# Struggling to Regain Momentum

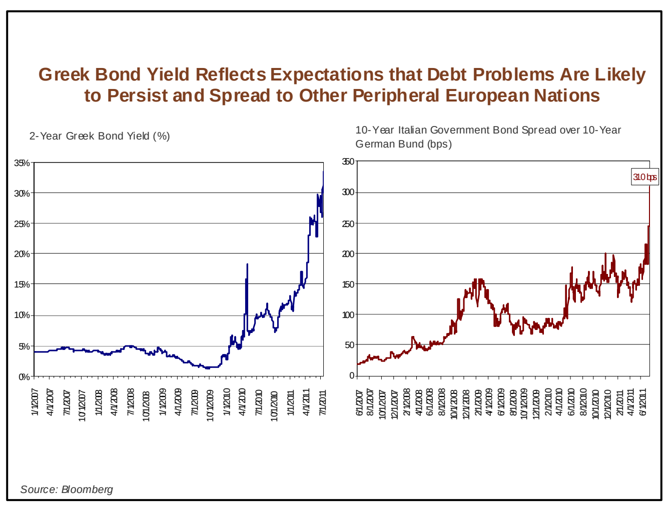
The economy is struggling to regain the momentum it has clearly lost since the beginning of the year. So far, economic data for the second quarter have been discouraging, and economic growth likely came in at about the same anemic pace witnessed in the first quarter of 2011 – 1.9 percent at an annualized rate. Two main factors combined to restrain growth: higher gasoline prices and supply-chain disruptions due to the Japanese earthquake, tsunami, and subsequent nuclear meltdown.

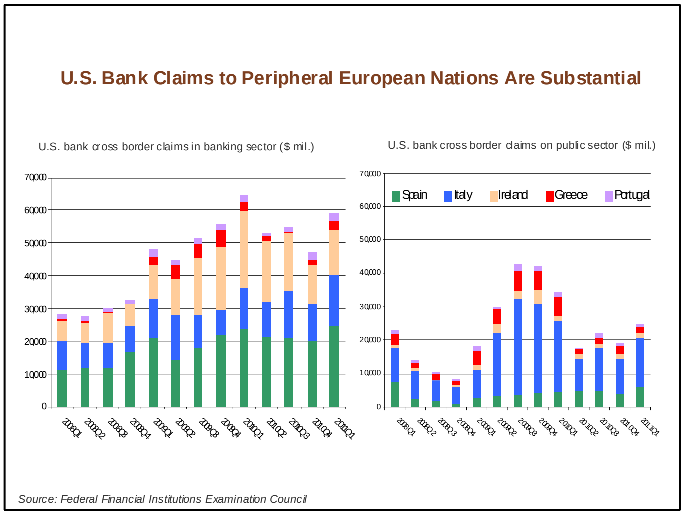
There is a case to be made for a modest acceleration in economic activity in the second half of the year, as these main drags to growth are fading. First, after rising from $84 a barrel in mid-February to a peak of about $114 a barrel in late April, West Texas Intermediate crude oil prices have partially reversed, dipping to a four-month low of just over $90 a barrel in late June, as the International Energy Agency released some of its oil reserves for only the third time in history. Crude prices have moved up since then, hovering around $95 a barrel at the time of this writing. Second, motor vehicle production is on track for a rebound, making up for the loss in the second quarter. However, more disappointing news from the June employment report, showing two consecutive scant monthly payroll gains, casts doubt on the prospect of a significant improvement in the near-term economic outlook. Given incoming positive news from the manufacturing sector, we continue to look for a modest rebound in economic growth to about 3 percent in the current quarter before slowing modestly in the final quarter. For all of 2011, growth is projected to slow to 2.4 percent, from 2.8 percent in 2010.

