



Economic Developments – December 2018

Economic Growth Expected to Slow and Housing to Stabilize in 2019

The U.S. economy is expected to grow 2.6 percent annualized in the fourth quarter, a slowdown from the 3.5 percent rate of growth in the prior quarter, as growth in consumer spending moderates. For all of 2018 we project economic growth to reach 3.1 percent, the fastest pace of the current expansion, before slowing to 2.3 percent in 2019 as the boost from federal fiscal policies wanes, the trade deficit widens, and growth in business investment slows.

In the face of slower economic growth and the absence of a break-out in inflation, we expect both mortgage rates and home sales to stabilize. The rise in for-sale inventories to date should contribute to a moderation in home price appreciation, which we forecast to be 5.4 percent in 2018 and 4.1 percent in 2019. Purchase mortgage originations are expected to climb over 2 percent in 2019 but refinance originations should fall nearly 11 percent, resulting in a small decline in total originations to \$1.605 trillion.

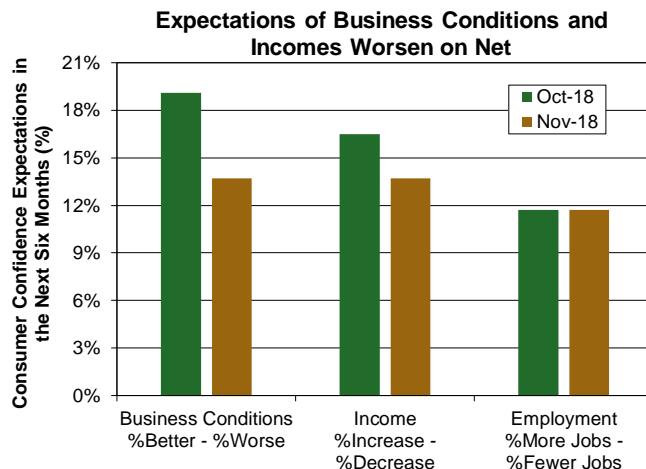
Increases in government spending and business fixed investment are expected to be positive contributors to economic growth in the fourth quarter. However, our forecast of fourth quarter business fixed investment was revised downward partially in response to softness in core capital goods orders and lower oil prices. Continued growth of business investment is key to sustaining the expansion. Over the fourth quarter, we now expect residential investment to be a drag on the economy as we downgraded our home sales and housing starts projections. We also anticipate that trade will likely drag on growth for the second consecutive quarter. The labor market should continue to improve in 2019, with sufficient job growth to bring the unemployment rate lower than in 2018. Our outlook for mortgage originations suggests that lender margins will remain under pressure in 2019 and we will likely see further consolidation. Key risks to our forecast include the uncertainty from trade negotiations between the U.S. and China, the trajectory of oil prices, and stock market volatility.

Consumer Spending Growth Strengthens

Consumer spending accounted for the largest contribution to headline gross domestic product (GDP) growth in the third quarter. Incoming data suggest that it will continue to play a leading role in the fourth quarter. Real personal consumption expenditures (PCE) rose by 0.4 percent in October, the largest monthly gain since March, with broad-based gains across durable and non-durable goods as well as spending on services.

Light vehicle sales slipped slightly in November following a modest rise in the prior month. Since 2015, sales of light vehicles have remained relatively steady, despite rising interest rates. Looking “under the hood,” the stability in light vehicle sales reflects growth in sales of light trucks amid declining auto sales. Light vehicle sales could come under pressure if short-term interest rates continue to climb, raising financing costs.

Consumer confidence remains near an 18-year high, despite a small dip in November. Confidence in the present situation rose to a level that was just shy of the expansion high set in August. However, these gains were offset by a slight dampening in expectations for the next six months. The drop in the expectations component was led by a decline in the net shares of consumers expecting improving business conditions and incomes. These results suggest that the trade tensions between the U.S. and China, as well as stock market volatility, so far have had a minor impact on consumer confidence.



Government Spending Will Contribute to Growth

Increases in local, state, and federal spending contributed to headline GDP growth in the third quarter. The spending and investment support at the federal government level is due in large part to the Budget Reconciliation Act passed earlier this year. Its positive effects on GDP growth are expected to peak this quarter and wane in 2019 through the first half of 2020 before subtracting from growth in the second half of 2020.

