# 2015: Economy Drags Housing Upward

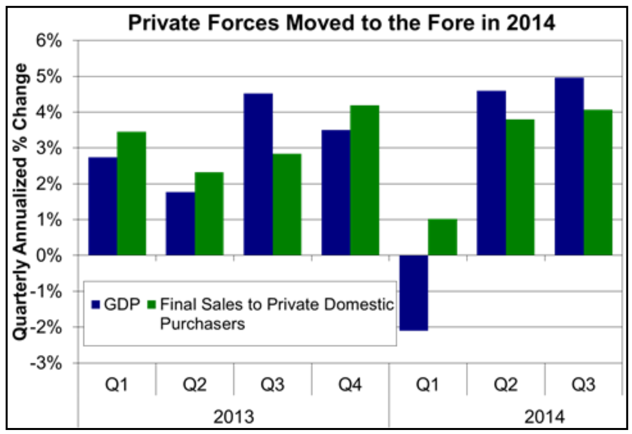
We present a preview of the key theme that will shape our outlook for the U.S. economy, housing, and mortgage markets over the coming year in our inaugural outlook for 2015 as we have done over the past several years. We believe that economic growth will accelerate modestly this year, driven by strengthening private domestic demand, especially consumer spending, amid continued low gasoline prices, firming labor market conditions, rising household net worth through both financial and housing wealth, improving consumer and business confidence, and reduced fiscal headwinds. We project that growth will accelerate to 3.1 percent in 2015 from our estimate of 2.6 percent in 2014. The stronger economic backdrop should lead to improving income prospects, underpinning a higher rate of household formation in 2015.

Housing, which has historically acted as an early driver of economic expansions, has lagged the progress of the overall economy in the current cycle. We expect that the strength in the broader economy, accompanied by meaningful income growth, should drag housing upward amid historically low mortgage rates and a gradual easing of lending standards. We expect that 2015 will mark a year of a moderate improvement in broad-based housing activity following a disappointing and uneven year for the housing recovery in 2014.

Downside risks to this outlook include the wait for income growth to materialize domestically, uncertainty regarding the pace and effects of monetary policy normalization, slowing global growth, and continued geopolitical tensions, including renewed concerns of a Greek exit from the Eurozone and the potential for currency market turbulence.

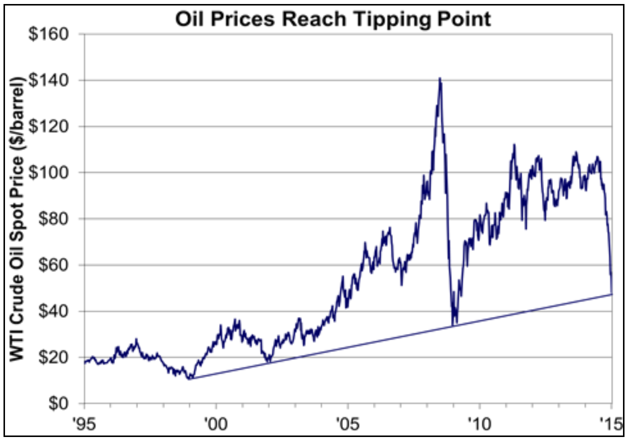
## Private Forces Moved to the Fore in 2014

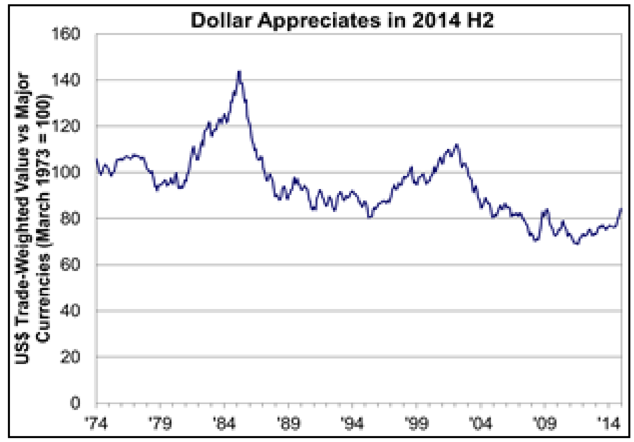
Our theme last year proved prescient as, after starting the year in deep negative territory due in large part to the severe winter weather, the economy rebounded strongly in the second quarter and gained even more momentum in the third quarter, reaching the strongest pace since 2003. Incoming data for the fourth quarter support our prior forecast that growth likely slowed markedly toward the end the year. Private domestic demand posted solid back-to-back growth in the second and third quarters and is poised for another healthy gain in the fourth quarter, as reduced uncertainty on the fiscal policy and regulatory fronts and diminishing drags from a cut in government spending set up a foundation for private forces to come to the fore.




