Fiscal Uncertainty Persists after Election

Economic growth picked up in the third quarter from an anemic pace in the second quarter. While the acceleration in the headline growth was encouraging, the details continued to show a lackluster recovery. Thirteen quarters after reaching the trough in the second quarter of 2009, real (inflation-adjusted) gross domestic product (GDP) has increased only 7.2 percent, compared with an average growth of about 16 percent for economic recoveries since the 1960s over the same period. Significant challenges to the near-term outlook remain.

While the outcome of the election removed one aspect of policy uncertainty, it remains unclear how the Administration and the new Congress will resolve the issue of the fiscal cliff. In addition, the Treasury recently announced that without "extraordinary measures" the U.S. would hit the $16.4 trillion debt ceiling by the end of this year, although it is likely that the Treasury will implement such measures, as they did in 2011 during the previous debt-ceiling debate, to delay hitting the limit until as late as March next year. As a consequence, contentious debates surrounding the issue may undermine consumer and business confidence similar to what we experienced in August 2011.

The first estimate of the third quarter GDP report showed that economic growth strengthened to an annualized rate of 2.0 percent from 1.3 percent in the second quarter. One notable surprise in the report was a surge in government spending, boosted by the fastest pace of defense spending growth in three years. As a result, government spending added 0.7 percentage points to GDP. This boost to growth is a one-off event, and we expect a payback in the form of a partial reversal in the current quarter.

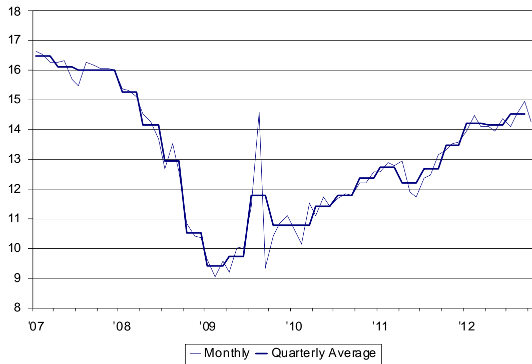
Consumer spending, which accounts for more than 70 percent of GDP, was the biggest driver, rising to a 2.0 percent rate from 1.5 percent in the second quarter on the strength of a robust 8.5 percent increase in spending on durable goods. Housing also was a contributor to growth, albeit a modest one given the near-record-low share of residential investment to GDP. Exports fell for the first time during the current expansion; however, imports also shrank and thus the drag from trade to GDP was rather small. Nonresidential investment was negative overall, as investment in structures fell while investment in equipment and software (capital expenditures, or capex) was flat. Total business inventories were a small drag as the drought led to a decline in farm inventories, resulting in a tepid rise in overall inventory investment.

Incoming data suggest that economic growth in the third quarter will be revised to close to 3 percent following recent upside surprises in September net exports and manufacturing inventories. However, an upward revision in third quarter economic growth is unlikely to change the trajectory of growth projected during the next several quarters. We expect growth to slow to a sub-2 percent pace in the current quarter and the first quarter of 2013.

Monthly data showed that consumer spending ended the third quarter on a firm note, rising 0.4 percent after adjusting for inflation, while real income was unchanged during the month. The robust gain in spending was at the expense of saving, as the saving rate fell to a 10-month low of 3.3 percent in September, declining by more than 1 percentage point since June. This pace of consumer spending, if supported by a draw-down of saving rather than an improving income trend, is unlikely to be sustainable going into early 2013. It's possible that the spending trend, which has outpaced income, is partially a result of reduced mortgage payments, which are not captured in consumer spending, due to mass refinancing. The current income picture is discouraging, as real after-tax income was flat in September and rose just 0.2 percent during the third quarter. The near-term income outlook appears to be darkening, given headwinds from the impending fiscal cliff, including the likelihood that after-tax income will fall if some of the tax cuts, such as the payroll tax cut, will expire as slated under current law.

While auto sales were a strong source of support for consumer spending in the third quarter, with unit sales rising by more than 10 percent annualized, they pulled back in October suggesting soft consumer spending at the start of the fourth quarter. Some of the decline may have reflected the effect of Hurricane Sandy in the last few days of October on the East Coast. If this proves to be the case, then some rebound is likely in coming months.