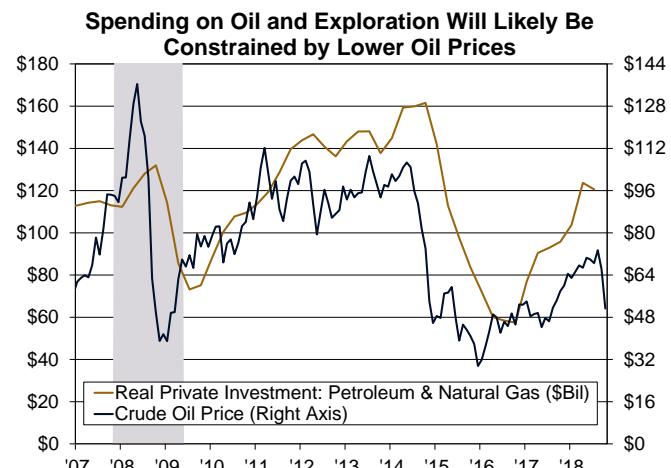
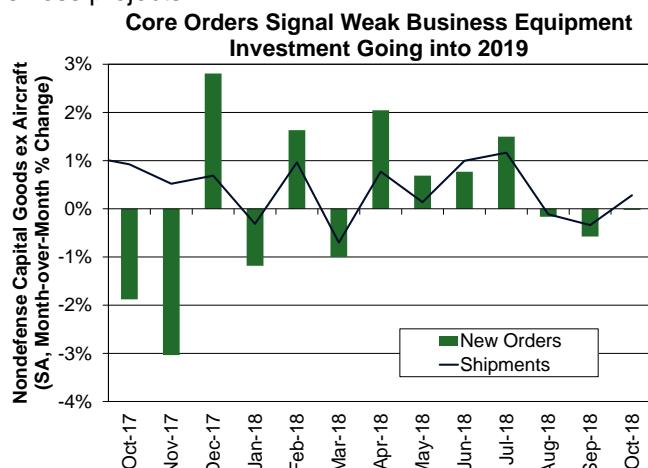


Business Fixed Investment Growth Expected to Tick Up

Despite an upward revision in the second estimate of third quarter GDP, business fixed investment growth still slowed markedly. The minutes from the November Federal Open Market Committee (FOMC) meeting revealed that some participants cited anecdotal evidence of higher tariffs and uncertainty about trade policy, slowing global demand, rising input costs, and rising interest rates as possible culprits behind the deceleration in business fixed investment growth.

Despite these concerns, encouraging news in the manufacturing sector bodes well for business fixed investment growth this quarter. The Institute for Supply Management manufacturing index rose in November, indicating a faster pace of expansion than in October. Higher readings on new orders, production, employment, and inventories all contributed to the uptick in the headline reading; supplier deliveries was the only subcomponent to register a monthly decline.

Small business sentiment has trended down from its record high in August, though it remains historically elevated. Several factors may restrain business fixed investment growth in the near term. Core capital goods orders, the forward-looking indicator of equipment spending, were unchanged in October after two consecutive drops in the prior months. Spending on structures related to oil and exploration will likely be constrained by lower oil prices. Additionally, many of the risks cited by participants at the last FOMC meeting are unlikely to be resolved soon and may delay investment in business projects.



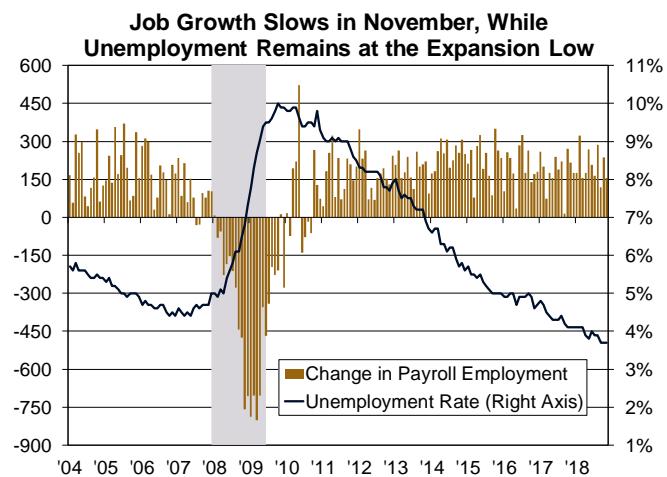
Trade Deficit and Inventory Investment Will Weigh on Growth

