Market & Investment Insights

Weather Woes

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Article Highlights

- Brutal winter weather hurt GDP growth, especially in January, and brought growth to a virtual standstill.
- By March, growth had reaccelerated thanks to continued consumer spending and resilient industrial activity.
- Hiring perked up significantly and could even lead to wage pressure by the second half of 2014.
- Housing suffered in the first quarter due to weather, continued tight lending standards and fewer institutional buyers, but future signs are moderately positive.
- While we expect economic growth to hit 3% by year end, we also expect less upward pressure on interest rates in 2014.

The first quarter of 2014 was even weaker than most thought it would be. Consensus estimates had expected growth to slow to 1.2% in Q1 from 2.6% in the fourth quarter. But that proved far too optimistic. GDP growth came to a virtual standstill, clocking in at a meager 0.1%, and we expect that number will be revised down as new data comes in.

Even so, don't despair. Weak as the report was, it's clear that severe weather, especially in January, was the culprit. By March, most economic indicators had picked up and April looks even better; labor market conditions are strengthening and the unit labor cost for the first quarter indicates some wage movement. We are upping our estimates for second quarter GDP to 3%, and these expectations could rise as new data arrives.

Perking up in March

There were even some encouraging numbers in the GDP report. Consumers continued to spend at a greater than 2% clip (even though durable expenditures were weak), and while a lack of inventory and construction spending weighed down business spending, other capital-related spending actually grew.

It appears that industrial activity also continues to heat up. Most industrial measures (Dallas Fed index, Chicago PMI) rose in their latest readings and the ISM manufacturing index hit 54.9. Together with other sentiment and consumption data, the first quarter economic narrative seems to be as follows: a severe freeze

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during January, a slow thaw in February and more normal conditions in March. For instance, durable orders for March was up sharply and the capital spending proxy also jumped (+2.2%).

Adding to the tenor of calm in the face of the GDP report was the Fed's decision in April, soon after the GDP number was released, to continue its tapering to $45 billion cumulative monthly purchases. The FOMC statement reiterated that the economy is progressing at about the right pace. We remain on track for an end-of-year end to quantitative easing.

Employment trends up

In other encouraging news, the economy added 288,000 jobs in April, up from an upwardly revised 203,000 in March. The unemployment rate dropped to 6.3%, the lowest level since September 2008—although that good news was tempered by the number of people leaving the workforce and those who are working part-time. Monthly job creation has averaged about 200,000 this year and should be 250,000 at this point in the recovery; however, we do expect monthly numbers closer to that higher figure by the end of 2014.

This employment growth may finally translate into higher wages, but for now wages and overall inflation remain low. According to the first-quarter GDP report, year-over-year core personal consumption expenditures (PCE) rose 1.3%, while month-over-month PCE rose 1.2% for the month. Our forecast remains benign for inflation well into 2015 with some modest wage pressures during the second half of this year.

Housing still a drag

The big cause for weakness in the first quarter was housing and spending on new home construction. For obvious reasons, construction activity grinds to a halt during bad weather, and potential buyers stay home. Even so, pending home sales for March and the Case Shiller housing price data were both positive on a month-over-month and year-over-year basis.

Despite these gains, data that measure both housing activity and corporate activity and sentiment have diverged over the past two or three quarters. There are two broad views on this matter. The first is that housing is weaker due to higher mortgage rates and lower than expected income growth, and there is certainly some truth to this argument. However, there is a second reason for housing's weakness: Institutional buyers, who came into this market heavily by 2012, began to pull back during the second half of last year, partially because returns elsewhere were rising and partially because rising interest rates tend to put downward pressure on home price growth rates.

Given the drop in mortgage applications during the first quarter, the spring is likely to be slow for housing across the country. But we expect housing activity to remain positive in 2014 (though moderately less positive than last year) thanks to:

- wages, which are starting to rise;
- employment growth, which is showing signs of improving; and
- loan growth, which is a sign that credit standards are easing.

We expect a 3-5% increase in home prices this year and close to a 0.5% boost to GDP growth from this segment in 2014.

Brighter days ahead

Nothing has changed in our basic economic forecast. The U.S. economy is still trending higher and we expect GDP growth to strengthen throughout the year to 3% by the fourth quarter, with average growth nearing 2.75% for the year.

Despite these positive GDP growth trends, in the short term we see less upward pressure on interest rates and are revising expectations for the 10-year Treasury to between 3% and 3.25% by year-end. The primary reason for this adjustment is the market's resistance to selling off the long end of the curve. This is less a commentary on economic growth and more a market reaction to various domestic and international uncertainties: supply/demand characteristics as the Fed changes its purchases, as well as issues surrounding the Ukraine situation, China's slowing growth and Bank of Japan's monetary policy.