Near-term Setback Likely to be Short-lived

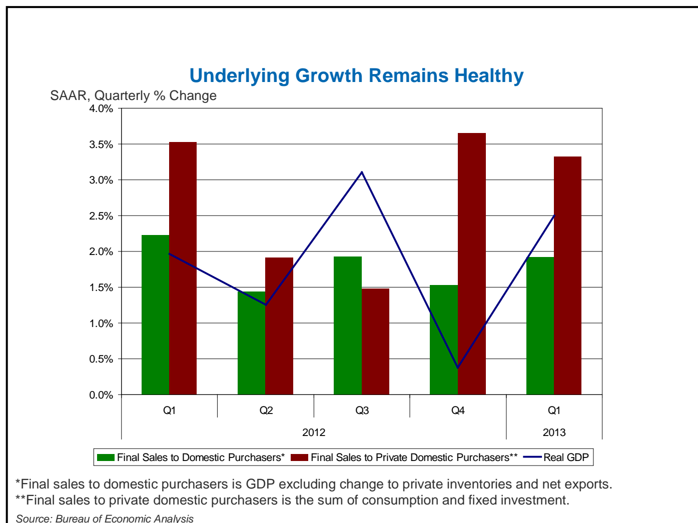
Economic growth accelerated in the first quarter of this year as expected, boosted by inventory replenishment following a sizable drawdown in the prior quarter as well as the strongest consumer spending growth since the end of 2010. We project growth in the current quarter to downshift to roughly half the pace witnessed in the first quarter as inventory accumulation will likely moderate going forward. In addition, the strong start to the year for many key economic indicators faded late in the quarter, pointing to weakening momentum, partly due to ongoing fiscal drags, including the sequester. Our view calls for a modest reacceleration in the second half of the year, as the economy as well as the labor market regains its traction amid waning impact from fiscal restraints, continued accommodative monetary policy around the globe, and expected further improvement in financial and housing market conditions. For all of 2013, we expect the economy to grow 2.2 percent, following 1.7 percent in 2012 and 2.0 percent in 2011, continuing a modest recovery.

Growth: Healthy Underlying Strength Despite Volatile Headline Figure

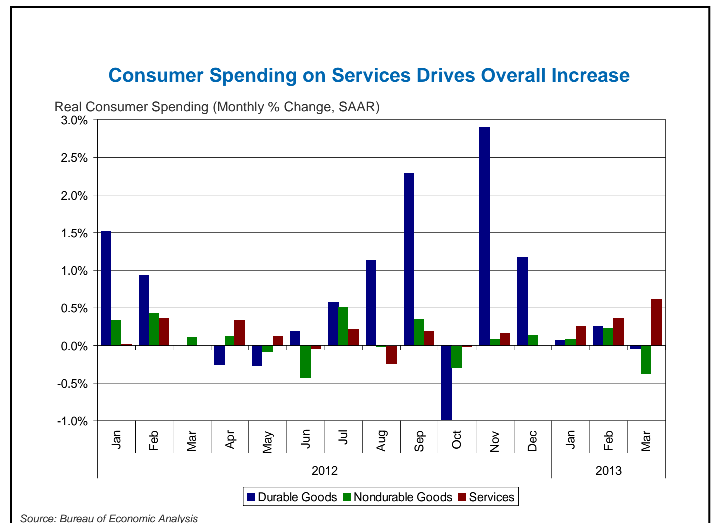
The headline growth from the first estimate of first quarter real (inflation-adjusted) gross domestic product (GDP) of 2.5 percent annualized showed a strong pickup from an anemic 0.4 percent pace in the final quarter of 2012. Importantly, final sales to domestic purchasers—GDP excluding the change in inventories and net exports and a better gauge of the underlying strength in domestic demand—also accelerated nearly half a percentage point to 1.9 percent. Another measure of the domestic economy's underlying strength is final sales to private domestic purchasers—the sum of consumer spending and business investment representing roughly 85 percent of the economy—continued to grow at a healthy pace. Given continued strong private domestic demand, we expect that economic growth will pick up as the negative impact from fiscal policy abates later this year.

