Growth Is Stalling, But Not Stalled

Will Supply Chain Repair Provide Second Half Support?

This month marks the two-year anniversary of the current economic expansion, which so far has been quite disappointing. The prospects for accelerating growth have grown dimmer recently with downward revisions of first-quarter activity and most economic data for the current quarter being downbeat. Markets have reacted quite negatively, but the question is whether the repeated onslaught of global shocks has generated an over reaction. We believe the doomsayers are wrong; nevertheless, growth is slowing appreciably and recession risks have risen.

A revision to first-quarter economic growth indicated that consumer spending was much weaker than initially believed, due in part to a sharp downward revision to real (inflation-adjusted) disposable personal income in both the first quarter of 2011 and fourth quarter of last year. Weakness in activities for the current quarter has been broad-based, spanning across consumer spending, manufacturing, jobs, and housing. The drop in auto output stemming from the supply chain disruptions explained weakness in one component of manufacturing activity as it fed through initial jobless claims, manufacturing payrolls, and auto sales, but there was additional weakness in the sector.

We expect that declining auto output will deduct about one half of a percentage point from second-quarter growth, much more than we previously projected, but that loss is likely to be made up later as production ramps back up, according to the production schedules released by auto makers. However, much of the slowdown in overall economic activity cannot be explained by temporary factors. As a result, we revised lower our projected growth in the current quarter, which shapes up to be only slightly stronger than the anemic pace in the first quarter, and also revised lower our projected growth for the second half of the year.

We believe the likelihood that the economy will slip into another downturn within a year is still quite low, but has risen slightly. For 2011, we now expect economic growth to come in at 2.5 percent, a downgrade from 2.9 percent in the previous forecast and more than a full percentage point lower than our forecast at the start of this year. International headwinds include continued European sovereign debt problems, a marked slowdown in growth in China as it fights rising inflation, and the trade-related effects of reduction in Chinese economic activity. Domestic headwinds are led by dampening effects surrounding U.S. monetary and fiscal policy.

Ultimately, employment remains the key to the outlook for the economy and the housing market. If the tentative labor market recovery falters amid signs of a slowdown in consumer demand, it could jeopardize the projected moderate rebound in home sales later this year. Continued deterioration in home prices, tight lending standards, and households' desire to reduce their debt loads much further are among the main risks to the housing market and the overall economy.

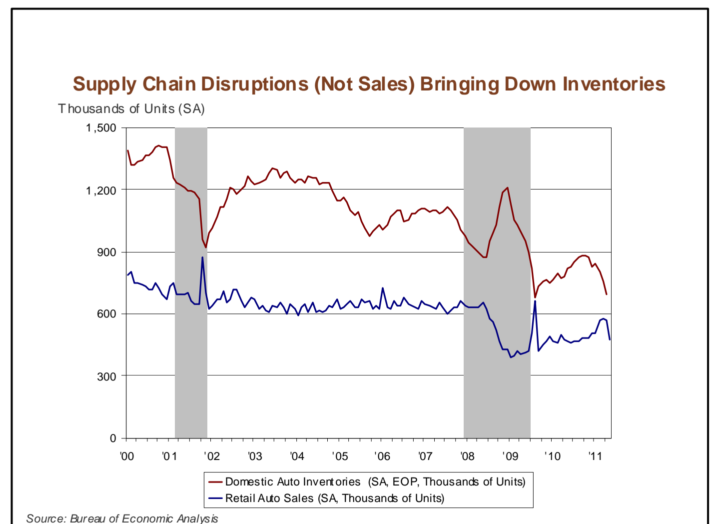
Economy: Stuck in Low Gear a While Longer

The revisions to first-quarter gross domestic product (GDP) revealed a different composition of growth though the level was unchanged. The revision was less optimistic on the consumer side as real consumer spending grew 2.2 percent, a slower pace than the initially reported 2.7 percent. Simultaneously, the inventory buildup was bigger than previously reported, which probably boosted first-quarter growth at the expense of the current quarter.

Supply Chain Disruptions…Will There Be a Second Half Rebound?

