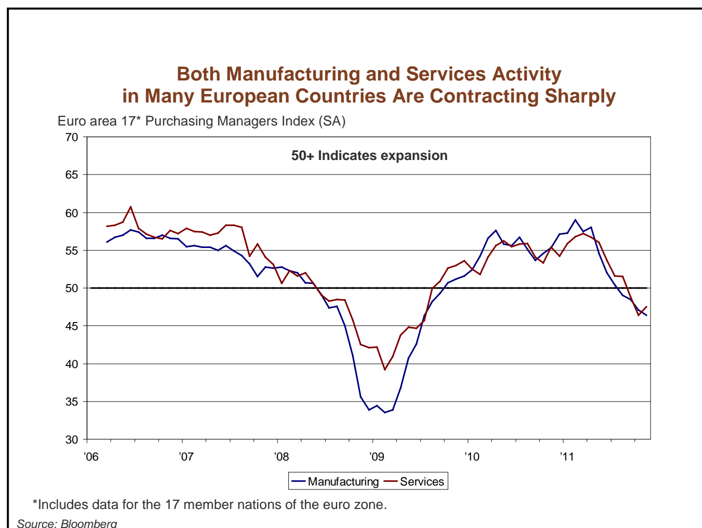
Ending the Year On a Positive Note

Early indications on fourth-quarter economic activity seem to indicate we will end 2011 on a positive note. Better retail sales, stronger employment, slight improvements in housing, and some inventory building are contributing to a decent close to a tough year (though all the data won't be in for some time). However, the U.S. economy continues to face many obstacles, and we expect momentum to slow going into 2012.

Economic growth in the third quarter was weaker than initially reported. Real (inflation-adjusted) gross domestic product (GDP) growth was revised down to a 2.0 percent annualized rate from the initial estimate of 2.5 percent. While the growth rate declined, the details offered some positive implications for current-quarter growth as the drop came largely from a revision to inventories that showed a decline instead of an initially reported increase. A decline in inventories is generally viewed as a plus for subsequent growth, as it signals an increase in production to replenish destocking.

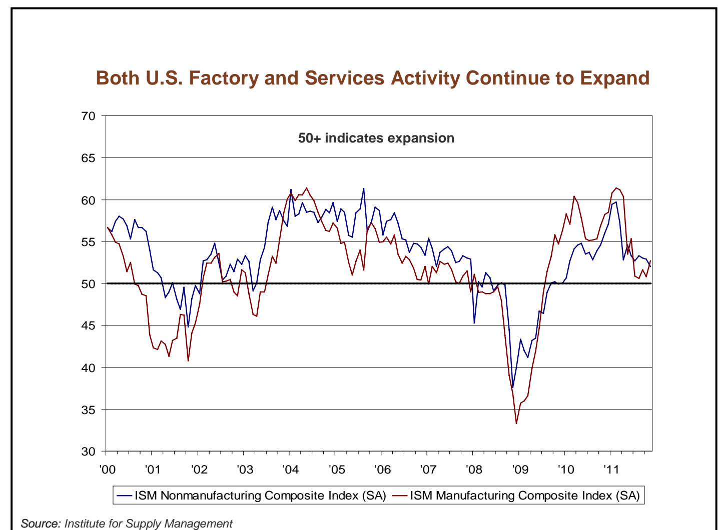
The European sovereign debt crisis and the resulting stresses in the financial markets remain the biggest risk to the economic outlook in the U.S. Fear of contagion to the European periphery has not subsided. Despite the announcement by the new Italian prime minister of another round of fiscal austerity measures designed to calm investor fears over Italy's ability to repay its debt, the yield on Italian 10-year notes rose to about seven percent in early December. While a credible resolution to permanently stabilize the European debt crisis does not appear to be easily attainable, we expect that the authorities will continue to take steps to keep the situation from spinning out of control. As a result, although stock markets have recovered somewhat following the sharp declines in the third quarter, we expect ongoing volatility next year.



