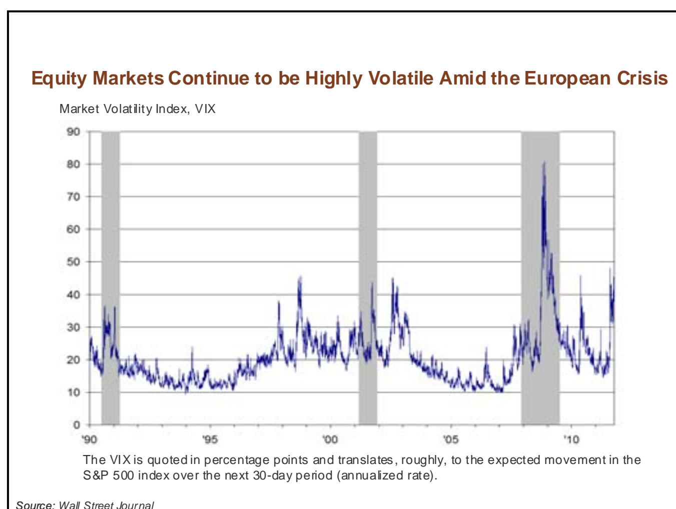
Economy at a Crossroads

Economic data released during the past month are consistent with our expectation of a modest pickup in economic growth in the third quarter to about 2.0 percent from 1.3 percent at an annualized rate in the second quarter. Auto sales posted a strong gain in September, and core durable goods shipments and orders rose in August, indicating solid capital expenditures. The Institute for Supply Management (ISM) manufacturing and nonmanufacturing surveys showed that both sectors remained in expansion territory. The employment picture also improved marginally in September.

Our forecast shows sluggish growth through next year, with real (inflation-adjusted) gross domestic product (GDP) rising only slightly more than 1 percent in 2012 – similar to the anemic rate expected for all of 2011. Uncertainty surrounding the degree of domestic fiscal austerity, including the scheduled expirations of the payroll tax cuts and the emergency unemployment benefit at the end of this year, as well as uncertainty about the magnitude of the impact of forthcoming regulations, remains a factor in determining how fast the economy will grow. The economy is highly vulnerable to a shock that could trigger a downturn. The most likely shock remains the contagion of the Greek sovereign debt crisis to other peripheral economies and the banking system across Europe. The evolving debt crisis in the Euro zone continues to result in significant volatility amid financial markets in the U.S. For example, the VIX Index, a measure of the volatility of the S&P 500 and a gauge of investor sentiment, hovered around 36 as of this writing – a level similar to that which prevailed during the summer of 2010, as the Greek sovereign debt crisis first began to unfold.



The index has trended down from its recent high of 45 on October 3, as the news that the European authorities were planning to recapitalize the banks in the Euro zone appears to have brought some relief. The current reading has remained substantially below its record high witnessed after the collapse of Lehman Brothers near the end of 2008.

Fear of contagion from the Greek sovereign crisis also remains firmly in place, reflected in the elevated costs of insuring Irish, Italian, Spanish, and Portuguese sovereign debt via credit default swaps (CDS), which have remained near their all-time highs. With the threat that banks have to write down the value of sovereign debt on their books, a complete recapitalization of banks and restructuring of sovereign debt of these countries will be necessary to convince financial markets that the debt crisis has been adequately addressed. This will be a long, drawn-out process, and as long as these issues remain unresolved, the U.S. economy will remain under pressure.

The European crisis threatens the global recovery through spillovers of tighter credit conditions as well as through a reduction in U.S. and other trading partners' exports to the region. Its impact on the U.S. financial markets is unclear due to the lack of clarity concerning the exposure of U.S. institutions to the region's debt, especially the indirect exposure via CDS written by U.S. banks to provide insurance against default to the holders of the troubled European peripheral securities. Banks do not have to provide detailed public information about the indirect credit exposures that they take on when they sell default insurance through the CDS market. In addition, a bank can hold two derivative contracts that effectively cancel each other out, although possibly with different counterparties of varying financial strength. Thus, it is unclear how any individual bank will be affected by a Greek default.