Manufacturing downshifted in the current quarter due to the combination of an inventory swing and supply chain disruptions. Industrial production was flat in April, taking a hit from a plunge in production of motor vehicles and parts. Durable goods orders posted a huge decline in April, and nondefense capital goods orders excluding aircraft, a leading indicator of business investment in equipment and software, fell for the third time in the last four months. Manufacturing payrolls fell in May for the first time in seven months. The Institute for Supply Management (ISM) manufacturing index fell

6.9 points in May, the biggest drop since the beginning of 1984. New orders, the forward-looking component of the index, plunged 10.7 points, suggesting that the factory sector will be a drag to growth for the second quarter.

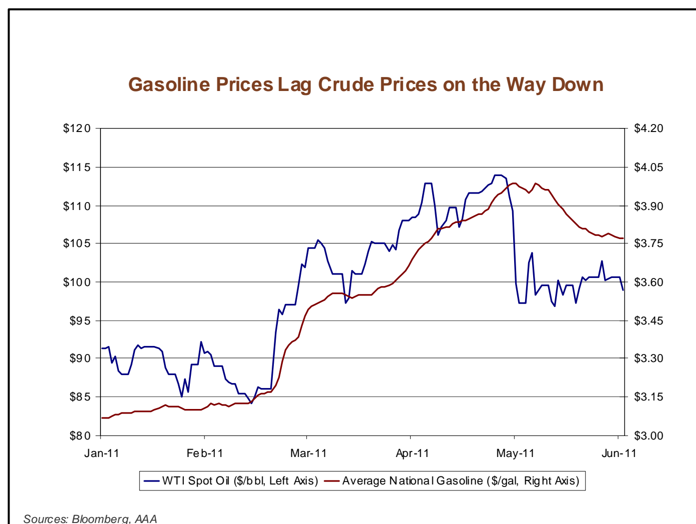


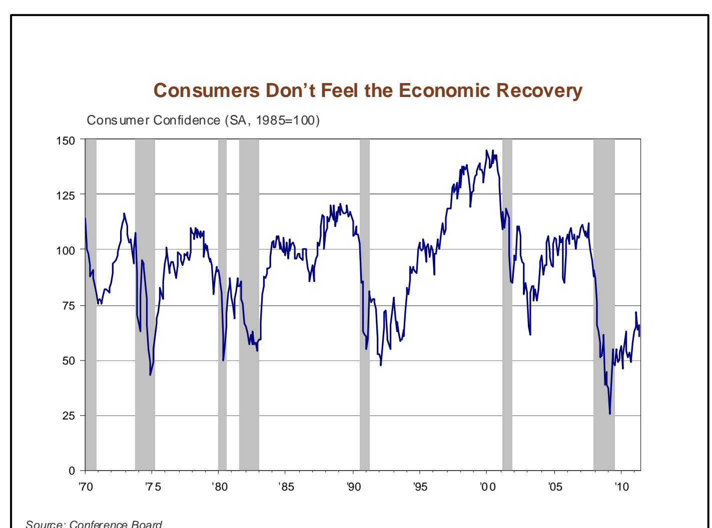
However, the ISM non-manufacturing survey suggested that service activity, which covers the vast majority of the economy, is still on track for continued expansion. After declining for three consecutive months following the surge in gasoline prices, the ISM non-manufacturing index rebounded modestly in May. This supports the notion that the economy is more likely to strengthen in the second half of the year, rather than continuing to grow at the anemic pace of the first half of the year.

Consumers Are Still Financially Wary

Personal income and consumer spending through April suggested consumers received less support from wage and salary income as higher gasoline prices eroded purchasing power. Inflation-adjusted incomes were flat again last month since December, and consumer spending posted an anemic 0.1 percent gain for the fourth time during the last five months.

Household net worth in the second quarter will likely take a hit from the recent selloffs in the stock market. From the end of April through the first week of June, the Wilshire 5000, the broadest measure of stock market value, fell nearly five percent. This will likely be a setback to the rebound in household financial wealth witnessed during the past three quarters as the Fed has sought to support a rebound in stock prices and therefore an improvement in household balance sheets. Housing wealth has yet to rebound, falling in the first quarter of this year for the fourth consecutive quarter, weighed down by declining home prices.





These factors led us to trim our forecast of consumer spending growth in the coming quarters. One positive for consumer fundamentals is that crude oil prices have backed off from their peak in late April and have hovered around $100 a barrel. The retail price of gasoline has been lagging the decline on crude prices, with gasoline prices trending down for the first time this year just around mid-May.

