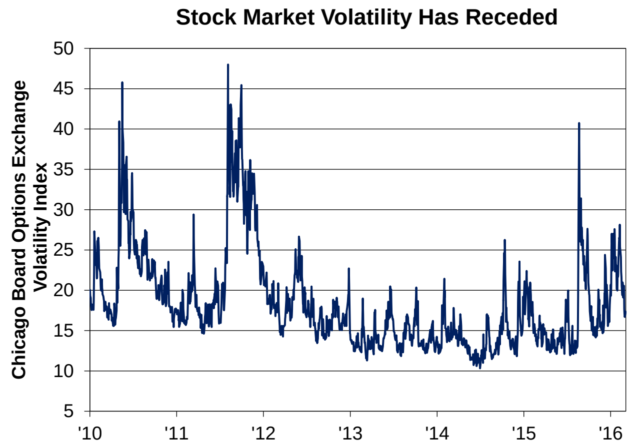
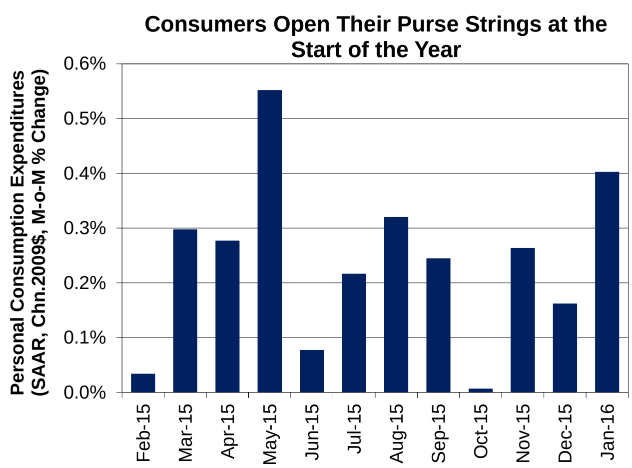
Moving Past the Soft Patch

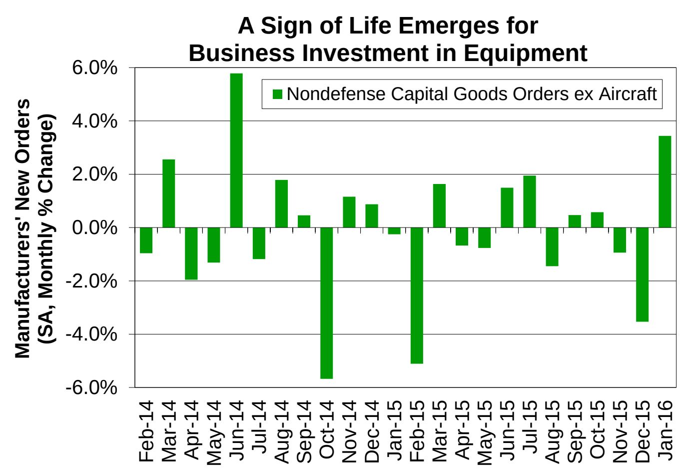
Financial market conditions and economic data have improved recently and eased concerns that the economy is at imminent risk of recession. However, these developments have not materially changed our outlook since our last forecast. We expect economic growth of 2.0 percent in 2016, essentially flat to the 2015 rate, with risk tilting toward the downside. We believe the full impact of the past rise in the dollar and the plunge in oil prices have not fully passed through the economy, and thus weakness in net exports and nonresidential fixed investments in equipment and structures related to energy exploration and development will continue to weigh on growth. We also expect the ongoing inventory correction process to drag on growth throughout this year following the largest back-to-back inventory accumulations on record during the first two quarters of 2015.



Stocks have bounced back from February lows to near their highest level this year; credit spreads have sharply narrowed, especially for high-yield corporate debt; and oil prices have climbed, with West Texas Intermediate oil prices increasing to more than $37 a barrel at the time of this writing. As a result of receding financial turmoil, volatility has receded. For example, the VIX—the options price-based stock market fear gauge—is back down to the level seen in mid-December when the Fed began raising the fed funds rate.

