Economic Developments – October 2018

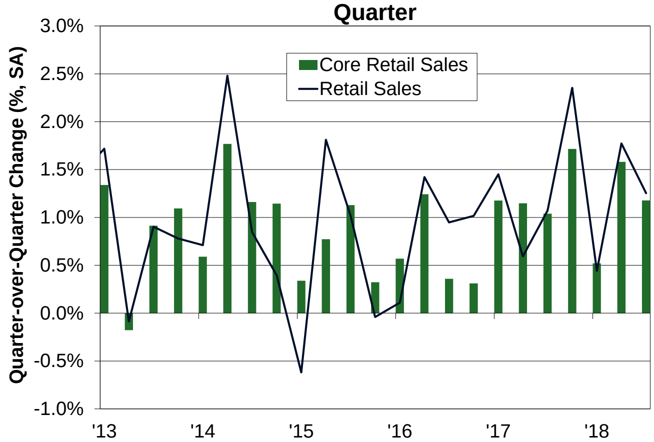
Outlook Remains Strong, But Housing Languishes

Economic growth is likely to be solid in the third quarter, and the lower level of job growth in September does not alter our view that the labor market is robust. However, gross domestic product (GDP) growth likely slowed from its second quarter pace, partly reflecting a deceleration of business investment and consumer spending. In addition, the trade deficit likely widened as the surge of soybean exports seen earlier this year ahead of tariffs subsided and the dollar strengthened. Residential fixed investment is expected to have fallen for the third consecutive quarter. Home sales, which drive brokers' commissions, hit a soft patch as higher mortgage rates likely deterred potential buyers. We expect home sales to rise in 2019 as rates stabilize, but annual growth should be muted as existing sales are expected to be flat for the year. In summary, the economy is expected to have grown slightly faster in the third quarter than projected in our September forecast, but our full-year growth expectations for 2018 and 2019 remain unchanged at 3.0 percent and 2.3 percent, respectively.

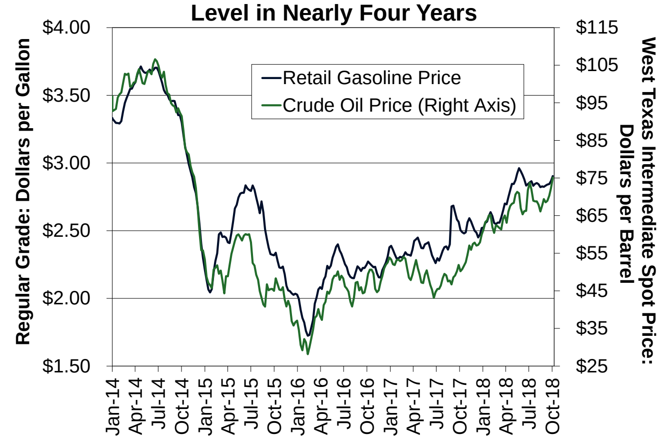
Consumer Spending to Slow Modestly

Incoming data for the first two months of the third quarter suggest that real consumer spending growth is likely to slow from its pace in the second quarter. The August slowdown in real consumer spending reflected a deceleration in spending growth for nondurable goods, while growth in spending on services was flat. Although real spending growth on durable goods accelerated in August, core retail sales data, which excludes autos, building materials, and gasoline, slowed modestly in the third quarter.

Core Retail Sale Growth Slows in the Third Quarter



Crude Oil Prices Rise to the Highest Level in Nearly Four Years



That said, gasoline prices continued to climb, tracking the upward trend in oil prices. Going forward, oil prices may continue to rise as production declines from Venezuela continue and U.S. sanctions against Iran's oil exports are set to be implemented by November 4. However, offsetting supply increases in September by Saudi Arabia, Libya, the United Arab Emirates, Nigeria, and Angola provided some relief.

