On Track for Faster Growth

Economic activity deteriorated somewhat at the end of 2013, but that did not change our expectation for a modest pickup in growth in 2014. The acceleration will have to wait until after the current quarter, however, to allow inventory to correct from the unsustainable buildup in the second half of last year. In addition, harsh winter weather contributed to weakening economic activity in the first quarter of 2014. We expect the return of weather to seasonal norms in coming months to help boost growth in the second quarter.

The auto industry has planned to cut back production following sluggish sales and accumulated undesired inventory over the past several months. We expect that reduced production across industries in an attempt to decrease stockpiling will subtract about one percentage point from economic growth in the first quarter. As drags from the declines in inventory investment and government spending gradually dissipate, we expect economic growth to firm to about 3.0 percent in the second half of the year, supported by consumer spending, business investment, and housing. Net exports, which added one percentage point to growth in the final quarter of 2013—the most in three years—will likely be a smaller contributor to growth this year.

Financial jitters related to investors' concerns over the outlook of emerging markets that intensified in early February have eased. Broad equity indices thus far have appeared to shrug off geo-political concerns related to Ukraine, with the S&P 500 establishing record highs at the time of this writing. After many disappointing economic reports over the past month, the upside surprise in the February jobs report helped soothe concerns that economic growth in the U.S. will downshift rather than strengthen. Meanwhile, uncertainty over fiscal policy subsided after the President signed the two-year bipartisan budget deal. The expiration of emergency unemployment benefits remains a negative but modest fiscal factor for growth this year.

On the monetary policy front, the testimony of Fed Chair Janet Yellen reinforced the market's expectation that the pace of tapering will likely be steady. We expect that the purchase program will end in November, and the Fed will likely continue to reinvest mortgage paydowns for some time, perhaps through the first half of 2015. The first hike in the target interest rate could occur soon after that, consistent with the Fed's forward guidance that it will not raise short-term rates until the unemployment rate falls well below 6.5 percent. The Fed will likely modify its guidance soon, and it may change to a qualitative rather than a quantitative approach.

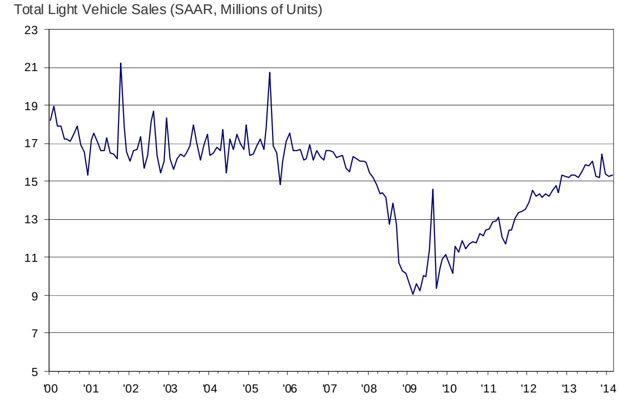
Overall, despite several factors—some transitory, some fundamental—that have appeared to cloud the near-term outlook, we remain confident that the economy will pick up momentum in the spring, building through the second half of the year. For all of 2014, we project growth to come in at 2.7 percent, compared with 2.5 percent in 2013.

Consumer Spending: Services Boost Overall Spending

Real (inflation-adjusted) consumer spending rose a strong 0.3 percent in January but the details were not as rosy as the headline. A jump in spending on utilities from the unusually cold winter was expected but the sharp rise in spending on health care services was not. According to the Bureau of Economic Analysis, the surge in health care service spending reflected the increase in demand stemming from the Affordable Care Act (ACA). The sharp rise in service spending came at the expense of spending on durable and nondurable goods, which both declined in January.

Auto sales ended 2013 on a soft note after their best performance since 2007, dropping 6.2 percent in December and another 1.0 percent in January before

Auto Sales Stumble



Source: Autodata

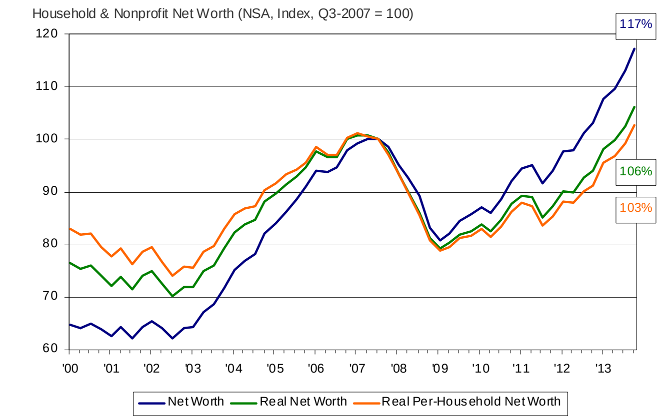
stabilizing in February. Bad weather was likely responsible for most of the downshift in recent months, as measures of consumer sentiment continued to hold up in February. We expect a sales rebound in March to begin to make up for sales lost in the prior months due to weather.

