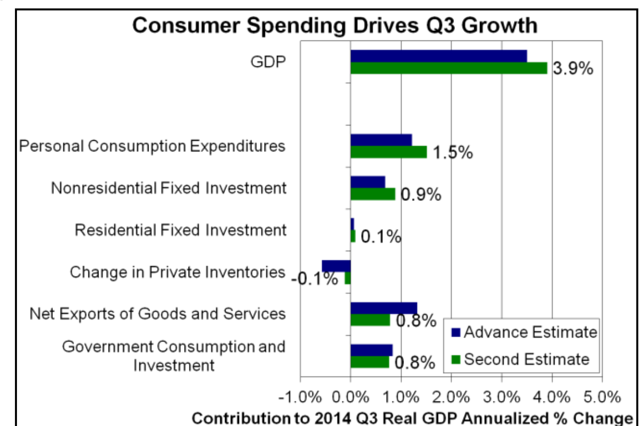
2014: Started with a Deep Hole, Ending with a Whimper

The year 2014 will be remembered for its roller-coaster pattern of economic growth. The unusually cold winter weather helped put growth in deep negative territory in the first quarter, which proved to be temporary. The economy came back with a vengeance, rebounding in the second quarter to the strongest pace in more than two years before losing a little steam in the third quarter. Economic growth is poised to weaken further, as some unsustainable forces that drove activity in the third quarter reverse in the final quarter. For all of 2014, we expect growth to come in at an unspectacular pace of 2.1 percent, one percentage point below the 2013 pace. We expect growth to strengthen from this year's fourth quarter pace into 2015, driven by continued rise in private domestic demand amid firming consumer income prospects, rising consumer and business confidence, a broadening housing recovery, and reduced fiscal headwinds, resulting in full-year growth of 2.7 percent for all of 2015. We have upgraded our 2015 view slightly compared with the prior forecast, thanks in part to the drop in oil prices during the second half of 2014, which should carry into the first quarter of 2015 before gradually increasing through the rest of the year. The global economic slowdown, domestic policy uncertainty, and ongoing geopolitical tensions present downside risks to our forecast view.

Growth Received an Upgrade…

Third quarter real gross domestic product (GDP) received an upgrade to 3.9 percent annualized from the 3.5 percent clip in the first estimate. Upward revisions to consumer spending and investment offset downward revisions to net exports and government spending. Overall, the revisions showed a healthier composition to growth as a key indicator of underlying growth for the private sector—real final sales to private domestic purchasers (which include domestic spending by consumers and businesses and exclude inventories)—strengthened to 3.0 percent, compared with 2.3 percent in the prior estimate.



…But Some Payback is in the Cards

Our forecast for the current quarter points to a slowdown in economic growth to slightly below 2.5 percent in the fourth quarter. Because inventories also were revised higher along with business fixed investment, it suggests that some production cutbacks may be in the offing, a negative for current quarter growth. The surge in federal defense spending, which added 0.7 percentage points to GDP in the third quarter, was unrevised and is likely to reverse in the fourth quarter. Trade data through October also suggest that, after contributing 0.8 percentage points to GDP in the third quarter, net exports are likely to be a drag to current quarter GDP as well as in all of 2015, consistent with weakening economic growth abroad and the dollar's strength.

In addition, business capital investment shows signs of cooling, based on the factory orders report. The decline in core capital goods shipments and core capital goods orders in October suggests that growth in business investment in equipment will slow markedly from the double-digit gains in the prior two quarters.

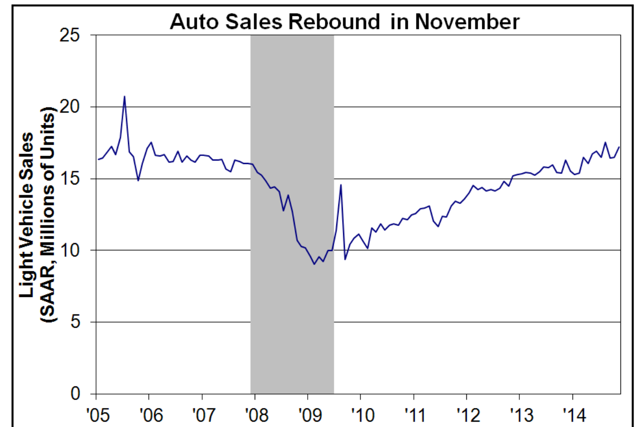
Meanwhile, the industrial production report showed that manufacturing output rose 0.2 percent in October for the second consecutive month, slowing from the more rapid pace of increases witnessed earlier in the year. While hard data on factory conditions have softened in recent months, the results from the Institute for Supply Management (ISM) manufacturing survey have been upbeat.

