



Economic Developments – March 2019

Economy Progresses But Is Clearly Slowing

U.S. economic growth is expected to slow to 2.2 percent over the full year of 2019 from 3.1 percent in 2018. Our forecast of deceleration of economic growth over 2019 reflects a number of factors, including the fading boost from the Tax Cuts and Jobs Act. Business investment and consumer spending are also expected to slow.

The risks to our outlook remain to the downside, but the impact of recent progress addressing these downside risks could shift the balance closer to neutral. The key downside risks to our forecast include slower foreign economic growth and trade uncertainty between the U.S. and China. However, consequent policy responses by some of the world’s major foreign monetary and fiscal authorities, as well as evidence of progress on U.S.-China trade deliberations, could limit the potential damage. We assume that the federal government debt ceiling will ultimately be raised and in a manner that does not permanently erode economic activity. In addition to the continued easing of financial conditions and a patient Fed, modest improvements in labor productivity represent a key upside potential to U.S. economic growth.

We continue to expect home sales to stabilize in 2019, flat from 2018 levels and below the expansion peak in 2017. The still-solid labor market, mildly discounted by the surprisingly slow pace of job growth in February, and strong rate of household formation, driven by owner-occupied households, support housing demand. Slowing house price appreciation and falling mortgage rates have improved housing affordability in recent months. Purchase mortgage originations are expected to expand slightly in 2019 amid expectations of stable home sales and continued house price growth. Meanwhile, refinance originations are expected to shrink this year from their 2018 level as rates hold steady over the year.

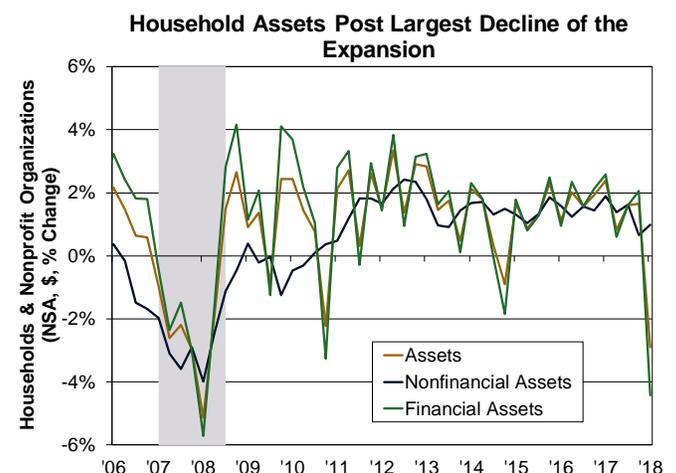
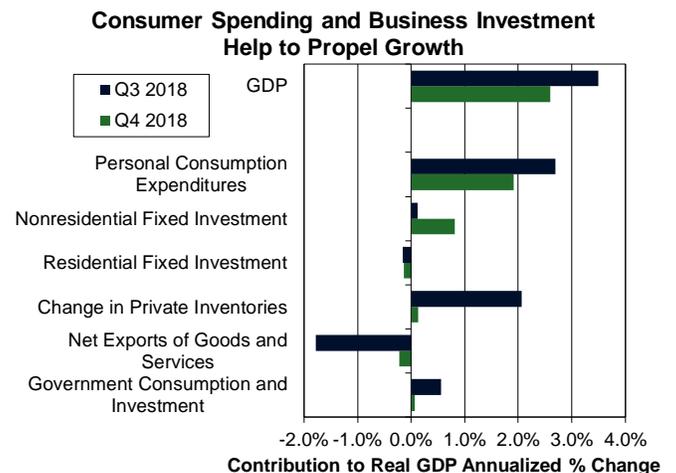
Business Spending Supports Fourth Quarter Economic Growth

The first estimate of fourth quarter real gross domestic product (GDP) growth came in at a 2.6 percent annualized rate, slower than the 3.4 percent annualized rate of growth in the third quarter. Consumer and government spending as well as private inventory accumulation provided a smaller contribution to overall economic growth in the fourth quarter than in the third quarter. Residential investment and the widening trade deficit subtracted from economic growth. Business spending growth was a bright spot, providing a stronger contribution to economic growth in the fourth quarter relative to the third quarter.

Economic growth in the first quarter of 2019 is expected to slow further. Risk aversion will likely restrain consumer spending in the first quarter, slower foreign economic growth is expected to weigh on the U.S. trade balance, and business spending should decelerate following the surprising jump in the fourth quarter. However, government spending is projected to accelerate in the first quarter following a sharp slowdown in the fourth quarter. Residential investment is expected to remain weak.

