

Transition to Normal Continues

At the beginning of the year, we introduced this year's theme—Transition to “Normal”? Herewith, a bit of data on the economy's transition: Growth in the first quarter of 2013 registered 2.4 percent annualized before dropping off to a forecasted 1.2 percent in the second quarter. We do expect growth in the second half of the year to push toward 2.5 percent for a full year growth rate of 2.1 percent, after an anemic 1.7 percent in 2012. We expect growth in 2014 to push past 2.5 percent for the year.

Four years into an expansion, it appears that the U.S. may be well into a prolonged period of sub-par, though sustainable, growth, with an annual growth rate between now and the end of the decade averaging between 2.25 and 2.50 percent. While the rate of real annual GDP growth believed to be “normal” is a subject of some debate among economists, consensus will likely come in at 2.75 percent. Thus, we expect a bit slower growth than the potential of the economy. If we are wrong, growth will likely be stronger than our baseline forecast, with housing and energy development as the primary drivers.

Since 1960, the average expansion has been four and a half years and the current expansion turns four years old this month. The longest expansion was ten years. Given the degree of monetary stimulus being provided, we believe it is unlikely that the current expansion will end soon. In addition, the Fed is keeping its options open and can provide more stimulus if the economy shows signs of faltering. And, while the sequestration is one aspect of a tighter fiscal policy, 2014 is a midterm election year and the Federal government rarely tightens fiscal policy in an election year.

For the intermediate term then, our view has been little changed since the start of the year: modest growth for this year before accelerating moderately next year, and a durable recovery—a journey to normal—for the housing market. In our analyses during the past six months, we have shown that many aspects of the housing market, including homebuilding activity and construction employment, are expected to transition to normal market conditions around 2016. We will continue to analyze other aspects of this theme for the rest of the year.

Big Picture: Modest Recovery Amid Fiscal Headwinds and Housing Tailwinds

While our overall view of the economy has not fundamentally changed over the last six months, we have encountered some surprises along the way. On the downside, fiscal policy turned out to be more restrictive than we had initially anticipated, as sequestration occurred largely without alteration against our expectations of some modified version with less fiscal restraint. On the upside, consumers were much more resilient during the first quarter of this year to a series of fiscal restraints, including the expiry of the payroll tax holiday, tax hikes on upper-income households and those associated with the Affordable Care Act, and the sequester. The robust gain in equities and accelerated home price gains bolstered household balance sheets in the first quarter, helping to offset some of the negative impact of tax increases on consumer spending.

The second print of first quarter gross domestic product (GDP) showed that the headline economic growth was revised a touch lower to 2.4 percent annualized, but the composition signaled an improvement in the underlying private demand. However, recent data showed signs that these fiscal drags have begun to affect consumer spending, and its growth will likely slow meaningfully, depressing overall economic growth in the current quarter. Data from other sectors, including manufacturing and trade, are consistent with a slowdown in activity in the near term. However, housing activity was largely positive entering the spring/summer season. Despite rising mortgage rates during the past month, affordability conditions have remained historically high and should not present a significant obstacle to potential homebuyers.

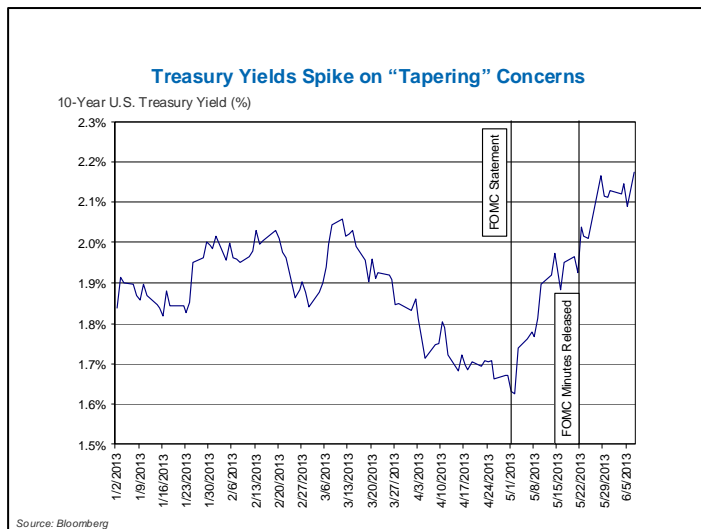
We maintain our view that economic growth will stay below 2.0 percent in the first half of 2013, suppressed by fiscal drags. We expect growth to strengthen gradually in the second half of the year and into 2014, as the impact of fiscal drags wanes amid the expected continued housing recovery, rising household wealth, and expanded energy production. For all of 2013, the economy should grow by a modest inflation-adjusted 2.1 percent annualized, an improving pace from 1.7 percent in 2012. Growth should continue to move in the positive direction to 2.6 percent in 2014.

