

## Weathering the Headwinds

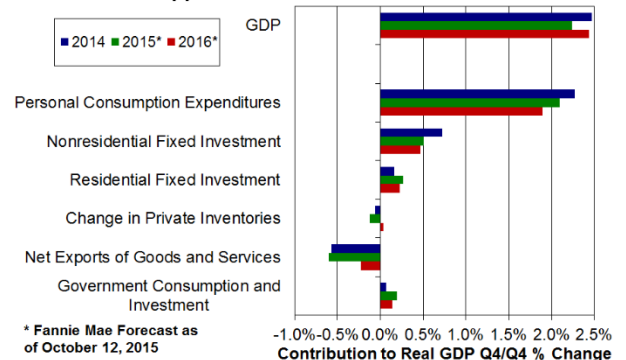
Economic growth in the first half of 2015 turned out to be decent despite a very slow start, thanks to a large upward revision that put second quarter growth at nearly 4.0 percent. However, the outlook for the second half is less upbeat than a month ago. While consumer spending appears to be holding up reasonably well, the economy is increasingly feeling the impact of the appreciating dollar and slowing global growth, especially in emerging markets. As a result, net exports will likely act as a significant drag on growth in the second half of the year, and declining demand abroad should continue to weigh on manufacturing. We now expect third quarter real gross domestic product (GDP) growth to come in at 1.7 percent annualized, a sizable downgrade from 2.5 percent in the prior forecast. While the inventory drawdown and deteriorating trade deficit are drags on growth as we anticipated, their impacts appear to be more substantial than we had projected. Growth should still pick up in the fourth quarter, as domestic demand should remain supportive amid a fading inventory drag. We expect the economy to grow 2.2 percent this year before strengthening slightly to 2.4 percent in 2016, as the negative impact from the strong dollar dissipates. Consumer spending should be the biggest driver of growth again in 2016, while net exports should be a smaller drag.

The expected downshift in growth in the third quarter is not because of more cautious consumers. Real consumer spending increased 0.4 percent in August following a 0.3 percent rise in July, and auto sales jumped in September to over 18 million annualized units—the highest in more than a decade. For the third quarter, real consumer spending growth likely came in at a similar pace to the second quarter’s 3.6 percent annualized. The renewed decline in gasoline prices will help boost purchasing power as it weighs on headline inflation. The personal consumption expenditures (PCE) deflator was flat in August, held down by declining energy prices, marking the first time it failed to increase in seven months. The underlying inflation trend has been steady, but remains well below the Fed’s 2-percent target, as core prices (excluding food and energy items) rose 0.1 percent from July and 1.3 percent from August 2014, posting the same year-over-year gain recorded for six of the last seven months.

The strength in consumer spending was in contrast to the downbeat September 2015 jobs report. Job gains for September came in at 142,000, well below expectations. In addition, August and July job gains were revised substantially lower, contrary to a widely anticipated sizable upgrade for August. As a result, the average monthly gain for the three months ending in September moderated to 167,000, the weakest since February 2014. For private-sector payrolls, the average monthly gain during the period was considerably weaker at 138,000, the worst showing since August 2012. Weakness was broad-based, affecting the manufacturing and energy sectors as expected, but also extending into the service industry. The average workweek ticked down to 34.5 hours, while average hourly earnings came in flat, leaving the year-ago increase unchanged at an uninspiring 2.2 percent.

