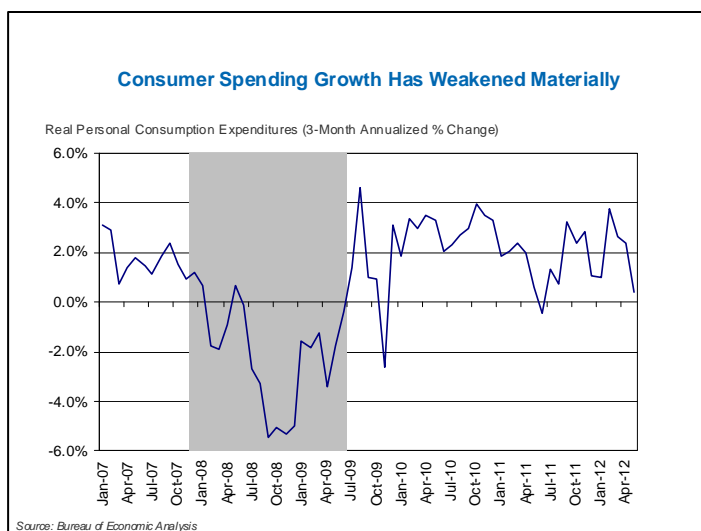


## Underwhelming Growth Continues

Incoming data over the past month have been bearish, pointing to a slowdown in momentum in overall economic activity. Our projected economic growth of just slightly more than 2 percent for the second quarter now appears to be too optimistic, which also diminishes expectations about the growth path for the second half of the year. With consumer spending accounting for 70 percent of gross domestic product (GDP), our forecast of a slight pickup in economic growth in the second quarter hinged on consumer resiliency, which should have resulted in just a modest slowdown in consumer spending growth from the strong pace of the first quarter. The weak personal income and personal consumption expenditures report essentially dashed that hope. Income prospects are unlikely to improve by much to provide support for consumers in the near term, given another lackluster June jobs report. At the same time, the Institute for Supply Management (ISM) manufacturing survey indicated a contraction in manufacturing activity in June, driven by a slowdown in demand globally as well as domestically.

Despite signs of deteriorating momentum for overall economic activity in the second quarter, the news from the housing market has been relatively upbeat, as housing activity continues to run well ahead of last year's pace. Even home prices are showing broad signs of firming, presenting a rare upside boost to the economy. Headwinds from the protracted sovereign debt crisis in Europe and the global economic slowdown, especially in Asia, will continue to present challenges for growth prospects in the U.S. Recently, central banks around the globe further eased monetary policy by cutting interest rates or purchasing assets (i.e., quantitative easing) in an attempt to stimulate growth. In the U.S., the Federal Reserve extended Operation Twist—where it sells short-term securities and uses the proceeds to buy long-term securities—and indicated its bias toward further easing as it substantially downgraded projections of economic growth this year. Recent weakening economic data, ongoing turmoil in the financial markets, and potential further erosion in consumer confidence as we move closer toward the end of the year, when a massive fiscal drag is scheduled to take effect, raise the odds of a third round of quantitative easing in the months ahead.



After holding our growth projection for 2012 at 2.2 percent in the June forecast with a bias toward downside risks, it is now clear that such risks have materialized and thus we have decided to downgrade our already modest growth projections. We now expect neither meaningful deteriorations nor improvements from the growth pace witnessed in the first quarter of this year of 1.9 percent (annualized rate), resulting in 2 percent growth for all of 2012, with risks remaining tilted to the downside.

We have long emphasized the role of consumers as the key to the economic outlook, and it is clear that consumers have turned increasingly cautious. Real (inflation-adjusted) consumer spending ticked up 0.1 percent in May, held down by spending on durable goods, which fell for the third consecutive month. In addition, previous months' data were revised substantially lower, resulting in a three-month

annualized growth rate of just 0.4 percent, the slowest pace witnessed in nearly a year.

Gasoline prices have fallen by about 13 percent since peaking in early April. However, in the face of declining gasoline prices, which act as a tax cut, cautious consumers chose to boost their savings rather than increase their spending. The saving rate steadily rose from a four-and-a-half-year low of 3.4 percent in February to 3.9 percent in May.