Growth in Business Investment Downgraded

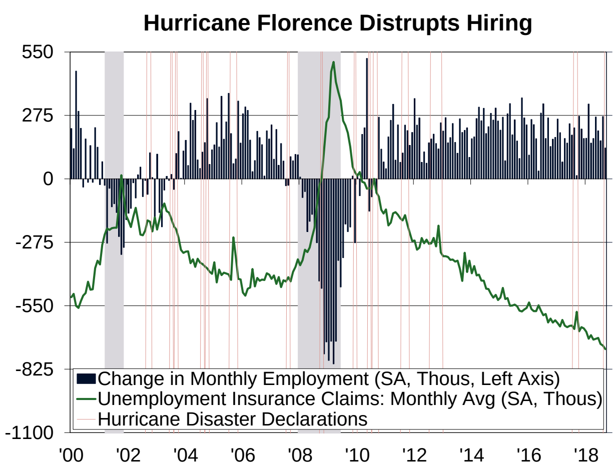
Recent trends in equipment spending lowered our forecast for business fixed investment in the third quarter of 2018. Sustainable business investment spending likely cooled in the third quarter as growth in core capital goods shipments, a key input into business equipment spending, declined in August. In addition, core capital goods orders, a forward-looking indicator of business equipment spending, also disappointed.

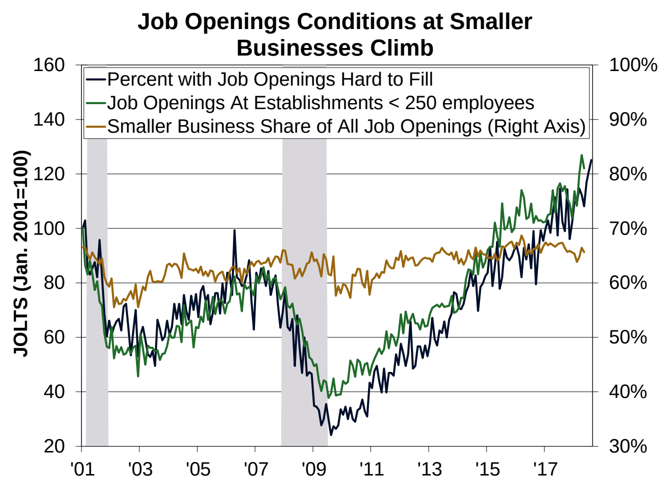
Contributing to the slowdown in business investment were the monthly declines in private nonresidential construction spending over the first two months of the third quarter, following three consecutive months of gains. Spending on infrastructure, commercial, and, to a lesser degree, manufacturing structures all contributed to the decline over July and August. At this pace, nonresidential construction spending will detract from third quarter output.

The Labor Market Tightens…

Following an impressive 270,000 jobs in August, only 134,000 jobs were created in September. However, the lower level of job growth in September likely reflects the effects of Hurricane Florence and should not be interpreted as a sign of labor market weakness. Details from the household survey indicated that the unemployment rate fell to its lowest level since 1969. At the same time, the establishment survey indicated that much of the monthly slowdown in job growth could be attributed to declines in weather-sensitive sectors, such as retail and leisure and hospitality. The decline in jobs within the leisure and hospitality sector was its first monthly drop since shortly after Hurricane Harvey made landfall in September of last year.

Other indicators, such as those for initial claims for unemployment insurance, also suggest a strong but tight labor market. Despite a hiccup in the week ending September 22, which likely reflected the effects of the hurricane, initial claims for unemployment insurance fell to 207,000 in September, a level not seen since 1969. In addition, the Job Opening and Labor Turnover Survey (JOLTS), which lags the employment situation report by one month, indicated that the number of job openings reached a record high of 6.9 million in July, exceeding the number of unemployed for a fifth consecutive month. The percentage of small businesses, which account for the majority of job openings, citing job openings being hard to fill maintained its record high in September.

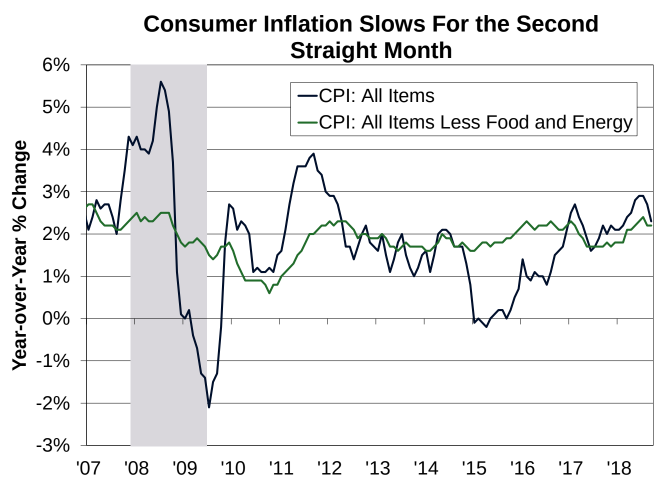




Going forward, solid growth in GDP suggests that the labor market should continue to tighten. In the near term, lost jobs due to Hurricane Florence are likely to be recouped in the coming months. At the same time, the unemployment rate should remain below its estimated natural rate.

