Economics: March Rate Hike Appears Likely

This week offered good news on consumer confidence, which rebounded in February to a 15-year high. However, news on consumer spending turned bearish at the start of the first quarter. Despite upward revisions for the fourth quarter of last year, January real personal consumption expenditures (PCE) showed the biggest drop in three years amid flat real personal income. Given January’s weak PCE showing and little change in auto sales between January and February, first quarter real PCE growth should come in weaker than our forecast of 2.6 percent annualized. Notably, the PCE deflator, the Fed’s favored measure of inflation, posted the strongest annual rise since April 2012 to just one-tenth below the Fed’s two-percent target. This week also provided mixed news on the factory sector. Durable goods orders outside of transportation weakened in January, with core capital goods orders, a leading indicator of business equipment investment, dropping for the first time in four months. However, the February ISM manufacturing survey pointed to the fastest pace of expansion since 2014, driven by strong new orders. Job market news remains upbeat, as initial jobless claims for the last week of February fell to the lowest reading since 1973. Last but not least, the biggest news centered on potential Fed action this month. Remarks from several Fed officials this week suggest that a rate increase could come soon, leading the fed funds futures market to price in a rate hike at the March 14-15 Federal Open Market Committee meeting. We now expect that the Fed will raise interest rate earlier than our June call, perhaps as soon as this month.

- **Gross domestic product (GDP)**, adjusted for inflation, rose 1.9 percent annualized in Q4 2016, according to the second estimate from the Bureau of Economic Analysis (BEA), unchanged from the first estimate. Real personal consumption spending was revised higher to 3.0 percent annualized from 2.5 percent, while investment and government spending were revised lower. Consumer spending added 2.1 percentage points to growth, offsetting downgrades in contributions from other major components.

- **Personal Consumption Expenditures**, adjusted for inflation, declined 0.3 percent in January, driven by weaknesses in durable goods and service spending, according to the BEA. The PCE deflator jumped 0.4 percent from December and 1.9 percent from last January. Core PCE rose 1.7 percent.

- **Durable goods orders** were up 1.8 percent in January, driven by a surge in aircraft orders, according to the Census Bureau. Excluding transportation equipment, orders fell 0.2 percent. Core capital goods orders (nondefense capital goods excluding aircraft) dropped 0.4 percent, while core capital goods shipments declined 0.6 percent. However, core orders and core shipments for December were revised higher by 0.4 percent and 0.6 percent, respectively.

- **The Institute for Supply Management (ISM) Manufacturing Index** increased 1.7 points to 57.7 in February (any reading above 50 indicates expansion). This marks the sixth consecutive gain, sending the index to the highest level since August 2014. Notably, the new orders component jumped to the highest reading since December 2013. **The ISM Nonmanufacturing Index**, a gauge of service sector activity, rose 1.1 points to 57.6 in February.

- **The Conference Board Consumer Confidence Index** advanced 3.2 points to 114.8, the highest level since July 2001. The present conditions index increased 3.4 points to 133.4. The expectations index rose 3.1 points to 102.4.

- **Light vehicle sales** edged down 0.2 percent to a 17.4 million annualized pace in February, according to Autodata. Sales have been at or above 17.4 million units in seven of the last eight months.

- **Initial claims for unemployment insurance** fell 19,000 to 223,000 in the week ending February 25, according to the Department of Labor. The four-week moving average fell 6,250 to 234,250, a new record low for the expansion.
Housing: Home Sales Face Ongoing Headwinds

Housing data released this week suggest the January rebound in home sales may be short-lived. In last week’s release, January existing sales approached a decade high. However, this week’s reports on leading indicators for home sales point to near-term weakness. Pending home sales, which record contract signings of existing homes and typically lead closings by one to two months, declined in January for the second time in three months to reach a 12-month low. Furthermore, purchase mortgage applications dropped on average during February to end a three-month stretch of monthly gains, despite a large jump in the last week of the month. The weakness in these leading indicators supports our view that some of the improvement in home sales at the start of the year was likely the result of a rush to enter the market before mortgage rates could rise further. While rates have trended down from their high in late December, they have remained about 50 basis points higher than prior to the election. In addition, a tight supply of homes remains a challenge for the market. Stiff competition for a limited number of homes for sale has put upward pressure on home prices, with the Case-Schiller National Home Price Index posting the strongest December-over-December gain in 2016 since 2013. On a positive side, new private residential construction spending is off to a solid start in 2017, as spending on single-family construction rose in January for the fourth straight month to a new expansion high. Single-family construction spending rose year-over-year for the second straight month, after declining the prior four months. Multifamily construction spending also reached a new expansion peak in January. The year-over-year gain in multifamily spending in January accelerated compared with December’s gain, which was the slowest pace since July 2011. The positive start for new construction spending points to another healthy increase in residential investment in the first quarter following back-to-back drops in the second and third quarters of 2016. Regarding mortgage applications, refinance activity rose last week, capping a gain for the entire month amid relatively flat mortgage rates. Freddie Mac’s survey showed that the average 30-year fixed mortgage rate fell six basis points this week to 4.10 percent, marking a six-week low.

- **Private residential construction spending** edged up 0.5 percent in January, weighed down by a drop in spending on home improvement, according to the Census Bureau. Spending on new single-family construction increased 1.1 percent, while multifamily spending rose 2.2 percent. Year-over-year, single-family spending improved 2.5 percent and multifamily outlays increased 8.6 percent. Spending on home improvements fell 1.0 percent from December but rose 9.1 percent from a year ago.

- **The National Association of REALTORS® Pending Home Sales Index** fell 2.8 percent in January. From a year ago, pending sales rose 2.7 percent. Sales dropped in the Midwest and the West and rose in the other two regions.

- **The S&P/Case-Schiller National Home Price Index** (not seasonally adjusted) rose 0.2 percent in the three months ending in December. Prices rose 5.8 percent in December from a year ago.

- **Mortgage applications** increased 5.8 percent for the week ending February 24, recovering the ground lost the prior two weeks, according to the Mortgage Bankers Association (MBA). Purchase applications rose 6.5 percent, following a 2.8 percent drop the prior week. Refinance applications improved 5.1 percent, as the MBA’s average 30-year fixed mortgage rate declined six basis points to 4.30 percent. For all of February, purchase applications fell 4.2 percent, as refinance applications rose 1.5 percent.
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