Starts and Fits But Up Incrementally

Economic growth was very choppy during the second half of last year, exaggerated by inventory swings, and more of the same is likely. We expect growth in the first quarter to accelerate to 3.2 percent—more than one percentage point higher than the estimated pace in the prior forecast. However, this above-trend pace will likely be unsustainable since one of the main drivers—a change in inventories—is a temporary one. The tone of several key economic indicators late in the quarter softened substantially, including the bleak March jobs report. The fiscal headwinds from the tax hikes and sequestration should restrain growth and counter the tailwinds from housing and continued Federal Reserve monetary policy easing. For all of 2013, we expect growth to come in at about 2.3 percent—remaining modest by recovery standards, but a pickup from the 2012 and 2011 pace of 1.7 percent and 2.0 percent, respectively. While fiscal restraint and the euro-zone crisis still pose downside risks to our forecast, the broadening housing recovery could very well be more robust than we anticipate, thus our modest increase in forecast growth.

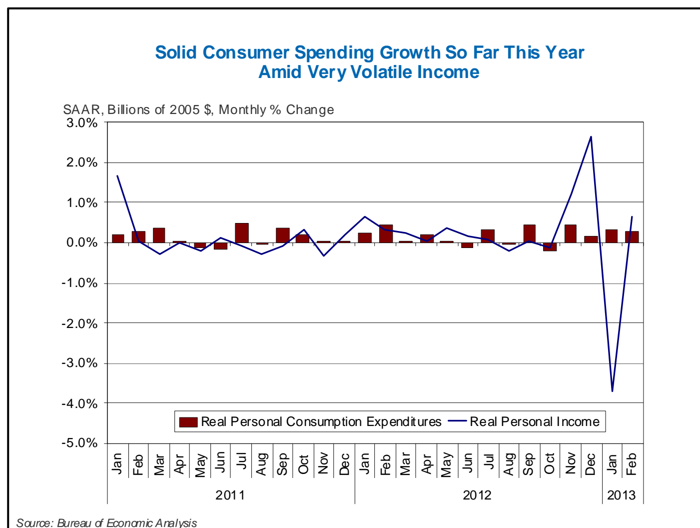
Buildup After Drawing Down

One source of the pickup in economic growth in the first quarter came from businesses' desire to build up inventories rapidly after a substantial drawdown in the prior quarter. Building up stockpiles is a transitory driver of growth and will likely fade after the first quarter. After the inventory drawdown subtracted from economic growth by 1.5 percentage points in the fourth quarter of 2012, we expect a complete reversal, with the inventory buildup having added 1.5 percentage points to economic growth in the first quarter.

Resilient Consumers in First Two Months of the First Quarter

Incoming data related to consumer spending showed that consumers were quite resilient to the tax hikes implemented at the beginning of the year, including the expiration of the payroll tax holiday, the tax increase on upper-income households, and new taxes related to the Affordable Care Act.

Real (inflation-adjusted) consumer spending increased 0.3 percent in February, and the previous month's figure was revised higher. The strength in consumer spending during the first two months of the year suggests an acceleration of more than 1 percentage point in the first quarter from the 1.8 percent annualized clip in the fourth quarter of last year, even allowing for a small decline in March. Auto sales edged down in March, but remained near cycle highs, which is encouraging given that the bulk of hurricane-related replacement has likely dissipated.



A key to growth this year will be whether resiliency in consumer spending, which accounts for more than 70 percent of the economy, will persist. The robust growth in the first quarter may have been partially due to a surge in bonus and dividend income in the fourth quarter of 2012 and rising stock values, which combined to help offset some of the negative impact of the tax hikes. In addition, housing indicators, especially home prices, continue to show strength. Robust home price appreciation helped propel household net worth in the final quarter of 2012 to the highest level in five years, strengthening consumer fundamentals. However, we expect the effects of the fiscal tightening to show up in consumer spending and other economic activity in coming months.

