ESR Economic and Housing Weekly Note *June 27, 2014*

Economics: Speed Bump Proves to be a Pothole

First quarter gross domestic product (GDP) was revised substantially lower in the government's third estimate, due in large part to healthcare spending contracting rather than surging. Inventory investment and exports also weighed on the economy in the first quarter. However, more timely indicators show that economic strength is growing. Consumer confidence reached a six-and-a-half year high in June, and May core capital goods orders suggest that businesses are preparing for increased activity. While real personal income continued to grow in May, real consumer spending pulled back for the second straight month. Combined with a significant revision during the first quarter, the weak May consumer spending suggests that in Q2 real consumer spending growth will likely be approximately 1.5 percentage points below our projected 3.3 percent annualized growth in the June forecast. Despite the disappointments in first quarter GDP and May consumer spending, we expect second quarter economic growth to pick up to approximately 3.0 percent as the pace of job gains has remained healthy and businesses are in solid financial shape, though consumers may play less of a role than previously anticipated.

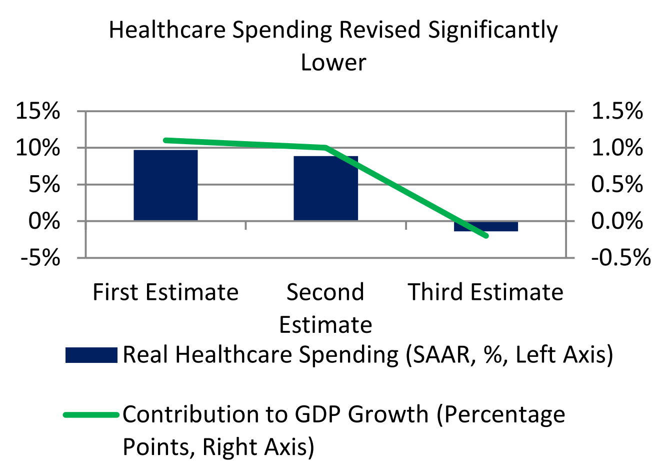
- **The Conference Board Consumer Confidence Index** jumped three points to 85.2 in June, reaching its highest level since January 2008. The present conditions component of the index surged from 80.3 to 85.1, while the expectations component increased more modestly from 83.5 to 85.2.

- **GDP**, adjusted for inflation, plummeted in the first quarter at a 2.9 percent annualized rate. The downward revision largely reflects new information showing that healthcare spending posted the largest drop in over three decades counter to the government's assumption that the rollout of the Affordable Care Act led to a surge to medical spending. As a result, real consumer spending increased at just 1.0 percent annualized, compared with the previous estimate of 3.1 percent. The small 0.7 percentage point contribution to GDP from consumer spending was outweighed by drags from all other GDP components—primarily inventory investment and net exports, which subtracted 1.7 and 1.5 percentage points, respectively, from GDP. Healthcare spending, which was previously estimated to have grown at an 8.9 percent annualized rate, was revised to show a 1.4 percent drop, subtracting 0.2 percentage points from GDP.

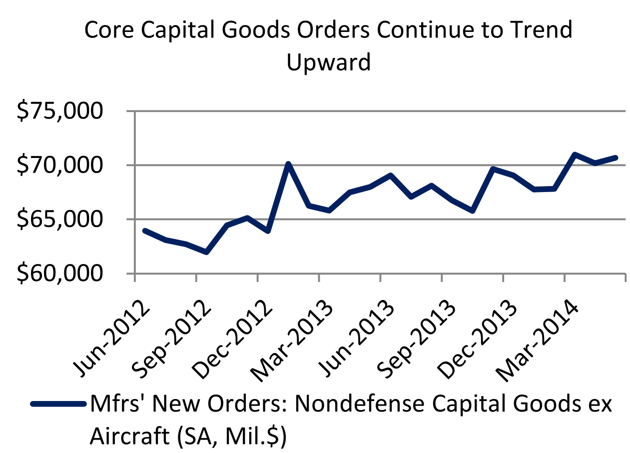
- **Durable goods orders** decreased 1.0 percent in May, dragged lower by a 25 percent drop in defense goods orders. Excluding defense goods, new orders increased 0.6 percent. Core capital goods orders (excluding defense capital goods and aircraft orders)—a leading indicator of business capital spending—increased 0.7 percent, partially offsetting a 1.1 percent drop in April that followed a 4.7 percent jump in March.

- **Personal income**, adjusted for inflation, grew for the fifth consecutive month in May, increasing 0.2 percent. Following a 0.2 percent drop in April, real consumer spending contracted 0.1 percent. The saving rate rose to 4.8 percent, the highest reading since last September. The personal consumption expenditure price index, the Fed's preferred measure of inflation, increased 0.2 percent from April 2014 and 1.8 percent from May 2013, the biggest year-over-year rise since October 2012.

- **The Reuters/University of Michigan Consumer Sentiment Index** rose 0.6 points to 82.5 in June, led higher by consumer perceptions of current conditions. The expectations component of the index decreased modestly from 73.7 to 73.5.



