U.S. Growth Outlook Remains Solid But Global Growth Slows

Our 2014 macroeconomic theme, *Private Forces Move to the Fore*, finally materialized in the second quarter of this year. Real economic growth for the final two quarters of the year appears ready to exceed 3.0 percent, providing a sound basis for growth in 2015. At the same time, a variety of factors are slowing global growth and raising some risks that likely will keep the Federal Reserve Board aligned with our expectation for no interest rate policy change until the third quarter of 2015.

Reduced fiscal uncertainty and slowing monetary intervention has enabled momentum in the private sector to build. Total government spending no longer declined, which had been masking improvement in the private economy. A key indicator of underlying growth for the private sector—real final sales to private domestic purchasers—accelerated to 3.8 percent annualized in the second quarter from 1.0 percent in the first quarter. Another contributor to growth in the second quarter was housing, which rebounded strongly after falling sharply in the prior two quarters. Recent housing indicators have been mixed, however, providing support for our expectation that housing will return to its gradual grind upwards.

The global economic slowdown has had little negative impact on the fundamentals of the U.S. economy so far. We expect real gross domestic product (GDP) to grow at 2.1 percent for all of 2014, one percentage point below the 2013 pace, due to the large decline in activity at the start of the year. Geopolitical events in Russia, Ukraine, Hong Kong, and the Middle East remain a downside risk to the forecast. The Eurozone appears to be entering recession again, or at least a significant slowdown. Japan's growth has slowed as has China's. Market rates are declining as a result of these international factors. This may mitigate what could be a significant risk to the housing market: a rapid and sizeable rally in interest rates through the market's re-pricing of the Federal Reserve's target rate hike expectations.

Consumer Spending Rebounds…

Real consumer spending jumped 0.5 percent in August following a slight drop in July, and the 2.6 percent year-over-year gain marks an eight-month best. The strong August gain helped soothe concerns of anemic spending growth for the third quarter. Real income now has increased for eight consecutive months (a streak unmatched since 2004) with year-over-year growth of 2.8 percent, the highest since late 2012.

One of the factors helping to boost real consumer spending was the subdued pace of inflation. The price index tied to consumer spending—the personal consumption expenditures (PCE) deflator—was flat in August and was up just 1.5 percent from a year ago, well below the Fed's target of 2.0 percent. The drop in retail gasoline prices since July is a major factor bringing down headline inflation. However, core PCE, which excludes food and energy prices, also came in at 1.5 percent on a year-over year basis in August. Crude prices continued to decline in early October, with the price of Brent Crude oil falling below $90 per barrel, the lowest level since June 2012, thanks in part to the rise in the value of the dollar against key trading partner currencies. As a result, inflation should remain subdued through the rest of 2014, providing support for our view of a pickup in consumer spending growth in the final quarter of 2014.

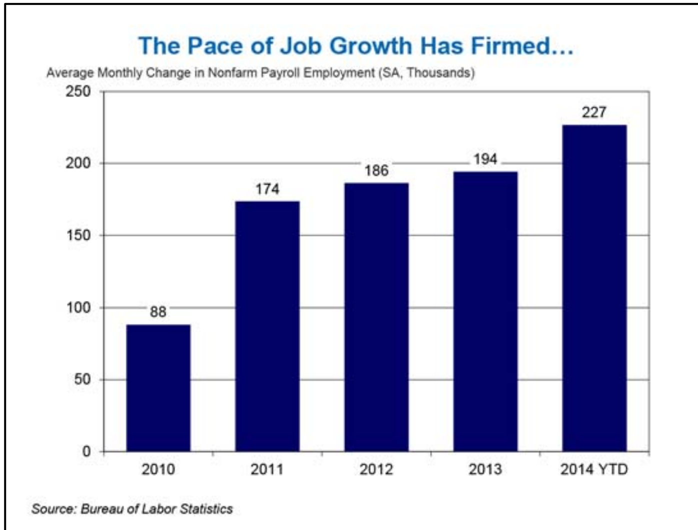
Market-based measures of inflation expectations have moved lower, with the 10-year break-even inflation rate dropping approximately 40 basis points since July to below 2.0 percent in early October. The dormant inflation environment also should be supportive of the Fed's accommodative stance.