The household survey wasn’t much better: The unemployment rate held steady at 5.1 percent amid a 0.2 percentage point decline in the labor force participation rate to a 38-year low of 62.4 percent. One improving aspect in the household

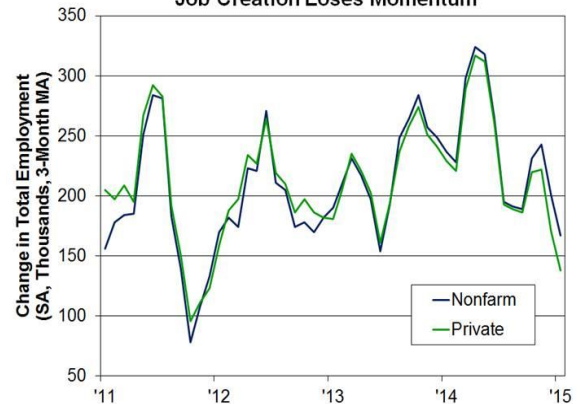
Consumer Spending Should Remain Supportive of Modest GDP Growth



Renewed Declines in Gasoline Prices Weigh on Inflation and Boost Disposable Income



Job Creation Loses Momentum



survey was a 0.3 percentage point drop in the broadest measure of unemployment (U-6) to 10.0 percent, as the number of part-time workers who want full-time jobs fell sharply during the month. Year to date, the U-6 has declined 1.3 percentage points, more than double the drop in the headline unemployment rate.

The weakness in the jobs report was at odds with other employment-related data, including initial jobless claims. The four-week moving average in claims fell in early October for the fourth consecutive week, keeping claims near their expansion lows. However, if the employment trend fails to show some improvement in the near term, it will add downside risks to our forecast of a pick-up in economic growth in the fourth quarter of this year.

We believe that the bearish jobs report and steady (albeit well below target) inflation make it unlikely that the Fed will raise rates this year, despite the fact that Fed Chair Yellen indicated in her September 24 speech that a hike before year's end was the most likely outcome. The minutes to the September 16-17 Federal Open Market Committee (FOMC) meeting showed that Fed officials focused on the risks around low inflation. Several voters cited the risk that deflationary pressures from lower oil prices or a stronger dollar "could persist and, as a result, delay or diminish the expected upturn in inflation." In the end, Fed officials decided that "it was prudent to wait for additional information," including data that would "bolster members' confidence" that inflation will move higher, before hiking rates. To the extent that "global developments" can put downward pressure on inflation (e.g., through declining import prices), it will likely take a long time to build confidence that inflation will move toward the Fed's target in the medium term. We now expect the liftoff in March 2016, as do market forward expectations, but would not be surprised if it happens this December or next June.

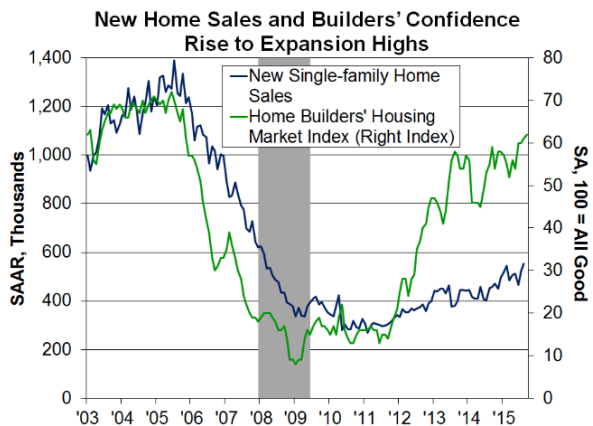
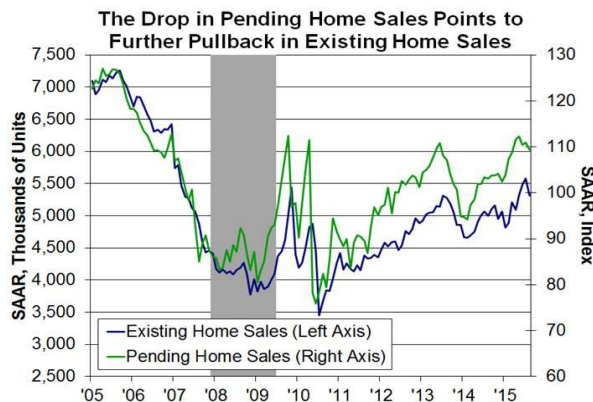
The impact of the appreciating dollar is evident in September import prices. Non-petroleum import prices fell for the ninth consecutive month and will likely continue to weigh on consumer goods inflation for the rest of the year. At the same time, the strong dollar and weak global growth are hurting the U.S. trade deficit. The August trade gap widened significantly and was the largest in five months, as exports fell for the third time in four months and imports rose for the second time in three months. After adding slightly to GDP in the second quarter, net exports should resume dragging on growth during the rest of the year.

