A Solid Second Half for the Economy?

The roller coaster first half of 2014 seems to be smoothing out to a second half featuring the more normal quarter-to-quarter variations, such as inventory adjustments but around a stronger growth path. Healthcare, cold weather and inventory building marked the first-half ups and downs ending the second quarter on a high note. The second quarter marked the five-year anniversary of the current economic expansion, passing the average length of post-World War II expansions. It arrived with good news as the economy grew more than one percentage point faster than the consensus estimate and pulled the first half into positive territory.

The better-than-expected second quarter growth rate, combined with the upward revision to first quarter economic activity, strengthens our confidence in our forecast for growth to average approximately 3.0 percent in the second half of 2014. It also raised our forecast of growth for all of 2014 by four-tenths to 1.9 percent. Improvements in consumer spending, inventories, and employment all have contributed.

Unfortunately, our view of the housing market has deteriorated as housing activity appeared to have lost momentum at the end of the second quarter. Near-term indicators suggest only minor improvement in the second half of the year. We continue to expect residential investment to be a contributor to growth in 2014 and 2015, but its contribution should be similar to 2013—a downgrade from our prior expectation that housing would act as a growing driver of growth going forward.

Economic Growth: A Volatile, Slightly Positive First Half

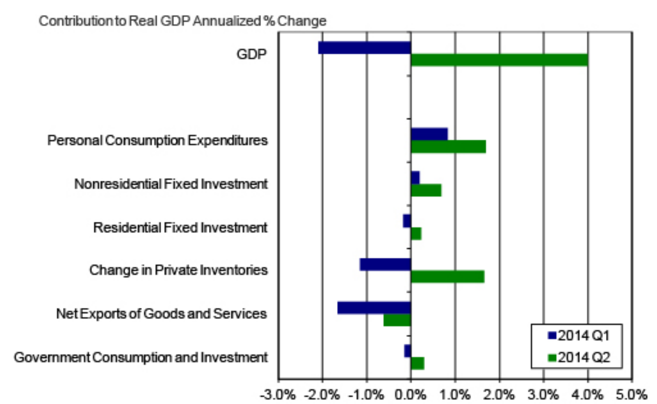
Extreme weather and healthcare expenditure measurement problems were the key factors in the first-half measurement roller coaster. The final estimate of first quarter real (inflation-adjusted) gross domestic product (GDP) was a decline of 2.1 percent annualized. Growth rose 4.0 percent in the second quarter, according to the Bureau of Economic Analysis (BEA) first estimate. On net, we experienced slight growth for the first half of the year.

The rebound in second quarter economic growth was broad-based, with every main component to GDP except net exports providing a positive contribution—a sharp contrast from the first quarter where consumer spending was the main driver to GDP. While net exports were a drag for the second consecutive quarter, they subtracted only 0.6 percentage points from growth compared with 1.7 percentage points in the first quarter, and the monthly June data released after the first estimate of GDP indicated that trade was a smaller drag than initially reported.

Consumer spending and inventory investment were the biggest drivers of growth during the second quarter, with each component adding 1.7 percentage points to GDP. The inventory swing will likely be transitory and subtract from GDP in the second half of the year. Government spending provided the first meaningful contribution to GDP since the third quarter of 2012, thanks to the biggest gain in state and local government spending in five years, while federal government spending continued to be a drag for the seventh consecutive quarter.

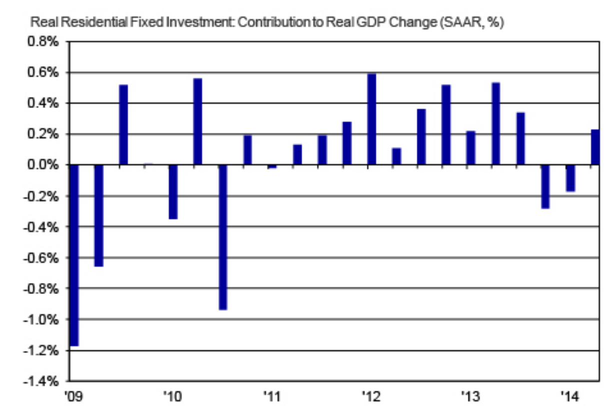
Residential investment rebounded modestly after dragging on growth for two consecutive quarters for the first time in

