Resiliency and Weaknesses Emerge from the Headwinds

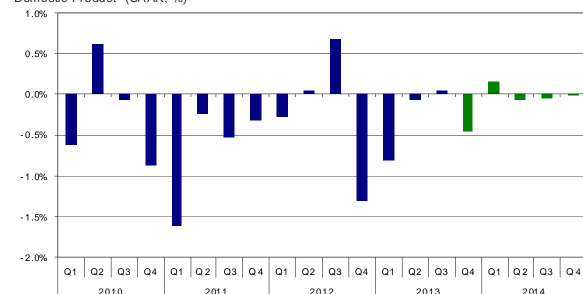
October proved to be a tough month for the U.S. economy. Through the 16-day government shutdown and highly contentious debt ceiling negotiations, the economy showed expected troubling spots but also surprising strength. Consumers were cautious in their spending amid continued eroding confidence, housing indicators slowed further, and housing expectations turned bearish despite declining mortgage rates. Meanwhile, businesses appeared to have shrugged off the fiscal uncertainty, showing the strongest private sector payroll gains since February. The resiliency in the labor market has moved the Fed tapering expectation sooner rather than later, reflected in the spike in the 10-year Treasury yield. Following strong headline economic growth in the third quarter, the economy still faces substantial downside risks in the coming quarters. The uncertainty around Fed policy has heightened, given the expected new Fed chair as well as shifts in the composition of the Federal Open Market Committee (FOMC) in 2014 due to three vacancies in the Federal Reserve Board and an annual rotation of District Bank Presidents. At the same time, the unresolved budget and debt ceiling issues remain to be addressed through the first few months of next year.

Fiscal Policy Remains a Wild Card

The President has signed a bill into law extending spending authority at the level that was in effect prior to the shutdown through January 15, 2014, when the next round of cuts under sequestration are scheduled to take effect. Lawmakers agreed to begin conference negotiations on the FY 2014 budget and instructed conferees to reach an agreement by December 13, 2013 in order to provide a path forward before the continuing resolution's January 15 expiration date. However, there is no formal enforcement mechanism attached to this deadline. The bill suspends the debt limit until February 7, but the exact time the debt limit will become binding—after exhausting “extraordinary measures”—could be in the second half of March.

Fiscal Drag From Government Spending Reductions and Tax Increases Is Waning But Subject to Upcoming Negotiation

Government Consumption Expenditures and Gross Investment's Contribution to Real Gross Domestic Product* (SAAR, %)



*Green bars denote Fannie Mae Forecast.
Source: Bureau of Economic Analysis, Fannie Mae

While fiscal uncertainty will potentially weigh on the economy, the direct drag from government spending and tax increases is waning. Real (inflation-adjusted) government spending edged up slightly in the third quarter as an increase in state and local spending offset continued declines at the federal level. While we expect government spending to resume acting as a drag to GDP growth in the coming quarters, the subtraction to growth should be fading.

Monetary Policy Will Provide Support

The minutes of the September FOMC meeting suggest that Fed officials want to wait to see evidence of sustained improving labor market conditions before it starts reducing its asset purchases. Many of the members view the declining trend in the unemployment rate as overstating the improvement in labor markets, given the drop in the labor force participation rate.

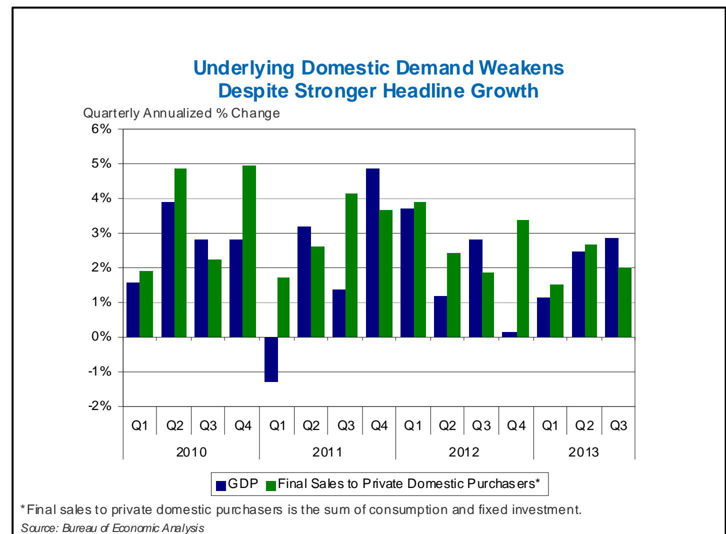
We expect the Fed to start tapering in March 2014 and end the asset purchases in September 2014, as we expect that labor market conditions will show signs of sustained improvement amid fading fiscal drags and political risks by then. The surprisingly strong job gains in the October jobs report, if sustained, could shift the timing of Fed tapering to earlier—perhaps January.