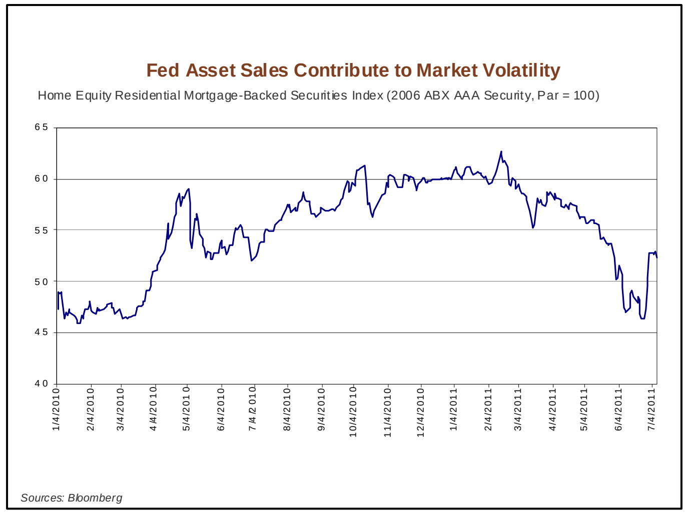
Clearly, the renewed slowdown in hiring underscores the uncertainty surrounding the economic outlook. The lack of sustained, robust job growth continues to push out into the future the time for the housing market to heal, which is crucial to a meaningful economic expansion.

There are risk factors on the horizon, notably the ongoing European debt crisis. While the markets appeared to breathe a sigh of relief as the Greek parliament passed the latest austerity measures, the positive tone was very brief, as Greece will continue to face an unsustainable debt burden and long-term structural issues. The two-year yield on Greek debt fell by 150 basis points from a record high of nearly 30 percent at the start of July, but has recently soared to more than 31 percent at the time of this writing, indicating the markets do not believe that Greece has fundamentally addressed its sovereign debt problems. Even more troubling, risk spreads for other countries in the region are moving to new euro-era highs, with the market currently focusing on Italy. The spread of 10-year Italian debt over that of Germany has soared by a full percentage point to about 3 percent at the time that this commentary was written. Italy's economy is more than twice the size of Greece, Ireland, and Portugal combined, and any bailout there would tax the resources of both the European institutions and the International Monetary Fund.

The fear of contagion in the peripheral European countries, which could result in a global financial crisis, remains. Thus, periods of falling Treasury rates in a flight to safety, rising volatility, and widening spreads across risky asset classes will continue to be part of the backdrop for the economy and markets. The U.S. banking system has substantial exposure to peripheral European sovereign debt and banks. Similar to the Lehman crisis, the problem with risk in one corner of the world, whether it be subprime mortgages or unsustainable debt levels in Greece, is that the interconnectedness of financial markets acts as an efficient transmission mechanism to all parts of the globe.





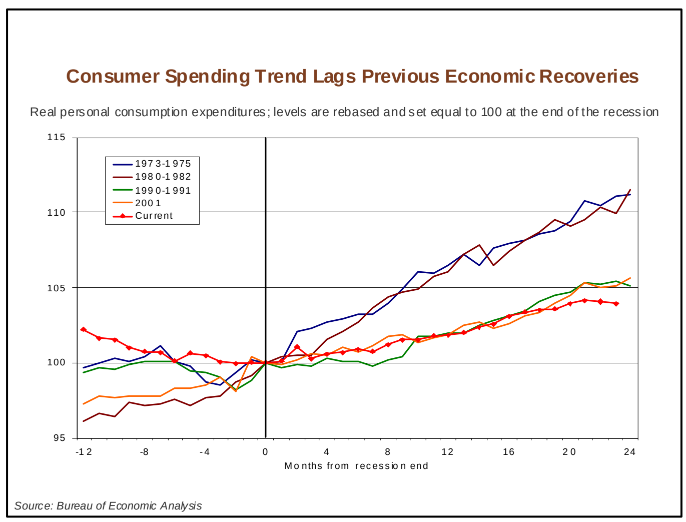




In addition, as the August 2 deadline for the U.S. debt ceiling is approaching, the failure to pass an increase in the debt ceiling poses a near-term risk for a disruption in the financial markets. The intermediate impact, i.e., the extent of the fiscal drag, will depend on how the deficit reduction will be achieved and over what timeframe. The positive long-term impact of a sustainable deficit trend (e.g., the impact on long-term interest rates) will depend on the credibility of the path to meaningful fiscal austerity.

Finally, the mortgage market itself is a source of financial risk. Recently, the Federal Reserve began a program to divest itself of the low-quality mortgage-related assets associated with its takeover of AIG.[1] The auctions did not go well, and severely disrupted the private-label market, leading to a process of price discovery that caused market participants to mark down asset values on banks' balance sheets. The program has been suspended, but the experience reveals that the banking sector is very vulnerable to mortgage-related risk.

