



Economic Developments – December 2017

Domestic Demand Builds Momentum into 2018

Despite hurricane-related disruptions, third quarter real gross domestic product (GDP) growth strengthened by two-tenths from the second quarter to 3.3 percent annualized. While we expect domestic consumer and investment spending growth to pick up this quarter, trade will likely drag on growth and inventory investment should add less to growth this quarter. Thus, we expect headline growth to slow to 2.6 percent annualized in the fourth quarter, putting full-year 2017 growth at 2.5 percent. We anticipate that GDP growth will decelerate to 2.1 percent for all of 2018.

On December 8, Congress reached agreement on a two-week continuing resolution to keep the government operating as it works on a two-year spending bill. At the same time, Congressional negotiators are reconciling tax bills from the Senate and House with a goal of enacting legislation by the end of the year. We will wait to see the final bill before estimating its impact, but, if tax legislation is passed, it should be a net positive for growth in coming years, posing upside risks to our forecast.

Business Investment Shines

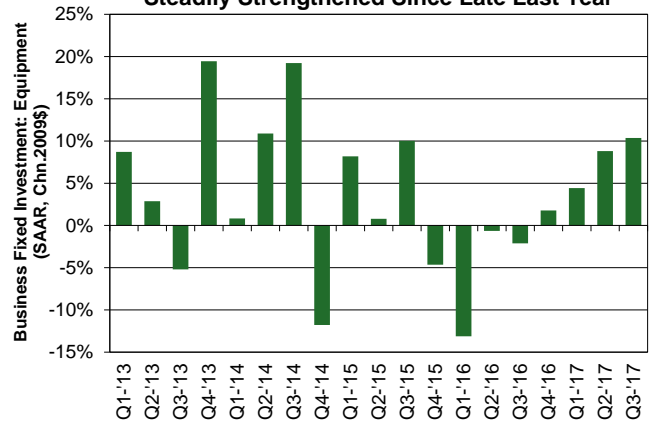
Our December forecast for 2017 economic growth is half a percentage point stronger than that in our January 2017 forecast. The biggest upside surprise to our economic forecast this year came from business equipment investment, which rose last quarter for the fourth consecutive quarter to the strongest pace in three years. At the start of the year, we had expected businesses to wait for widely anticipated fiscal stimulus before ramping up their capital expenditures. As it turned out, the unexpected strength in business equipment investment likely reflected, in part, deregulation that has occurred throughout this year.

To gauge regulatory actions, some analysts use the number of pages added to the Federal Register, where new regulations must be published. The number of Federal Register pages fell sharply from nearly 97,000 in 2016 to approximately 60,800 pages annualized as of early November 2017, the lowest reading since early 1990s. This marks the biggest decline in regulatory actions since the introduction of the Federal Register in 1936.

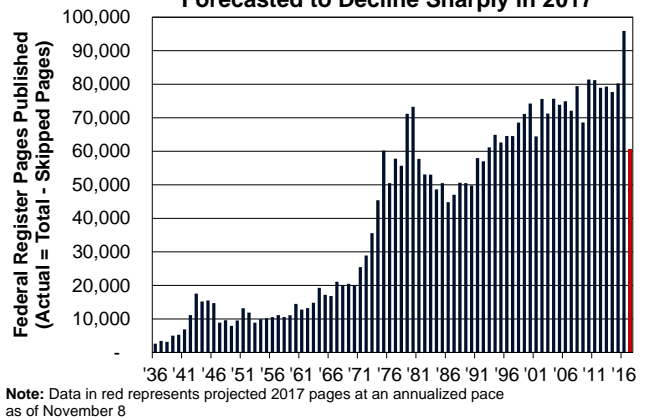
One way to see the impact of the rollback in regulations on business sentiment is to look at the survey of small businesses by the National Federation of Independent Businesses (NFIB). The survey showed that the Small Business Optimism Index jumped sharply after the presidential election. While the index has declined somewhat this year, the October index was only about two points shy of the expansion best reached in January.

