Economy Poised for a Stronger Second Half

We expect growth to pick up in the second half—the same view we have held since the start of this year. Recent consumer fundamentals are supporting an improving picture of economic activity. The latest jobs report showed steady job creation year to date, and measures of consumer confidence are at or near their recovery highs, reinforcing the theme of a resilient labor market and consumers in the face of fiscal tightening. That said, disappointing growth during the first quarter was followed by anticipated weakening economic activity in the second quarter.

The economy will face challenges from rising long-term interest rates, induced by expectations that the Federal Reserve will likely reduce its monetary accommodation in coming months. Equities have fallen from their highs and credit spreads have widened. However, home prices continued to post robust gains, boosting household wealth, and despite a surge in mortgage rates, leading indicators of home sales have held up well and consumer expectations regarding the housing market continue to improve. If the backup in rates accompanies an improving economic backdrop, which we believe to be the case, we expect housing will continue to be a driver of growth. Combined with improving consumer fundamentals amid receding fiscal drags, the ongoing housing recovery should help boost headline growth in the second half of the year, with real (inflation adjusted) gross domestic product (GDP) averaging about 2.5 percent.

For all of 2013, we project growth to come in at 2.0 percent, further underscoring an ongoing lackluster recovery. The outlook for 2014 is brighter, as an expected gain in momentum later this year should help carry growth to an above par pace of 2.6 percent, which would be the strongest since 2005.

Monetary Policy: Letting Up On the Gas Pedal

The Fed officials' upgraded economic outlook, released at the June Federal Open Market Committee (FOMC) meeting, reflects their diminished concerns about downside risks to growth and the labor market. Long-term rates jumped after Fed Chairman Ben Bernanke's press conference, where he noted that if the economy continues to improve as expected, the Fed could start reducing the pace of asset purchases—the so-called tapering—before the end of this year and cease the purchase program by mid-2014, when the unemployment rate is expected to be around 7.0 percent. In an effort to distinguish between reducing the pace of asset purchases and raising short-term interest rates, Bernanke compared tapering to "letting up a bit on the gas pedal as the car picks up speed, not to begin to apply the brakes."

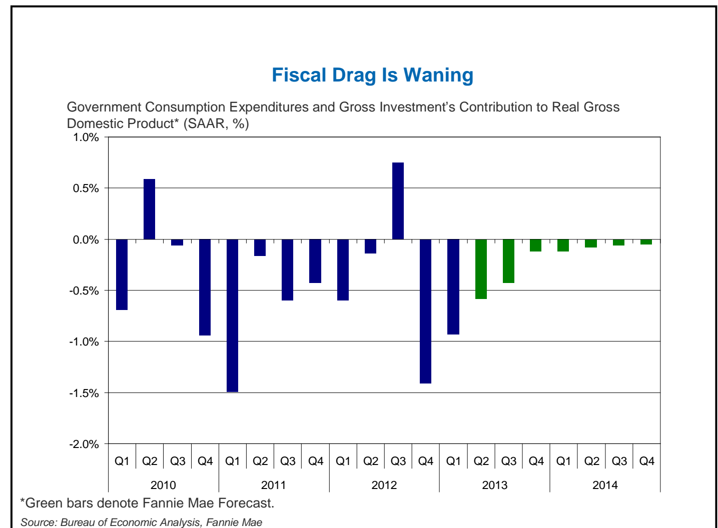
In light of recent Fed communications and the upbeat June jobs report (more below), we have changed our view of the Fed's timing on changing its securities purchase policy. We now expect the Fed to start scaling back its asset purchases later this year rather than the beginning of next year, with the announcement of terms coming as early as at the September FOMC meeting.

Despite Fed officials' attempt to separate slowing purchases from raising rates, market expectations—reflected in the fed funds futures market—have moved forward the first fed funds rate hike to around the end of 2014. Our call has not changed, however, as we still expect the Fed to keep the target rate on hold until the second half of 2015, consistent with the FOMC's rate guidance, which calls for no rate hikes at least as long as the unemployment rate remains above 6.5 percent. Bernanke reiterated that the 6.5 percent rate is a threshold and not a trigger, and this threshold could eventually be lowered, as the committee will consider other factors including inflation and the state of the labor market (i.e., whether the decline in the unemployment rate is a result of improving market conditions or a drop in the labor force participation rate).

