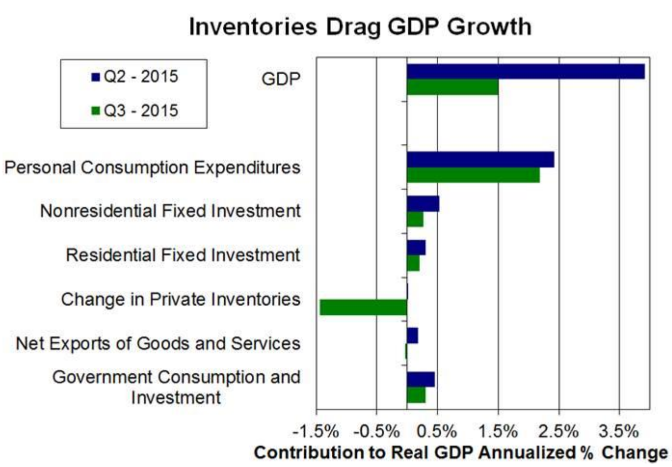
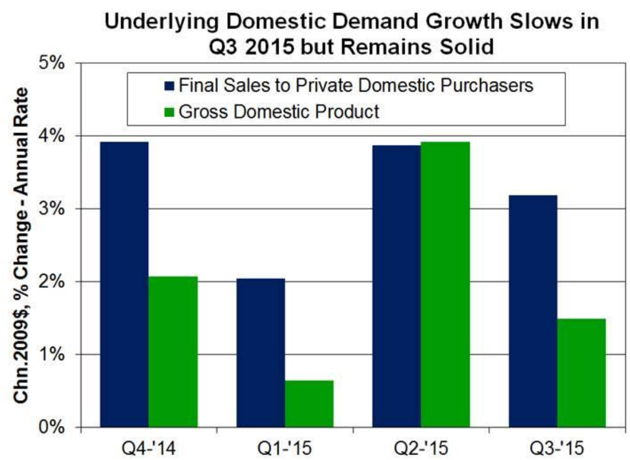
Economy Remains on a Firm Footing Amid Global Risks

After a marked slowdown in the third quarter, economic growth is poised to pick up in the current quarter as expected. Our outlook for the second half of the year is little changed from our prior forecast, and thus our view for all of 2015 has not changed over the past month. We expect the economy to grow 2.2 percent this year and expand at a 2.4 percent pace in 2016, supported by solid consumer spending growth and a pickup in construction activity and continued rising home sales and prices. Headwinds for manufacturing and exports stemming from the strength in the dollar and weak global growth are unlikely to dissipate in the near term. However, the drag on manufacturing from the inventory cycle and declining oil prices should fade next year.

The sharp slowdown in economic growth in the advance estimate of third quarter Gross Domestic Product (GDP) to 1.5 percent annualized from 3.9 percent in the second quarter was neither surprising nor alarming. The sole negative component of economic growth was an expected slowdown in the pace of inventory building from unsustainable levels. Real inventory investment, which surged to about $113 billion in each of the first two quarters of the year—the largest back-to-back inventory builds on record—slowed sharply to a $56.8 billion pace in the third quarter. While the marked deceleration was a negative for the third quarter, subtracting 1.4 percentage points from GDP growth, it sets the stage for faster growth in coming quarters. Growth in real consumer spending and in nonresidential and residential fixed investment also slowed from the second quarter, but only moderately. As a result, final sales to private domestic purchasers—a gauge of underlying domestic demand—moderated from the second quarter, but still maintained a solid 3.2 percent pace, suggesting that the economy has ample momentum heading into the final quarter of the year.





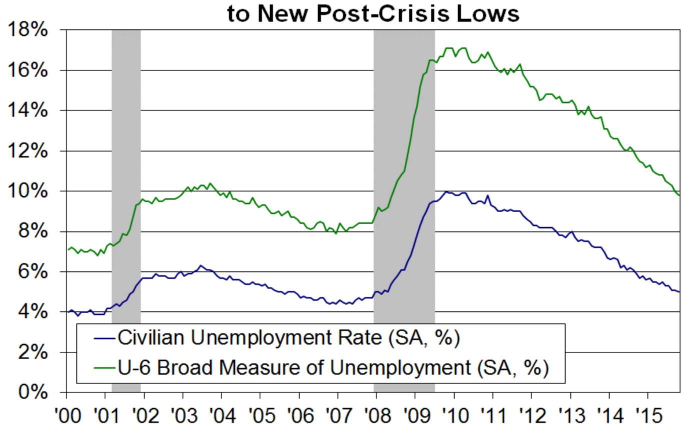
Net exports were largely neutral to growth in the third quarter, thanks to the substantial narrowing in the trade deficit in September as exports rose during the month and imports fell after a surge in the prior month. However, we expect imports to bounce back given positive consumer fundamentals in the U.S. domestic economy and continued appreciation of the U.S. dollar.