The Second Quarter Rebound was Broad-Based



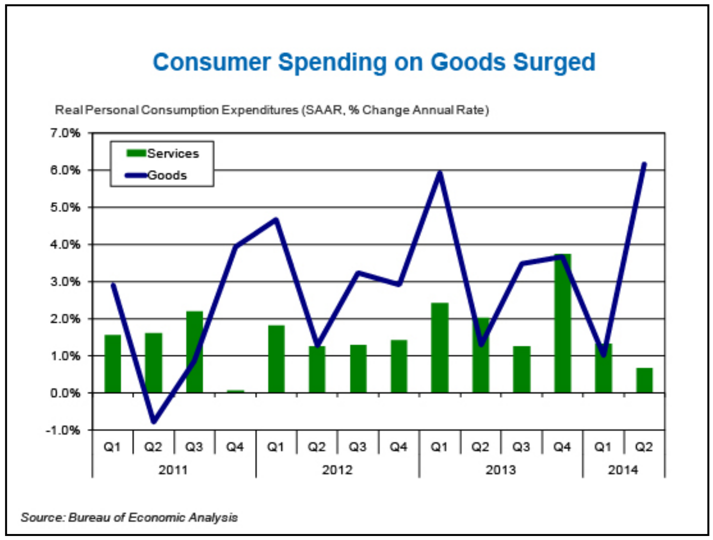
Source: Bureau of Economic Analysis

Residential Investment Resumes its Role as a Positive Contributor



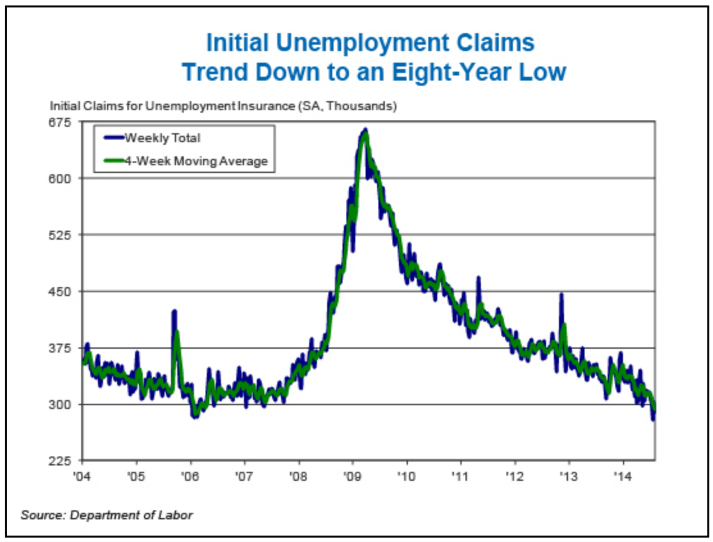
Source: Bureau of Economic Analysis

the current economic expansion. It contributed 0.2 percentage points to GDP in the second quarter.



Real consumer spending increased at a 2.5 percent annualized pace, approximately one percentage point higher than we anticipated, driven by a jump in durable goods spending. Spending on services was lackluster amid modest growth in healthcare spending following the surprise drop witnessed in the first quarter.

The outlook for consumer spending for the current quarter is positive given the improving trend in personal income (more on conflicting income data below). The annual revisions in the National Income and Product Accounts (NIPA) revised higher real disposable income growth in the first quarter to 3.5 percent annualized from 1.5 percent. That measure increased 3.8 percent in the second quarter, the fastest pace in a year. The July Fannie Mae National Housing Survey showed deterioration in consumers' attitudes about the economy, with 59 percent of households saying the economy is on the wrong track. However, consumers surveyed are more optimistic about their personal income and expenses. These results are consistent with the Labor Department survey data that suggest labor market conditions have improved. Initial jobless claims continue to move lower, with the four-week moving average trending down in early August to an eight-year low.



The July jobs report showed a solid hiring trend as nonfarm payrolls rose 209,000 on the heels of upward revisions to the prior two months. Despite the deceleration of job growth in July from the 277,000 average monthly gain in the second quarter, it was the sixth consecutive month with employment gains above 200,000—a first since 1997. In the separate survey of households, the unemployment rate ticked up one-tenth to 6.2 percent, marking the first rise in 19 months, due to an increase in the labor force outpacing a gain in household employment.