Consumers: Strong Engine of Growth

Real consumer spending started the year off growing 3.2 percent annualized in the first quarter—a surprisingly strong pace in light of the tax hikes and the expiration of the payroll tax holiday. Consumer spending added 2.2 percentage points to GDP, its biggest contribution to growth in two years. Contrary to many other headline economic indicators, real consumer spending ended the quarter on a firm note, rising 0.3 percent for a second consecutive month. However, its strength is unlikely to hold up, as some of the increases were due to temporary factors, including unusual weather patterns that contributed to a surge in real spending on home heating (gas and electricity) in February and March—the largest back-to-back gains on record since the inception of this series in 1995. The jump in real service spending in March, which reflected spending on gas and electricity, was solely responsible for the strong overall gain in consumer spending as both durable goods and non-durable goods fell during the month—the first time that has occurred since last October.



*Final sales to domestic purchasers is GDP excluding change to private inventories and net exports.
**Final sales to private domestic purchasers is the sum of consumption and fixed investment.
Source: Bureau of Economic Analysis



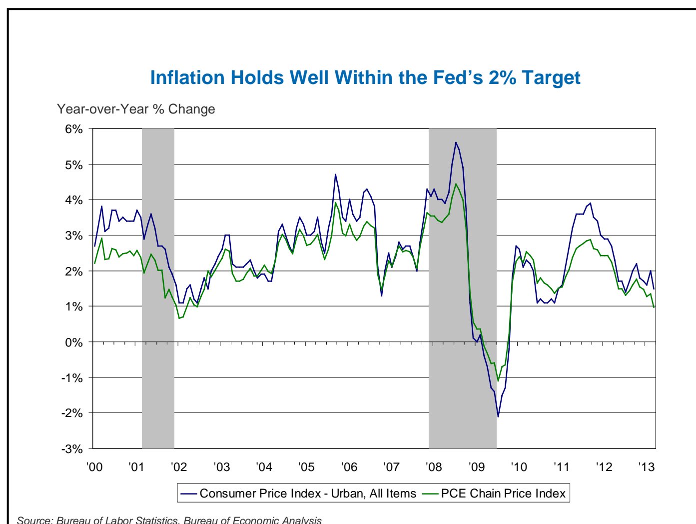
Source: Bureau of Economic Analysis

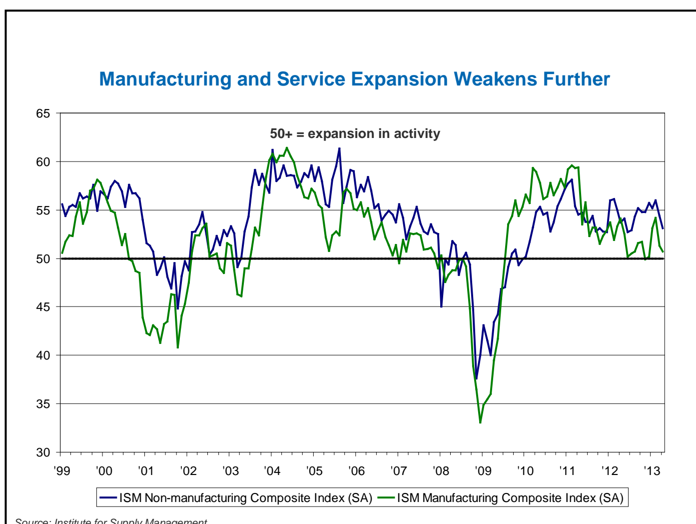
March's consumer credit (non-mortgage) showed the pace of debt accumulation slowed substantially. While consumers continued to take advantage of low interest rates and improving lending standards by increasing non-revolving credit to finance spending on education (i.e., credit from the federal government as part of the health care reform legislation) and autos, they reduced their revolving credit usage (largely credit card debt). The latest data echoed the trends witnessed over the past few years: an increase in non-revolving credit primarily drove the gain in overall consumer credit, with modest gains from revolving credit.