While auto sales dropped sharply as expected in September—a payback from the early Labor Day that boosted sales in August—the average pace for the third quarter was the strongest quarterly rate since the first quarter of 2006. We expect real consumer spending growth to come in around 2.0 percent annualized in the third quarter and pick up to nearly 3.0 percent in the final quarter, supported by lower energy prices.

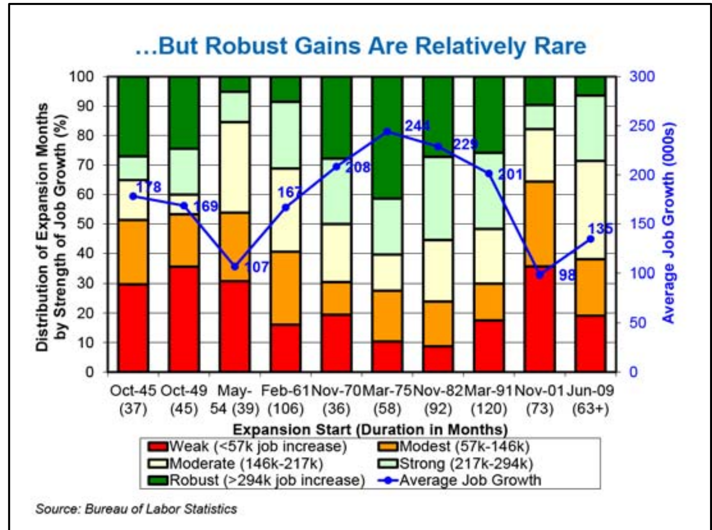
…Amid a Pickup in Hiring and a Return to a "Five-Handle" Unemployment Rate…

Combined with ongoing declines in gasoline prices that help boost consumers' disposable income, job growth picked up in September, setting the stage for stronger wage gains. Following the disappointing August jobs report, nonfarm payrolls rose 248,000 in September, and much of the weakness in the August hiring number was revised away. Upward revisions to the prior two months totaling 69,000 jobs pushed the average monthly gain in the third quarter up to 224,000, down from 267,000 in the second quarter. The year-to-date average monthly gain so far this year was 227,000 and is poised to surpass the average monthly gain in 2013 of 194,000.

Despite steady improvement during the current expansion, job gains have not been as strong when compared to most previous expansions. For example, during the expansions of the mid-1970s and the early 1980s, robust monthly job gains of roughly 300,000 or more occurred during about 40 percent and 25 percent of months, respectively. In the current expansion, such gains have occurred in less than 10 percent of months.