While real consumer spending growth registered a solid 3.2 percent pace during the third quarter, the monthly data showed that it lost momentum heading into the fourth quarter, increasing just 0.2 percent in September following a 0.4 percent rise in August. However, auto sales strengthened further in October to 18.24 annualized units, surpassing 18 million units for two months in a row for the first time since 2002, and are poised to set an annual record high.

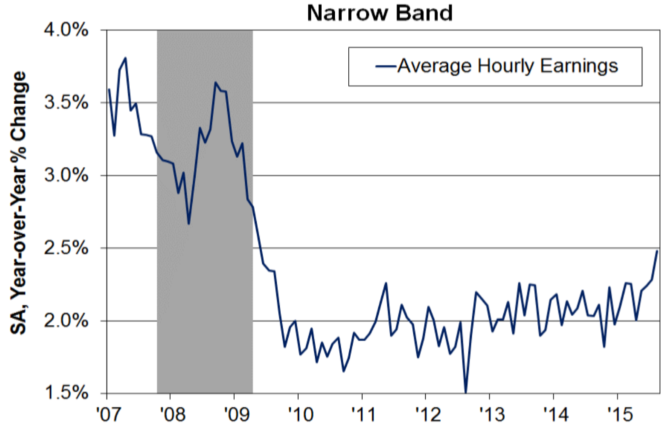
In addition, the October jobs report showed strong employment and wage gains, which will help support consumers in the current quarter. Nonfarm payrolls posted a 271,000 gain, the biggest increase this year. Upward revisions to previously reported data brought the average gain over the last three months to a solid 187,000, erasing concerns that hiring slowed sharply in recent months. Gains were broad-based, led by private services. Manufacturing payrolls were flat, and mining payrolls extended losses to 10 consecutive months. The real estate industry received some good news, as construction payrolls posted the biggest gain since February; however, the gain for the residential segment remained relatively modest compared with the increases seen earlier this year.

The headline unemployment rate edged down to 5.0 percent for the right reasons, as a large increase in household employment outweighed the increase in the number of people joining the labor force. More importantly, the broader U-6 unemployment rate, which includes discouraged workers and part-time workers who prefer full-time jobs, ticked down to 9.8 percent, the lowest level since May 2008. Another piece of good news was the 0.4 percent jump in average hourly earnings after a flat reading in the prior month. The annual gain accelerated to 2.5 percent, breaking out of the narrow band witnessed during most of the expansion to reach the fastest rate since July 2009. The outsized gain in October average hourly earnings likely reflects some payback for weakness in September, however.

The Two Main Measures of Unemployment Fall to New Post-Crisis Lows

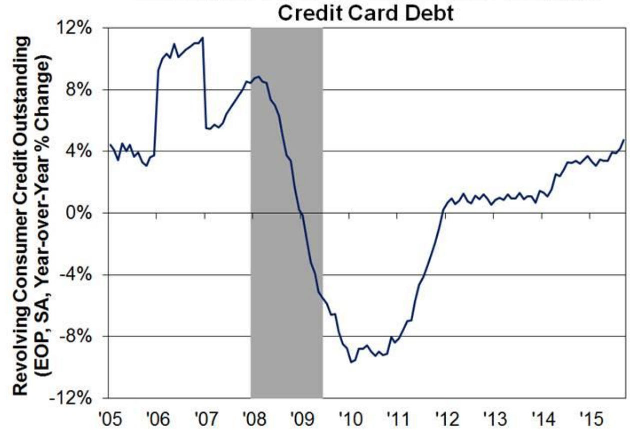


Annual Wage Growth Finally Breaks out of Its Narrow Band



Recent credit data indicate that consumers are becoming more comfortable using their credit cards. Total consumer credit surged $28.9 billion in September, among the largest monthly gains on record, mainly because of a jump in non-revolving credit (mostly auto and student loans), which has increased every month since August 2011 and accounts for nearly three quarters of total consumer credit. However, revolving credit also posted a healthy monthly gain in September, the largest increase since April. The year-over-year gains in revolving credit have accelerated in recent months, with the September increase marking an expansion best. The October Fed's Senior Loan Officer Survey showed banks loosened lending standards on consumer loans over the past three months amid rising demand, which is a positive for the near-term outlook for consumer spending.

