Uneven Growth Clouds Picture of Modest Recovery Trend

Economic growth in the second quarter surprised on the upside, coming in at a 2.5 percent annualized rate, according to the Bureau of Economic Analysis' second estimate of gross domestic product (GDP)—a sizable upgrade from 1.7 percent in the first print and the meager 1.1 percent gain in the prior quarter.

We had expected growth to pick up in the third quarter to about 2.5 percent from a sub-2 percent in the second quarter. The upward revision removed our anticipated strengthening in the current quarter. Moreover, continued increases in mortgage rates, rising oil prices from the tension in the Middle East, uncertainty regarding the pace of the wind-down of monetary stimulus, and potential negative outcomes surrounding the budget and debt ceiling negotiations all present downside risks to growth in the current quarter. Overall, we expect growth to slow in the third quarter before accelerating in the final quarter in response to continued rising household wealth and fading fiscal drag. Despite a different quarterly pattern during the year, we project full-year growth to come in at 2 percent—unchanged from our forecast at the beginning of the year and the same as the rate of growth for 2012.

Monetary Policy at Center Stage

Market volatility has increased as the Fed attempted to provide more clarity for its forward guidance, outlining a conditional outlook for winding down its quantitative easing program. The minutes from the Federal Open Market Committee (FOMC) July 30-31 meeting suggested that members generally agreed with Fed chairman Ben Bernanke's conditional timeline for tapering its asset purchases. We maintain our view that the FOMC will start to scale back the size of its asset purchase program at its September 17-18 meeting, ending the program by mid-2014. We still believe that an actual increase in the federal funds rate is unlikely before mid-2015, given the Fed's rate guidance and our forecast of the unemployment rate and inflation.

We expect market volatility to remain somewhat elevated as a result of the uncertainty regarding the leadership and the new mix of the FOMC members. Bernanke's term expires in January 2014, and we expect that President Obama will soon name his nominee for Bernanke's successor. In itself, this is eventful, considering that there have only been three Fed chairmen in more than three decades, and the next one will face the difficult task of winding down the current unprecedented monetary easing. In addition to the change at the top, the composition of the FOMC will also change because the President will likely need to replace about three to five Board members over the next year. Moreover, some members from the regional banks will rotate out and be replaced by others who are not currently voting members. Overall, the return of volatility should not be surprising at some level since monetary policy had been targeted at lowering volatility and its return to the market will be part of monetary policy normalization.

Fiscal Policy Inches Toward the Front Burner

Several issues are creating more uncertainty as we are weeks away from entering the first quarter of the fiscal year 2014. First, Congress must adopt a budget by September 30 when the current stopgap Continuing Resolution expires or, as it has done over the past four years, pass another Continuing Resolution by October 1 to avoid a government shutdown. The 2011 Budget Control Act, which instituted strict spending caps, suggests another across-the-board sequester in January 2014 of $21 billion—the amount over the cap. Our forecast assumes that Congress will allow sequester to occur but it is possible that there may be some modification, resulting in a smaller fiscal drag.

The second major fiscal issue is the looming breach of the debt ceiling. After hitting the statutory debt ceiling on May 19, the Treasury has been using "extraordinary measures" to address the government's borrowing needs in order to avoid breaching the debt ceiling. Although many speculated that the Treasury would not run out of the extraordinary measures (and thus breach the debt ceiling) until November, Treasury Secretary Jacob Lew recently said that the U.S. will reach its borrowing limit in mid-October.

While our forecast expects orderly outcomes out of the Continuing Resolution and the debt ceiling negotiations amid fading drag to GDP from the government sector, uncertainty regarding a Continuing Resolution, the debt ceiling, and the impact of the 2014 sequester will present some headwinds for the economy in coming months.

Headline Growth Showed Upside Surprise

The two main drivers for the upward revision in the second quarter were 1) more improved net exports and 2) stronger inventory build-up than previously reported rather than an upgrade in the private domestic demand. Growth in personal consumption expenditures went unrevised, while growth in residential and nonresidential investment received a slight downgrade. One positive emerged from the second print of GDP, which offered the first glimpse into corporate profits, showing a rebound of 3.9 percent following a decline in the first quarter.