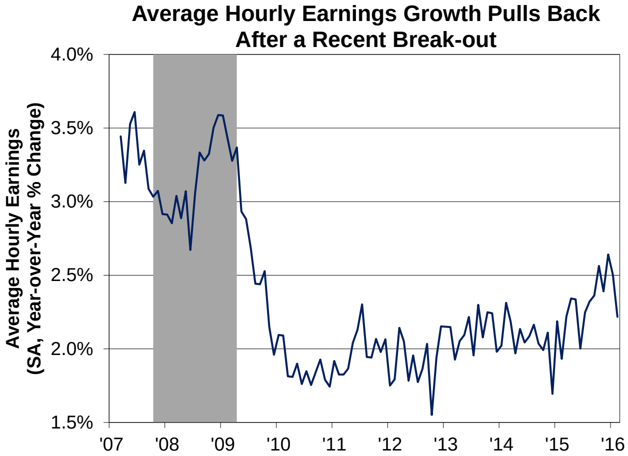
Meanwhile, the economy appears to have regained some footing after a fourth quarter slowdown during which real gross domestic product (GDP) grew just 1.0 percent annualized. Domestic consumer and business spending showed signs of strengthening this quarter. Real consumer spending rose 0.4 percent in January, the biggest gain since last May. While February auto sales edged down slightly to 17.5 million units annualized, the sales pace was the strongest for any February since 2000. Improving labor market conditions, cheap gasoline, and easy credit have combined to keep sales elevated. On the business side, core durable goods orders — a leading indicator of business investment in equipment — posted the first rise in three months and the biggest gain since June 2014. After declining in the fourth quarter for the first time in a year, business equipment investment should return to modest growth in the current quarter.

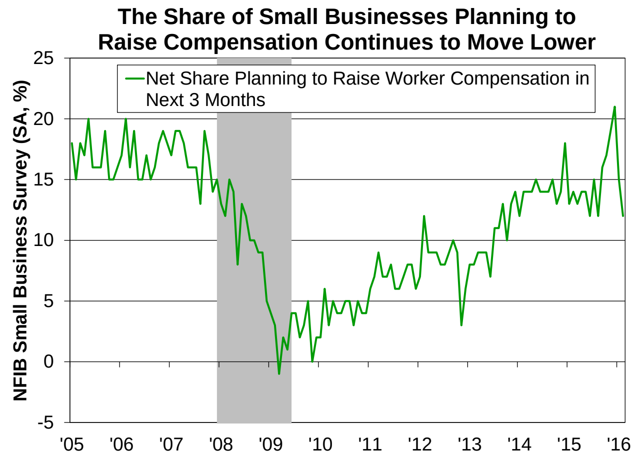




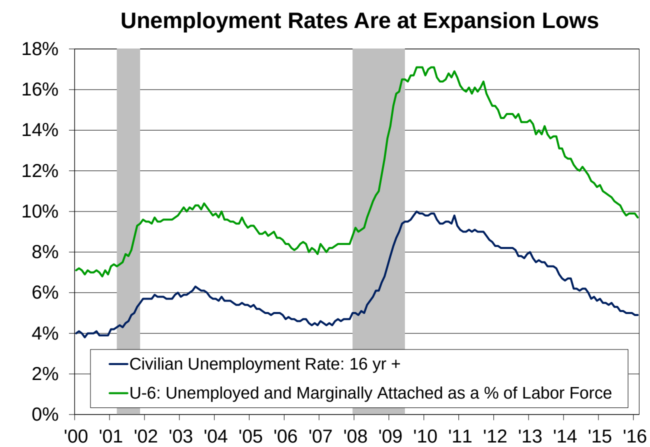
The hiring picture remains solid, as job growth strengthened to 242,000 in February. With upward revisions of 30,000 jobs in the prior two months, monthly job gains over the last three months averaged 228,000, close to the average monthly gain in 2015. The current pace of job gains is more than sufficient to keep up with growth in the working age population.

Job growth was broad-based in the service sector, but weakened for goods-producing industries. Both mining and manufacturing shed jobs. While construction jobs increased on a seasonally adjusted basis, the pace of gains, especially for residential construction employment, has trended down sharply since last November. Tempering the optimism from the headline job growth figure, average hourly earnings and the average work week fell following encouraging improvements in January. The year-over-year gain in average hourly earnings fell back into the narrow band witnessed over the past few years after showing signs of breaking out. The outlook for future wage gains also suffered a troubling setback, according to the February National Federation of Independent Business (NFIB) survey. The net share of small businesses planning to increase worker compensation dropped for the second consecutive month, bringing the cumulative decline to 9.0 percentage points. The NFIB compensation outlook measure has now retraced all of the improvement seen between September and December, when it reached an expansion high.