The manufacturing index edged down only slightly in November to 58.7 from the October level, which was near the expansion high, indicating continued expansion in the manufacturing sector (a reading above 50 signifies expanding manufacturing activity). Details showed that new orders, a forward-looking subcomponent of the report, edged up slightly, suggesting forward momentum in the sector. One notable detail is the surge in new export orders, which erased the declines in the prior two months—an encouraging development given the global economic slowdown and the rising value of the dollar.

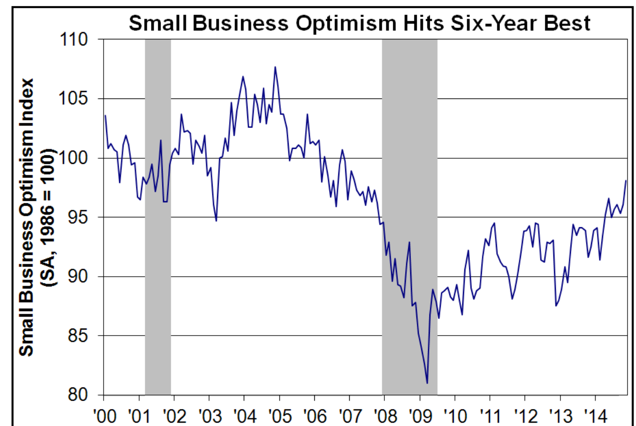
The ISM survey for the service industry was quite bullish in November, as the nonmanufacturing index rose 2.2 points to 59.3 in November, the second highest reading in the expansion. Taken together, the two ISM surveys imply a pickup in the economic growth in the fourth quarter, which contrasts with other incoming data. Thus we are cautious in interpreting their results.

Consumers Will Continue to Drive Growth

After picking up to a 3.7 percent annualized rate in the fourth quarter of 2013, real consumer spending growth has disappointed so far this year, and we expect it to accelerate only modestly in the current quarter from the 2.2 percent pace in the third quarter. Following a flat reading in September, real consumer spending increased 0.2 percent in October. However, it is poised to accelerate in November, as unit auto sales jumped 4.5 percent to an annual rate of 17.2 million units, just shy of the August reading, which was the strongest pace since 2005. In addition, spending on home heating likely picked up during the colder-than-normal November from the mild October. Most importantly, the boost to disposable income from declining gasoline prices over the past several months should bolster holiday spending.



The two main measures of consumer confidence moved in opposite directions in November, with the Conference Board consumer confidence index down sharply while the Reuters/University of Michigan sentiment index ticked up to a new expansion high. The latter measure was more in line with small business confidence during the month, as the National Federation of Independent Business (NFIB) Small Business Optimism Index jumped to its best showing since February 2007, boosted by improving expectations regarding the economy. The net share of respondents who believed that the economy will improve over the next six months surged 16 percentage points to 13 percent—the largest since November 2010. Sales prospects also improved during the month, as the net share expecting an increase in real sales volume over the next six months jumped 5 percentage points to the highest reading since May.



