Fannie Mae

Economic and Strategic Research

Economic Developments – February 2018

A More Dovish Fed Helps Improve Economic and Housing Market Conditions

Over the full year of 2019 we project economic growth will slow to 2.2 percent from our expectation of 3.1 percent growth in 2018. We expect a shrinking benefit from federal fiscal policies, a widening of the trade deficit, and a deceleration in the pace of business investment will contribute to the slowdown in economic growth. Key downside risks to our forecast include the slowdown in global economic growth and trade uncertainty. The dovish shift by the Federal Reserve, easing financial conditions, and an expanding labor pool represent upside risks to our forecast. As a result, the balance of risks may have shifted from predominantly downside to closer to neutral.

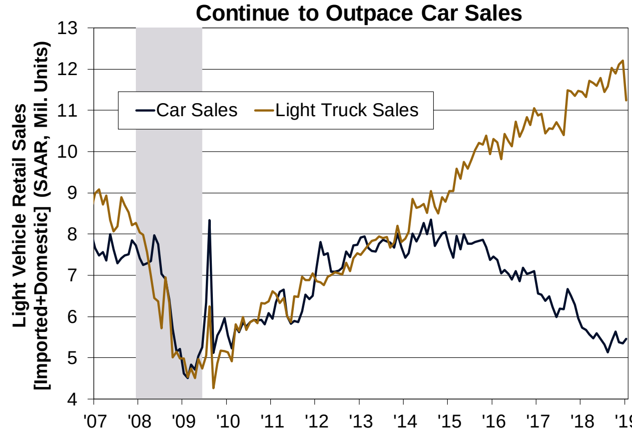
In the first quarter of 2019 the U.S. economy is expected to grow at a 1.7 percent annualized rate, a 0.1 percent reduction from our forecast last month and a notable slowdown from the 2.8 percent annualized rate of growth we expect occurred during the fourth quarter of 2018. Our forecast of slowdown in economic growth in the first quarter largely reflects our expectation that consumer spending has slowed as consumers' expectations of future economic conditions have deteriorated. While the shutdown was a hot topic during the past month, we believe most of the impact should be recovered by the end of this quarter. We assume that the federal government debt ceiling will be raised in a manner that does not unduly undermine investor, business, or consumer confidence.

We lowered our forecast of home sales in the fourth quarter of 2018 as declines in existing home sales more than offset a large increase in new homes sales in November. The December data on new home sales are delayed by the shutdown. Forecast home sales over the first quarter of 2019 were also revised lower in response to December pending home sales posting the third straight month of declines. Our lower forecast of existing home sales led us to reduce our projection of 2019 purchase mortgage originations, but falling mortgage rates, strong employment and average hourly earnings growth, and slowing house price appreciation suggest that home-buying conditions remain favorable heading into the spring buying season.

Lower Auto Sales Weigh on Consumer Spending

Important data on consumer spending have been delayed by the shutdown, but spending activity measured by the private sector has shed light on recent trends. Retail gasoline prices fell by 5.0 percent in January to $2.25 per gallon. Falling gas prices should support consumer spending growth, though it will be constrained by declines in light vehicle sales which fell to a seasonally-adjusted annual rate of 16.7 million in January. Despite a 7.9 percent decrease in light truck sales during the month, sales of light trucks outpaced car sales, a trend that has continued for over four years.

Despite a Decline in January, Light Truck Sales Continue to Outpace Car Sales

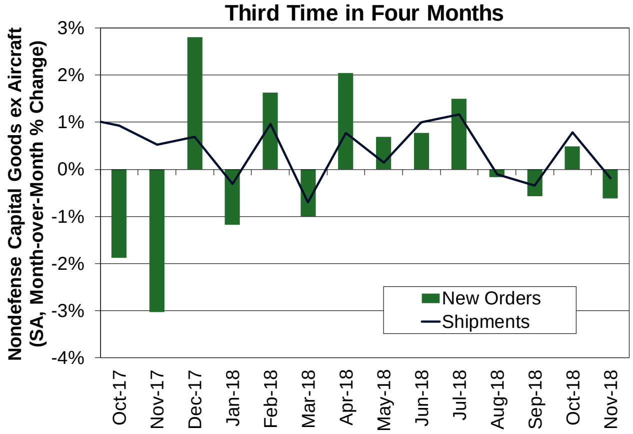


Measures of consumer confidence fell in January as headline risks appeared to weigh on sentiment in spite of healthy labor market conditions and recovering equity prices. The Consumer Sentiment Index fell in January to the lowest level since the Presidential election, while the Consumer Confidence Index declined for the third straight month to an 18-month low. The shutdown and still-volatile stock market appear to be weighing on confidence. While we believe consumer confidence will stage a recovery in coming months, uncertainty over U.S. and Chinese trade negotiations as well as a slowdown in global economic growth may continue to weigh on equity markets, even with the expected slowdown in monetary policy tightening. In addition, the boost from the Tax Cuts and Jobs Act is expected to wane, lowering the path of consumption growth.