After shaving off 1.9 percentage points from GDP growth in the third quarter, the U.S. trade deficit is on pace to drag on broader economic growth over the current quarter as well. The U.S. real goods trade deficit, which is used in the estimate of GDP, widened to \$87.9 billion in October, the worst trade gap since the series began in 1994. The expansion of the U.S. trade deficit partly reflected a decline in exports, especially to China, and a rise in imports. Going forward, we expect a stronger dollar and weaker global growth to weigh on the U.S. trade balance and partially offset strength in other areas of the economy.

Following a decline in the second quarter, a jump in private inventories contributed 2.3 percentage points to growth in the third quarter. Over the month of October, wholesale inventories rose 0.8 percent, suggesting that inventory investment will remain solid in the fourth quarter. However, the pace of inventory investment is expected to slow from its strong third quarter rate, implying a modest drag on fourth quarter economic growth.

Job Growth Underwhelms, but Other Labor Market Indicators Remain Solid

The economy added 155,000 jobs in November, significantly fewer than the 237,000 jobs added in October. However, the pace of job growth in October may have been artificially high due to the recovery from the natural disasters that struck in September. The annual growth in average hourly earnings





stabilized at the expansion peak set in October. The unemployment rate held steady at 3.7 percent for the third consecutive month, a level last seen in 1969, and the labor force participation rate was unchanged at 62.9 percent.

Trade Tensions, Stock Market Volatility, and Oil Prices Pose Risks to Forecast

Trade issues present uncertainty to our forecast. The U.S. and China agreed to a 90-day truce beginning on December 1, which will freeze the tariff rate on \$200 billion in Chinese imports at 10 percent instead of increasing to 25 percent on January 1 as planned. In light of these circumstances, many of the downside risks to economic growth are temporarily removed, but the uncertainty of whether a final agreement could be reached may dampen business or consumer confidence and derail some spending and investment activity.

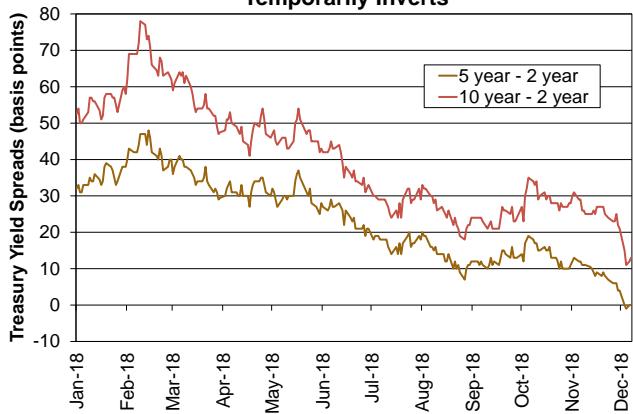
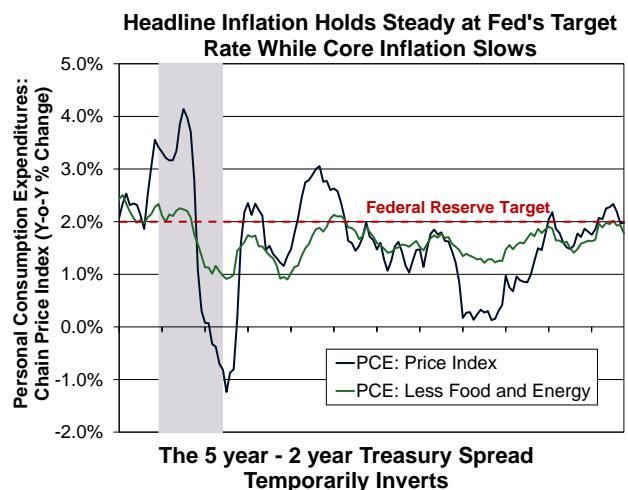
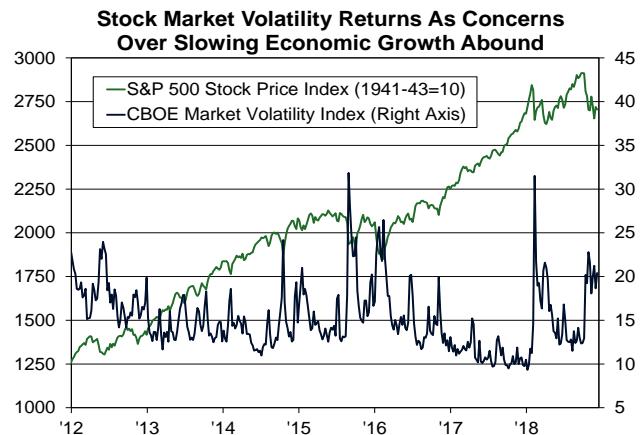
Following a sharp decline in oil prices in November, members of the Organization for the Petroleum Exporting Countries (OPEC) and a Russia-led contingency agreed to curb oil output by 1.2 million barrels per day for the first six months of 2019. Crude oil prices initially rose on news of the agreement. Lower oil prices generally benefit U.S. consumers as the reduction in prices acts as a tax cut that boosts disposable income. However, lower prices can also weigh on business investment as expectations of less revenue from oil production dissuade the capital investment needed for exploration. Expectations of slower economic growth around the world may dim the outlook for oil demand, potentially offsetting the price impact from lower supply.