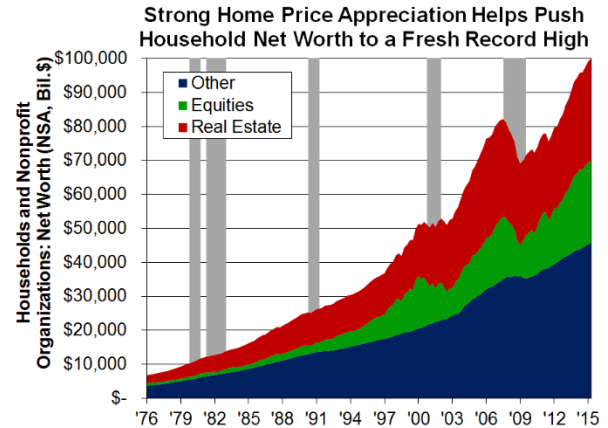
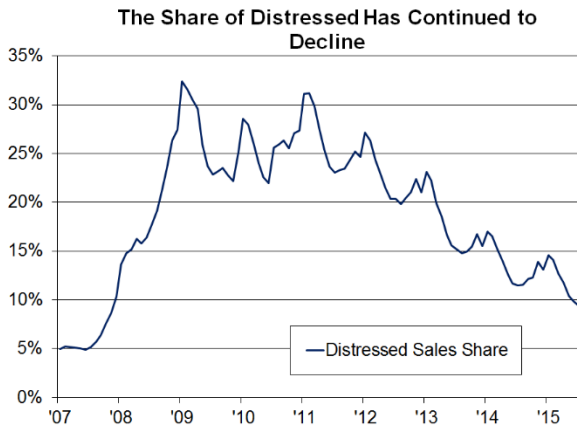
Slow global demand has hurt the manufacturing sector. The Institute for Supply Management (ISM) showed that the manufacturing index fell in September for the third consecutive month, sending the index to the lowest level since May 2013, where it now stands just slightly above the 50-mark threshold, indicating expansion in the sector. The expansion in the service industry also slowed during the month, with the ISM nonmanufacturing index falling for the second consecutive month. However, unlike the manufacturing index, the nonmanufacturing index remains well in expansion territory.

### Housing Roundup

Housing indicators were mixed in August. On the negative side, single-family and multifamily starts and existing home sales dropped during the month. The inventory of existing homes for sale (not seasonally adjusted) remains tight, however, posting a year-over-year drop for the third month in a row. Pending home sales, a forward-looking indicator of existing home sales, fell for the second time over the last three months, suggesting existing home sales could remain soft in the near term. Purchase mortgage applications also trended lower in August, but picked up in September and surged in early October as lenders rushed to file applications before the new TILA-RESPA Integrated Disclosure (TRID) rule took effect on October 3. In contrast to the sharp drop in existing home sales, new home sales jumped in August after a surge in July, rising to a fresh expansion high. Inventories of homes for sale also remain near historic lows, which bodes well for housing starts going forward if supply constraints from the shortage of skilled labor are alleviated. The upward trend in new home sales is consistent with home builders' rising confidence, which moved up in September for the third time over the last four months to the highest reading of the expansion.

