

## Second Half Growth Likely to Creep Higher Despite Turmoil Abroad

Our forecast for U.S. growth for the remainder of the year is largely unchanged despite heightened market volatility in recent weeks as investors adjusted their expectations for growth in China and the potential of monetary policy tightening. Wall Street's favorite gauge of market volatility and anxiety level—the Chicago Board Options Exchange VIX index—spiked to the highest level in more than three years. Nonetheless, we expect real GDP growth to come in at 2.5 percent annualized in the third quarter and accelerate in the final quarter of the year as positive domestic fundamentals more than offset weaker export outlook. This would result in second half growth averaging modestly higher than the first half growth of 2.2 percent. For all of 2015, we expect the economy to grow 2.4 percent, compared with 2.1 percent in the prior forecast. This rate of growth along with the dual dynamic of a stronger dollar and lower oil prices should result in inflation remaining subdued.

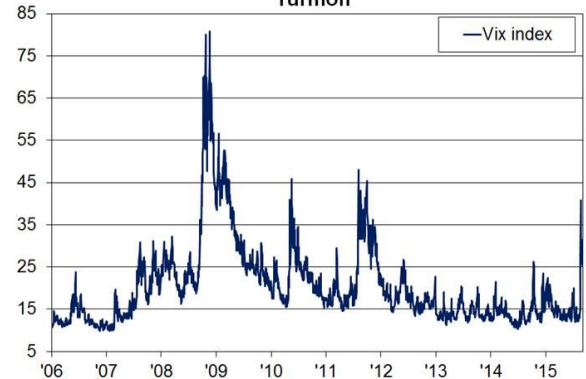
We expect consumer spending to again be the biggest driver of growth for the current quarter. Real consumer spending rebounded in July, rising 0.2 percent after June's flat reading. Meanwhile, core personal consumption expenditures rose just 1.2 percent from a year ago, the weakest gain in more than four years. Combined with a 1.5 percent rise in August auto sales to the strongest pace in more than a decade, the moderate increase in real consumer spending at the start of the third quarter suggests that our prior forecast of real consumer spending of 2.9 percent annualized for the third quarter remains valid.

While August nonfarm payroll gains came in weaker than expected at 173,000, the overall jobs report was a solid one, with an upward revision of 44,000 to prior months' increases, a 0.3 percent rise in average hourly earnings, and an uptick in the average workweek to tie the expansion-high of 34.6 hours. The soft headline job growth may not even be an issue next month, as August payroll gains typically get meaningful upward revisions, partly due to the low response rate during the first estimate. Between 2010 and 2014, August nonfarm payrolls were revised up by an average of 80,000 jobs from the first to third estimates. The August jobs report points to a strong gain in August personal income, as the product of the average workweek and average hourly earnings—a payroll proxy for labor income—posted the biggest gain since January.

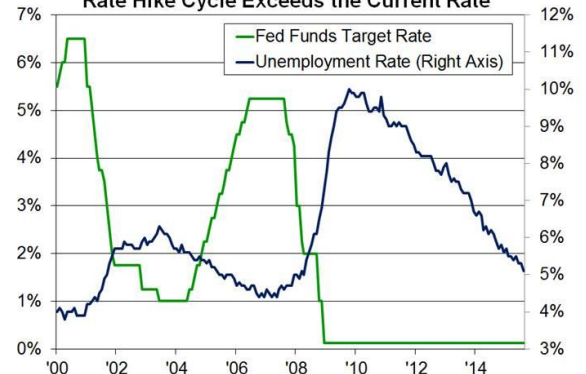
The household survey marked a milestone in August, as full-time employment surpassed its pre-recession peak. The unemployment rate fell two-tenths of a percentage point to 5.1 percent, one full percentage point lower than a year ago and the lowest rate since March 2008. The drop in the unemployment rate was for good reasons, as the labor force participation rate held steady, albeit at a historically low rate of 62.6 percent. However, the employment-to-population ratio ticked up to 59.4 percent, tying the expansion's best.

The August unemployment rate was half a percentage point lower than the rate at the time the Fed started to hike the fed funds rate in June 2004. In the context of the current Fed, the 5.1 percent rate is below the bottom of the central tendency (excludes the three highest and three lowest projections) of the Fed's year-end forecast for 2015, and now sits within the central tendency of its forecasts for 2016 and 2017.