Meanwhile, real personal income rose 0.2 percent in January in response to many special factors, including the ACA (due to incorporation of an increase in Medicaid payments and premium assistance tax subsidies), cost-of-living adjustments for some government transfer payment programs, a pay increase for government civilian and military personnel, and expiring emergency unemployment benefits.

Employment: Breathing a Sigh of Relief

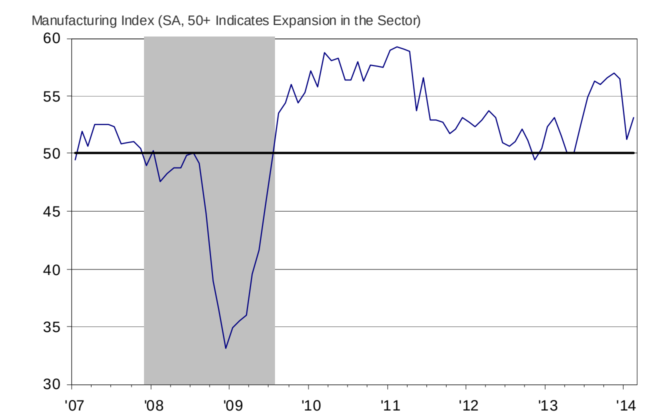
The February jobs report finally exceeded expectations, though the bar was quite low given the disappointing jobs picture in the prior two months. Nonfarm payrolls rose 175,000 in February, in line with the 180,000 average monthly gain over the past year. Other encouraging details include a cumulative upward revision of 25,000 jobs to December and January, and a 0.4 percent jump in average hourly earnings. Even the one-tenth rise in the unemployment rate to 6.7 percent had some upside, as it was because more people joined the labor force, a sign of growing confidence in the jobs market. One weakness was in the average workweek, which fell during the month to a three-year low. This could reflect the weather impact. Further pointing to weather as a factor in the employment report is a series from the Household Survey—employed but not at work due to bad weather—which was well above the February norm. Parsing the weather effect is not an easy task, but to the extent that weather has suppressed hiring in recent months, we should see some rebound in coming months.

Rising Stock and Home Values Help Bolster Net Worth to Record High



Source: Federal Reserve Board, Bureau of Economic Analysis, Census Bureau

Manufacturing Activity Rebounds Modestly



Source: Institute for Supply Management

Net Worth: Continuing to Heal

Meanwhile, household balance sheets have improved further. Federal Reserve Financial Accounts of the U.S. showed that household net worth—assets minus liabilities—increased $3.0 trillion to $80.7 trillion in the final quarter of 2013, thanks to rising equities and home prices. The level of net worth is now at a record high, even after adjusting for inflation and the growing number of households

However, evaluating the distributional aspects of wealth, the positive wealth effect on consumer spending during the current recovery will be more limited than witnessed in previous recoveries. (For more details on real household wealth per household, see Brian Hughes-Cromwick, "An Uneven Recovery in Household Wealth, Fannie Mae Housing Insights," December 2013). Thus, while we expect consumer spending growth to firm this year, the strength is much more moderate compared to previous periods of booming household wealth.

Manufacturing: Encountering Some Setbacks

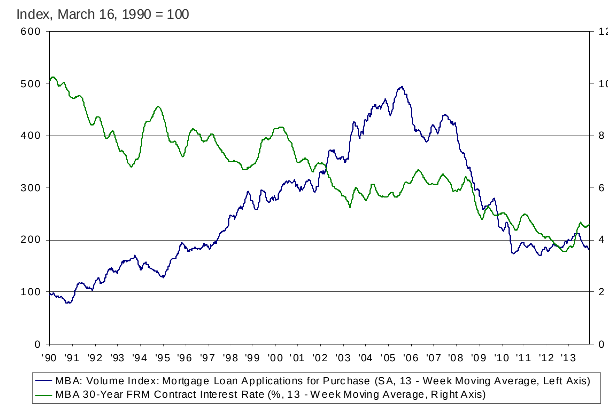
It was unsurprising to see a sharp drop in auto production in January given the soft auto sales and continued strong motor vehicle assemblies in the second half of 2013. This helped pull manufacturing output down 0.8 percent during the month. Surveys of purchasing managers corroborated slowing activity in January, with the Institute for Supply Management (ISM) manufacturing index plummeting by more than five points in January.