For April, the boost from utility spending likely reversed, acting as a drag to overall spending. Combined with April soft auto sales, consumer spending should weaken materially, suggesting that the highly anticipated negative effect of tax increases at the start of the year on consumers was delayed rather than muted. However, after a spike in gasoline prices in February, prices receded in March and slowed further in April, providing support to consumers. The strength in equities and home prices should further boost household balance sheets, helping to offset some of the adverse impact of fiscal tightening. The Dow Jones Industrial Average closed at an all-time high above 15,000 in early May, while the CoreLogic house price index, a measure used by the Federal Reserve to estimate housing wealth in the Flow of Funds, showed that March home prices posted the strongest annual gain in six years.

Inflation: Back-Burner Issue for the Fed

The Fed's preferred inflation measure, the personal consumption expenditure (PCE) price index, has eased substantially in recent months. It fell 0.1 percent in March, and the year-over-year rise has slowed from its recent peak of 1.8 percent last October to just 1.0 percent in March—a full percentage point below the Fed's target. Core PCE inflation (excluding food and energy items) has also moderated, rising just 1.1 percent from a year ago. Other inflation indices, such as the Consumer Price Index (CPI), also experienced similar decelerating trends. We expect continued muted inflationary pressure this year, reflecting weakening momentum in the global economy, which should help hold down commodity prices. In addition, the gradual improvement in the labor market should keep labor costs subdued, restraining underlying inflation.





The softening inflationary pressure supports our current view that the Fed will maintain its accommodative monetary policy stance by continuing its asset purchase program until at least the end of this year and keeping the fed funds rate near zero until the second half of 2015. The Fed views the current fiscal policy to be "restraining economic growth," according to the statement from the April Federal Open Market Committee (FOMC) meeting. Another notable change in the statement is that the Fed raised the possibility of increasing the pace of asset purchases if the economy deteriorates.

Key Economic Indicators: Bearish in March and Slowed Further

Economic data during the final month of the first quarter were largely downbeat. Following a robust gain of 0.9 percent in February, manufacturing output fell 0.1 percent in March. Meanwhile, durable goods orders fell sharply, as aircraft orders tumbled. The important core capital goods orders (non-defense excluding aircraft), a leading indicator of business capital investment, rose just slightly after plunging in February, suggesting a second consecutive quarter of lackluster growth in business investment.

Incoming April indicators showed a further weakening in some activity. For example, after plummeting in March, the Institute for Supply Management (ISM) manufacturing index fell again in April, barely staying in expansion mode. Its counterpart, the ISM non-manufacturing index, also dropped in April for the second consecutive month but remained firmly in expansion territory.

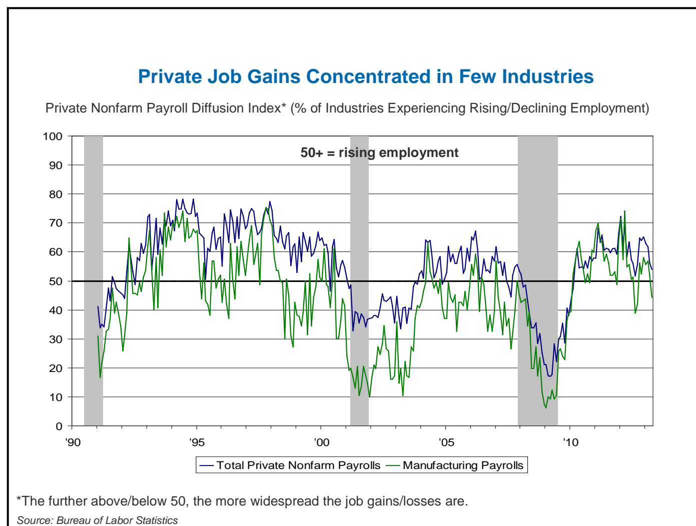
Confirming that a slowdown in coming months is likely in the cards, the Conference Board's Leading Economic Index—a gauge for the economic outlook three to six months ahead—ticked down in March, marking the first drop in seven months.