## Economy: A quick snap-back is not expected

Evidence that economic activity is likely to rebound modestly in the current quarter could be seen in recent data out of the factory sector. Auto production has rebounded following the supply-chain disruptions. This was likely the reason behind the rebound in the Institute for Supply Management (ISM) manufacturing index in June. The May durable goods report, including upward revisions to April, was stronger than expected and shows an encouraging pickup in orders during the past few months. Core capital goods orders, a leading indicator of business investment in equipment and software, posted a healthy gain in May and were up substantially during the three months through May.



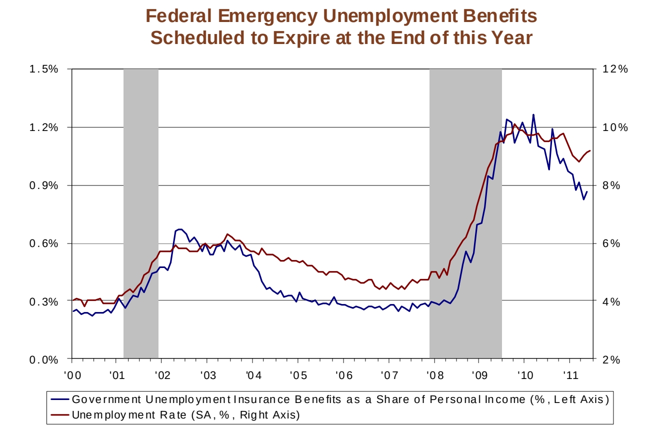

While the supply-chain disruptions and the rise in oil prices were expected to be a drag to economic activity in the second quarter, the extent of the weakness in consumer spending was a surprise. During the first year of the current economic recovery, the real (inflation-adjusted) consumer spending growth trend was comparable to those seen during the recoveries following the 1990-91 and 2001 recessions, albeit substantially lagging those following the severe recessions

[1] This program is known as the Maiden Lane sale - a series of auctions conducted beginning in April to sell the $31 billion portfolio. The Fed rejected an offer from AIG to purchase the assets for $15.7 billion in March. The portfolio consisted of 800 securities. However, the Fed sold only 306 of them before the program was suspended last month after an unsuccessful auction on June 9 in which only 36 of the 73 securities offered to the market were sold.

in the mid 1970s and early 1980s. However, since the beginning of this year, the real consumer spending trend has trailed behind all of the last four economic recoveries.

Real consumer spending fell 0.1 percent in May for the second consecutive month and is on track to increase at an weak one percent annualized rate for the second quarter. Sluggish consumer spending is due to poor consumer fundamentals, most notably, real disposable income, which has been essentially flat-lining since the beginning of the year. The significant slack in the labor market has hurt wage trends and the surge in oil prices also has depressed real income. In addition, there is a risk to incomes stemming from the scheduled expiration of emergency Federal unemployment benefits at the end of the year. While the unemployment benefits share of total income is off its peak, it remains very elevated by historical standards. At present, about 3.25 million people receive such benefits.

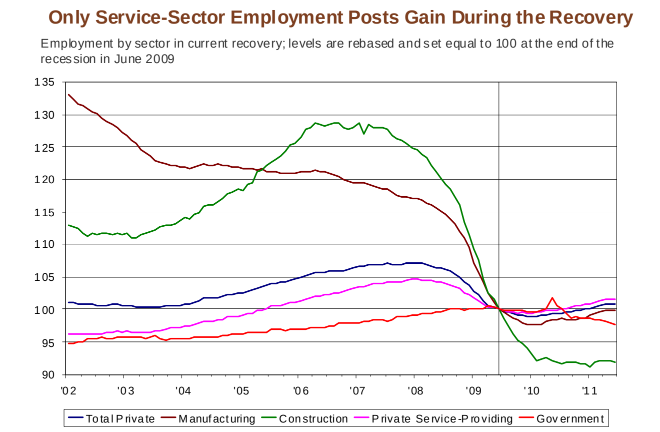
The weakness in consumer spending through May was driven by substantial declines in spending on vehicles and parts, which partially reflected the supply-chain disruptions of auto production that limited inventories and pushed prices up. Auto sales fell further in June to a one-year low. For the second quarter, sales dropped at an annual rate of about 25 percent, more than offsetting the jump in the first quarter. While auto production is poised to recover strongly, the strength of the rebound in consumer demand is uncertain, especially when consumer confidence has remained at depressed levels. Consumers have plenty of reasons to be cautious: stock markets slipped from the highs seen in May and house prices deteriorated during the first few months of the year. These two negative factors, which combine to erode household wealth, have outweighed the impact of easing gasoline prices, which fell about 50 cents per gallon between their peak in early May and mid-June.