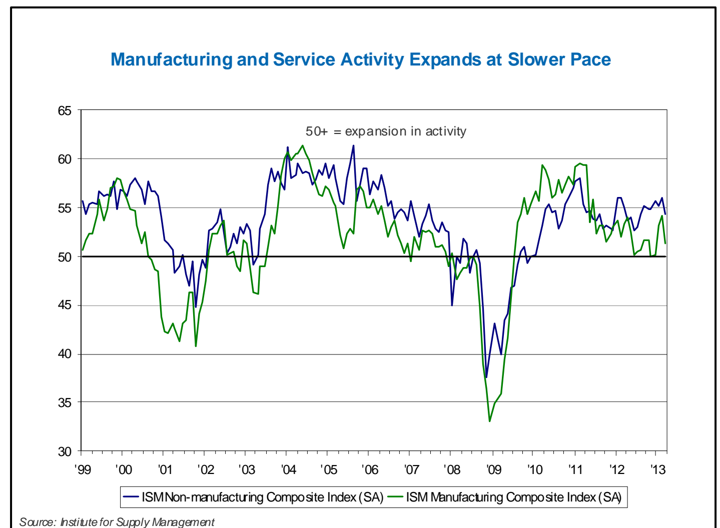
Business Investment Growth Poised to Moderate

After rising at the fastest pace in more than a year in the fourth quarter of last year, business capital investment should slow substantially in the first quarter, presaged by a moderate gain in core capital goods shipments (nondefense excluding aircraft), which are key source data for estimating business investment in equipment and software (Capex). While February core capital goods orders—a leading indicator for Capex—pulled back following January's surge, the average of the first two months of the first quarter is tracking substantially above the fourth quarter average, suggesting a pickup in Capex in the current quarter.

After a strong showing late last year, spending on business structures has essentially stalled and thus we expect business investment in structures to post a decline in the first quarter and remain relatively flat for the rest of the year.

No Deal to Take the Sting Out of Sequestration

While overall economic activity during the first quarter was much more bullish than we had expected, our fiscal policy assumptions proved to be too conservative. Our prior forecasts assumed a compromise deal during the continuing resolution debate in late March to extend government spending authority that would temper the impact of the cuts under the sequester. As it happened, the spending bill enacted in late March, which extended spending authority through the end of this fiscal year, has mitigated some of the specific effects of sequestration but did not restore some of the spending cuts at the beginning of March as we had expected. Thus, we replaced the gradual cuts assumed in prior forecasts with the sequestration signed into law as part of the Budget Control Act of 2011, which called for a reduction in budget authority of roughly $110 billion in each of the next 10 years. In effect, the actual cuts scheduled under the latest development are more front-loaded compared with what we previously expected.

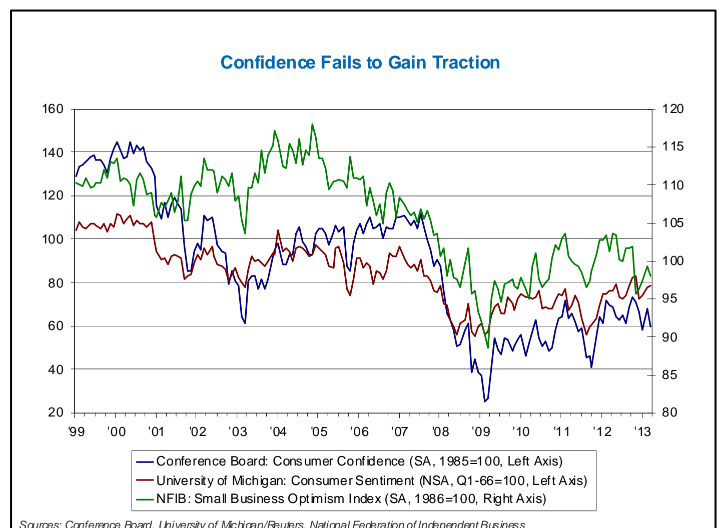


Slowdown in Overall Economic Activity Expected

Incoming data late in the first quarter showed signs of a slowdown in manufacturing and service activity. After expanding faster for two consecutive months, a survey of purchase managers from the Institute for Supply Management (ISM) showed that the expansion in manufacturing slowed in March, driven by a plunge in its forward-looking component—new orders. The ISM survey for the service sector also showed that the service industry expanded at the slowest pace since August.

