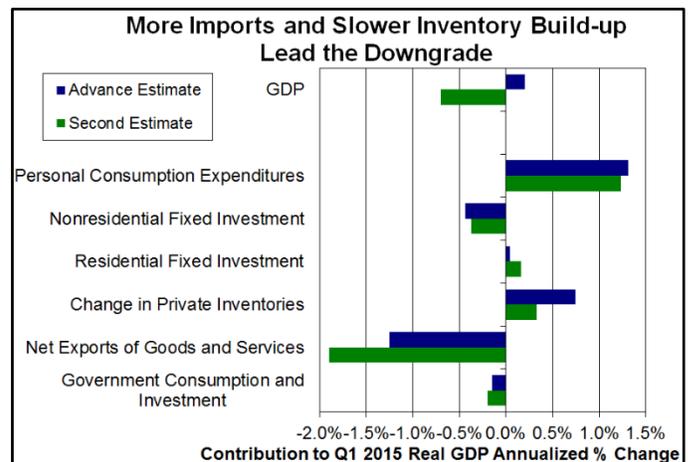


A Moderate Rebound Is Underway after a Blip

Recent developments reinforced our view that, once again, the decline in economic activity during the first quarter was temporary, and the economy is poised to rebound in the current quarter. The strong dollar and the shale oil slump will continue to drag, but the unwinding of the temporary weather distortion will be a positive. We expect growth to pick up to 2.4 percent annualized in the second quarter before accelerating in the second half of the year averaging around 3.0 percent. Our forecast for the current quarter and the rest of the year is little changed from the prior forecast; however, because of the government's downward revision in its growth estimate for the first quarter, we revised lower our projection for all of 2015 to 1.9 percent from 2.3 percent in the prior forecast. Our view for 2015 has deteriorated substantially over the past two months, with a downgrade in this year's growth of nearly one percentage point between the April and June forecasts. Disappointing consumer spending against our expectations for a swift rebound is the key reason behind the deterioration in our outlook. Despite sizable declines in gasoline prices over the past year and strong fundamentals—including firming disposable income growth, rising household wealth, and high consumer confidence—real consumer spending grew just 1.8 percent annualized during the first quarter, as the bulk of the windfall from declining oil prices was saved.



As widely expected, the second print of first quarter gross domestic product (GDP) showed the economy contracted, compared with a modest gain reported in the first estimate. Real GDP fell 0.7 percent annualized, a downgrade from a 0.2 percent increase in the first estimate. The main source of the downward revision was more imports than previously reported, reflecting a surge after West Coast ports reopened in late February. The drag from net exports was revised to nearly two percentage points—the largest since 1985. Slower inventory buildup was another cause of the downward revision. Despite the downgrade, inventory accumulation during the first quarter was still strong. Businesses likely will draw down inventories in the coming months, which will weigh on production and be a negative for growth in the current quarter.

Seasonal adjustment issues—as mentioned in the minutes of the April Federal Open Market Committee meeting as “statistical noise”—may have weighed on GDP aside from the temporary factors of severe weather and the West Coast port strikes. This quirk, also dubbed “residual seasonality,” implies that, even after the Bureau of Economic Analysis (BEA) adjusts GDP for seasonality, first quarter GDP figures still show a seasonal pattern, which tends to suppress growth during the quarter. This suggests that GDP may not be an accurate gauge of the economy's true performance for the first quarter. Real gross domestic income—another indicator of economic growth that measures overall economic activity by aggregating income generated from producing GDP rather than spending—indicated that the economy expanded 1.4 percent annualized in the first quarter. The large divergence between the two measures suggests the GDP measure understated the underlying strength in the economy during the first quarter. The BEA indicated that it will address some of the issues related to seasonal adjustment in the annual revision, to be released in July.