We have left our expected timing of the first Fed funds rate hike unchanged in the second half of 2015—consistent with the Fed’s rate guidance, as our forecast continues to point to a decline in the unemployment rate to 6.5 percent around the middle of 2015. However, the guidance could change next year. Recent studies published by the most senior Fed staff economists argue for a reduction in the 6.5 percent unemployment threshold for the first funds rate hike, which could delay the first hike to 2016.

Strong Headline Growth Masks Weak Details

Top-line economic growth for the third quarter accelerated to a 2.8 percent annualized pace in the first estimate of gross domestic product (GDP) from 2.5 percent in the second quarter. The strongest quarterly increase in inventory investment since early 2012, which contributed 0.8 percentage points to GDP growth, provided most of the upside surprise and masked weakening domestic demand. Consumer spending growth was uninspiring and business capital spending fell. Final sales to private domestic purchasers, the sum of consumer and investment spending, and a more informative measure of the economy's underlying growth, rose at a tepid 2.0 percent annual rate during the quarter, slowing from 2.7 percent in the prior quarter.

Strong inventory accumulation suggests that economic growth during the final quarter of 2013 will be weaker than projected in our prior forecast, as businesses will likely respond by cutting production. As a result of our expected inventory swing, we revised lower our projection of economic growth in the fourth quarter to 1.5 percent annualized from 2.0 percent. However, this is not a concern as we expect the underlying demand to strengthen. For all of 2013, growth should still come in around 2.0 percent, very close to our projection in the October forecast of 1.9 percent and the January 2013 forecast of 2.0 percent. Our outlook for 2014 is little changed: We expect growth to pick up to 2.5 percent, as fiscal drags from government spending and tax increases wane amid continued improving labor market conditions.



*Final sales to private domestic purchasers is the sum of consumption and fixed investment.
Source: Bureau of Economic Analysis

Hiring Surprisingly Resilient

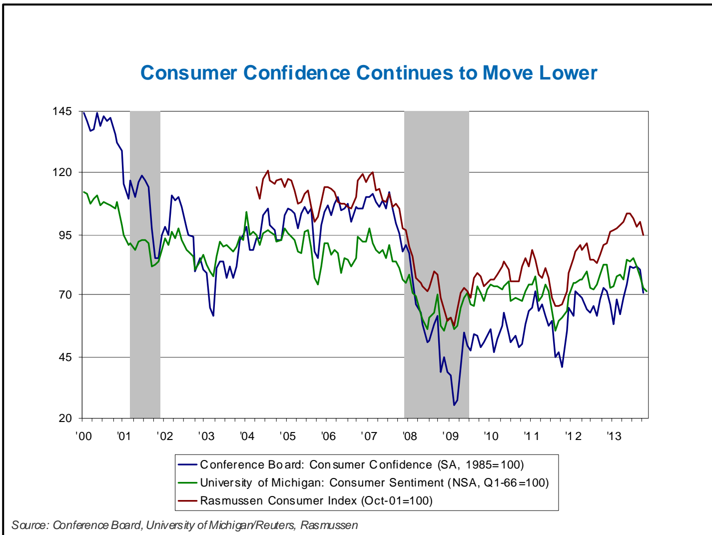
The October jobs report surprised on the upside, showing an increase in nonfarm payrolls of 204,000. Combined with a net upward revision of 60,000 in the two prior months, monthly gains averaged a decent 202,000 in the three months through October, accelerating from 146,000 in July. State and local government payrolls were up 4,000 and federal government payrolls were down 12,000. There appears to have been very little impact on federal payroll employment from the government shutdown as federal workers, who were paid, were counted as employed in the survey of establishments. At the same time, we saw little spillover effect into the private sector, as private payrolls posted a solid gain of 212,000.