Details of the NFIB survey show the share of small businesses saying that government requirements is the most important problem fell to 14 percent in October from 21 percent a year ago. Meanwhile, the percentage of businesses saying that the quality of labor is the most important problem surpassed those citing government requirements. However, taxes have consistently been the most important problem, cited by between 20 percent and 22 percent of respondents this year.

Business Capital Expenditures Growth Has Steadily Strengthened Since Late Last Year

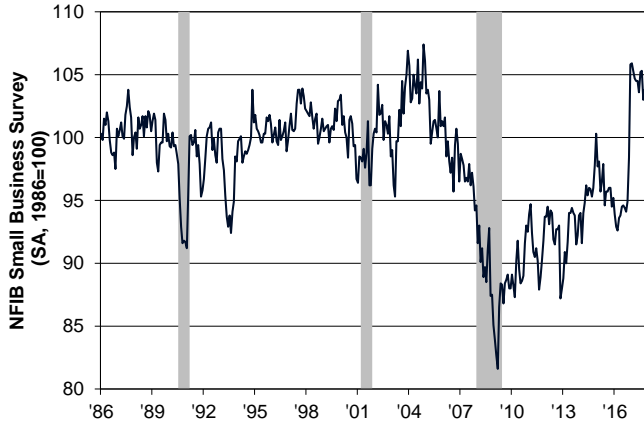


The Number of Pages in the Federal Register Is Forecasted to Decline Sharply in 2017

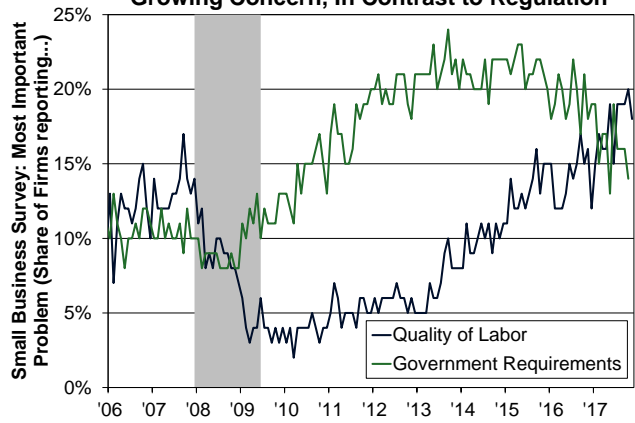




Small Business Confidence Remains Elevated



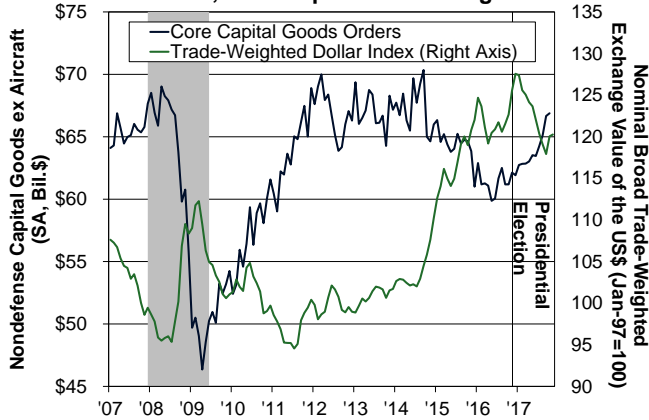
For Small Businesses, Quality of Labor Is a Growing Concern, In Contrast to Regulation