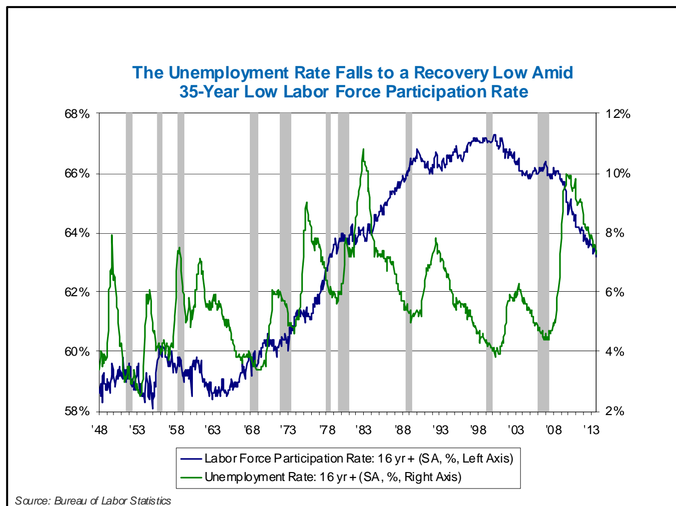
Incoming economic data for the current quarter have been mixed. On the encouraging side, initial jobless claims have trended down to near their five-year lows, suggesting gradual improvement in labor market conditions. Readings on purchasing manager surveys of manufacturing and service activity continued to rise in August to the highest levels in more than two years and seven and a half years, respectively. Auto sales rose to 16.1 million units annualized in August, the strongest pace in nearly six years, boosted by domestic truck sales. In addition, the Conference Board's index of leading indicators—a gauge for near-term outlook—posted a large gain in July following a flat reading in the prior month, signaling a pickup in the growth pace.

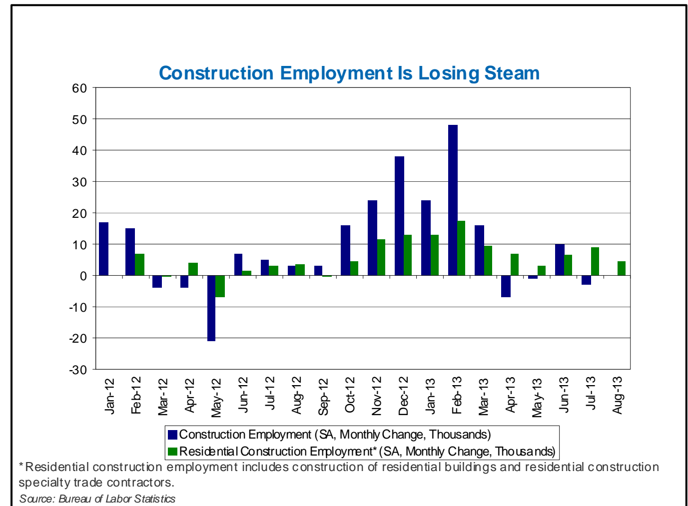
The disappointing side included July manufacturing output, which fell slightly, driven primarily by a large decline in production of motor vehicles and parts. The drop may have reflected seasonal adjustment issues during the summer retooling, when automakers temporarily shut down factories to get ready for the new model year, and could reverse in coming months. The strength of August domestic auto sales bodes well for vehicle assemblies in the fourth quarter. Meanwhile, durable goods orders fell sharply in July. While the volatile civilian aircraft and defense orders drove the sizable drop, both core shipments and core orders (nondefense capital goods excluding aircraft) declined, suggesting that a strong rebound in business capital investment from the lackluster first half is unlikely.

Employment Report Showed Mixed Labor Market Conditions

The September jobs report showing an increase in nonfarm payrolls of 169,000 was roughly in line with market expectations, though the downward revision of 74,000 in the prior two months is discouraging. The outlook for labor income improved slightly as the average workweek rebounded after a dip in the prior month, while the average hourly earnings edged up.

Although the unemployment rate ticked down to 7.3 percent—the lowest reading since the end of 2008—it masks a downbeat trend in the labor force participation rate, which slipped two-tenths to 63.2 percent, a 35-year low.