Fiscal Policy: Letting Up On the Brake Pedal

Fiscal tightening at the federal, state, and local government levels has combined to restrain growth since 2011. The sector continued to subtract nearly 1.0 percentage point from GDP in the first quarter of this year. While government spending is expected to remain a drag to growth through next year, we project that the impact may have peaked in the first quarter and should gradually wane going forward.

The risks associated with fiscal policy also have receded in the near term. The Treasury has been employing “extraordinary measures” to keep the U.S. from default scenarios since May 19 when the debt ceiling was reinstated. In response to lower-than-expected deficit projections from the Congressional Budget Office and stronger revenues, the date that the Treasury is expected to breach the debt ceiling remains a moving target that keeps drifting farther back to between October and December. The near-term fiscal policy risk will come at the end of September—a deadline for appropriations bills for fiscal 2014. While a government shutdown cannot be ruled out, we deem the odds to be small.



*Green bars denote Fannie Mae Forecast.

Source: Bureau of Economic Analysis, Fannie Mae

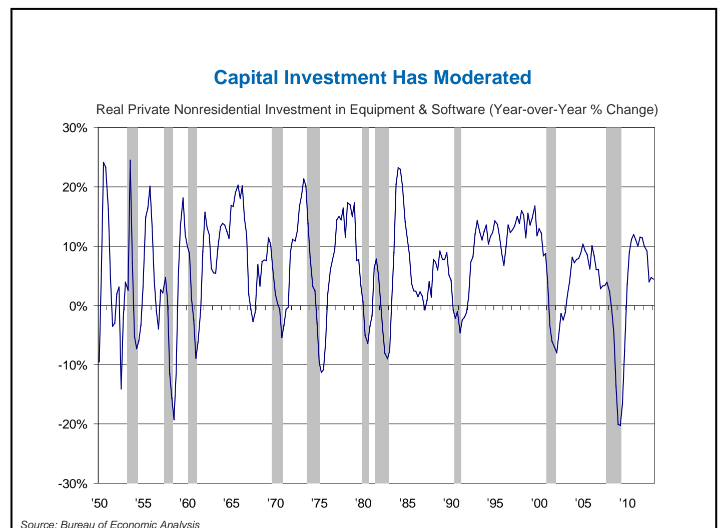
Overall Economy: Lackluster Growth Moves to Moderate?

The third estimate of GDP revised first quarter economic growth lower to 1.8 percent annualized from 2.4 percent largely because of a 0.8 percentage point downgrade in consumer spending growth. Incoming data suggest a further slowdown in consumer spending and headline growth in the second quarter. While real consumer spending increased 0.2 percent in May, the slight gain in April was downgraded to a slight decline. One upside was the jump in June auto sales to the strongest pace since the recession began in December 2007. Overall, we expect consumer spending growth to moderate by about a percentage point to 1.6 percent in the second quarter.

Other data were in line with a loss in momentum in the second quarter. The trade deficit widened substantially in May as imports jumped, and May industrial production was flat following a sharp drop in the prior month. Surveys of purchasing managers showed weak manufacturing and service activity in June. The Institute for Supply Management (ISM) nonmanufacturing survey indicated that the expansion in the service industry was the slowest since February 2010. While the ISM manufacturing survey showed that manufacturing activity improved modestly, the industry was barely in expansion territory, confirming stalling manufacturing activity since March.

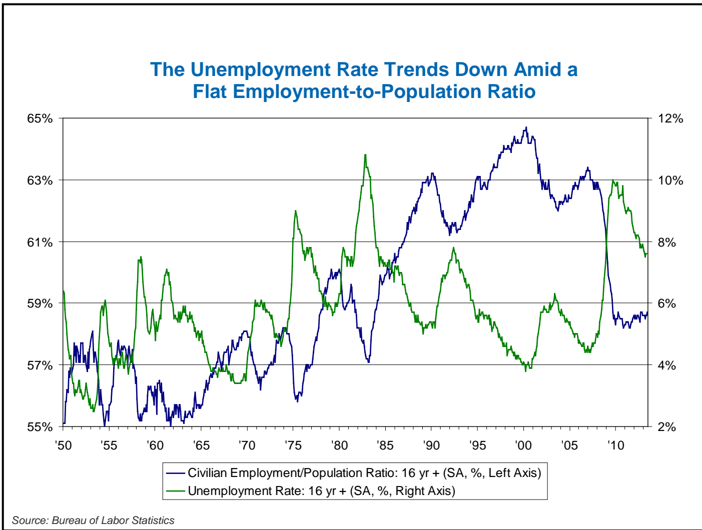
However, other economic indicators point to a pickup in growth in the current quarter. On the business front, the factory orders report showed that core capital goods orders—a forward-looking indicator of business capital investment—rose in May for third consecutive month—suggesting a rebound in business investment from a lackluster first half.