Mixed News on Confidence

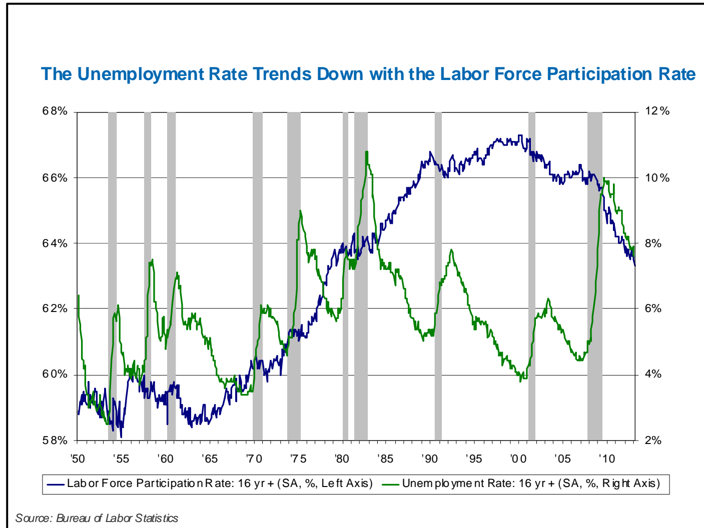
Measures of consumer confidence were mixed in March. While the Conference Board's consumer confidence reading plunged, the Reuters/University of Michigan consumer sentiment reading rose for the third consecutive month. One notable aspect of the Reuters/University of Michigan survey is that the preliminary survey fell 5.8 points in early March but snapped back, rising 6.8 points in the final reading—the largest upward revision in the history of the series. Thus, an indicator to watch will be whether the Conference Board consumer confidence survey stabilizes in April. Small businesses were less optimistic in March, according to the National Federation of Independent Business (NFIB) small business optimism index. After three consecutive monthly gains, small business confidence stumbled, weighed down by the labor market, inventory investment plans, and sales expectations. The details of the survey showed that the "single most important problem" facing small businesses was taxes, followed by government requirements and poor sales.

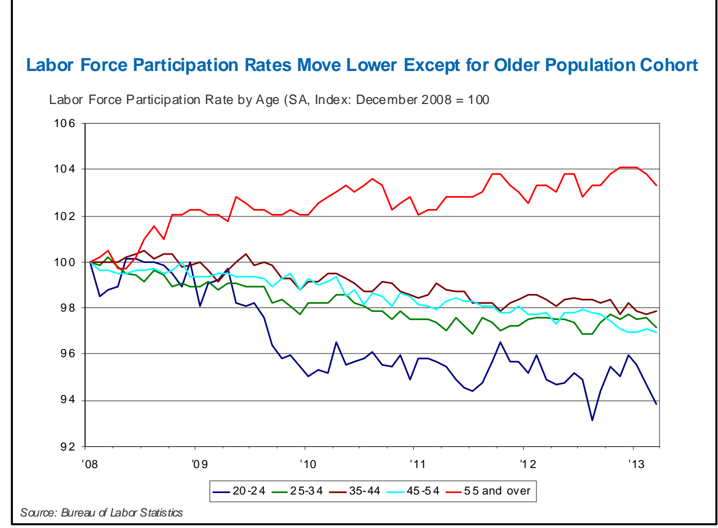


Unambiguously Bearish News in the Jobs Report

The downbeat employment report showed that nonfarm payrolls rose only 88,000 in March—the weakest job creation since last June. Even with an upward revision of 61,000 jobs over the prior two months, the loss of momentum was clear, as the average monthly gain slowed to 168,000 in the first quarter from 209,000 in the fourth quarter of 2012.

There was no real good news from the household survey: the one-tenth percentage point drop in the unemployment rate to 7.6 percent was a result of a substantial decline in the labor force that outweighed a drop in household employment. The drop in the civilian labor force of nearly half a million was the biggest since December 2009, bringing the labor force participation rate down to 63.3 percent, the lowest level witnessed since 1979.