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics

The biggest disappointment of all was the June employment report. Nonfarm payrolls rose an anemic 18,000, the weakest gain since last September when payrolls declined. The private sector added 57,000 jobs while governments shed 39,000 jobs. Job gains in the prior two months were revised lower by 44,000. For the second quarter, nonfarm payroll gains averaged only 87,000 per month, slowing appreciably from the average monthly gain of 166,000 in the first quarter.

Other main aspects of the labor market also were a bust. Average hourly earnings were flat, and the average workweek fell. The unemployment rate, calculated from a separate survey of households, rose to 9.2 percent from 9.1 percent in May, as household employment plunged by 445,000, the biggest monthly decline since December 2009, which more than offset the sizable drop in the number of people looking for jobs. The increase in the unemployment rate in June marks the third consecutive monthly gain, totaling 0.4 percentage points, sending the rate to the highest level this year. The broad measure that includes discouraged job seekers and forced part-timers surged to 16.2 percent from 15.8 percent.

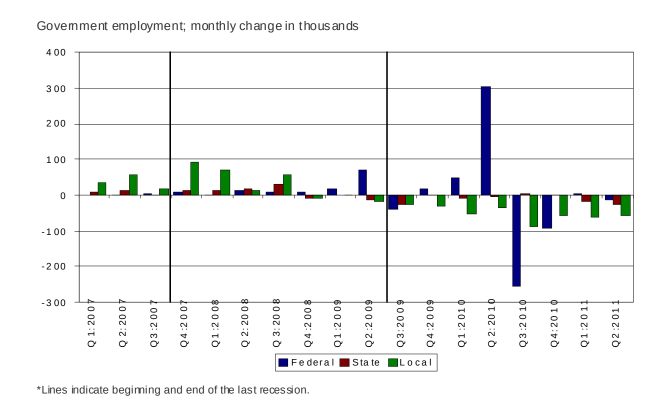


Source: Bureau of Labor Statistics

During the two years of economic recovery that started in June 2009, private employment has increased at a moderate pace, gaining by one percent with all of the gain observed coming from the service sector. Within the goods-producing sector, manufacturing employment has reversed its losses during the past two years, while construction employment continues to experience losses, remaining more than 8.0 percent below the level in place at the end of the recession. Government hiring (federal, state, and local) has declined 2.2 percent from the level recorded in June 2009. The spike in government employment in 2010 reflected the temporary jump in Decennial Census hiring.

Government employment generally accounts for approximately 16 percent of total employment in the U.S. In June, government payrolls fell 3.0 percent from a year ago after a 3.8 percent decline in May, which was the largest year-over-year drop during the post-war period. The decline in government employment persists. During the first six months of the year, local government shed 116,000 jobs, compared with a cut of 49,000 jobs for state government and a loss of 23,000 jobs for the federal government. Layoffs at the local government level have dominated the decline in the government sector as local government payrolls have plunged 468,000 since the peak in September 2008. The fiscal challenges faced by local governments will continue to be a drag to overall employment for the remainder of this year.

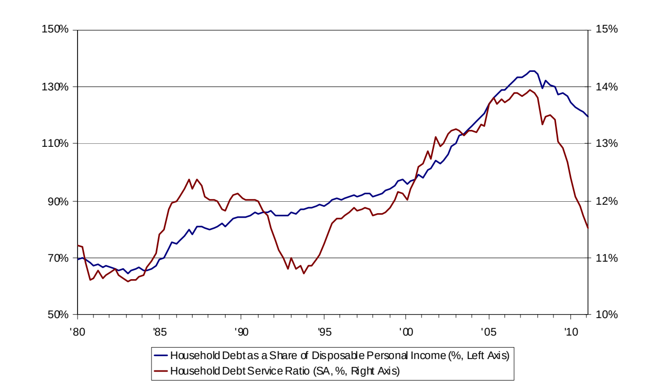
**Local Governments Drive Public Sector Job Losses**