Other details were soft, with average hourly earnings and average hours worked both flat. Average hours worked was unchanged at 34.5 hours since March, while average hourly earnings rose 2.0 percent from a year ago, remaining within a tight range of 1.8 percent and 2.2 percent observed over the last four years.

Business Capital Investment: Improving with Manufacturing Activity

Recent factory-related reports confirmed a strengthening in the manufacturing sector and in business capital investment. Factory orders rose in June for the fourth time over the last five months, and orders for core capital goods—a leading indicator of business capital investment—were revised higher to show a strong gain. The revisions to NIPA showed notably higher business capital investment in 2013, indicating a healthier corporate sector than previously believed and pointing to a stronger trend this year. Overall nonresidential investment, including investment in structures, equipment, and others, should provide a steady boost to growth for the remainder of this year and next as long as consumers hold up.

The Institute for Survey Management (ISM) manufacturing survey suggests that momentum continues to build into the third quarter, as the manufacturing index rose in July to a three-year high. The ISM nonmanufacturing survey for the service sector suggests broad-based improvement in economic activity at the start of the third quarter, as the ISM nonmanufacturing index jumped to the highest level since the end of 2005.

Net Exports: A Supporter for Second Half Growth

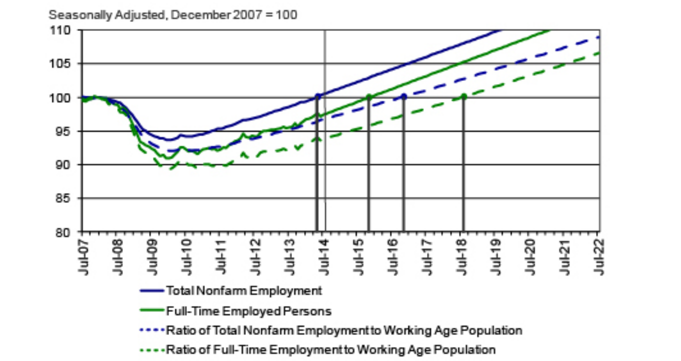
As mentioned earlier, the June trade deficit showed a better picture than assumed by the BEA's first estimate of second quarter GDP. The real trade deficit narrowed as exports increased while imports fell, improving prospects for the third quarter. After subtracting from growth during the first half of 2014, we expect trade to support growth in the second half before acting as neutral to growth in 2015. Russia's retaliation against Western sanctions by banning or limiting agriculture imports from countries that have imposed sanctions on Russia should have little impact on the U.S., as exports to Russia account for less than 1.0 percent of total U.S. exports. However, the turmoil around the globe has led to another flight to quality in the US bond market recently and yields have fallen as investors seek the safe haven of the U.S. Treasuries.

Fed Policy: Bracing for a Change of Posture

The latest Federal Open Market Committee (FOMC) statement signaled that Fed officials were somewhat less concerned about falling inflation. In previous statements, the Fed noted that inflation was running below its longer-term target (i.e., 2.0 percent rise in the Personal Consumption Expenditures deflator). In its July statement, the Fed remarked that inflation has "moved somewhat closer" to its longer-run target. The Fed removed the statement that the unemployment rate remains elevated, but referenced that other indicators still suggest "significant underutilization of labor resources."

Our own analysis suggests that alternative interpretations of recent data can have a significant impact on how the health of the labor market is viewed. In Chart 5 below we note that the total number of employed people has indeed reached and now surpassed the number at the peak before the recession. However, at the current pace of job growth, the total full-time jobs equaling the peak will not be achieved until November 2015. If we further adjust for the increase in the working age population we see total jobs and full-time jobs not being equaled for another two or more years.

The Recovery* of the Full-Time Employment to Working Age Population Ratio Will Be Slow



*Data starting in August 2014 are forecasted using the BLS labor force projections and assuming the prior year of employment growth remains constant.

Source: Bureau of Labor Statistics

Wage pressure now is under scrutiny given the debate surrounding the extent of the slack in the labor market as a key for the Fed to withdraw monetary stimulus. The current lack of wage pressure from the July jobs report supports the view that the Fed can be patient in removing monetary accommodation. Currently, other gauges of wage inflation—such as the employment cost index, which measures not only wage and salaries but also benefits—showed a pickup in the second quarter to the fastest pace since the third quarter of 2008. However, the 2.1 percent year-over-year increase was in line with the gains over the past four years.