Leading indicators suggest soft consumer spending in May. Auto sales fell from more than 13 million annualized units in April to just below 12 million units, the first decline since last September. While supply chain disruptions were a factor and some of the drop in sales will likely be made up in coming months, it is unlikely that sales will return in the near term to 13

million units, the pace they have held during the past several months. Chain store sales also weakened in May, especially after excluding fuel purchases.

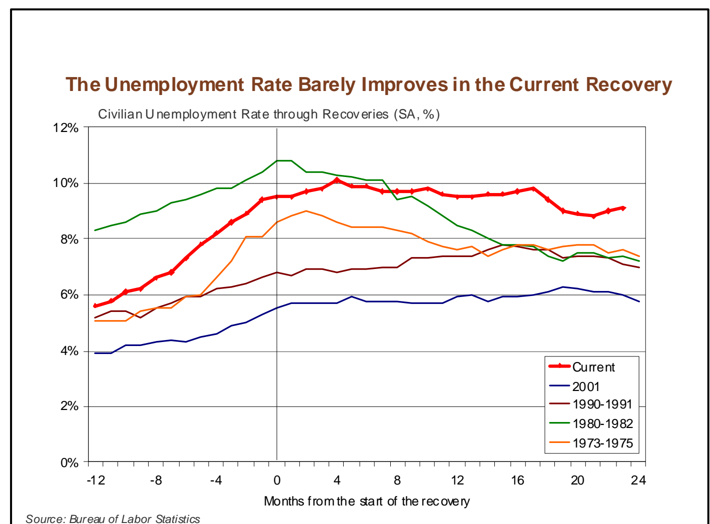
Consumers continue to be cautious with their debt usage. While consumer credit outstanding increased in April for the seventh consecutive month, the improvement during this period was largely due to student loans (which are classified as non-revolving Federal government credit). Despite loosening lending standards for consumer loans, revolving credit (largely credit card debt) has steadily declined each month since 2009, with the exception of only two months. The trend in credit card debt is consistent with moderate consumer spending growth going forward.

(Lack Of) Employment Growth Is The Continuing Theme

Nonfarm payrolls from the survey of establishments rose 54,000 in May, marking the smallest gain since last September. Revisions to prior months amounted to a loss of 39,000 jobs, resulting in an average monthly job gain of about 220,000 in the three months ended in April. The gain in private payrolls of 83,000 in May was the smallest since last June.

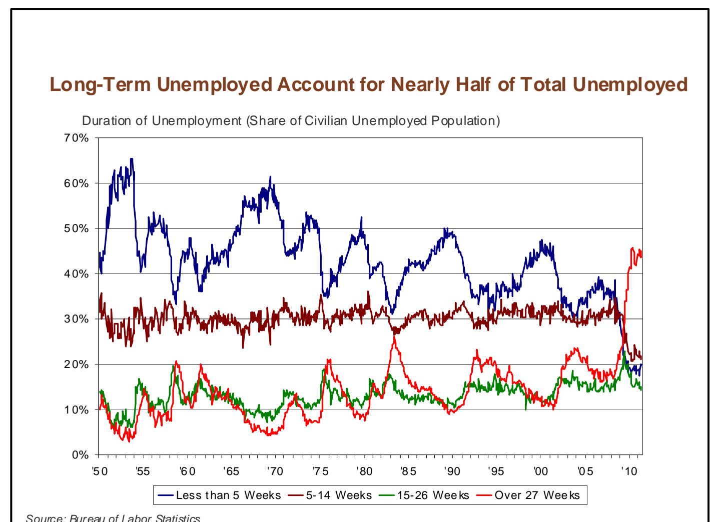
Weakness in hiring was broad-based, with far fewer industries adding jobs during the month. The diffusion index, which measures the breadth of hiring, fell to 53.6 percent in May, its lowest level since last September. (A reading of 50 percent indicates an equal balance between industries with increasing and decreasing employment). The index reached a cycle peak at 70.8 percent as recently as February of this year.

The unemployment rate edged up one-tenth to 9.1 percent in May, as an increase in the labor force outpaced a gain in household employment. The rate has been volatile lately, declining sharply from 9.8 percent to 8.8 percent between November 2010 and March 2011. Occasional increases in the unemployment rate during improving market conditions are not uncommon, as previously discouraged workers decide to rejoin the labor force when job prospects improve. However, it is now two years after the recession ended, and the unemployment rate in the current recovery has not trended down as quickly as it has in previous recoveries. We expect the rate to move lower very gradually throughout the year, remaining at an elevated level of 8.8 percent by the end of 2011.