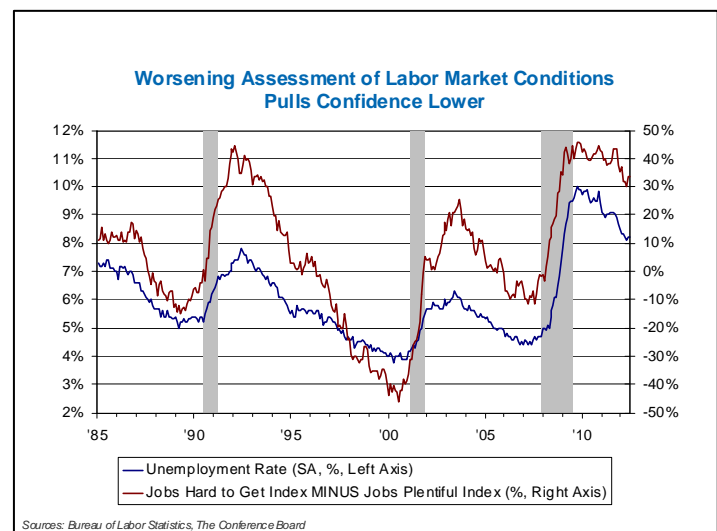
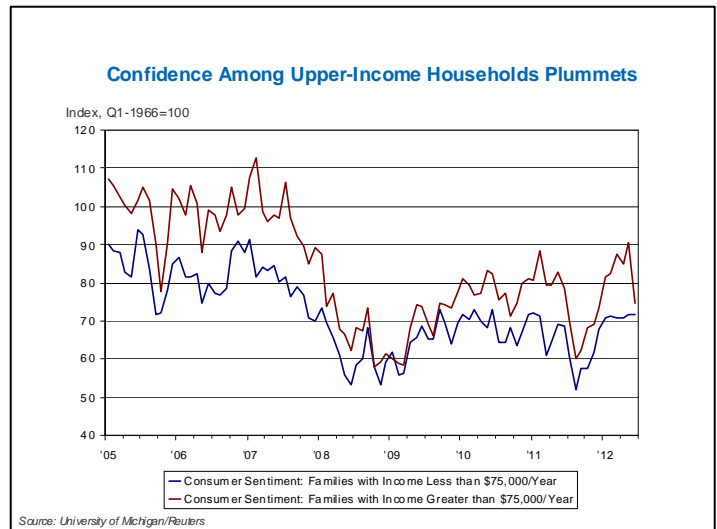
A strong pickup in consumer spending is unlikely given June auto sales, which rose only modestly from May, leaving the second quarter sales pace below the pace of the first quarter.

In response to worsening economic conditions and outlook, measures of consumer confidence showed a marked deterioration. The Reuters/University of Michigan consumer sentiment index fell sharply in June—the first monthly drop since last August. The large pullback brought the sentiment index down to the lowest level this year. Declining gasoline prices since April helped lift confidence but it appears other negative factors dominated, dragging down overall confidence. The entire drop in sentiment in June was among households with incomes above \$75,000, who were less optimistic about economic prospects as well as about their own financial prospects. Sentiment among lower-income households held relatively steady.

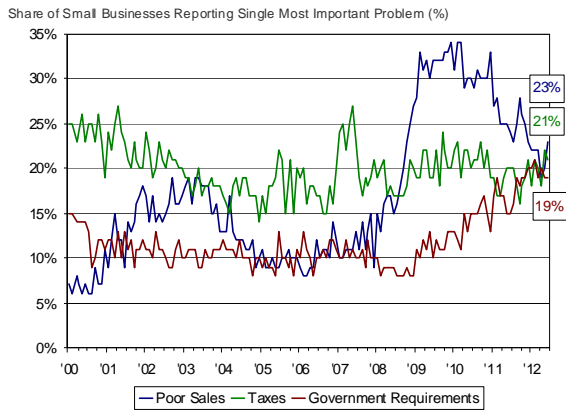
The Conference Board survey of consumer confidence showed further erosion in June, with the consumer confidence index falling for the fourth consecutive month to the lowest level since January. The June drop was entirely due to a decline in the expectations component, as expectations regarding the prospects for job and income growth weakened further, consistent with recent trends in the labor market. The labor market differential—the percent reporting jobs to be plentiful less the percent reporting jobs hard to get—worsened for the second consecutive month after trending down to a recovery low in April. This indicator has correlated well with the unemployment rate and thus its recent trend suggests that the unemployment rate will likely remain elevated in the near term.