Fiscal Policy: Negative Impact Will Subside

Government spending declined sharply again in the first quarter, subtracting 1.0 percentage point from GDP following a drag of 1.4 percentage points in the prior quarter. We expect government spending to act as a drag through the rest of the year, but the impact should be steadily smaller as the year progresses. The debt ceiling was reinstated on May 19, and Treasury has initiated “extraordinary measures” to prevent the nation from entering default scenarios. Due to increased receipts at Treasury, the government is not expected to reach a potential breach until possibly November.

Monetary Policy: “Tapering”? Not So Fast

While the next phase of fiscal headwinds appears to be postponed through the fall, the financial markets are now faced with uncertainty from monetary policy. The Treasury market started to sell off after the latest Federal Open Market Committee (FOMC) meeting on May 1, triggered by comments from Fed Chairman Ben Bernanke and other Fed officials that the Fed could soon scale back the amount of Treasuries and mortgage-backed securities it purchases if the labor market shows signs of sustained improvement. The selloff pushed Treasury yields higher across the curve, with the 10-year yield rising slightly more than 50 basis points since the beginning of May to 2.17 percent, its highest level in over a year, at the time of this writing.



Meanwhile, measures of inflation have been declining, allowing the Fed to focus on the full employment mandate rather than the price stability mandate. The Fed’s preferred measure of inflation—the personal consumption expenditures price index—fell 0.3 percent in April from March and rose just 0.7 percent from last April, well below the Fed’s target of 2.0 percent.

Given the economic backdrop of continued fragile economic recovery and an uneven labor market improvement, we continue to expect that the Fed will begin tapering its asset purchases next year rather than this year, when the economy gains firmer footing. A reduction in securities purchases could occur before that, but it would require meaningful improvement in labor market conditions. While the employment picture improved somewhat in May (more below), we expect job gains to slow in coming months. We also maintain our expectation that the Fed will begin hiking

the target fed funds rate in the second half of 2015, when our projected unemployment rate reaches 6.5 percent, consistent with the Fed’s rate guidance.

Manufacturing: Losing Momentum

The manufacturing industry is struggling, weighed down in part by the global economic slowdown. In addition, the inventory cycle also has run its course and likely will no longer add to growth. Manufacturing output fell 0.4 percent in April, marking the second consecutive monthly decline. While factory orders rose a modest 1.0 percent following a plunge in March, the details that have implications for capital investment remained soft.

Regional and national surveys of corporate purchasing managers suggest that the slowdown in activity will continue in the near term. The Institute for Supply Management (ISM) manufacturing index for the nation declined in May into contraction territory for the first time since November 2012, with the index falling to its lowest reading since the recession ended in June 2009. The details showed weakness across the board, with current production and the important forward-looking new orders component declining, providing little hope for much of an improvement in the near term. The employment component remained barely in expansion territory for the second consecutive month, in line with manufacturing payrolls data in the May employment report, which fell for the third consecutive month.

However, the manufacturing industry has an upside potential in the energy sector that bears watching. The widespread adoption of new drilling and exploring techniques has increased the domestic supply, lowering the price of natural gas in the U.S. relative to those abroad and providing a huge cost advantage to produce a variety of related goods in the U.S., including fertilizer, solvents, and plastics. The petroleum and natural gas sector currently accounts for about one-third of

nonresidential structures investment, and its share is rising rapidly. Furthermore, rising domestic energy production has increased the country's independence, helping to reduce net exports and its drag to GDP.

Employment and Income: Slow, Uneven Healing

The May employment report offered mixed news on the labor market. The headline nonfarm payroll gain of 175,000 was solid—the best showing in three months. However, the downward revisions of a combined 12,000 jobs in the prior two months put the average monthly gain over the last three months at 155,000 jobs, much slower than witnessed earlier in the year. In addition, average weekly hours and average hourly earnings were flat—at a time that consumers could use more support.

The unemployment rate from the survey of households also deteriorated, rising one tick to 7.6 percent, but that was because the number of the people joining the labor force outpaced a strong increase in household employment. This is a desirable development, as it suggests that an improving market is drawing some people who previously stopped looking for work to re-enter the market. The labor force participation rate rose for the first time in seven months, ticking up 0.1 percentage point to 63.4 percent.