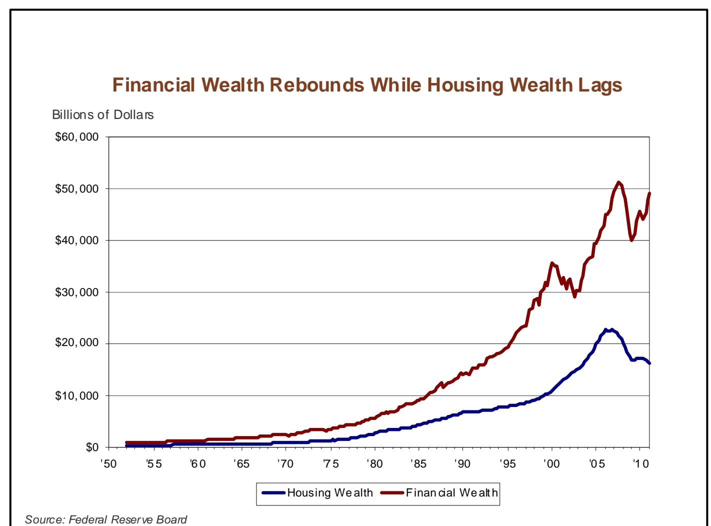


The picture on long-term employment is very troubling. The so-called long-term unemployed (those who have been out of a job longer than 27 weeks) make up nearly half of the unemployed.

This has pushed the average duration of unemployment up to a record high of 39.7 weeks, roughly doubling the previous peak following the 1981–82 recession. Other reports on labor market conditions confirm that the labor market has lost momentum. The underlying trend of initial jobless claims deteriorated. For several weeks in February and March, claims dipped below 400,000. However, in each of the past nine weeks, claims have remained above 400,000. So far in the current quarter, claims have averaged 425,000 per week, up from 406,000 during the first quarter.



In turn, deteriorating labor market conditions weigh on consumers. The Conference Board consumer confidence index fell 5.2 points to 60.8 in May, the lowest level since last November and about eleven points below its recent peak in February. Since the recovery began, the index has averaged near levels seen during the past five recessions, implying that consumers again continue to feel downtrodden, similar to the way they have felt during previous typical recessions.



Source: Federal Reserve Board

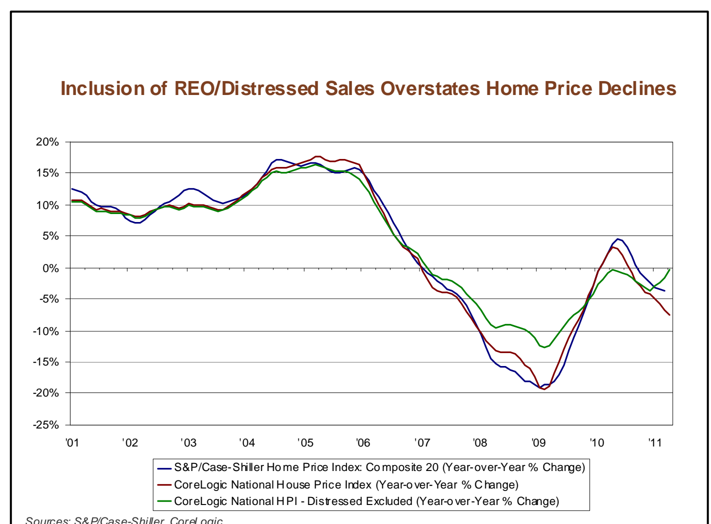
Housing: Stuck in a Rut

Most housing indicators started the second quarter with little momentum. Single-family starts have remained at depressed levels as the new home market continues to face tough competition from foreclosures. The National Association of Home Builders/Wells Fargo housing market index, a gauge for builders' confidence, remained at 16 in May for the sixth time during the last seven months. (A reading of 50 indicates neutral market conditions, where half of the respondents view conditions as good and half view them as poor).

Sluggish construction activity is one of the reasons the current economic recovery is much more moderate than previous ones. While total construction spending rose in April, it was because of a surge in the volatile home improvement component (both single-family and multifamily construction spending declined). Excluding the improvements category, construction spending dipped to a level below the first quarter's average, dashing the hope for a weather-related rebound in residential investment in the second quarter. Single-family construction spending fell for the third consecutive month, reaching its lowest level since July 2009. Public construction spending dropped for the seventh consecutive month as state and local budgets continue to be under pressure.

