Outlook Brightens

The economy is starting to "perk." The *Oxford English Dictionary* says to percolate means "be or become full of lively activity or excitement." Maybe we are not at the stage of "lively," but there are some areas of the economy that are starting to show signs of improved growth.

The economy grew during the third quarter at an upwardly revised 2.5 percent annualized rate. While the magnitude of the upward revision in gross domestic product (GDP) was modest, and growth remained below the economy's longer-term capacity, the composition of the revision gives encouragement for stronger future growth. Both consumer and investment spending were revised higher, while inventory investment was marked down. As a result, final sales, considered a better indicator of the economy's underlying strength, were revised to double the initially reported rate. Thus, we close 2010 with a sense of building momentum.

Information about the probable compromise between the Administration and Congressional leaders should be viewed as positive for growth in coming years. The compromise is likely to entail a two-year extension of the Bush-era tax cuts in exchange for an extension of emergency unemployment benefits through the end of 2011. Other key elements of the possible compromise include a one-year payroll tax reduction of two percentage points for employees (which more than offsets the expiring Making Work Pay tax credit), business expensing of capital expenditures for 2011 followed by 50 percent bonus depreciation in 2012, a two-year fix of the Alternative Minimum Tax, two-year extensions of a variety of American Recovery and Reinvestment Act (ARRA) tax breaks, and other stimulus-related tax breaks for individuals and businesses.

Given these recent positive developments, we believe that economic growth is poised to kick into higher gear, with an above-par performance lurking just around the corner—by the second quarter of 2011. For all of 2011, we expect growth of 3.4 percent, compared with a projected 2.9 percent in the previous forecast. We also expect improving labor market conditions, despite a huge disappointment from the November employment report. The form of the package that will eventually be enacted is still uncertain, as the specifics of the legislation are being ironed out. Consequently, the forecast is subject to change depending on final details. At the very least, a tax plan will help reduce the uncertainty surrounding the issue of future tax liability, which is an important step toward creating an environment more conducive to growth.

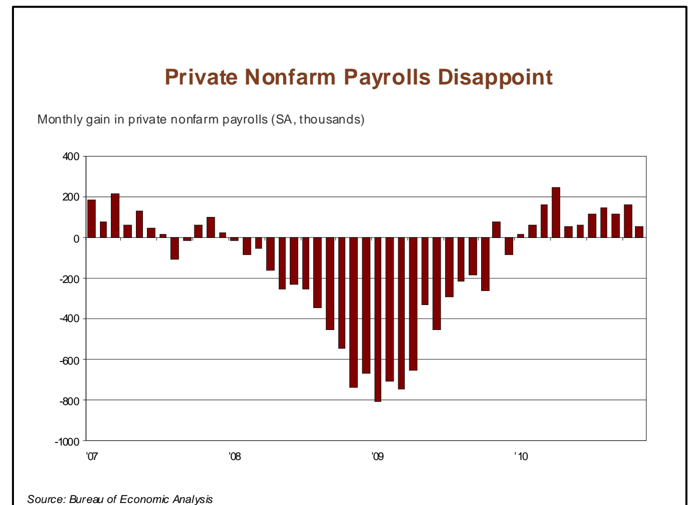
Despite a more bullish outlook, the economy is facing substantial headwinds. State and local governments will continue to struggle with budget problems. China faces potential inflation problems. And there is renewed turmoil in Europe: the Greece solvency concern has spread to Ireland, and other European countries (including Portugal, Spain, and Italy) are facing substantially wider capital market risk spreads. Unlike the Greek crisis earlier this year, the recent episode concerning Ireland has not significantly affected the U.S. financial market, as participants appear to be satisfied with the efforts by the European Union and the European Central Bank to contain the damage. Nonetheless, the contagion fear will continue to be in the background, posing a potential threat to the U.S. and global economies.

Finally, another risk is that, while the compromise tax proposal will likely benefit the U.S. economy in the short run, the plan is estimated to add roughly $900 billion to the deficit if there is no attempt to rein in spending. Failure to curtail spending may have an adverse economic impact in the longer term without eventual corrective action.