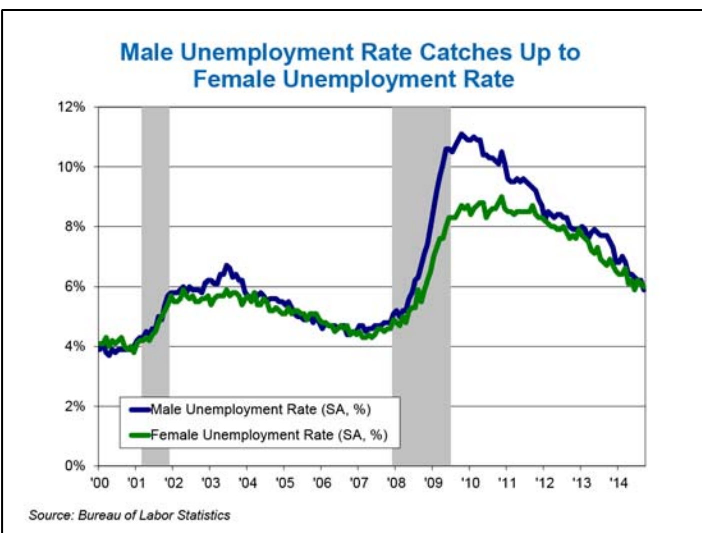
Source: Bureau of Labor Statistics



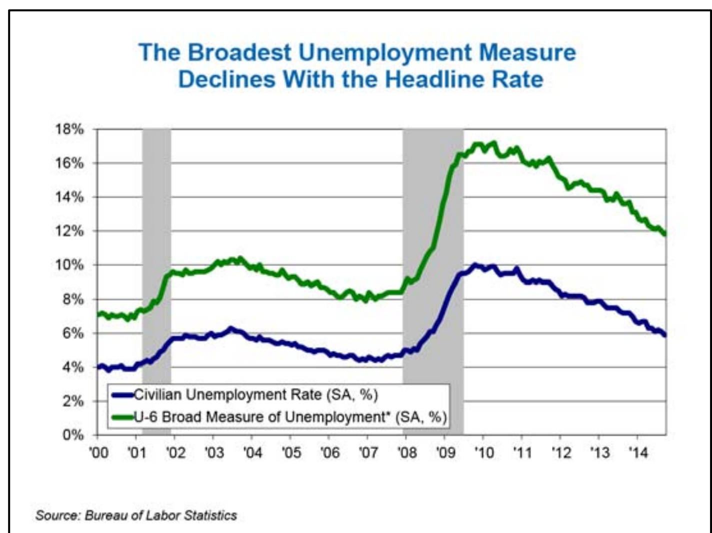
Source: Bureau of Labor Statistics

Wage gains were muted in September with average hourly earnings unchanged during the month and up 2.0 percent from last September—hovering around the trend established during the past five years. On a positive note, the length of the average work week ticked up to 34.6 hours—the best since May 2008—which will help support total labor income. The separate household survey showed a 0.2 percentage point decline in the unemployment rate to 5.9 percent, the lowest level since July 2008, amid a pickup in household employment and a decline in the civilian labor force. One notable detail in the unemployment rate is the trend between male and female unemployment rates. At the start of the recession, the male unemployment rate rose much faster and much higher than the female counterpart but has shown a more pronounced decline during the expansion. In September, the male unemployment rate dipped below the female unemployment rate for the first time since 2006.

The labor force participation rate fell slightly for the second consecutive month to 62.7 percent, the lowest reading since February 1978. The broadest measure of unemployment, the U-6 unemployment rate, which includes discouraged workers and part-timers who want full-time jobs, fell to nearly a six-year low of 11.8 percent, as the number of people working part-time for economic reasons fell for the second consecutive month to the lowest level since October 2008.

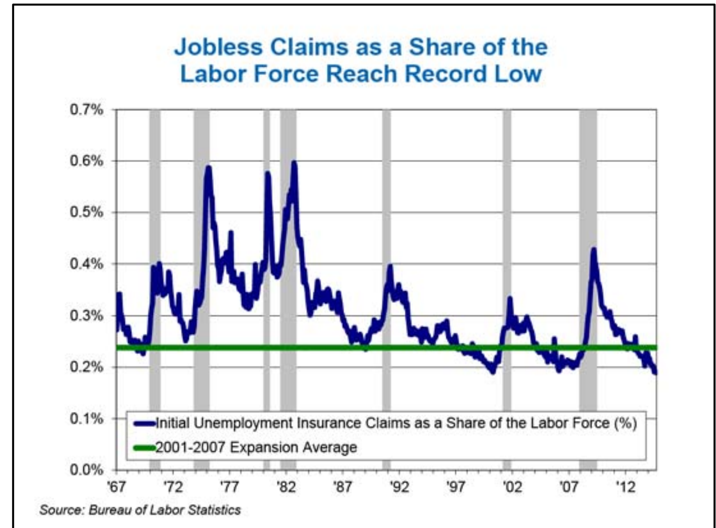


Source: Bureau of Labor Statistics



Source: Bureau of Labor Statistics

Other labor market indicators also have been solid. High frequency data such as the weekly initial unemployment claims point to improving market conditions. The four-week average of claims has trended down to 287,750 during the first week of October, the lowest reading since February 2006. As a share of the labor force, initial jobless claims have dropped to a record low.