The June jobs report confirms that the labor market has weakened materially in recent months. The 80,000 increase in nonfarm payrolls brought the second-quarter monthly average gain down to just 75,000, sharply slowing from the 226,000 average monthly rise in the first quarter and marking the slowest quarterly job gain in nearly two years. The trend is particularly notable in the private sector, as June's 84,000 private payroll gain is the lowest reported since last August. The slowdown in jobs gains is more likely now to be driven by worsening fundamentals rather than a payback from a weather-induced boost earlier in the year. It appears businesses are increasingly cautious amidst concerns about the debt crisis in Europe and the domestic fiscal situation among other factors, including a global growth slowdown and slowing profit growth.

Small business confidence also took a big hit, declining sharply in June, according to the National Federation of Independent Business (NFIB) Index of Small Business Optimism. This marks the third drop over the past four months, sending the index to the lowest reading since last October. Labor market indicators and spending plans for capital equipment and inventories accounted for a large portion of the decline. The single most important problem cited by small business owners in June was poor sales, followed by taxes and government regulations. Poor sales were cited as the biggest problem in every month between August 2008 and March 2012 but were second to government regulations and taxes in April and May, respectively.

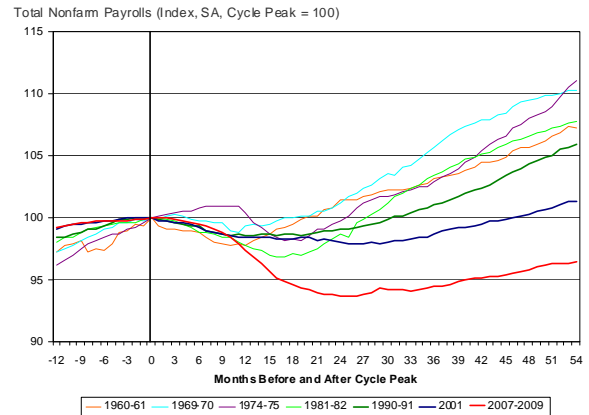


### Poor Sales Resume as Greatest Concern Among Small Businesses



Source: The National Federation of Independent Business

### Employment in the Current Recovery Still Far Below Its Peak



Source: Bureau of Labor Statistics

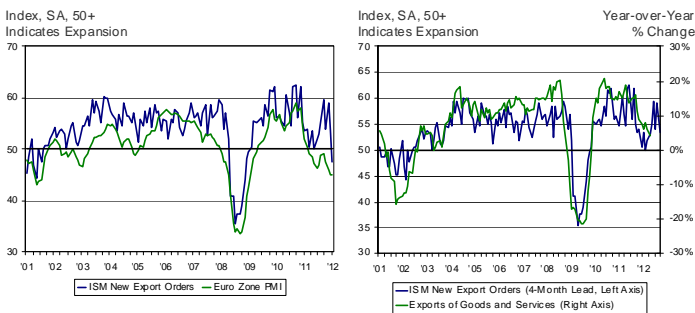
The massive job losses during the last recession and the slow pace of job creation in the current recovery are especially striking when compared to previous business cycles. In prior business cycles since 1960, employment surpassed its pre-recession peaks within four years, sometimes substantially. However, in the current business cycle, employment remains more than 3.5 percent below its peak after 54 months.

There were a few positive signs in the jobs report, however. The average number of hours worked picked up, reversing a drop in May, and average hourly earnings for all workers rose 2 percent from a year ago, an improvement over the past two months. Despite these improvements, conditions remain weak, as both average hours worked and wage gains are still below their previous peaks in the current recovery.

The survey of households showed that the unemployment rate held steady at 8.2 percent as the moderate increase in employment offset the number of people joining the labor force.