Market conditions continue to favor multifamily and rental housing, as demand is outpacing supply in many areas, pushing rents up. (For more information on multifamily market conditions, read the *June 2011 Multifamily Market Commentary*). Given their strength in the first quarter, we revised higher our multifamily starts projection for this year. Total housing starts are expected to increase 3.5 percent, solely because of a rise in multifamily starts. Single-family starts are expected to fall modestly this year from last year.

The inventory of new homes available for sale fell to a record low in April. At the same time, new home sales advanced for the second consecutive month from a record low reached in February. The drop in inventory, combined with rising sales, brought the months' supply down to 6.5 months, within reach of the long-term average of about six months. This is progress on the supply side.



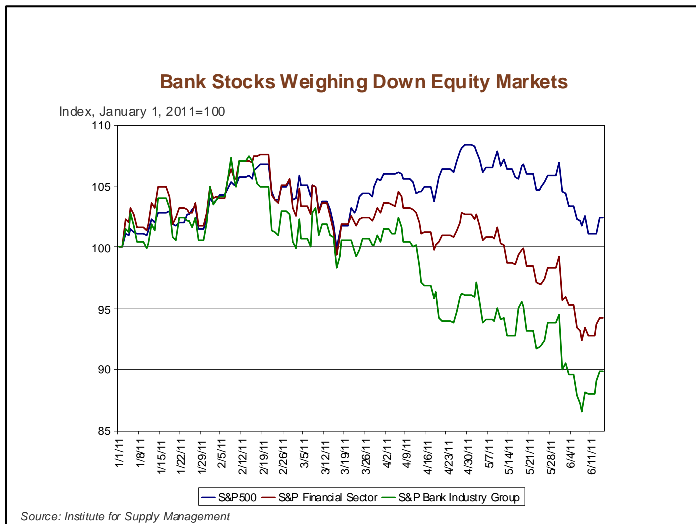
Sources: S&P/Case-Shiller, CoreLogic

Meanwhile, existing home sales disappointed, declining modestly in April despite the increase in March pending home sales and purchase mortgage applications. The National Association of REALTORS® (NAR) attributed the lackluster housing market to "unnecessarily tight credit" and a steady flow of low appraisals. A separate survey of practitioners from NAR showed that, because of low appraisals, about a quarter of REALTORS surveyed had to

cancel contracts or renegotiate them at a lower price.

The NAR survey showed that distressed and cash sales continued to account for large shares of the market, supported by investor activity. The share of distressed sales was 37 percent, compared with 40 percent in March, while the share of all-cash transactions stood at 31 percent, down from a record high of 35 percent in the prior month. Continued declining distressed sales share, which would reduce the discount component, could provide a badly needed lift to home prices in the second quarter.

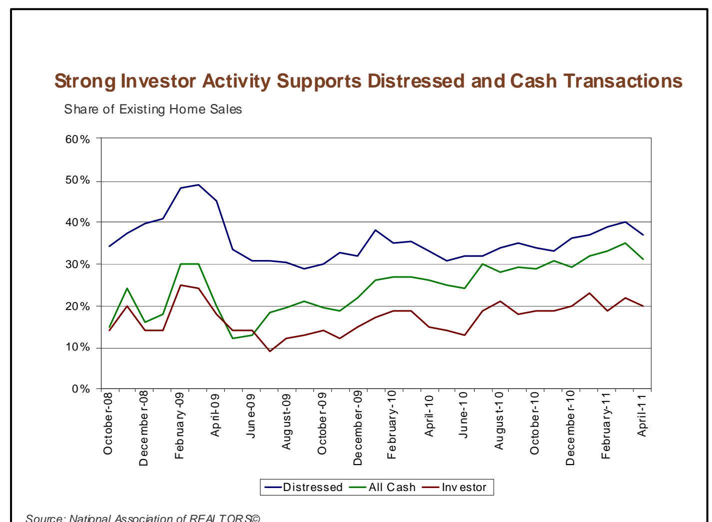
However, the near-term outlook for home sales appears gloomy. Mortgage purchase applications fell slightly in May and dropped further in early June. Furthermore, pending home sales plummeted nearly 12 percent in April. Together, these leading indicators bode poorly for spring season sales.