…But Inflation Risks Remain Largely At Bay

Despite evidence of tightening labor market conditions, measures of inflation took a breather in the third quarter. Annually, the headline consumer price index slowed for the second straight month in September. Core CPI growth was unchanged from August but has slowed since reaching an expansion high in July. Growth in the price index associated with the personal consumption expenditures (PCE) category in GDP slowed in August. However, headline PCE, the preferred inflation target of the Federal Open Market Committee (FOMC), remained above 2 percent on a year-over-year basis, while core PCE sat at 2 percent for the fourth consecutive month. Although measures of consumer inflation remain near 2 percent, rising oil prices as well as expanding trade tensions may contribute to modest acceleration in inflation.

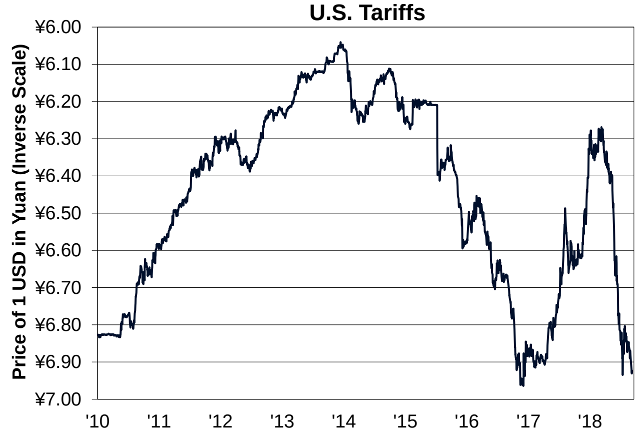


Global Risks Could Impact the Outlook

In a positive development for the economic outlook, trade tensions receded this month when Canada agreed to join the U.S. and Mexico in the United-States-Mexico-Canada-Agreement (USMCA) that will replace the North American Free Trade Agreement (NAFTA). Although U.S. steel and aluminum tariffs on Canada and Mexico have yet to be resolved, the USMCA has some important changes, particularly on local content and labor standards for automobile production. In addition, the USMCA can be reviewed every six years with an option to "sunset" it in 16 years. Daily changes in the U.S. 10-year TIPS (Treasury Inflation Protected Securities) note rate suggest that financial markets may be interpreting the recent breakthroughs in negotiations as beneficial for underlying U.S. growth. Although the agreement could have a small positive impact on U.S. manufacturing employment, the potential for an increase in manufacturing employment is expected to be offset by losses in manufacturing employment due to technology-based productivity gains. The USMCA is expected to be signed by national leaders in late November, but Congress, as well as the legislatures in Canada and Mexico, still have to approve the agreement.

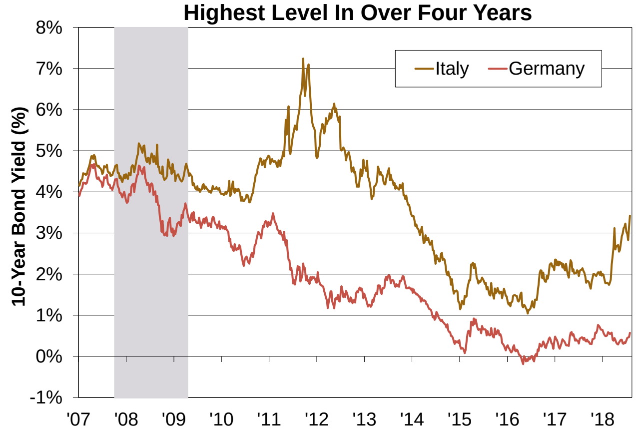
While the trade relationship among the U.S., Mexico, and Canada has improved, tensions with China have worsened. On September 24, the Administration implemented tariffs on another $200 billion of Chinese imports. Moreover, the President stated that "if China takes retaliatory action against our farmers or other industries, we will immediately pursue phase three, which is tariffs on approximately $267 billion of additional imports." Consumer goods represent a larger share of the imports targeted by the new and proposed tariffs. At first blush, the new round and the prospect of subsequent tariffs could substantially influence consumer inflation and, by extension, Fed policy; however, the inflationary impact is likely to be small in part due to the dramatic weakening of the Chinese yuan.

