Fannie Mae

Economic and Strategic Research

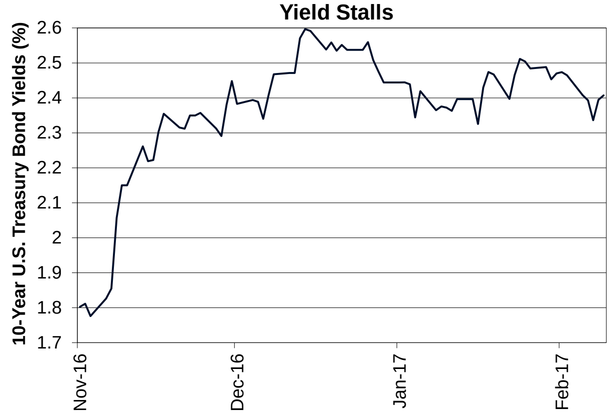
Economic Developments – February 2017

Subdued Growth Continues as Markets Assess Policy Risks

We expect full-year economic growth to be 2.0 percent for 2017, similar to the 1.9 percent growth in 2016 and unchanged from our prior forecast. Consumer spending's contribution to growth in 2017 should decline slightly, government spending should add to growth at a similar pace, and residential and nonresidential investment should contribute more to growth. Trade is expected to be a bigger drag on growth this year than last year, while inventory investment should add slightly to growth after subtracting from it in 2016.

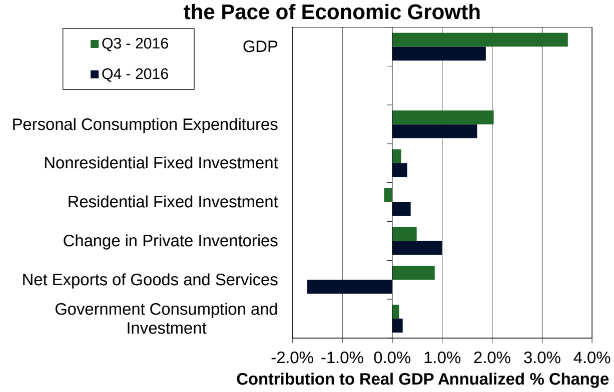
Our view is based on the assumption that materially positive impacts on growth from any new fiscal stimulus and deregulation will likely be limited in 2017. In addition, we see some downside risks from the Administration's trade and immigration policy. The President's executive orders so far have been generally consistent with expectations stemming from his campaign promises, including rejecting the Trans Pacific Partnership (TPP), reviewing the North American Free Trade Agreement, tightening travel and immigration policy, repealing the Affordable Care Act, and reducing regulatory burden. Considerable uncertainty regarding the net impact of new policies on the economy leads us to wait for more clarity before factoring them into our forecast, as the policy agenda presents risks in both directions. For example, while a lighter regulatory burden could potentially be a positive for businesses, restricted travel and immigration policy could hurt businesses' ability to recruit talent. Also, walking away from the TPP is potentially detrimental to growth, because if the rest of the TPP countries successfully form free-trade agreements, the U.S. will be left out of the benefits of resulting trade with those countries.

Post-Election Rise in U.S. 10-Year Treasury Yield Stalls



Following the post-election run-up, long-term Treasury yields have slipped, with the 10-year Treasury yield hovering around 2.4 percent at the time of this writing, still more than 50 basis points higher than immediately before the election. Global economic growth has gained momentum, but downside risks from Europe and elsewhere, including banking stress in Italy, elections in the Netherlands and France, and financial instability in China, remain in the near term.

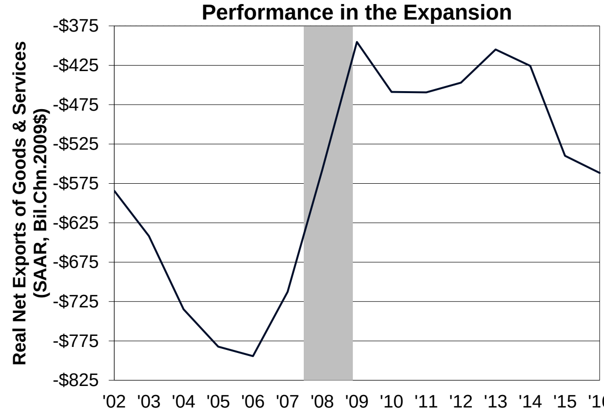
An Expected Drag from Net Exports Slows Down the Pace of Economic Growth



Trade Subtracts Sizably from Growth

As expected, economic growth slowed to 1.9 percent annualized in the fourth quarter after an unsustainably strong third quarter. Following an outsized rise in net exports in the third quarter due to a temporary surge in agricultural exports, net exports posted a record quarterly drop. In the fourth quarter, trade was the only detractor from growth among the major components of gross domestic product (GDP), but the drag from net exports was large enough to fully offset the contribution from consumer spending. For all of 2016, net exports posted the worst annual performance during the expansion.