The global economic recovery appears to be losing steam. We now expect that the euro zone has slipped into a recession in the current quarter that will likely last through the first half of 2012. The European Central Bank (ECB) has continued its monetary easing, further cutting its benchmark rate this month. It also reduced reserve requirements for banks and announced a new program to offer banks unlimited three-year term loans using relaxed collateral criteria. However, the ECB disappointed the market by announcing its unwillingness to trigger a large scale bond purchase program (i.e., substantially expanding the ECB balance sheet), which had been expected by the market to ensure sovereign funding needs. Clearly, a euro zone recession will make austerity measures more difficult to implement. At the same time, emerging markets also face challenges. China's manufacturing contracted in November for the first time since February 2009 as the property market cooled and Europe's turmoil cut export demand. In the 17-nation euro zone, surveys of purchase managers showed that manufacturing and service industries shrank at the fastest pace in more than two years, signaling that the region has edged toward recession.

In contrast, similar surveys indicate continued expansion in both manufacturing and service industries in the U.S., although the pace of expansion has slowed appreciably from the pace seen at the start of the recovery. The Institute for Supply Management (ISM) manufacturing survey offered one of many positive pieces of news seen during the past month. The index increased nearly two points in November, indicating the fastest pace of manufacturing activity in five months. However, the index for the services industry disappointed, posting a third consecutive decline during the month, indicating the slowest rate of expansion in nearly two years.

Fiscal policy in the U.S. also adds substantial uncertainties to the outlook for 2012 and beyond, as the Joint Select Committee failed to reach agreement on a plan to cut the budget deficit by $1.5 trillion over the next ten years. We continue to assume a path for federal spending that incorporates the spending caps of the recently passed Budget Control Act, as we expect that new efforts will be made to avoid automatic sequestration that will take effect in 2013. However, without a credible deficit reduction plan, the U.S. sovereign debt rating could face a downgrade risk next year.



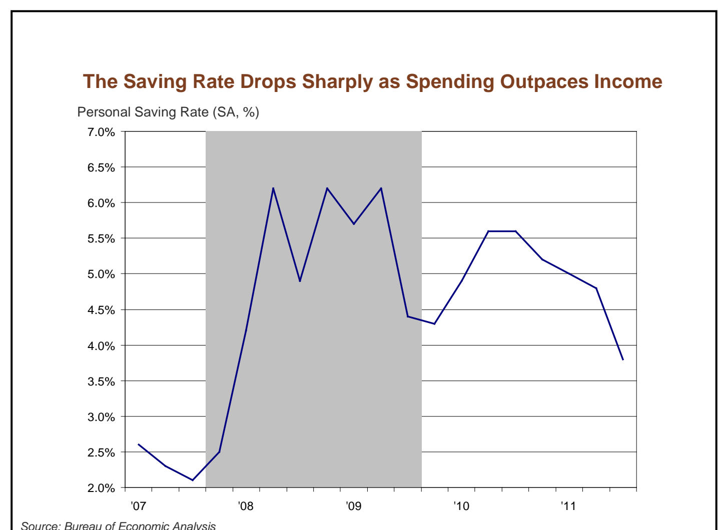
Fiscal contraction at all levels of government, including the scheduled increase in payroll taxes and reduction in unemployment benefits, will restrain growth. State and local governments will see another sharp decline in federal government transfers in 2012—a payback from the stimulus (the American Recovery and Reinvestment Act, which was passed in February 2009). This will keep state and local government budgets under pressure through next year. At the time of this writing, there are bi-partisan efforts to extend the payroll tax holiday, but there is not yet an agreement on how to pay for it. Without congressional action, payroll taxes are scheduled to jump roughly $125 billion, and unemployment insurance benefits will decline by about $50 billion in 2012.

While the odds of extensions to these programs, especially the payroll tax holiday, have risen recently, our forecast assumes that neither the payroll tax holiday nor emergency unemployment benefits will be extended through 2012. If Congress acts to extend the payroll tax holiday into 2012, it will likely boost our 2012 growth forecast, but the degree will depend on how the program is paid for. Thus, even with the extension, this recovery will remain subpar by historical standards.