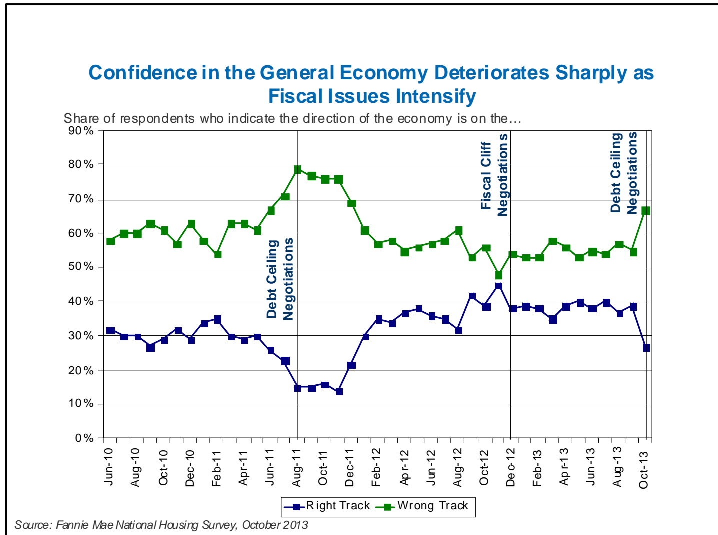
By contrast, the survey of households showed the impact of the government shutdown as furloughed workers were counted as unemployed. The unemployment rate edged up 0.1 percentage points to 7.3 percent. However, there were reports that the Bureau of Labor Statistics counted some government workers as absent from work rather than unemployed, which understated the rise in the unemployment rate from the shutdown. In any case, the rise in the unemployment rate stemming from an increase in unemployed federal workers will likely reverse in the November jobs report. One worrisome aspect of the report is the 0.4 percentage point drop in the labor force participation rate to 62.8 percent—the lowest level since March 1978.

Consumers Exercise Caution

The biggest component of GDP—consumer spending—was lackluster. Real consumer spending decelerated to 1.5 percent in the third quarter, matching the weakest gains since the final quarter of 2009. Monthly data showed weakening momentum going into the fourth quarter, with spending edging up just 0.1 percent in September. By contrast, real personal income was strong, rising 0.4 percent after a strong gain in August. The saving rate ticked up two-tenths to 4.9 percent, marking the seventh rise over the last eight months to the highest level this year.

It appears that consumers have remained reluctant to take on more debt to increase their spending despite a gradually improving labor market and easing lending standards. The September consumer credit (excluding mortgage debt) report showed that non-revolving debt (including auto and student loans) posted a robust gain, continuing the trend witnessed over the past several years. However, revolving debt (largely credit cards) fell for the fourth consecutive month, marking the longest string of declines since 2010.





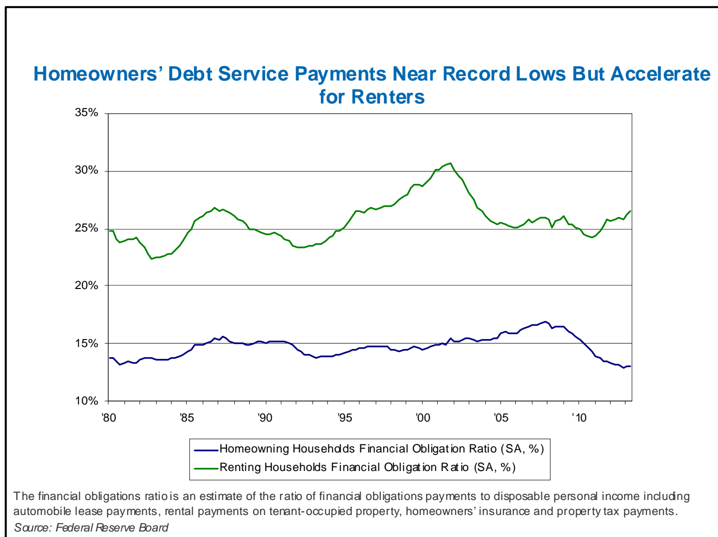
The modest consumer spending levels in recent months are consistent with the bearish trend in consumer confidence. Measures of consumer confidence from the Conference Board, Rasmussen, and Reuters/University of Michigan dropped sharply in October amid the fiscal standoff. The preliminary Reuters/Michigan index fell further in early November, suggesting unresolved fiscal issues continue to weigh on consumers.

