Economics: Solid Third Quarter Growth with Some Payback in the Cards

This week's economic reports were broadly positive. While economic growth in Q3 2014 was slightly stronger than we expected, the upside surprise largely came from a surge in federal defense spending and a sharp narrowing of the trade deficit, both of which are unlikely to sustain. Cautious consumers cut back spending at the end of the quarter as the saving rate rose to 5.6 percent, matching the level in July, which was the highest since 2012. However, declining gasoline prices, which helped lift October confidence to multi-year highs, will provide support to consumers going into the holiday season. The September durable goods report suggested a weak trajectory of business capital spending in the current quarter. Despite some soft spots, we maintain our expectation of slightly more than 3.0 percent growth during the second half of 2014. Our view of the timing of the "lift off" in the target fed funds rate also remains unchanged at Q3 2015, following this week's meeting of the Federal Open Market Committee (FOMC). As expected, the Fed announced an end to its asset purchase program though it will maintain the size of the balance sheet at approximately $4.5 trillion. The FOMC also retained its assurance that the target rate would remain near zero for a "considerable time" against the back drop of inflation well below its target and the underlying trend in initial jobless claims declining to the lowest level since 2000.

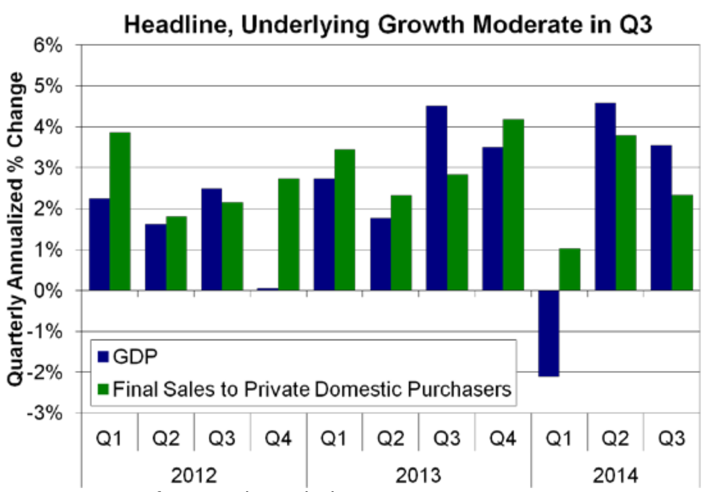
- **Gross Domestic Product (GDP)**, adjusted for inflation, increased at a 3.5 percent annual rate in Q3 2015. The largest contribution to GDP came from net exports, which contributed 1.3 percentage points. Real consumer spending increased 1.8 percent, while fixed business investment rose 5.5 percent. Real government spending jumped 4.6 percent, the biggest gain since mid-2009. Housing disappointed, as real residential investment grew just 1.9 percent after an 8.8 percent gain in the prior quarter. Inventory investment slowed, subtracting 0.6 percentage points from GDP. A key indicator of underlying growth for the private sector, real final sales to private domestic purchasers—which includes domestic spending by consumers and businesses excluding inventories—grew 2.3 percent, slowing from 3.8 percent in the second quarter.

- **Personal income**, adjusted for inflation, edged up 0.1 percent in September, the weakest gain so far this year. Real personal consumption expenditures (PCE) fell 0.2 percent. The PCE deflator rose 0.1 percent from August and 1.4 percent from September 2013, matching the annual gain in August and well below the Fed's 2.0-percent inflation target.

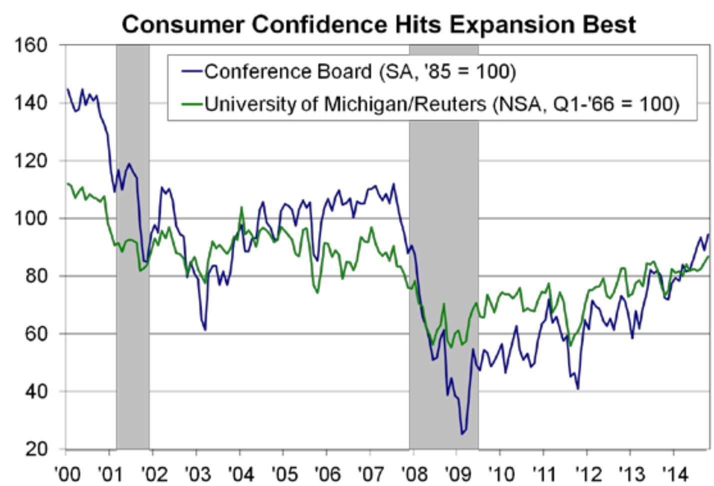
- **The Conference Board Consumer Confidence Index** rose to a seven-year high of 94.5 in October from 89.0 in September (revised up from 86.0), driven by a surge in the expectations index, which jumped 8.6 points to 95.0, its highest level since February 2011. The present situation component edged up 0.7 points to 93.7. Despite the impressive headline, buying plans for autos, major appliances, and homes failed to improve, suggesting a high level of consumer caution. The final October reading of the Reuters/University of Michigan Consumer Sentiment Index ticked up from 84.6 in September to 86.9—the highest reading since July 2007—boosted by an improvement in the expectations component that outweighed the second consecutive modest drop in the present conditions component.

- **Durable goods orders** fell 1.3 percent in September. Nondefense capital goods excluding aircraft, a leading indicator of business investment in equipment, sank 1.7 percent, the largest drop since January.

- **The Employment Cost Index (ECI)** rose 0.7 percent in Q3 2014 for the second consecutive quarter. The year-over-year gain of 2.3 percent marks the fastest pace since Q4 2008.