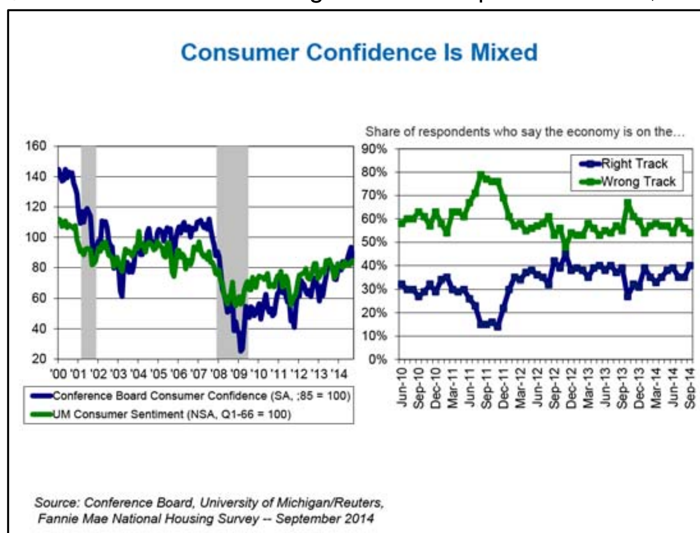
Another report on labor market conditions, albeit with a one-month lag to the employment report, is the Job Openings and Labor Turnover Survey (JOLTS). The August survey continued to show robust increases in job openings, with the job openings rate jumping to 3.4 percent, its highest level since April 2001. However, other aspects were less rosy: The hire rate declined and the quit rate, which tends to rise when confidence in the labor market improves, held steady. Nonetheless, the August survey signals a tighter labor market, as there were approximately two unemployed workers per job opening, the lowest level since the recession and a marked decline from almost seven per opening in 2009. This suggests that wage pressure, which is a lagging indicator, should start to build later this year.

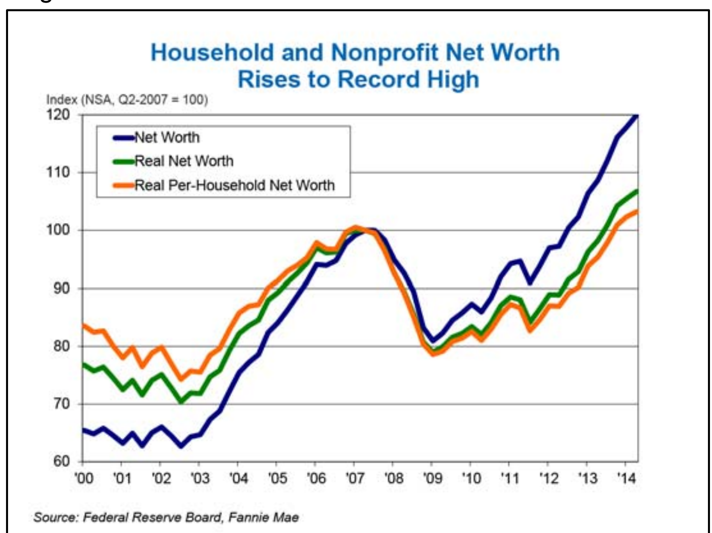
…and Mixed Confidence

Measures of consumer confidence were mixed at the end of the third quarter. Following four consecutive monthly gains, the Conference Board consumer confidence index fell sharply in September. The current expectations component slipped as views of the labor market conditions deteriorated, partly driven by the soft August jobs report, and should be poised for a rebound in October given the positive September jobs report. Growing geopolitical worries likely caused the future expectations component to tumble.

The decline in the September consumer confidence index contrasted with a rise the Reuters/University of Michigan consumer sentiment index during the month to a 14-month high and the second highest level in the past seven years. More favorable prospects for the economy and personal income expectations helped boost sentiment. Also in the positive column, the Fannie Mae September 2014 National Housing Survey showed a jump in consumers' positive views toward the economy, with 40 percent of respondents saying it is now on the right track—a five percentage point increase from the prior month and the highest in more than a year.

One factor that could weigh on confidence going forward is increased volatility in the stock market. Over the past month, equity markets in the U.S. and abroad experienced sharp swings in response to concerns that core economies in Europe, particularly Germany, will slip into recession. So far through the second quarter of 2014, the run-up in the stock market and rising home prices continued to strengthen household balance sheets. The value of household net worth and nonprofit organizations—assets minus liabilities—rose $1.4 trillion during the second quarter to $81.5 trillion and was up $26.5 trillion from the trough in the first quarter of 2009, according to the Fed's Financial Accounts of the United States.