On the consumer front, the outlook is moderately upbeat, as main measures of consumer confidence have remained near multi-year highs in June. Most importantly, the June jobs report showed that the hiring picture improved materially, with nonfarm payrolls rising 195,000 in June, and gains in the prior two months were revised higher by 70,000. The larger-than-expected gain in June and the upward revisions resulted in a solid average monthly gain in the second quarter of 196,000, similar to the average over the past six months as well as that over the last nine months. The June employment report suggests that the labor market, especially private hiring, has weathered the storm from the fiscal drag better than previously believed.



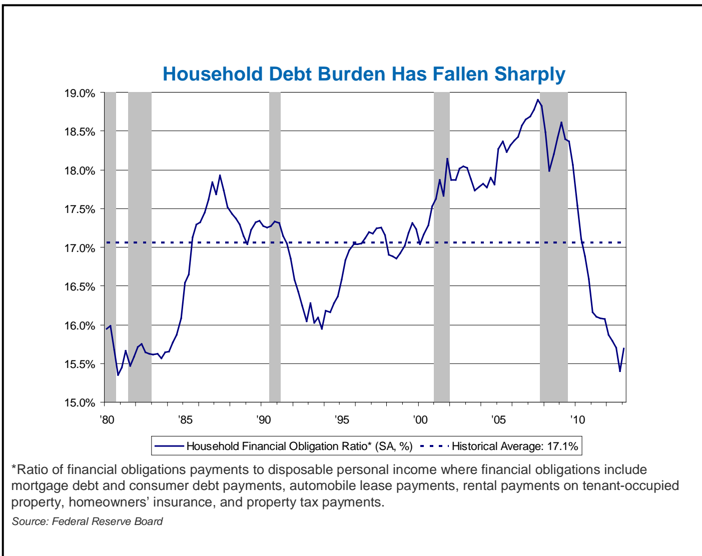
Source: Bureau of Economic Analysis

However, an assessment of the labor market four years into the current economic expansion reveals a lackluster recovery. During the 2007-2009 recession, payroll employment posted the sharpest contraction among the recessions since the 1960s, with nearly 9 million jobs lost over the two-year period. The current four-year labor market recovery bests only the recovery from the mild 2001 recession, also characterized by slow employment growth.



After rising in May for the first time in four months, the unemployment rate was flat in June at 7.6 percent, just 0.3 percentage points below the rate at the start of the year and 2.4 percentage points below the peak in October 2009. Some of the decline in the unemployment rate from the peak reflected the drop in the labor force participation rate rather than genuine improvement in the labor market. Four years into the current expansion, the trend in the unemployment rate is well above those in previous expansions.

Although the unemployment rate was unchanged in May, the labor force participation rate ticked up for a second consecutive month—a welcome development. In addition, average hourly earnings jumped during the month, posting the biggest year-over-year increase since mid-2011, which should help provide support to consumers in the near term.



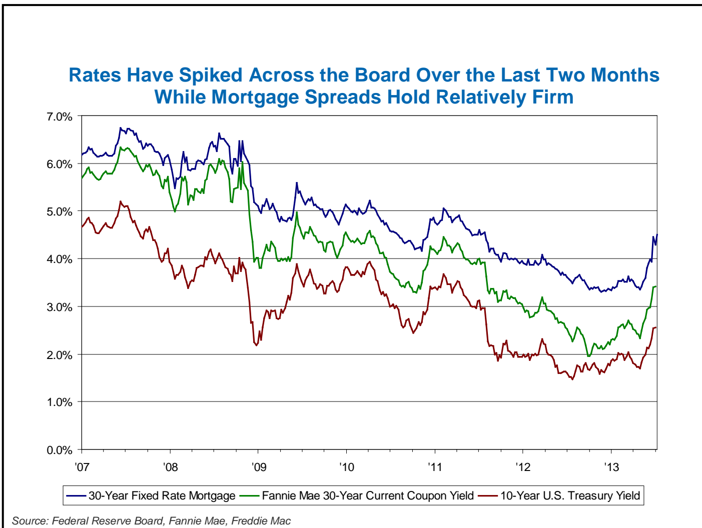
Consumer Spending Should Rise Moderately