The economic health of Europe and the U.S. is a main concern for China, which is a major exporter to both. Given its status as the world's second largest economy, a significant slowdown in economic growth in China is clearly a source of risk for the global recovery. While a recession in the Euro zone is increasingly likely, the odds of a hard landing in China are quite small, given the ability of the Chinese government to stimulate its economy, compared with other countries that are likely to face political gridlock.

Economy: Near-Term Recession Fears May Ease but Elevated Risk Remains

Recent economic reports portray a picture of an economy that is growing tepidly, but not stalled. Real GDP in the second quarter was revised up three-tenths to 1.3 percent – a result of upward revisions in consumer spending, nonresidential investment in structures, residential investment, and net exports, all of which are positive for the near-term outlook. Corporate profits also were revised higher and have nearly doubled from their lows in the fourth quarter of 2008.

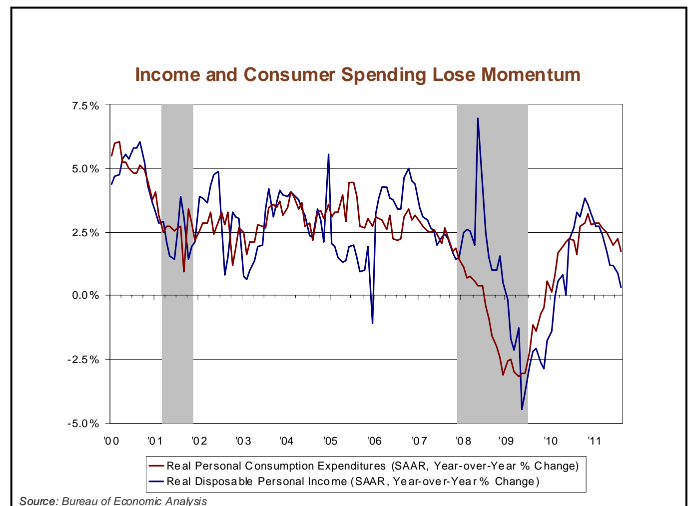
One of the factors expected to boost growth modestly in the third quarter is consumer spending. After a strong showing at the start of the third quarter, increasing by 0.4 percent in July, real consumer spending was flat in August, and from a year ago it grew by just 1.8 percent. The softness in consumer spending is hardly surprising given the recent weakening trend in personal income, which fell in August for the first time since October 2009. Income also was revised lower during the last several months. After adjusting for inflation and removing tax liabilities, real disposable income fell in August for a second consecutive month and barely stayed above last year's level, growing just 0.3 percent. This anemic growth is rare during economic recoveries and suggests a very challenging outlook for consumer spending ahead.

One bright spot for consumer spending in the third quarter is a jump in auto sales in September to 13.1 million annualized units from 12.1 million in August, putting the third quarter average above the second quarter. However, the recent strength is likely to represent a rebound from the pullback during the supply-chain disruptions earlier this year, rather than an improvement in underlying demand. Incoming data indicate that real consumer spending is tracking to rise by about 1.5 percent at an annualized rate in the third quarter, a modest pace, but an acceleration from the anemic 0.7 percent rate attained in the second quarter.

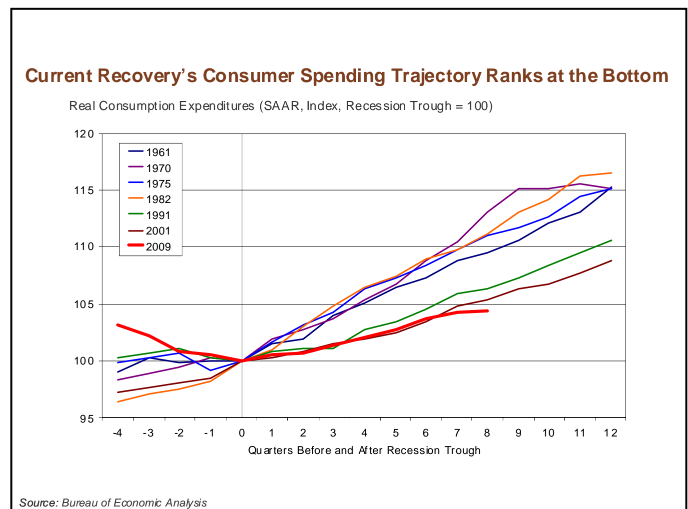
The performance of consumer spending during the two years of the current economic recovery ranks at the bottom of all recoveries since 1960.

