



Economic Developments – July 2018

Second Quarter Growth Likely to be the High Point for the Rest of the Expansion

It appears that the expansion celebrated its ninth anniversary with a bang, as economic growth likely approached the expansion high seen nearly three years ago. We estimate that real gross domestic product (GDP) growth picked up during the second quarter to 4.2 percent annualized from 2.0 percent during the first quarter. Accelerating consumer and government spending growth, inventory investment, as well as more favorable trade for the first time in three quarters, likely drove a strong rebound despite an anticipated slowdown in business fixed investment growth from the double-digit pace in the first quarter. In addition, residential investment should turn from a drag in the first quarter to a modest positive contributor in the second quarter. However, we do not expect the robust growth to be sustainable, and our forecast points to a slowdown in the second half of the year. We project that full-year 2018 growth will reach 2.8 percent, one-tenth higher than in our prior forecast, before slowing to 2.2 percent in 2019 as fiscal impacts fade.

While fiscal stimulus will likely continue to support consumer, business, and government spending during the second half of this year, we expect trade to return to being a drag on growth, in part due to continued strength in the dollar, which has appreciated about 5 percent since the end of February. With stronger growth in the U.S. than in the Eurozone and other major trading partners and U.S. monetary policy continuing to tighten, we expect the dollar to rise further in the near term.

We see the upside risks from fiscal stimulus counteracting the downside risks from trade. Trade tensions have ratcheted up this month, as Canada implemented 25 percent tariffs on \$12.5 billion in imported U.S. goods. Meanwhile, the U.S. also imposed new 25 percent tariffs on \$34 billion of imports from China, prompting China to impose 25 percent tariffs on \$34 billion of imports from the U.S. The Administration also released a list of \$200 billion in additional imports from China on which it proposes an additional 10 percent tariff to take effect in September at the earliest. While the direct impacts of already imposed tariffs on the overall economy may be small, potential retaliation from China could be devastating for some local economies. For example, as China accounts for about half of U.S. soybean exports, Chinese businesses could cancel significant amounts of U.S. soybean shipments during the third quarter, potentially reversing the recent surge in U.S. soybean exports, which jumped \$2 billion to \$4.1 billion in May. If the U.S. imposes a wider range of tariffs on Chinese imports, restricts investment from China, or implements new tariffs on auto imports worldwide, we could see meaningfully negative impacts on the U.S. and global growth.

While trade rhetoric has become more heated, actual trade data have continued to improve. The nominal trade deficit narrowed in May for the third straight month to the lowest level since October 2016. Exports rose 1.9 percent to a record high, driven by a surge in food and beverages, which likely reflected the efforts of firms abroad to pull forward their imports from the U.S. ahead of announced tariffs. At the same time, U.S. imports increased just 0.4 percent, weighed down by a drop in auto and consumer goods. The inflation-adjusted goods deficit, used to calculate net exports in the GDP estimate, narrowed to the smallest level since March 2017, suggesting that net exports likely contributed meaningfully to second quarter GDP growth.

The Institute for Supply Management (ISM) manufacturing index also indicated little evidence of negative impacts of tariffs announced or imposed so far on the manufacturing sector in June. The index rose to 60.2, matching the second highest level of the expansion and implying the fastest pace of expansion in the sector since February. (A reading of more than 50 indicates an expansion in activity). Notably, the supplier delivery index jumped to the highest reading since 2004,

The Dollar Has Strengthened This Year



Trade Deficit Narrows to Lowest Level in 19 Months

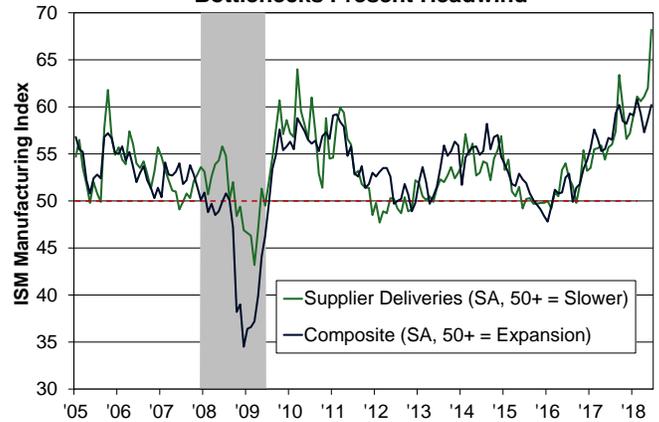




indicating a marked increase in product delivery delays, partly because of a shortage of truck drivers. Anecdotally, firms continued to report supply chain bottlenecks that could limit production and put upward pressure on prices. Several industries reported that the steel tariffs have already pushed prices significantly higher, while respondents in other industries noted that further tariffs could lead firms to reduce their investment.