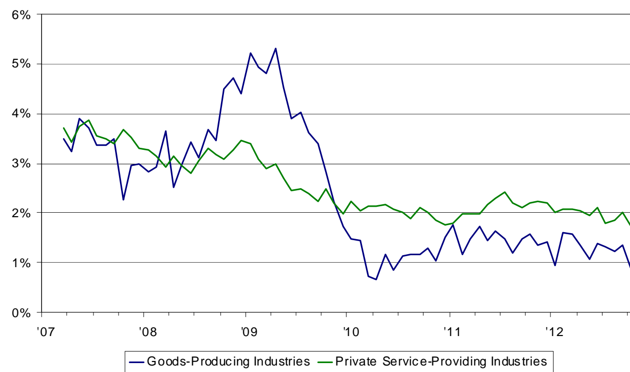
Auto Sales Start the Fourth Quarter Below the Third Quarter Average



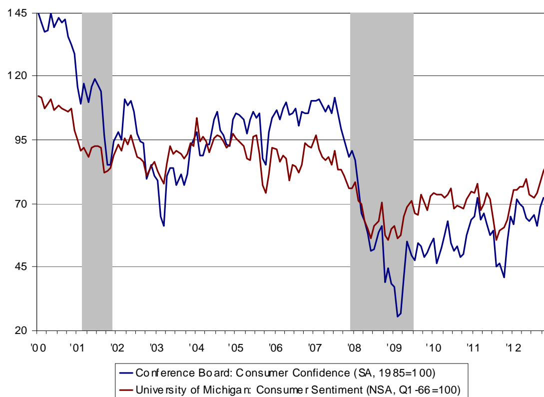
Source: Autodata Corporation

Wage Growth Is Anemic Despite a Pickup in Hiring

Average Hourly Earnings for Private Employees (Year-over-Year % Change)



Consumer Confidence Reaches Multi-Year Highs



Source: Conference Board, University of Michigan/Reuters

One positive development for consumers is the pickup in the pace of hiring in recent months. The October jobs report showed that total nonfarm payrolls rose 171,000, with broad-based gains across the private sector. With a total of 84,000 in upward revisions to the prior two months, the October figure is in line with the average monthly gain in the third quarter of 174,000. The unemployment rate edged up one-tenth of a percentage point to 7.9 percent, but the underlying details were positive, as the uptick was due to a surge in labor force entrants—a sign of increased confidence in the market—that outpaced a healthy gain in employment. The participation rate rose for the second consecutive month to a four-month high of 63.8 percent, while the employment-to-population ratio rose 58.8 percent, the highest in more than three years.

Somewhat tempering this optimism, hours worked and average hourly earnings were unchanged in October. A pickup in hiring during the last several months has occurred without meaningful wage gains. Average hourly earnings rose just 1.6 percent from last October—the weakest gain in the relatively short history of the series that began in 2007.

Despite the anemic income trend, the improving hiring picture combined with continued recovery in the housing market has helped buoy consumer confidence. Measures of consumer confidence have shown a notable pickup in recent months. For example, the Conference Board's consumer confidence index rose in October following a surge in the prior month, reaching the highest reading since early 2008, boosted by an improving assessment of current labor market conditions. It appears that consumers are not overly concerned by the possibility that their taxes will rise next year, as their income expectations during the next six months improved. Similarly, the Reuter's/University of Michigan's consumer sentiment index also rose during October, and the preliminary November reading was the fourth consecutive monthly increase, sending the index to its highest level since July 2007—a few months before the economy slipped into recession. The income outlook also improved in the Michigan survey, as more than 50 percent of respondents expected their income to rise during the next year for the first time since November 2008.

However, surveys of consumers and business have shown diverging results. While consumers are more optimistic about both current conditions and the outlook, business caution has increased. For example, the National Federation of Independent Business small business optimism index, which ticked up in October, remained well below levels witnessed just five months ago. The percent of owners planning capital outlays in the next three to six months has remained depressed.