## Oil Prices Fall Off a Cliff

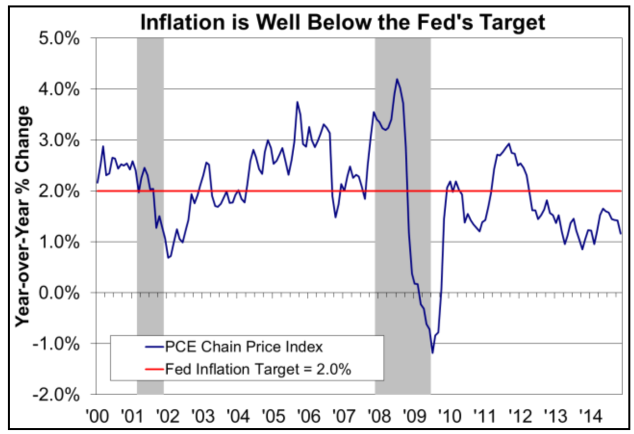
One of the major surprises of 2014 was the collapse in oil prices. This is a sign of both declining demand amid weakening global growth and an increase in supply, stemming from increased production in North America and unwillingness among key oil producing countries to cut production. This has occurred in tandem with a strengthening of the dollar to its highest level since 1994. Falling prices of other commodities (such as copper) have added to disinflationary pressures, which appear to have been important contributors to the bond rally, flattening yield curves, and widening credit spreads. The 10-year U.S. Treasury yield moved below 2.0 percent in early January, underscoring investors' concerns over the uncertain global economic outlook and potential deflation. At the same time, West Texas Intermediate crude oil fell below the psychological threshold of $50 per barrel for the first time since 2009, or more than half the price at the beginning of 2014. This has occurred despite some supply disruption, as Libya has entered a civil war that has effectively cut its oil production in half, erasing almost half of the supply overhang in the global oil market. While the U.S. has become a bigger energy producer in recent years, lower oil prices are a net positive to the U.S. economy. The consumer and producer benefit of lower energy costs should offset any drag on economic growth from the stronger dollar and employment and business investment weakness in oil producing regions.



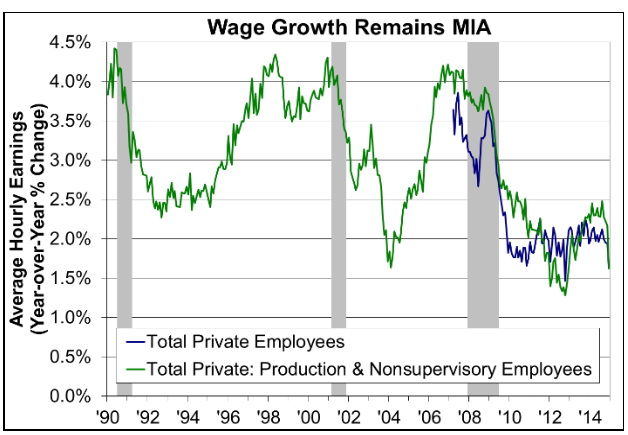



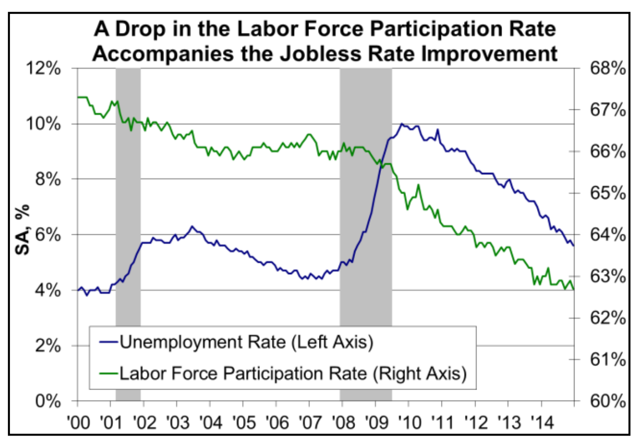

## When Will Monetary Policy "Normalization" Begin?

Short-term interest rates have been near zero since late 2008 while inflation pressure has remained muted. Thanks in part to the stronger dollar and declining gasoline prices, inflation has recently moved well below the Fed's 2.0 percent target. The backdrop of lackluster growth and low inflation around the globe appears to justify a cautious pace of rate hike by the Fed. In the statement following the December meeting of the Federal Open Market Committee (FOMC), the Fed adjusted its forward guidance, noting it would be "patient" in rate normalization. However, the minutes from the meeting showed that the FOMC sees the plunge in oil prices and the stronger dollar as creating only a temporary drop in inflation.