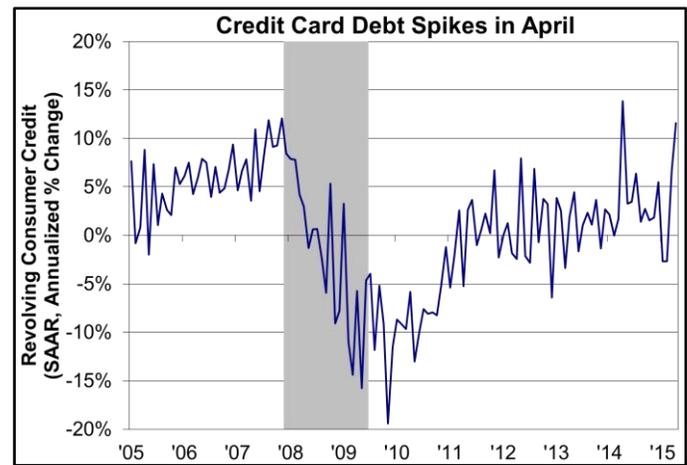
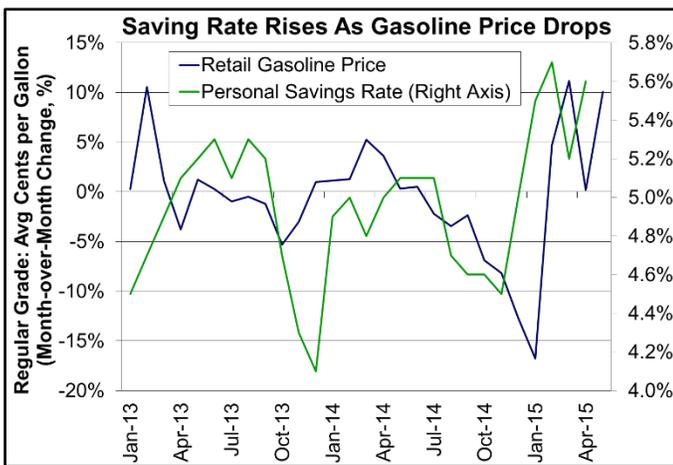
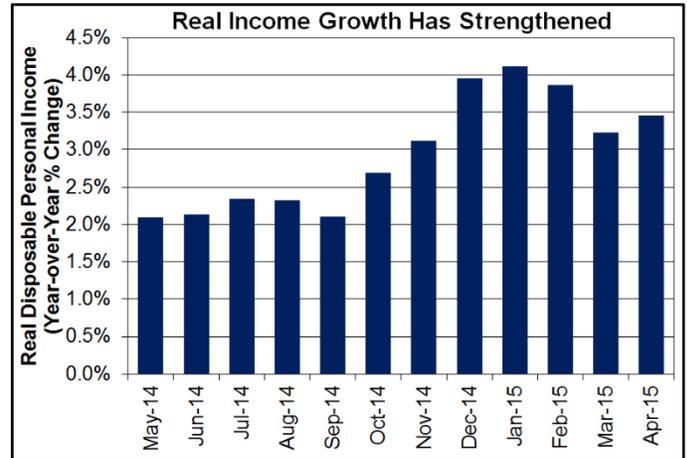
Consumer Spending Disappoints So Far...

Consumers resumed building up their saving at the start of the second quarter as personal consumption expenditures (PCE) were flat against a rebound in personal income. After declining one-half of a percentage point in March to 5.2 percent, the saving rate nearly reversed the drop, rising to 5.6 percent in April. Adjusted for inflation, personal income increased 0.4 percent in April after a 0.1 percent drop in the prior month. Meanwhile, real PCE remained flat following a 0.4 percent rise in March, a weak start for the second quarter. Over the past year, real disposable personal income rose 3.5 percent in April, accelerating from 3.2 percent in the prior month. So far this year, year-over-year gains in disposable personal income have been healthy, ranging from 3.2 percent to 4.1 percent, compared with an average growth rate of just 2.5 percent in 2014. The improving trend in real disposable income should help to support consumer spending this year.

It appears that much of the windfall from declining gasoline prices last year went to saving. Between June 2014 and April 2015, personal saving rose \$85.6 billion annualized—roughly two-thirds of the decline in spending on gasoline and fuels

during the same period. The pickup in the saving rate in late 2014 coincided with the steep drop in retail gasoline prices. Perhaps the decline in gasoline prices could lead to a delayed boost in consumer spending rather than the immediate jump many expected. Auto sales jumped 7.8 percent in May to 17.8 million units annualized, the strongest pace in nearly a decade, suggesting a rebound in consumer spending is in the cards. However, the downside to our forecast of improving trends in consumer spending is that consumers may opt to save the windfall or use it to pay down debt, leaving spending growth weaker than we anticipate.