Consumers Are More Comfortable Incurring Credit Card Debt

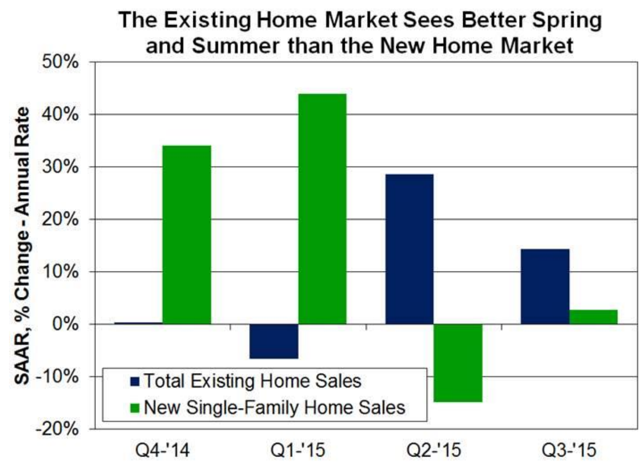


On the business spending front, core capital goods orders (nondefense capital goods orders excluding aircraft)—a leading indicator of business equipment spending—declined in September for a second consecutive month, suggesting that business equipment spending should moderate substantially from the strong pickup in the third quarter. Low energy prices will likely lead to another decline in nonresidential investment in structures in the current quarter.

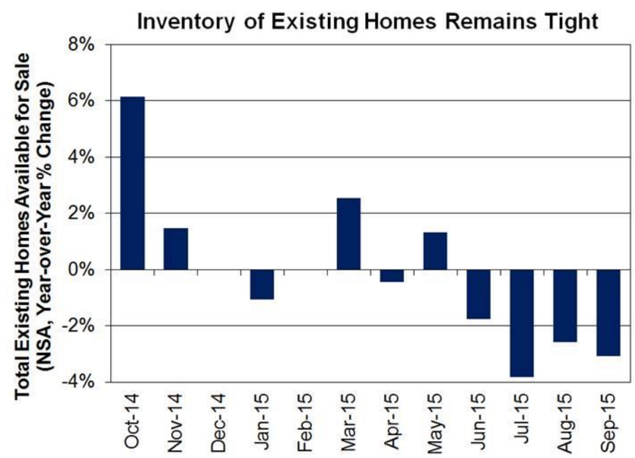
For the current quarter, we expect consumer spending to be the biggest driver of growth for the rest of this year and moving into 2016. Net exports should turn from neutral to a drag on growth. However, residential investment growth is expected to strengthen modestly from the 6.1 percent annualized pace in the third quarter. Meanwhile, we revised higher our government spending growth forecast due to the Bipartisan Budget Act of 2015. Most importantly, we expect inventory investment to be neutral to growth after subtracting substantially from growth in the third quarter. On net, we believe economic growth will accelerate about one percentage point to 2.6 percent annualized in the current quarter.

In her testimony to the House Financial Services Committee last month, Fed Chair Janet Yellen noted that a December rate hike is a "live possibility" based on an expectation that inflation will move toward the 2.0 percent target amid an improving labor market and fading transitory factors that have weighed on inflation. The October jobs report served to fuel market expectations that a liftoff this year is very likely. According to fed funds futures, the odds of a December rate increase rose to slightly more than 70 percent from nearly 60 percent before the jobs report. Barring a dismal November jobs report and international turmoil over the next month, we expect the Fed to raise the fed funds rate in December, which will shift the monetary policy debate to the question of how fast the Fed will tighten.

Housing Roundup

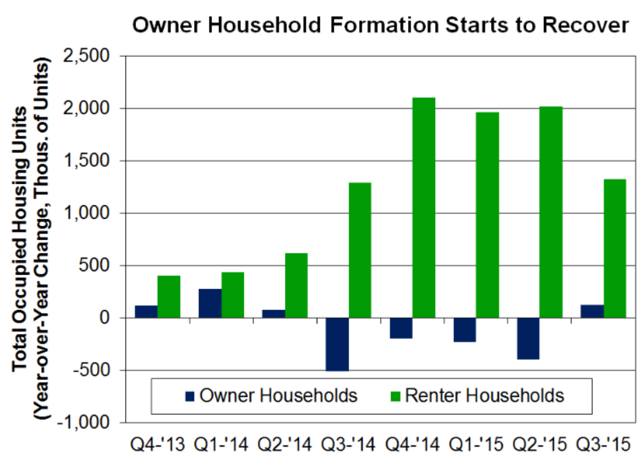


Recent housing and mortgage news has been mixed. After two monthly drops, housing starts rebounded in September, exceeding 1.2 million units for the second time since October 2007. Multifamily starts drove the gain, while single-family starts were little changed during the month. (For more information on multifamily market conditions, read the [November 2015 Multifamily Market Commentary](#).) However, permits fell in September for the second time over the last three months. Meanwhile, following strong gains in each of the prior two months, new home sales plummeted in September to the weakest pace since November 2014, making the average for the third quarter only slightly better than the second quarter. While the inventory of new homes for sale has posted year-over-year increases since January 2013 and jumped to a five-year high in September, a tight supply of more affordable homes likely contributed to the soft sales trend for the spring and summer months. Despite lackluster single-family starts and home sales, home builders remain optimistic, with a gauge of their confidence jumping in October to a fresh expansion high.