The October Fannie Mae National Housing Survey showed that confidence in the general economy deteriorated sharply. The gap between the share of consumers who said the economy is on the wrong track and those who believe it is on the right track widened from 16 percentage points in September to 40 percentage points in October. While this is a record monthly change in the gap since the survey's inception in 2010, the gap was significantly wider during the debt ceiling debate in August 2011 at 64 percentage points.

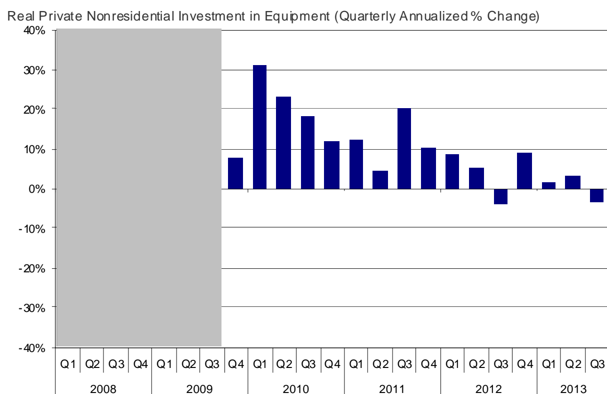
Fiscal Issues Intensify

However, a few factors are positive for consumers: Gasoline prices are declining and household net worth is trending up, thanks to rising home and stock prices. In addition, the impact of tax hikes at the start of the year—including the expiration of the payroll tax cut, the expiration of the upper-income Bush tax cuts, and new taxes on high incomes related to the Affordable Care Act—should abate going into 2014, and thus the increase in disposable income amid continued improving labor market conditions should help boost consumer spending growth.

Another positive factor for consumers is the ongoing decline in the household debt burden. One such measure is the financial obligations ratio—a ratio of 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. While some of the decline in debt service reflects charge-offs or some other form of debt forgiveness, the rest is a result of voluntary debt pay-down, declining interest rates, and, to a lesser extent, rising income. As a share of disposable personal income, household payments to service various types of debt and to pay for housing-related expenses have dropped sharply since the end of the recession. During the second quarter, the homeowner's financial obligation ratio remained near record low at 12.9 percent. After reaching its long-term average at the end of 2012 of 25.7 percent, the renter's financial obligation ratio has trended up.



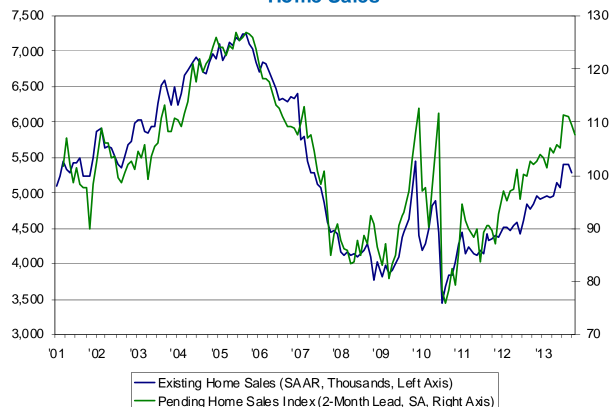
Businesses Pull Back Capital Expenditures