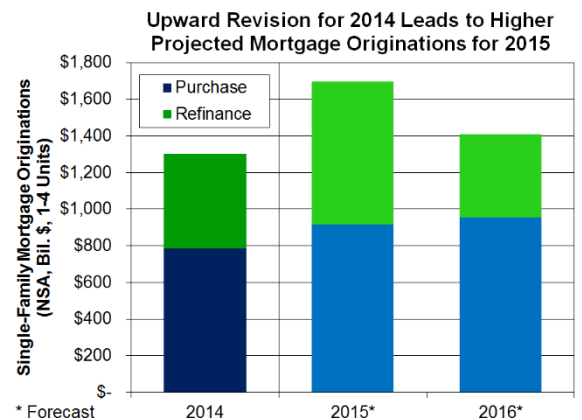
Supported by lean inventories, home prices showed healthy gains this summer, with the main home price measures showing annual gains of approximately 5.0 percent in July. In addition to the tight inventories,





distressed sales have trended down. Distressed sales as a share of total existing home sales fell to 9.4 percent in July, the lowest share since prior to the recession, according to data from CoreLogic. The most bullish measure of home prices, the CoreLogic Home Price Index, which is used by the Federal Reserve to estimate the value of owner-occupied real estate, jumped in August, posting the biggest year-over-year gain since last June. Strong home price gains helped drive the increase in second quarter household net worth to a record high, and likely did so again in the third quarter. The gains in housing wealth were badly needed at a time when the equity market became very volatile amid global financial turmoil. While strong home price appreciation helps boost household net worth and lift negative equity mortgages into positive positions, home price gains that are faster than income growth erode affordability unless mortgage rates drop sufficiently. Over the longer term, demographics should turn more favorable for the housing market, with more Millennials forming households amid continued improving labor market conditions, creating increased demand for both rental and owner-occupied properties. With home building activity and home sales expected to increase in 2016, residential investment should continue to add to economic growth next year.

Jitters over global economic growth and the financial market's adjustment to the delay in the Fed's expected lift-off have caused long-term interest rates to move lower over the past month. Freddie Mac's weekly survey showed that the average yield on 30-year fixed-rate mortgages declined to 3.76 percent for the week ending October 8, the lowest level since the end of April. Given the risk-off environment, we expect mortgage rates to remain below 4.0 percent this year before rising only gradually to 4.1 percent by the end of next year, if the Fed begins normalizing monetary policy as we expect. Our forecast of housing activity is little changed over the past month, with total home sales projected to rise about 8.0 percent in 2015 before advancing another 4.0 percent in 2016. However, we updated our estimate of single-family (1-4 unit properties) mortgage originations for 2014, as a result of our annual benchmark to the newly released Home Mortgage Disclosure Act (HMDA) data. We revised higher our estimated purchase and refinance originations by \$107 billion and \$10 billion, respectively, putting 2014 mortgage originations at \$1.30 trillion, with a refinance share of 40 percent. We upgraded our projected mortgage originations for 2015 to \$1.70 trillion, an increase of about 31 percent from 2014, compared with a 25 percent rise in the prior forecast. The projected refinance share of 46 percent in 2015 is the same as we projected in the prior forecast. For 2016, we expect total single-family mortgage originations to decline from 2015 originations by approximately 17 percent to \$1.41 trillion, with a refinance share of 32 percent.



For information on multifamily market conditions, read the [October 2015 Multifamily Market Commentary](#).

October 12, 2015  
Economic & Strategic Research (ESR) Group

For a snapshot of macroeconomic and housing data between the monthly forecasts, please read the ESR Group's [Economic and Housing Weekly Notes](#).

**Sources for chart data:** Bureau of Economic Analysis, Energy Information Administration, Bureau of Labor Statistics, CoreLogic, the National Association of REALTORS®, the National Association of Home Builders, Census Bureau, the Federal Reserve Board, Fannie Mae ESR Group Forecast as of October 12, 2015

*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  
Orwin T. Velz, Director  
Richard Koss, Director

Mark Palim, VP  
Frank Shaw, Business Analyst  
Hamilton Fout, Director