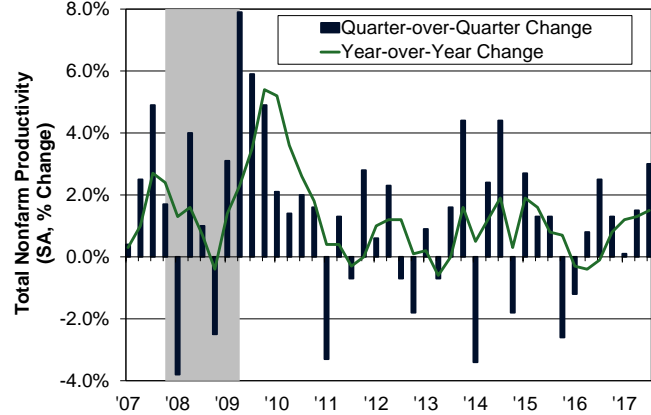
Deregulation is not the only factor supporting business equipment investment, however. Core capital goods orders (nondefense durable goods orders excluding aircraft)—a forward looking-indicator of business equipment investment—started to rebound late last year, coinciding with the election but also with the rebound in crude oil prices. As crude rebounded, core orders benefited from a recovery in mining machinery orders and energy exploration activity late in 2016. In addition, the decline in the dollar at the beginning of 2017 and strengthening demand abroad have also helped spur capital investment. In October, core orders rose for the fourth consecutive month, suggesting solid business equipment investment growth again this quarter.

As business capital expenditures growth firmed, productivity has shown signs of life. Nonfarm productivity (output per hour) rose 3.0 percent annualized in the second quarter, the strongest quarterly gain in three years. On a year-over-year basis, productivity increased 1.5 percent, the biggest annual gain since the second quarter of 2015. Still, over the current expansion, productivity growth has been anemic compared to previous expansions, suggesting more room to grow, which could allow economic growth to accelerate with wage pressures under control.

Core Capital Goods Orders Trend Up Since Election, with Help from Declining Dollar



Productivity Growth Shows Some Signs of Life



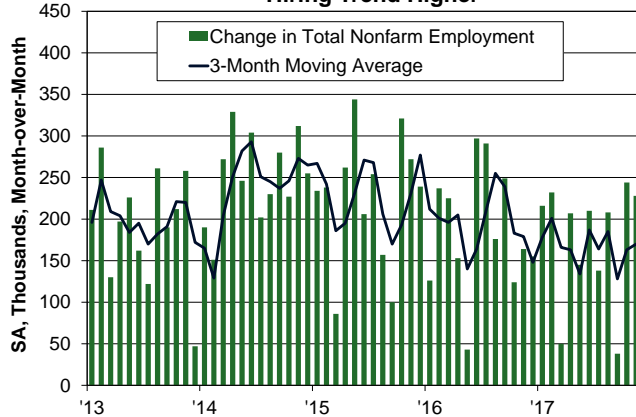
Jobs Growth Is Solid and Broad-Based

Nonfarm payrolls rose 228,000 in November. A small net upward revision for the prior two months put the three-month average gain at 170,000. The year-to-date average monthly gain came in at 174,000, compared with 190,000 in 2016.

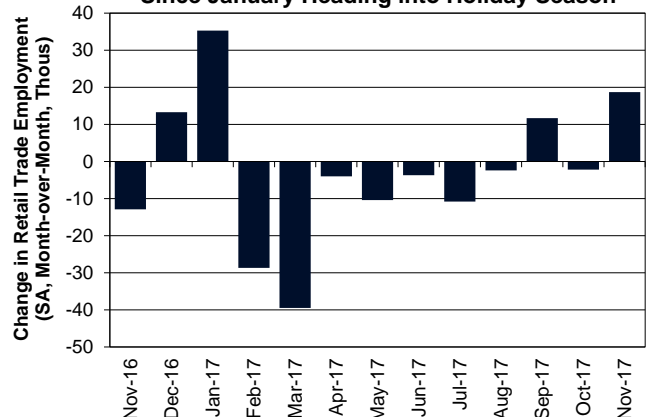
Job gains were broad-based. Manufacturing payrolls rose 31,000 following a 23,000 gain in the prior month, consistent with the strength in recent trends in core capital goods orders. Even the retail sector, which lost jobs in eight of the first eleven months this year, saw the biggest increase since January, soothing concerns about the health of brick-and-mortar store sales going into the holiday season. Residential construction employment also posted healthy monthly back-to-back gains, hinting that residential investment will likely add to growth this quarter for the first time in three quarters.