Consumers Grew Cautious as Financial Wealth Contracted

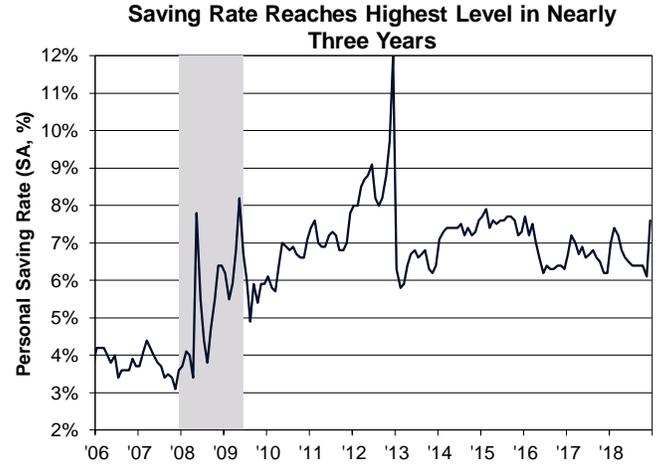
Personal consumption expenditures (PCE) grew by 2.8 percent annualized in the fourth quarter, slowing from 3.5 percent in the prior quarter due in part to the largest monthly decline in real consumer spending in over nine years in December. Meanwhile, households’ financial assets declined in the fourth quarter for the first time since 2015, as the Standard and Poor’s 500 Composite Index (S&P 500) fell in every month of the quarter. In response to lost financial wealth consumers likely grew more cautious. The growth in personal income combined with a drop in





spending over December contributed to a 1.5 percentage point increase in the savings rate over the month of December to 7.6 percent, the highest level since January 2016.

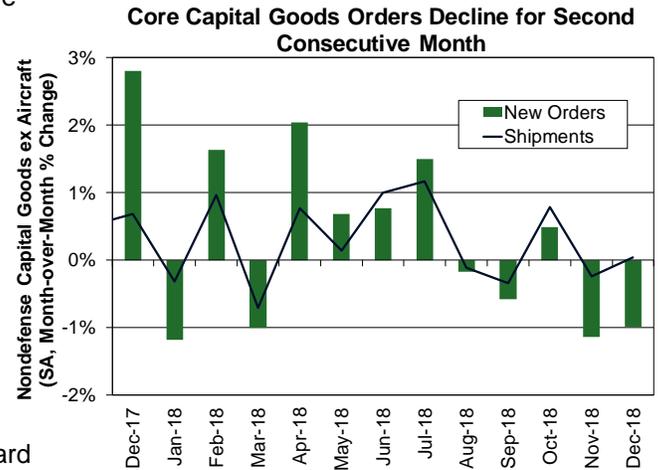
Consumer spending growth should remain modest in the near-term. Core retail sales, which excludes autos, gas, and building materials, rose by 1.1 percent in January following a downwardly revised 2.3 percent drop in December. Personal income edged down in January, the first decline since November 2015. Although wages and salaries grew, the subsidy payments to farmers that boosted growth in December waned in January and personal interest and dividend income on asset holdings fell. Both the Conference Board's Consumer Confidence Index and the University of Michigan's Consumer Sentiment Index improved significantly in February, following the end of the government shutdown and an improvement in financial conditions. The U.S. Department of Treasury announced on February 28 that the average refund at that point in the filing season was up 1.3 percent relative to the same time in 2018.



