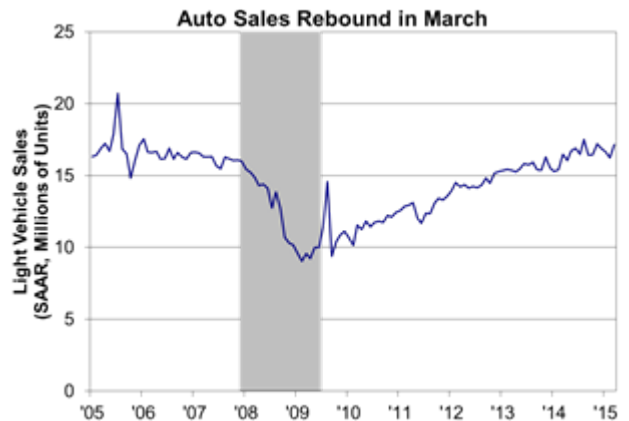


## Looking Forward to the Spring Bounce-Back

Many key economic indicators surprised on the downside over the past month, bringing our estimate of first quarter economic growth down to 1.3 percent annualized from our prior forecast of 2.0 percent. Several transitory factors, including the West Coast port disruptions and the severe winter weather across much of the Northeast, played a role to suppress economic activity during the first quarter. Nonetheless, we expect the economy to gain momentum going into the spring. We project 2015 growth to come in at 2.8 percent, unchanged from the previous forecast. However, the risk to our outlook is tilted to the downside. Despite early signs of improving income trends and continued rising household net worth, consumers remain cautious, and the pickup in consumer spending, which is key to the rebound in growth, may be weaker than we anticipate. We also expect increased volatility in financial markets as they anticipate the first rate hike by the Fed in coming months. A market response generating rapid interest rate increases would likely set housing back again, something the Fed would like to avoid.

### Fed Watch Intensifies

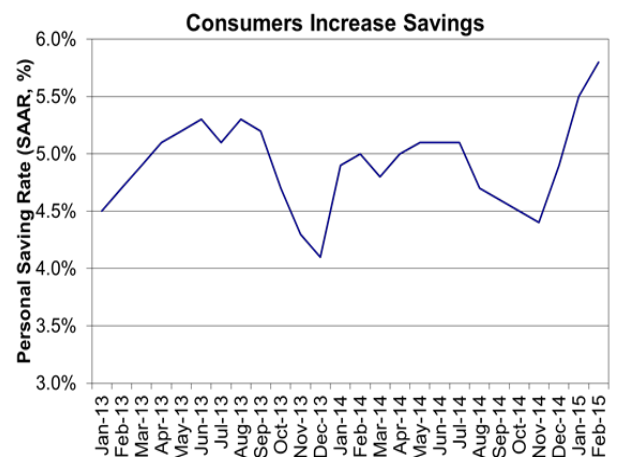
The Fed has now removed all of its qualifiers, and monetary policy action now is “data dependent” as though data did not previously matter. One data element consistently included for Fed comment is employment. Nonfarm payroll growth weakened substantially in March to the slowest pace since the end of 2013, on the heels of sizable downward revisions. The sharp slowdown in hiring after a string of robust job gains finally realigned the labor market with the broader picture of economic activity. We believe that the setback in hiring will likely be short-lived and will not meaningfully change consumer fundamentals, which remain largely positive. We have already witnessed some rebound in activity, including March auto sales.



Other factors monitored by the Fed, including the strength in the U.S. dollar and declining oil prices, will continue to have negative impacts on exports and the oil and gas sector. While the strength of the dollar is not strictly in the Fed’s purview, its impact on economic activity will be monitored. The minutes to the March Federal Open Market Committee (FOMC) meeting revealed that the Fed was increasingly concerned that further appreciation of the dollar—partly because some foreign central banks are continuing their accommodating monetary policy—could potentially drag U.S. economic activity down further and continue to weigh on the inflation outlook. Thus, some Fed officials favored waiting until later in the year to hike the target rate. The March jobs report, released after the FOMC meeting, reaffirms the Fed’s desire to err on the dovish side, and we remain comfortable with our call that the fed funds rate lift-off will occur in September.