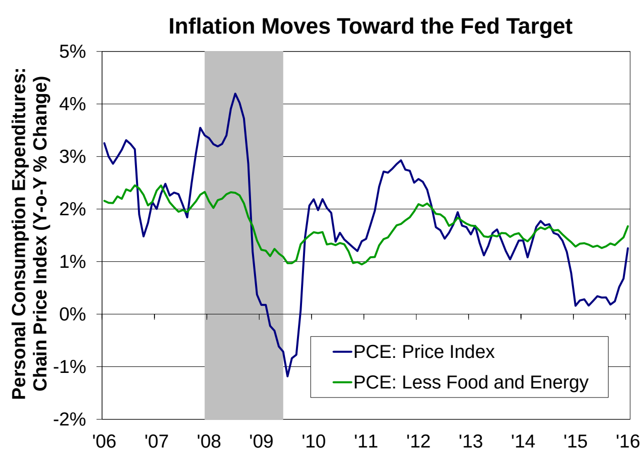


Results from the February employment report's household survey were encouraging, showing that the labor force participation rate rose for the third consecutive month — the first time that has happened since late 2006 — to a 13-month high of 62.9 percent. Even as improving labor market conditions attracted people back into the labor market, the headline unemployment rate maintained its lowest level in eight years of 4.9 percent. Furthermore, the broadest measure of labor underutilization, which includes part-time workers who prefer full-time jobs and workers marginally attached to the labor force, fell to a new expansion low of 9.7 percent.



The Fed Can Afford to be Patient

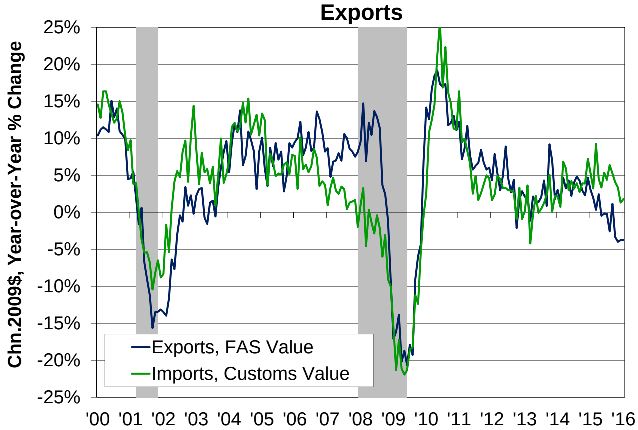
The February jobs report should reassure the Fed that the labor market remains healthy amid benign wage pressures, which should allow it to be patient in gathering more information before resuming policy normalization. On the inflation front, the Fed's favored measure, the personal consumption expenditure (PCE) deflator, moved up measurably in January, sending the year-over-year increase to 1.3 percent from a year ago, nearly doubling the prior month's gain. The core PCE deflator (excluding food and energy items) rose 1.7 percent from a year ago, the biggest gain since July 2014. While the PCE deflator moved in the right direction, we believe it will likely stay below the Fed's target of 2.0 percent for some time before trending higher as the effects of the rise in the dollar and the drop in oil prices wane. Overall, we believe that labor market and inflation conditions support our expectation that the Fed will raise the target twice by 25 basis points each in June and December.



While recent positive developments in the labor market and domestic demand point to continued economic expansion despite jitters over global financial market turmoil, the strong dollar and soft overseas demand suggest that trade will be a meaningful drag on growth this year. The accumulated rise in the dollar of more than 20 percent since the second half of

2014 has been quite detrimental to U.S. exports. Real exports continued to weaken in January, posting the fourth straight year-over-year drop. Real imports have also slowed in recent months, but exports have declined faster. We expect net exports, along with inventories and oil-related nonresidential investment, to exert further drags on growth this year.