Consumer credit data also lend support to the view that consumer spending should pick up in the current quarter. Revolving credit balances (largely credit card debt) jumped 11.6 percent annualized in April, the second largest gain in the current expansion. The month-to-month change can be volatile, however, and the year-over-year increases so far this year have been similar to the average gain in 2014. Therefore, further evidence of a sustained improvement is required before we can conclude that consumers have become less cautious in their debt usage.



...But Jobs Report Suggests Things Are Looking Up

Labor market conditions are providing more near-term support for consumers, indicating the acceleration in income growth this year is likely sustainable. May nonfarm payrolls posted the largest increase since December, rising 280,000. Revisions to the prior two months also added a net gain of 32,000 jobs, putting average growth over the past three months at 207,000. Gains were broad-based across industries, though mining employment dropped for the fifth consecutive month, losing 17,000 jobs. Average hourly earnings rose 0.3 percent from April and 2.3 percent from a year ago, tying the biggest annual gain since August 2009.

Although the unemployment rate from the separate household survey ticked up to 5.5 percent, it was because the number of people joining the labor force outpaced the healthy rise in household employment. The labor force participation rate increased for the second consecutive month, edging up one-tenth to 62.9 percent, an indication that improving job prospects are attracting more people into the labor force.



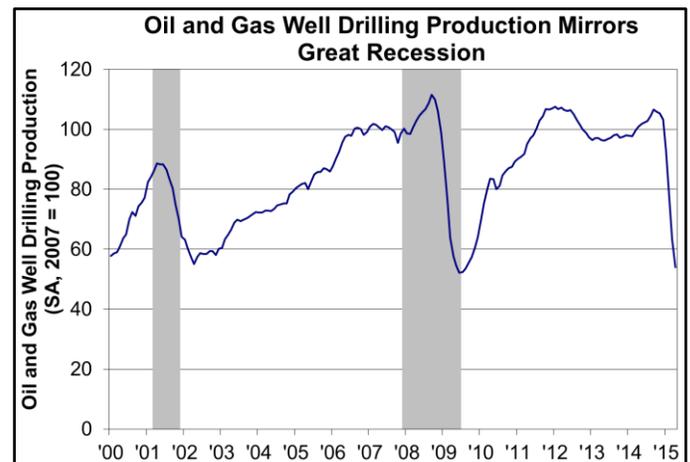
The combination of a decent gain in average hourly earnings and a strong increase in employment suggests more growth in wage and salary income in May. In addition, employment related to discretionary spending picked up strongly, including

31,000 jobs added in retail and 57,000 jobs added in leisure and hospitality. Combined with the surge in May auto sales, the May jobs report reinforces our expectation for PCE growth averaging above 3.0 percent in the second half of the year. The Job Opening and Labor Market Turnover Survey (JOLTS), which is released with a one-month lag to the jobs report, showed that businesses increased their effort to search for workers in April. Job openings jumped to a record high since record keeping began in December 2000 of 5.4 million. The job opening rate (openings as a share of total employment) rose to 3.7 percent, the highest share since January 2001 and the second highest in the history of the series.

Manufacturing May Soon Stabilize

The prolonged slump in the factory sector continued in April under pressure from the drop in energy-related investment, weak global demand, and the strong dollar. Weakness in activity is evident in the industrial production data, with mining output dropping in April for the fourth consecutive month, driven by a plunge in oil and gas well drilling nearly matching the decline witnessed during the Great Recession. The fourth consecutive double-digit decline in oil and gas well drilling this year has left activity 46.5 percent below the level a year ago. Meanwhile, the report showed that manufacturing output was flat after rising in March for the first time in four months.

The factory orders report told a similar story, as orders fell in April for the eighth time in nine months. Details were disappointing, as core capital goods shipments—an input used to estimate business equipment spending—were revised lower. In addition, core capital goods orders, a leading indicator for shipments, were also downgraded from a solid gain to a modest loss, marking the third drop in the last four months. Durable goods orders data are quite volatile and tend to be revised substantially from month to month. Though the April data suggest that real business investment will likely weaken or even decline in the second quarter, we are not overly concerned at this point. Businesses may have front-loaded reductions in capital investment in drilling, and the drag from the decline in mining capital expenditures will likely diminish considerably in the second half of the year barring another collapse in crude prices.