*Source: Bureau of Labor Statistics*

One positive for consumers is a continued healing of the household balance sheet. Household debt outstanding as a percentage of disposable income surged in the last decade, especially during the housing boom, which boosted mortgage debt outstanding growth to an unsustainable pace through new mortgages, cash-out refinancing, and home equity loans. The ratio reached a record high of more than 135 percent in the third quarter of 2007 and has declined substantially to nearly 120 percent in the first quarter of this year. While this marks the lowest ratio since mid-2004, it is still high relative to recent history. For example, the ratio averaged just below 90 percent in the 1990s. Not all of the declines since 2007 were an intentional paring down of debt usage on the part of households. Some of the decline reflected an involuntary deleveraging, resulting from short sales, foreclosures, consumer loan charge-offs, and tight lending standards.

**The Household Debt Burden Has Declined**



*Source: Federal Reserve Board*

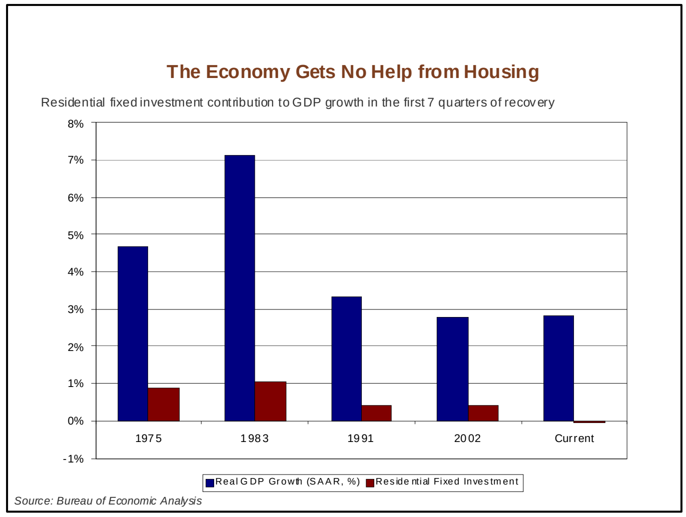
Another measure of household financial stress – the household debt service ratio – measures payments as a share of after-tax income households are required to pay to be current on their debt (both mortgage debt and consumer debt). Thus, this measure takes into account the decline in interest rates during the past several years to historical lows. The debt service ratio rose throughout the 1990s and advanced further afterward, reaching a record high of nearly 14 percent in the third quarter of 2007. Since then, the debt service ratio has plummeted, reaching a 16-year low of 11.5 percent in the first quarter of 2011. Unlike the debt-to-income ratio that has trended down but remained elevated, the debt service ratio is now sitting slightly below its long-term average.

Continued declining debt burden will help households feel comfortable with their personal finances in the face of economic uncertainty, but it will take some time before households feel secure enough to increase their debt usage again. Also, a sharp rise from historically low interest rates also could reverse some of the recent decline in debt burden. Additionally, credit standards are unlikely to become as loose as they did in the early to mid-2000s. Thus, the economic expansion will likely remain moderate through next year.

## Housing: Continues on a slow track, but some positive signs are emerging

Besides restrained credit expansion, the tepid housing recovery is another reason for the modest pace of economic growth seen in the current recovery. During the two years of the current economic expansion, residential investment has yet to make a contribution to economic growth. This is quite an unusual phenomenon: at this point of an economic expansion, housing has generally added significantly to growth. Housing's contribution to gross domestic product (GDP) growth was about one percentage point for the expansions that followed severe recessions.

The current state of the housing market remains downbeat. Sales of existing homes in May fell to their lowest level since last November, while new home sales dropped during the month after two consecutive monthly gains. Total housing starts rebounded modestly in May, only partially offsetting the large drop in the prior month, and builders' confidence eroded further in June.




There are some positives for the near-term outlook of the housing market. One positive for the existing home market is that pending home sales (contract signings) rose 8.2 percent in May, suggesting that sales of existing homes, which are recorded at closing, should rebound in coming months.

The share of distressed sales continues to inch lower, as sales enter the summer season. This is a reversal of conditions witnessed during the winter months, when distressed sales accounted for a greater share of sales, downwardly distorting home prices due to their large price discounts. With the declining share of distressed sales, the pressure on overall home prices is abating for the time being. This is evident in the home price index of non-distressed properties from CoreLogic, which posted its fourth consecutive monthly gain in May, and the year-over-year change approached positive territory. Improvement should continue in the seasonally stronger summer months. However, we do not think home prices have bottomed, as this seasonal improvement will likely fade again by the end of the year.