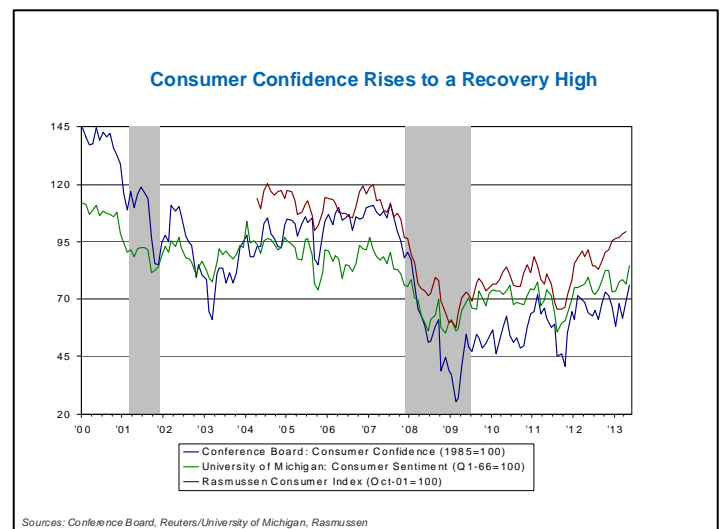
The recent income trend has been choppy. The second print of GDP revised higher the pace of real (inflation-adjusted) personal income growth in the fourth quarter, as the bonus income pulled forward ahead of the expiration of the Bush-era tax cuts was greater than initially reported. However, the first quarter income growth was revised to show a larger decline. The monthly April data showed an anemic rise in real disposable income. Combined with flat average hourly earnings from the May employment report, the recent income trend bodes poorly for consumer spending in the near term.

Consumers: Spending Less but Feeling Better

Real consumer spending edged up 0.1 percent in April, the weakest gain in six months. Some of the weakness reflected an unwinding of the surge in spending for home heating associated with the unusually cold March. The anemic April gain in consumer spending will likely be revised to a modest decline as a result of the annual revision to the retail sales report. The report showed a downward revision in April core retail sales (which exclude autos, building materials, and gasoline stations and are an input to estimate consumer spending) from a strong 0.5 percent gain to a 0.1 percent drop, the first monthly decline since last June. This revision has not yet been incorporated in the April consumer spending data.

Moreover, the release of the Quarterly Services Survey—a comprehensive source of data for spending on services—suggests considerably less consumer spending on services in the first quarter than the Bureau of Economic Analysis assumed. It is possible that the third (and final) print of first quarter GDP will downgrade consumer spending on services, which suggests less momentum for the current quarter. Thus, despite an encouraging rebound in May auto sales, we expect consumer spending growth to slow to 1.7 percent annualized in the current quarter—half the pace currently reported for the first quarter.

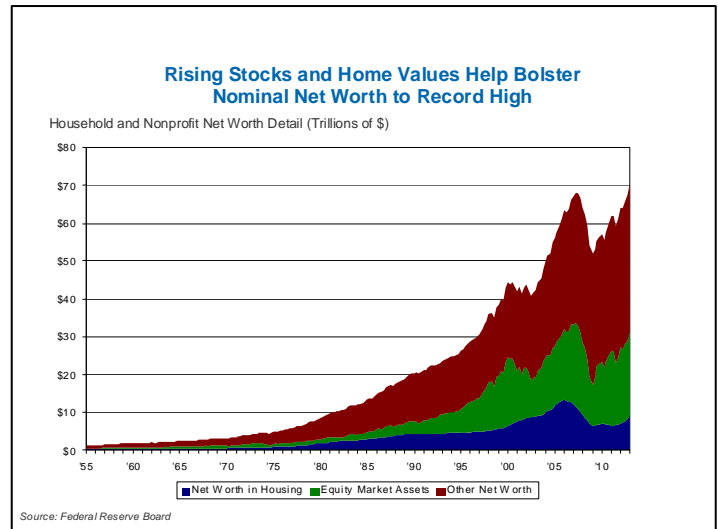
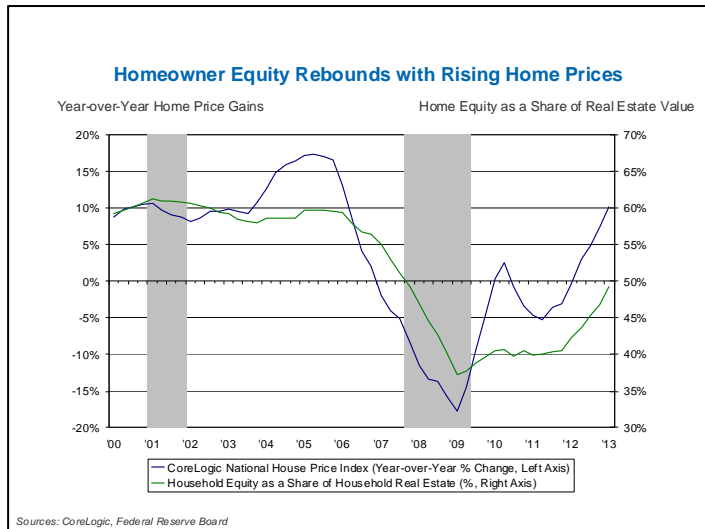
One piece of upbeat news on the consumer front emerged from surveys of consumer confidence. The Conference Board index of consumer confidence soared in May to a fresh recovery high. Other gauges of confidence were similarly bullish: The Rasmussen and the Reuters/University of Michigan measures all hit recovery highs during the month.