This poor performance, coupled with the lackluster housing recovery, explains the tepid growth of the current recovery thus far. Softness in consumer spending is a result of many factors, including a weak labor market, a massive decline in household net worth suffered during the last recession as well as ongoing deleveraging of household debt, and rising energy prices from the supply shock earlier this year. Since consumer spending accounts for more than 70 percent of GDP, its path will largely determine the trajectory of the recovery going forward.

Developments in the labor market will be a key aspect in shaping the path of consumer spending during the next several quarters. The September employment report helped



Source: Bureau of Economic Analysis



Source: Bureau of Economic Analysis

ease concerns that the deteriorating labor market could cause the economy to slip quickly into recession. Nonfarm payrolls rose 103,000 in September, and previous figures were revised upwardly by 99,000. The return of 45,000 striking Verizon workers boosted the overall number, and thus the underlying trend continues to portray a labor market that is struggling to create jobs. Since April, when the economy visibly lost momentum from the renewed European sovereign debt crisis and the tragedy in Japan, the labor market has created an average of just 72,000 jobs per month.

Government employment fell 34,000 in September, largely from losses of postal service jobs and local government jobs. So far, local government employment has dropped by 535,000 from the peak in September 2008, and job losses in this sector are expected to continue.

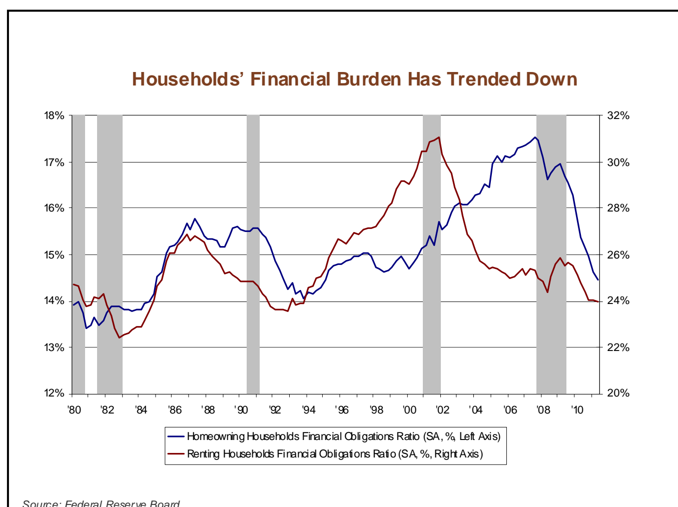
The unemployment rate, calculated from a separate survey of households, remained stuck at 9.1 percent for the third consecutive month in September, reflecting large gains in both the labor force and household employment. The gain in household employment, which was necessary to hold the unemployment rate steady as more workers entered the labor force, came entirely from the employment of part-time workers who want full-time jobs. As a result, the broadest measure of the unemployment rate that includes discouraged workers and part-timers for economic reasons rose to 16.5 percent, the highest level since late last year.

One better piece of news was on the earnings front: After declining in August, average hourly earnings for total private industries rose in September. The year-over-year gain remains subdued at 1.9 percent. Given our expectations for a continued weak labor market as well as higher payroll taxes in 2012, assuming that the payroll tax cut is allowed to expire as scheduled, consumer spending will remain under pressure in coming quarters.

In addition, American households suffered another huge decline in financial wealth in the third quarter as equity value fell sharply. The Dow Jones Industrial Average fell 12 percent, the biggest percentage drop since the first quarter of 2009.

