

Economics: Fed Inches Closer to a Liftoff but Shifts “Dots” Lower

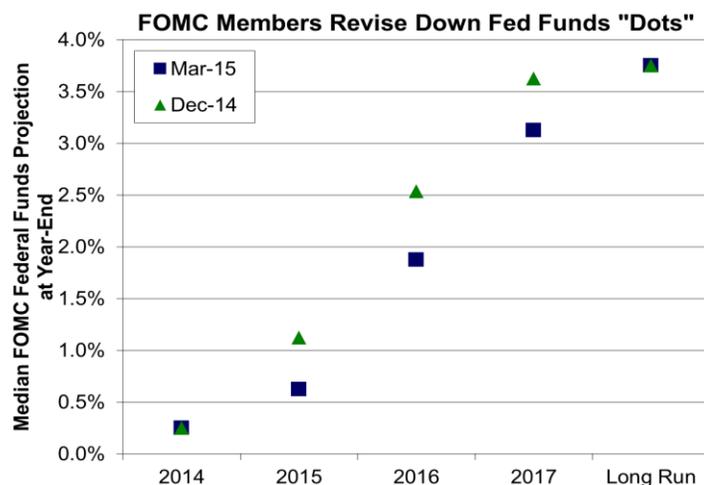
This week’s sparse economic news took a backseat to the Federal Open Market Committee (FOMC) meeting. As expected, the Fed dropped from its forward guidance the “patient” language in beginning to normalize the stance of monetary policy, and, in effect, achieved more flexibility to implement the first fed funds rate hike since 2006. However, in its new quarterly Summary of Economic Projections (SEP) released at the meeting, the Fed cut its projections for the expected path of the fed funds rate over the next few years amid downward revisions in its inflation and growth outlook, as well as in estimates of the long-run (or “structural”) unemployment rate. The median projection for the fed funds rate, or “dot plot,” at the end of 2015 fell 50 basis points to 0.625 percent. The dots also dropped sizably in 2016 and 2017. The downgrade suggests a slower pace of rate hikes, which appears to have soothed the market. Treasuries rallied on the Fed announcement, with the yield on the 10-year Treasury dipping below 2.0 percent for the first time in three weeks. We remain comfortable in our call for a September liftoff in the fed funds rate. The bottom-line is Fed’s action will depend on incoming data on inflation and labor market. The Fed reiterated that it would like to see continued improvement in the labor market and to be “reasonably confident” that inflation will move toward the target over the medium term. How much improvement the Fed needs to see and how much confidence is considered reasonable is likely to spur speculation and heighten market volatility in coming months.

Economic reports this week showed deteriorating manufacturing and mining output, which would have caused a decline in industrial production if not for a record surge in utility output. The downshift in manufacturing is also weighing on the near-term economic outlook, as reflected by only a modest rise in the February Leading Economic Index.

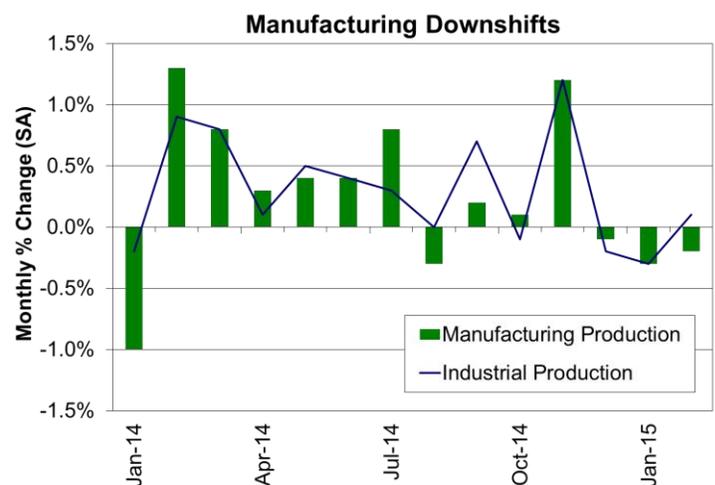
➤ **Industrial production**, a gauge of output in the manufacturing, utility, and mining sectors, ticked up 0.1 percent in February, according to the Federal Reserve Board. Manufacturing output, which accounts for about 70 percent of the total, declined 0.2 percent, weighed down by a 3.0 percent drop in production of motor vehicles and parts. Significant downward revisions in the prior two months’ data resulted in three consecutive monthly drops in manufacturing output, declining 2.3 percent annualized over that span, the worst performance since late 2012. Some of this recent weakness may be attributable to temporary factors, including supply chain disruptions associated with the West Coast port shutdown. However, it is possible that recent weakness in auto sales has led to a cutback in production. The stronger dollar is another factor that may be weighing on activity. Utility output surged 7.3 percent in February amid the harsh winter. Mining output fell for the fourth time in the last five months, dropping 2.5 percent as oil and gas well drilling plunged a near-record 17.3 percent.

