Economic and Forecast Update (July 1, 2015)

Posted in Economic Updates, by Lawrence Yun, PhD., NAR Chief Economist and Senior Vice President on July 1, 2015

View the forecast video, midyear forecast (July 2015) slides, and the full U.S. Economic Outlook on the Research & Statistics page.

The Economy

- GDP growth was slightly negative in the first quarter but will pick up in the second half. For the year as whole, GDP will expand at 2.1 percent. Not bad but not great. A slow hum.
- Consumer spending will open up because of lower gasoline prices. Personal consumption expenditure grew at 2.1 percent rate in the first quarter. Look for 3 percent growth rate in the second half.
  - Auto sales dropped a bit in the first quarter because of heavy snow, but will ramp up nicely in the second half.
  - Spending for household furnishing and equipment has been solid, growing 6 percent in the first quarter after clocking 6 percent in the prior. Recovering housing sector is the big reason for the nice numbers.
  - Spending at restaurants was flat. That is why retail vacancy rates are not notching down.
  - Online shopping is up solidly. That is why industrial and warehouse vacancy rates are coming down.
  - Spending for health care grew at 5 percent in the first quarter, marking two consecutive quarters of fast growth. The Affordable Care Act has expanded health care demand. The important question for the future is will the supply of new doctors and nurses expand to meet this rising demand or will it lead to medical care shortage?
- Business spending was flat in the first quarter but will surely rise because of large cash holdings and high profits.
  - Spending for business equipment rose by 3 percent in the first quarter. Positive and good, but nothing to shout about.
  - Spending for business structures (building of office and retail shops, for example) fell by 18 percent. The freezing first-quarter weather halted some construction. This just means pent-up construction activity in the second half.
  - In the past small business start-ups spent and invested. It was not uncommon to experience double-digit growth rates for 3 years running for business equipment. Not happening now. But business spending will inevitably grow because of much improved business financial conditions of lower debt and more profits and rising GDP.
  - What has been missing is the “animal spirit” of entrepreneurship. The number of small business start-ups remains surprisingly low at this phase of economic expansion.
- Residential construction spending increased 6 percent in the first quarter. Housing starts are rising and therefore this component will pick up even at a faster pace in the second half.

- Government spending fell by 1 percent. At the federal level, non-defense spending grew by 2 percent, while national defense spending fell by 1 percent. At the state and local level, spending fell by 1 percent.
  - The federal government is still running a deficit. Even though it is spending more than what it takes in from tax revenue, the overall deficit level has been falling to a sustainable level. It would be ideal to run a surplus, but a falling deficit nonetheless does provide the possibility of less severe sequestration.
  - U.S. government finances are ugly. Interestingly though, they are less ugly than other countries. That is why the U.S. dollar has been strengthening against most other major currencies. It's like finding the least dirty shirt from a laundry basket.
- Imports have been rising while exports have been falling. The strong dollar makes it so.   Imports grew by 7 percent while exports fell by 6 percent. The *net exports* (at minus $548 billion) were the worst in seven years. Fortunately, with the West Coast longshoremen back at work, the foreign trade situation will not worsen, which means it will help GDP growth.
- All in all, GDP will grow by 2.5 to 3 percent in the second half. That translates into jobs. A total of 2.5 million net new jobs are likely to be created this year.
  - Unemployment insurance filings have been rising in oil-producing states of Texas and North Dakota.
  - Unemployment insurance filings for the country as a whole have been falling, which implies a lower level of fresh layoffs and factory closings. That assures continuing solid job growth in the second half of the year.
- We have to acknowledge that not all is fine with the labor market. The part-time jobs remain elevated and wage growth remains sluggish with only 2 percent annual growth. There are signs of tightening labor supply and the bidding up of wages. Wages are to rise by 3 percent by early next year. The total income of the country and the total number of jobs are on the rise.

The Housing Market

- Existing-home sales in May hit the highest mark since 2009, when there had been a homebuyer tax credit … remember, buy a home and get $8,000 from Uncle Sam. This tax credit is no longer available but the improving economy is providing the necessary incentive and financial capacity to buy. Meanwhile new home sales hit a seven-year high and housing permits to build new homes hit an eight-year high. Pending contracts to buy existing homes hit a nine-year high.
- Buyers are coming back in force. One factor for the recent surge could have been due to the rising mortgage rates. As nearly always happens, the initial phase of rising rates nudges people to make decision now rather than wait later when the rates could be higher still.
  - The first-time buyers are scooping up properties with 32 percent of all buyers being as such compared to only 27 percent one year ago. A lower fee on FHA mortgages is helping.
  - Investors are slowly stepping out. The high home prices are making the rate of return numbers less attractive.
- Buyers are back. What about sellers? Inventory remains low by historical standards in most markets. In places like Denver and Seattle, where a very strong job growth is the norm, the inventory condition is unreal – less than one month supply.