With continued low mortgage rates and record high housing affordability, housing indicators have showed some improvement. The positive tone of housing reports bodes well for conditions in the final quarter of 2011. However, given the challenges facing the overall economy and the labor market as well as still-distressed housing market conditions, a robust gain in housing demand is unlikely and home prices are expected to continue to soften going into 2012.

Economy: Substantial Headwinds Ahead

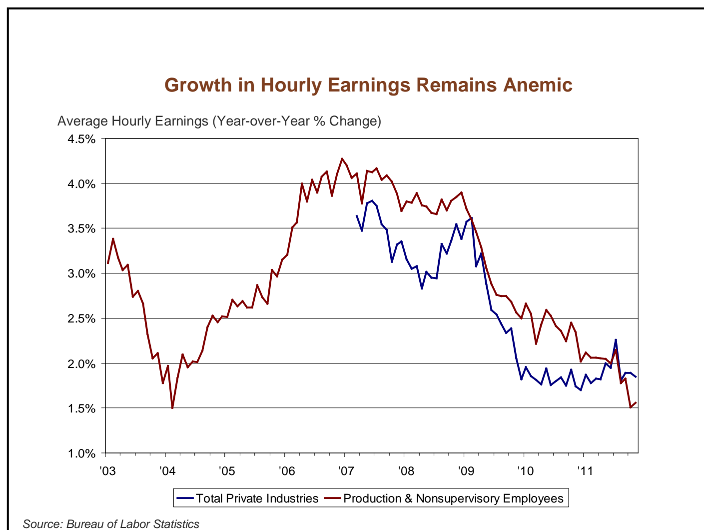
While the GDP revision offered a good inventory story it also contained some negative news as wage and salary income was revised lower for both the second and the third quarters. Real disposable income has been revised down accordingly, showing declines in both the second and the third quarters. At the same time, real consumer spending rose by 0.7 percent and 2.3 percent annualized rates in the second and third quarters, respectively. The downward revision in disposable income accentuates the disconnect between consumer spending growth and income growth. As spending growth outpaced income growth, the saving rate (saving as a share of disposable income) dropped sharply from 4.8 percent in the second quarter to 3.8 percent in the third quarter, the lowest level since the fourth quarter of 2007, when the economy began to slip into recession.



Monthly data show that real income firmed in October,

rising by 0.4 percent and outpacing real spending growth of just 0.1 percent. Weakening consumer spending growth in October appeared to support the view that the recent sharp decline in the saving rate would cause consumers to be more cautious and moderate their spending growth. However, consumer spending is poised to strengthen in the current quarter, thanks to robust November auto sales, which rose to an annual rate of 13.6 million units, putting the October-November average strongly ahead of the 12.5 million sales pace registered in the third quarter. The November pace was the strongest sales pace seen during the expansion, except for the Cash for Clunkers spike in August 2009. In addition, strong chain store sales early in the holiday selling season offered evidence of healthy consumer spending in the current quarter.

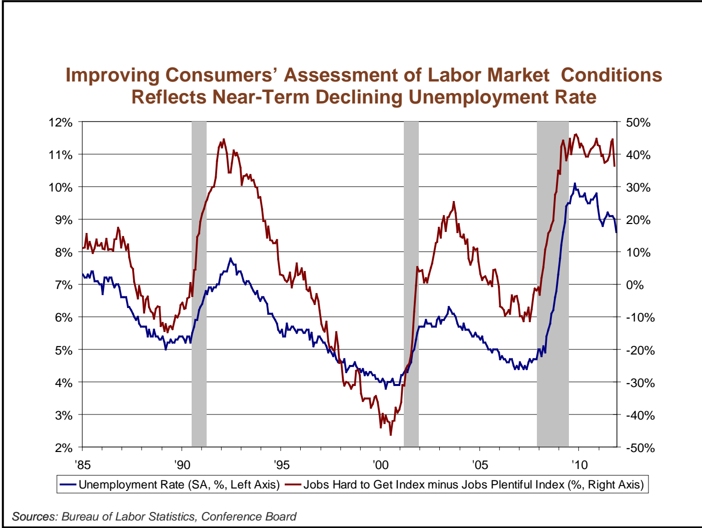
Labor market conditions also have improved during the past month, with initial jobless claims declining in early December to a nine-month low. Job creation also strengthened modestly in November. Payroll employment increased a net 120,000 in November, with a 72,000 upward revision to the prior two months' data. Private payroll employment rose 140,000 in November. Other aspects of the report were less encouraging. The average workweek was unchanged at 34.3 hours, while average hourly earnings for total private industries fell 0.1 percent from September and were only 1.9 percent higher than the level a year ago. So far this year, growth in earnings has remained anemic.