Activity improved in February as the index posted a modest rebound. The details were mixed. The production component fell for the third consecutive month to below 50, the breakeven level, indicating contracting activity for the first time since August 2012, while the forward-looking new orders component rebounded. The modest bounce-back in the overall survey in February was encouraging, though the headline index remains well below its fourth quarter average as weather and weakening auto production weigh on manufacturing activity.

Housing: Muddled Picture

It was clear that housing lost momentum during the second half of last year, and most housing activity cooled further at the start of this year. Existing home sales fell 5.1 percent in January, marking the fifth decline over the past six months to the slowest pace since July 2012. It is possible that severe winter weather has exacerbated the negative impact of the sharp rise in mortgage rates and the dwindling supply of housing inventory, especially for bargain-priced properties. However, regional trends suggested that weather may be a small part of the problem, as existing home sales fell sharply in the West, where the weather was warmer than normal. A meaningful rebound in the near term is unlikely, as purchase mortgage applications have trended down substantially since their recent peak last summer.

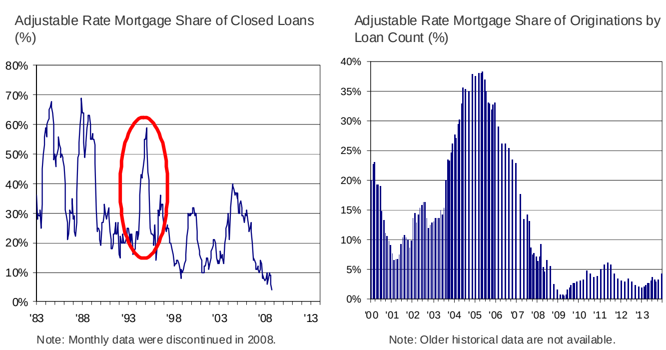
Mortgage Purchase Applications Continue to Trend Down



Source: Mortgage Bankers Association

Pending home sales—another leading indicator measuring contract signings of existing homes—only stabilized in January after declining for six straight months. Again, the West experienced the largest drop, declining about 18 percent from its level a year ago. Deteriorating affordability appears to have hurt homes in high-priced areas more significantly than in lower-priced areas. In the past, potential homebuyers could switch to adjustable mortgage products to increase their purchase power. For example, data from Federal Housing Finance Agency's Monthly Interest Rate Survey (MIRs) showed that the ARM share of loans closed surged to 60 percent in 1994, when the yield on 30-year fixed mortgage rates jumped by more than 2 percentage points during the course of the year.

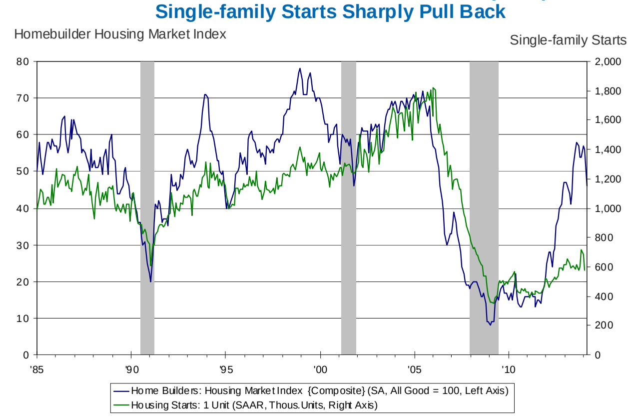
ARM Originations Have Been Subdued in Recent Years



Source: Federal Housing Finance Agency, CoreLogic

Since monthly ARM share from the MIRs was discontinued in 2008, we can observe more recent trends of the use of ARMs based on CoreLogic mortgage originations data. While the ARM share has risen modestly since 2009, it will likely remain subdued going forward, given tighter lending standards for ARMs and the new Qualified Mortgage rule that took effect in January of this year, which curtailed availability of the riskier ARMs, including interest-only products and those with balloon payments. The limited ability of potential homebuyers to switch to ARMs in the face of declining affordability in the current environment supports our cautious outlook for existing home sales, which we expect to rise just 1.0 percent this year. (For more details on the use of ARMs during period of declining affordability, see Orawin T. Velz, "[Enhancing Affordability Through Adjustable Rate Mortgages: Not What It Used to Be]()," *FM Commentary*, March 17, 2014).