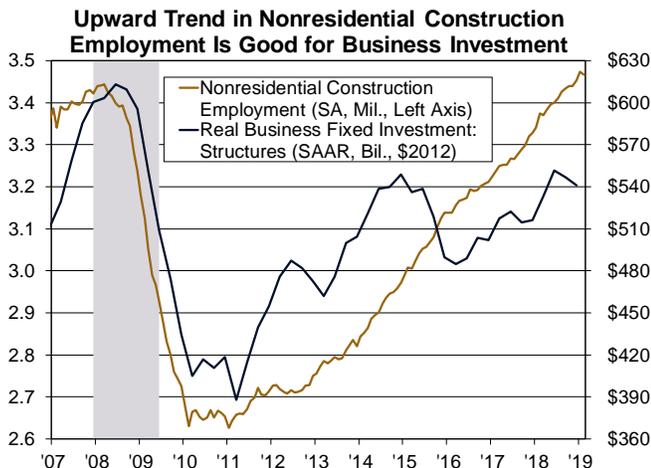
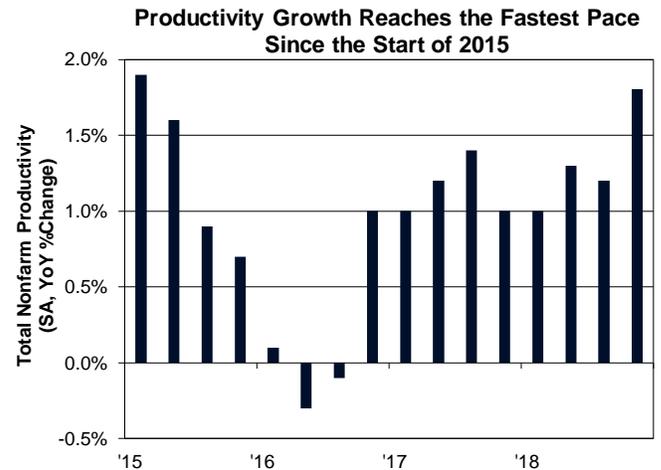
Business Investment and Productivity Growth Improved

Nonresidential investment growth accelerated to 6.2 percent annualized in the fourth quarter from 2.5 percent in the third quarter. Business spending growth was boosted by a 13.1 percent surge in intellectual property products, but we expect some giveback of that momentum this quarter. Equipment spending growth also quickened in the fourth quarter, but non-residential structures spending declined for the second consecutive quarter.

Business spending growth is expected to slow in the first quarter of 2019. The second straight month of declines in new orders of nondefense capital goods, excluding aircraft, in December will restrain business spending at the start of 2019. A continued upward trajectory in nonresidential construction employment, builders and specialty contractors, suggests that structures spending could stabilize in the first quarter. The decline in employment over February likely reflected severe winter weather during the month and is expected to prove temporary.



Productivity rose by 1.8 percent annually in the fourth quarter, breaking out of the 1.0 percent to 1.4 percent range that has prevailed since the end of 2016. Faster productivity presents upward potential for broader economic growth.





Trade Deficit Widens to a 10-Year High

The U.S. trade deficit widened over the fourth quarter of 2018, subtracting 0.2 percentage points from GDP growth. Exports rose by 1.6 percent annualized over the fourth quarter, but import growth rose by 2.7 percent. The U.S. trade deficit hit a 10-year high of \$59.8 billion in December, driven by a surge in imports while exports posted the largest monthly decline in nearly three years.

The trade deficit is expected to widen this quarter. We expect exports to decline further as slower economic growth abroad limits foreign demand for U.S. goods and services. Additionally, the dovish shift by the European Central Bank (ECB) could result in a stronger dollar relative to the euro, making U.S. exports more expensive to our major trading partners in Europe. However, if the ECB policy change strengthens aggregate demand across the euro area, then U.S. exports could ultimately benefit.

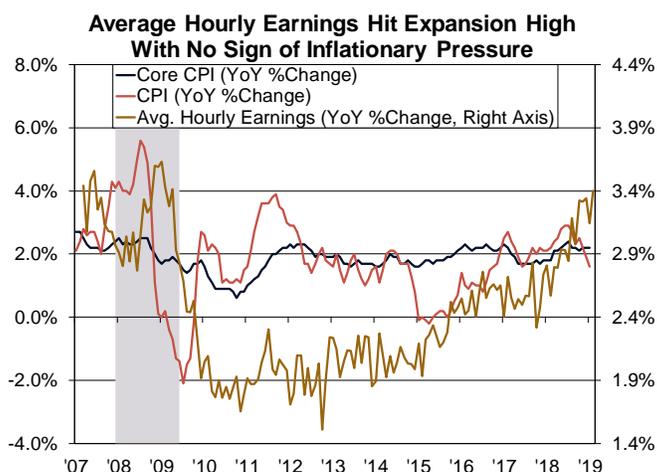
Government Spending and Private Inventories Contribute to Growth

Government spending slowed in the fourth quarter, partly reflecting a 5.6 percent decline in nondefense federal expenditures, the largest drop since the fourth quarter of 2013, when the government also experienced a shutdown. Much of this spending is expected to be recouped over 2019, and the federal government is expected to ultimately raise the debt limit that was reinstated on March 2. However, any flare-up in political tension associated with the process of raising the debt ceiling could weigh on business and consumer sentiment. Nevertheless, the boost to government spending from the 2018 Budget Reconciliation Act is expected to fade by the end of 2019, limiting future spending growth. Meanwhile, private inventories edged up in the fourth quarter, contributing only 0.1 percentage points to growth, the smallest positive contribution since 2002. We expect inventory investment to slow in the first quarter, dragging modestly on growth.