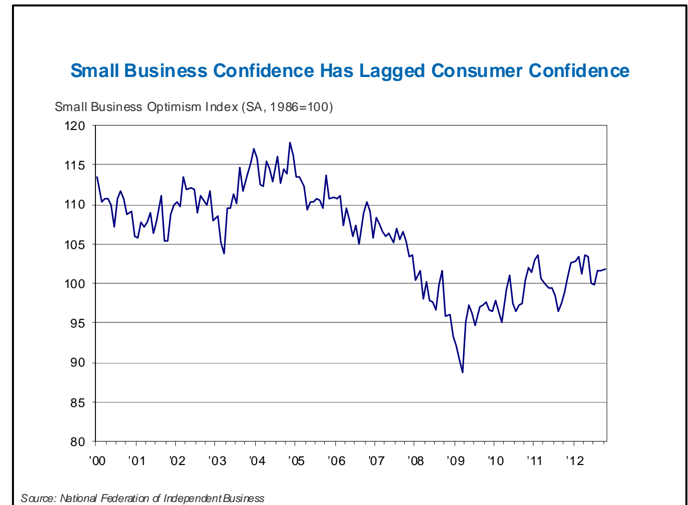
Slowing global growth and concerns regarding the fiscal cliff likely weighed on capex. Core capital goods orders—a leading indicator of capex—barely rose in September and August after falling sharply in the prior two months. From a year ago, core capital goods orders fell in September for the fourth consecutive month, establishing a trend rarely witnessed in an economic expansion.

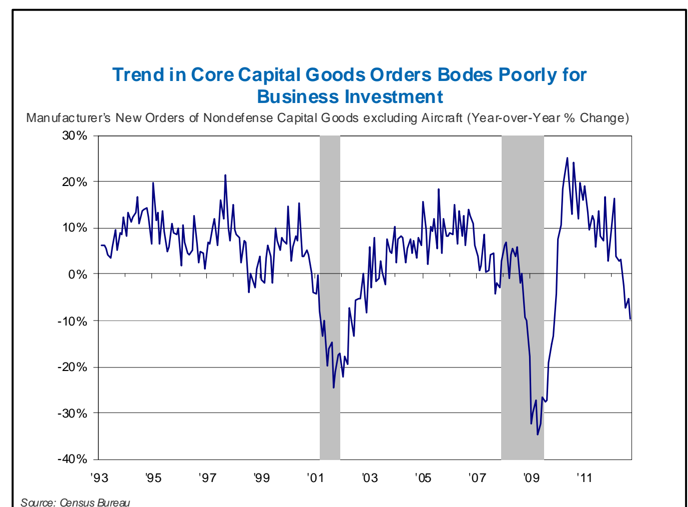
Given the trend in core capital goods orders, we expect capex to decline in the current quarter, which would mark the first quarterly decline in the current recovery.

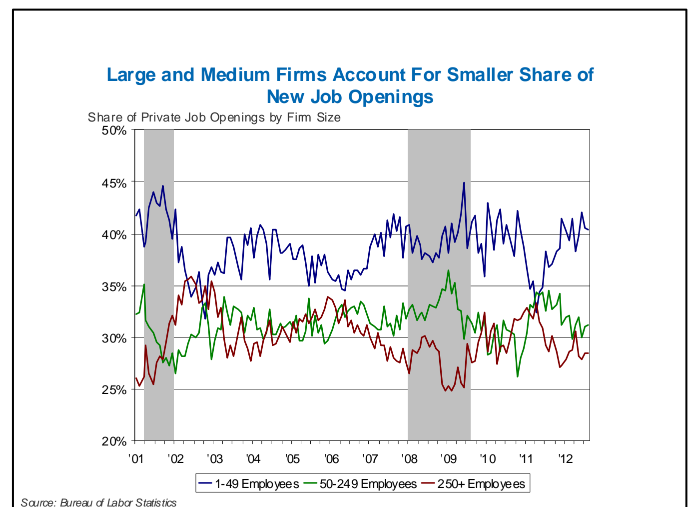
It appears likely that the slowdown in global economic activity has impacted large firms on the employment side, as the September Job Opening and Labor Turnover Survey (JOLTS) showed a continuing trend of a lower share of total job openings for large and medium sized firms (firms with 50 or more employees) than witnessed previously in the recovery. This trend may continue as larger firms are more likely to export abroad and thus be impacted by declining sales volumes in slowing economies in Europe.

The global slowdown has also hurt manufacturing activity in the U.S. The industrial production report showed that manufacturing output contracted in the third quarter for the first time during the current recovery, as output rose only modestly in September after plunging in August. Elsewhere, a survey of manufacturing suggests modest growth in activity in the current quarter. After contracting for three months between June and August, the Institute for Supply Management (ISM) manufacturing index rose slightly in October, remaining in expansion territory for the second consecutive month. However the details continued to show a weak trade component, as new export orders fell during the month, remaining in contraction territory for the fifth consecutive month.