Stock market volatility returned in October and has continued to the time of this writing as concerns that economic growth is slowing weigh on the market. However, the extent of volatility, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index, has not been as extreme as it was earlier in the year. Nevertheless, equity market volatility has the potential to lower consumer confidence and weigh on consumer spending.

Fed Rate Hikes Likely to Continue in December as Measures of Inflation Remain Near the Fed's Target

The annual growth in the PCE index, the Fed's preferred measure of inflation, held steady at the 2.0 percent target for the second consecutive month in October, while core PCE inflation decelerated to 1.8 percent. The recent decline in oil prices, as well as a rise in the dollar making U.S. imports less expensive to American consumers, should put downward pressure on inflation.

In early December, the spread between the 5-year and 2-year Treasury yields inverted for the first time since 2007, triggering recession concerns across the market. The recent inversion, stock market volatility, and weakness across the housing industry have sparked speculation that the Fed may pause its current tightening cycle in 2019. In a speech given on November 28, Fed Chairman Powell noted that "Interest rates are still low by historical standards, and remain just below the broad range of estimates of the level that would be neutral for the economy," which seems to be a departure from an earlier comment that interest rates were "a long way from neutral." He also acknowledged that the "economic effects of our gradual rate increases are uncertain, and may take a year or more to be fully realized." These statements suggest that the FOMC is likely to grow increasingly data-dependent during its deliberations.





Despite the slowdown in job creation in November, labor market and broader economic conditions remain solid and the pace of inflation is at or near the Fed's target. While market commentary has shifted to the potential for a pause, we maintain our call for two rate hikes in 2019 and one more this month, unchanged from our prior forecast.

Housing Roundup

Home sales were mixed in October with existing home sales rising modestly while sales of new homes fell sharply. However, year-to-date total home sales fell amid a sharp rise in mortgage rates. In October, the average 30-year fixed mortgage rate had increased 92 basis points from its year-ago levels, according to Freddie Mac. Meanwhile, the latest data from the National Association of Realtors showed that the Affordability Index fell 8.4 percent in September from a year ago. In a positive development for homebuyer demand, mortgage rates stabilized in November, with the monthly average rising only 4 basis points to 4.87 percent.