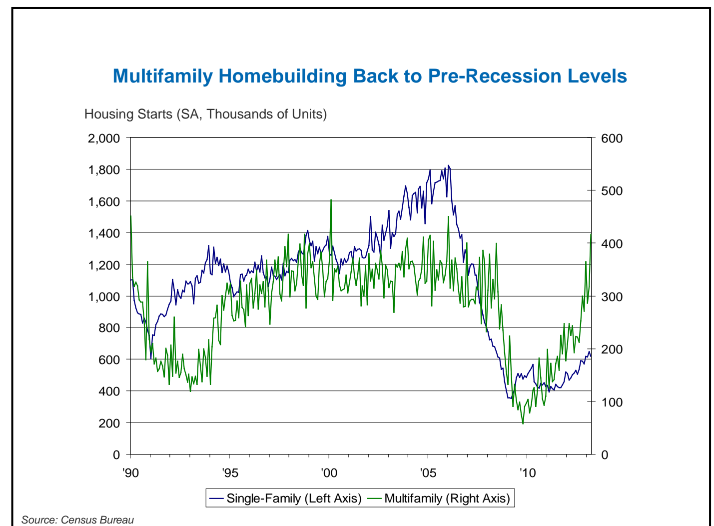
Key Economic Indicators: Bearish in March but Rebounded in April

Others indicators showed some improvement. Following the March jobs report showing the weakest job creation since last June, the April report provided some upside surprise. Non-farm payrolls rose 165,000 on the heels of an upward revision totaling 114,000 jobs in the prior two months, resulting in a solid average monthly gain over the three months ending in April of 212,000. The entire increase in payrolls came from the service sector, as manufacturing employment held steady and construction employment posted the first drop in nearly a year. The decline in construction employment did not suggest weakening housing activity as residential construction payrolls (construction and specialty trade contractors) rose 13,000 in March and a total of nearly 80,000 over the past six months.

The household survey showed some improvement as the unemployment rate dipped 0.1 percentage points to 7.5 percent, the lowest reading since December 2008. While this marks the third consecutive monthly drop, the April decline indicated truly improving market conditions as a large gain in employment outpaced a decent gain the labor force, the first increase in three months.

A few soft spots remained, however. Average weekly hours fell sizably, marking the first drop in three months. In addition, job gains were not broad-based, with increases concentrated in only few industries. The diffusion index—a gauge of how widespread job gains are across industries—fell for the fourth consecutive month to 53.9 in April, the lowest level since last August. The index for the manufacturing industry slumped to 44.4, indicating that more factories reduced head counts than took on more workers.





Despite a few blemishes, the April employment picture, combined with a continued decline in initial unemployment claims to the lowest levels since December 2008, should help boost consumer sentiment on the overall economy. A measure of consumer confidence showed some improvement in April: the Conference Board's consumer confidence index essentially reversed the prior month's decline, driven largely by the expectations component, which jumped to the highest reading since last November.