Despite a Lower Unemployment Rate, Upside Inflationary Risks Appear Limited

The February jobs report indicated that the economy added 20,000 jobs, a sharp decline from the upwardly revised 311,000 jobs added in January and the slowest pace of job growth since September 2017. The less volatile three-month moving average declined by 59,000 to 186,000. However, other metrics from the report suggest that the labor market remains solid. The labor force participation rate held steady at the highest rate since September 2013. The unemployment rate fell two-tenths to 3.8 percent, suggesting that the effects from the government shutdown on the unemployment rate have been reversed. Average hourly earnings growth rose 3.4 percent year over year, an expansion best.

Despite the uptick in wage growth to a near-decade high, inflationary pressures remain limited. The PCE deflator, the Federal Reserve's preferred measure of inflation, slowed to 1.7 percent annually in December, while core PCE growth, which excludes more volatile food and energy prices, held steady in December at 1.9 percent. In February, the Consumer Price Index (CPI) showed that annual headline inflation had decelerated for the fourth consecutive month to 1.5 percent. Core CPI grew 2.1 percent annually and has ranged between 2.1 percent and 2.4 percent since March 2018. The University of Michigan's measure of expected inflation one year from now has fallen to 2.6 percent, the lowest level since November 2017, a month before the Tax Cuts and Jobs Act was signed into law. In addition, the announcement by the Administration of an indefinite delay of the tariff hike on \$200 billion in imports from China will also constrain inflation.



Downside Risks Lessen

Over the month of February, many of the downside risks to our forecast have moderated. While the trade conflict between the U.S. and China has not been resolved, at the end of February the Administration announced a delay of the tariff hike on \$200 billion in Chinese exports to the U.S. that was slated to begin on March 2. The Administration cited "substantial progress" in trade talks. The U.S. ambassador to China noted that while a trade deal is not imminent, the two sides are "closer than they have been for a long time." On March 10, the Wall Street Journal reported that China has agreed to not devalue its currency to help its export sector.



Slowing foreign growth could also undermine our forecast. China's February exports fell 20.7 percent from a year earlier, the steepest decline in three years. Chinese exports to the U.S. plunged 26.2 percent, a decline that may be partly attributable to higher U.S. tariffs. China's government expects economic growth in 2019 to fall within a range of 6.0 to 6.5 percent, slowing from 2018's pace of 6.6 percent. In response to slower growth, a package of tax cuts, increased government spending, and relaxed controls over foreign access to Chinese markets was announced.

The ECB recently lowered its economic growth projection for the euro area in 2019 by six-tenths to 1.1 percent and lowered its inflation outlook four-tenths to 1.2 percent, further below its 2.0 percent target. Expectations of slower economic growth, lower inflation, and the potential of a "hard Brexit" (i.e., that the United Kingdom would leave the European Union without a deal to lessen the economic shock) prompted the ECB to announce that it will now hold interest rates steady through the end of the year as well as offer a series of cheap long-term loans to the region's banks.