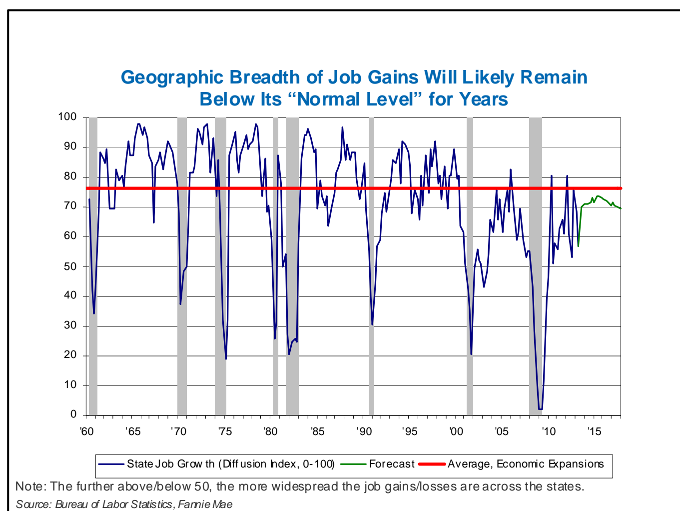




Industry details were bearish for real estate—showing flat construction employment—confirming a deteriorating trend, as total construction payrolls have risen in only one month since posting strong gains between last October and March of this year. However, residential construction employment has performed better than overall construction activity.

Steady but tepid job growth has been a hallmark of the current economic recovery. Four years into the recovery, total nonfarm payrolls have increased by an average of only 0.2 percent per quarter, roughly one-third the pace of job growth experienced during all economic expansions of the last half century.

A lack of geographic breadth is one indication of the labor market's lukewarm recovery. We can look at the trend in the geographical diffusion index to gauge the extent of job growth across the states. The state job diffusion index value ranges from 0 to 100, with values greater than 50 indicating that more states are experiencing job gains than job losses. Not surprisingly, the geographic breadth of employment gains is highly correlated with the national pace of job creation. Since the current recovery began in June of 2009, the state job diffusion index has averaged just 58, compared with an average of 76 for all economic expansions since 1960. The geographic extent of job growth during the current expansion has been similar to that experienced during the "jobless recovery" of the 2001 recession.



Note: The further above/below 50, the more widespread the job gains/losses are across the states.
Source: Bureau of Labor Statistics, Fannie Mae

Continuing with our “transitioning to normal” theme, we attempt to gauge when the state job diffusion index will reach its “normal” level or its long-term average by applying our forecast of national employment to the historical relationship between the national job growth rate and the state job diffusion index. Our research shows that prospects for substantially broader job growth are not promising. While we project that the diffusion index will increase over the next four years, it will fail to reach its normal level and will remain at or below 74 through 2017. By contrast, during most recoveries of the last half century, the diffusion index reached or exceeded the 90-mark (i.e., about 90 percent of the states experienced growth).

Consumer Spending is Tracking Stronger

Consumer fundamentals started the current quarter on a weak note, with both real (inflation-adjusted) personal income and consumer spending flat in July. However, incoming reports suggest an improving near-term outlook. First, data from the Quarterly Services Survey pointed to more spending on services in the second quarter, which lifted the momentum for service spending in the current quarter. Second, the CoreLogic home price index, an input for estimating housing wealth in the Federal Reserve’s Financial Accounts of the U.S., posted a strong gain during July, showing the fastest year-over-year rise since February 2006. Combined with strong August auto sales, recent trends in consumer fundamentals continue to support our August forecast that real consumer spending growth in the current quarter will post a modest pickup from 1.8 percent annualized pace in the second quarter.

Broad measures of consumers’ attitudes were mixed in August. The Conference Board’s consumer confidence index rose slightly following a small decline in July. Although the Reuters/University of Michigan consumer sentiment index improved between the preliminary and final readings, the August reading remained below the level in July.

Consumers may feel the pinch of rising gasoline prices in the near term. The turmoil in Syria raised concerns that the conflict could spread to major oil-producing nations such as Iran and Saudi Arabia, leading to a jump in crude prices. The October futures contract for WTI crude oil rose from $96/barrel at the beginning of July to more than $110/barrel in early September before settling around $108/barrel at the time of this writing.

We continue to anticipate that economic growth will pick up to 2.5 percent in the fourth quarter in response to continued strengthening consumer spending growth as well as improving residential investment and net exports amid waning fiscal drag. Both business investment in equipment and software and in structures should add only slightly to growth.