Meanwhile, labor market conditions have improved substantially, but diminishing labor market slack has not yet translated into stronger wage growth. Many Fed officials have noted that the decline in the unemployment rate over the past year has overstated the degree of improvement in the labor market, as part of the drop was a result of the decline in the labor force participation rate. We continue to expect the first hike in the target fed funds rate in the third quarter of this year with no change in the balance sheet policy until 2016. The pace of tightening is projected to be gradual, with the fed funds rate rising to below 2.0 percent by the end of 2016. The yield curve should flatten further as short-term rates rise while longer-term rates will likely remain well-anchored.

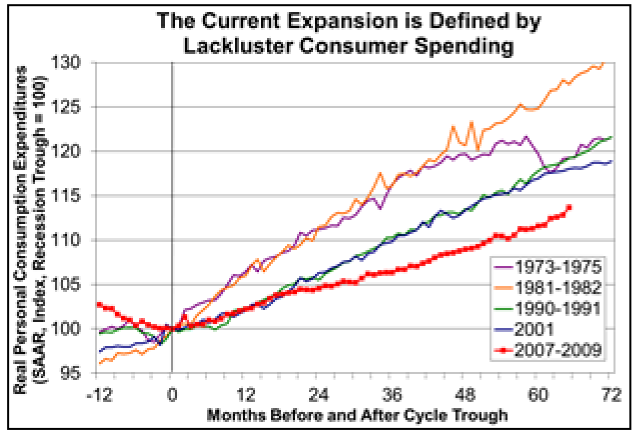



## Strengthening Growth Into 2015

The economy grew at a 5.0 percent annual rate in the third quarter, an upgrade from the second estimate of 3.9 percent from the Bureau of Economic Analysis, marking the strongest quarterly pace of growth since 2003. The upward revision largely came from consumer spending, which grew 3.2 percent—a full percentage point higher than the prior estimate.

Consumer spending growth in the current expansion has been lackluster when compared to prior cycles. The outlook is looking up, however. Real consumer spending growth likely picked up in the fourth quarter of 2014 to about 4.0 percent annualized, given the robust 0.7 percent gain in real consumer spending in November, a solid December auto sales pace, and continued declines in gasoline prices. We expect spending growth to pick up to 3.1 percent in 2015, which would tie 2010 for the fastest growth since 2006.




Consumers have been wary of taking on additional credit card debt for much of the current economic cycle. Last year, we saw the first sustained acceleration in revolving consumer credit debt outstanding since the onset of the crisis. Year-over-year growth rose to above 3.0 percent in the second half of 2014 after posting approximately 1.0 percent annual gains for much of the prior two years. Revolving credit growth still remains modest by historical standards, however, and appeared to have lost some steam late in the year, posting a monthly decline in November 2014 for the second time in the last four months.

Continued solid hiring remains the key fundamental supporting spending. The December jobs report provided a strong finish to a good year for the 2014 labor market. The job gain of 252,000 was in line with the average monthly gain of 246,000 jobs for all of 2014, the best year of job growth since 1999. However, other aspects of the report were underwhelming. In particular, a decline in average hourly earnings left year-over-year growth at just 1.7 percent, the smallest since late 2012. Although the unemployment rate dropped to 5.6 percent, the lowest level since June 2008, it was accompanied by a slip in the labor force participation rate to 62.7 percent, which tied for the worst since October 1977.

Despite our expectation that consumer spending remained robust through the close of 2014, we estimate that headline economic growth slowed in the fourth quarter by about two percentage points (to a still healthy pace of 3.0 percent) from the third quarter pace, as some unsustainable forces that drove activity in the third quarter, such as the surge in federal defense spending, likely reversed. Manufacturing activity also cooled modestly at the end of the year, according to surveys of purchasing managers. The decrease in core capital goods orders in November—the third consecutive monthly drop—suggests that business capital expenditures likely posted a decline during the final quarter of 2014 following two consecutive quarters of double-digit annualized growth.

For 2015, we expect that consumer spending will strengthen, partly because of the positive impact of the plunge in gasoline prices that temporarily boosts real disposable income. We also expect the ongoing tightening labor market will lead to firmer labor income (through both increased hours worked and measured but real gains in wages) amid continued rising household net worth.