Overall, we expect uncertainty from trade policy to weigh on businesses, and thus we lowered modestly our projection for business investment for the second half of the year. Along with concerns over tariffs from the ISM survey, the minutes from the June Federal Open Market Committee (FOMC) revealed that most participants said that “uncertainty and risks associated with trade policy had intensified,” and members were concerned about the possible negative effects of rising trade tensions on business sentiment and investment spending. According to some of the Fed’s regional contacts, the uncertainty over trade policy has resulted in scaled back or postponed plans for capital spending.

Manufacturing Activity Expands Faster, but Bottlenecks Present Headwind

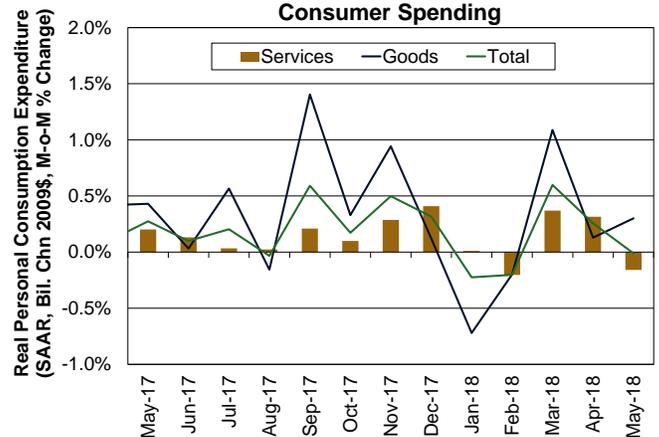


Consumer Spending Growth Likely Tripled in the Second Quarter

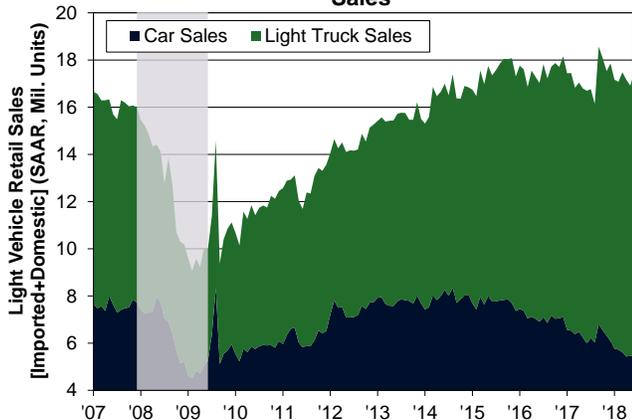
Real consumer spending disappointed in May as a decline in real service spending offset increases in durable and nondurable goods spending. A large drop in spending on household utilities such as natural gas and electricity amid cooler than normal temperatures drove the decline, which is poised to reverse in June. However, spending on discretionary service categories, including recreational services, also fell in May. Flat real consumer spending in May followed a 0.3 percent rise in April, a downgrade from an initially reported 0.4 percent gain.

Spending growth likely picked up in June, partially supported by a 3.3 percent rise in unit vehicle sales, the strongest gain in nine months, to 17.5 million annualized units. Light truck sales, which exceeded 12 million units for only the second time since record keeping began in 1990, drove the increase as auto sales were little changed. With auto sales trending down over the past year, light truck sales as a share of total sales rose to a record high of 69 percent in June. While gasoline prices were little changed in June, they have risen about 17 percent this year, which is taking a bite out of the increased disposable personal income from the tax cuts. Given an expected rebound in consumer spending growth in June, we estimate that real consumer spending growth accelerated to 2.7 percent annualized last quarter from 0.9 percent in the first quarter.