The labor market is not alone in showing signs of softening, as reports related to the factory sector indicated weakening manufacturing activity and business investment. The Institute for Supply Management (ISM) manufacturing index dropped to below the 50-mark that divides expansion and contraction in activity—the first time the index signaled a contraction in activity since July 2009. The most worrisome aspect of the June ISM survey was the plunge in new orders from strong expansion territory to contraction for the first time since April 2009 and the steepest decline in over a decade.

### Plunge in Export Orders Following Deepening Manufacturing Contraction in Euro Zone Bodes Poorly for Exports Outlook



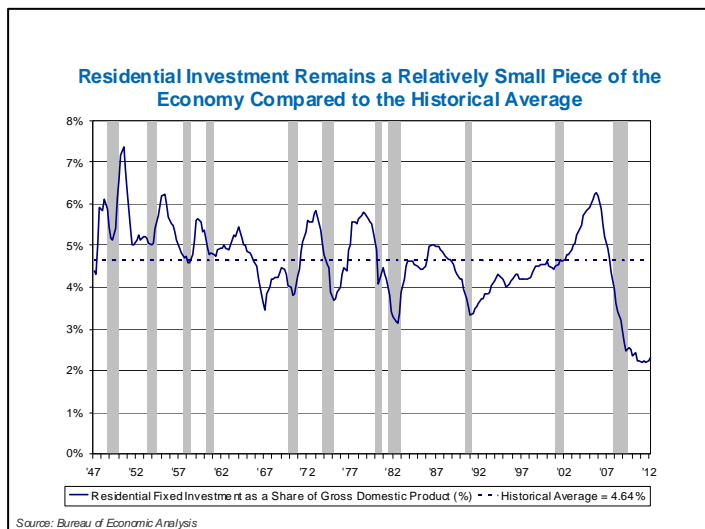
Sources: The Institute for Supply Management, Bloomberg, Census Bureau

The ISM new export orders data suggest that the economic downturn in the eurozone appeared to have a serious negative impact on manufacturing activity in the U.S. The index had held up well relative to manufacturing activity in the eurozone, as measured by the Purchasing Manager Index (PMI) in the region, which has slipped into contraction territory since last August. However, the ISM new export orders index posted the second consecutive sharp decline in June, resulting in the second biggest two-month drop on record next to the plunge in late 2008.

The trend in the ISM new export orders index generally correlates well with U.S. exports of good and services, which have already slowed sharply over the past year. The recent trend in the ISM export orders index signals a further slowdown in U.S. exports in the second half of the year, which is one of the reasons for our subdued economic growth projection.

Besides signs of cooling from the survey of manufacturing activity, hard data also indicate a slowdown for the sector, likely caused by increasingly cautious businesses. The durable goods orders report showed a rebound in activity in May after sharp pullbacks in the prior two months. While core capital goods orders (nondefense, excluding aircraft)—a leading indicator of business investment in equipment and software—also rose in May for the first time in three months, their trend has weakened significantly. Taken together with the ISM report, it is clear that the manufacturing sector has weakened—a trend that will likely continue through the rest of the year—suggesting that business investment will not contribute to economic growth as much as it did in the early stages of the recovery.

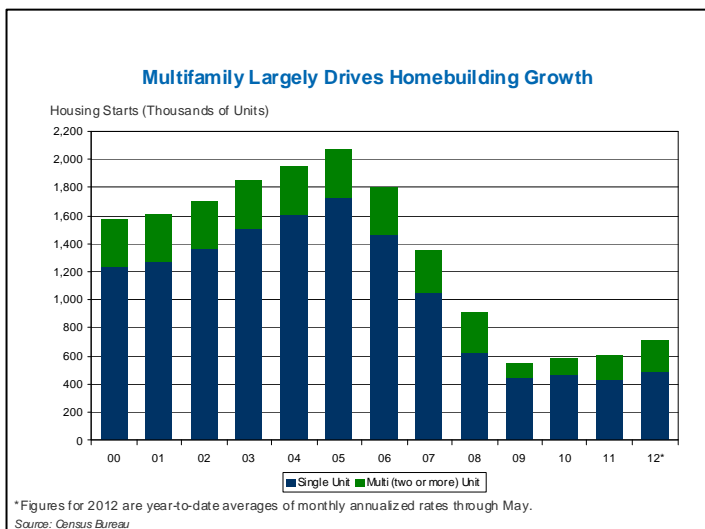
Service activity fared better than manufacturing activity, expanding in June but at a much slower pace, according to the ISM non-manufacturing index, which fell to its lowest level since January 2010. Reflecting the global economic slowdown, new export orders fell into contraction territory for the first time since last July.