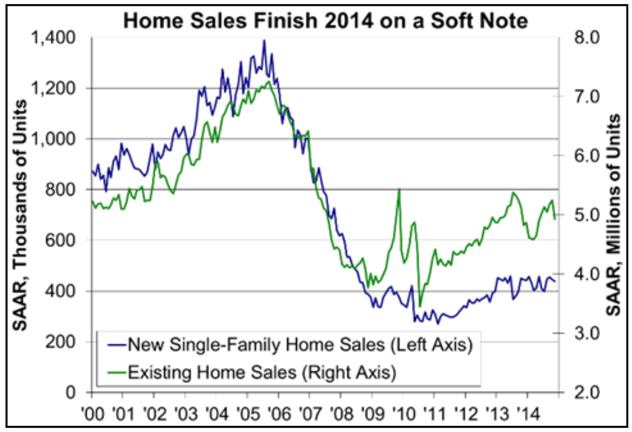
Business capital expenditures are likely to grow at a slightly slower clip than last year's pace, partly because the plunge in energy prices are expected to cause U.S. energy companies to curtail their investment this year. In addition, the strengthening dollar and slow growth abroad will likely weigh on net exports.

While we expect a faster pace of economic growth this year, our view for the housing market remains cautious, as we believe that meaningful income growth needs to occur to spur household formation, which has been frustratingly anemic in the current economic expansion. This view is supported by results from our [December 2014 National Housing Survey], which has generally shown a strengthening of attitudes towards the economy and individual financial situations amid flat housing sentiment.

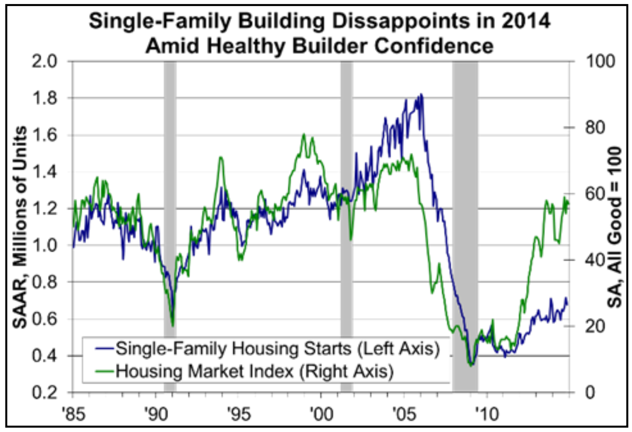
## Housing Expected to Contribute More to Growth in 2015

Housing activity in November softened: existing home sales fell sharply to the slowest pace since May, and new home sales were down to the weakest pace since July. While multifamily starts rose for the second time in three months, both single-family starts and permits fell. Home builders' confidence edged down in December to end a disappointing year for single-family building activity. Housing likely was a meager contributor to growth in 2014, with real residential investment spending growing at about half the 6.9 percent 2013 pace. (For more information on multifamily market conditions, read the [January 2015 Multifamily Market Commentary].)

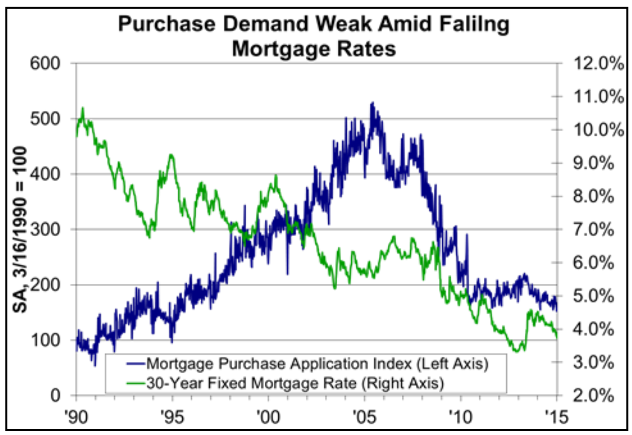
The near-term outlook for home sales appears soft. Pending home sales—a one-to-two-month leading indicator of existing home sales—edged up only slightly in November. Meanwhile, the Mortgage Bankers Association's purchase mortgage application index plunged in December to the lowest level since 1995 before partially rebounding in early January. Weekly mortgage applications tend to be volatile around this time of year, however, and it will take some time before we can evaluate the underlying trend.