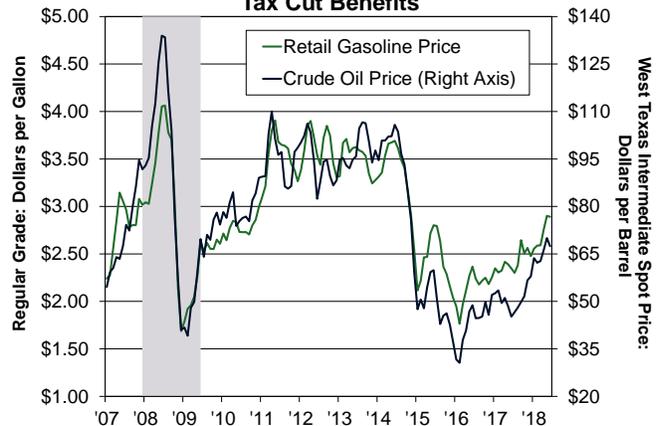
Service Spending Weighs on Overall Consumer Spending



Record-High Light Truck Sales Drive Vehicle Sales



Rising Gasoline Prices Have Partially Offset Tax Cut Benefits





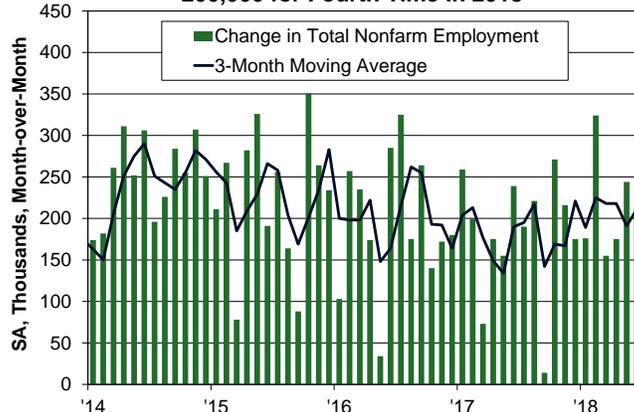
The Labor Market Continued to Improve

Solid improvement in the labor market will continue to support consumers. Nonfarm payrolls increased 213,000 in June, and upward revisions to the prior two months pushed the 3-month average job growth to 211,000. Meanwhile, average hourly earnings rose 0.2 percent from May and 2.7 percent from last June, leaving the annual gain unchanged from the prior month and staying within the tight range of 2.6 percent to 2.8 percent seen since December. The average workweek remained unchanged at 34.5 hours for the fifth consecutive month.

While the unemployment rate moved up for the first time since August to 4.0 percent, the increase was accompanied by the first rise in the labor force participation rate in four months to 62.9 percent from 62.7 percent in May. The participation rate has moved within a tight range of 62.7 percent to 63.0 percent over the past two years. Continued increase in the supply of labor would support the view that more labor market slack exists than previously believed and that solid hiring can continue without overheating the market. Over the past year, the labor force has grown by an average of 160,000 per month, running below the average monthly gain in household employment. We expect the trend to continue, and project a decline in the unemployment rate to 3.6 percent during the second half of the year before reaching a trough of 3.5 percent in mid-2019.

The Job Openings and Labor Turnover Survey (JOLTS), which is released with a one-month lag to the employment report, showed continued tight labor market conditions. The hires rate (hiring as a share of total employment) jumped in May to an expansion high, while the job openings rate edged down one tick to 4.3 percent from a record high. Jobs openings continued to exceed unemployed workers for the third consecutive month. In addition, after hovering between 2.2 percent and 2.3 percent for a year, the quits rate, which is a gauge for workers' confidence in the job market, edged up to 2.4 percent, an expansion best. Results from the National Federation of Independent Business (NFIB) Survey underscore the difficulties small businesses are facing in filling open positions. The share of firms reporting few or no qualified applicants in filling open positions surged 7.0 percentage points in June to 55 percent, a record high.