A number of factors have helped to drive sentiment higher. The labor market continues to improve slowly, and declining trends in jobless claims and layoffs have helped soothe consumers' fears of losing jobs. As we mentioned earlier, political headwinds have moved to a back burner, at least until the fall. Equities posted impressive performance through the end of May, though they have pulled back somewhat in early June. Home price gains also have accelerated. During the first quarter, the CoreLogic home price index, which is used by the Federal Reserve to estimate the value of housing in the

Financial Accounts of the U.S. (formerly known as the Flow of Funds Accounts), showed the strongest year-over-year rise since the first quarter of 2006. The index briefly posted year-over-year increases in 2010, when the homebuyer tax credit was in effect, but it has persistently increased since the second quarter of 2012, helping to boost homeowner equity. Household equity as a share of household real estate, which hit a record low in the first quarter of 2009 at 37.3 percent, rebounded slightly and moved sideways between 2010 and 2011. It has begun to move up steadily since early 2012 when home prices bottomed, reaching 49.2 percent in the first quarter of this year, the highest since the end of 2007.

Combined with rising stock and other asset prices as well as shrinking debt, rising homeowner equity during the past year has helped household net worth (assets minus liabilities) regain the massive decline of \$16 trillion recorded during the recession. Net worth jumped \$3.0 trillion during the first quarter, reaching a record high in nominal terms of \$70.3 trillion.

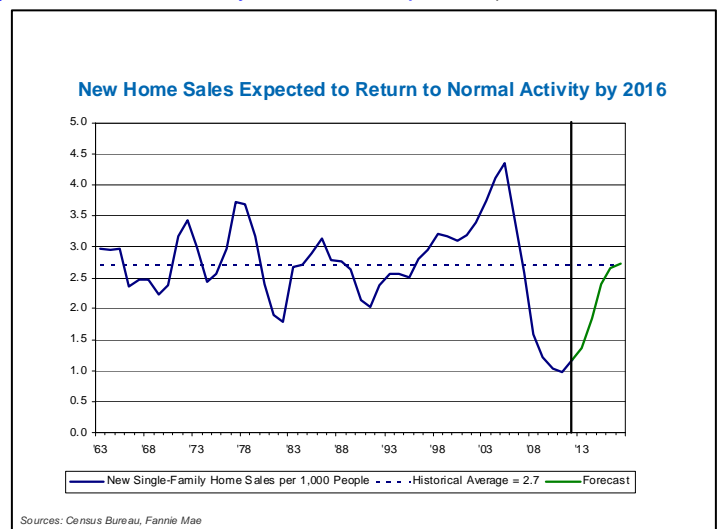


Housing: Upward Momentum Builds

Home sales, especially for new single-family homes, were upbeat in April, rising to the highest level since April 2010. Following a 20 percent rise in 2012 from a record low in 2011, year-to-date sales through April were 26 percent above those last year. Despite the surge in new home sales over the past two years, the level of sales has remained near the record low relative to the size of the population. Our forecast calls for steadily rising new home sales, reaching normal levels by 2016, when the ratio of new home sales per 1,000 population approaches 2.7 percent. This would mark a 10-year process of transition from the downturn back to normal activity, coinciding with our expectations of normal activity for homebuilding activity, existing home sales, and construction employment. (For previous research on a transition to normal of these housing indicators, please see [January 2013 Developments](#) and [February 2013 Developments](#)).