The Federal Reserve Announces It Will Remain Patient

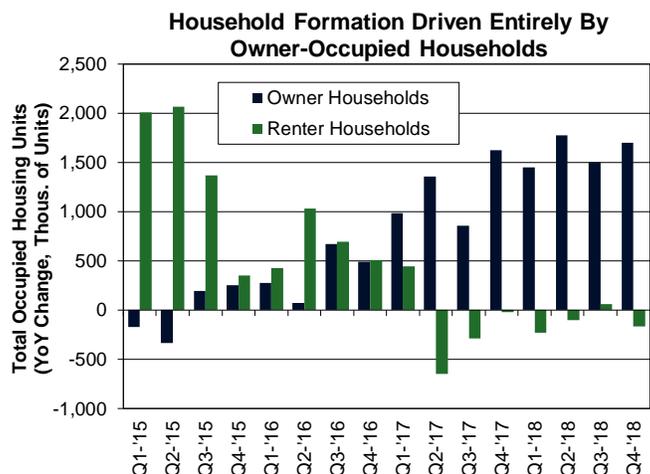
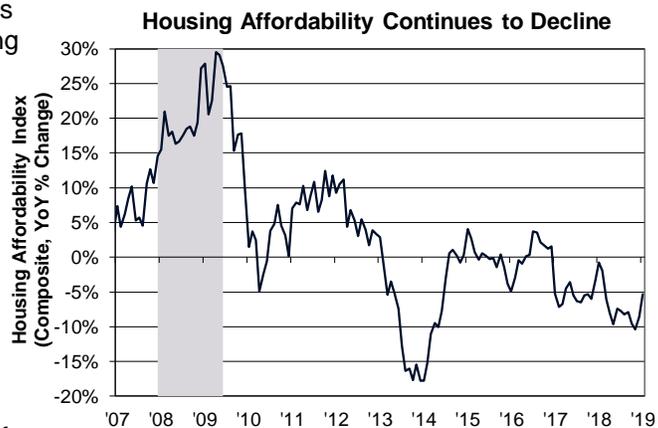
The Federal Reserve maintained its key policy rate at a range of 2.25 to 2.50 percent at its January meeting and noted in its statement that it would be patient in determining future adjustments to the federal funds rate. Financial conditions, measured by the Federal Reserve Bank of Chicago's National Financial Conditions Index, continued to ease in the weeks following the January meeting. The minutes of the January meeting signaled that the characterization of monetary policy as "patient" would need to be reassessed if uncertainty abated. Although policy responses to slowing foreign economic growth and progress on the U.S.-China trade conflict have materialized, more time is likely needed to assess the full impact on the economy from these risks. Amidst these risks and uncertainties as well as still-muted inflation, we have pushed back our expectation of the timing of the Federal Reserve's next rate hike from mid-year to the fourth quarter of 2019. If downside risks continue to dominate, then we do not expect there to be an increase in 2019.

Home Sales Remain Soft as Affordability Outlook Improves

Home sales remain soft relative to their year-ago pace. Annualized existing home sales fell 8.5 percent in January to 4.94 million, the lowest level since November 2015. Sales of new homes were 2.4 percent below their year ago level in December. According to the National Association of Realtors' Housing Affordability Index, home buying affordability declined on a year-over-year basis in January for the 25th consecutive month. However, the recent decline in mortgage rates has helped improve affordability. Contract rates on 30-year mortgages fell in February to a monthly average of 4.37 percent, the third consecutive monthly drop. In addition, the S&P Case/Shiller National Home Price Index indicated that annual home price growth decelerated to 4.7 percent, the slowest pace of growth since September 2015.

The Housing Vacancy Survey reported that household formation increased by 1.5 million units year over year in the fourth quarter of 2018 as a sharp expansion in the number of owner-occupied households over the quarter offset a small contraction in renter households. In addition, pending home sales, which measure contract signings on existing homes, rose 4.6 percent in January, suggesting that closings on existing homes should experience growth in the coming months.

Prospects for housing demand remain favorable, but several recent releases suggest that some momentum has been lost. Following a surge in January, average monthly purchase applications fell 10.3 percent in February to a level 1.1 percent above the December reading, suggesting more modest growth in home sales at the beginning of the year than we anticipated last month. Fannie Mae's Home Purchase Sentiment Index[®] reported that the percentage of respondents believing it is a





good time to buy a home fell 7 points in February from the prior year.

Supply of existing homes remains low and could derail homebuying entering the spring season. Although the months' supply of existing homes rose to 3.9 months in January, it remains well below the 6.0-month level consistent with a balanced market. Months' supply of new homes sat at 7.8 months in December, unchanged for the third straight month. In addition, the 25.1 percent increase in single-family starts in January suggests that additional supply could arrive in the coming months.

We continue to expect home sales to hold steady in 2019 near 2018 levels. In response to the decline in average monthly purchase mortgage applications in February, we lowered our forecast of home sales in the first half of 2019. However, we expect a portion of these sales to be recovered in the second half of the year as mortgage rates remain low.

Due to the small downward revision to our home sales forecast this year, purchase mortgage originations were lowered to \$1.176 trillion from \$1.181 trillion and are now expected to expand by 2.7 percent from 2018, slightly less than the 3.0 percent projected increase in our February forecast. Refinance originations were lowered from \$431 billion to \$417 billion in response to a 4 basis point increase in our projection for mortgage rates in 2019 and are now projected to shrink by 8.6 percent in 2019 from their 2018 level, steeper than the 6.5 percent decline projected in our February forecast.

For information on multifamily market conditions, please see the [March 2019 Multifamily Market Commentary](#).

Economic & Strategic Research (ESR) Group

March 11, 2019

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: Bureau of Economic Analysis, Federal Reserve, Census Bureau, Bureau of Labor Statistics, National Association of REALTORS®

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