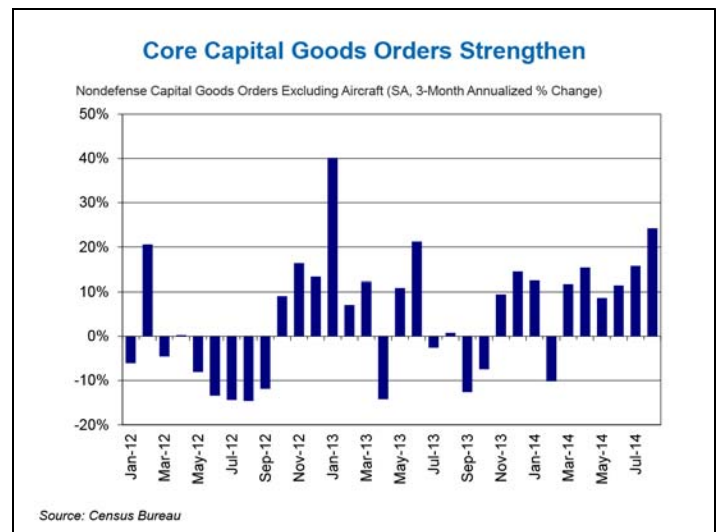


Although the Fed does not adjust the data for inflation or households, our estimates show that real net worth and real net worth per household also set record highs in the second quarter.

One measure of the financial health of householders is the debt-service ratio, or household debt service payments as a share of disposable income, which fell 0.5 percentage points to 9.91 percent in the second quarter of 2014, staying just above its record low of 9.84 percent in late 2012. This downward trend suggests that household cash flow is in much better shape than it was a few years ago.

Manufacturing Activity Remains Solid

Manufacturing output fell in August, driven by the fall in production for motor vehicles and parts following the surge in July. Auto output data generally are volatile during the summer months because the timing and magnitude of retooling for the new model year varies from year to year, and the absence of some traditional summer retooling shutdowns might have been partially responsible for the volatility. The drop in manufacturing production was at odds with the bullish trend in the August Institute for Supply Management (ISM) manufacturing survey, which showed the best result in three and a half years. Other factory-related reports and regional purchasing manager surveys point to healthy conditions in the sector. While durable goods orders declined in August, reflecting a payback from the surge in commercial aircraft orders in the prior month, details of the report were consistent with strong growth in business equipment spending in the second half of the year, as the three-month annualized growth rate for core capital goods orders posted the biggest gain since January 2013.



Despite the pullback in the ISM manufacturing index in September for the first time in three months, the third quarter average was the best showing since the first quarter of 2011. In addition, the September employment report showed that the average weekly hours for manufacturing production workers rose 0.4 percent, pointing to a rebound in manufacturing output in September.

Nonresidential Investment in Structures Disappointed

While the trend in business capital investment is more upbeat, business investment in structures has weakened. The August construction spending report showed that private nonresidential construction spending declined during the month on top of downward revisions to the prior two months. Despite the support from oil and gas drilling, business investment in structures likely was neutral to GDP in the third quarter after adding 0.4 percentage points to GDP in the prior quarter. We expect nonresidential investment in structures to add modestly to GDP in the fourth quarter and in 2015.

Net Exports Subjected to Downside Risk

The trade deficit unexpectedly declined in August, suggesting net exports will likely add to GDP in the third quarter after subtracting from it in the prior two quarters. We expect a sizable contribution of nearly one percentage point to GDP in the third quarter. The boom in the energy sector in the U.S. continued to support net exports as it has reduced the U.S. dependence of foreign sources of energy.

While the strong dollar contributed to declining energy prices, helping to lift consumer spending, it also will negatively affect U.S. exports. We expect trade to be a modest drag on growth in 2015 but acknowledge that it could be a bigger drag than expected if the global slowdown worsens.

Federal Reserve’s Rhetoric Poised to Change

The minutes of the September 17-18 Federal Open Market Committee (FOMC) meeting showed that Fed officials were concerned about weak growth overseas, including Europe, Japan, and China, and about the impact of the strengthening of the dollar, which would depress U.S. exports and tamp down inflation, leaving inflation below the 2.0 percent target for a longer period. We expect the Fed to adjust its forward guidance, which pledges to keep interest rates low for a "considerable time" after it stops adding to its holdings of agency MBS, which is expected to end this month. We also expect the Fed to alter the language regarding the "significant underutilization" of the labor market soon—perhaps at the

next meeting later this month. We maintain our view that the Fed will raise rates in the third quarter of 2015, with risks tilted toward June, if labor market conditions improve more significantly than expected and global events don't reduce U.S. growth prospects.