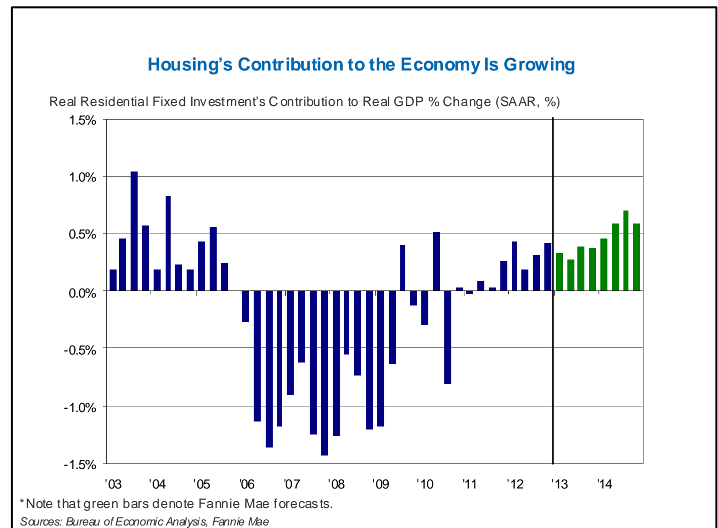


The most worrisome aspect of labor market conditions is the decline in labor force participation among age cohorts under 55, not among those close to or in their retirement years as commonly believed.

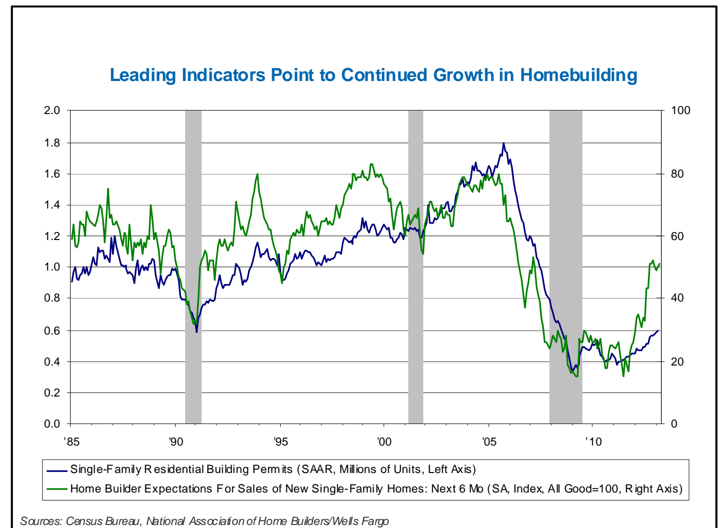
As expected, there was no indication that sequestration drove the weakness in the March jobs report. However, the impact will likely start to show in the April figure. The huge drop in retail payrolls, the first decline in nine months, may be indicative of the delayed impact of tax hikes. The slowdown in job creation was broad-based, as reflected in the decline in the diffusion index, which showed the share of industries experiencing expanding employment—from 59.6 percent in February to 54.3 percent, marking the second lowest share in three years. A silver lining for housing seen in the employment data was the solid increase in construction employment, despite the coldest March since 1996. The March gain brought the average monthly gain in construction employment during the first quarter to 30,000 jobs, the biggest in seven years, supporting the view that the housing recovery remains intact despite headwinds from fiscal drags.

Housing's Contribution is Growing

While overall economic reports signal some moderation in economic activity heading into the current quarter, the continued housing recovery and rising home prices will provide a cushion to growth this year and present the most likely source of upside to our forecast. Residential investment added 0.4 percentage points to economic growth in the final quarter of 2012, marking seven consecutive quarters of positive or neutral contribution. We expect this year's contribution to growth from housing to be similar to last year and to strengthen further in 2014.