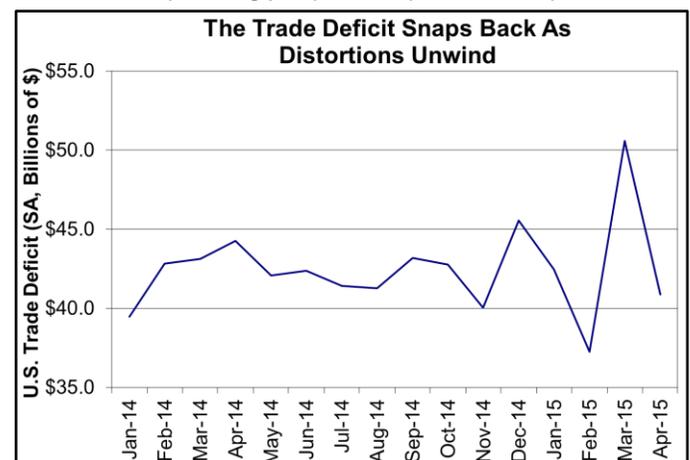
Surveys of purchasing managers provided a glimpse of hope for stabilization in the factory sector. The Institute for Supply Management (ISM) manufacturing index rose in May for the first time in seven months. The forward-looking new orders component advanced for the second month in a row to its highest level this year. The healing is expected to be gradual, however. While some temporary factors have unwound, some headwinds will likely persist, particularly a strong U.S. dollar. Comments from survey respondents also showed continued concerns over the strong U.S. dollar and challenges in the oil and gas industries.

Nonresidential Investment in Structures Shows Signs of Improvement

After a 20.8 percent annualized drop in the first quarter, driven by plummeting investment in mining structures related to the sharp decline in oil prices, nonresidential investment in structures will likely improve in the second quarter. The construction spending report showed that private nonresidential construction spending jumped 3.1 percent in April, compared with an average monthly gain of just 0.6 percent during the first quarter. The increase was broad-based across sectors. Although the report excludes the drilling component of structure investment, the strength in non-energy structures should help offset some of the ongoing weakness in energy-related structures investment during this quarter. However, given the sharp decline in the first quarter, nonresidential investment in structures will likely post a decline for all of 2015.

Trade Picture Improves Substantially as Distortions Unwind

The April trade deficit narrowed significantly as exports posted a solid gain while imports fell sharply after the surge in the prior month, confirming that the spike in the March deficit was temporary, largely caused by the unwinding backlogs at West



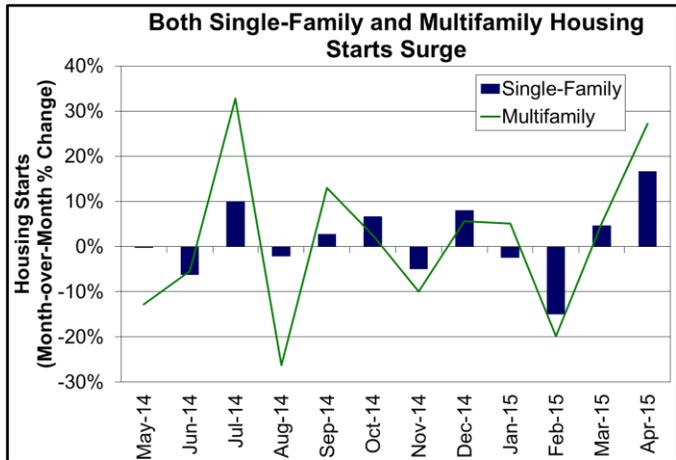
Coast ports. Revisions to data through March were positive, suggesting that net exports were a smaller drag on GDP than reported in the government's second estimate. Overall, net exports should contribute to GDP in the second quarter but are expected to weigh on full-year growth amid a strong U.S. dollar.

Fed's September Hike Appears on Target

The strength in hiring in May and accelerating wage gains suggest that the Fed should stand ready to begin normalizing interest rates in coming months. However, bearing on the other half of the Fed's dual mandate, inflation still sits well below its 2.0 percent target. We continue to hold our call that the lift-off in the target fed funds rate will occur in September, though we expect the pace of tightening to be slower than in past monetary cycles.