Choppy Housing Recovery Continues

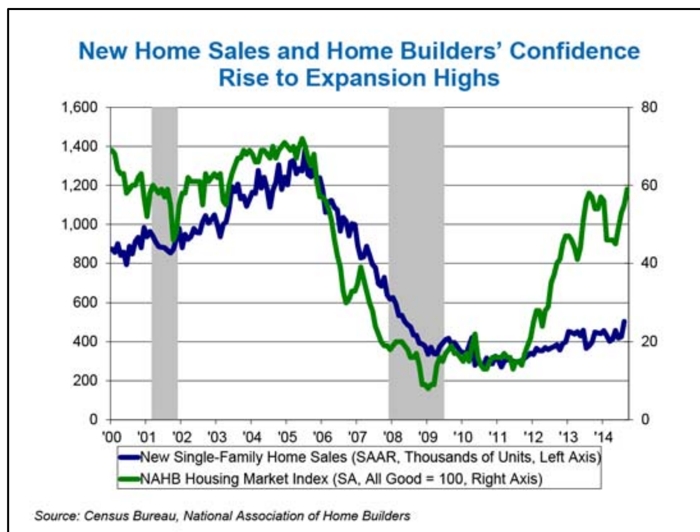
The rise in interest rates subsequent to the "Taper Tantrum" of mid-2013, combined with an inflation-adjusted increase in home prices of around 8 percent, took a toll on housing activity from late 2013 into 2014. This was augmented with the coldest winter since the late 1970s, which was exhibited in very weak housing numbers in the first quarter of 2014.

Recent housing activity has been mixed. After rising in July to the strongest pace in more than six years, housing starts posted the sharpest monthly drop in August since April 2013, largely driven by the volatile multifamily segment. (For more information on multifamily market conditions, read the October 2014 Multifamily Market Commentary.) Year-to-date through August, both single-family and multifamily starts were running above their year-ago levels by 3.1 percent and 20.7 percent, respectively. However, single-family permits were running below their levels during the first eight months of last year.

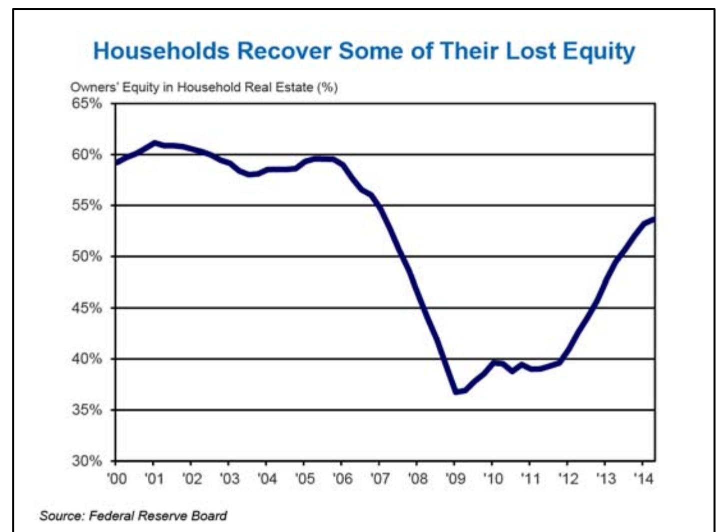
After four consecutive monthly rises, existing home sales fell modestly in August. Through the first eight months of this year, existing home sales are running 5.6 percent below their 2013 pace. August pending home sales also dropped, suggesting limited near-term gains, while mortgage applications (another near-term leading indicator of home sales) have remained lackluster.

On a positive note, new home sales jumped by nearly 20 percent in August to an expansion high, and homebuilder confidence continued to push higher in September for the fourth consecutive month, also to a new high for the expansion.

In addition, the September 2014 Fannie Mae National Housing Survey showed a rebound in consumer expectations regarding housing following a couple of months of eroding confidence. The share of consumers who say now is a good time to buy a home rebounded four percentage points to 68.0 percent from August, and the share saying they would prefer to buy a home on their next move rose two percentage points to 66.0 percent.