### Little Signs of Positive Effects from Declining Oil Prices on Consumer Spending in Early 2015

It appears that the further decline in gasoline prices at the start the year, which helped boost disposable income, has turned into saving rather than spending. Real personal consumption expenditures (PCE) edged down 0.1 percent in February, the first drop since last April. Even with the first rise in four months in March auto sales, we expect first quarter real consumer spending growth to come in at 2.3 percent annualized, 0.4 percentage points below our expectation in the prior forecast. Income continued to grow faster than spending, pushing the saving rate up further to 5.8 percent, its highest reading in over two years.



Inflation pressure remains muted. The PCE deflator, the Fed’s favored inflation gauge, was up 0.2 percent from January and just 0.3 percent from a year ago. Excluding food and energy, core prices edged up 0.1 percent, rising 1.4 percent year-over-year. Meanwhile, consumer credit data confirmed consumers’ caution to spend in February and their continued reluctance to incur credit card debt. While consumer credit outstanding jumped in February, the increase was solely from nonrevolving credit (largely student and auto loans), which posted the biggest gain since February 2013. Revolving credit (largely credit card debt) fell in February for the second consecutive month and the third time during the last four months.

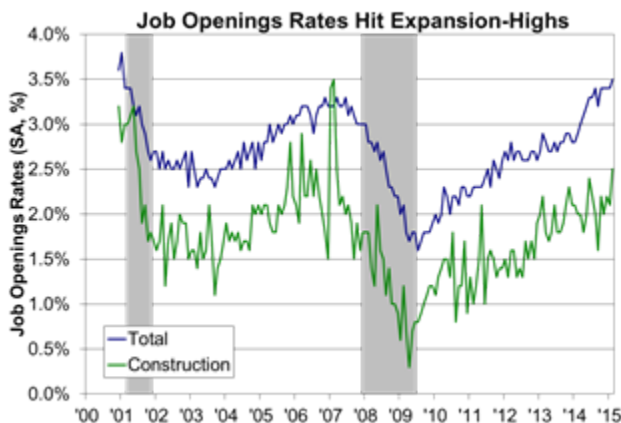
## Job Growth Takes a Breather

The downside-surprise March jobs report, featuring a net gain of 126,000 nonfarm payrolls and downward revisions totaling 69,000 jobs in the prior two months, reinforced a loss in momentum already witnessed in other recent data, including consumer spending and manufacturing. Weakness was broad-based, including rare declines in manufacturing and construction payrolls—the first in each industry since 2013. Another notable was mining employment (which includes oil and gas extraction), which fell 11,000 (due primarily to a monthly loss of 10,000 support jobs) for the second straight month, and the loss in the industry may linger in coming quarters. For the entire first quarter, monthly job gains averaged 197,000, a one-year low. The unemployment rate held at 5.5 percent as a drop in the labor force offset a weak gain in household employment. The unemployment rate averaged 5.6 percent in the first quarter, one percentage point below the level a year ago, and we expect the rate to move lower gradually, averaging 5.2 percent in the fourth quarter.

The silver-lining from the report was a pickup in average hourly earnings of 0.3 percent. While the year-over year rise of 2.1 percent showed no signs of a break-out from its trend over the past two years, its three-month annualized growth ending in March surged to 4.0 percent annualized, the biggest gain yet in this expansion.