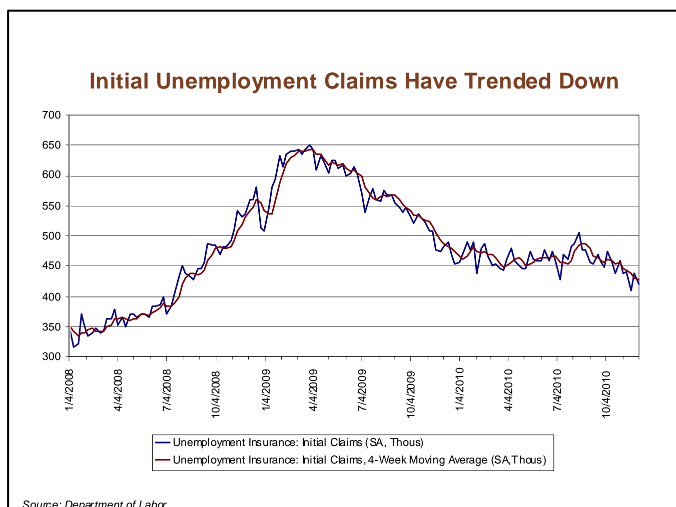
Employment: Two Steps Forward, One Step Back

The November employment report was a huge disappointment, raising doubts about other indicators, which have firmed during the past month. Total nonfarm payrolls grew an anemic 39,000, with the private sector creating just 50,000 jobs. Other aspects of the labor market also were bearish. Both the average workweek and average hourly earnings were flat, which boded poorly for incomes going into the holiday season.

One upside was that September and October data, which were already strong, were revised higher, bringing the average private payroll gain during the last two months to 105,000. The gain was not too far from the 124,000 average monthly increase during the third quarter. While this is unspectacular at this point of the recovery, it does indicate some healing in the labor market and a vast improvement over the last year. Year-to-date, the nation has created 1.17 million jobs, compared with a loss of 4.58 million jobs during the same period in 2009.



The employment numbers can be volatile from month to month so it is too early to conclude from the December data that private job growth is poised to trend down, as it did after April as the European turmoil emerged. However, the anemic gain underscores that job creation in the current recovery is too weak to bring down the unemployment rate, which will likely require sustained employment gains of about 150,000 a month. Unfortunately after moving in a narrow range of 9.5 percent to 9.6 percent for five consecutive months, the unemployment rate rose 0.2 percentage points to 9.8 percent in November, the highest level since April and not too far from the cycle's peak of 10.1 percent witnessed in October 2009.

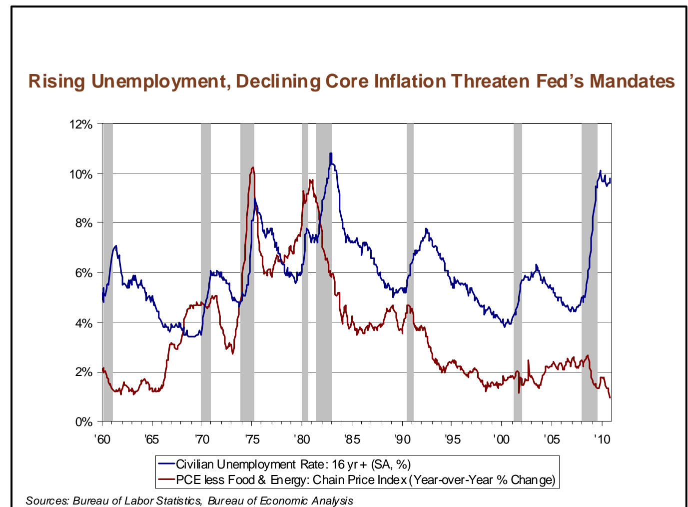


Other labor market indicators, such as weekly initial unemployment claims, point to a gradual improvement. While claims have been elevated by typical recovery standards, they have developed a clear downward trend. The four-week moving average, at 427,500, is the lowest level since August 2003 and is notably lower than the level at which it had been hovering since April, of about 450,000.

With an improving growth outlook, we expect the labor market to continue to improve, despite the November setback, with nonfarm payrolls averaging about 180,000 per month in 2011, leading to a slow decline in the unemployment rate toward 9.4 percent by the end of 2011.