A Weakened Yuan May Offset Some Effects of U.S. Tariffs



Although fears of emerging market contagion have subsided a bit, concerns over Italy's budget situation have intensified. The Italian national government's budget plans, which reportedly include a mix of spending increases and tax cuts, would raise their deficit as a share of the overall economy at a time of high debt, slow economic growth, and in defiance of broader European Union fiscal rules. Concerns about the potential for a widening deficit have pushed up rates on Italian bonds relative to the bonds of their German peers. Tighter financial conditions reflected in higher rates makes it more expensive for the Italian national government to finance new spending through the capital markets. Currently, our forecast does not anticipate significant impact from these developments. The Italian-German 10-year bond spread suggests that stress has not returned to 2011 and 2012 levels, the period of the Greek crisis, but given Italy's size reflected in its G-7 membership, it bears close watching for signs of additional stress and broader contagion risks, either through the banking sector or financial markets.

Italian 10-Year Bond Yield Spikes to the Highest Level In Over Four Years

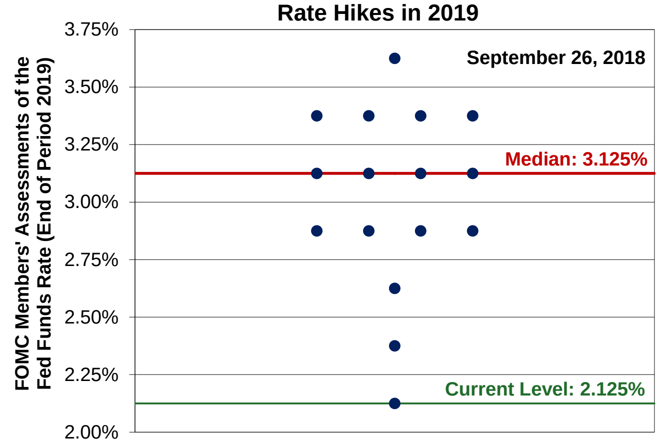


Fed Expected to Proceed with Gradual Rate Hikes

In a widely expected move, the FOMC raised its target federal funds rate by 25 basis points to a range of 2.00 to 2.25 percent at its September meeting, citing "realized and expected labor market conditions and inflation" in its post-meeting statement. In addition, the statement dropped the phrase, "The stance of monetary policy remains accommodative." However, as Chairman Powell noted in his post-meeting press conference, "This change does not signal any change in the likely path of policy; instead, it is a sign that policy is proceeding in line with our expectations. We still expect, as our statement says, 'further gradual increases in the target range for the federal funds rate.'"

With economic growth solid and inflation expected to remain at or modestly above 2 percent, conditions are supportive for another rate hike in December. However, Chairman Powell and his colleagues have repeatedly articulated a shift from an assessment of economic indicators relative to the economy's

FOMC Members Signal Three Rate Hikes in 2019



potential level toward a risk management framework that seeks to balance the risks between "removing accommodation too quickly" and needlessly ending the expansion and "moving too slowly" and risking higher inflation and inflation expectations. The expected path of gradual rate hikes is meant to balance these risks.

The Summary of Economic Projections that accompanied the September statement indicated that, at the median, the FOMC expects an additional three hikes in 2019. However, the underlying "dot plots" from which this median is calculated also shows that the same number of FOMC members expect either two, three, or four hikes next year, assuming one more 25 basis point hike in 2018. This suggests that members' views have yet to converge on the number of rate hikes next year.

If economic conditions evolve as expected, we anticipate that the FOMC will raise its short-term policy rate three more times, once more by the end of this year and then twice in 2019. Since rates on many residential construction loans are typically tied to the bank prime rate, tightening monetary policy will also likely raise builders' borrowing costs, adding to the factors inhibiting a much-needed increase in single-family housing production.