Three-Month Average Job Gain Rises Above 200,000 for Fourth Time in 2018



Hires and Quits Rates Rise to Expansion Bests



Share of Firms with Few or No Qualified Applicants Rises to a Record High

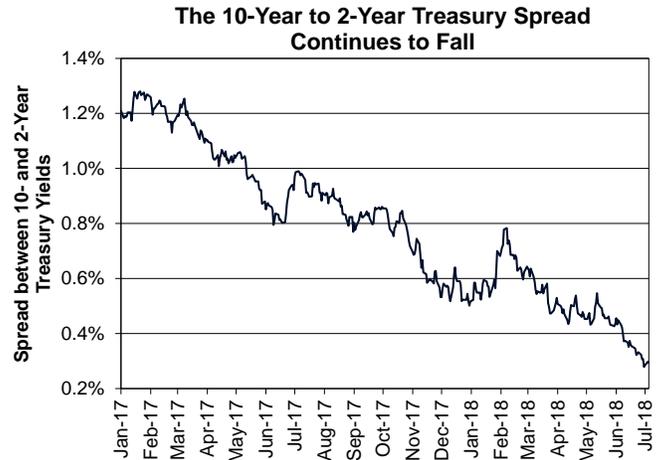


Fed Poised to Raise Rates in September

While the June jobs report indicated that wage pressures remain contained, inflation has moved up. The personal consumption expenditures (PCE) deflator, the Fed's preferred measure, rose 0.2 percent in May for the second consecutive month, pushing the annual growth rate to 2.3 percent, above the Fed's two-percent target for the first time since February 2017. The core deflator, excluding food and energy prices, also accelerated year over year to hit the target for the first time since April 2012. Incoming data led us to revise higher our projected PCE inflation in the fourth quarter of 2018 to 2.3 percent from 2.1 percent in the prior forecast. Consumers' inflation expectations also firmed in June, according to the University of Michigan survey of consumer sentiment, with one-year inflation expectations rising two-tenths to 3.0 percent and 5-year inflation expectations edging up one tick to 2.6 percent.

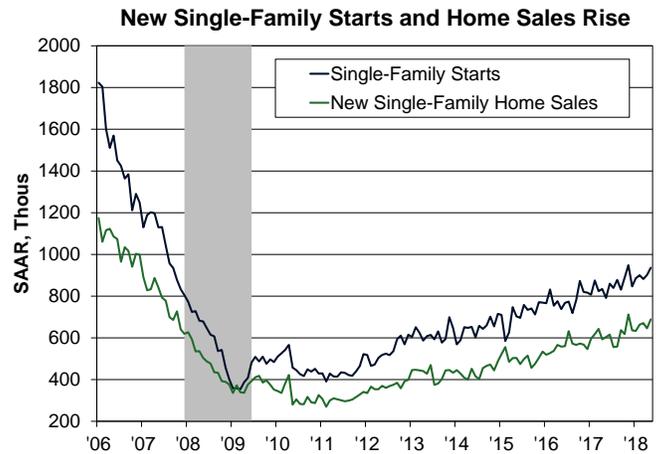


The Fed has described its inflation objective as “symmetric,” suggesting it will tolerate inflation overshooting the target in the medium term. The June FOMC meeting minutes noted that some participants were concerned that the flattening of the yield curve could signal a coming economic slowdown. However, others pointed to the large Fed balance sheet as a factor keeping long-term rates low and suggested that an inverted yield curve may not be a reliable signal of a recession, as implied by their historical relationship. The spread between 2-year and 10-year yields has fallen to about 30 basis points as of this writing. Despite the flattening yield curve, we expect the Fed to continue its monetary policy normalization. Given the strong labor market, our higher inflation forecast, and signals from the Fed of its willingness to tolerate an inverted yield curve, we changed our Fed rate hike call to two increases in the second half of this year, in September and December, compared with just one hike in our June forecast.



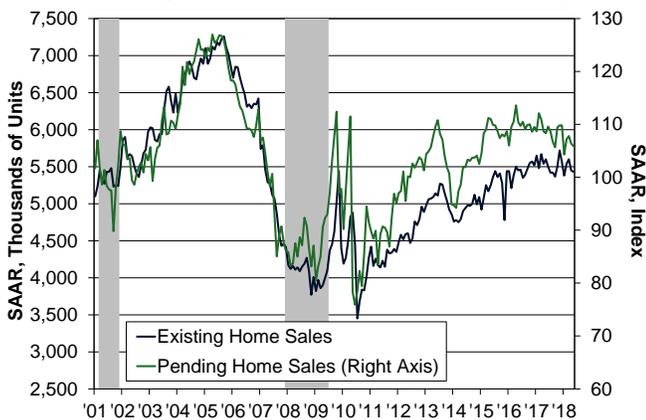
Housing Roundup

Housing activity was mixed in May. Single-family starts rose for the fourth time in five months but remained below the expansion best reached last November. Multifamily starts rebounded, reversing about half of the prior month’s drop. However, permits dropped for both segments. New home sales rose in May, driven solely by sales in the South, which rose to the highest level in more than a decade. By stage of production, sales of new homes not yet started drove the gain in overall sales, rising for the third time in four months to a six-month high, suggesting building activity has not kept pace with demand as builders continued to face challenges from labor shortages of labor and rising building material costs.