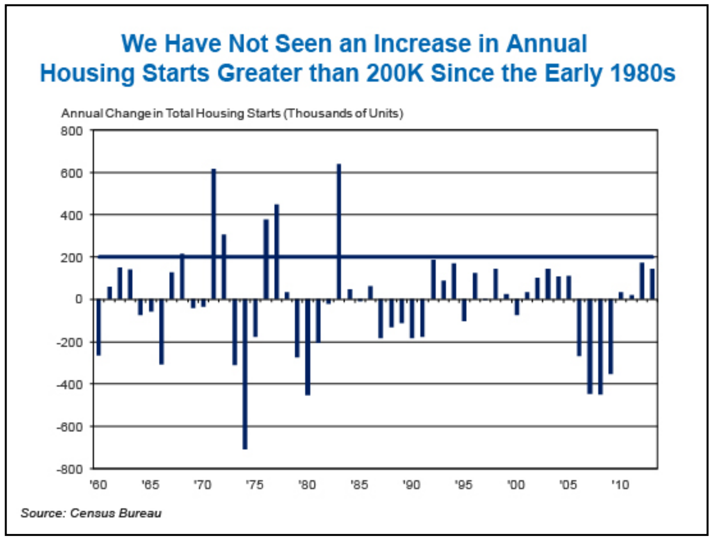
We expect the Fed to continue to taper its monthly purchases at the next two Federal Open Market Committee (FOMC) meetings, and to end the asset purchase program at the October meeting. By then, the size of the Fed's balance sheet will likely be close to $4.5 trillion. We expect the Fed to continue to reinvest the proceeds of its maturing asset holdings until some point after the first rate hike, which we expect to be in the third quarter of 2015. We do not expect this to be affected by any interim federal fiscal factors that may arise.

Fiscal Policy: An Election and Federal Fiscal Decisions Ahead

The public will conduct their off-year Congressional elections in November, and the election season will likely feature discussions of both domestic and international conditions. In our view, the deterioration in consumers' positive attitude on the performance of the economy based on a question from our [Fannie Mae National Housing Survey] is most likely being affected by international tensions at the moment. However, the question is not asked in a way that allows us to confirm that view. Nonetheless, two considerations are relevant on the fiscal front. Several appropriations bills remain to be passed by September 30, 2014 or the ongoing funding for a number of federal agencies expires. It is likely that at least a continuing resolution will be passed to continue funding until after the election this coming November, but that is not certain. Also, the currently suspended debt ceiling will be reinstituted in mid-March of 2015 and is a potential factor in the political discussion. While the public engage in a debate over the level and nature of federal spending, they do not seem to like either a shutdown of the government or a breach of the debt ceiling, which makes both unlikely.

Housing: A Mid-Year Downgrade

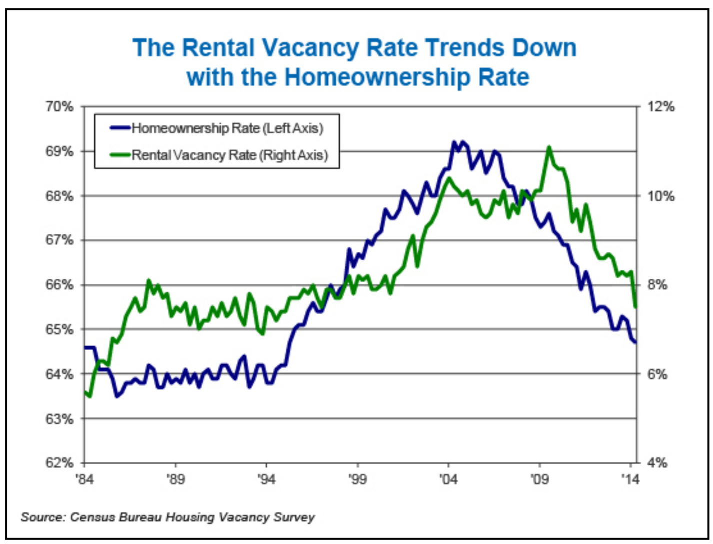
Housing activity ended the second quarter on a weak note. Both single-family and multifamily starts fell in June for the second consecutive month. The performance of single-family starts so far this year has been particularly disappointing. Through the first six months of 2014, single-family housing starts are running just 1.0 percent ahead of their year-ago pace, compared with 16.0 percent for multifamily starts. Severe winter weather as well as supply issues—including shortages of skilled labor, lots, and materials—may have played a role in restraining homebuilding activity. However, new single-family home demand also has been lackluster of late. Despite our forecast at the start of the year for a double-digit gain in new home sales, sales during the first six months of this year are running below last year's pace. Notably, there have been only five years since the data on housing starts were first collected in which the year-over-year increase in starts has exceeded 200,000 units. Each of these 200,000-plus years was prior to the mid-1980s when the Boomers were going through prime first-time homeowner years and also before the Tax Reform Act of 1986 reduced tax incentives for investment in rental housing.