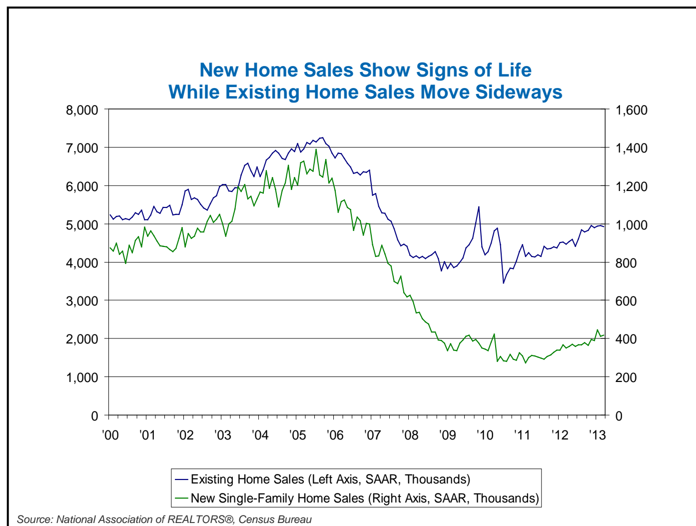
Housing: Recovery is Undeterred

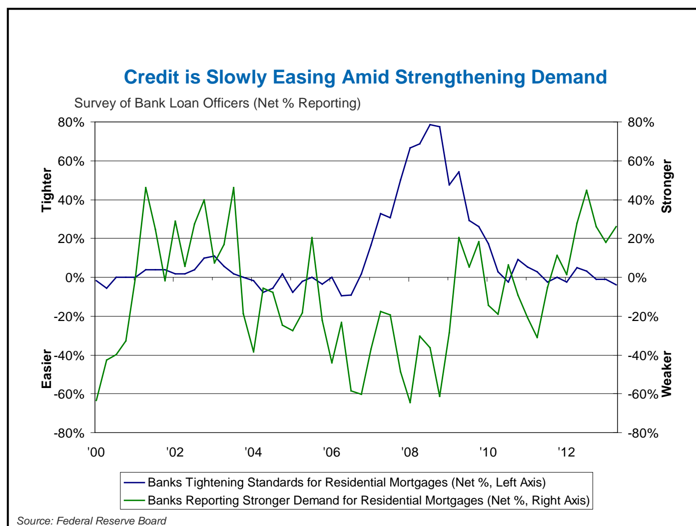
Residential investment contributed to economic growth for the eighth consecutive quarter, adding 0.3 percentage points during the first quarter. Recent housing indicators point to continued recovery. The annualized pace of total housing starts in March surpassed the one million mark for the first time since mid-2008, driven solely by a surge in multifamily home

building activity, which outweighed a decline in the single-family segment. The level of March multifamily starts is now back to the levels witnessed in the early 2000s, prior to the housing downturn. (For more information on multifamily market conditions, read the May 2013 *Multifamily Market Commentary*.

Multifamily homebuilding has benefitted from a shift in tenure choice over the past several years toward renting. The homeownership rate continued to decline in the first quarter of 2013, dropping to 65 percent—the lowest rate since the third quarter of 1995.

Existing home sales slipped in March, after slight increases in the prior two months, essentially moving sideways during the first quarter. By contrast, new single-family home sales rose in March, reaching the second strongest pace since April 2010 after the January pace. For the first quarter, new home sales jumped 51 percent annualized, the biggest gain since the second quarter of 2003.





The level of home sales have remained depressed by historical standards, especially given the currently high affordability conditions as indicated by the National Association of REALTORS® (NAR) Housing Affordability Index, which reached the highest level in January since record keeping began in 1971.

As part of our 2013 "transition to normal" theme, we constructed our own annual affordability index using a similar methodology to NAR's. The index depends on three key factors: mortgage rates, family income, and home prices. The higher the index, the more affordable homes are. Of the three determinants, affordability is the most sensitive to changes in mortgage rates. Using our forecast of those three variables, housing affordability should trend down gradually from its peak in 2012 but will remain above the level we deem to be normal through 2017. Our forecast of the yield on 30-year fixed rate mortgages points to an average rate of 5.0 percent in 2017. Using a more aggressive mortgage rate increase scenario, with the rate rising nearly 150 basis points higher in 2017, our measure of affordability will approach normal levels around 2017.

Our analysis suggests that housing affordability will likely remain a support for the housing recovery. However, affordability is no longer a primary driver of homebuying activity. Going forward, the trends in lending standards, regulations regarding lending and securitization of mortgages, and housing finance reform will be key to a transition to normal for the housing market.

Despite the robust gain in new home sales in the fist quarter, homebuilders' confidence from the National Association of Home Builders' survey continued to cool in April, declining for the third consecutive month. However, the details of the survey suggested improving outlook for the housing market: while both the measures of current sales and prospective buyer traffic fell during the month, the measure of sales expectations over the next six months increased sharply to a new peak for the expansion.