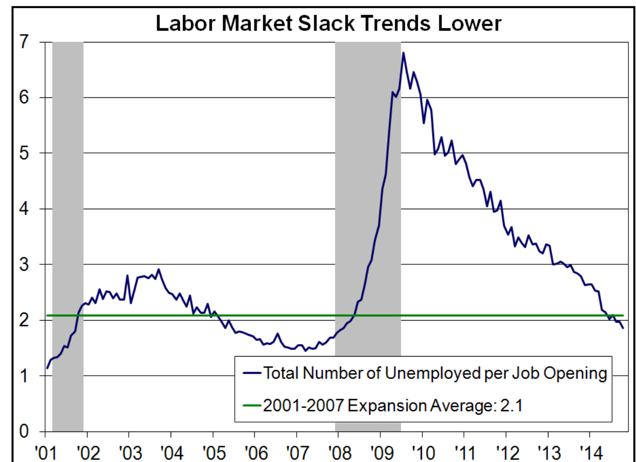
Labor Market Shows Steady Improvement

The November jobs report showed sizable improvement in labor market conditions. Nonfarm payrolls rose 321,000, and upward revisions of 44,000 jobs for the prior two months put the average monthly gain over the last three months at 278,000—the best showing in over four years.

Other details also were strong, with average hourly earnings posting the biggest monthly gain since June 2013, rising 0.4 percent. While the year-over-year gain of 2.1 percent did not yet break away from its ongoing trend, the jump in earnings, combined with the rise in average hours worked to the longest since May 2008, points to a pickup in labor income in the fourth quarter. The labor income proxy for private workers—the product of earnings and hours worked—jumped 1.0 percent, the biggest gain since March.

The separate household survey results were less rosy, showing that the unemployment rate and the labor force participation rate remain unchanged at 5.8 percent and 62.8 percent, respectively. However, the broadest measure of unemployment, which includes discouraged workers and part-time workers for economic reasons, edged down one tick to a six-year low of 11.4 percent.

The Job Openings and Labor Turnover Survey (JOLTS), released with a one-month lag to the jobs report, showed continued improving labor market conditions in October. The job openings



rate (openings as a share of total employment) ticked up while the total hires rate remained at its expansion high. The ratio of unemployed job seekers to job openings—a gauge of labor market slack—fell to the lowest reading since February 2008.

While the JOLTS showed that the quits rate, a key indicator of labor market confidence, edged down in October, the drop was from its expansion high in the prior month. The rising trend in the quits rate supports our view that wage gains are poised to accelerate, as the private wages in the Employment Cost Index tend to lag the quits rate.

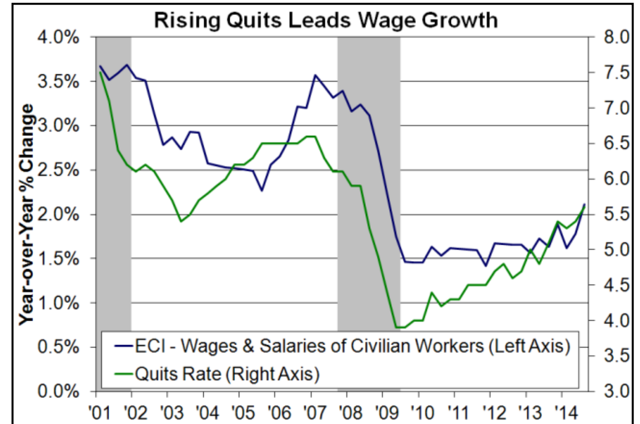
Surveys of consumers show increasing optimism about their income and personal finance expectations. For example, the Reuters/University of Michigan sentiment survey shows household income expectations have gradually increased this year. The November Fannie Mae National Housing Survey also showed an upward trend this year in consumers' assessment of their personal finances, with 46 percent of respondents—near the survey's high—expecting their personal financial situation to improve over the next 12 months. Overall, measures of labor market utilization point to diminishing slack and accelerating wage gains, which will be a key driver for consumer spending on top of the transitory boost to disposable income from declining energy prices.