- The principal reason for the inventory shortage is the cumulative impact of homebuilders not being in the market for well over five years. Homebuilders typically put up 1.5 million new homes annually. Here's what they did from 2009 to 2014:
  - 2009: 550,000
  - 2010: 590,000
  - 2011: 610,000
  - 2012: 780,000
  - 2013: 930,000
  - 2014: 1.0 million
  - Where is 1.5 million? Maybe by 2017.
- Building activity for apartments has largely come back to normal. The cumulative shortage is on the ownership side.
- Builders will construct more homes. By 1.1 million in 2015 and 1.4 million in 2016. New home sales will follow this trend. This rising trend will steadily relieve housing shortage.
- There is no massive shadow inventory that can disrupt the market. The number of distressed home sales has been steadily falling – now accounting for only 10 percent of all transactions. It will fall further in the upcoming months. There is simply far fewer mortgages in the serious delinquent stage (of not being current for 3 or more months). In fact, if one specializes in foreclosure or short sales, it is time to change the business model.
- In the meantime, there is still a housing shortage. The consequence is a stronger than normal home price growth. Home price gains are beating wage-income growths by at least three or four times in most markets. Few things in the world could be more frustrating and demoralizing than for renters to start a savings program but only to witness home prices and down payment requirements blowing by past them.
- Housing affordability is falling. Home prices rising too fast are one reason. The other reason is due to rising mortgage rates. Cash-buys have been coming down so rates will count for more in the future.
- ***<u>The Federal Reserve will be raising short-term rates soon.</u>*** September is a maybe, but it's more likely to be in October. The Fed will also signal the continual raising of rates over the next two years. This sentiment has already pushed up mortgage rates. They are bound to rise further, particularly if inflation surprises on the upside.
- Inflation is likely to surprise on the upside. The influence of low gasoline prices has been bringing down the overall consumer price inflation to essentially zero in recent months will be short-lasting. By November, the influence of low gasoline prices will no longer be there because it was in November of last year when the oil prices began their plunge. That is, by November, the year-over-year change in gasoline price will be neutral (and no longer a big negative). Other items will then make their mark on inflation. Watch the rents. It's already rising at near 8-year high with a 3.5 percent growth rate. The overall CPI inflation could cross the red line of above 3 percent by early next year. The bond market will not like it and the yields on all long-term borrowing will rise.
- Mortgage rates at 4.3% to 4.5% by the year end and easily surpassing 5% by the year end of 2016.

- The rising mortgage rates initially rush buyers to decide but a sustained rise will choke off as to who can qualify for a mortgage. Fortunately, there are few compensating factors to rising rates.
    - Credit scores are not properly aligned with expected default rate. New scoring methodology is being tested and will be implemented. In short, credit scores will get boosted for many individuals after the new change.
    - FHA mortgage premium has come down a notch thereby saving money for consumers. By the end of the year, FHA program will show healthier finances. That means, there could be additional reduction to premiums in 2016. Not certain, but plausible.
    - Fannie and Freddie are owned by the taxpayers. And they are raking-in huge profits as mortgages have not been defaulting over the past several years. The very high profit is partly reflecting too-tight credit with no risk taking. There is a possibility to back a greater number of lower down payment mortgages to credit worthy borrowers without taking on much risk. In short, mortgage approvals should modestly improve next year.
    - Portfolio lending and private mortgage-backed securities are slowly reviving. Why not? Mortgages are not defaulting and there is fat cash reserves held by financial institutions. Less conventional mortgages will therefore be more widely available.
- Improving credit available at a time of likely rising interest rates is highly welcome. Many would-be first-time buyers who have been more focused about getting a mortgage (even at a higher rate) than with low rates.
- All in all, existing and new home sales will be rising. Combined, there will be 5.8 million home sales in 2015, up 7 percent from last year. Note the sales total will still be 25 percent below the decade ago level during the bubble year. Home prices will be rising at 7 percent. For the industry, the business revenue will be rising by 14 percent in 2015. The revenue growth in 2016 will be additional 7 to 10 percent.

Lawrence Yun, PhD., Chief Economist and Senior Vice President

Lawrence Yun is Chief Economist and Senior Vice President of Research at NAR. He directs research activity for the association and regularly provides commentary on real estate market trends for its 1 million REALTOR® members.