonally adjusted) rose 2.2 percent in May. However, strong sales outpaced the rise in inventory, pushing the months' supply down one-tenth to 5.6 months, still below average. Distressed sales (foreclosures and short sales) accounted for just 11.0 percent of sales, down from 18.0 percent in May 2013. Meanwhile, the share of existing home sales that were bought using cash remains elevated at 32.0 percent, little changed from May 2013.

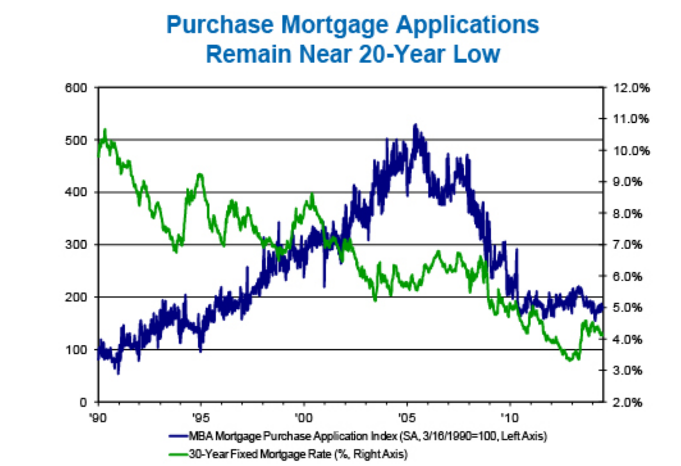
New single-family home sales jumped 18.6 percent, pushing sales to the fastest pace in six years. Through the first five months of the year, new home sales are up 2.1 percent over the same period last year. The surge in sales amid flat inventory pushed the months' supply down eight-tenths to 4.5 months—an 11-month low. We expect that the tight supply bodes particularly well for the near-term homebuilding outlook, which disappointed in May, as both single-family and multifamily starts fell. However, single-family permits—a leading indicator of starts—rose in May for the second time in three months, though remained down nearly 3.0 percent through the first five months of the year compared with the same period last year.

With an improvement in new home sales, the home builders' confidence index rose four points to 49 in June, marking the first monthly rise since last December, albeit remaining one point shy of the 50 threshold—what is considered the neutral mark where half of builders think conditions are good.

Near-term leading indicators for home sales were mixed. While the pending home sales index posted the strongest monthly gain since October 2011 of 6.1 percent, purchase mortgage applications were essentially flat in June and down 16.0 percent from June 2013 amid declining mortgage rates.



Source: National Association of REALTORS®



Source: Mortgage Bankers Association, Freddie Mac

Measures of home prices continued to show signs of moderation, in line with our expectations. The average yield on 30-year fixed mortgage rates has fallen 40 basis points since the beginning of 2014, hovering near its nine-month low of 4.15 percent in the week ending July 10 according to Freddie Mac. From a year ago, the yield was down 36 basis points, marking the third consecutive week of year-over-year drops. Our outlook for mortgage rates has not changed over the past month: We expect mortgage rates to continue to rise gradually, reaching approximately 4.5 percent a year from now. However, market expectations regarding Fed actions on monetary policy could cause rates to rise faster than we expect. Alternatively, if markets perceive the rebound in growth to be modest we may not see much movement in rates. Our forecast of housing and mortgage activity also is little changed from the June 2014 forecast. We continue to expect total home sales to decline about 2.0 percent in 2014. For all of 2014, total mortgage originations should decline approximately 41.0 percent to $1.13 trillion, with the refinance share of 38.0 percent. We expect total single-family (1- to 4-family properties) mortgage debt outstanding will post a slight rise this year before strengthening further in 2015.

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