Both homebuilding activity and new home sales contrasted sharply with increased homebuilder optimism in July. Permits, a leading indicator of housing starts, suggest cause for only modest optimism. Total permits declined in June for a second consecutive month, pushed lower by a retrenchment in authorized five or more unit structures. Although single-family permits increased 3.1 percent during the month following a similar gain in May, they still remain below the recovery-best pace reached near the end of last year. Through the first six months of 2014, single-family permits are below the level reached over the same period in 2013.

The demographic fundamentals for multifamily building remain positive despite the recent pullback in the multifamily sector. (For more information on multifamily market conditions, read the August 2014 Multifamily Market Commentary.) The pace of household formation remains sluggish and according to the Census Bureau Housing Vacancy Survey it appears that most of the newly created households went into rental units. As a result, the rental vacancy rate plummeted 0.8 percentage points to 7.5 percent, pushing the rate down to the lowest reading since 1997. By contrast, the homeowner vacancy rate edged down just one tick to 1.9 percent, remaining within the tight range witnessed during the past two years. The drop in the rental vacancy rate has been consistent with the declining trend in the homeownership rate, which edged down 0.1 percentage points to 64.7 percent, marking the lowest level since 1995 and down from its peak of 69.2 percent in mid-2004.

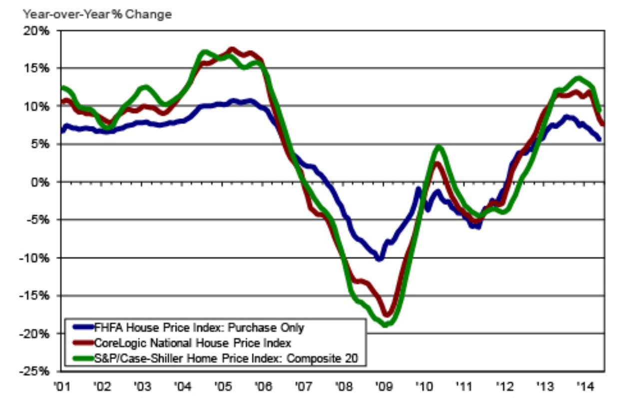
Our demographic research[1] supports the view that homeownership could fall further in the short run. It seems that younger households aspire to eventually own homes at similar rates as their predecessors, but are being more conservative financially about how and when they make that happen. More of them are living at home longer and with their parents' approval, and more find renting a better option for various reasons without any stigma attached to that choice. As interest rates and house prices rise, they will likely support that trend at least until household structure changes (e.g., marriage, children) and real incomes rise to create the triggering event to become a homeowner.



Existing home sales increased for the three months ending in June. However, near-term leading indicators suggest some weakness. Pending home sales (contract signings of existing homes), fell in June and purchase mortgage application data from the Mortgage Bankers Association also dropped about 4.0 percent in July, down approximately 14 percent from last year.

Meanwhile, the number of homes available for sale (not seasonally-adjusted) has trended up and home price appreciation has slowed across different measures on both an annual and monthly basis. The CoreLogic home price index (not seasonally adjusted) posted a month-to-month gain of 1.0 percent in June, following similar gains in May and April. However, after seasonal adjustment, the index was flat during those three months. From a year ago, the index increased 7.5 percent in June 2014, the smallest gain since October 2012, slowing from the peak of approximately 12.0 percent in February 2014. The 20-city S&P/Case-Shiller house price index posted a drop in May after seasonal adjustment for the first time since early 2012 and showed the slowest pace of annual appreciation since February 2013. The FHFA house price index also showed a similar trend. The ongoing moderation in home price gains is consistent with our forecast for home price appreciation to slow this year and next year as more supply comes to market, that the return of the first-time homebuyer remains tentative, and the markets see reduced investor demand.