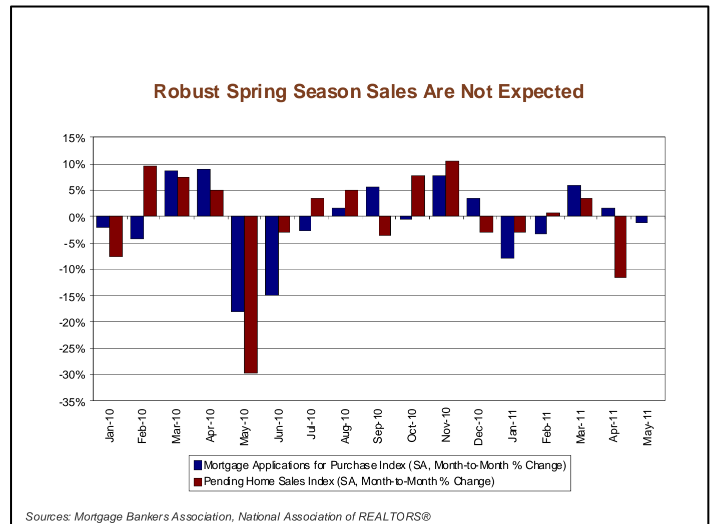
There was some welcome news for mortgage performance for the first quarter as the Mortgage Bankers Association reported that short-term mortgage delinquencies remained near their pre-recession levels. Loans 90 days or more past due have dropped for five consecutive quarters and are at their lowest level since the beginning of 2009. Foreclosure starts posted the second largest drop on record during the quarter, reaching the lowest reading since the end of 2008. The percentage of loans in the foreclosure process also fell sharply, albeit from a record high in the prior quarter. Overall, these data indicate that the shadow supply of housing may have peaked, although remaining at very elevated levels. It will likely take years for the excess supply and the shadow supply of housing to be absorbed, even with a meaningful improvement in the labor market and household formation, which has been elusive so far.

Elevated inventories continue to put downward pressure on home prices, with major measures of home prices falling in March, continuing the trend that started since the end of the homebuyer tax credit last summer. However, most third-party price indices adjusted for distressed sales seem to indicate that troubled loans being put through foreclosure are getting seasonally adjusted (foreclosure is not a seasonal activity), and also are likely causing an over statement of price declines for “arms length” transactions.

The large price discounts associated with high distressed share serve to depress appraisal values, leading to some delayed or cancelled contracts. Deteriorating expectations of home prices also persuade more potential homebuyers to delay pulling the trigger on the purchase of a non-distressed home. Continued declining home prices will hamper household net wealth and weigh on consumer confidence and consumer spending.



The weak housing numbers and slowing economy is raising fears in the minds of investors and regulators over the health of bank portfolios and bank capital adequacy. Bank stock valuations have been in decline relative to the rest of the equity market and are dragging down the overall measures. Bank regulators have been issuing commentary regarding appropriate levels of capital in light of current conditions. These concerns have been heightened by the problems of sovereign debt in Europe in light of the fact that much of that debt is held in the banking sector.



Housing affordability has continued to improve, as expectations for slower economic growth drove long-term interest rates lower. In addition, inflation expectations have moderated amid lower gasoline prices, which helped keep rates low. For example, the difference between the 5-year nominal Treasury note yield and Treasury Inflation-Protected Securities (TIPS) stood at about 2 percent in early June, down from a recent high of about 2.5 percent at the end of April. While measures of core inflation (excluding food and energy items) have climbed in recent months, they have remained modest. With a downgrade of the outlook for economic growth and the unemployment rate, as well as an improving inflation expectation, we now expect the Fed to postpone hiking the Fed funds rate until the second half of 2012, instead of earlier in that year. Long-term rates are projected to rise only modestly, with mortgage rates remaining below 5 percent through early 2012.

We lowered projected purchase originations modestly and refinance originations were revised somewhat higher for the current quarter, in response to lower mortgage rates. For all of 2011, total mortgage originations are projected to decline to $1.07 trillion from an estimated $1.51 trillion in 2010, with a refinance share of 53 percent. We expect total single-family mortgage debt outstanding to fall an additional 2.4 percent this year, moderating slightly from a drop of 3.0 percent in 2010.

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