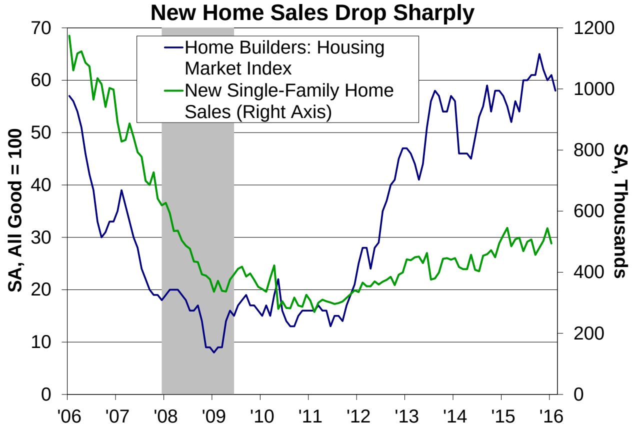
The Rise in the Dollar Has Greatly Hurt U.S. Exports



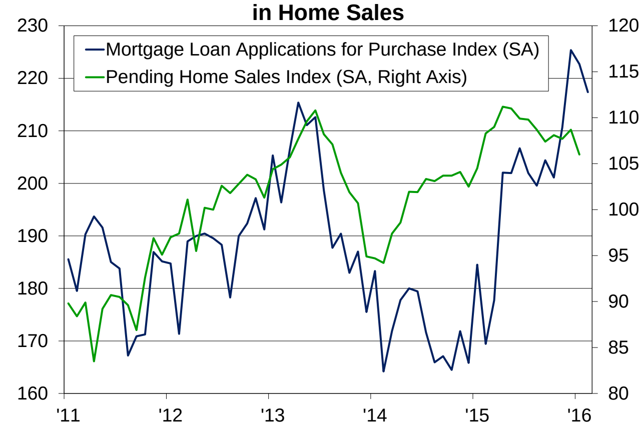
Housing Roundup

Real residential investment, which contributed 0.3 percentage points to growth in 2015, is expected to add similarly to growth this year. However, housing activity started 2016 on a soft note. Existing home sales posted a small gain in January following a surge in the prior month, new home sales dropped sharply, and both single- and multifamily starts pulled back. (For more information on rental market conditions, read the March 2016 Multifamily Market Commentary). Builders' confidence slipped in February to the lowest reading since May 2015. Leading indicators suggest weakness in sales in coming months. Pending home sales declined in January, marking the fourth drop over the last six months. After rising sharply in November and December, average monthly purchase applications decreased in January and fell further in February.

Builders' Confidence Resumes Decline as New Home Sales Drop Sharply

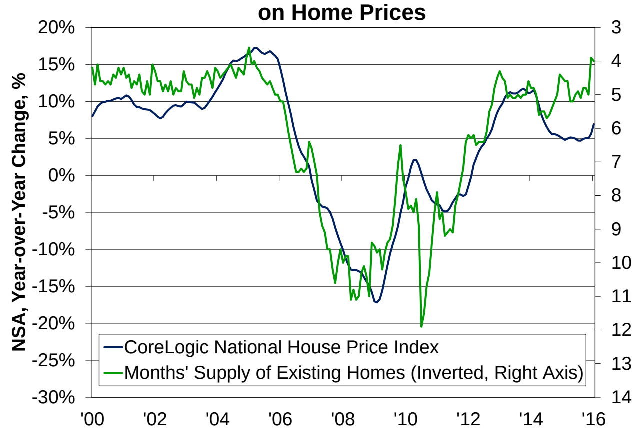


Leading Indicators Point to Near-term Pullback in Home Sales



The inventory of existing homes for sale, which has been a lingering constraint for the market, fell on an annual basis for the eighth straight month in January. The months' supply (an inventory-sales ratio released on a not seasonally-adjusted basis) remains at a historically low level of 4.0 months, compared with 4.5 months in January 2015. Lean inventories relative to the sales pace continue to put upward pressure on home prices. The Case-Shiller, FHFA purchase-only, and CoreLogic national home price indices all appreciated between 5.0 and 6.0 percent on a year-over-year basis in December 2015.