Note: Shading denotes recession

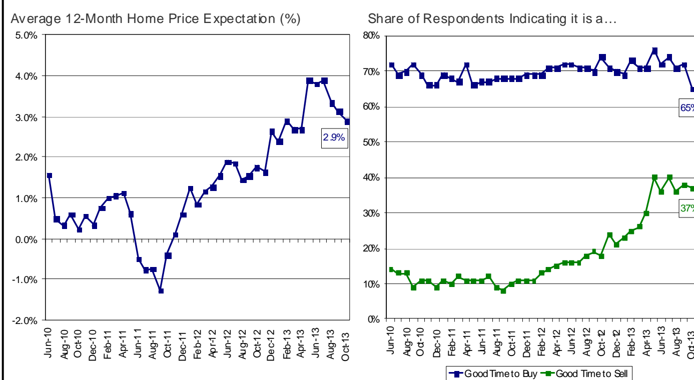
Source: Bureau of Economic Analysis

Slowdown in Pending Home Sales Foreshadows Declining Existing Home Sales



Source: National Association of Realtors®

Expectations Regarding the Housing Market Worsen in Response to the Fiscal Negotiations



Source: Fannie Mae National Housing Survey, October 2013

Businesses Cut Back Capital Spending Amid Policy and Demand Uncertainty

Business investment was mixed in the third quarter. While investment in structures was solid, equipment spending fell—for only the second time since the recovery began in mid-2009. After contributing solidly to growth for three years in a row, business capital investment barely added to growth in the first half of this year and subtracted from growth in the third quarter. Its leading indicator—nondefense capital goods orders, excluding aircraft—fell in September for the second time in three months, suggesting another lackluster capital spending in the current quarter.

Housing Recovery is Intact, Albeit Moderating

Housing has consistently contributed to GDP since the fourth quarter of 2010. During the third quarter, real residential investment contributed 0.4 percentage points to GDP for the second consecutive quarter. The government shutdown has delayed the release of government data for housing, including September housing starts, permits, and new home sales. So far this year, single-family starts have disappointed as they trended down in the spring even before mortgage rates started to rise, despite a rising trend in permits. Meanwhile, volatile multifamily starts have pulled back from recovery highs witnessed in the spring. (For more information on multifamily market conditions, read the November 2013 Multifamily Market Commentary.) Incoming housing indicators from the private sector showed signs of slowing, reflecting the previous rise in mortgage rates. Existing home sales eased in September and the sharp decline in pending home sales—a one-to-two-month leading indicator—suggests further pullback in home sales in coming months.

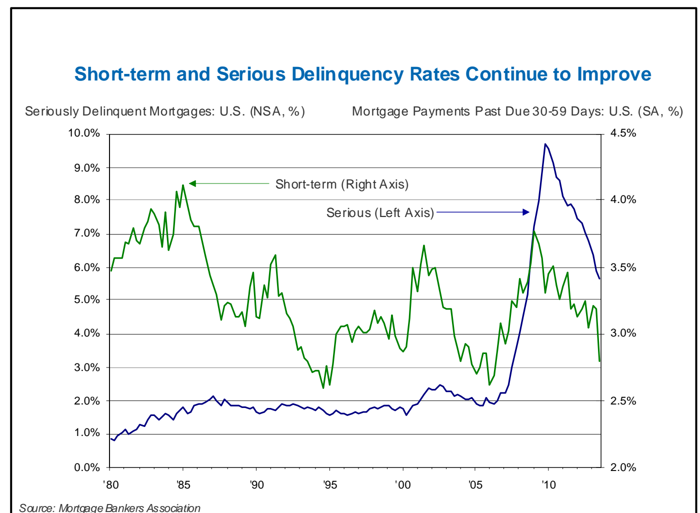
Builder confidence also edged down in October for the second consecutive month, and housing market sentiment has worsened in the wake of the recent government shutdown and debt ceiling debate, according to the October Fannie Mae National Housing Survey. Home price growth expectations continued to moderate, the share of consumers who expect home prices to go up in the next 12 months fell sharply, and the share who say it is a good time to buy a house had the biggest ever one-month change, declining to a survey low.

Home price gains also showed signs of moderating, partly because of seasonal factors, though the year-over-year gains remain strong. For example, the CoreLogic house price index—a measure used by the Federal Reserve to estimate housing wealth in the Financial Accounts of the U.S.—rose 12 percent in September from a year ago, the eighth straight month of double-digit annual returns.