Housing Activity Largely Positive

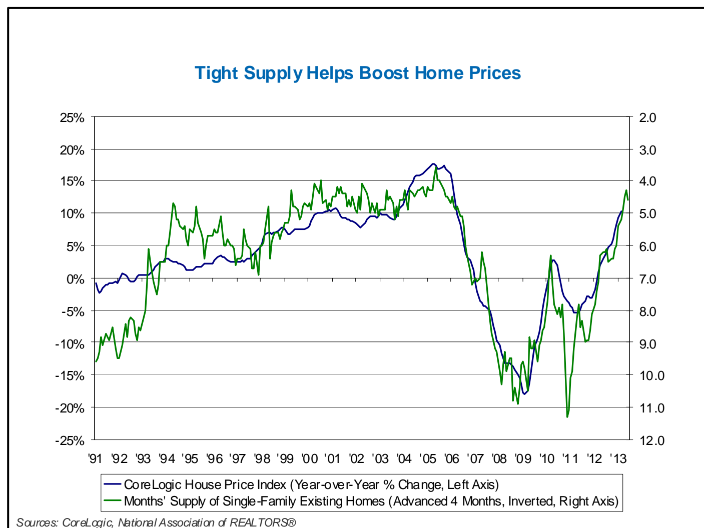


Incoming housing indicators suggest a continued upward trajectory. Existing home sales edged up in February for a second consecutive month to a three-year high, boosted by condo sales in the South. February new home sales gave back some of the surge from January. Despite the pullback, February's sales pace is the second highest since April 2010, and the average sales pace during the first two months of the year is well above the fourth quarter's average. Housing starts posted a modest gain, but housing permits—a leading indicator of building activity—suggest a substantial gain in homebuilding activity again this year.

Builders' confidence has stalled, however, with the Wells Fargo/National Association of Home Builders (NAHB) housing market index slipping in March for the second consecutive month to its lowest level since October. One positive takeaway is that the index's forward-looking component—sales expectations over the next six months—rose during the month for a second consecutive month, helping to buffer the decline in the overall index. On net, leading indicators suggest that the rebound in homebuilding activity is on firm footing.

Supply Constraint Partly Leads to Tight Inventories, Boosting Home Prices

A recent NAHB survey indicated that growing labor shortages in all aspects of the residential construction sector are impeding the housing recovery, partly because many skilled workers had to seek employment elsewhere during the recession and are no longer available. In addition, a lack of buildable lots as well as increased costs for materials and labor has contributed to supply constraints. Outside of the supply problems, builders cited issues with appraisals and credit availability as obstacles to closing the transactions.



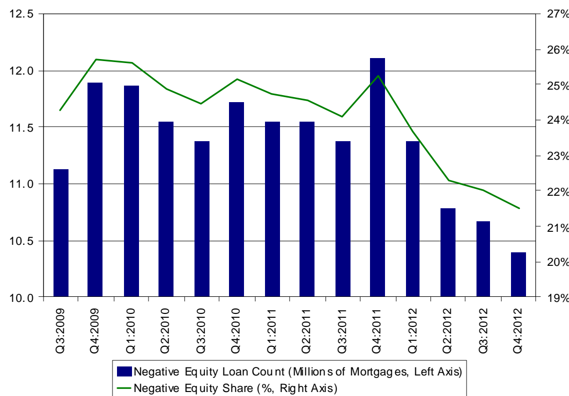
The months' supply of homes has remained well below its long-term average. Some existing homeowners have been unwilling to list their properties as they are waiting for prices to firm further. Others are unable to list their homes because they are underwater—their mortgage balance exceeds the value of their homes. The lean inventory, coupled with rising investor demand, led to stronger than expected home price growth in 2012. In addition, the declining share of distressed sales and the increased use of short sales helped support home prices.

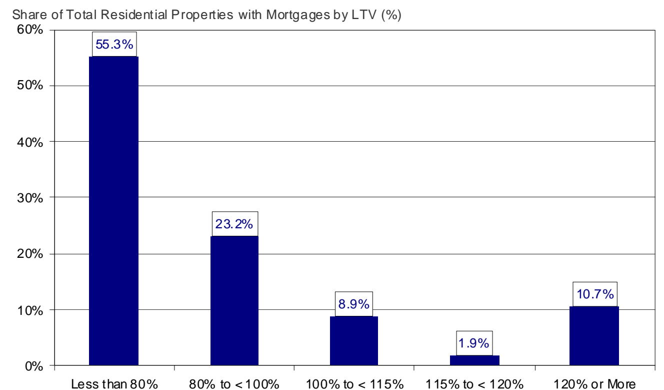
Some measures of home prices defied seasonality, continuing to build momentum in the face of the typically weak winter selling season. For example, the CoreLogic house price index (not seasonally adjusted) was up in February for the fourth consecutive month and posted the strongest year-over-year rise since March 2006.