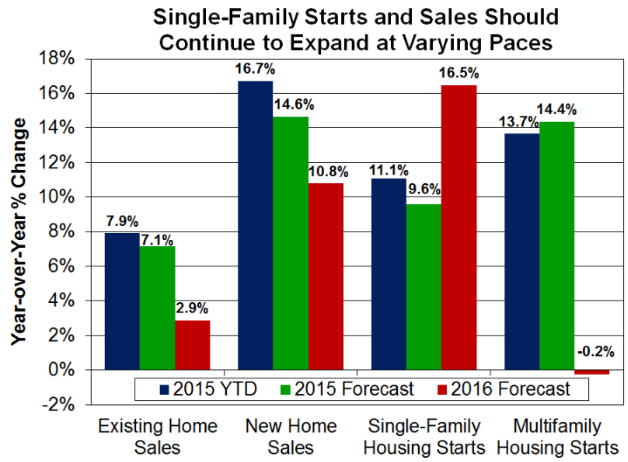
Existing home sales rebounded in September, nearly recouping the large drop in August and returning to July's expansion best. For the third quarter as a whole, total existing home sales posted a double-digit annualized gain, but moderated from the robust pace of the second quarter. Forward-looking indicators suggest some near-term setbacks, however. Pending home sales pulled back during September for a second consecutive month, and average weekly purchase mortgage applications for all of October fell for the third time over the last four months.

Inventory in the existing home market remains lean. The number of homes for sale posted an annual drop in September for the fourth consecutive month. The tight supply and the declining distressed sales share over the past year continued to put upward pressure on home prices. The August Case-Shiller national index showed the biggest year-over-year home price gain in about a year, while the September CoreLogic index posted the strongest annual increase in more than a year.



Over the past several years, the housing market has been characterized by sustained declines in the homeownership rate and sluggish household growth. The Housing Vacancy Survey offered some tentative signs that both of these trends may be turning the corner in the third quarter. Over the past year, the number of households increased 1.4 million, boosted by a strong gain in renters and the first rise in owner households since the second quarter of 2014. Meanwhile, the homeownership rate (not seasonally adjusted) rose 0.3 percentage points to 63.7 percent, the first quarterly increase in two years. However, the rate remained 0.7 percentage points below the level of the third quarter of 2014.

Treasury yields rose sharply following the upbeat October jobs report, reflecting the increased odds of a December rate hike, with yields on 2- and 10-year Treasury Notes jumping 15 and 18 basis points to 0.90 percent and 2.34 percent, respectively. Given our expectations that the Fed will tighten monetary policy at a measured pace during this cycle amid monetary easing abroad, including a cut in the deposit rate by the European Central Bank this December, fixed mortgage rates should gradually trend up to just slightly more than 4.0 percent by the end of 2016, the same as in our prior forecast. Our forecast for housing activity is also little changed. Year-to-date housing indicators show a marked improvement from the year-ago period, and we expect improvement in single-family starts and home sales to continue in 2016, supported by continued low mortgage rates and the improving income trend. In addition, lending standards, especially for government-sponsored enterprise (GSE) mortgages, eased further over the past three months, according to the October Federal Reserve Senior Loan Officers Survey. These positive fundamentals should help some recently formed renter households move into homeownership, stabilizing the downtrend in the homeownership rate. For mortgage production this year, we project that total mortgage originations will rise approximately 32 percent to $1.71 trillion, with a refinance share of 46 percent. Expected improving housing starts, home sales, and home prices in 2016 should drive purchase mortgage originations higher. However, rising mortgage rates will significantly curtail refinance activity. We project that the decline in refinance originations will outweigh the increase in purchase originations, resulting in an 18 percent drop in total mortgage origination in 2016 to $1.41 trillion, and a 14 percentage point drop in the refinance share to 32 percent.



November 10, 2015
Economic & Strategic Research (ESR) Group

For a snapshot of macroeconomic and housing data between the monthly forecasts, please read ESR's Economic and Housing Weekly Notes.

Sources for chart data: *Bureau of Economic Analysis, Bureau of Labor Statistics, The Federal Reserve Board, the National Association of REALTORS®, Census Bureau, Fannie Mae ESR forecast*

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