The ISM survey for the service sector has showed service activity outperforming that in manufacturing for most of this year. However, the gap narrowed in October as the ISM nonmanufacturing index fell slightly. The survey also showed weakening trade details, as new export orders fell into contraction territory for the first time since June. Both ISM surveys confirmed our expectations of sub-2 percent economic growth in the current quarter.

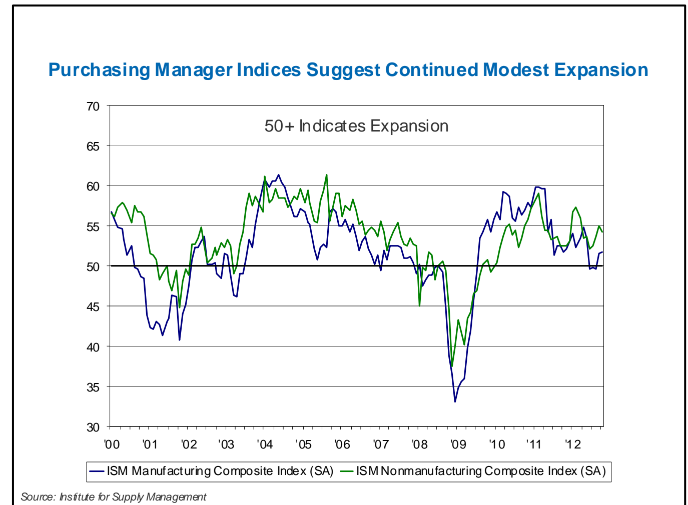






Housing: Gaining Steam — From a Drag to a Boost

After acting as a drag to growth for six consecutive years, housing will contribute to growth this year and the positive contribution should be bigger next year. However, because residential investment accounts for a small share of GDP—currently at 2.5 percent compared with its long-term average of about 6 percent—the sector is too small to propel the currently subdued economic recovery into a robust one.

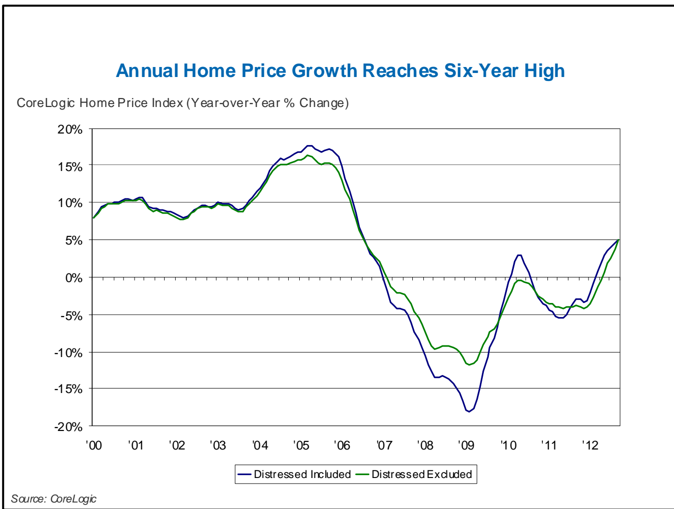


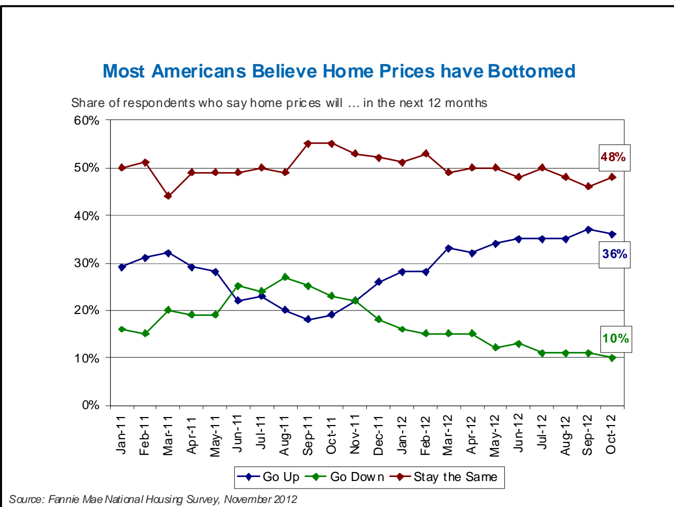
Incoming data continue to suggest a gradual, strengthening housing recovery. After a surge in August, existing home sales pulled back slightly, presaged by a drop in August pending home sales (i.e., contract signings of existing homes), their leading indicator. Despite the decline, September's existing home sales pace was the second fastest in more than two years. The months' supply, a gauge of the supply-demand balance in the housing market, slipped to 5.9 months, below the six-month mark—the level consistent with a normally functioning housing market—for the first time since March 2006. New home sales outperformed existing home sales during the month, rising sharply in September and sending sales to the highest level since April 2010. The solid sales pace, combined with near-record-low inventory of new homes listed for sale, pushed the months' supply down to 4.5 months, the lowest level since October 2005.