Many Underwater Borrowers Will Likely Regain Buoyancy This Year

Continued rising home prices should help some homeowners, who have involuntarily remained on the sidelines, to gradually put their homes on the market, as more than 1.7 million properties returned to positive equity by the end of 2012, according to CoreLogic.

The number of underwater residential properties peaked in the fourth quarter of 2011 and steadily declined in each quarter of 2012. The share of properties with negative equity, which peaked during the fourth quarter of 2009, also has trended down.





To gauge the extent of how home price appreciation will lift underwater properties into positive equity positions over time, we examine the share of underwater properties by loan-to-value ratio (LTV) buckets. Properties with the most severe negative equity, defined here as those with LTV of 120 percent or higher, comprised slightly more than 10 percent of total residential properties with mortgages. Even with reasonably strong home price gains over the next few years, these properties will likely remain in negative equity positions, unless the borrowers default or prepay. Those underwater properties with LTVs between 100 percent and less than 120 percent could potentially move into positive equity positions with continued home price appreciation amid ongoing amortization. A quarterly survey of home price expectations conducted by Zillow in March showed an expected cumulative gain of 17.5 percent between 2013 and 2016. Applying this projected appreciation and assuming continued amortization, all of the underwater properties at the end of 2012, except the most severe, will likely regain their positive equity positions by 2016—the same time that the forecast of our Economic and Strategic Group (ESR) indicates that housing-related activity, including homebuilding and residential construction employment, will return to "normal."

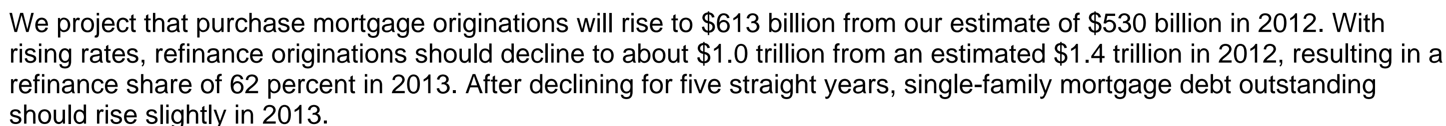
Besides helping underwater borrowers regain their positive equity positions and boost household net worth, rising home prices should increase banks' willingness to make mortgage loans, as they are gaining more confidence that the collateral they are lending against will hold its value. Continued tightness in mortgage credit, which has shown little sign of abating since 2010, has remained one of the final barriers to a return to a normal housing market.

The Housing Recovery Expected To March On

We expect low mortgage rates to continue to support the housing market. During the past month, Treasuries rallied across the curve in response to events in the euro-zone. The yield on 10-year Treasuries fell to a three-month low of 1.70 percent following the disappointing March jobs report and hovered around 1.75 percent at the time of this writing. We expect the yield on 30-year fixed-rate mortgages to rise gradually to 4.0 percent by the end of the year.

Our forecasts of housing starts and new home sales are little changed. After surging in 2011 and 2012, we expect multifamily housing starts to rise in 2013 by another 19 percent, with single-family starts rising approximately 24 percent. (For more information on multifamily market conditions, read the *April 2013 Multifamily Market Commentary*.) New home sales should rise 18 percent from 2012.

We revised higher our projected home prices but lowered our forecast of existing home sales this year and next year. It appears that very tight inventories, especially in the lower-end price range, have restricted sales and boosted home prices by more than we had anticipated. While investor demand has commanded a strong presence in many markets, organic demand, as gauged by purchase mortgage applications, has not picked up substantially. In addition, the share of first-time homebuyers has not been encouraging, accounting for less than one-third of total sales.



We project that purchase mortgage originations will rise to $613 billion from our estimate of $530 billion in 2012. With rising rates, refinance originations should decline to about $1.0 trillion from an estimated $1.4 trillion in 2012, resulting in a refinance share of 62 percent in 2013. After declining for five straight years, single-family mortgage debt outstanding should rise slightly in 2013.

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Economic and Strategic Research
April 10, 2013

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