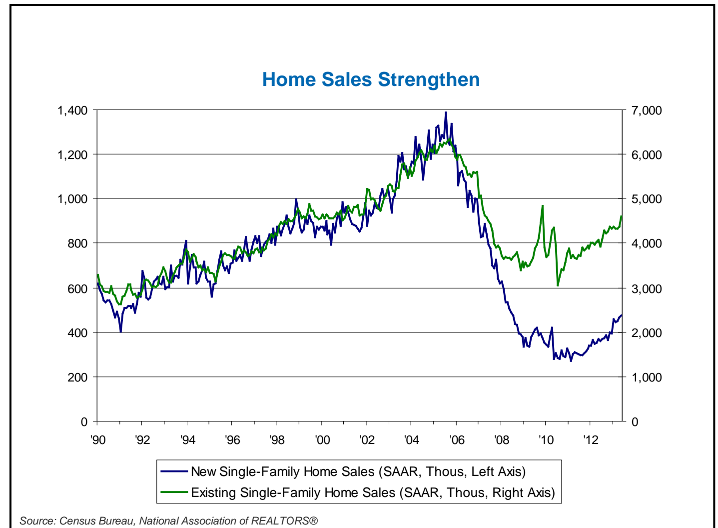
The improving job and wage picture as well as the rebound in household net worth have improved the outlook for consumer spending. Some think the sustained period of consumer deleveraging may finally be ending. While May consumer credit (excluding mortgage debt) showed that non-revolving debt (including auto and student loans) rose to new highs—continuing the trend witnessed during the past year—revolving debt (largely credit cards) posted the biggest monthly gain since May 2012. This marks the first time that the rise in revolving credit has outpaced growth in non-revolving credit in a year. The gain in credit card usage could be because consumers were more comfortable in increasing their debt usage amid improving job prospects and modest easing in lending standards. Alternatively, it may be because consumers attempted to offset the decline in after-tax income stemming from the ongoing fiscal tightening. Thus, it bears watching in coming months to see if higher revolving debt usage will continue.

One clear positive factor for consumers is a sharp decline in the household debt burden. One such measure is the financial obligations ratio—a ratio of financial obligations payments (including mortgage debt and consumer debt payments, automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance and property tax payments) to disposable personal income. The financial obligation ratio peaked at nearly 19 percent just before the economy entered recession in 2007 but trended down to its long-term average of about 17 percent, which represents a normal household debt burden, in 2010. The ratio fell further, approaching a record low of 15.4 percent at the end of 2012. The declines in interest rates and the reduction in debt usage—voluntarily or involuntarily (e.g., from charge-offs)—as well as rising income have contributed to the downtrend. The ratio rose in the first quarter of 2013 for the first time since early 2009, driven by the decline in disposable income during the quarter. We expect the ratio to gradually climb toward the level associated with normal debt burden again in coming years as long-term interest rates trend up and as consumers are increasingly comfortable with incurring more debt to finance their spending.

Housing Recovery: Rising Rates Amid Stronger Economic Backdrop Is a Modest Threat

Mortgage rates have risen significantly since early May, largely because of the market's expectation that the Fed will slow or stop purchases of securities, which appears likely to be realized in coming months. The 30-year fixed mortgage rate increased more than 110 basis points from 3.35 percent during the first week of May through the end of June before easing somewhat in early July, according to the Freddie Mac Primary Mortgage Market Survey.