Source: Census Bureau, National Association of Home Builders



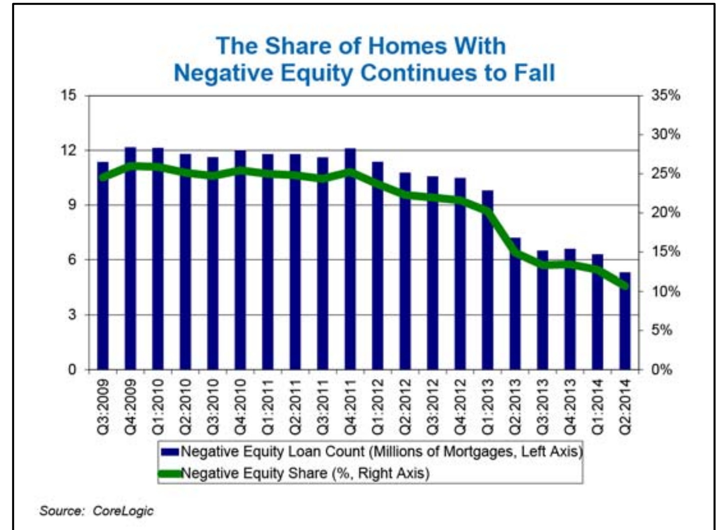
Source: Federal Reserve Board

Home price gains continued to moderate from the robust pace a year ago. Prices are still rising thanks to lean inventories of homes in most markets and limited new home construction. The declining share of distressed sales continues to be a positive factor for home prices. The Case-Shiller national composite index increased on a seasonally adjusted basis in July, ending a three-month streak of declines, and the year-over-year gain slowed modestly to 5.6 percent. The August CoreLogic house price index, which is used in the Fed's estimated value of owner-occupied homes, showed that the 12-month gain steadily slowed to 6.5 percent after holding in the 11.0 to 12.0 percent range between April 2013 and February 2014.

Rising home prices have benefitted the equity position of U.S. households with real estate. Equity as a share of the value of owner-occupied household real estate rose for 12 consecutive quarters to 53.6 percent in the second quarter, the

highest since the first quarter of 2007 and a sizable gain from a record low of 36.7 percent witnessed in the first quarter of 2009.

In addition, rising home prices, in conjunction with improving labor markets and tighter lending standards, have helped improve loan performance, bringing down delinquency and foreclosure rates. They also lifted some negative equity mortgages into positive positions, helping to unlock housing supply and demand. CoreLogic data showed that the share of all residential properties with a mortgage that were in negative equity position has declined steadily over the past few years. At the end of the second quarter of 2014, 10.7 percent (nearly 5.3 million homes) were in negative equity, with nearly 1 million homes regaining positive equity during the quarter.



Source: CoreLogic

Jitters over global economic growth during recent months brought long-term interest rates lower, with the yield on 30-year fixed mortgage rates declining to 4.12 percent for the week ending October 9, the lowest in a more than a month, according to Freddie Mac. The forward yield curve suggests mortgage rates will rise only gradually over time, reaching 4.7 percent at the end of 2015. Our forecast of housing activity is little changed over the past month. Total home sales are expected to fall roughly 3.0 percent from their 2013 levels, as investor sales have fallen substantially without enough traditional first-time and repeat homebuyers entering the market to fill the void. We are cautiously optimistic about 2015 and expect continued improving labor market conditions, relatively low mortgage rates, and rising inventories to help boost housing demand. While we believe that demand weakness trumps credit tightness in today's market, we expect that an easing lending standards environment, even only around the edges, should combine with other factors to boost new home sales next year, which we expect to rise roughly 5 percent. New home construction will remain limited compared with previous expansions, with housing starts rising to 1.17 million units in 2015 from about 1 million units projected for all of 2014.

As a result of our annual benchmark to last month's release of the 2013 Home Mortgage Disclosure Act (HMDA) data, we revised higher our estimate of 2013 purchase originations and downgraded our estimate of refinance originations. On net, our estimate of total mortgage originations in 2013 was downwardly revised by $47 billion to $1.87 trillion. We also downgraded our projected mortgage originations for 2015—we now expect a decline of about 8.0 percent from our 2014 estimate to $1.01 trillion in 2015, with the refinance share expected to drop nine percentage points to 30.0 percent in 2015 from a projected 39.0 percent in 2014. Total single-family mortgage debt outstanding was 0.2 percent annualized in the second quarter of 2014, moderating from the 1.4 percent drop in the prior quarter, and we expect it to be relatively flat this year following six consecutive annual declines.

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Economic and Strategic Research (ESR)

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