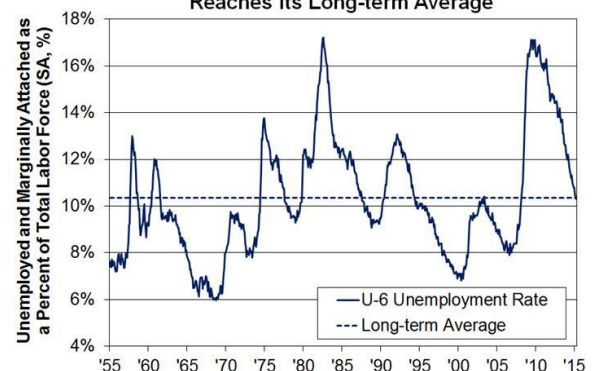
Market Volatility Spikes amid International Turmoil



Unemployment Rate at the Start of the Last Rate Hike Cycle Exceeds the Current Rate



Broadest Measure of Unemployment Rate Reaches Its Long-term Average



The Fed also considers other measures of labor underutilization besides the headline unemployment rate. The U-6 measure—the broadest measure of the unemployment rate that includes discouraged workers and part-time workers who prefer full-time jobs—fell one tick to 10.3 percent, 1.7 percentage points below the rate a year ago and equal to the long-term average. While the Fed could find reasons to delay raising rates beyond the September FOMC meeting, including increased downside risk for inflation and financial instability, we believe that it will not find one in the August jobs report.

Other data released over the past month generally showed improving economic activity. The July factory goods orders report confirmed the advanced estimate of the biggest gain in core capital goods orders in more than a year, pointing to renewed life in business equipment spending after a slight drop in the second quarter. Nonresidential investment in structures was revised higher to show a gain in the second print of GDP from a decline in the first print, and the July construction spending report points to continued improvement in the third quarter. However, renewed declines in oil prices pose downside risk to the nonresidential investment outlook.

Recent financial turmoil is due in part to deteriorating global economic growth prospects, with China's August Purchasing Managers' Index (PMI) declining to contractionary territory for manufacturing activity—the worst performance in three years. Real GDP in Canada, our biggest trading partner, contracted again in the second quarter of this year, as its economy has been hurt by weak commodity demand. Combined with the strong dollar, weak global growth resulted in anemic U.S. real export growth in July. However, U.S. real imports declined during the month, partly because of the drop in the value of petroleum imports, causing the real goods deficit to narrow. Overall for 2015, we expect inventory investment and net exports will be drags on growth while consumer spending, nonresidential investment, government spending, and residential investment will contribute to growth.

## Housing Roundup

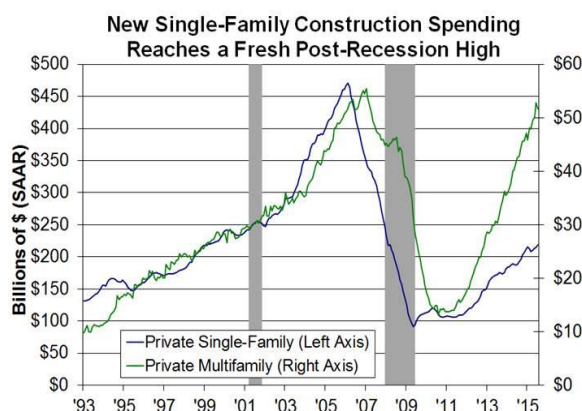
Housing activity was largely positive in July, especially for the single-family segment. Existing home sales advanced 2.0 percent during the month, marking the third consecutive monthly gain and reaching the fastest sales pace since February 2007.

Meanwhile, new home sales rebounded 5.4 percent, recouping some of the 7.7 percent drop in June. While other housing indicators including home builders' confidence, existing home sales, and single-family and multifamily starts have reached levels witnessed prior to the recession or at the onset of the recession, new home sales have not yet reached their pre-recession levels. Combining new and existing home sales, July total home sales surpassed six million annualized units for the first time since the onset of the recession.

Leading indicators of home sales softened, however. Pending home sales, which lead existing home sales by one to two months, rebounded in July but recouped less than half of the drop in the prior month. Meanwhile, average purchase mortgage applications dropped in August for the second consecutive month and applications during the first week of September fell after two consecutive weekly gains.