The use of credit also will shape the strength of consumer spending. After increasing for eleven consecutive months, consumer credit outstanding (excluding mortgages) posted the biggest drop in more than a year in August, as both revolving credit (credit cards) and nonrevolving credit (auto and student loans) fell. The drop was a surprise, and it remains to be seen whether this was just a one-time event, perhaps because households were extremely cautious during the heat of the debt ceiling debate and a downgrade of the U.S. sovereign debt rating, or a change in behavior due to rising concerns about the outlook of the economy.

While households will continue to struggle with headwinds, one upside is a sharp drop in the debt service burden, thanks to a combination of declining interest rates and deleveraging, voluntary or otherwise. A broad measure of households' financial burden is the financial obligations ratio, which measures debt service on consumer and mortgage debt as well as other financial payments, including automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax, as a share of disposable income. The ratio for renters is significantly higher than that for homeowners, as renters tend to have lower incomes and correspondingly higher debt obligations as a share of their disposable incomes.

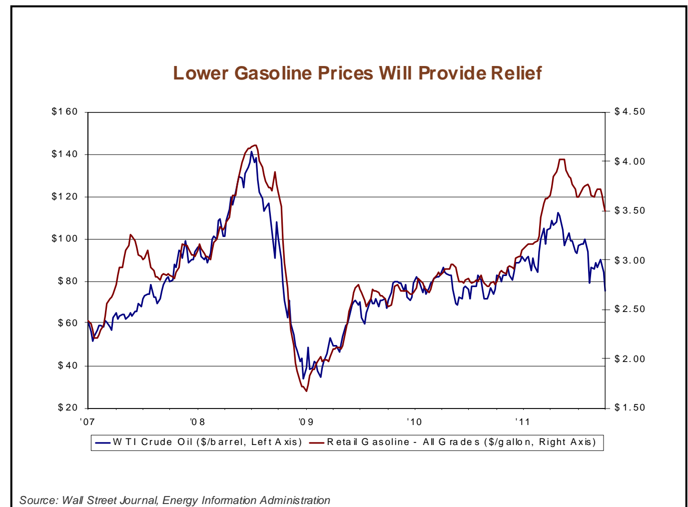


Source: Federal Reserve Board

After peaking at the end of 2001, the financial obligations ratio for renters fell sharply through 2004, as interest rates declined substantially, before leveling off. After the bump-up during the 2007-09 recession, the ratio has resumed its down-trend, reflecting ongoing declines in consumer credit outstanding. In the second quarter of this year, the financial obligations ratio for renters fell to its lowest reading since the end of 1993.

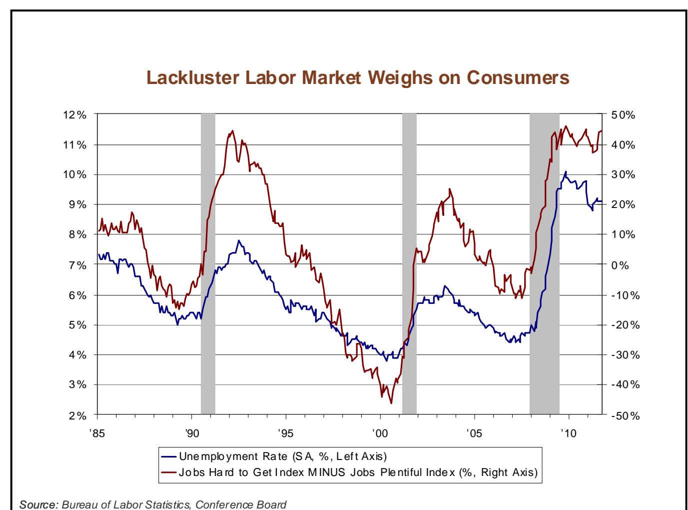
In contrast, the financial obligations ratio for homeowners peaked much later than that for renters, around late 2007, as households continued to take on more mortgage debt during the housing boom. Since the end of the recession, the ratio for homeowners has dropped sharply, much faster than the pace of decline in the renter financial obligations ratio, reaching the lowest reading since the end of 1994. The steep decline in financial obligations for owners reflected an ongoing deleveraging in mortgage debt outstanding through household voluntary deleveraging (e.g., homeowners refinancing from 30-year fixed-rate loans to shorter-term fixed-rate loans), loan modifications, and charge-offs.