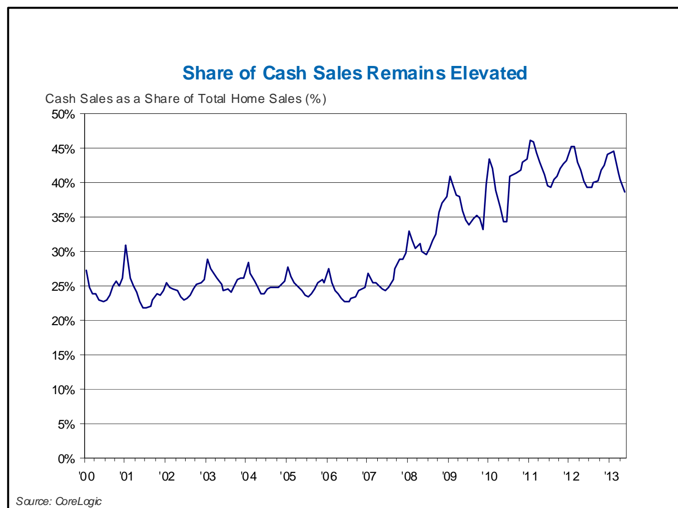
Housing is Feeling the Pain of Rising Interest Rates

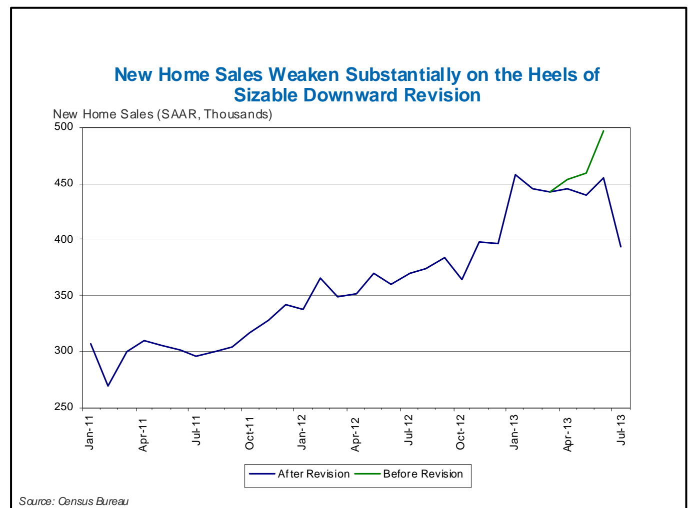
The FOMC minutes from the July meeting indicated that committee members expressed concerns that the rise in mortgage rates could potentially harm the housing market. Since then, long-term interest rates continued to move even higher, and, as we mentioned earlier, we expect interest rates to remain volatile for some time. Over the next year, we

expect long-term interest rates to drift higher, albeit gradually, given the expected modest pace of growth. The yield on 30-year fixed rate mortgages should trend up to approximately 5.3 percent by the end of 2014 from the rate in early September of slightly more than 4.5 percent, which is about 120 basis points higher than its recent trough in early May.

Recent housing indicators have shown signs of softening from the rise in mortgage rates. After their recent peak in February, single-family housing starts fell in July for the third time over the past five months, remaining more than 5 percent below February's pace. The volatile multifamily starts surged during the month, more than offsetting the plunge in the prior month. (For more information on multifamily market conditions, read the September 2013 Multifamily Market Commentary.)

Existing home sales posted a solid gain in July to the strongest pace since late 2009. However, because they track closings they are a lagging housing indicator. July pending home sales, which tracks contract signings, fell moderately for a second consecutive month, suggesting that existing home sales will pull back in coming months. This is consistent with our expectation that the rise in rates provided a strong incentive to accelerate the pace of closings and thus pulled forward some sales. Purchase mortgage applications—another leading indicator of home sales—have declined roughly 15 percent from their peak in early May. So far, the drop in purchase mortgage applications has been much more severe than that for pending home sales. Given the elevated share of home sales using cash, the relationship between mortgage applications and home sales is less tight than it has been in the past.