Tight Months' Supply Puts Upward Pressure on Home Prices

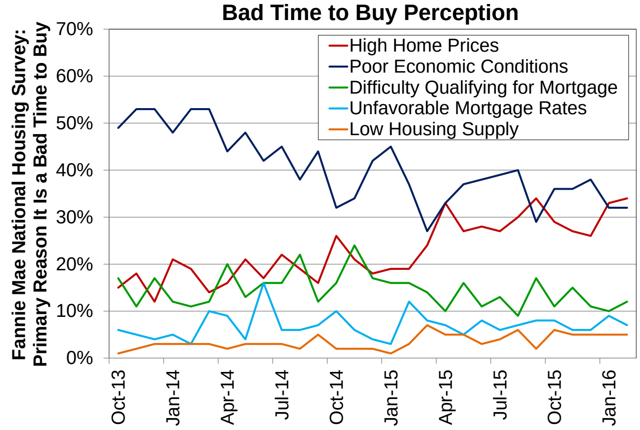


The January CoreLogic index firmed further, posting the biggest year-over-year gain since June 2014. While home prices remain strong nationally, they showed signs of weakening in some states and local areas. Two states — Louisiana and Mississippi — showed annual home price declines, while two oil-producing states, Oklahoma and Texas, saw slowdowns in annual price gains. Notably, in Midland, Texas, which has the highest concentration of oil employment of all metropolitan areas, the year-over-year home price increase moderated to 4.3 percent in January 2016, less than half the pace of gain in January 2015.

While new home inventories have gradually trended up over the past year, their levels have remained low by historical standards. Builders continue to report shortages of labor and lots as the two biggest obstacles to increasing construction. According to a special survey from the National Association of Home Builders in January 2016, 71 percent of builders reported that cost and availability of labor was a problem in 2015, and 76 percent expected it to be an issue in 2016. The second most significant problem is cost and availability of lots, with 58 percent saying it was an issue in 2015 and 59 percent believing it will be a problem this year. While we expect an accelerating pace of single-family housing starts in 2016, labor and lots will likely remain a supply constraint, presenting some downside risk to our forecast.

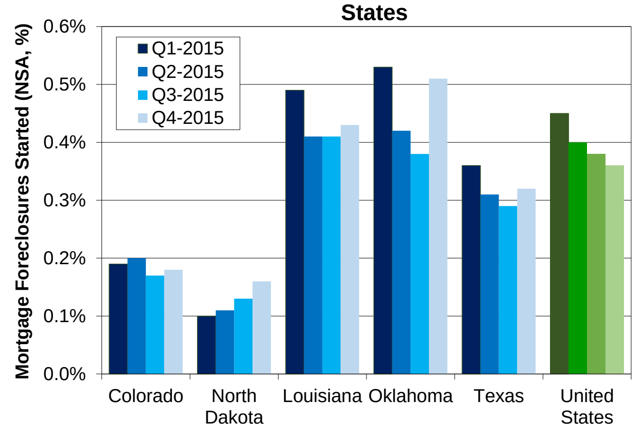
Home price appreciation that continues to outpace income growth will further erode home purchase affordability, especially for first-time home buyers. Repeat buyers could potentially realize capital gains from selling their current home to buy another one, and thus are less likely to be deterred by rising prices. Fannie Mae's Home Purchase Sentiment Index™, which combines various measures of our National Housing Survey® into a single gauge of housing sentiment about the twelve months ahead, ticked up in February, essentially reversing the prior month's drop. Details from the survey showed that, for consumers who think it's a bad time to buy a home, high home prices have been an increasingly important factor.

High Home Prices Are Now Top Reason for Bad Time to Buy Perception



Strong home price appreciation, combined with solid job creation, has helped to significantly improve overall mortgage performance. Notably, the foreclosure starts rate decreased to 0.36 percent in the fourth quarter of 2015, the lowest reading since 2003, according to the Mortgage Bankers Association's National Delinquency Survey. Interestingly, out of 12 states that posted an increase in foreclosure starts, five have oil-dependent economies — Oklahoma, North Dakota, Louisiana, Colorado, and Texas.

Foreclosure Rates Rise in Oil-Dependent States



One factor that should help support a continued rise in home sales this year is low mortgage rates. We revised lower our forecast of mortgage rates by about 10 basis points in 2016, with 30-year fixed mortgage rates expected to average 3.7 percent during the fourth quarter of this year. Our forecasts of housing activity and purchase mortgage originations are essentially the same as our prior forecast: housing starts and total home sales should increase 10.9 percent and 3.3 percent, respectively. We expect purchase mortgage originations to rise about 4.0 percent in 2016 to $951 billion. However, with our lower mortgage rate forecast this year, we upgraded our projected refinance originations by approximately $50 billion to $609 billion. Refinance originations should decline about 23 percent from 2015 and account for 39 percent of total originations this year, 7.0 percentage points below the level in 2015.

March 9, 2016
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.

Data source for charts: *The Chicago Board Options Exchange, Bureau of Economic Analysis, Census Bureau, Bureau of Labor Statistics, National Federation of Independent Business, National Association of Home Builders, National Association of REALTORS®, Mortgage Bankers Association, CoreLogic, Fannie Mae*

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