Besides declining financial burdens, there is another factor that should help support consumers in the near term – the price of gasoline. Gasoline prices have fallen to an eight-month low, as the slowdown in global economic growth and the resulting decline in demand has brought down crude oil futures.



Source: Wall Street Journal, Energy Information Administration

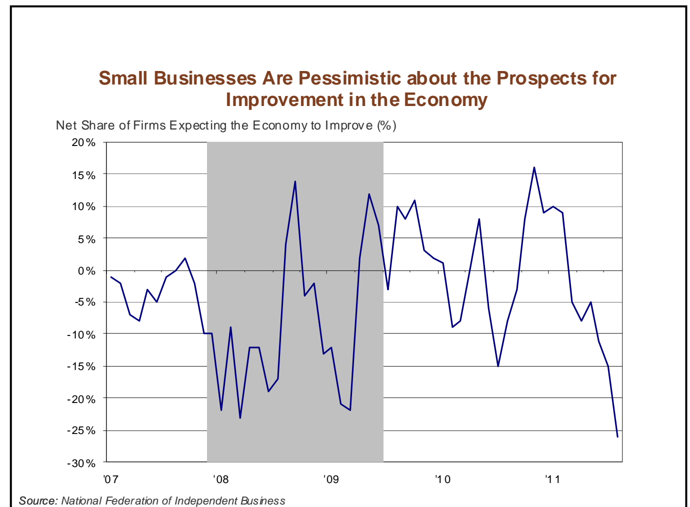
Measures of consumer confidence improved marginally in September from depressed levels in August. Unless the labor market improves substantially, confidence will remain subdued. The Conference Board survey of consumer confidence, which focuses on consumers' assessments of the labor market, stabilized in September after plunging 14 points during the prior month. While more consumers found jobs to be plentiful in September, more also found them to be hard to get. The share of consumers finding jobs hard to get, at 50 percent, is the highest reading since the early 1980s, exceeding its peak in the recent recession. Historically, the difference between the two shares has a strong positive correlation with the unemployment rate. For the current recovery, despite the decline in the unemployment rate from its recent peak in October 2010, consumers' assessments of the labor market has not shown appreciable improvement.



Source: Bureau of Labor Statistics, Conference Board

Other surveys also maintained a downbeat tone about sentiment regarding personal finances, income expectations, and the labor market. For example, the September Fannie Mae National Housing Survey continues to indicate a high level of caution among consumers regarding additional financial commitments. In addition, 77 percent of consumers believed that the economy is on the wrong track, little changed from the share in August.

Sentiment in the small business community continued to erode in August for the sixth consecutive month, according the National Federation of Independent Business Small Business Optimism Index. Details of the survey showed one striking result: the net share of respondents who believed that the economy will improve continued to dip in August, reaching the lowest reading since monthly tracking began in 1986.



Housing: Mixed Near-Term Performance, but Subdued Trend Remains in Place

Amid the global financial market volatility, the existing home market held up well in August, with sales jumping 7.7 percent, the strongest one-month gain since December 2010. Some of the increase can be partially explained by buyers rushing to purchase before the decline in the conforming loan limits that took effect at the end of September, as the largest increase in sales was posted in the West where the price of a typical home is higher than the rest of the nation. Closings in the Northeast, the other region with higher-priced homes, could have been impacted by Hurricane Irene, as sales rose only modestly.

This strong gain is unlikely to be sustained. Home sales are poised to weaken, heading into upcoming seasonally slow months, suggested by the 1.2 percent decline in pending home sales (contract signings of existing homes) in August, which usually lead closings by one to two months. In addition, purchase mortgage applications also fell in August and have shown no appreciable improvement in September, despite continued declines in mortgage rates, on the heels of the Federal Reserve's announcement that it would implement “Operation Twist.” In early October, the conventional 30-year fixed-rate mortgage fell to an all-time low of 3.96 percent, about 25 basis points lower than the rate at the start of the September.