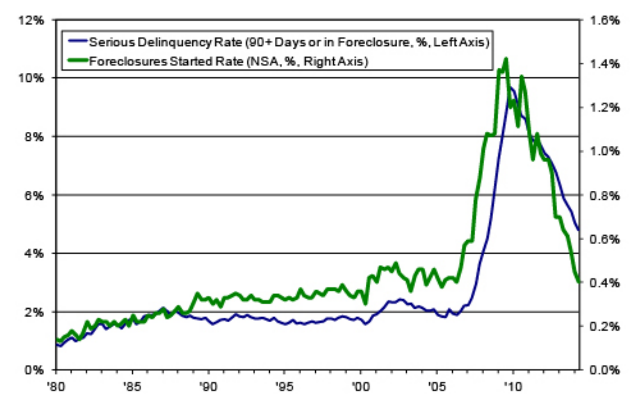
Home Price Gains are Moderating



Source: Federal Housing Finance Agency, CoreLogic, S&P/Case-Shiller

On a positive note, loan performance continues to improve. Mortgage performance continued to improve in the second quarter of 2014, according to the Mortgage Bankers Association National Delinquency Survey. Short-term delinquency is near a 40-year low and the new foreclosure rate declined to pre-crisis levels. While the serious delinquency rate remains elevated at 4.80 percent, sluggish improvement in judicial foreclosure states is mostly to blame. Of the 18 states with foreclosure rates above the national average in the second quarter, 15 are judicial foreclosure states. The serious delinquency rate for the judicial states was approximately three percentage points higher than the 1.29 percent rate for the non-judicial states during the quarter.

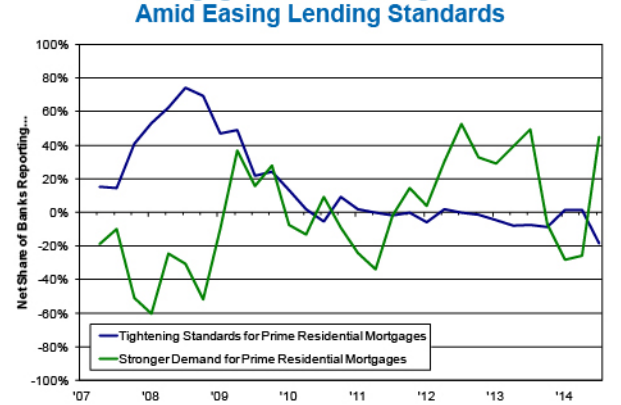
Mortgage Performance Continues to Improve



Source: Mortgage Bankers Association

Conditions in the mortgage market also improved in the three months ending in July according to the Federal Reserve Senior Loan Officer Survey. The survey showed a substantial pickup in demand for prime residential mortgages for the first time in a year, as a net share of 45.1 percent of banks reported a rise in demand. The strengthening demand coincided with a renewed loosening in lending conditions after conditions tightened in the previous two quarters, as a net balance of 18.3 percent of banks reported relaxing their mortgage lending standards to prime residential borrowers. These results are broadly consistent with the [Second Quarter Fannie Mae Mortgage Lender Sentiment Survey].

Mortgage Demand Strengthens Amid Easing Lending Standards

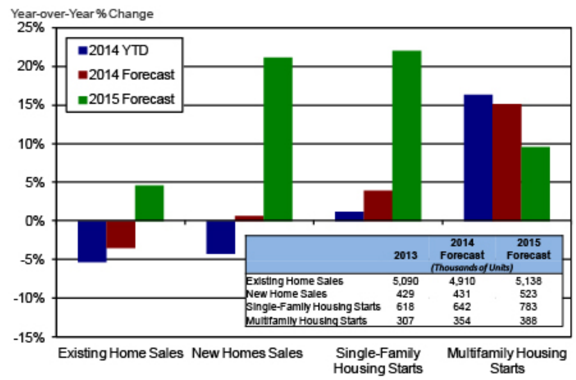


Source: Federal Reserve Board Senior Loan Officer Opinion Survey

The gradual loosening of lending standards at the end of a refinance wave and thus a more competitive lending environment is not surprising. While a large net share of the July Fed survey respondents said that they loosened standards, the extent of the loosening was unclear. In addition, the data from the survey showed that the level of credit conditions is still much stricter than before the crisis.