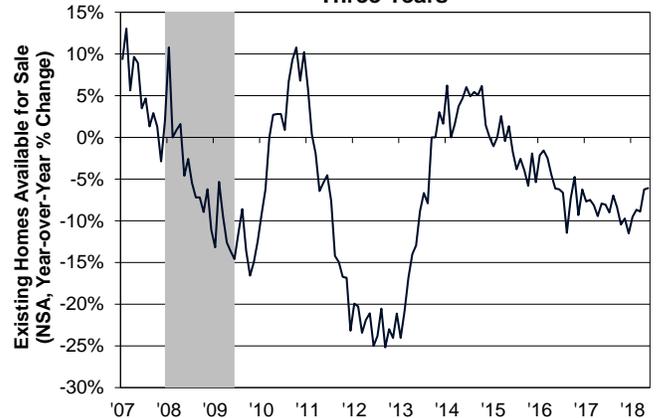


In contrast to the improvement in new home sales, existing home sales fell in May for the second straight month and declined on an annual basis for the fourth time in five months. The for-sale inventory has remained below year-ago levels for three years. Inventory shortages are impeding sales and supporting strong home price appreciation. According to the National Association of REALTORS®, properties typically stayed on the market in both April and May for only 26 days, the shortest duration since the series began in 2011. The near-term outlook remains bearish as pending home sales, a forward-looking indicator of existing home sales, dropped in May for the second consecutive month.

Existing Home Sales Market Trends Sideways



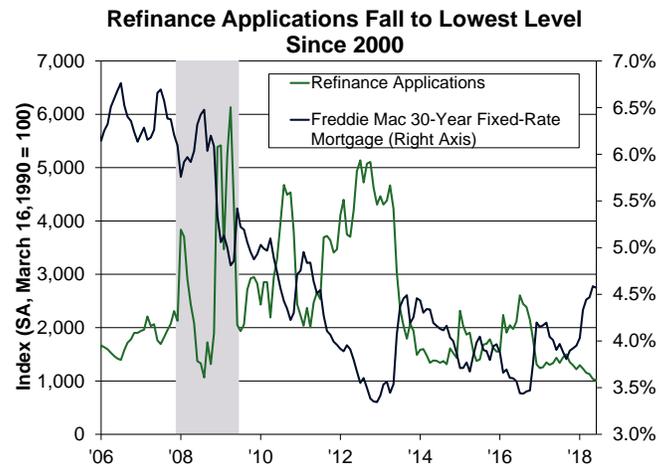
For-Sale Inventory Has Declined Annually for Three Years





Mortgage demand continued to be bearish during June despite the slight drop in the average 30-year fixed mortgage rate to 4.57 percent from 4.59 percent in May, marking the first monthly decline since last September. Monthly average purchase mortgage applications were virtually flat after declining in May for the first time in three months. Refinance applications declined for the fifth straight month and the eighth time in nine months, sending the monthly level of applications to the lowest level since December 2000.

Disappointing existing and pending home sales prompted us to lower our forecast of 2018 existing home sales to a slight drop from a slight rise in the June forecast and downgrade purchase mortgage originations by \$20 billion. We left our forecast of refinance originations unchanged from the prior forecast, showing a drop of about 26 percent this year from last year, which drove an 8 percent decrease in total mortgage originations to \$1.69 trillion in 2018. We expect the refinance share to fall 8 percentage points from 2017 to 28 percent.



Economic & Strategic Research (ESR) Group

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

Data source for charts: Federal Reserve Board, Census Bureau, Institute for Supply Management, Bureau of Economic Analysis, Autodata, Energy Information Administration, Bureau of Labor Statistics, National Federation of Independent Business, National Association of REALTORS®, Freddie Mac, and Mortgage Bankers Association

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