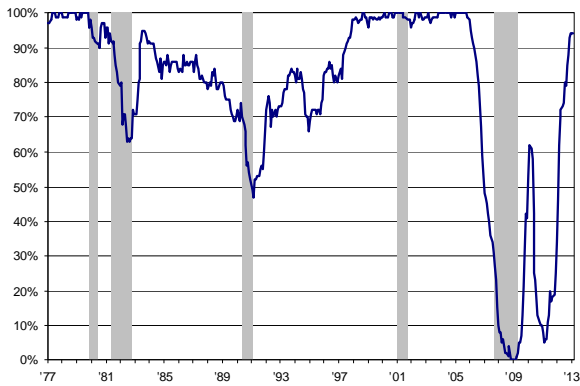
Other housing activities were largely positive. Existing home sales edged up in April, reaching their highest level since mid-2009. However, after hitting an annualized pace of 1 million in March for the first time since mid-2008, housing starts fell sharply in April, primarily because of the volatile multifamily sector. (For more information on multifamily market conditions, read the [June 2013 Multifamily Market Commentary](#)). Leading indicators of building activity remain bullish, as housing permits jumped during the month to a 1 million unit pace, and home builders' confidence rebounded in May after three consecutive monthly drops, with the expected sales component rising to a seven-year high.

Key to our view of a durable housing recovery is the turnaround in home prices, with several measures of home prices showing accelerating gains so far this year. In



Home Price Gains Are Widespread

Share of Top 100 Core-based Statistical Areas (CBSAs) with Year-over-Year House Price Growth



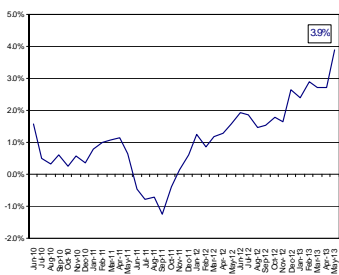
Source: CoreLogic

In addition to rising at a rapid clip, home price gains also are widespread. According to CoreLogic, home prices in more than 90 percent of the top 100 metro areas posted year-over-year gains every month this year.

The expectation of rising prices may entice potential homebuyers to get into the market. For those who want to sell but have waited for better prices, rising home prices amid tight inventories signal more favorable selling conditions. Consumer expectations have gradually caught up with the strength of the housing market. The [May 2013 Fannie Mae National Housing Survey](#) showed a surge in consumer expectations of home price gains during the next 12 months. Furthermore, the share of respondents who say now is a good time to sell posted the biggest jump since the survey's inception.

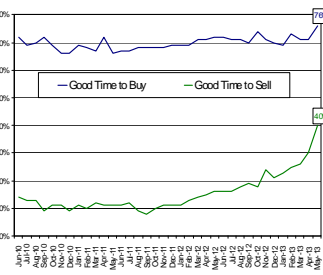
Expectations Regarding the Housing Market Improve Meaningfully

Average 12-Month Home Price Expectation (%)



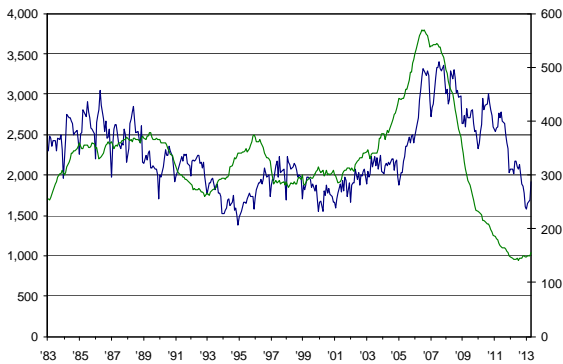
Source: Fannie Mae National Housing Survey, May 2013

Share of Respondents Indicating it is a ...



Declining distressed sales as well as limited inventory levels have been key drivers of rapid house price appreciation. A survey from the National Association of REALTORS® showed that the share of distressed sales declined in April to 18 percent—10 percentage points below the share last April. This marks the first time since 2008 that the share stayed below 20 percent. However, signs that tight supply conditions are easing have emerged, at least in the existing home segment, with the number of existing homes listed for sale having risen sharply over the last several months. By contrast, the number of new homes available for sale has only gradually trended up from a record low seen last summer.