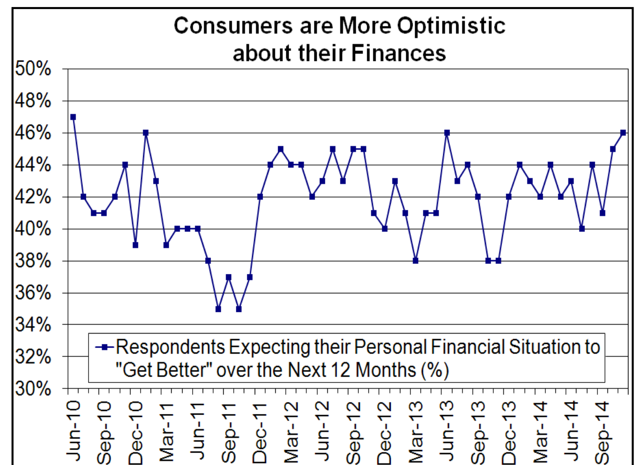
Fading Headwinds Will Support Housing in 2015

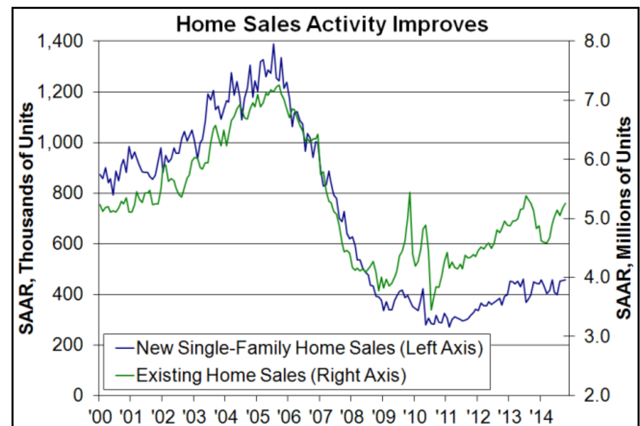
Improving income prospects are key to an increase in the rate of household formation, which has so far been sub-par. However, a robust housing recovery, as policy support is removed, will require meaningful gains in household income. The year 2014 marks a disappointing one for the housing recovery, which has been tentative, especially for the single-family segment, due to the severe winter weather and the spike in mortgage rates during the second half of 2013 that weakened housing demand. While mortgage rates have stabilized, weak housing demand remains a challenge for the sector, as first-time homebuyers have been slow to fill the void left by investors who have exited the market.

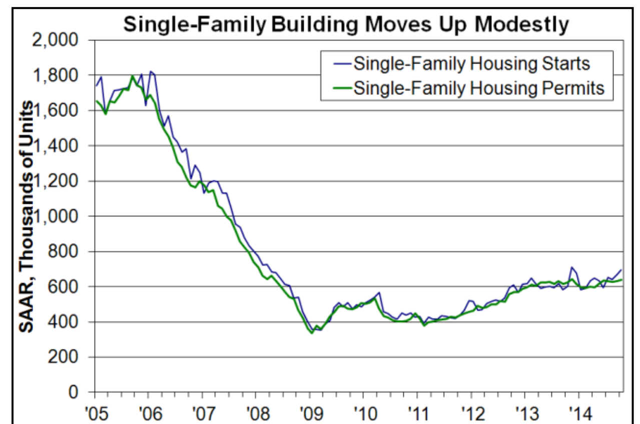
Recent housing and economic indicators generally have been positive. Existing home sales rose for the second consecutive month in October to the strongest pace since September 2013, increasing on a year-over-year basis for the first time in a year. The number of homes available for sale (not seasonally adjusted) dropped in October for the third consecutive month, pushing the months' supply down to 5.1 months, the lowest reading since March. While existing home sales have clearly trended up since hitting their recent trough in March of this year, new home sales largely have moved sideways. In October, new single-family home sales edged up on the heel of large downward revisions to sales in the prior three months.

Despite disappointing performance in the new single-family home market, homebuilders' confidence rebounded sharply in November, nearly reversing the big drop in October. Building activity continues to show mixed performance this year. While multifamily starts are volatile from month to month, the broad trend has been remarkable, with their recent peak recorded in July 2014, marking the strongest pace witnessed since early 2006. (For more