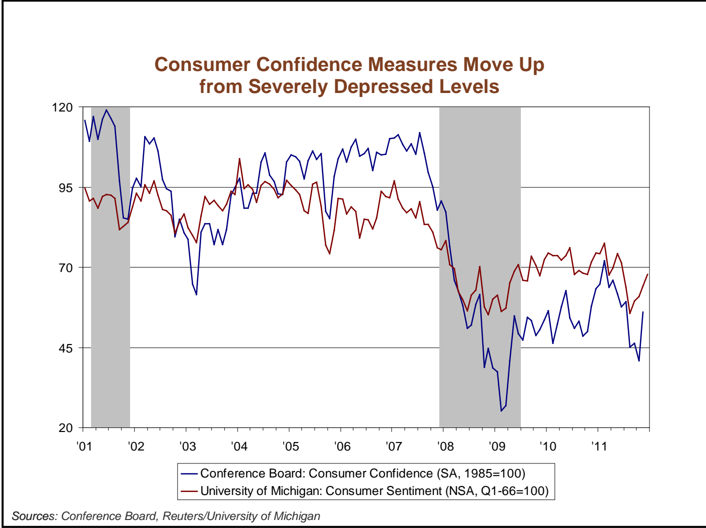


The increase in payroll employment, combined with a decline in earnings, is likely to result in only a modest increase in personal income during November, underscoring that the weak income trend will remain a headwind for consumer spending going forward.

The survey of households showed that the unemployment rate fell sharply from 9.0 percent to 8.6 percent, its lowest level of the recovery. The reasons behind the drop were not all good. While the household employment measure was up 278,000, the number of people in the labor force dropped by 315,000. This sharp decline in the unemployment rate will likely reverse going forward, as job creation is expected to be too weak to offset the flow of new entrants into the labor force. We expect the unemployment rate to remain elevated next year, averaging around nine percent.

The labor force participation rate, which had been trending down sharply since the start of the recession before stabilizing early this year, fell 0.2 percentage points to 64.0 percent in November, just above its cyclical low of 63.9 percent reached in July. Essentially, the rate has been moving sideways throughout this year, hovering at levels last seen in late 1983 and early 1984. The lack of improvement in the participation rate during an economic expansion is quite unusual, with the notable exception of the recovery following the 2001 recession. There is some anecdotal evidence that an increasing number of workers near the retirement age have decided to go into early retirement, and that older unemployed workers are too discouraged to reenter the labor force and are deciding to retire instead. This trend could potentially delay the rebound in the participation rate.



