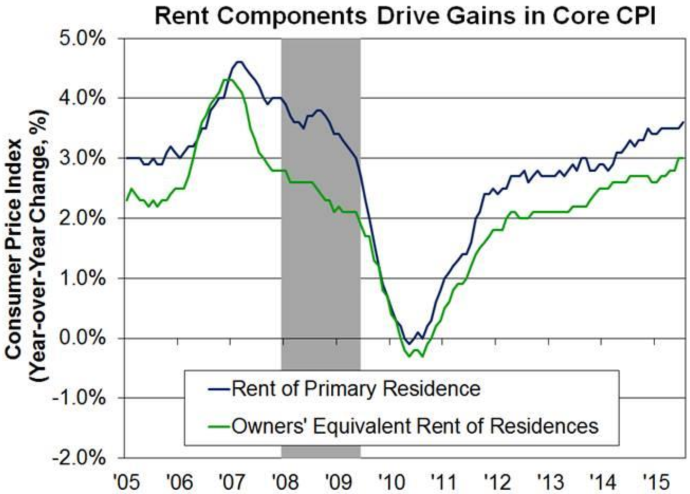
Economics: Downside Risks to Inflation Will Likely Weigh on Fed's Decision

This week offered just a few economic reports, including one on inflation, an indicator closely monitored by the Federal Reserve. July 2015 retail inflation came in slightly weaker than expected, and given declining commodity prices and the renewed climb in the dollar, downside risks on the inflation outlook have increased. The latest drop in crude oil prices points to some declines in the energy component of the Consumer Price Index in the near term, potentially weighing on the headline number. The minutes of the July 28-29 Federal Open Market Committee (FOMC) meeting, also released this week, suggested that while members generally agree that the labor market has strengthened, with only some additional improvement needed to trigger a rate hike, they were more divided on the inflation outlook as some participants cited downside risks to inflation from the potential for energy prices to decline and the dollar to appreciate further. While we believe that a September lift-off remains in play, a move at the September 16-17 FOMC meeting is a toss-up. The August jobs report—the last one before the meeting—will be a critical input to the Fed's decision. This week's report on initial jobless claims shows that the four-week moving average edged higher for the first time since mid-July but remained at historically low levels, consistent with a gradually improving labor market. However, the past four August jobs reports came in below expectations. A weak report this time around would likely nudge the FOMC toward a later lift-off this year.

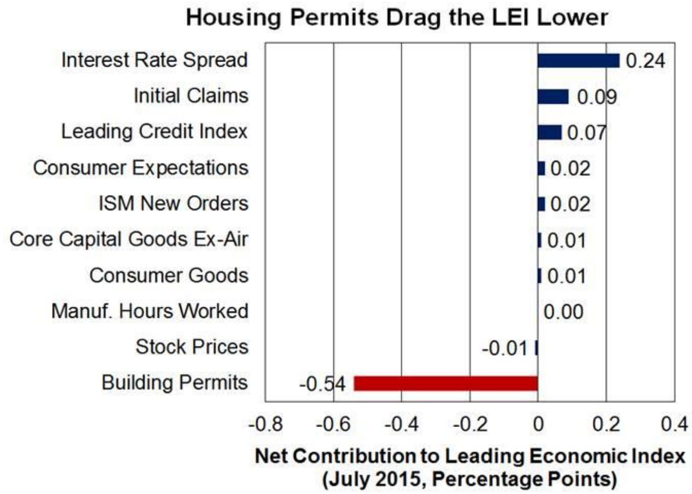
- **The Consumer Price Index (CPI)** ticked up 0.1 percent in July, according to the Bureau of Labor Statistics. Core prices (excluding food and energy items) also edged up 0.1 percent as the gain in core services prices, boosted by rent components, outweighed the drop in core good prices, weighed down by the strong dollar and weak global growth. From a year ago, overall CPI and Core CPI increased 0.2 percent and 1.8 percent, respectively. Shelter, which includes rents of primary residences and owners' equivalent rents (a proxy for homeowner rents), accounts for more than 40 percent of the core CPI. Each shelter component rose 0.3 percent in July, moderating from a 0.4 percent jump in June. From a year ago, rents rose 3.6 percent, the biggest gain since November 2008, and owners' equivalent rents rose 3.0 percent, matching June's gain as the largest increase since August 2007.

- **Initial claims for unemployment insurance** increased 4,000 to 277,000 in the week ending August 15, 2015, according to the Department of Labor. The four-week moving average increased to 271,500 from 266,000 but has remained below 280,000 for five consecutive weeks.

- **The Conference Board Leading Economic Index (LEI)** fell 0.2 percent in July to 123.3, following a 0.6 percent increase in each of the prior three months. A sharp drop in July housing permits, which came after three consecutive robust gains, was largely responsible for the first pullback in the index in five months. After adding at least 0.2 percentage points to the LEI in the prior three months, permits subtracted 0.54 percentage points from growth in the index in July, the largest drag in the current economic expansion. Seven out of 10 components made positive contributions, indicating broad-based strength in the economy.