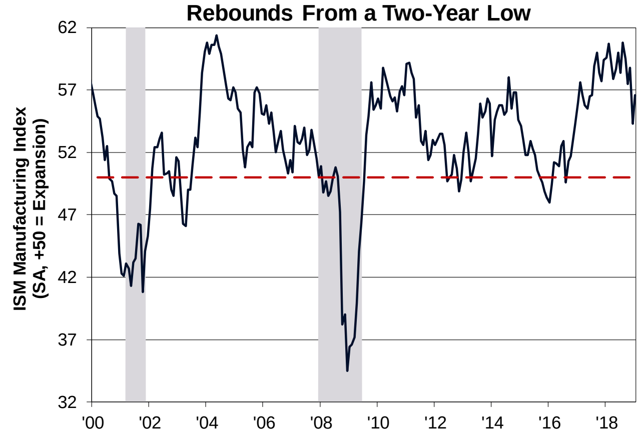
Businesses Tapped the Brakes on Investment

Incoming data suggest that business investment growth slowed in the fourth quarter. Private nonresidential construction spending fell by 1.2 percent over the month of November to $450.8 billion, its lowest level since January 2018. Both shipments and new orders of nondefense capital goods excluding aircraft declined in November, weighing on fourth quarter equipment spending and suggesting that spending will have had little momentum heading into 2019. On a more positive note, the Institute for Supply Management (ISM) Manufacturing Index rebounded to 56.6 in January. Readings above 50 indicate that the manufacturing industry is growing. While the gain reversed only about half of the drop in the prior month, it demonstrated resilience in the sector amid trade uncertainty and slowing global economic growth.

Core Orders and Shipments Decline for the Third Time in Four Months



Manufacturing Sector Activity Partially Rebounds From a Two-Year Low



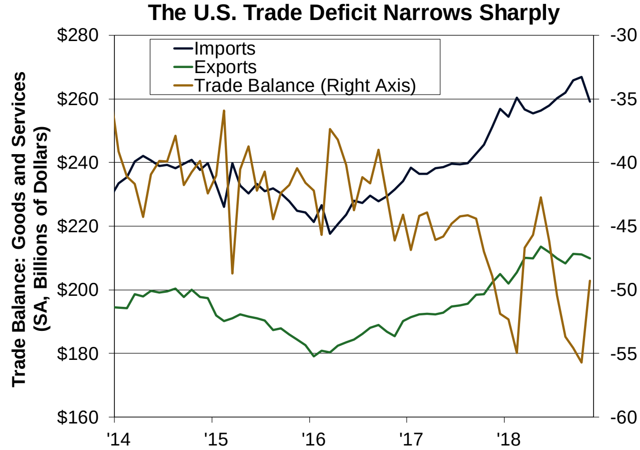
The Trade Deficit Shrinks in November and Suggests Less Inventory Investment

The U.S. trade deficit narrowed sharply in November to $49.3 billion from $55.7 billion in October. The smaller deficit reflected a 2.9 percent decline in imports to $259 billion while exports fell 0.6 percent to $210 billion. The decline in imports is the first monthly drop since April 2018 while the decrease in exports over the month is its fifth in the past six months and may reflect the slowdown in global economic growth as well as past dollar appreciation. The improved trade deficit offset weakness in the November factory orders report and boosted our fourth quarter growth forecast.

After adding to growth in the third quarter of 2018, private inventories are expected to have been a drag on fourth quarter growth as the decline in imports over the month of November points to less inventory-building.

The U.S. trade deficit is expected to widen in the first quarter. The drop in the new exports orders and import components of the ISM Manufacturing Index suggests that exports growth should moderate in the first quarter while import growth should accelerate. However, the trade-weighted exchange value of the U.S. dollar weakened 1.5 percent in January and should slow the pace of the widening in the trade deficit. As the dollar weakens, foreign goods and services become more expensive to American consumers and U.S. goods and services become less expensive to foreigners; however, the responses can lag.

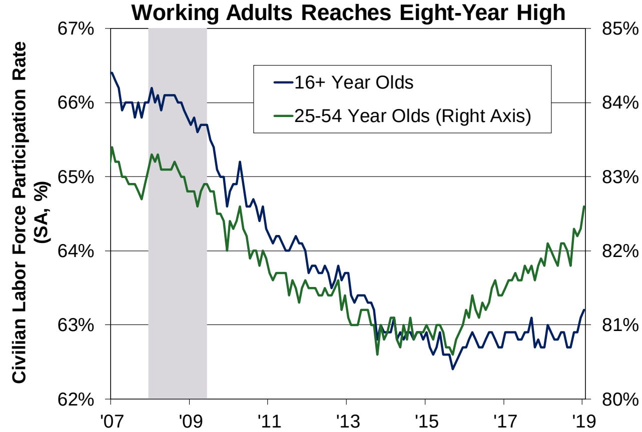
The U.S. Trade Deficit Narrows Sharply



Strong Job Growth Signals a Healthy Labor Market

The U.S. economy added 304,000 jobs in January, its largest monthly increase since February 2018, despite the shutdown that covered the first 25 days of the month. Although parts of the government had ceased operations during the reference week of the Establishment Survey used to calculate job growth, the furloughed workers were not considered unemployed because Congress passed and the President signed legislation guaranteeing back pay for all federal workers when they returned to work. The January jobs report suggests that the impact on federal contractors was likely minor relative to the performance across the entire economy.