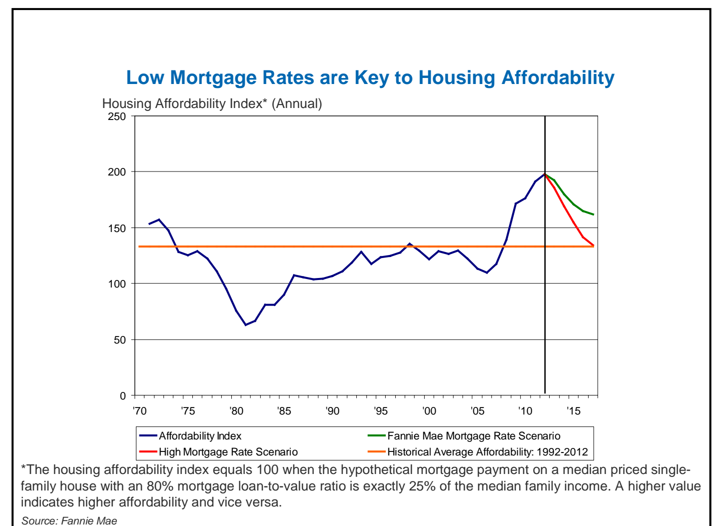
Recent weakness in builders' confidence and existing home sales have stemmed from supply-side issues, which include increasing material and land costs in the new home market and very lean inventories in the existing home segment, which is now improving. While the months' supply for both new and existing homes reached the lowest quarterly levels since the second quarter of 2005, conditions gradually improved toward the end of the quarter. For existing homes, the months'

supply rose to 4.7 months in March from its recent trough of 4.3 months in January, largely because of a rise in the number of new listings.

Lean inventories, a declining share of distressed sales and increased efforts to implement short sales and other foreclosure alternatives have helped boost home prices, which showed strengthening annual gains so far this year. Both CoreLogic indices of overall home prices and prices excluding distressed sales rose more than 10 percent in March from a year ago for the first time since 2006, suggesting that the housing recovery is broadening across distressed and non-distressed properties. We expect home prices going into the spring homebuying season to rise further as housing inventories remain lean, albeit gradually improving.

Another positive for future home price trends is a decline in shadow inventories, as measured by the Mortgage Bankers Association seriously delinquent rate—the share of mortgages that are delinquent for 90 days or more or in the process of foreclosure. The rate has gradually declined from its record high of 9.7 percent during the final quarter of 2009 to 6.4 percent in the first quarter of this year. Overall, mortgage performance has improved meaningfully, with the combined share of loans at least one payment past due or in foreclosure falling to 10.3 percent, the lowest in over four years.

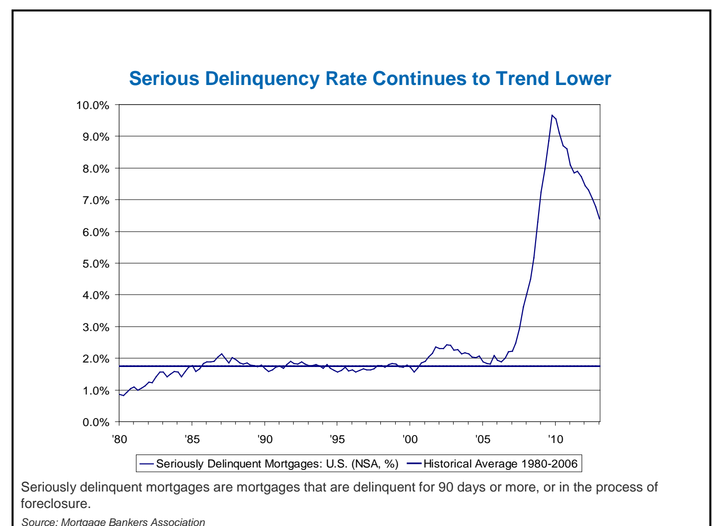
Anecdotal evidence showed that the market is turning more and more toward a seller's market, with multiple bidding becoming more common. The *April Fannie Mae National Housing Survey* indicates that the housing market is gradually approaching its sweet spot, as the share of consumers who believe that it is a good time to buy remains high at 71 percent while the percentage of those who think it is a good time to sell doubled over the past year, albeit to a still low share of 30 percent. Supporting the seller's market is that more and more consumers believe that home prices already hit bottom. The survey also showed that, for the first time in its three-year history, the majority of respondents expect home prices to increase. Those who believe home prices will decline remained at the survey low of 10 percent for the fourth straight month.