The current high unemployment rate is helping to contain wage increases in the labor market. Underlying inflation also has been muted. While the overall price level has moved higher, driven by rising energy prices, core prices (excluding food and energy) have declined. For example, the core personal consumption expenditures deflator—the Federal Reserve's favored measure of underlying inflation—rose 0.9 percent in October, its smallest year-to-year gain on record since the inception of the series in 1959. The 3-month annualized change is running at just 0.4 percent, indicating even more deflation risk, which triggered the Fed's decision to resume the long-term asset purchase program known as quantitative easing.

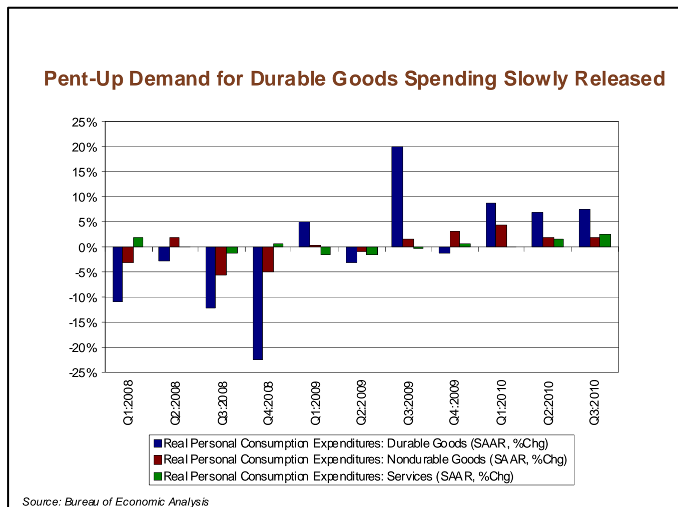
At its November meeting, the Federal Open Market Committee noted its concern that it had not fulfilled its dual mandate of price stability and full employment. The Fed cited the historically high unemployment rate and uncomfortably low inflation as the justification to conduct another round of quantitative easing, this time in the form of a purchase of $600 billion of Treasury securities following the $1.75 trillion long-term asset purchase program that expired in March 2010. Fed Chairman Ben Bernanke remarked on the CBS program "60 Minutes" earlier this month that the Fed stands by to conduct an additional purchase of Treasuries if needed. We continue to believe that the Fed's thinking indicates their first interest rate hike won't occur until sometime between late 2011 and mid-2012. If the proposed tax plan is enacted with the basic outline currently being discussed, the likelihood of a third round of quantitative easing will be reduced and the timeline of the Fed's exit will likely be moved forward.



Consumers: Pent-Up Demand Gradually Released

Consumer spending is rising. Real (inflation-adjusted) consumer spending rose 2.8 percent at an annual rate in the third quarter versus 2.2 percent in the first print of the GDP report – and is tracking at least as strong into the current quarter. Real consumer spending started the final quarter of 2010 at a solid pace, increasing 0.3 percent in October. Early indicators of consumer spending signaled another decent performance in November: Vehicle sales held steady at a strong pace while chain store sales posted a solid gain.

After declining during the fourth quarter of 2009 following the expiration of the Cash for Clunkers program, real consumer spending for durable goods has rebounded strongly. So far this year, durable goods consumer spending has been significantly stronger than nondurable goods and services. This indicates a release of pent-up demand for durable goods following the deep recession, when real durable goods consumer spending suffered double-digit annualized declines during much of 2008.