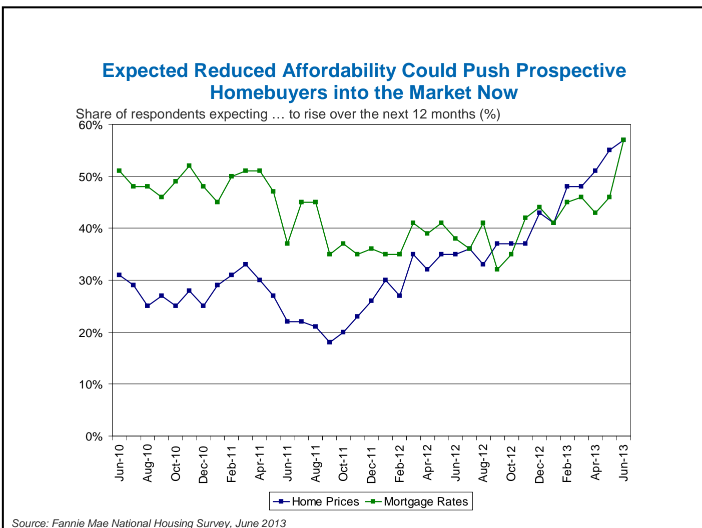




While mortgage rates are still low by historical standards, the recent spike was significant during a short period of time and thus could potentially hurt housing activity. However, incoming data signal continued improvement in the housing market. Sales of existing homes jumped in May to the highest level in six years, excluding a spike witnessed in November 2009 prior to the expected expiration of the first-time homebuyer tax credit (which was later extended and expanded to include all homebuyers). New home sales rose in May for the third consecutive month, sending sales to the highest level since July 2008.

While purchase mortgage applications have declined by about 9.0 percent since early May, pending home sales—a leading indicator of existing home sales—jumped in May to the highest level in more than six years, suggesting that existing home sales likely came in strong in the second quarter. Since cash sales have accounted for about one-third of existing home sales over the past year, according to the National Association of REALTORS®, sales may be less sensitive to the fluctuation in mortgage rates than in the past.

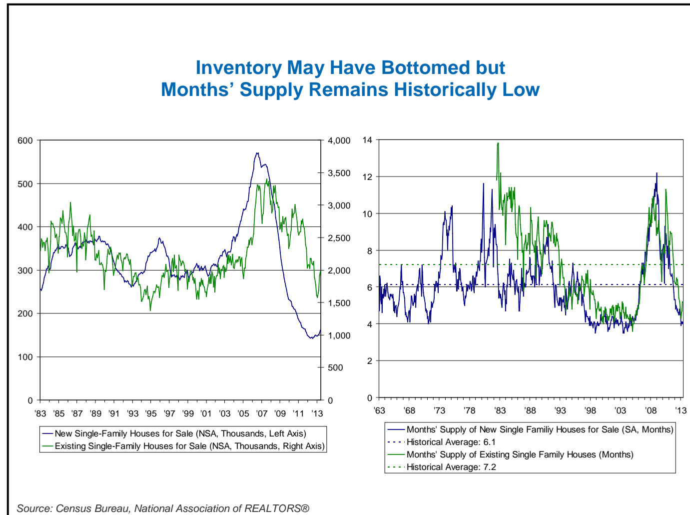
Some prospective homebuyers will not be able to qualify for their desirable mortgage product and size because of the surge in mortgage rates. However, others might decide to pull the trigger to buy if they believe mortgage rates as well as home prices are going to rise further, which will essentially pull sales forward. The sharp rise in pending home sales, if followed by a pullback in the following months, will confirm this view. The June 2013 Fannie Mae National Housing Survey showed that the share of consumers expecting mortgage rates to rise jumped while the share expecting home prices to rise over the next year continued to increase. Such expectations could drive an urgency to buy.



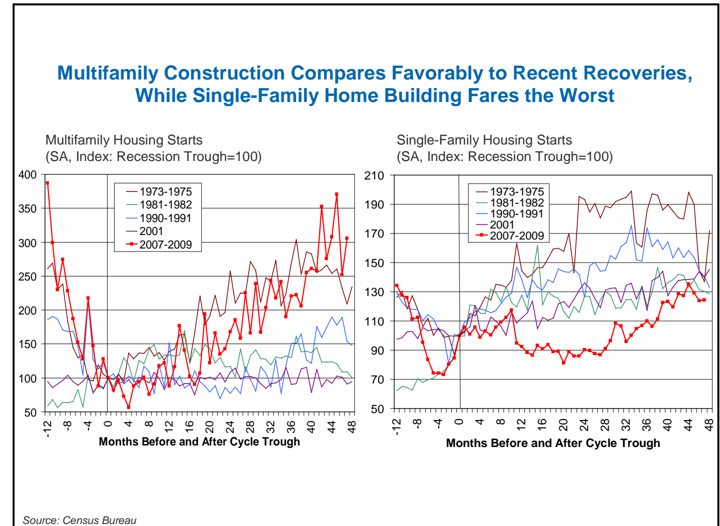
While the inventory of homes available for sale appears to have bottomed, leading to the view that home price gains will likely moderate from the double-digit year-over-year increases currently witnessed in many measures of home prices, the months' supply measures have remained below their long-term averages for both new and existing home sales. Thus, a rise in inventories is more desirable than harmful, as it will promote more sales transactions in the second half of the year compared with the first half, where limited inventories and strong investor interests led to multiple offers in many areas.