Net Exports Post the Worst Annual Performance in the Expansion

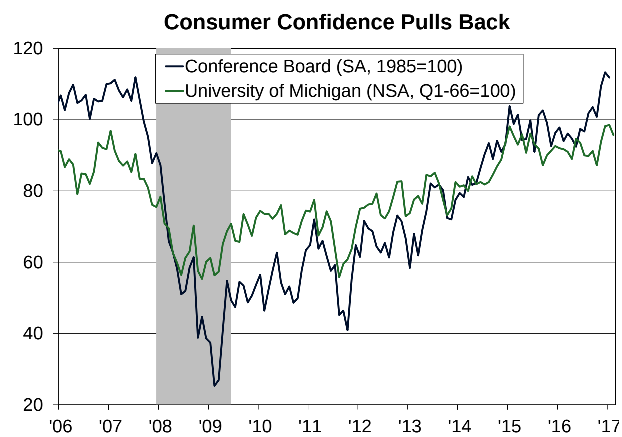


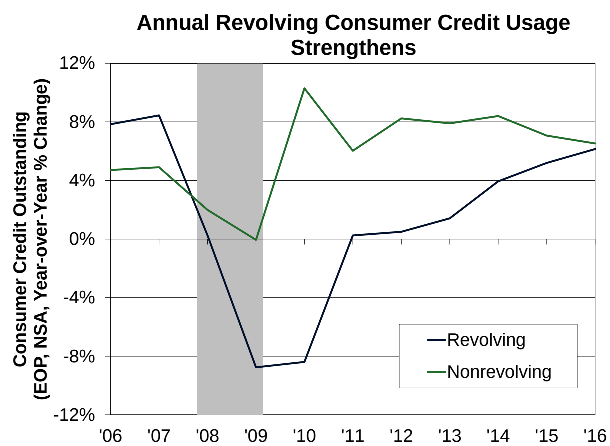
Meanwhile, residential fixed investment contributed to growth for the first time in three quarters. Business fixed investment expanded modestly for the third consecutive quarter as the first expansion in equipment investment in five quarters and ongoing growth in intellectual property outweighed the drop in structures investment. The volatile inventory investment component made the largest contribution to growth since early 2015. Despite the weakening growth headline, a gauge of domestic demand, final sales to domestic purchasers (or GDP excluding net exports and inventory investment) accelerated to 2.5 percent annualized, the strongest gain since the third quarter of 2015.

Consumer Spending Will Underpin Economic Growth…

We expect economic growth in the current quarter to be similar to the fourth quarter, supported by slightly stronger real consumer spending growth. Real consumer spending ended 2016 on a strong note, rising 0.3 percent. The gain was driven by an increase in auto sales to an expansion high. However, auto sales fell 4.4 percent in January, more than offsetting the gain in the prior month. Consumer spending increases continued to outpace gains in personal disposable income, and, as a result, the saving rate fell in December for the second consecutive month to 5.4 percent, the lowest reading since March 2015. Increased household net worth from rising equity values and strong home price gains should help support consumer spending, but increasing energy prices will weigh on real disposable income.

Consumer sentiment cooled slightly in January, with the Conference Board consumer confidence index slipping from a 15-year high at the end of 2016. The largest drop in the expectation component since November 2015 outweighed the rise in the present situation component. The University of Michigan preliminary sentiment index pulled back in February for the first time in four months as the expectations component eroded, with household finance expectations declining to the lowest level since last August. Both measures of confidence remain elevated, however, which should help support demand for credit, another driver of consumer spending. Growth in revolving credit (largely credit card debt) slowed markedly in December after posting the biggest annual gain of the expansion in November. However, for all of 2016, the gain in revolving credit continued to accelerate to 6.1 percent, rivalling the increase in nonrevolving credit outstanding (largely auto and student loans), which has decelerated in recent years to 6.5 percent. However, the increase in revolving credit in 2016 was still smaller than the gains seen prior to the recession.