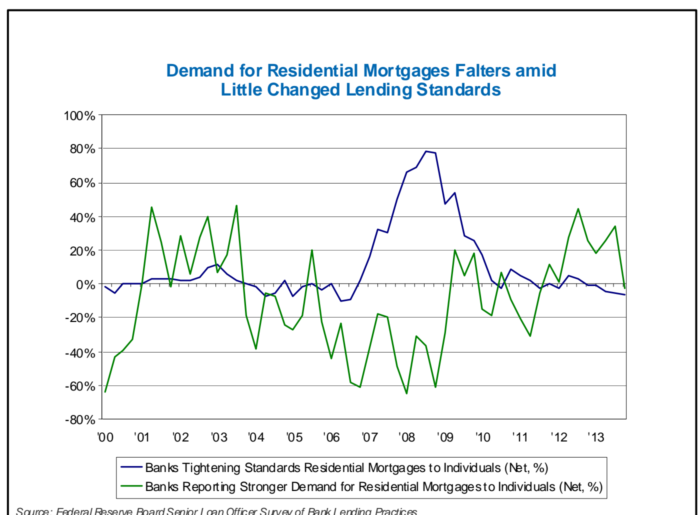
We expect that historically tight supply conditions will continue to support further home price gains. While the number of new and existing homes available for sale has risen during the past year, the months' supply has remained lean by historical standards. Data from the Census Bureau's Housing Vacancy Survey showed that the homeowner vacancy rate was unchanged at 1.9 percent—remaining slightly higher than its long-term trend. The rental vacancy rate edged up one-tenth to 8.3 percent, trending down from its record high of 11.1 percent four years ago.

One positive for future home price trends is a decline in shadow inventories. Thanks to the rapid home price appreciation during the first half of the year, the decline in negative equity properties accelerated. CoreLogic data showed that, in the second quarter, the share of borrowers with negative equity fell to 14.5 percent, or 7.1 million borrowers, down from 19.7 percent or 9.6 million borrowers in the prior quarter. Another measure of shadow inventory is the Mortgage Bankers Association seriously delinquent rate—the share of mortgages that are delinquent for 90 days or more or in the process of foreclosure. The rate has gradually declined from its record high of 9.70 percent during the final quarter of 2009 to 5.65 percent in the third quarter of this year. The Mortgage Bankers Association short-term delinquency rate declined sharply during the quarter, with the share of loans at least one payment past due falling to 2.79 percent, the lowest in more than seven years.

The Federal Reserve Board's Senior Loan Officer Opinion Survey continues to point toward an incremental easing of credit conditions. For the fifth consecutive quarter, more respondents reported an easing of credit standards for prime residential mortgage borrowers. However, on balance, banks reported weaker demand for residential mortgage loans. More than 90 percent of respondents reported moderately to substantially lower mortgage refinancing volumes relative to levels seen in the spring. To a lesser extent, banks also reported reduced volume of purchase mortgage applications. The survey commentary showed that a large fraction of banks said they had reduced the processing time for purchase mortgage applications and had increased their marketing efforts to potential homebuyers.

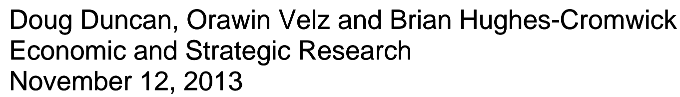


The drop in mortgage demand is consistent with the results from the Mortgage Bankers Association Weekly Survey of Mortgage Applications. Refinance applications declined sharply between May and early September before rebounding modestly through mid-October. However, the latest survey during the first week of November showed that refinance applications fell for the second time in three weeks, while purchase applications dropped for the fourth time in six weeks to their lowest level this year.



Long-term interest rates moved up following the strong October jobs report, with the yield on 10-year Treasuries jumping 15 basis points to 2.75 percent. After declining about 40 basis points from their recent peak late August, mortgage rates will likely rise somewhat in the near term. As the economy picks up in 2014, we expect mortgage rates to rise gradually through the year, reaching about 4.8 percent by the end of 2014.

As mentioned earlier, the performance of single-family starts measures has been lackluster. Thus, we revised lower the projection of single-family starts and new home sales for rest of this year and the next two years. We maintain our view for existing home sales and home prices. For all of 2013, we expect total mortgage originations to decline about 15 percent to $1.83 trillion, with the refinance share dropping 10 percentage points from an estimated 73 percent in 2012. We expect mortgage debt outstanding to post a small decline, marking the sixth consecutive annual drop.



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