➤ **The Conference Board Leading Economic Index (LEI)**—a gauge of the economic outlook for the next three to six months—advanced 0.2 percent in February for the second consecutive month. The gains were broad-based as seven out of 10 components increased, outweighing negative contributions from the manufacturing industry and rising initial jobless claims, which spiked during the second half of February.

➤ **Initial claims for unemployment insurance** rose 1,000 to 291,000 in the week ending March 14, according to the Bureau of Labor Statistics. The small rise followed a 35,000 drop in the prior week, keeping claims below 300,000 for the second straight week. The four-week moving average rose 2,250 to 304,750, the third increase in the past four weeks.



Source: FOMC March 2015 Summary of Economic Projections



Source: Federal Reserve Board

Housing: Another Winter to Forget

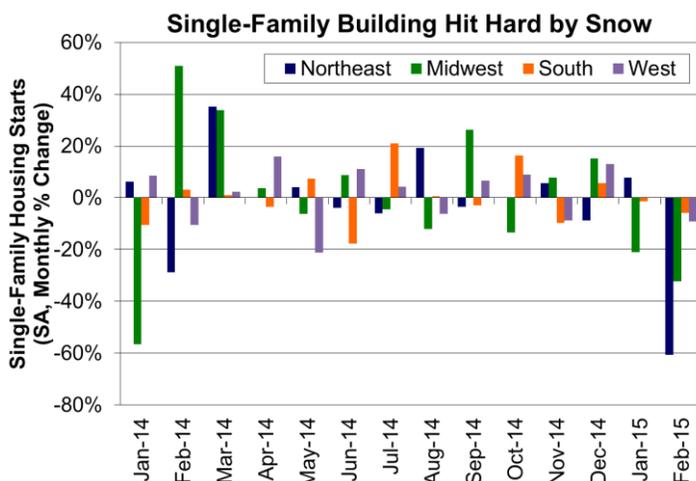
It's déjà vu this winter in the housing market. Homebuilding activity faltered in February amid severe winter weather throughout much of the country, similar to the homebuilding slowdown witnessed one year ago. Housing starts in February were the lowest since January 2014, exacerbated by plunging single-family construction in the Northeast and Midwest. Not all of the anemic building activity in February can be blamed on the weather, as the West also saw a significant monthly decline in housing starts. In addition, single-family building permits—typically less impacted by severe weather—were also downbeat during the month, declining sharply in every region except the West. Home builders took notice, with builder confidence sinking further in March to an eight-month low, with notable weakness in the buyer traffic and current sales components. After all, who wants to house hunt in a blizzard? Mortgage applications continued to trend lower following a surge in activity in January, with pullbacks in both purchase and refinance demand. However, even with a 37 percent cumulative decline in refinance application volumes since mid-January, refinance demand last week was higher than all but one week in 2014. The contract interest rate for 30-year fixed rate mortgages fell 8 basis points to 3.78 percent this week, according to Freddie Mac, and the recent plunge in long-term Treasury yields, if even partially sustained, could pull mortgage rates lower, reviving the fading 2015 mini refi-boom. FHA demand continued to outperform the conventional market in light of the reduced mortgage insurance premiums (MIP) that took effect in January.