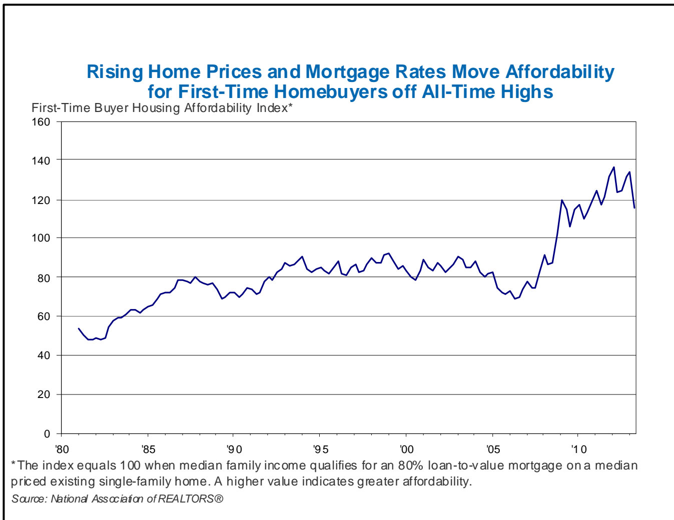


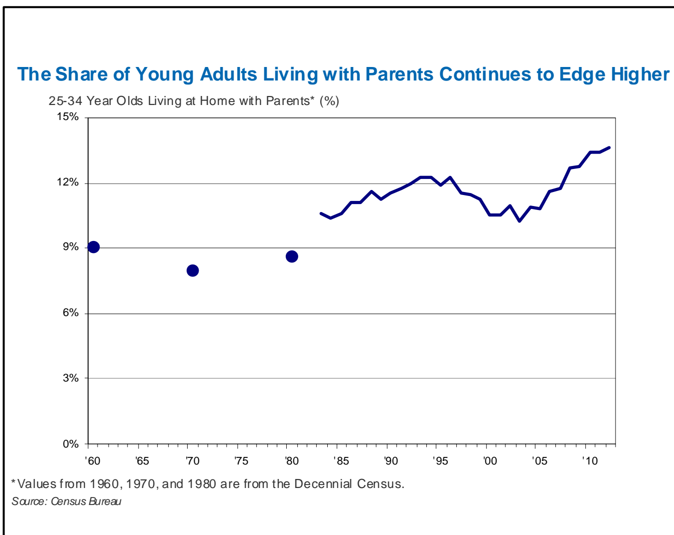
July new home sales plunged, showing the largest drop since the expiration of the homebuyer tax credit in 2010. Like pending home sales, new home sales are based on contract signings rather than closings and thus are also a more timely indicator than existing home sales. In addition to the weak July reading, previous months' data were revised sharply lower.

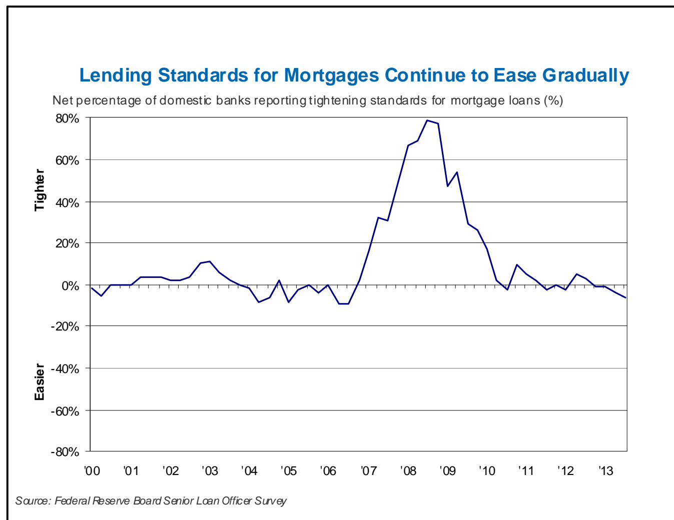
The weakness in new home sales appears at odds with home builders' sentiment, as the National Association of Home Builders/Wells Fargo Housing Market Index rose in August for the fourth consecutive month, sending the index to the highest reading in nearly eight years. This could mean that the pullback in new home sales is temporary or it could presage a reversal in builders' sentiment in coming months.

Rising mortgage rates have not yet materially affected home prices, which continue to show solid monthly gains but at a more moderate pace than that witnessed earlier this year. Limited inventory has helped push house price growth higher to an unsustainable rapid pace. However, inventory conditions have been improving amid reduced demand, and we will likely see further moderation in home price gains in coming months.

Affordability, while remaining historically high, is becoming an issue for some potential homebuyers, especially first-time homebuyers, who are no longer able to qualify as mortgage rates spiked amid continued rising home prices and anemic income growth. The affordability index for first-time homebuyers fell sharply in the second quarter and will likely post another sizable drop in the current quarter.







Weak labor market conditions, high student loan debt burden, and tight lending standards have likely combined to hold back many young adults from forming households, delaying their transition into homeownership. A recent report from the Bureau of the Census showed that the share of those aged 25 to 34 living with their parents, which surged at the onset of the last recession, continued to edge higher to 13.6 percent in 2012.

While lending standards for residential mortgages have remained tight, they have shown signs of gradual easing over the past year, according to the Federal Reserve Survey of Senior Loan Officer Opinion on Bank Lending Practices.