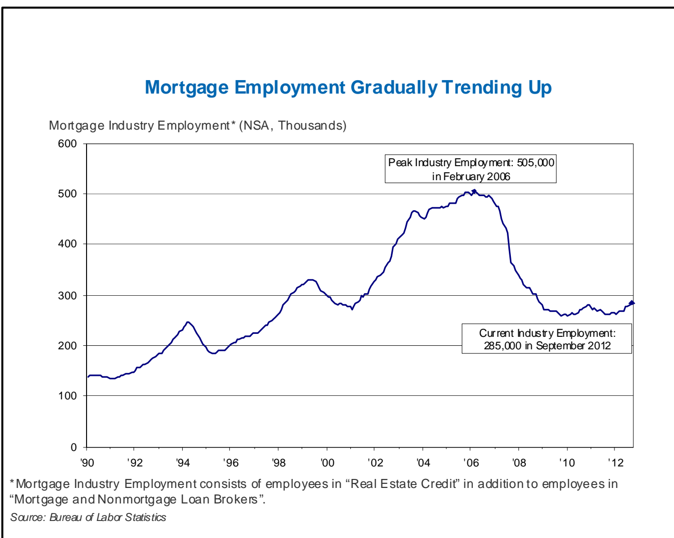
While the performance was mixed at the end of the third quarter, both existing and new home sales posted a gain in the third quarter from the second quarter. During the first three quarters of this year, existing home sales were up by 8 percent over the same period in 2011. Year-to-date new home sales were nearly 23 percent above last year. The strong percentage increase was from a very depressed level, as new home sales recorded an annual record low last year.

Separate data from the Census Bureau's Housing Vacancy Survey confirms the declining trend of excess supply in the housing market, a result of anemic home building activity during the past several years amid stronger home sales. In addition, the pace of distressed sales released into the market has slowed, partly reflecting a shift towards short sales and a rising share of foreclosures in states with a judicial process, where it could take several years to complete the foreclosure timeline. In the third quarter, the homeowner vacancy rate—the share of owner-occupied homes that are vacant and for sale—continued to decline for the seventh consecutive quarter to 1.9 percent. This marks the lowest rate since the third quarter of 2005, a full percentage point below its peak witnessed in 2008 and only slightly above its long-run average of 1.6 percent. Following three consecutive quarterly drops, the rental vacancy rate was flat in the third quarter, remaining at the lowest level since mid-2002. (For more information on multifamily market conditions including rents and vacancy rates, read the November 2012 *Multifamily Market Commentary*.)

While the pace of distressed properties coming into the market has slowed, the pipeline of distressed inventory remains elevated, as measured by the share of seriously delinquent mortgages (which has only trended down gradually from its peak at the end of 2009, according to the Mortgage Bankers Association National Delinquency Survey). The flow of new delinquencies has also trended down, thanks to improving labor market conditions, but that trend may reverse if economic conditions sharply deteriorate. For the time being, a better alignment of housing demand and supply, coupled with strong seasonal sales in spring and summer months, has helped strengthen home prices, which rose in the second and third quarters of this year according the Fannie Mae Home Price Index. However, the seasonal pattern for home prices going into the fall is under way, as non-seasonally adjusted prices have weakened. For example, the CoreLogic House Price Index posted the first decline in seven months in September. Despite the month-to-month drop, the year-over-year price gains continued to accelerate, showing the largest annual price increase since July 2006 of 5.0 percent.