Another Solid Monthly Payroll Gain Lifts the Hiring Trend Higher



Retail Sector Posts Largest Monthly Job Gain Since January Heading into Holiday Season



Average hourly earnings rose 0.2 percent from October and 2.5 percent from a year ago, leaving the annual gain four-tenths below the expansion best seen last December. The average workweek increased for the first time in five months, ticking up to 34.5 hours. The increases in average hourly earnings and the average workweek, when combined with strong job gains, point to a more upbeat picture for labor income.

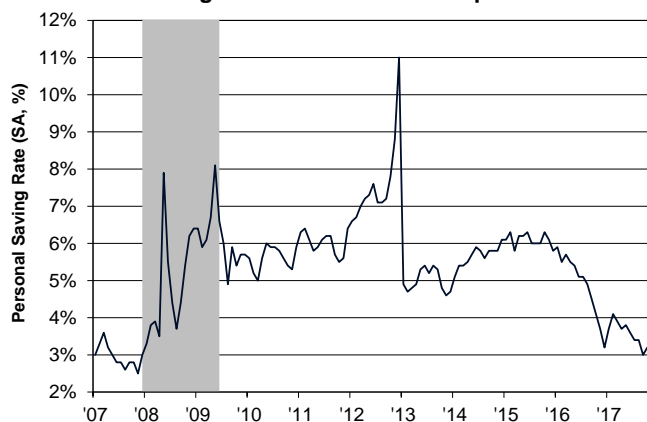
The household survey showed that the unemployment rate and the labor force participation rate were flat at 4.1 percent and 62.7 percent, respectively. The broadest measure of labor underutilization (the U-6 rate), which includes discouraged workers and part-time workers who prefer full-time jobs, edged up one-tenth from an expansion low to 8.0 percent.

Consumers Should Remain the Biggest Driver of Growth

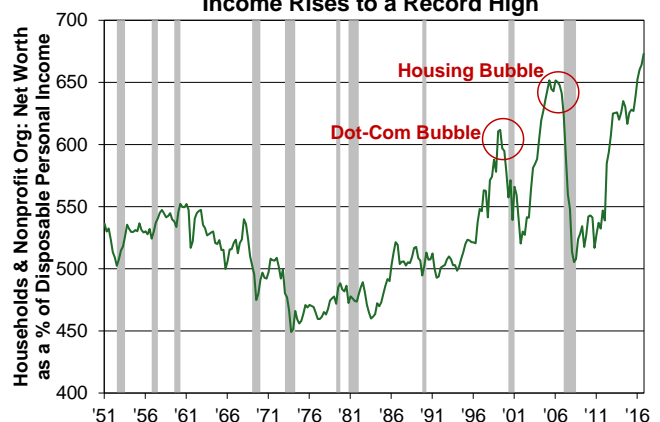
After a strong third quarter finish, consumer spending disappointed at the beginning of the fourth quarter. Real consumer spending edged up just 0.1 percent in October after a 0.5 percent gain in September, while real personal income rose 0.4 percent. The weaker spending growth and stronger income gain pushed the saving rate two-tenths higher from an expansion low to 3.2 percent, the first increase since May. The downtrend in the saving rate occurred as households reduced savings to boost consumer spending. The increase in labor income presaged by the employment report should provide more support for spending or for savings.

While the saving rate hovered around its expansion low, household net worth—assets minus liabilities—continued to rise, setting a fresh record high. Net worth for households and nonprofit organizations increased \$1.7 trillion to \$96.9 trillion in the third quarter, driven by gains from both stock market wealth and housing wealth, the latter of which reflects strong home price appreciation. Net worth as a percent of disposable personal income increased to 673 percent, the highest reading since quarterly record keeping began in the early 1950s. With a better near-term income outlook and an improving household balance sheet, we expect real consumer spending growth to pick up to 2.7 percent annualized in the fourth quarter from 2.3 percent last quarter, and maintain similar growth rates through 2018.