➤ **Housing starts** plunged 17.0 percent in February to 897,000 annualized units, according to the Census Bureau. Single-family housing starts sank 14.9 percent to 593,000 units, compared to a 20.8 percent drop for the volatile multifamily housing starts. Weakness was concentrated in the Northeast and Midwest regions which saw 60.7 percent and 32.4 percent monthly declines in single-family housing starts in February, respectively, compared to a 9.1 percent drop in the West and a 5.9 percent decline in the South. Through the first two months of 2015, single-family and multifamily housing starts are up 9.5 percent and 5.6 percent over 2014, respectively. New residential building permits rose 3.0 percent in February to 1.09 million annualized units. An 18.3 percent jump in multifamily permits outweighed a 6.2 percent drop in single-family permits to a nine-month low of 620,000 units.

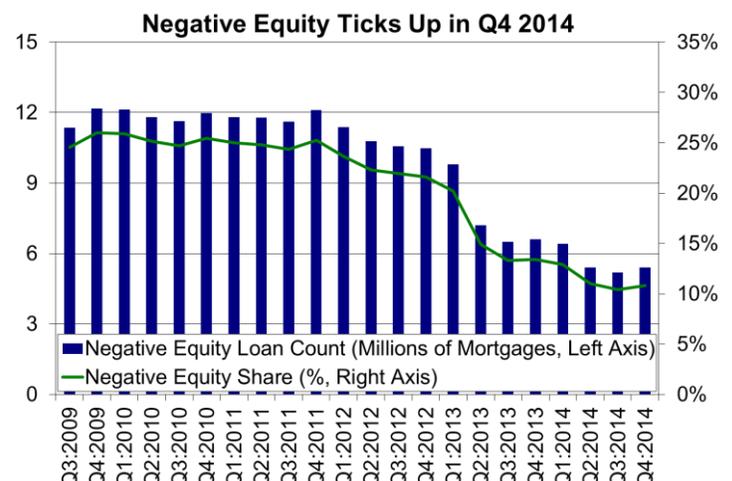
➤ **The National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index** edged down 2 points to 53 in March (a reading above 50 indicates more builders view the market as good than poor). The current sales component fell 3 points to a five-month low and the buyer traffic component sank 2 points to a nine-month low, while sales expectations over the next six months held steady. Only the Midwest region had an increase in builder confidence in March, while the Northeast and West regions witnessed a sharp decline.

➤ **Negative equity** for residential mortgages increased in Q4 2014, reflecting the typical weakness in home values during the final quarter of the year, according to CoreLogic. The share of mortgaged properties with unpaid balances larger than the value of the residence increased to 10.8 percent in Q4 from 10.4 percent in Q3. The total number of underwater properties increased to 5.4 million during the quarter from 5.2 million in the prior quarter. Still, negative equity was down from Q4 2013 when 13.4%, or 6.6 million properties, were underwater.

➤ **Mortgage applications** fell for the fifth time in six weeks, according to the Mortgage Bankers Association (MBA). Total applications dropped 3.9 percent in the week ending March 13. Purchase applications declined 1.5 percent on the week amid a 5.2 percent dip in refinance applications. After breaching 4 percent in the prior week for the first time since the start of the year, the survey contract interest rate for 30-year fixed rate mortgages ticked down 2 basis points to 3.99 percent.



Source: Census Bureau



Source: CoreLogic



Brian Hughes-Cromwick and Orawin T. Velz
Economic and Strategic Research Group
March 20, 2015

Opinions, analyses, estimates, forecasts and other views of Fannie Mae's Economic and Strategic Research (ESR) Group included in these materials should not be construed as indicating Fannie Mae's business prospects or expected results, are based on a number of assumptions, and are subject to change without notice. How this information affects Fannie Mae will depend on many factors. Although the ESR group bases its opinions, analyses, estimates, forecasts and other views on information it considers reliable, it does not guarantee that the information provided in these materials is accurate, current or suitable for any particular purpose. Changes in the assumptions or the information underlying these views could produce materially different results. The analyses, opinions, estimates, forecasts and other views published by the ESR group represent the views of that group as of the date indicated and do not necessarily represent the views of Fannie Mae or its management.