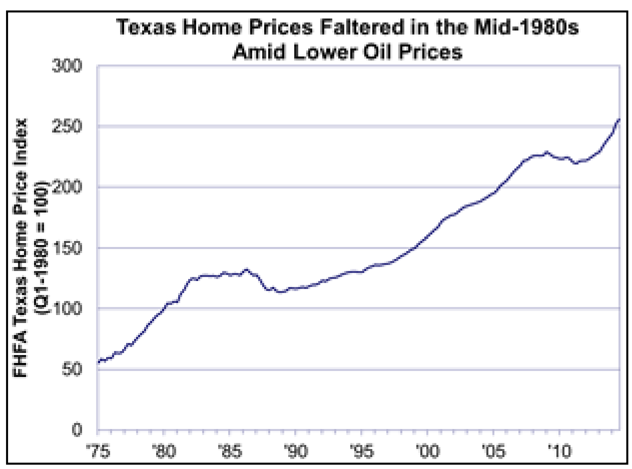

Conditions have been more favorable for home buying at the start of 2015. Mortgage rates continued to slide, with the contract interest rate for 30-year mortgages sinking 14 basis points to 3.73 percent during the first week of January, according to Freddie Mac. Credit standards continue to loosen up modestly based on both the latest [Fannie Mae Mortgage Lender Sentiment Survey] and the Federal Reserve Senior Loan Officer Opinion Survey. We expect first-time home purchases will get a boost from the FHFA's new guidelines in clarifying rules around when a loan can be put back to a lender, new GSE initiatives to increase availability of credit to borrowers with lower down payments, and the FHA's plan to reduce mortgage insurance premiums for FHA loans by 50 basis points effective on January 26.




Having more first-time buyers entering the market is crucial to the housing recovery, especially at a time when institutional investor buyers have pulled back from the market as foreclosures have fallen. Distressed transactions as a share of total sales fell to about 12 percent in October 2014, marking the 40th consecutive month of year-over-year declines, according to data from CoreLogic. As a result, most measures of home prices have shown moderating year-over-year gains to the mid-single-digit range.

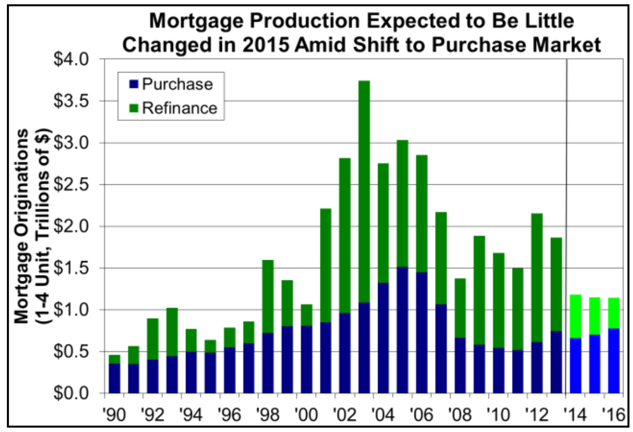



Declining oil prices may hurt some local housing markets if the decline is sustained, particularly in Texas and North Dakota. Texas home prices dropped nearly 15 percent between 1986 and 1988 after oil prices fell around 50 percent during the first half of 1986.




Given expected more favorable fundamentals, the housing market should gradually gain momentum in 2015. Weaker or no growth in several economies abroad should help keep long-term interest rates anchored. Fixed mortgage rates are likely to increase only modestly if at all, climbing only slightly above 4.0 percent through the end of 2015, which should help to support housing activity. Our view for homebuilding activity remains cautious and is based on our concern of both supply constraints (including skilled labor) and demand constraints associated with still very low levels of household formation that will limit the magnitude of growth. We expect 2015 total housing starts to increase nearly 20 percent to 1.16 million units—well below the approximately 1.50 million unit pace witnessed on average over the past half-century. Total home sales should rise approximately 6.0 percent to 5.66 million units, which would be the best showing since 2007, following an estimated 3.0 percent decline in 2014—the first annual drop in since 2009.

We upgraded our estimate of total originations in the third quarter of 2014 as refinance volume came in by more than we had anticipated, according to data from Fannie Mae acquisitions as well as from other data sources we use to benchmark total market mortgage originations. We also revised higher our projected refinance volume for 2015 as a result of a lower forecast for mortgage rates. We estimate that total single-family mortgage originations dropped approximately 37 percent in 2014 to $1.17 trillion. For 2015, we project that total originations will edge up to $1.18 trillion, as an increase in purchase originations should slightly outweigh a drop in refinance originations. The refinance share is projected to slip from an estimated 43 percent in 2014 to 41 percent in 2015. Total single-family mortgage debt outstanding should be relatively flat in 2015 before strengthening gradually going forward.

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Economic and Strategic Research (ESR)

For a more timely snapshot of macroeconomic and housing data, read ESR's Economic and Housing Weekly Notes.

*Sources for chart data: Bureau of Economic Analysis, Energy Information Administration/Chicago Mercantile Exchange, Federal Reserve Board, Bureau of Labor Statistics, Census Bureau, National Association of REALTORS®, National Association of Home Builders, Mortgage Bankers Association, Federal Housing Finance Agency, Fannie Mae*



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