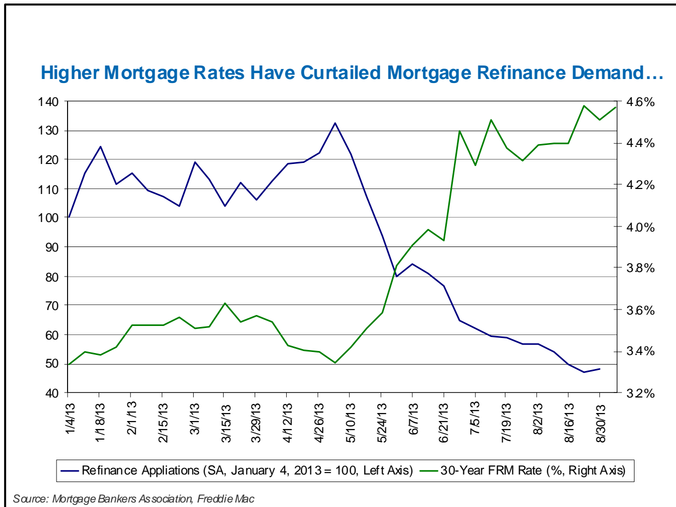
We do not anticipate a dramatic reversal in the ongoing easing of lending standards, especially after the recent release of the proposed new Qualified Residential Mortgage (QRM) rule by Federal regulators, which aligns with the Consumer Finance Protection Bureau's Qualified Mortgage (QM) rule finalized earlier this year. The proposed QRM rule eliminates much stricter down payment rules that the previous version of QRM would have created.

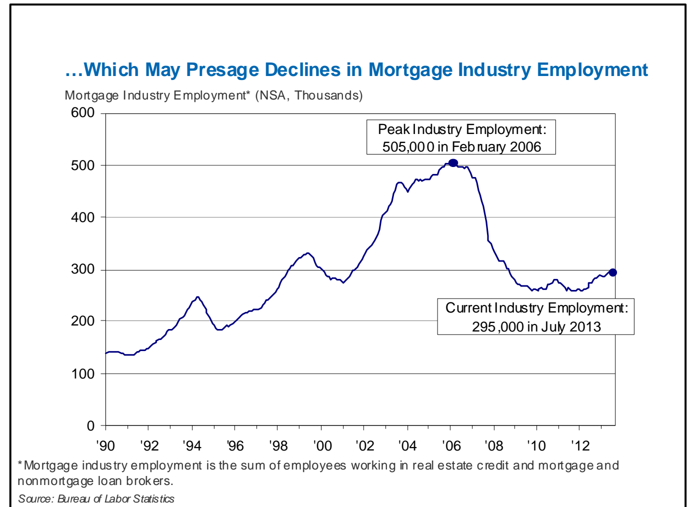
While the spike in mortgage rates has dampened the improving trend in consumer sentiment regarding housing witnessed in our survey since the start of this year, consistent with slowing trends in home purchase contract signings and mortgage applications, we continue to expect a solid and sustained housing recovery. Both new and existing home sales experienced strong year-to-date gains through the first seven months of the year, rising 22 percent and 12 percent, respectively, from last year's levels, and we expect them to rise further through the rest of the year, albeit at a slower pace.

Given the weak July new home sales and the sizable downward revisions of previous months' figures, we downgraded our new home sales trend for the rest of the year. However, our forecast for an 8.5 percent gain in existing home sales, which account for the vast majority of total home sales, was little changed from our view in the prior month.

The surge in mortgage rates has led to a significant decline in refinance demand, with refinance applications plunging more than 60 percent since early May.

Given our expectation that rates will continue to trend higher, we believe that the refinance boom has peaked, and the mortgage market is now shifting toward more purchase activity, which we project to account for more than 50 percent of originations starting in the fourth quarter of this year. Anticipated declines in refinance originations suggest that mortgage industry employment, which has trended up since reaching bottom in early 2012, will likely pull back in coming months.





Our projected mortgage originations remains essentially unchanged from our view in the prior month. For all of 2013, total mortgage originations should decline approximately 14 percent to $1.75 trillion, with the refinance share dropping by 9 percentage points to 64 percent. The share of mortgage originations financed with adjustable-rate mortgages is projected to rise steadily going forward as adjustable-rate mortgages offer a more attractive value during the periods of rising fixed mortgage rates and a steeper yield curve. We expect the deleveraging in mortgage debt to end soon, with total single-family mortgage debt outstanding rising modestly in 2013 after five straight annual drops.

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Economic and Strategic Research
September 10, 2013

The authors thank Patrick Simmons for his analysis on the labor market’s geographical diffusion index.
For details of the analysis please contact Patrick at patrick_a_simmons@fanniemae.com.

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