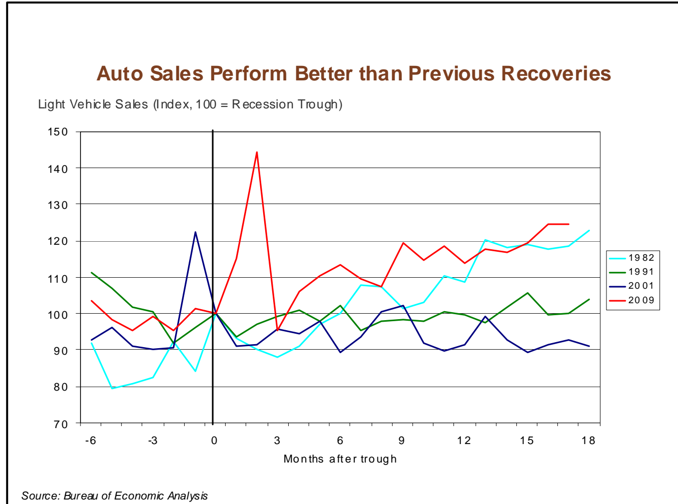


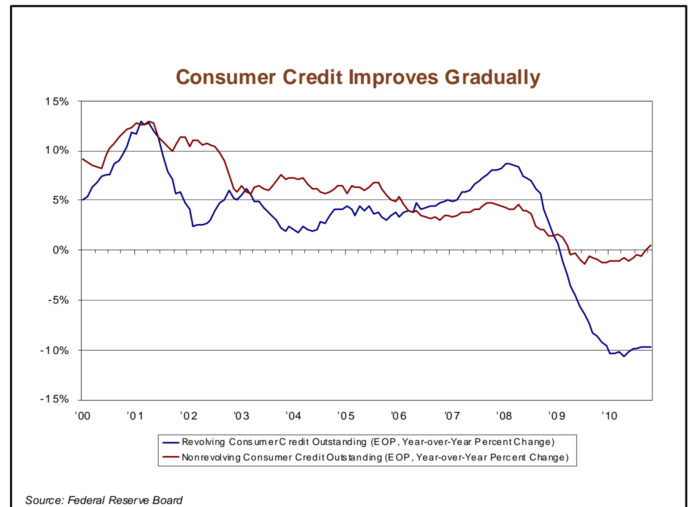
Durable goods consumer spending growth is likely to accelerate in the current quarter. Sales of autos and light trucks exceeded 12 million units at an annual rate in the first two months of the fourth quarter, compared with an average of 11.6 million for the third quarter.

The rebound in vehicle sales in the current recovery has been stronger than in other recoveries since 1980 (data are not available for prior recoveries). While sales dropped sharply in September 2009 after the Cash for Clunkers program ended, sales have rebounded quickly to a stronger pace than was seen prior to the subsidy and now stand at the highest sales level since September 2008.

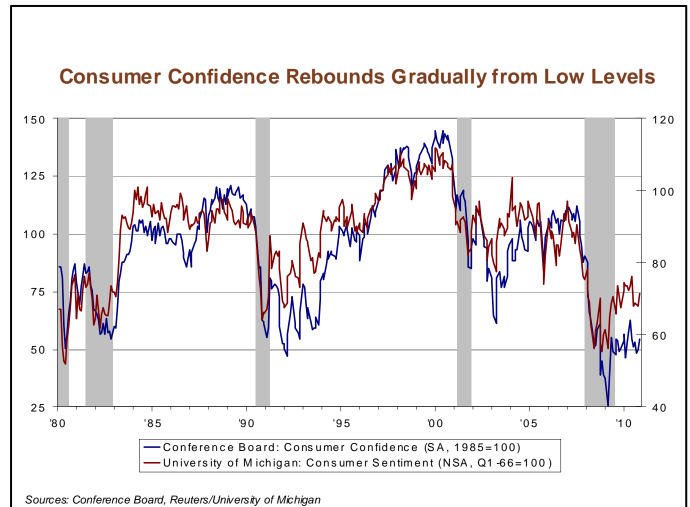
Demand for credit appears to be strengthening, according to monthly data of consumer credit outstanding (excluding mortgages). Consumers' increased willingness to borrow bodes well for consumer spending ahead. Consumer credit outstanding increased at an annualized rate of 1.7 percent in October, accelerating significantly from a 0.7 percent rise in the prior month. This marks the second consecutive gain after declining each month since February 2009. Of the two major components of consumer credit, nonrevolving credit

(largely autos) has shown better improvement than revolving credit (credit cards), rising from a year ago for the first time since March 2009. Nonrevolving credit continued to show a sizable drop from a year ago but the pace of decline has slowed, albeit gradually, from the peak witnessed in the spring.