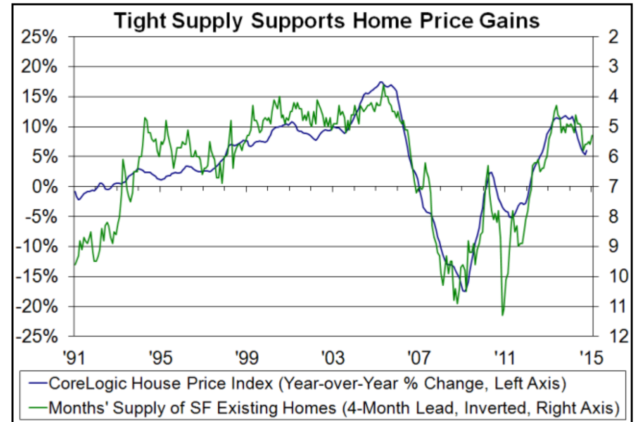




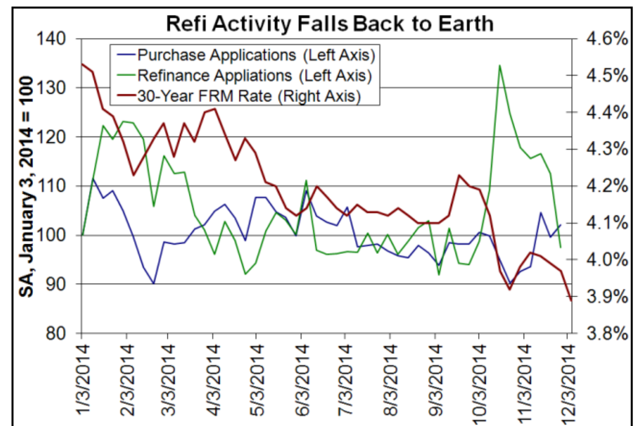


information on multifamily market conditions, read the December 2014 Multifamily Market Commentary.) By contrast, improvement in single-family starts and permits has been much more modest this year. Year-to-date housing starts were roughly 10 percent above last year's level, with multifamily starts poised to post a double-digit gain for the fourth consecutive year. The level of total housing starts for all of 2014 likely will be slightly below one million units, an anemic level by historical standards, especially after more than five years of economic expansion.

Major home price measures continued to show moderating annual growth rates in September, with the CoreLogic house price index on the top-end of the range, rising 5.3 percent. The index unexpectedly accelerated in October, reversing the downward trend in annual gains since February. Despite soft housing demand this year, relatively tight supply has continued to support healthy home price gains.



For 2015, we expect a broad-based but measured housing recovery amid improving consumer sentiment and income growth, slowly easing lending standards, and continued historically low mortgage rates. Soft spots in several economies around the globe and the resulting highly accommodative monetary policy abroad have benefitted long-term Treasuries in a flight to quality, depressing yields. The Freddie Mac 30-year fixed mortgage rate has hovered near an 18-month low of below 4 percent at the time of this writing. We continue to expect the Federal Reserve to start hiking short-term interest rates in the third quarter of 2015, with no change in the balance sheet policy until 2016. The yield curve should flatten further as short-term rates rise while longer-term rates move up only gradually, with fixed mortgage rates staying below 4.5 percent through 2015, continuing to support the housing market.



For all of 2015, we expect total housing starts to increase about 22 percent. Total home sales should rise approximately 5 percent, more than offsetting the expected drop of approximately 3 percent in 2014. The Mortgage Bankers Association purchase mortgage applications index has moved higher since November, building momentum for increasing home sales going into 2015. Meanwhile, refinance applications have plummeted, setting the stage for a purchase market in 2015.

After an expected drop of nearly 40 percent in 2014, total mortgage originations should edge up slightly in 2015 to $1.13 trillion, as an increase in purchase originations slightly outpaces a drop in refinance originations. The refinance share should decline further to 37 percent in 2015 from a forecast of 40 percent in 2014 and an estimated 60 percent in 2013. Total single-family (1- to 4-unit properties) mortgage debt outstanding should post a slight decline in 2014 before picking up modestly in coming years.

December 10, 2014
Economic and Strategic Research (ESR)

For a more timely snapshot of macroeconomic and housing data, read ESR's Economic and Housing Weekly Notes.

Sources for chart data: Bureau of Economic Analysis, Autodata, National Federation of Independent Business, Bureau of Labor Statistics, Fannie Mae National Housing Survey, Census Bureau, National Association of REALTORS®, CoreLogic, Mortgage Bankers Association, Freddie Mac

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