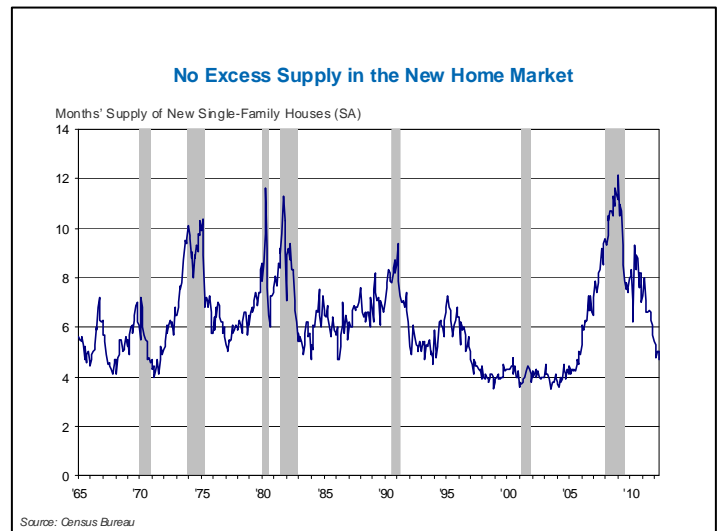
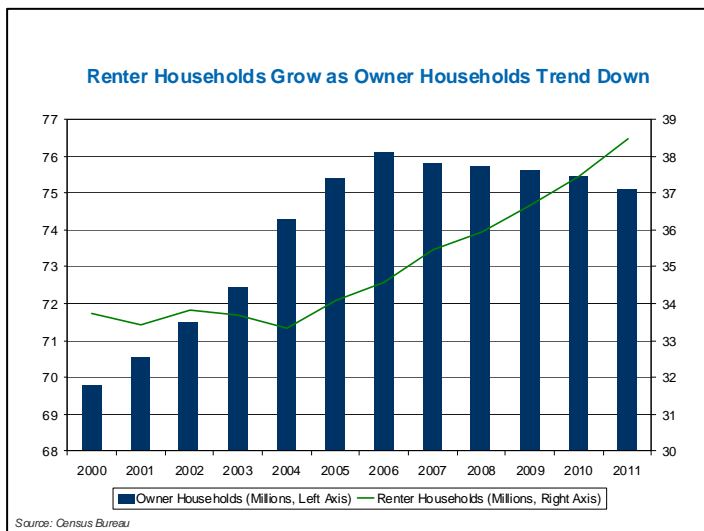
Overall, economic reports on consumer spending, exports, and business investment during the past month reinforce the view that economic growth will remain modest through the rest of the year. One component of GDP that appears to be gradually gaining momentum is housing, and we expect residential investment to increase this year but from a very low base, and to contribute to economic growth for the first time since 2005. Given the small share of residential investment of GDP, at 2.3 percent, compared with over 6 percent during the housing boom and its long-term average of about 4.6 percent, the contribution to economic growth from the housing sector this year will be quite modest.

### Housing: Hopeful Signs

Recent housing indicators have been positive in the face of disappointing overall economic data. Single-family housing starts and new single-family home sales rose in May, and their year-to-date activities were about 20 percent above last year's levels. The volatile multifamily starts fell sharply in May, but the year-to-date level remained nearly 45 percent ahead of last year.



The stronger recovery in the multifamily segment is driven by growing demand for rental units, as many homeowners lost their homes through foreclosure and many others opt to rent rather than to own. The number of renters has been on the rise since 2004, while the number of homeowners has been trending down since peaking in 2006. (For more information on multifamily market conditions including an outlook for the seniors rental housing sector, read the *July 2012 Multifamily Market Commentary*).