Measures of consumer confidence have rebounded in recent months, though they remain at historically low levels. Improving labor market conditions are key to supporting confidence and consumer spending. Another driver of confidence is equity prices, which should continue to trend up, boosted by the increased likelihood of lower taxes and a more bullish outlook, strong profits (and thus dividends), and narrowing risk premia. However, rising oil prices will likely dampen optimism somewhat—as higher prices reduce disposable income.

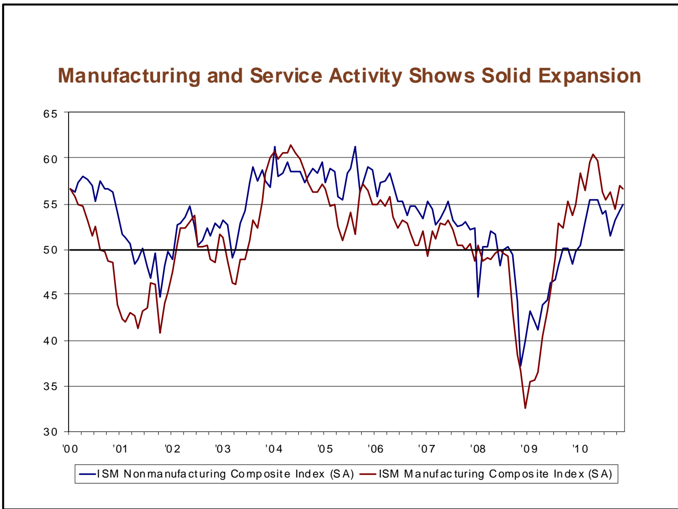


Manufacturing: Solid Expansion Poised to Slow

Despite the fading inventory cycle, manufacturing growth has held up, supported by durable goods spending and exports, which have remained strong. However, the turmoil in Europe has led to an increase in the relative strength of the dollar instead of the decline that had been anticipated in response to the second round of quantitative easing. Thus, the expected improvement to net exports for the second half of 2011 and for 2012 is now less than what we projected in the previous forecast.

Manufacturing output from the industrial production report posted a healthy gain in October, with improvement across nearly all major categories. Manufacturing activity continued to expand at a slightly more moderate pace in November, according to the Institute for Supply Management (ISM) manufacturing index. Despite the decline, however, the index remains at the second highest reading in six months. The details of the report suggest that activity should continue to expand, though at a more moderate pace in coming months.

Business investment in equipment and software has been a great driver of manufacturing activity during the current economic recovery. However, it is showing signs of a slowdown according to the report on factory orders, which fell sharply in October. The component used as a leading indicator of business investment in equipment and software—



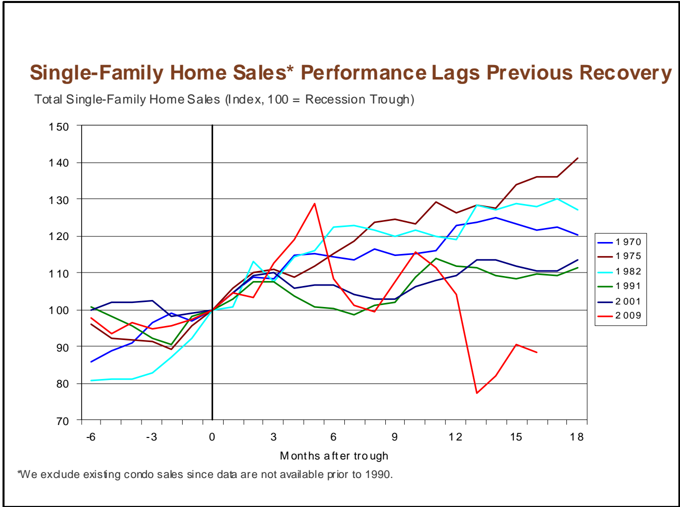
nondefense durable goods orders excluding aircraft—dropped 4.3 percent. Despite the sharp monthly drop, orders in this category stand about 15 percent above the level a year ago.

We believe that growth in equipment and software spending will slow appreciably in the current quarter. However, this follows a stellar performance earlier this year, when it contributed roughly half of all economic growth over the first three quarters.

The ISM nonmanufacturing survey signaled that activity in the service industries expanded at a faster pace in November. The nonmanufacturing index has rebounded from a cycle low of 37 to 55 in the latest reading, its average level during the expansion of 2001-2007.