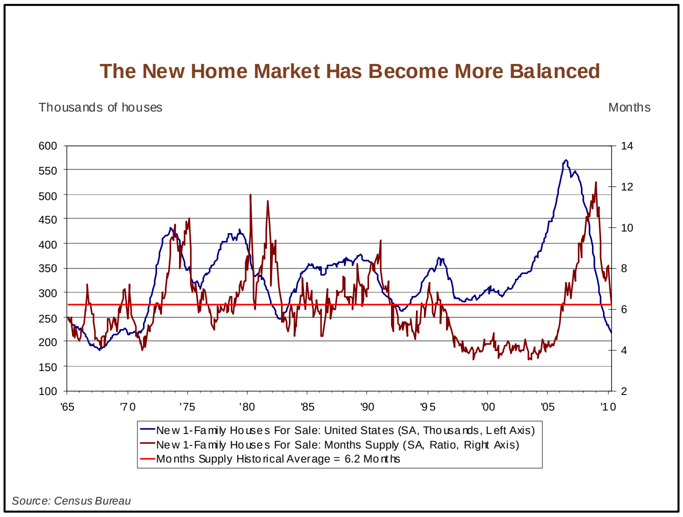
There also is a positive for the new home market as supply-demand conditions have become more balanced. The inventory of homes available for sale continued to fall in May, reaching a record low. The inventory-sales ratio, a measure of the supply-demand imbalance, fell to 6.2 months, matching its long-term average. However, outside of the new home market, there remains a sizable excess supply of housing in the form of vacant homes currently available for sale and for rent. In addition, the number of mortgages that are 90 days or more past due or in the foreclosure process, some of which represent the shadow supply of housing, have remained elevated. The foreclosure problems that erupted in the fall of 2010, which have resulted in temporary halted foreclosures in some states and new foreclosure laws or court proceedings in others, will prolong the time it will take for the excess supply and the shadow supply of housing to be absorbed, delaying the recovery of the housing market.

Despite some positive signs, we continue to expect only a gradual housing recovery, as the excess supply of housing is being absorbed slowly. Tight lending standards and the renewed slowdown in the pace of hiring will continue to weigh on home sales for the rest of the year, despite historically high affordability conditions.

In late June, concerns that the debt crisis in Greece could lead to a global financial crisis created a flight to safety in the U.S. Treasury market, bringing down the 10-year Treasury yield to 2.90 percent. However, after Greece passed its austerity package the yield temporarily jumped to 3.15 percent, but has retreated below 3.00 percent at the time of this writing as conditions in Europe remain volatile. The Fed concluded its Treasury purchase program at the end of June, and short-term interest rates are likely to stay low as the Fed should remain on hold at least through the first half of 2012.

We expect mortgage rates to move up just slightly during the course of the year amid modest economic growth, rising to about 4.8 percent by the end of the year.

We have downgraded our outlook modestly for housing activity through next year. The Fannie Mae housing survey for June showed a marked deterioration in consumers' expectations of home prices during the next year – their weakest outlook since monthly tracking began a year ago. This continues the stream of monthly consumer survey data that show consumers remain reluctant to take on a large debt in the midst of a shaky economy.




For 2011, we expect single-family starts to post a decline of about 7 percent, while new home sales are expected to be relatively flat. Existing home sales should rise by about 4 percent from 2010. The multifamily market continues to be the only bright spot in housing, supported by the ongoing decline in the homeownership rate. During the past year, growth in demand for apartments has outpaced growth in supply, bringing down rental vacancy rates and pushing rents up. (For more information on multifamily market conditions, read the *July 2011 Multifamily Market Commentary*). Multifamily permits have risen during the past several months, and we expect multifamily starts to rise by nearly 30 percent in 2011, although the levels will remain low by historical standards.

Home prices are expected to decline further this year. For all of 2011, total mortgage originations are projected to decline to $1.07 trillion from an estimated $1.51 trillion in 2010, with a refinance share of 54 percent. We expect total single-family mortgage debt outstanding to fall an additional 2.6 percent this year, moderating slightly from a drop of 3.0 percent in 2010.

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