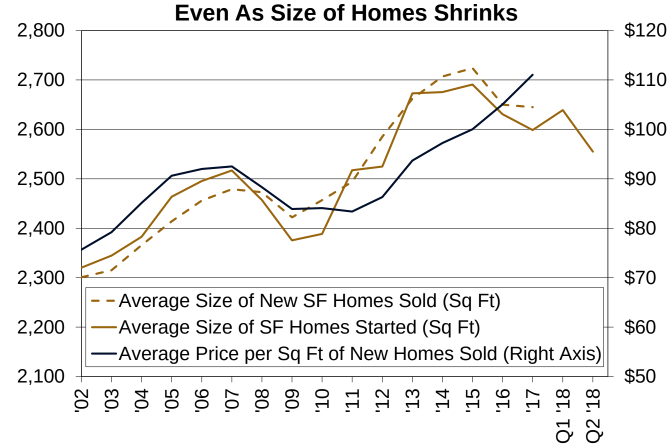
Housing Roundup

Incoming data suggest that residential fixed investment will drag on growth in the third quarter. Existing home sales were flat in August after declining for the prior four months as homebuyers adjusted to higher mortgage rates and tighter inventories in many metros. Fannie Mae's Home Purchase Sentiment Index® (HPSI) was lower in September, partly reflecting an increase in the proportion of respondents expecting mortgage rates to "go up" over the next 12 months and a decline in the share expecting mortgage rates to "go down." In addition, forward-looking indicators for existing home sales suggest a lack of upside potential for home sales in the near term as well. The National Association of Realtors' Pending Home Sales Index declined nationwide in both July and August, while an index of purchase mortgage applications from the Mortgage Bankers' Association fell across the entire third quarter. Fannie Mae's Mortgage Lender Sentiment Survey® (MLSS) also reported an erosion in purchase mortgage demand in the third quarter of 2018, and lower demand may be contributing to mortgage lenders' net negative outlook as they face "competition from other lenders." In view of growing downside risks, we lowered our forecast for home sales over the duration of 2018, and we have marked down sales growth in 2019 as existing home sales are now expected to be flat next year.

As part of this month's forecast, we downgraded our projections for purchase and refinance mortgage activity, given the higher rate environment and weak incoming sales and application data. In particular, we lowered our purchase originations forecast by approximately 2 percent for both 2018 and 2019 and lowered our refi originations forecast by about 3 percent for 2018 and over 8 percent for 2019.

Single-family starts, a key component of real residential fixed investment, rose in both July and August; however, due to a steep decline in June, single-family construction on average across the third quarter is likely to be below its average level in the second quarter. After increasing in the years following the Great Recession, the average size of single-family homes began to decline in 2016, further suggesting that builders are producing a larger proportion of smaller homes due to the geographic spread of employment to areas with lower land costs. In spite of the decline in the size of new homes, the average price per square foot rose to a new high in 2017, offsetting the downward pressure on prices from the construction of smaller homes.

New Homes' Price Per Square Foot Has Risen, Even As Size of Homes Shrinks



Multifamily starts rose significantly in August but have been highly variable. The 92,000 unit increase in multifamily starts in August largely reversed the 77,000 unit decline over June and July. At 406,000 units, multifamily production remains robust as demand for multifamily rental units on a national basis remained positive despite a slight slowing of rent growth. National estimated multifamily rents appear to have increased in the third quarter of 2018 by 0.75 percent, bringing the estimated national asking rent level to $1,267. That is a similar increase as a year ago in the third quarter of 2017 but a slowdown from second quarter 2018's robust 1.5 percent rise and asking rent level of $1,258.

For information on multifamily market conditions, read the October 2018 Multifamily Market Commentary.

Economic & Strategic Research (ESR) Group

October 15, 2018

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: *Census Bureau, Bloomberg, Energy Information Administration, Chicago Mercantile Exchange, Department of Labor, FEMA, Bureau of Labor Statistics, Federal Reserve*

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
Hamilton Fout, Director
Eric Brescia, Economist
Mark Palim, VP and Deputy Chief Economist
Michael Neal, Director
Rebecca Meeker, Business Analyst