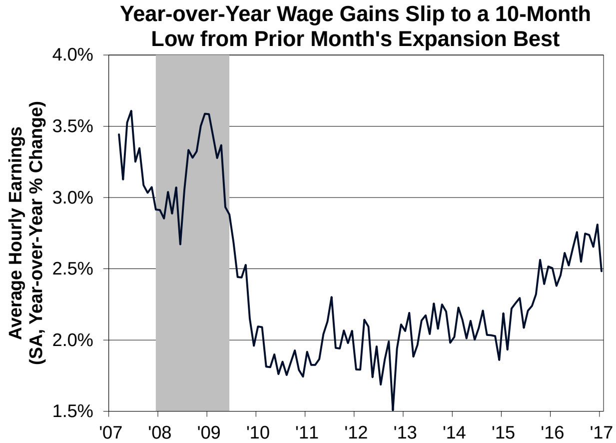


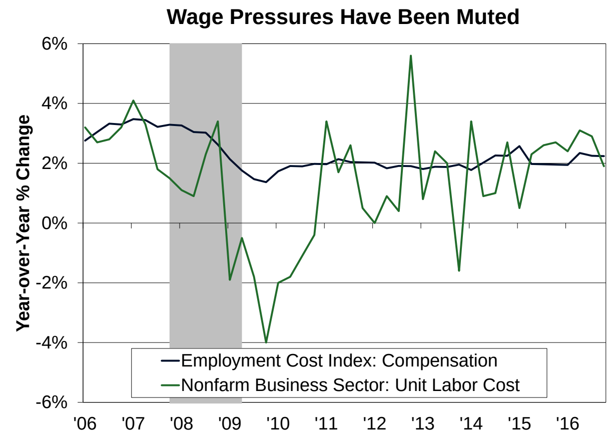


One potential headwind for consumers is tighter lending standards for autos, credit cards, and other consumer installment loans. The Federal Reserve Senior Loan Officer Opinion Survey for the three months ending in January showed that the net share of banks reported tightening standards for auto loans jumped to the highest level since the inception of the series in the second quarter of 2011. Tightening likely reflected the potential for increased defaults on subprime auto loans as interest rates rise. Another notable result from the survey was the surge in the net share of banks tightening lending standards for credit cards for the first time in nearly seven years to the highest reading since the second quarter of 2010.

…With Support from the Labor Market

Labor market conditions were mixed in January. Nonfarm payrolls increased by 227,000, and, despite downward revisions to the prior two months' data, the average monthly gain over the past three months picked up to 183,000, the best hiring pace since last October. However, wage gains disappointed, with average hourly earnings up only 0.1 percent during the month despite increased minimum wages in many states around the start of the year. Annual wage gains slowed to 2.5 percent from an expansion high in the prior month. Other recent wage-related reports also showed muted wage pressures in the fourth quarter. The Employment Cost Index showed that annual growth in compensation held steady, while the productivity report pointed to moderating unit labor cost growth.





The January employment report also showed an uptick in the unemployment rate to 4.8 percent amid the second consecutive increase in the labor force participation rate. More people joining the labor force point to more slack in the labor market than the 4.8 percent unemployment rate might suggest. Overall, despite the stronger-than-expected headline, the January employment report pointed to more room for improvement in the job market and a lack of wage pressure, supporting a gradual normalization of monetary policy.

Business Investment Fundamentals Improve

Nonresidential investment in both structures and equipment fell in 2016, in large part reflecting declines in mining activity resulting from falling oil prices. The recent upturn in oil prices has boosted drilling activity and mining exploration, and as a result nonresidential investment should add slightly to growth in coming quarters. However, nonresidential investment in structures faces the headwind of ongoing tightening of lending standards on commercial real estate loans. The Fed survey showed that banks continued to tighten lending standards for commercial real estate loans but not as severely as in recent quarters. The trend in commercial real estate loan demand has been softening in recent years, and the latest survey showed the first decline in demand since 2010.

We expect some improvement this quarter in business investment in equipment, as its leading indicator, core capital goods orders, rose in December for the third consecutive month. While improved business sentiment is encouraging, without a concrete plan for tax cuts and deregulation, we expect only a slight improvement in business investment this year.