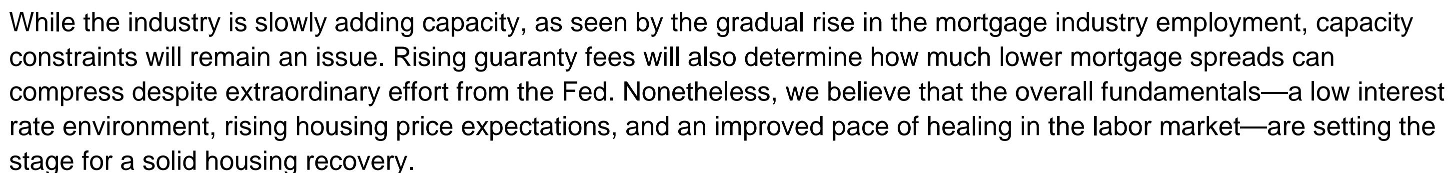


While home prices may decline again through early 2013, we believe that they will remain above the level witnessed in the first quarter of this year, if current market trends continue. Measured in terms of the S&P/Case-Shiller National Home Price Index, we estimate that the peak-to-trough decline in home prices was 34.7 percent between the second quarter of 2006 and the first quarter of 2012.

Low inventory, rising sales, and firming prices have boosted building activity. September housing starts posted impressive gains for both single-family and multifamily construction. Single-family starts jumped to the highest level since August 2008, while multifamily rose to the strongest pace since September 2008. Permits—a leading indicator for starts—also rose strongly, posting the best showing since July 2008. Stronger homebuilding activity, which responds to rising demand with a lag, is in line with signs of a rebound in household formation after years of substantial below-trend growth. The jump in September home building activity, home sales, and strengthening home prices confirms the steady increase in home builders' confidence, which rose in October for the sixth consecutive month to the highest level since June 2006.

Improving perceptions of the housing market have helped lift consumer confidence. The October Fannie Mae National Housing Survey showed continued widening in the gap of consumers expecting home prices to rise and those who believe they will fall.

We expect mortgage rates to remain supportive for housing activity given the Federal Reserve's open-ended purchase of mortgage–backed securities (MBS). Given our forecast of modest economic growth, we assume that the Fed will continue its $40 billion per month MBS purchase program, announced in September, through all of 2013. We also assume that the Fed will allow Operation Twist to come to an end at the end of this year but, in its place, we anticipate that the central bank will add purchases of long-term Treasuries to its MBS asset purchase program. We also continue to assume that the Fed will keep the fed funds rate unchanged until mid-2015. As a result, long-term interest rates should rise only gradually during the next few years, with the yield on the 10-year Treasury Note rising from 1.7 percent in the current quarter to 1.9 percent in the fourth quarter of 2013. The Fed's MBS purchase program led to a decline in mortgage rates, and we expect that the mortgage spread to the 10-year Treasury will hover around 160-170 basis points through the end of next year.



While the industry is slowly adding capacity, as seen by the gradual rise in the mortgage industry employment, capacity constraints will remain an issue. Rising guaranty fees will also determine how much lower mortgage spreads can compress despite extraordinary effort from the Fed. Nonetheless, we believe that the overall fundamentals—a low interest rate environment, rising housing price expectations, and an improved pace of healing in the labor market—are setting the stage for a solid housing recovery.

Given the improvement in recent housing activity, we revise higher our forecast for this year and next year from the prior forecast. We expect housing starts to increase 25 percent this year following by slightly more moderate growth in 2013. Following an expected increase of 10 percent this year from depressed levels, total home sales should rise an additional 6 percent in 2013. We believe that there is an upside risk to our housing forecast: the pent-up demand amid stronger household formation may result in stronger housing activity next year than we currently anticipate.

For all of 2012 and 2013, we project slightly stronger purchase and refinance originations than the prior forecast, with total single-family mortgage originations rising to $1.81 trillion and $1.54 trillion in 2012 and 2013, respectively. The refinance share should rise from 66 percent in 2011 to 71 percent in 2012 before falling to a still-elevated level of 62 percent in 2013. Total single-family mortgage debt outstanding should decline by an additional 1.6 percent following a 2.4 percent decline in 2011, and we expect a slight drop in 2013.

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