Housing: Recovery Should Gain Momentum with the Expected Stronger Labor Market

Housing remains in the doldrums at present though there are a few hopeful signs. Home sales have declined since September, and house prices have posted renewed drops following the expiration of the homebuyer tax credit. Unlike vehicle sales, which have performed quite well post-tax-credit, home sales pulled back sharply, breaking below the cycle's low reached in 2009. It is noteworthy that despite substantial government support, single-family home sales have performed quite poorly in the current recovery compared with previous recoveries.

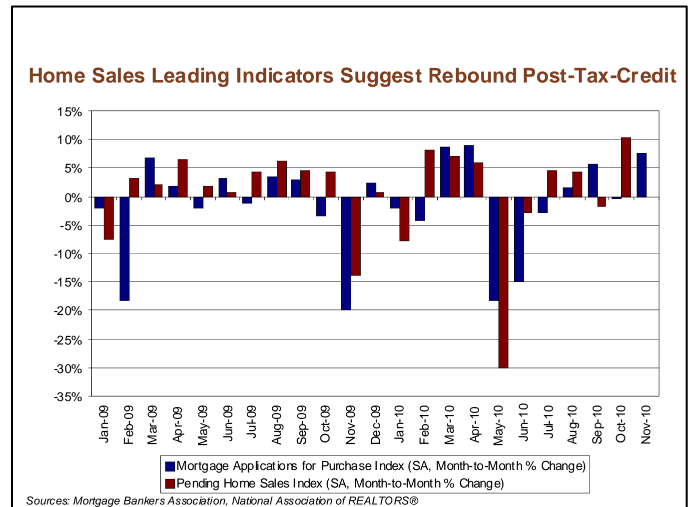


In the November forecast, we expressed some concern that the recent foreclosure problems have the potential to depress home sales significantly in the near-term. However, recent leading indicators suggest that housing is poised to rebound somewhat late this year or early next year. After dropping slightly in October, purchase applications in the Mortgage Bankers Association Weekly Survey of Mortgage Applications rebounded strongly in November. October pending home sales, which measures contract signings of existing home sales, posted the biggest jump in the history of the series.

Homebuilding activity remains depressed. Total housing starts declined sharply in October, largely from weakness in multifamily starts, which plummeted to 83,000 (seasonally-adjusted annualized rate), while single-family starts dropped modestly. In recent months, multifamily starts have been even more volatile than normal, essentially doubling between June (at 89,000 annualized units) and August (at 182,000 annualized units), and have now returned to near June's level. (For more information on current multifamily market conditions, read the *December 2010 Multifamily Market Commentary*).

The financial market's response to the Fed's implementation of the second round of quantitative easing has been disappointing for housing market participants. While equity prices have trended up, long-term rates have spiked, with the yield on the 10-year Treasury note reaching over 3.2 percent by early December. As a result, mortgage rates have trended up.

Despite rising mortgage rates, our forecast for home sales is stronger than the previous forecast, given our brighter economic growth and labor market outlook. We have repeatedly mentioned that the strength of the rebound in home sales will largely depend on improvement in the labor market. We expect total home sales to fall seven percent this year before rising by about five percent in 2011, slightly stronger than the three-percent gain expected in the previous forecast. Our projection for housing starts is little changed from the November forecast, with total starts rising in 2010 by about six percent from 2009's record-low level, followed by an increase of about 18 percent in 2011.



For all of 2010, total mortgage originations are projected to decline to $1.53 trillion from an estimated $1.92 trillion in 2009, with a refinance share of 66 percent. For next year, while the positive impact of stronger job gains will outweigh the negative impact of rising mortgage rates in supporting higher home sales and purchase mortgage originations, rising rates will hurt refinance activity. We expect the refinance share to fall to just 42 percent of the projected $1.13 trillion of total mortgage originations in 2011. Total single-family mortgage debt outstanding is projected to decline by 1.9 percent in 2011, moderating from a projected 2.7 percent drop this year.

While we await stronger results in housing and watch the labor market for improvement and the European scene for stability, we see the sum of positives as greater than the sum of the negatives and look for the economy to show some percolation in 2011.

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Economics and Mortgage Market Analysis
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