Source: The Bureau of Labor Statistics



Source: The Conference Board

Housing: Good Vibes Continue for the Housing Market

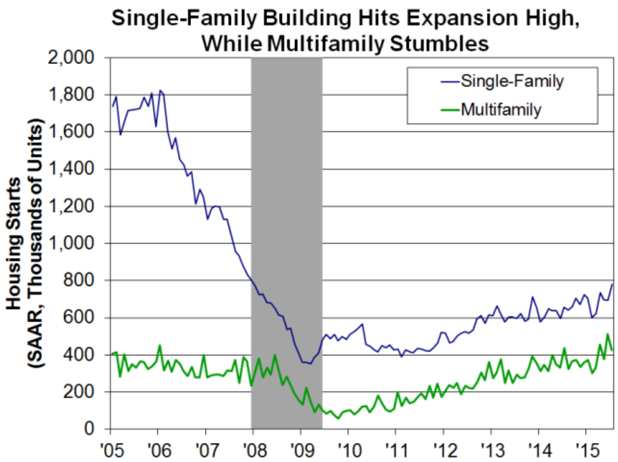
Housing data released this week featured new post-crisis highs for several key metrics, but leading indicators suggest some near-term cooling. Housing starts edged upwards in July after a strong gain in June. Unlike June, when gains in the multifamily segment accounted for all of the increases in construction activity, single-family starts grabbed the headline in July, jumping to the highest level since December 2007. However, it remains to be seen if single-family construction can continue to gain momentum, as July single-family permits, a leading indicator of building activity, fell for the first time in five months. Home builders continued to be more positive in August, as an index gauging their confidence rose to a near-decade high. Existing home sales also rose in July to a new expansion high. However, low inventory and rapid home price appreciation are squeezing first-time homebuyers, whose share of existing home sales fell to 28 percent, the lowest level since January. Refinancing applications continued to increase as homeowners responded to falling mortgage rates, with Freddie Mac's 30-year fixed-rate mortgage down one basis point to 3.93 percent. On the other hand, purchase mortgage applications fell for the third time in the last four weeks. The decline in purchase applications, when combined with a drop in June pending home sales (which lead existing home sales by one to two months), point to some near-term pullback in home sales in coming months.

- **Housing starts** rose 0.2 percent in July to 1.21 million annualized units, according to the Census Bureau, as a 12.8 percent gain in single-family starts to 782,000 units outweighed a 17.0 percent fall in multifamily starts to 424,000 units. Single-family and multifamily starts through the first seven months of 2015 are up 11.2 and 11.7 percent, respectively, from the same period last year. New residential permits plunged 16.3 percent from June to 1.12 million units in July. Unlike the strong gain in starts, single-family permits fell 1.9 percent in July, ending four months of increases. Permits for multifamily buildings mirrored the dive in starts during the month, decreasing 31.8 percent—the largest drop in seven years. One factor behind the sharp decline in multifamily activity was the scheduled expiration of tax exemptions on New York City housing development projects in June, leading to a plunge in permits in the Northeast region in July. However, permits also fell in other regions except the South.

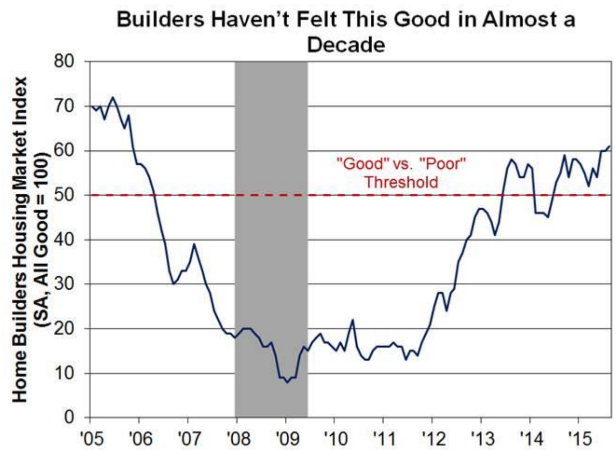
- **Existing home sales** climbed 2.0 percent in July to 5.59 million annualized units, according to the National Association of REALTORS®—the highest level since February 2007. Year-to-date sales are 8.4 percent higher than the same period last year. The number of homes for sale, which is not seasonally adjusted, fell 0.4 percent from the previous month and 4.7 percent from July 2014. The months' supply, or inventory/sales ratio, ticked down one-tenth to 4.8. The median sales price of existing homes, which is not adjusted for the composition of sales, is 5.6 percent higher than a year ago.

- **The National Association of Home Builders/Wells Fargo Housing Market Index** edged up one point to 61 in August, the highest level since November 2005. (A reading above 50 indicates more builders view the market as "good" than "poor.") Builders' assessment of current sales and buyer traffic improved, while expectations for the next six months remained unchanged.

- **Mortgage applications** increased 3.6 percent in the week ending August 14, according to the Mortgage Bankers Association. Refinance applications rose for the fourth consecutive week, the sixth rise over the last seven weeks, increasing 7.3 percent. Purchase applications, on the other hand, fell again this week, dropping 1.1 percent. The survey's 30-year fixed mortgage rate edged down two basis points to 4.11 percent during the week.



Source: Census Bureau



Source: National Association of Home Builders/Wells Fargo

Frank Shaw and Orawin T. Velz
Economic and Strategic Research Group
August 21, 2015

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