Mortgage rates were little changed. The average yield on 30-year fixed mortgage rates stayed in the tight range of 4.12 percent to 4.15 percent over the last seven weeks through the first week of August, near the low for the year, according to Freddie Mac. We expect mortgage rates to trend up to 4.3 percent and 4.7 percent by the end of 2014 and 2015, respectively, the same as in our prior forecast. Thus, our forecast for a meaningful decline in refinance originations holds firm.

Housing Recovery Continues



Source: National Association of Realtors®, Census Bureau, Fannie Mae

The pace of improvement in housing indicators will likely be more subdued than we had anticipated previously given their recent trends and near-term forward looking indicators. Consequently, we downgraded our forecast of single-family housing starts and total home sales, and modestly upgraded projected multifamily starts. We expect total housing starts to reach slightly below 1 million units in 2014 before rising to 1.17 million units in 2015. This is compared with a projected rise to 1.05 million units and 1.27 million units in 2014 and 2015, respectively, in our July forecast. Total home sales should decline approximately 3.0 percent in 2014 followed by a 6.0 percent gain in 2015, a downward revision from a drop of approximately 1.0 percent in 2014 and a gain of 7.0 percent in 2015 in our prior forecast.

Given our same home price forecast and reduced projected housing starts and existing home sales, we also downgraded our projected purchase originations. For all of 2014, total mortgage originations should decline approximately 42.0 percent to $1.11 trillion, with a refinance share of 39.0 percent. For 2015, we expect total mortgage originations to drop another 5.0 percent to $1.05 trillion, with the market tilting substantially more toward the purchase market, as indicated by a sizable drop in the refinance share to just 26.0 percent. Total single-family (1 to 4 unit properties) mortgage debt outstanding is projected to rise modestly this year and strengthen further going forward.

Risks and 2015

After making these adjustments, we now see the risks in our forecast as more balanced. Though we expect economic growth in 2015 to moderate from the second half of this year to trend-like growth of 2.5 percent, our expectation depends on a number of factors. These factors include whether second-half growth materializes as expected and is maintained into 2015; whether a stronger economy will stimulate much higher interest rates than we expect; whether the global geopolitical turmoil continues; and whether accounting for healthcare is improved and settled.

It is possible that growth could stay elevated into 2015. If so, we would expect it to result in stronger employment and ultimately lead to stronger wage growth. That would imply that the risks to our rate hike call tilt toward an earlier rate hike than later.

Meanwhile, global tensions have increased in Ukraine and the Middle East amid worrying economic indicators in Europe, which present some downside risks to the forecast. This also appears to have led to a flight to quality in U.S. capital markets and is holding interest rates down. There also could be an impact to oil prices, which would shock consumer budgets. However, “fracking” in the U.S. and increased production of oil and gas offset the declines in production in the Middle East.

Healthcare spending remains a wildcard in estimating consumer spending, and it could be revised higher in subsequent estimates of GDP given anecdotal evidence from earnings announcements from publicly traded health services providers, particularly hospitals. In addition, recent Treasury data continue to show that health-related fiscal transfers, especially Medicaid payments (which go mainly to reimburse the states for health care consumption that already occurred) accelerated into the third quarter. The picture of consumer spending will be muddled for some time as current estimates are subject to change based on the Quarterly Services Survey for the second quarter, which will be released in September.

In summary, we think the risks are balanced regarding our forecast accuracy and we expect the unexpected.

Doug Duncan, Orawin T. Velz, and Brian Hughes-Cromwick
Economic and Strategic Research
August 11, 2014

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[1]Stephanie Postles, "Why Are Young Adults Living with Their Parents and When Will They Move Out?", *FM Commentary*, Fannie Mae, July 29, 2014.

Sarah Shahdad, "What Younger Renters Want and the Financial Constraints They See", *FM Commentary*, Fannie Mae, May 6, 2014.

Patrick Simmons, "Are Aging Baby Boomers Abandoning the Single-Family Nest?", *Housing Insights (4, 3),* Fannie Mae, June 12, 2014.

Patrick Simmons, "Upper-Income, Educated, Married with Children, and Still Not Buying: Declining Homeownership among 'Prime' First-Time Home Buying Candidates", *Housing Insights (4, 4),* Fannie Mae, August 18, 2014.