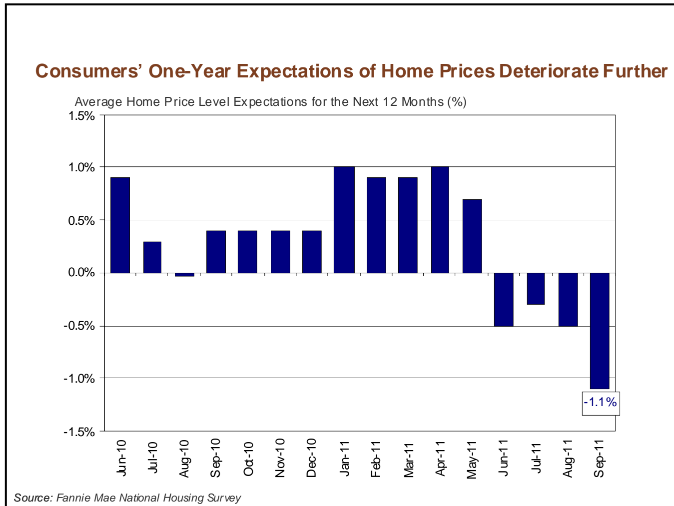
According to the Fed’s announcement, it will sell $400 billion worth of its short-term Treasury holdings and buy an equal amount of longer-term Treasury securities with maturities ranging from 6 years to 30 years. The Fed also will reinvest the proceeds from its agency debt and mortgage-backed securities (MBS) holdings back into MBS, instead of into Treasury securities. The objective is to reduce interest rate spreads between MBS and Treasuries, which had widened in recent months, in an effort to help support refinance and home purchase activity.

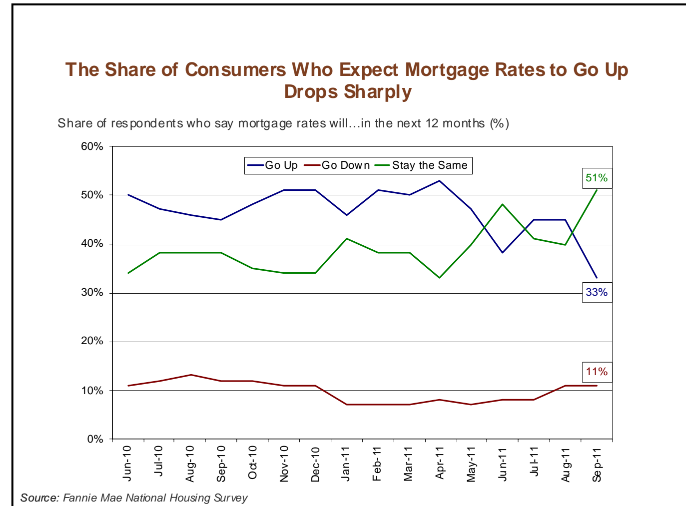
Given recent developments, we expect the Fed to hold the fed funds rate target steady until mid-2014. Operation Twist and the slow pace of economic activity should keep long-term interest rates low in the coming year. We expect the yield on 10-year Treasuries to stay below 2 percent for the current quarter, and to rise only modestly through next year, with 30-year fixed-rate mortgages climbing to slightly above 4 percent by the end of 2012.

While mortgage rates have declined to record lows, home purchase activity in the non-distressed segment of the market, those that generally require mortgage financing, has not benefitted to any great extent. Potential homebuyers have remained on the sidelines, as they are concerned about their job security.

The Fannie Mae National Housing Survey provides insights on consumers' views of the housing market. The September survey showed a marked deterioration in expectations for home prices during the next year—their weakest outlook since monthly tracking began in June 2010.

At the same time, the share of consumers expecting mortgage rates to go up dropped sharply to the lowest level recorded in the survey, likely influenced by the news that the Fed will attempt to keep interest rates low for years to come.