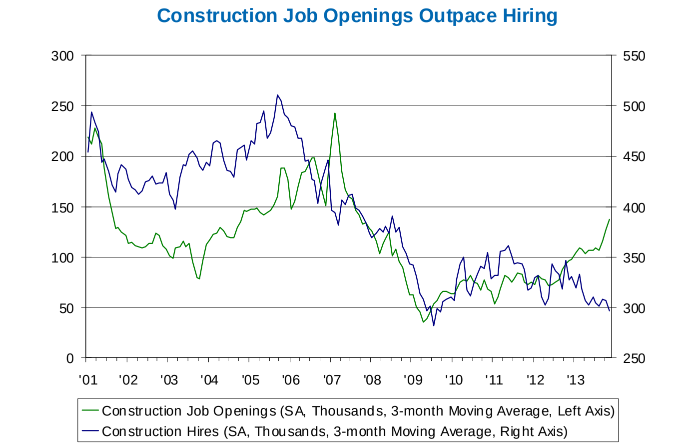
Builders' Confidence Posts a Record Monthly Drop as Single-family Starts Sharply Pull Back



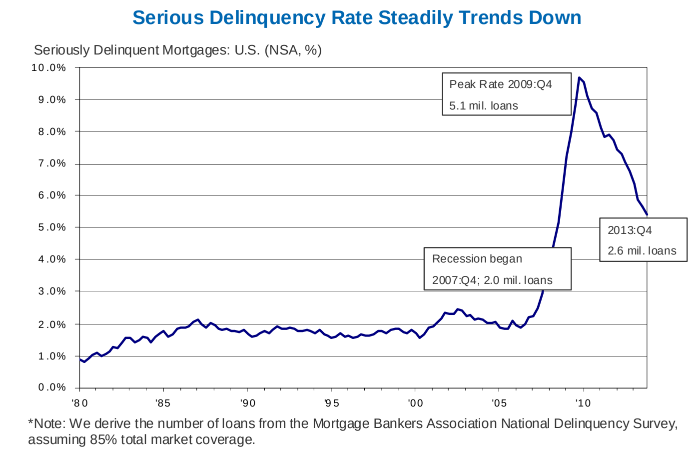
Source: Bureau of the Census, National Association of Home Builders

Homebuilding activity also took a hit, with housing starts declining 16.0 percent in January. Building permits, which are less sensitive to weather, also fell modestly during the month but remained higher on a year-over-year basis. The

Wells Fargo/National Association of Home Builders' Housing Market Index, a measure of builders' confidence, eroded sharply in February, posting a record monthly drop since the inception of the series in 1985 of 10 points to 46. This marks the first time since May 2013 that the index sat below the breakeven point of 50. The index now indicates that more than half of the respondents view the market as poor versus good.

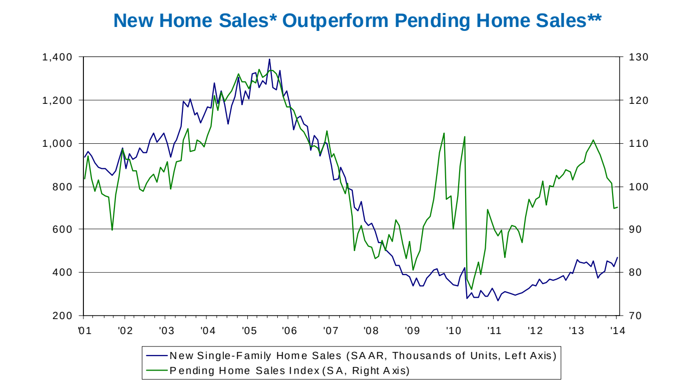


Source: Bureau of the Labor Statistics Job Openings and Labor Turnover Survey



*Note: We derive the number of loans from the Mortgage Bankers Association National Delinquency Survey, assuming 85% total market coverage.

Source: Mortgage Bankers Association



*New home sales measure contract signings of new homes

**Pending home sales measure contract signings of existing homes

Source: Census Bureau, National Association of REALTORS®

The weather suppressed buyer traffic, but builders also expressed a wide range of concerns including difficulties in securing finished lots, materials, and skilled labor. Despite disruptive weather during the past two months, the February jobs report suggests a modest impact on total construction payrolls, which rose 15,000 following a 50,000 gain in January. During the current recovery, total construction employment, which includes employment in both residential and commercial real estate, posted a peak-to-trough job loss of 2.3 million jobs and has since recovered just 509,000 jobs through February of this year. It appears that the bulk of workers may not be returning after four years of weak construction job prospects. Data from the January Job Openings and Labor Turnover Survey (JOLTS) showed that job openings in the construction sector have trended up steadily, returning to pre-recession levels; however, hiring has remained at depressed levels.