*The housing affordability index equals 100 when the hypothetical mortgage payment on a median priced single-family house with an 80% mortgage loan-to-value ratio is exactly 25% of the median family income. A higher value indicates higher affordability and vice versa.

Source: Fannie Mae

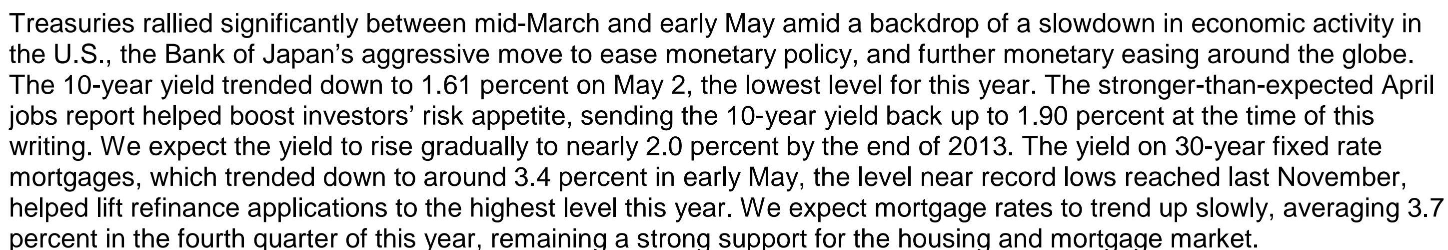
The mortgage lending environment has also improved with rising home prices. While cash sales continue to account for almost one-third of existing homes, according to a survey from the NAR, mortgage demand has gradually improved. Purchase mortgage applications from the Mortgage Bankers Association Weekly Mortgage Applications Survey trended up in March and April, and data in early May showed an increase to the highest level in three years. The most recent Fed's "Beige Book" released last month also noted commentary from the Fed's District Banks of "widespread increases" in mortgage demand, which is consistent with results from the Fed's April 2013 Senior Loan Officer Opinion Survey on Bank Lending Practices. However, the survey showed only a slight easing of lending standards.



Seriously delinquent mortgages are mortgages that are delinquent for 90 days or more, or in the process of foreclosure.

Source: Mortgage Bankers Association

The survey includes special questions about current policies in approving applications for GSE-eligible and FHA-eligible home purchase loans compared with those last year. Banks indicated that, relative to a year ago, they are less likely to approve home-purchase loan applications with a 620 FICO score and a down payment of 10 percent, suggesting that the availability of mortgage credit will remain an obstacle for first-time homebuyers.



Treasuries rallied significantly between mid-March and early May amid a backdrop of a slowdown in economic activity in the U.S., the Bank of Japan's aggressive move to ease monetary policy, and further monetary easing around the globe. The 10-year yield trended down to 1.61 percent on May 2, the lowest level for this year. The stronger-than-expected April jobs report helped boost investors' risk appetite, sending the 10-year yield back up to 1.90 percent at the time of this writing. We expect the yield to rise gradually to nearly 2.0 percent by the end of 2013. The yield on 30-year fixed rate mortgages, which trended down to around 3.4 percent in early May, the level near record lows reached last November, helped lift refinance applications to the highest level this year. We expect mortgage rates to trend up slowly, averaging 3.7 percent in the fourth quarter of this year, remaining a strong support for the housing and mortgage market.

We revised higher our projection of the volatile multifamily starts for this year and next year in response to their recent improving trend but essentially kept the forecasts of single-family starts and home sales unchanged. Multifamily starts should post an increase of about 35 percent in 2013—nearly as strong as the gain in 2012—with single-family starts rising approximately 24 percent. Total home sales should rise by about 8 percent from 2012. For mortgage production, we expect total single-family mortgage originations to fall 14 percent to $1.66 trillion in 2013 from 2012, as the drop in refinance originations outpaces a moderate gain in purchase originations. The refinance share should fall nine percentage points to 63 percent this year. We expect mortgage deleveraging to come to an end later this year. For all of 2013, total single-family mortgage debt outstanding should rise slightly, marking the first increase in six years.

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Economic and Strategic Research
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