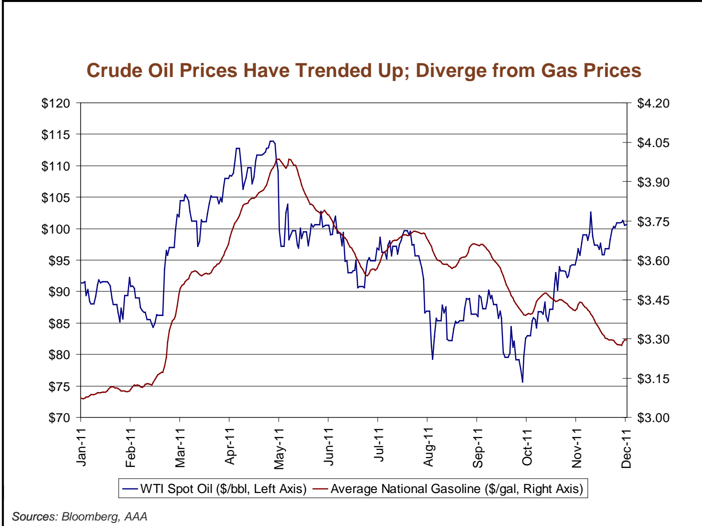


Improving economic news appeared to help lift consumer moods, according to several consumer confidence barometers. The November Conference Board consumer confidence index posted the biggest monthly gain since April 2003. The preliminary reading of the Reuters/University of Michigan consumer sentiment index for December showed that sentiment continued to improve for the fourth consecutive month. The latest confidence levels of both measures largely undid the declines reported between July and October (the October levels were the lowest of the recovery for both measures).

The Fannie Mae National Housing Survey showed little improvement in consumer attitudes regarding the direction of the economy. The share of people who believe the economy is headed in the wrong direction fell from a peak of 78 percent to 75 percent in November, but the decline was all captured in the undecided category with no change in the 16 percent of respondents who feel the economy is headed in the right direction.

The Conference Board survey showed that consumers' assessment of the labor market improved substantially in November, with the gap between the share of consumers reporting jobs hard-to-get and those reporting jobs plentiful narrowing sizably. Historically, this gap shows a strong correlation with the unemployment rate, and the shrinking of the gap in November was consistent with the plunge in the unemployment rate seen in the employment report.

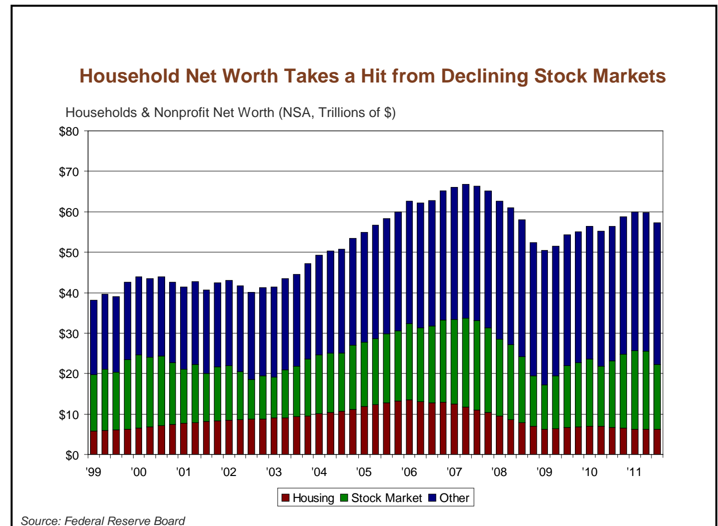
The ongoing decline in retail gasoline prices, which fell another 15 cents during the last month, appeared to have helped boost sentiment. Consumers are not likely to get much support from declining oil prices in the coming year, however. After dropping below $90 a barrel in August and helping to bring down retail gasoline prices, crude oil prices have climbed above $90 again in late October and were over $100 a barrel in early December.



We expect oil prices to edge down to slightly below $100 a barrel in the first quarter of next year and remain near the first quarter's level throughout the year. Given the fact that oil and gas prices tend to move together with lags, we would expect some increase in gas prices above current levels, which is usually quickly reflected in household comments on their expenses relative to incomes.

Consumers are expected to continue to face challenges in repairing their balance sheets. The Federal Reserve's Flow of Funds report indicated that household net worth (assets minus liabilities) fell $2.4 trillion to $57.3 trillion during the

quarter, largely driven by a decline in financial wealth (corporate equities, mutual fund shares, and pension fund reserves) as stock markets declined sharply amid the debt ceiling debate, the S&P downgrade of U.S. sovereign debt, and the European sovereign debt turmoil. Housing equity declined only modestly during the quarter.