Other labor market indicators have remained upbeat. The Job Openings and Labor Turnover Survey (JOLTS), reported with a one-month lag to the jobs report, showed that the job opening rate rose in February to 3.5 percent, a 14-year high. The number of unemployed workers per available position has fallen to 1.70, approaching the pre-recession low of 1.45, suggesting that employers no longer have the pick of the litter to fill open positions. Notably, the job opening rate for the construction industry surged to 2.5 percent during the month, the highest rate since March 2007. The quit rate, a gauge of workers' confidence in the labor market, ticked down to 1.9 percent from its expansion-recession high of 2.0 percent in the prior month. The trend in a high-frequency indicator of labor market activity—initial jobless claims—also points to healthy conditions, with the four-week average in early April declining to the lowest reading in nearly 15 years.



Consumer confidence remains elevated. The Conference Board Consumer Confidence Index rebounded in March, reversing half of the February drop from its expansion-high in January. According to data from the Federal Reserve Financial Accounts of the United States, household net worth—the value of assets minus liabilities—rebounded in the fourth quarter from a slight drop the previous quarter, thanks to solid gains in both financial and housing wealth. In addition, the Federal Reserve's measure of the debt-service burden, which calculates the share of household debt service payments out of disposable personal income, remains near its record low over the 25-year history of the series. These factors should help support consumer spending going forward.

## Manufacturing Downshift Continues

Weak global demand, the run-up in the U.S. dollar, and the West Coast port shutdown have taken a toll on the factory sector. While declining oil prices since last fall have helped reduce input prices for manufacturers, they have also led to declining drilling activity and spending on oil-related investment. Shipments of core capital goods, an input used to estimate business equipment investment, posted just a modest rise in February, suggesting another quarter of weak

growth in business equipment investment to start the year after barely eking out a gain in the fourth quarter. Core capital goods orders, a leading indicator of business equipment spending, declined in February for the sixth consecutive month, painting a dim picture of business equipment investment beyond the first quarter.

Regional and national surveys of purchasing managers continue to show softening manufacturing activity. For example, the Institute for Supply Management (ISM) manufacturing index fell 1.4 points to 51.5 in March (any reading above 50 indicates expansion in the sector). This marks the fifth consecutive drop in the index, which matches the longest losing streak since 2008, though the drop is much shallower, keeping the index in expansionary territory. The details were weaker across the board. Notably, new export orders remain in contractionary territory for the third consecutive month, underscoring the adverse impact of the strong dollar and weak global economic growth on manufacturing.



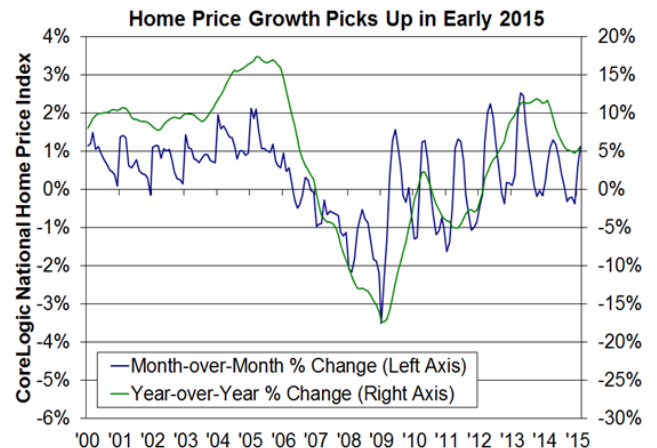
Declining oil prices also have led to a pullback in nonresidential investment in structures spending, especially those related to oil, and this condition should continue in the current quarter. Thus, we expect weak growth in overall nonresidential investment at least through the first half of this year.