Homebuilding activity continues to trend up. Housing starts rose in May on the strength of multifamily, and single-family starts edged up slightly following two consecutive large drops. Multifamily has been a bright spot from the start of the current recovery, reflecting the unprecedented decline

in the homeownership rate amid massive job losses, rising foreclosures, and tight lending standards during the recession. Consequently, multifamily building activity has performed more favorably compared with prior recoveries. (For more information on multifamily market conditions, read the July 2013 Multifamily Market Commentary). By contrast, the recovery in single-family building activity has been much more modest, and compared with previous recoveries, the current expansion has performed the worst.



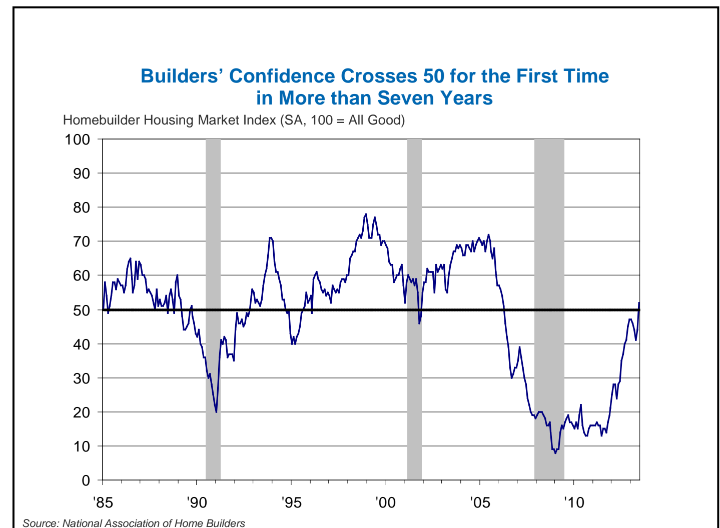
Source: Census Bureau, National Association of REALTORS®



Source: Census Bureau

Single-family permits—a leading indicator of construction activity—increased in May for the eighth time in the last nine months, consistent with our expectation of a rebound in single-family starts in the second half of this year. The improving trend in homebuilders' confidence amid rising mortgage rates supports this view. The NAHB/Wells Fargo Housing Market index rose 8 points to 52—the first reading above 50 since April 2006 and the largest monthly increase since 2002. (The index over 50 indicates that more builders see a better market than those judging it as poor.)

We expect mortgage rates to continue to rise gradually, averaging 4.7 percent in the fourth quarter of this year—about 40 basis points higher than in our June forecast. Our forecast of home sales is little changed. We continue to expect total home sales to rise about 8.0 percent in 2013, with a stronger sales pace in the second quarter but weaker in the second half than in the prior forecast. However, we revised higher our forecast of home prices, given the rapid appreciation year to date, and thus we project a modest increase in purchase mortgage originations compared with the prior forecast. While the surge in mortgage rates has not significantly hurt purchase mortgage applications, they have led to a marked decline in refinancing applications. As a result, we revised lower our projected refinance originations for a second consecutive month. For all of 2013, we expect total mortgage originations to decline to $1.65 trillion from an estimated $2.03 trillion in 2012, with the refinance share dropping from an estimated 73.0 percent in 2012 to 62.0 percent in 2013. Total single-family mortgage debt outstanding should post a slight increase in 2013 following five consecutive annual declines.



Source: National Association of Home Builders

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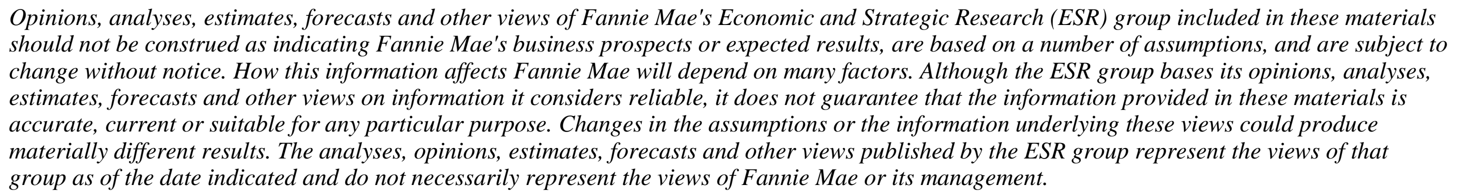

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