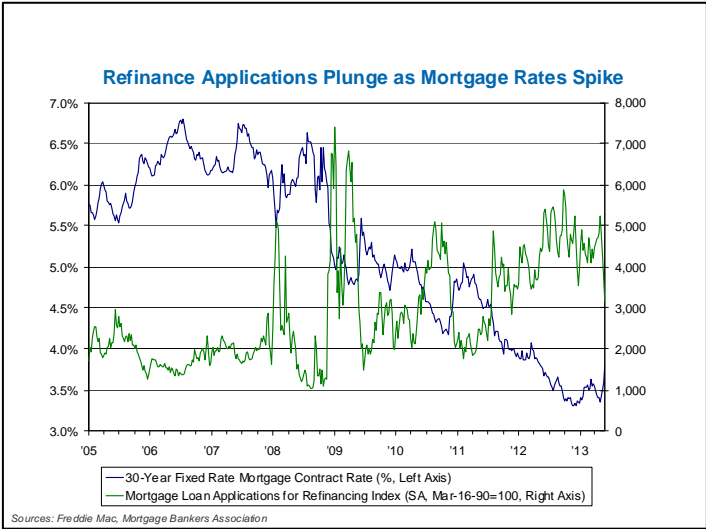
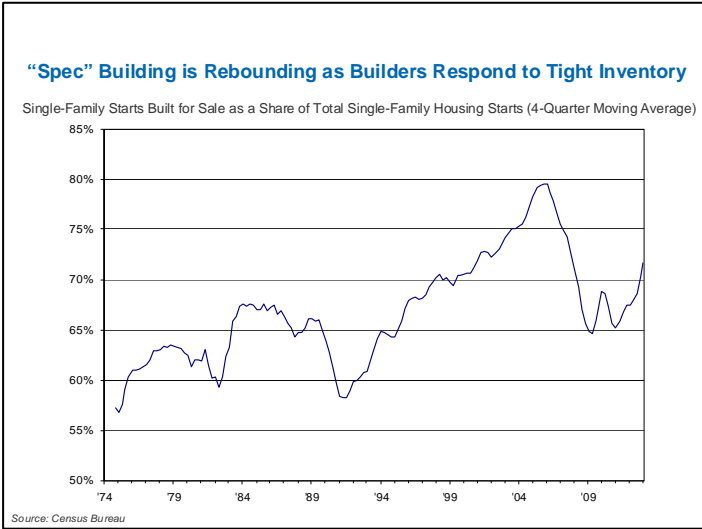
Tight Inventories of Existing Homes for Sale Show Signs of Easing



Sources: Census Bureau, National Association of REALTORS®

Tight inventory in the new home market has created an opportunity for speculative (or spec) building—a house built in advance without a contract signing from a buyer. Building on spec was common during the housing boom, as builders attempted to keep up with soaring demand. Spec building as a share of single-family starts surged to nearly 80 percent late 2005 before falling sharply during the housing downturn, reaching its trough in 2010. The share has steadily trended up, although the number of single-family starts has remained at historically low levels.

Mortgage rates spiked to approximately 3.90 percent in early June from 3.35 percent in early May, according to the Freddie Mac primary mortgage market survey, and have already impacted mortgage demand, especially for refinancing. After trending up in March and April, mortgage applications for home purchase fell 6 percent between the first and the last week of May but have remained more than 10 percent above their levels a year ago. Meanwhile, refinance applications fell almost 40 percent during the same period.



Our forecast of mortgage rates is approximately 50 basis points higher than the previous forecast, with the yield on the 30-year fixed rate mortgage rising to 4.7 percent by the end of next year. Despite the backdrop of rising rates, we expect the housing recovery to continue, with projected housing starts and home sales rising this year by 25 percent and 7 percent, respectively. For mortgage production volume, we revised higher our estimate of 2012 total mortgage originations as we believe that we underestimated the amount of originations held by depository institutions' portfolios. In addition, since there are no official data on mortgage originations, we occasionally benchmark our estimate to various data sources, which suggest an upgrade to our 2012 estimate of total mortgage originations from \$1.92 trillion to \$2.02 trillion, largely on the refinance component. The upgrade also lifted the trajectory for 2013 originations by about \$75 billion to \$1.74 trillion, with a slightly higher refinance share of 65 percent. While the increase in our projected mortgage rates only reduced our forecast of refinance originations slightly during the final quarter this year, it significantly decreased our projected refinance originations in 2014. For mortgage debt, the latest data from the Federal Reserve showed that total single-family (1-4 properties) mortgage debt outstanding fell 2.3 percent annualized in the first quarter of this year. We expect it to post a slight gain for all of 2013, marking the first annual increase in six years.

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 Economic and Strategic Research
 June 10, 2013

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