Source: Federal Reserve Board

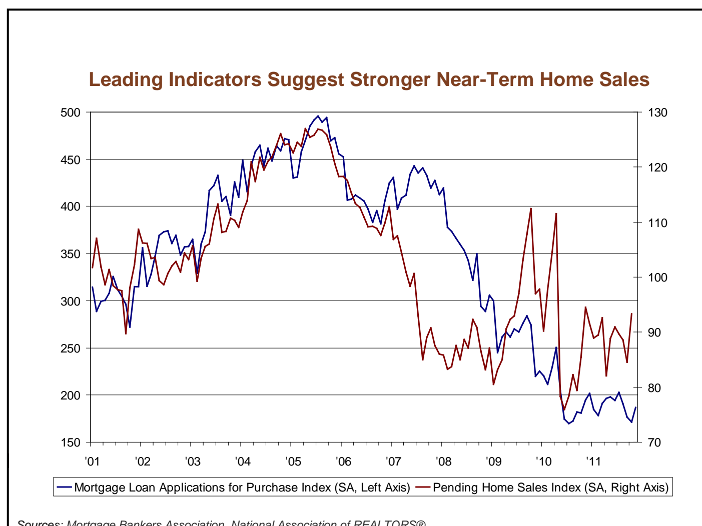
Equity markets have partially recovered from these shocks so far in the fourth quarter, and thus some of the hit to financial wealth is likely to be reversed. However, housing equity is not expected to add to household net worth in coming quarters.

As the economy enters 2012, we expect financial conditions will weaken markedly in the euro zone with spillover effects in the U.S., which will likely result in a widening of credit spreads that restrains both business investment and residential investment. With a slowdown in global growth, net exports are expected to contribute very little to U.S. economic growth in 2012. We expect that weaker disposable income, volatile stock markets, wider credit spreads, and a euro zone recession will combine to result in a slowdown in economic growth in the U.S. to about 1.5 percent in 2012, similar to the pace expected this year. There are both upside and downside risks to this forecast. Improved conditions in Europe or less than expected fiscal drag in the U.S. would likely boost growth by more than we expect. However, if the European crisis leads to more severe contagion to Italy, Spain, or even France, the U.S. could slip into recession next year.

Housing: Moving in the Right Direction

With the improving overall economy and continued low mortgage rates, housing indicators also have performed somewhat better during the past month, though levels of activity remain depressed by historical standards. Construction spending rose in October, driven by a surge in spending on home renovations. Spending on home improvements has accounted for a greater share of residential investment since the 2007-2009 recession, thanks to a large number of foreclosure sales, which are typically in poor condition, requiring more home improvement spending. Homebuilding activity also improved in October, with both housing starts and permits posting increases, and homebuilders' confidence rose in November to the highest level since its recent peak during the homebuyer tax credit.

Existing and new home sales advanced in October, putting the sales pace higher than the third quarter average. Pending home sales, or contract signings of existing homes, surged in October to their highest level in almost a year after three straight monthly drops, signaling further improvement in home sales in coming months. However, the actual increase in home sales will likely be more moderate. The National Association of REALTORS® reported a sharp increase in the number of contract cancellations in its latest survey. Cancellations rose to a record 33 percent in October, compared with 18 percent in September and only 8 percent a year ago.



Sources: Mortgage Bankers Association, National Association of REALTORS®

There are other signs that record low mortgage rates are spurring housing demand. Purchase mortgage applications rose nearly 10 percent in November after trending lower in the prior three months. Freddie Mac reported that the average 30-year fixed mortgage rate for conforming loans fell to a new monthly low of 3.98 percent in November.

Home prices stabilized in the third quarter. However, they are poised to weaken in coming quarters, reflecting the winter season, an expected slowdown in economic activity, and a potential increase in distressed sales. The S&P/Case-Shiller house price index posted a decline in September, the first drop since March, while the FHFA purchase-only index unexpectedly rose during the month.

Another measure of home prices, the CoreLogic house price index, which is used by the Federal Reserve to estimate the value of housing in the Flow of Funds accounts, dropped in October for a second consecutive month. The recent decline in prices was mainly driven by distressed sales, as prices were up when distressed sales are excluded.