Housing Moves in the Right Direction

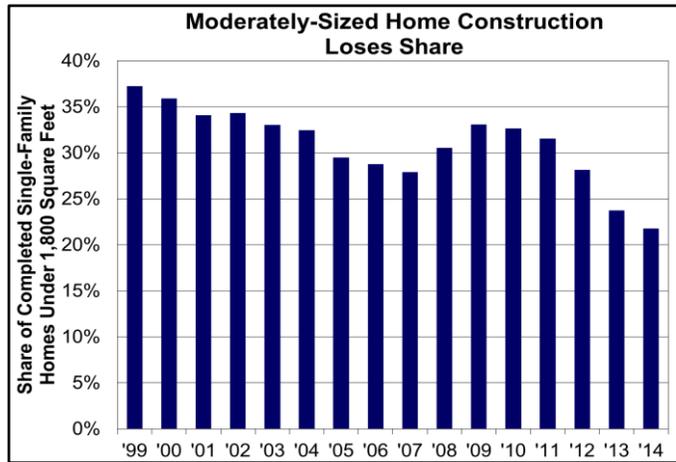
Housing indicators at the start of the second quarter were generally upbeat. Following the dismal performance in the first quarter amid severe winter weather, April total housing starts posted the biggest gain since early 1991, reaching the strongest pace since November 2007, just before the economy dipped into recession. Both single-family and multifamily starts showed double-digit gains, with the Northeast leading the increase, surging 85.9 percent during the month and a cumulative 300 percent since February. Total building permits also jumped in April, driven by the multifamily segment. (For more information on multifamily market conditions, read the [June 2015 Multifamily Market Commentary](#).)



New home sales rebounded in April following a plunge in March. Although the number of homes for sale (seasonally adjusted) has risen 44 percent from the low recorded in July 2012, the for-sale inventory remains at historically low levels. Inventories are especially lean at the lower-end of the market, as there is little building of lower-priced homes. In the Census Bureau's annual report on the Characteristics of New Housing Units Completed/Sold in 2014 released in early June, the share of single-family homes completed with square footage below 1,800 fell to 21.8 percent, down from 23.7 percent in 2013 and 37.2 percent in 1999 when record-keeping began.



Homebuilders' confidence disappointed as the spring selling season got underway. The National Association of Home Builders (NAHB) Housing Market Index (HMI) edged down two points in May to 54, driven by declines in the present sales and buyer traffic components. However, the index remains above the neutral threshold of 50, which indicates that the majority of homebuilders are optimistic about the single-family market. The index also sits well above 48, its long-term average since the series' inception in 1985. The silver-lining was improvement in the future sales component, which ticked up to the highest reading this year. Continued tight supply of developed lots is a primary concern for builders and helps explain the modest recovery in single-family homebuilding and lean inventories. The NAHB May 2015 survey showed that 62 percent of builders noted that the supply of developed lots in their areas was low to very low, the largest share recorded since tracking began in 1997. On the consumer front, the NAHB reported that consumers demand prices below costs and are concerned about selling their existing home. And despite low mortgage rates, first-time buyers constitute only about half their normal share of new home purchases.