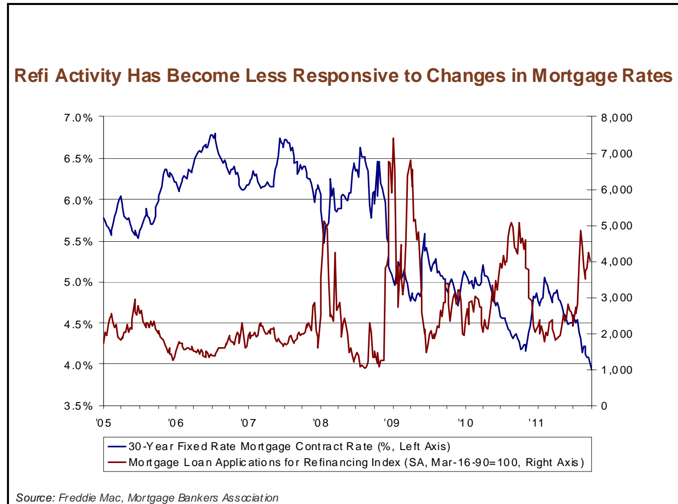
Consumers' lack of a sense of urgency to buy homes, given expectations for further declines in home prices and continued low mortgage rates, coupled with general pessimism regarding their own personal finances and the economy, bodes poorly for the recovery of the housing market.

Moreover, for some of those who decide to buy a home, appraisals continue to be a hurdle, as they should remain conservative for a foreseeable future, suppressed by prices of distressed homes. Some purchase mortgage applications and contract signings of homes have failed to translate into home sales as a number of buyers are unable to sell their current homes. Some contracts have been delayed or cancelled because appraisals came in below contract prices. Cash sales look set to account for a substantial share of home sales for some time to come.

Home prices are expected to trend lower in the fall and winter months on the heels of weak housing demand and an expected rise in the share of distressed sales as additional foreclosures come on the market during the seasonally slow sales period. After four straight monthly gains, the CoreLogic home price index fell 0.4 percent in August from July and 4.4 percent from a year ago. Home prices in the non-distressed segment of the housing market (excluding short sales and REO transactions) continued to gain in August for the fifth consecutive month and were only slightly below last year's level – the best performance witnessed since the spring of 2010, when the homebuyer tax credit helped boost demand and prices.

The new home market continues to languish. New home sales and housing starts dropped in August, remaining at depressed levels, and home builders became more pessimistic, with confidence at a three-month low in September. While single-family construction and sales have shown little progress during the past year, multifamily construction remains a bright spot. Through August of this year, multifamily starts have been about 37 percent higher than those during the same period in 2010. The increase in construction is in response to increased rental housing demand that has outpaced supply, pushing vacancy rates down and rents higher. (For more information on improving fundamentals for multifamily, read the October 2011 Multifamily Market Commentary).

With persistently low mortgage rates, refinance activity has picked up sizably. Mortgage applications for refinancing have risen 41 percent since July. However, the refinance index has remained below its recent weekly highs of nearly 4,900 reached in mid-August despite fresh lows in mortgage rates.



However, that could change in the near future. Mortgage rates could dip further and remain below four percent for some time, or policy changes could be forthcoming that would remove various hurdles inhibiting refinance activity, allowing a boom in such activity that could rival last year's pace.

Our forecast looks for a modest rise in new home sales and single-family construction in 2012, while existing home sales should be little changed through the end of 2012. Housing demand will remain sluggish until we see sustained, robust job gains, and homebuilding activity is not expected to show a significant increase until the excess supply of existing homes is worked through.

We revised higher our projected near-term refinance originations in response to lower mortgage rates. For all of 2011, total single-family mortgage originations are projected to decline to $1.30 trillion from an upwardly revised estimate of $1.69 trillion in 2010, as a result of an annual benchmark to recently released data from the 2010 Home Mortgage Disclosure Act. The refinance share is projected to be 70 percent. Total single-family mortgage debt outstanding is expected to decline by an additional 2.3 percent following a 3.2 percent decline in 2010.

Doug Duncan and Orawin T. Velz
Economics and Mortgage Market Analysis
October 10, 2011

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