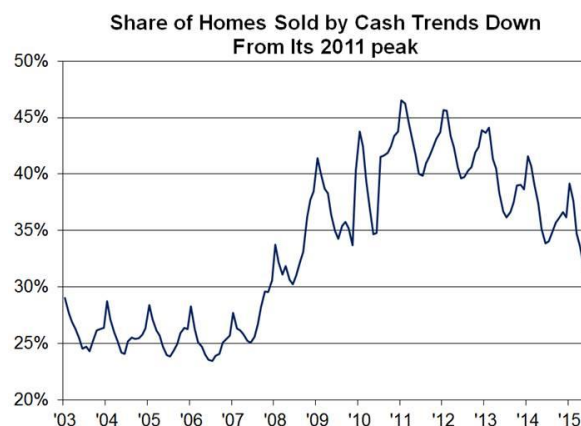
Most home price measures continued to improve but at a more modest pace than last year. The CoreLogic home price index was an exception, posting the strongest year-over-year gain in July in more than a year.

Mirroring a jump in July single-family starts and a pullback in multifamily starts, new construction spending for single-family homes rose to a fresh expansion high, while multifamily construction spending took a breather for the first time in four months, dropping slightly from June's expansion best. (For more on multifamily market conditions, read the [September 2015 Multifamily Market Commentary](#).) Despite reaching the highest level in the expansion, single-family construction spending remains well below the level witnessed prior to the recession.



By contrast, multifamily construction spending is only about 7.0 percent below its record high reached in January 2007 (not adjusted for inflation).

After edging up above 4.0 percent in early June, the average yield on 30-year fixed-rate mortgages has dropped below 4.0 percent again since the last week of July, according to Freddie Mac. We expect that a fed funds rate hike of 25 basis points by the Fed this year will flatten the yield curve, as the rising short-term rates in the U.S. will likely activate a carry trade by institutions in countries whose central banks are easing, creating flows into U.S. capital markets and holding down long-term rates. As we expect a gradual pace of Fed tightening amid continued monetary easing from central banks abroad, slow global growth, and anchored inflation expectations, mortgage rates should rise only gradually, averaging 4.2 percent in the final quarter of 2016, 10 basis points below the path in our prior forecast.



Our forecast for existing home sales for the rest of this year and next year is largely the same as in the prior forecast. However, we revised our purchase mortgage originations forecast modestly higher due to an expected decline in the share of homes sold for cash. CoreLogic data show that the share of cash sales has been trending down from its record high in 2011, and the share in recent months has been lower than we assumed in our forecast. We also revised higher our forecast of refinance originations in the second half of this year due to slightly lower mortgage rates than we expected.

One disappointing aspect of the housing market this year is sub-par single-family new home construction. The National Federation of Independent Business (NFIB) and the National Association of Home Builders (NAHB) surveys provided some evidence of supply constraints, due in part to a lack of skilled labor. The NAHB also cited tight standards for acquisition, development, and construction (AD&C) lending as one factor suppressing home building activity in recent years. However, the outlook for lending standards is mixed. The Federal Reserve Senior Loan Officer Opinion Survey showed tighter lending standards for AD&C loans (including both residential and commercial real estate loans) for the three months ending in July for the first time since 2010. However, the second quarter NAHB AD&C financing survey indicated that lending standards for AD&C loans continued to ease. On the demand side, while household formation has picked up since late 2014, all of the net gain in households over the past year was due to renters. We believe that, as a result of both supply and demand constraints, improvement in single-family starts has been muted this year. While we expect these constraints to improve somewhat next year, we revised lower our projected single-family starts in 2016. On net, the combination of lower cash shares and reduced single-family starts leads to a higher projected purchase originations for next year. For all of 2015, total mortgage originations should increase approximately 25 percent to \$1.48 trillion, with a refinance share of 46 percent. We project the total production volume to decline about 18 percent to \$1.22 trillion in 2016 and the refinance share to drop about 15 percentage points.

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

For a snapshot of macroeconomic and housing data between the monthly forecasts, please read ESR's [Economic & Housing Weekly Note](#).

**Sources for chart data:** Bloomberg, Bureau of Labor Statistics, Census Bureau, The National Association of REALTORS®, CoreLogic

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