### Trade Deficit Narrows

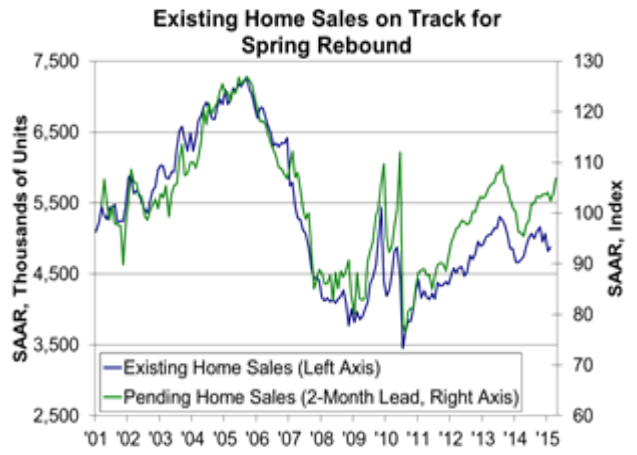
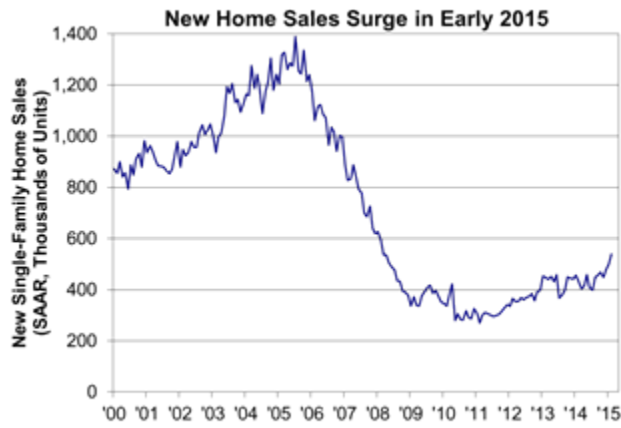
Those factors that have stymied manufacturing activity also impacted the trade deficit, which narrowed sizably and unexpectedly in February, as imports nosedived more than exports. While declining oil prices helped push the value of petroleum imports down to the lowest level in a decade, and weak demand abroad and a strong dollar discouraged U.S. exports, it is likely that the port disruptions played an important role in depressing overall trade volume during the month. It is difficult to assess how much of the recent weakness in manufacturing, exports, and imports stemmed from the port disruptions and how much was a result of softening underlying domestic and global demand and ongoing strengthening of the dollar. We expect export and import volumes to rebound in March as the port issue was resolved at the end of February, though we expect the real trade deficit to widen and thus net exports will likely drag on growth in 2015.

### Spring Selling Season Is Underway

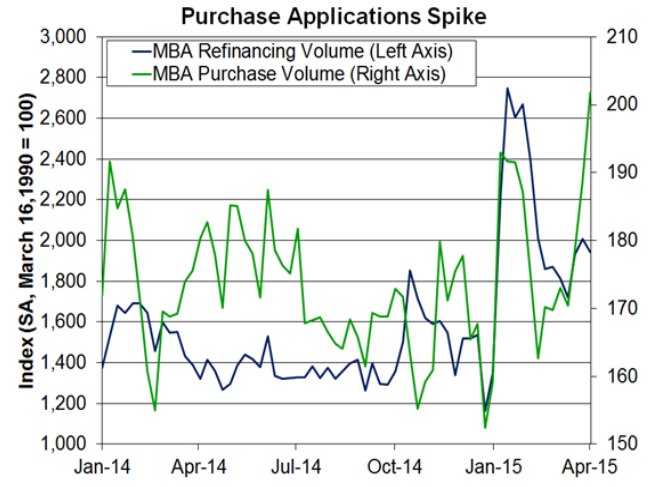
Declining homebuilding activity and private residential construction spending in February point to anemic growth in real residential investment in the first quarter. Total housing starts were flat in January and plunged in February, posting the largest monthly decline in four years, and home builders' confidence dropped in March for the third consecutive month. Existing home sales rose modestly in February after a sharp drop in the prior month. Even as sales volumes faltered at the outset of the year, inventory remains tight, helping to support home price growth. Most home price measures continued to show solid gains. For example, the CoreLogic national home price index increased for the second consecutive month in February, rising by 1.1 percent on a non-seasonally adjusted basis. The 5.6 percent year-over-year increase in February was the largest gain in six months.