Source: Bureau of Economic Analysis



Source: Census Bureau

Housing: Home Sales Take Flight, Home Price Appreciation Clear for (Soft?) Landing

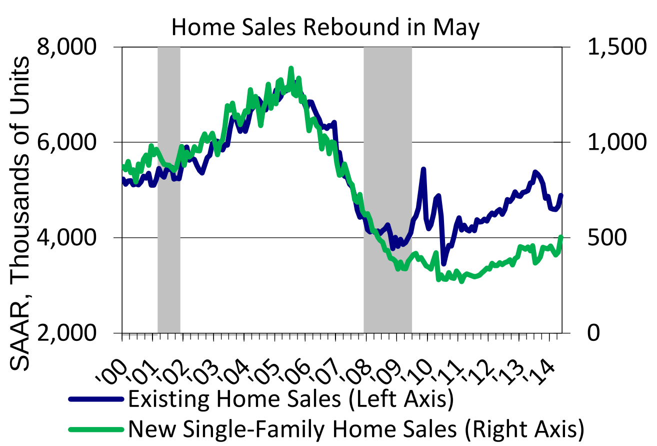
The elusive Spring selling season finally arrived in May as total home sales (existing home sales plus new home sales) jumped to a seven-month high on the strength of the biggest surge in new home sales in 22 years and the largest gain in existing home sales since mid-2011. The sharp gain in new sales, accompanied by a flat trend in inventory, bodes particularly well for the near-term homebuilding outlook. Annual home price growth has slowed in recent months, in line with our expectations, but the flat reading in the seasonally-adjusted FHFA purchase-only home price index in April bears watching. A gentle slowdown in home price appreciation at a time when mortgage rates have stabilized at historically low levels (the Freddie Mac 30-year fixed mortgage rate is at 4.14 percent this week) is positive for the expected rebound in the housing market during the second half of the year.

➢ **Total existing home sales** rose 4.9 percent in May to a seasonally adjusted annual rate of 4.89 million units—the fastest sales pace since October 2013. Despite a pickup in activity over the past two months, existing home sales through the first five months of 2014 remained more than 7 percent below levels for the same period last year. Following a 13.8 percent jump in April, the inventory of homes for sale (not seasonally adjusted) rose 2.2 percent in May. The months' supply (inventory/sales ratio) ticked down one-tenth to 5.6 months. Distressed sales (foreclosures and short sales) accounted for just 11 percent of sales, down from 18 percent May 2013. Meanwhile, at 32 percent, the cash share of resales remains elevated and is little changed from May 2013.

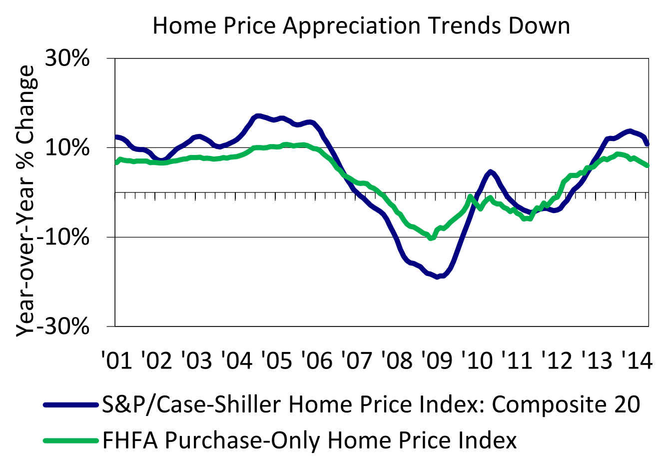
➢ **New single-family home sales** jumped to a seasonally adjusted annual rate of 504,000 units. The 18.6 percent jump pushed sales to the fastest pace in six years. Through the first five months of the year, new home sales are up 2.1 percent over the same period last year. The surge in sales amid flat inventory pushed the months' supply down eight-tenths to 4.5 months—an 11-month low.

➢ **The S&P/Case-Shiller composite 20-city home price index** (not seasonally adjusted) rose 1.1 percent during the three months ending in April. Over the past 12 months, prices are up 10.8 percent, off from their recent peak of 13.7 percent year-over-year appreciation recorded November 2013. On a regional basis, annual price appreciation ranged from 18.8 percent in Las Vegas, Nevada, to 2.7 percent in Cleveland, Ohio. The headline index is up a cumulative 25.2 percent from the January 2012 trough but remains 16.9 percent below the April 2006 peak.

➢ **The FHFA purchase-only home price index** was flat in April (reported by FHFA on a seasonally adjusted basis). Declines in the New England and West South Central Census Divisions offset gains in other Divisions. Prices are up 6.0 percent over the past 12 months, down from their recent peak of 8.6 percent year-over-year price growth reported July 2013.



Sources: Census Bureau , National Association of REALTORS®



Sources: FHFA, S&P/Case-Shiller, CoreLogic

David Kopita and Brian Hughes-Cromwick
Economic and Strategic Research Group
June 27, 2014