Fed Expected to Gradually Tighten amid Fiscal Policy Uncertainty

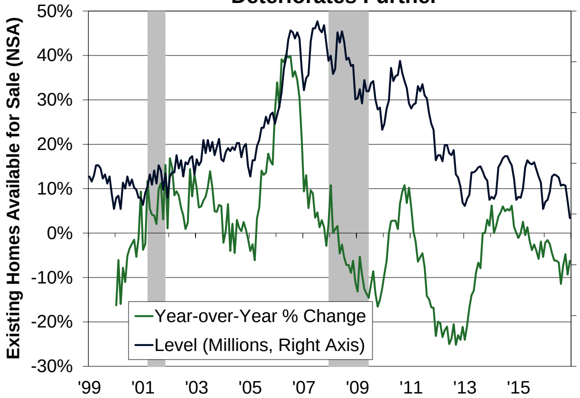
The Fed held the target range for the fed funds rate steady at the January 31-February 1 Federal Open Market Committee meeting. Overall, the statement was little changed relative to December. The Committee removed the reference to transitory factors related to energy and import prices as holding down inflation, likely reflecting the recent firming in energy prices. The Fed’s preferred measure of inflation—personal consumption expenditures deflator—posted a year-over-year increase of 1.6 percent in December, the fastest gain since September 2014. While the statement acknowledged inflation is below the Fed’s two-percent target, it noted inflation had “increased in recent quarters.” Given substantial fiscal policy uncertainty, we expect two quarter-point rate hikes this year, with the first occurring in June.

Housing Roundup

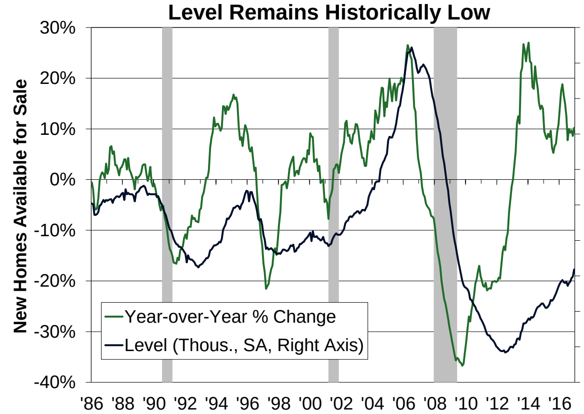
Both existing and new home sales declined in December, likely due to the spike in mortgage rates after the election. For all of 2016, existing and new home sales posted the best annual performance since 2006 and 2007, respectively. Inventory remains very tight, as the number of existing homes for sale has fallen year-over-year for 19 straight months, ending the year at a record low since the series’ inception in 1999. While the inventory of new homes for sale has trended up, it remains historically low.

The depressed level of inventory has maintained upward pressure on home prices, as the main price measures recorded solid year-over-year growth in late 2016. Both the Case-Shiller and the CoreLogic National House Price Indices showed that homes in the lower price range appreciated faster than those in the upper end of the price distribution.

Inventory of Existing Homes for Sale Deteriorates Further

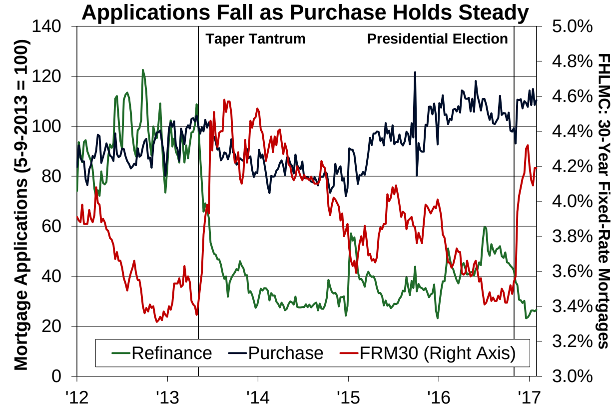


New Home Inventory Has Trended Up, But the Level Remains Historically Low



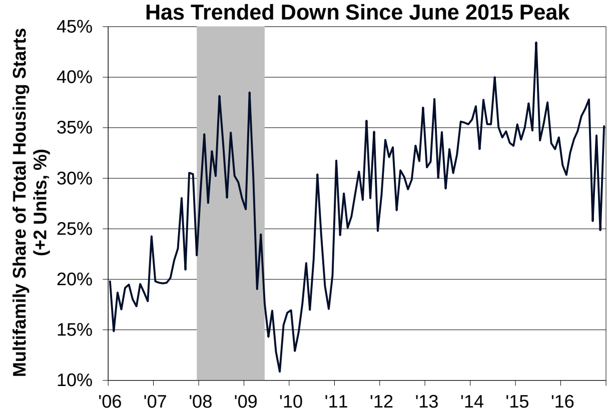
Leading indicators of home sales have been encouraging. Pending home sales, which record contract signings on existing home sales, rebounded in December, and purchase mortgage applications continue to hold up well relative to refinance applications. In addition, the Fannie Mae Home Purchase Sentiment Index® (HPSI) showed that housing sentiment rebounded in January, ending a string of five consecutive monthly drops.