New housing inventory has fallen substantially over the last year, as builders have restrained new construction activity in the face of sluggish demand, allowing new homes available for sale to be absorbed and restoring balance in the new home market. The months' supply of new homes, an indicator of supply and demand imbalances, fell to 4.7 months in May—the lowest reading since October 2005 and well below its long-term average of 6.2 months.

The tight supply conditions in the new home market provide some upside to home building activity, as builders will have to add supply should demand pick up strongly. Builders are now more optimistic than they have been in more than five years, according to the June National Association of Home Builders/Wells Fargo Housing Market Index.

While existing home sales retreated modestly in May, pending home sales increased during the month to their highest level in more than two years. The National Association of REALTORS® suggests that May existing home sales may have been held down by a limited supply of homes in the lower end of the market. As a result of the change in the mix of sales with relatively fewer sales in the low-end segment, the median home price was nearly 8 percent above its year-ago level—the largest year-over-year increase in more than seven years.

Measures of home prices that are not affected by the change in the mix of sales continued to show improvement in the spring, and there are signs that prices should continue to firm in early summer. For example, both the CoreLogic overall measure and the measure excluding distressed sales rose in May for the third consecutive month. From a year ago, both measures also posted gains for the third straight month. In addition, the CoreLogic Pending Home Price Index indicates that house prices, both including and excluding distressed sales, will continue to rise through June. The pickup in the CoreLogic home price measures as well as in some other measures, such as the FHFA Purchase-Only House Price Index, look to be so strong in the second quarter such that prices may appreciate in 2012 from 2011 even if they resume declining in the second half of this year. Home price appreciation will help increase household net worth after the massive decline during the recession, alleviating some of the pressure on households to continue to deleverage and build up their savings. The rise in home prices also will help support flagging consumer confidence.

Expectations that home prices have bottomed in the face of continued low mortgage rates should help incite some potential homebuyers to get into the market to take advantage of great home buying conditions. Fannie Mae's June 2012 National Housing Survey showed that while consumers remain cautious about the general economy, their attitudes toward the housing market continue to improve. The share of consumers who say they would buy if they were going to move increased by 6 percentage points to the highest level seen in the survey's two-year history. At the same time, 35 percent of respondents believe that home prices will go up in the next 12 months, with an average rise of 2 percent—also the highest level recorded since the survey began in June 2010.



Given expected continued moderate growth, we expect long-term interest rates to remain low, supporting home buying conditions. The yield on 10-year Treasury notes should rise only modestly, ending the year at around 1.8 percent, with 30-year fixed mortgage rates rising to 3.8 percent. Industry capacity will prevent mortgage rates from dropping much further than the current record low levels of about 3.6 percent. On the other hand, rising rates should alleviate capacity pressures, which would benefit less rate-sensitive refinancing activity such as the Home Affordable Refinance Program (HARP) and FHA streamlined refinance.

If economic activity deteriorated significantly further, the Fed would likely launch another round of quantitative easing targeted at purchases of mortgage-backed securities, which should help tighten mortgage spreads at a time when overall risk spreads would tend to widen.

While we downgrade our projection of economic growth, we slightly upgrade our forecast of housing and mortgage activity. We expect housing starts to rise by 22 percent and total home sales to increase by 9 percent in 2012. Home prices for 2012 overall are now projected to be above last year's depressed levels, compared with a slight decline in the previous forecast. A projected increase in home sales, combined with an improved home price outlook, will push purchase mortgage originations higher this year than last year by more than we projected in the prior forecast. The volume of refinance originations estimated to have come in for the second quarter of 2012 exceeded our earlier estimate and therefore we revise higher the trajectory of refinance volume, resulting in an increase in projected refinance originations in 2012 from 2011 versus a slight drop in the June forecast. For all of 2012, total mortgage originations are projected to rise to \$1.49 trillion from an estimated \$1.36 trillion in 2011. The refinance share is expected to be 66 percent, the same as the share in 2011. We expect total single-family mortgage debt to post the fifth consecutive annual drop, falling by 1.4 percent in 2012, compared with a 2.5 percent drop in 2011.

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Economics and Strategic Research  
July 10, 2012

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