Saving Rate Hovers Around Expansion Low



Household Net Worth as a Share of Personal Income Rises to a Record High





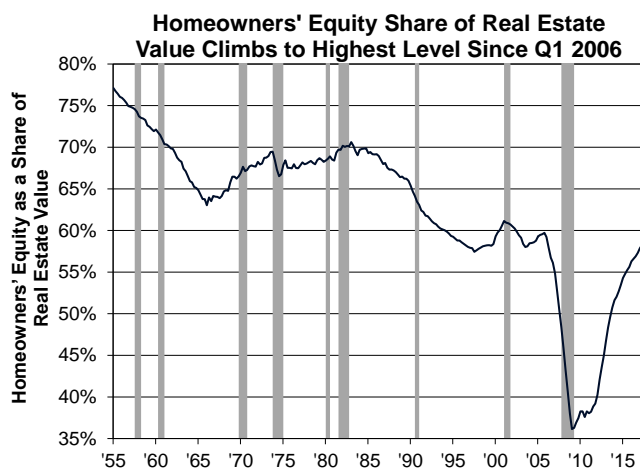
Inflation Pressure Is Muted

The Personal Consumption Expenditures (PCE) deflator, the Fed’s favored measure of inflation, edged up 0.1 percent in October following a 0.4 percent rise in the prior month, with the moderation largely attributable to a decline in energy prices following the hurricane-induced surge. The annual increase slowed one-tenth to 1.6 percent, well under the Fed two-percent target. Excluding food and energy, the core PCE price index increased 0.2 percent, while the annual rise remained at 1.4 percent. We continue to expect two more fed funds rate increases in 2018. Passage of a tax cut bill would likely lead to more Fed tightening, however.

Housing Roundup

Housing activity was upbeat across the board at the start of the fourth quarter. Total housing starts rose in October to the highest level in a year, existing home sales posted the first back-to-back gains this year, and pending home sales (contract signings on existing homes) increased for the first time in four months, as sales rebounded from the hurricane disruptions. Meanwhile, new home sales jumped, approaching a decade high.

Tight inventory continues to boost home prices. The CoreLogic house price index, which is used by the Federal Reserve Board to estimate the value of real estate assets, rose 6.9 percent annualized during the third quarter. The strong home price appreciation helped boost home equity, which increased 8.5 percent annualized during the quarter. As a percent of real estate value, homeowner equity rose to 58.6 percent, only 1.2 percentage points below the most recent peak at the end of 2005.



The yield on 30-year fixed-rate mortgages is expected to average 4.0 percent this year. Thus, compared with the January forecast, we overestimated mortgage rates for all of 2017 by two-tenths. We also overstated housing starts, as year-to-date total housing starts through October are about 2.5 percent higher than during the same period last year, less than half of the gain projected at the start of the year. While we expected shortages of skilled labor and land to be a factor restraining building activity, the problem appears to have been more severe than we had anticipated. However, our forecast for total home sales should come very close to our January prediction, as year-to-date sales showed a 2.0 percent gain this year from last year, compared with our forecast of a 2.2 percent increase in the January forecast. Our modest prediction hinged on our expectation that strong home price appreciation throughout 2017 would likely be a headwind for affordability and sales.

We expect mortgage rates to rise gradually, averaging 4.2 percent in the fourth quarter of 2018 from 3.9 percent in the current quarter. Total housing starts and total home sales should rise about 5 percent and 3 percent, respectively, in 2018. Passage of a tax bill would pose both upside and downside risks to the forecast. Our expectations for total single-family mortgage originations are little changed from the prior forecast, as they are predicted to drop about 12 percent this year to \$1.81 trillion before declining further by about 5 percent to \$1.73 trillion in 2018. The refinance share should drop from 37 percent this year to 31 percent in 2018.

For information on multifamily market conditions, read the [December 2017 Multifamily Market Commentary](#).

Economic & Strategic Research (ESR) Group

December 11, 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: Bureau of Economic Analysis, Federal Register, National Federation of Independent Business, the Federal Reserve Board, Census Bureau, Bureau of Labor Statistics



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