Despite the near-term improvement, the housing market recovery will likely remain subdued next year. Foreclosure activity seems likely to pick up as process issues are resolved, which should result in more foreclosure completions in 2012. The Mortgage Bankers Association National Delinquency Survey showed that, after declining for three consecutive quarters, the foreclosure rate rose in the third quarter of this year. Job security will remain an obstacle to home purchases. If the European debt crisis deepens, it is likely that lending standards will be tightened further and mortgage spreads could widen substantially.

We continue to expect that the Fed will keep the zero fed funds rate policy through mid-2014. At this time, we do not anticipate that the Fed will engage in another round of quantitative easing. However, we believe that the Fed will stand ready to expand its balance sheet by purchasing mortgage-backed securities (MBS) in an effort to bring down mortgage rates if the European crisis intensifies and threatens the U.S. economic expansion.

Long-term interest rates have been little changed during the past month, with the yield on 10-year Treasuries hovering around 2 percent. Our interest rate forecast is similar to that from the November forecast. Given the forecast of continued sluggish growth next year, we expect the 10-year Treasury yield to move up only gradually, to less than 2.5 percent by the end of 2012, bringing the 30-year fixed mortgage rate up to just slightly more than 4 percent.

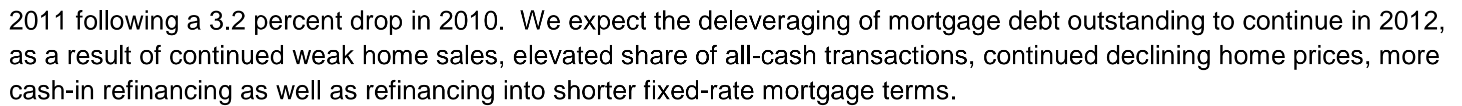
Despite more upbeat housing news for the current quarter, our housing outlook for next year is largely the same as the view we had last month. We look for a modest rise in new home sales and single-family construction in 2012, as demand for new homes will continue to face competition from distressed properties. Multifamily will remain a bright spot, with multifamily starts expected to rise by about 35 percent in 2012, supported by the continued decline in the homeownership rate. (For more information on multifamily market conditions, read the *December 2011 Multifamily Market Commentary*).

Existing home sales should be flat in 2012, as housing demand will remain lackluster amid sluggish economic growth and weak job gains.

On the refinancing side, despite multi-year lows for mortgage rates, the refinance index has been around 10-15 percent lower than the levels reached at the peak of the 2010 refi wave. The release of new HARP program details on November 15 provided more clarity on the program, which took effect on December 1, 2011 and is currently set to expire at the end of 2013. However, implementation by Fannie Mae and Freddie Mac will take place in stages, and lenders will have their own schedule of automation infrastructure to develop. Thus, the prepayment effects are not likely to be felt until next spring. We expect the program to generate about $200 billion of refinance originations by the end of 2013. However, the impact of HARP refinancing will depend on economic conditions, e.g., home prices, interest rates, and labor market conditions, and thus the impact over the next two years will vary with the development in the overall economy and housing market conditions.

For all of 2011, total single-family mortgage originations are projected to decline to $1.36 trillion from an estimated $1.69 trillion in 2010, with a refinance share of 71 percent. For next year, we expect total originations to decline to nearly one trillion dollars as the drop in refi originations offsets a modest increase in purchase originations. The refinance share is expected to plunge to 54 percent.

The Flow of Funds accounts showed that total single-family mortgage debt outstanding fell in the third quarter by a 2.3 percent annualized rate, marking the 14th consecutive quarter of contraction, and we expect it to decline by 2.3 percent in



2011 following a 3.2 percent drop in 2010. We expect the deleveraging of mortgage debt outstanding to continue in 2012, as a result of continued weak home sales, elevated share of all-cash transactions, continued declining home prices, more cash-in refinancing as well as refinancing into shorter fixed-rate mortgage terms.

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