New home sales fared much better than existing home sales, surging in February, marking the third consecutive monthly gain. If improved new home sales volumes stick through typically large revisions, a pickup in builder confidence and building activity should follow. In addition, pending home sales, which record contract signing of existing home sales and thus act as a forward-looking indicator for existing home sales, also jumped in February, reaching the highest level since the summer of 2013, before the “taper tantrum” led to a surge in mortgage rates that restrained home sales.

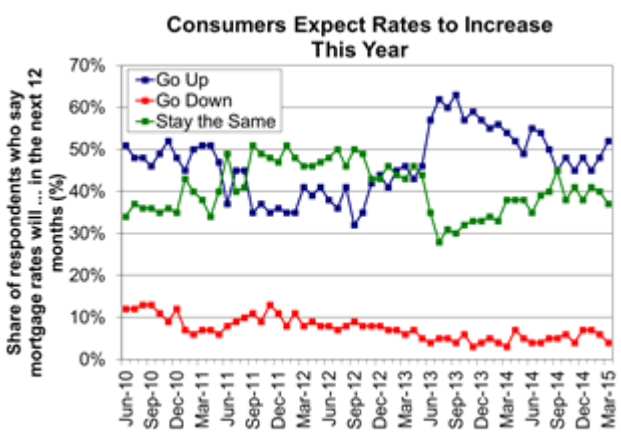


Following a pullback in February, purchase mortgage applications, another leading indicator of home sales, rebounded sharply, rising in early April for the third consecutive week, reaching the highest level since July 2013. The spike in purchase applications—the second one this year after a sizable surge in January—suggests a strong spring-summer buying season amid continued low mortgage rates. Following the weak March jobs report, the contract interest rate for 30-year fixed-rate mortgages fell four basis points to 3.66 percent in early April, according to the Freddie Mac weekly survey.



As we mentioned earlier, a potential increase in interest rate volatility constitutes a headwind for the housing market. The [March Fannie Mae National Housing Survey™](#) showed a jump in the share of consumers believing that mortgage rates will go up over the next 12 months. At the same time, the survey showed a marked deterioration in consumers' assessment in some key areas for the housing market amid a recent dip in confidence regarding personal finances and income growth. Notably, the share of respondents who said they would buy a home if they were to move fell 5 percentage points to 60 percent—a new all-time survey low.

On the bright side, the share of consumers who believe now is a good time to sell a home reached a new survey high of 46 percent, narrowing the gap with those reporting it is a good time to buy, perhaps signaling increased inventory of homes available for sale.



Anecdotally, inventory remains very tight at the lower end of the market, making it difficult for potential first-time homebuyers. As home equity continues to recover, we may see an increased supply of entry-level homes as would-be move-up buyers become more confident that they can extract equity for their next down payment and, therefore, put their current home on the market. Increased inventories of starter homes will go a long way to help renters make a move to owning and spur organic move-up home buying activity, which has been sluggish so far.

For all of 2015, we expect housing starts and home sales to rise about 13 percent and 5 percent, respectively—little-changed from the prior forecast. However, we revised higher our projected purchase originations as we downgraded our assumption of the share of cash sales. In addition, we upgraded our forecast of refinance originations due to higher incoming volume in early 2015 than we had expected, especially in the government segment. We project that total single-family mortgage originations will rise nearly 15 percent in 2015 to \$1.35 trillion before declining modestly in 2016. The refinance share should fall from 45 percent in 2015 to 35 percent in 2016. Single-family mortgage debt outstanding edged up 0.2 percent annualized in the fourth quarter of 2014 from the third quarter but fell 0.2 percent from a year ago. We expect it to post a modest rise this year, the first annual gain in eight years, and pick up further in 2015.

For information on multifamily market conditions, read the [April 2015 Multifamily Market Commentary](#).

April 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:** Autodata, Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Labor, Census Bureau, Institute for Supply Management, CoreLogic, National Association of REALTORS, Mortgage Bankers Association, Fannie Mae National Housing Survey, March 2015.

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