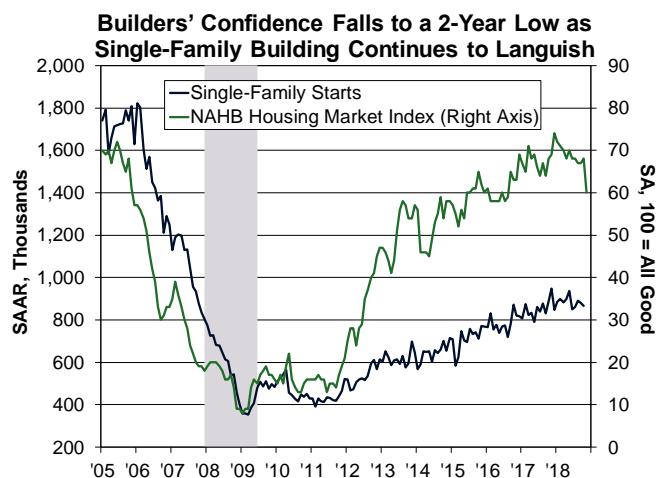
Amid rising mortgage rates, pending home sales, which represent contract signings of existing homes and precede closings of existing homes by a month or two, fell by 2.6 percent in October. While average monthly purchase applications also fell in October, they struck a more positive note in November, registering a 2.5 percent increase as mortgage rates were nearly flat.



Measures of house price growth have slowed. For example, the annual growth in the Federal Housing Finance Agency's Purchase-Only House Price Index slowed to 6.0 percent in September, its slowest rate since January 2017. Home price expectations have also moderated significantly, according to the home price expectation component in Fannie Mae's Home Purchase Sentiment Index. The net share of consumers expecting prices to increase dropped in November to the lowest reading since October 2016.

While housing demand has moderated, for-sale inventories have risen. In October, the inventory of existing homes grew 2.8 percent annually at the current sales pace, compared with 18.0 percent for new homes. The increase in the for-sale inventory, driven by interest rate-induced declines in demand, has resulted in an increase in the months' supply of both existing and new homes over the past 12 months. The months' supply of existing homes rose to 4.3 months in October from 3.9 months last year. Readings below 6 months suggest that supply remains below the long-term average level. The large decline in new home sales and the significant increase in for-sale new home inventory pushed the months' supply of new homes higher from 5.9 months in October 2017 to 8.1 months in October 2018.

As the inventory of homes for sale has increased substantially over the past year, the level of single-family starts fell 1.8 percent in October from September and 1.5 percent from a year ago. Leading indicators of single-family production suggest that construction will remain modest over the remainder of the year. Single-family permits fell in October, while the National Association of Home Builders/Wells Fargo Housing Market Index (HMI) dipped 8 points in November to a reading of 60. Readings above 50 indicate that more builders view the housing market as good than poor, but the decline in the HMI to its lowest level since August 2016 underscores significant affordability challenges faced by potential buyers.



We expect residential fixed investment to fall in the fourth quarter, the fourth consecutive quarterly decrease. For 2019, we expect home sales to be little changed and project that single-family construction will continue to grow. Mortgage rates are expected to stabilize in 2019, allowing potential homebuyers time to adjust to the higher rate levels and should, in combination with a slower pace of house price growth, support affordability. At the same time, the labor market should



remain solid as job growth is expected to keep the unemployment rate near historically low levels which is positive for income growth.

We lowered our purchase mortgage originations forecast by \$4 billion in 2018 and \$11 billion in 2019 due to weaker-than-expected incoming data for average home sale prices and the downward revision of our existing home sales and single-family starts forecast. We continue to expect purchase originations for 2018 to be slightly lower than 2017 volumes (\$1.17 trillion vs \$1.18 trillion), with a recovery into 2019 and 2020 (\$1.19 trillion and \$1.25 trillion, respectively). We have revised up slightly our refinance originations forecast for 2018, 2019, and 2020 as actual data came in higher than expected and our projection of mortgage rates was revised lower than in the prior forecast. We continue to expect refinance originations to decline over the forecast horizon, dropping from \$461 billion in 2018 to \$413 billion in 2019 and \$404 billion in 2020.

For information on multifamily market conditions, please see the [December 2018 Multifamily Market Commentary](#).

Economic & Strategic Research (ESR) Group

December 10, 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: The Conference Board, Census Bureau, Bureau of Economic Analysis, Energy Information Administration, Chicago Mercantile Exchange, Bureau of Labor Statistics, Financial Times, Wall Street Journal, Chicago Board Options Exchange, Federal Reserve, National Association of REALTORS®, National Association of Home Builders

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