Source: Bureau of Economic Analysis



Source: Conference Board, University of Michigan/Reuters

Housing: A Steady Grind

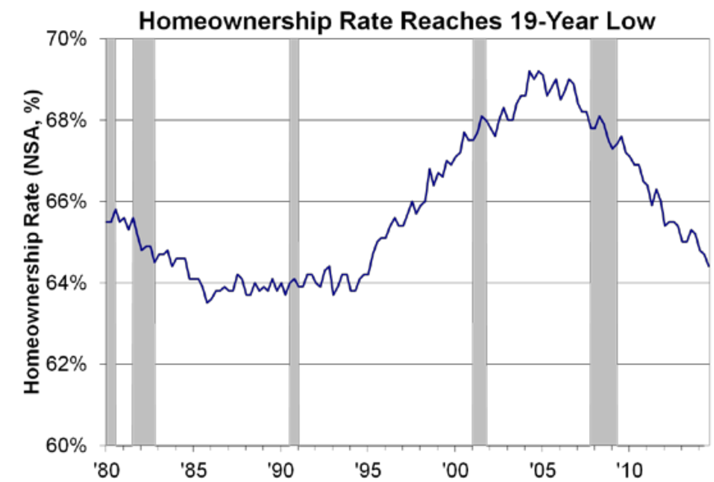
In case more evidence of the sluggish and uneven recovery in housing activity was needed, the broad array of housing data released this week largely fit the bill. A leading indicator of existing home sales moved in the right direction in September but failed to recover from the decline in the prior month. Mortgage applications cooled a bit last week as refinance demand took a breather following a remarkable three-week stretch amid renewed declines in mortgage rates. Meanwhile, purchase demand as measured by mortgage applications continues to disappoint. Similar to last week's report on home prices as measured by the FHFA purchase-only home price index, August data for the S&P/Case-Shiller index confirmed the steady decline in annual home price appreciation that has been ongoing for the better part of a year. A less timely but equally important data source, the Housing Vacancy Survey (HVS), also was mixed as residential vacancy rates improved amid a homeownership rate that continues to grind lower and notably weak household formation. According to Freddie Mac, the 30-year fixed-rate mortgage yield held under 4.0 percent for the third straight week, rising six basis points to 3.98 percent this week.

- **The National Association of REALTORS® pending home sales index**, which records contract signings of existing homes and typically leads existing home sales by one to two months, increased 0.3 percent in September following a 1.0 percent decline in August. The index is up 1.0 percent over the last year—the first annual increase registered since September 2013. Pending sales improved on a monthly basis in both the Northeast and South, but declined in the Midwest and West. The Midwest was the sole region to experience a year-over-year drop in September.

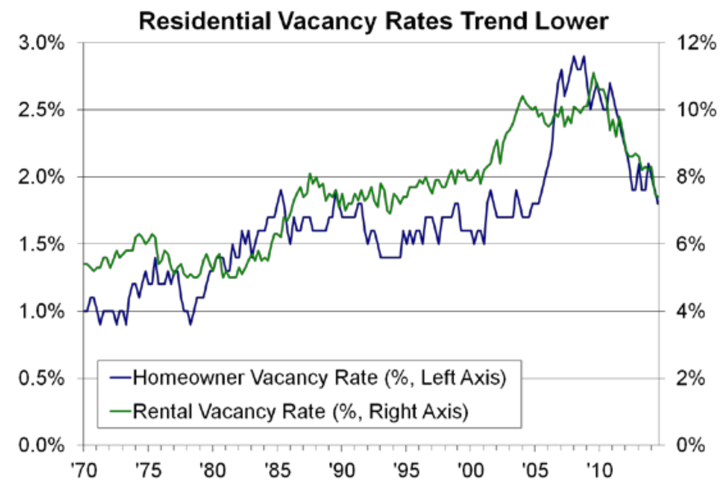
- **The Housing Vacancy Survey (HVS)** for Q3 2014 (not seasonally adjusted) released by the Census Bureau showed a 0.3 percentage point decline in the homeownership rate to 64.4 percent—the lowest since Q1 1995 and down from a peak of 69.2 percent reached in 2004. Vacancy rates declined during the quarter, with the rental vacancy rate ticking down 0.1 percentage points to a near two-decade low of 7.4 percent amid an equal decline in the homeowner vacancy rate to 1.8 percent—a nine-year best. The report also showed continued sluggish household formation—just 541,000 over the past year—due entirely to new renter households. The number of owner-occupied households declined over the past four quarters according to the survey.

- **The S&P/Case-Shiller composite 20-city home price index** (not seasonally adjusted) increased 0.2 percent in the three months ending in August—the slowest pace of growth since February. Annual price growth also has decelerated, with year-over-year growth of 5.6 percent in August compared to its recent peak of 13.7 percent last November. All 20 cities measured showed annual price growth in August, though they also all recorded lower year-over-year appreciation than in August 2013.

- **Mortgage applications** declined 6.6 percent in the week ending October 24 according to the Mortgage Bankers Associations (MBA), weighed down by the third consecutive weekly decline of purchase applications (down 5.0 percent) and a pullback in refinance applications of 7.4 percent following a 43 percent cumulative gain in the prior three weeks. After reaching a 16-month low in the prior week, the contract interest rate for 30-year fixed-rate mortgages edged up three basis points to 4.13 percent.



Source: Census Bureau Housing Vacancy Survey



Source: Census Bureau Housing Vacancy Survey

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