After Post-Election Rise In Rates, Refinance Applications Fall as Purchase Holds Steady



While mortgage rates trended down to an average of 4.17 percent during the second week of February after their recent peak of 4.32 percent at the end of 2016, they remain more than 60 basis points higher than during the first week of November. It is premature to suggest that home sales will be immune to the post-election rise in mortgage rates. Higher rates might have brought buyers into the market before rates increased further, which would mean that the rise in rates pulled forward some sales, and the negative impact of rising rates will be felt with a lag.

Multifamily Share of New Home Construction Has Trended Down Since June 2015 Peak

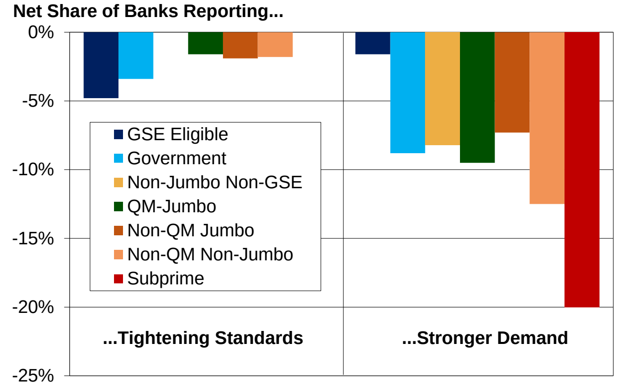


Single-family housing starts fell further in December from the expansion best in October, while multifamily starts remain very volatile, jumping following a large drop in the prior month. For all of 2016, total housing starts reached the highest level since 2007, but the annual gain was the weakest since 2011. Single-family starts have risen every year of the expansion except 2011 but still remain more than 240,000 units below the long-term annual average of 1.02 million units. Multifamily construction likely has peaked, declining slightly in 2016 after recording the sector's best year since 1988 in 2015. The multifamily share of total housing starts also peaked in 2015 and has trended down since, hovering around 35 percent in recent months. Home builders remain optimistic in early 2017, hopeful of regulatory reform under the new Administration and Congress. Their top concerns for 2017 include rising mortgage rates, a lack of lots, and labor shortages.

Rising mortgage rates likely led to declining mortgage demand reporting by lenders. The Federal Reserve's Senior Loan Officer Opinion Survey for the three months ending in January showed that overall mortgage demand fell from the prior quarter for the first time in a year. In addition, demand for mortgages declined across all loan types for the first time in two years. The drop in demand occurred amid the 11th consecutive quarter that the net share of banks reported easing lending standards, though the share in the most recent three months was the smallest of the easing streak.

Our forecasts of mortgage rates, home sales, and home prices are little changed from last month. We expect mortgage rates to rise only gradually, from an average of 3.8 percent in the fourth quarter of 2016 to 4.3 percent during the fourth quarter of 2017. We project that total home sales will continue to increase in 2017 but that the pace of gains should slow to 2.2 percent from 4.5 percent in 2016. Our 2017 home sales outlook hinges on our expectation for a slow rise in interest rates and continued improvements in household income and household formation. We project total mortgage originations to drop about 19 percent this year to $1.57 trillion, as the decline in refinance originations outpaces the rise in purchase originations. The refinance share of total production should decline 15 percentage points from 2016 to 33 percent.

Mortgage Demand Declines Across All Loan Types, Amid Easing Lending Standards



Economic & Strategic Research (ESR) Group

February 10, 2017

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, Bureau of Economic Analysis, The Conference Board, The University of Michigan, Bureau of Labor Statistics, National Association of REALTORS®, Census Bureau, Mortgage Bankers Association, Freddie Mac, FHFA, Case-Shiller, CoreLogic.*

Opinions, analyses, estimates, forecasts and other views of Fannie Mae's Economic & 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.

ESR Macroeconomic Forecast Team

Doug Duncan, SVP and Chief Economist
Orawin T. Velz, Director
Hamilton Fout, Director
Mark Palim, VP and Deputy Chief Economist
Frank Shaw, Economist
Michael T. Vangeloff, Strategic Planning Analyst III