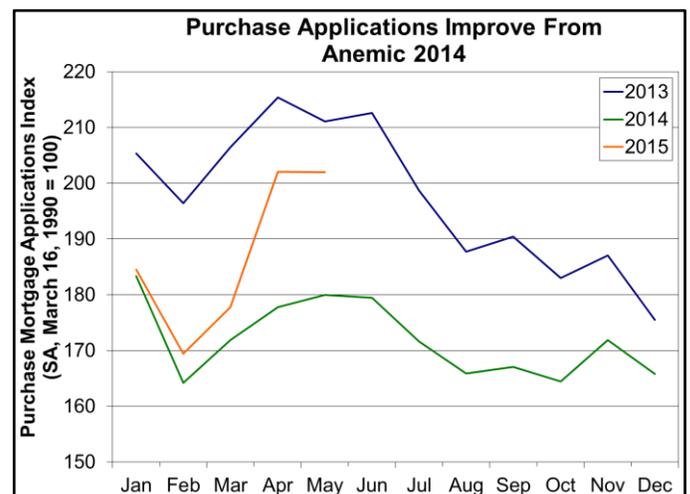
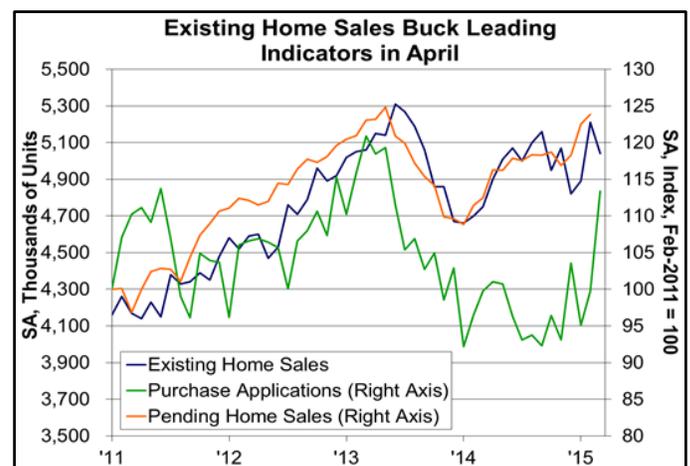
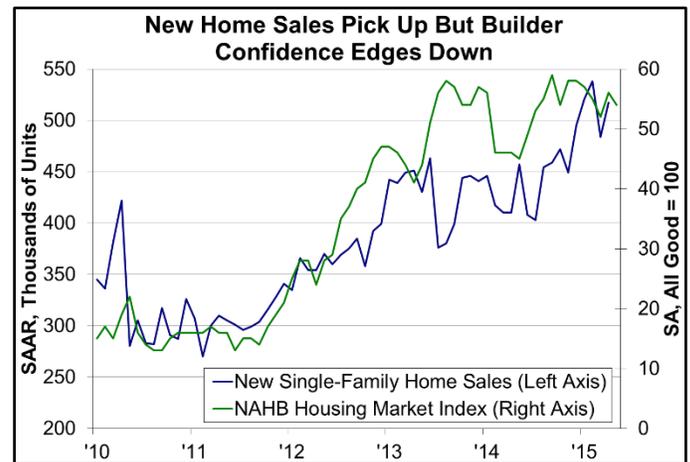


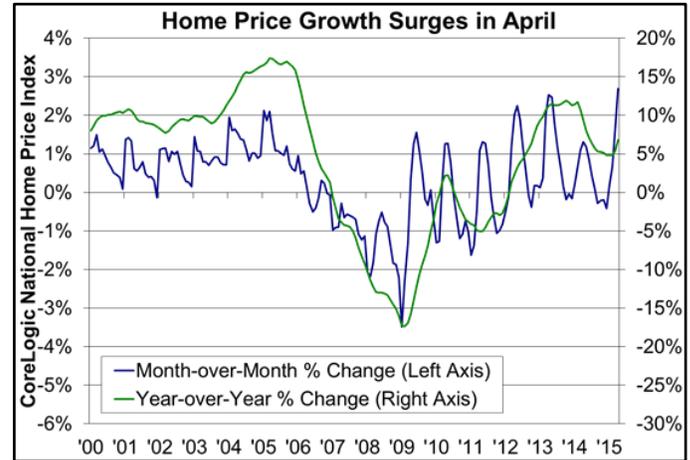
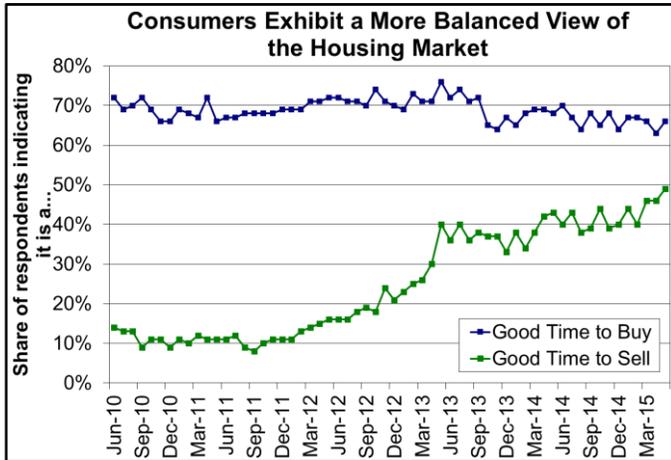
In contrast to new home sales, existing home sales unexpectedly fell in April after a surge in the prior month, bucking healthy improvements in pending home sales and purchase mortgage applications. However, pending home sales, which lead closed sales by one to two months, continued to rise in April for the fourth consecutive month to the highest level since mid-2010. Furthermore, year-to-date purchase applications remain appreciably above the levels witnessed in 2013. We expect the April drop in existing home sales to be an aberration, and sales should resume rising in May, supporting our forecast of a broad-base improvement in housing activity in 2015.