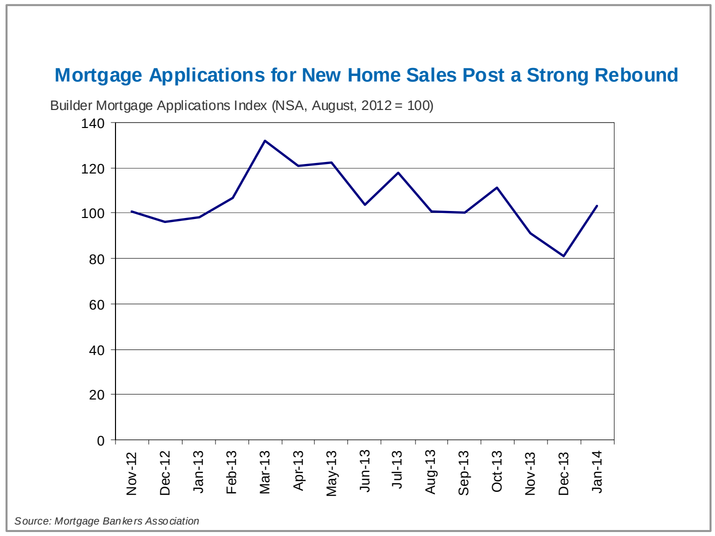
We expect housing starts to rise nearly 20 percent to 1.1 million units this year. Our forecast faces downside risks related to the constraints that may impede the ability of builders to ramp up supply. We remain optimistic on the demand side in the new home market, which is facing less competition from foreclosures and distressed properties. Data from the Mortgage Bankers Association show that the overall mortgage market serious delinquency rate, which includes mortgages 90 days or more past due or in the foreclosure process and a proxy for a shadow inventory, fell to 5.41 percent in the fourth quarter of 2013, gradually trending down from a peak of 9.67 percent reached in the fourth quarter of 2009.

New home sales were the sole exception to the recent weakening housing activity, jumping nearly 10 percent in January to the strongest sales pace since July of 2008. The upbeat new home sales trend supports our forecast of a 21 percent rise in sales this year. Like pending home sales, which measures contract signings of existing homes, new home sales measure contract signings rather than closings. The two series show the very different performance between the new home and existing home markets.

Months' supply of new homes fell to 4.7 months in January from 5.2 months in December, supporting the need for increased homebuilding activity. The brighter outlook for new home sales relative to existing homes sales also is evident in the more upbeat performance of mortgage applications for new homes.

Despite slowing momentum for housing activity in the second half of last year, measures of home prices finished 2013 on a firm note, suggesting further upward momentum in 2014, especially in today's tight supply environment. However, a pullback in the demand in the existing home market points to moderating gains going forward.

Mortgage rates have moved within a narrow range this year, with the yield on 30-year fixed mortgage rates hovering between 4.2 percent and 4.5 percent. Our forecast of mortgage rates for this year is little changed from the previous forecast, with the yield on the 30-year fixed-rate mortgage expected to rise gradually, averaging 4.6 percent during the final quarter of 2014.



Our projected home sales for this year also is similar to our February forecast. For mortgage production volume, we revised lower both the purchase and refinance forecast volume by about $70 billion to account for slower than anticipated near-term activity. We expect total single-family mortgage originations to decline approximately 34 percent to $1.21 trillion for all of 2014, with a refinance share of 39 percent—the lowest since 2000. Total single-family mortgage debt outstanding resumed its declining trend in the fourth quarter, sliding 0.4 percent annualized after rising in the prior quarter for the first time since early 2008. The drop was the smallest since the first quarter of 2009, however. Single-family mortgage debt outstanding fell 0.7 percent from a year ago, extending the string of annual declines to six years. We expect the deleveraging process to end this year, with mortgage debt outstanding posting a rise of 0.7 percent.

For information on multifamily market conditions, read the March 2014 Multifamily Market Commentary.

Doug Duncan, Orawin T. Velz, and Brian Hughes-Cromwick
Economic and Strategic Research

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