We appear to be in a sellers' market this spring. According to the National Association of REALTORS® (NAR), the average time on the market for existing homes declined to just 39 days in April, the second shortest duration since tracking began in May 2011. About 40 percent of homes sold at or above their asking price, the highest share since NAR began tracking in December 2011. These developments are consistent with results from the May Fannie Mae National Housing Survey™. The share of consumers believing that it is a good time to sell rose three percentage points to 49 percent, a record high since the inception of the survey in June 2010. Unlike the good time to buy share, which has moved within a relatively narrow range of between 63 and 76 percent over the past five years, the good time to sell share has gradually trended up from a low of 8.0 percent in late 2011. These seller-friendly market conditions should induce more homeowners to put their homes on the market. While the number of existing homes for sale rose in April, as it normally does in the spring, it remains slightly below the level of a year ago and is historically low.

Lean inventories, low levels of new construction, and declining shares of distressed sales have helped boost home prices, but the pace of appreciation varies depending on the reported measure. For example, the Case-Shiller 20-city composite index and the FHFA purchase-only index showed annual appreciation stabilizing near 5.0 percent in March, slightly below the 5.4 percent gain in the CoreLogic Index. The latter improved further in April, posting the largest monthly increase since February 1978, pushing year-over-year price growth near 7.0 percent—the fastest annual appreciation since last June.

Yields on long-term Treasuries moved substantially higher during the first week of June in response to the first positive inflation figure since last November in the Eurozone and an upbeat May Jobs report. Bond yields rose sharply in core European economies. For the U.S., the yield on the 10-year Treasury Note rose nearly 30 basis points over the week to close at 2.41 percent on the day of the employment report and remained elevated at the time of this writing. Despite the recent pickup in long-term Treasury yields, our forecast for mortgage rates is little changed from the prior forecast, with 30-year fixed mortgage rates rising gradually from an average of 3.8 percent in the current quarter to 4.0 percent in the fourth quarter.





We have noted in our previous forecasts that, as the Fed is preparing to normalize interest rates, volatility in mortgage rates poses downside risks to the housing market. As we saw in the taper tantrum during the summer of 2013, spikes in interest rates led to sharp declines in housing activity during the second half of the year. However, fundamentals for the housing market are more positive today than two years ago. Employment growth has been strong amid firming wage and income growth and a pickup in household formation. In addition, lending standards have gradually eased. Given uneven economic growth in the U.S. and events abroad, including a possible exit of Greece from the Eurozone and continued slow economic growth around the globe, interest rates are unlikely to surge and remain persistently high. Thus the housing market should be able to better withstand some headwinds from higher rates this year than in the past.

Housing activity continues to show improving trends. Year-to-date housing starts and total home sales through April were up 5.5 and 6.4 percent, respectively, above the levels during the same period last year, in line with our expectations. Our forecast for housing and mortgage activity in 2015 is the same as the last forecast, with total housing starts and total home sales rising about 10 and 5 percent, respectively. We expect mortgage originations to increase approximately 23 percent this year to \$1.46 trillion, with a refinance share of 48 percent.

June 10, 2015
Economic & Strategic Research (ESR) Group

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

Sources for chart data: Bureau of Economic Analysis, Energy Information Administration, Federal Reserve Board, Bureau of Labor Statistics, Census Bureau, National Association of Home Builders, Fannie Mae National Housing Survey, National Association of REALTORS®, Mortgage Bankers Association, CoreLogic.

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.

ESR Macroeconomic Forecast Team

- Doug Duncan, SVP and Chief Economist
- Orawin T. Velz, Director
- Brian Hughes-Cromwick, Economist
- Mark Palim, VP
- Frank Shaw, Business Analyst
- Richard Koss, Director
- Hamilton Fout, Director