The Labor Force Participation Rate of Prime Working Adults Reaches Eight-Year High



The unemployment rate edged up a tenth to 4.0 percent in January, reflecting the government shutdown. In the Household Survey, many furloughed workers were counted as temporarily unemployed for the month of January though some were misclassified as employed but absent from work, thereby limiting the increase in the unemployment rate. It is likely the unemployment rate will be adjusted downward in the February release. Amid a still low unemployment rate and strong job growth, the labor force participation rate reached 63.2 percent in January driven by prime age workers, those between 25 and 54, whose participation rate climbed to the highest level since April 2010. The rising labor force participation rate should help alleviate labor shortages reported by many industries and keep wage pressures contained, providing room for increased hiring without adding significant inflationary pressures.

Slowing Global Growth, Trade, and Political Uncertainty Pose Downside Risks

Several factors present downside risk to our baseline forecast. Evidence of a slowdown in foreign economic growth continues to mount. Germany's economy grew by 1.5 percent in 2018 after climbing by 2.2 percent the prior year. China's economic growth slowed to 6.6 percent last year, decelerating from 6.8 percent in 2017 and marking the slowest pace of growth in 28 years. The International Monetary Fund (IMF) expects global economic growth to weaken to 3.5 percent in 2019 from an estimated 3.7 percent in 2018. A slowdown in foreign economic growth could dampen foreign demand for U.S. goods and services, widening the U.S. trade deficit. With the U.S. economy also expected to slow this year, the deceleration in global economic growth may result in less international trade overall, which would lower our estimate of the U.S. economy's sustainable rate of growth.

After agreeing to a 90-day truce beginning on December 1, a resolution to the trade dispute between the U.S. and China remains elusive. As of this writing, Treasury Secretary Steven Mnuchin, U.S. Trade Representative Robert Lighthizer, and a broader team will travel to China in search of an agreement by the March 1 deadline. On February 7, the National Economic Council Director Larry Kudlow asserted that "there is still a long way to go before the U.S. will strike a deal with China." The S&P 500 Index fell by 0.9 percent that day. Stock market declines and trade uncertainty could erode consumer confidence, restrain spending, and limit firms' willingness to spend and invest.

The shutdown ended on January 25 when Congress passed and the President signed a short-term spending bill. We expect that the negative impact on economic activity will be largely recouped by the end of the first quarter. However, a portion of the lost activity will be permanent.

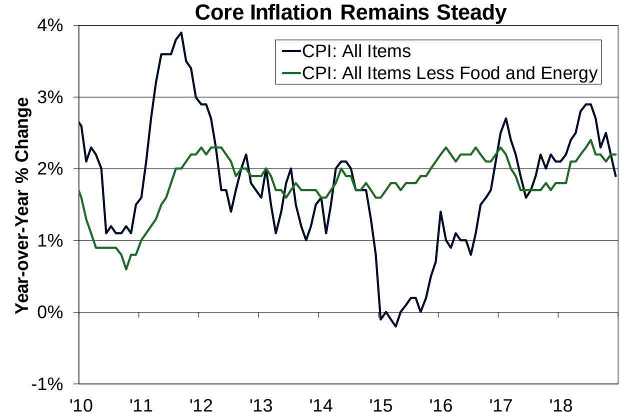
The Fed Will Be Patient

The Fed maintained the federal funds rate at a range of 2.25 to 2.50 percent at its January meeting, as expected. The surprising outcome was the dovish shift in the Fed's tone. In its statement the Fed said that it would be patient in determining future adjustments to the federal funds rate. Forward guidance about further gradual rate increases was eliminated. In view of the strong labor market, we continue to expect the Fed to raise rates once more, in June, before pausing.

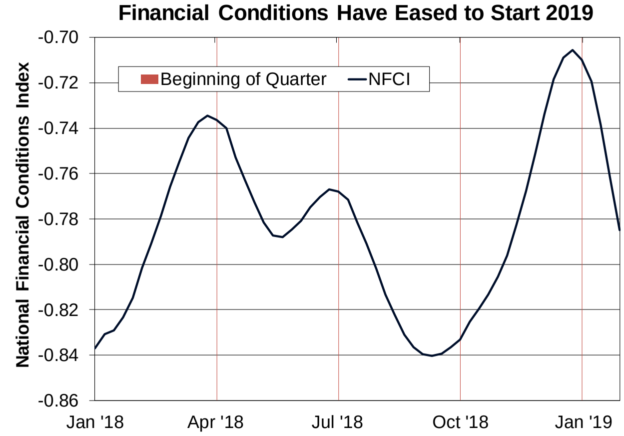
Despite strong annual average hourly earnings growth, annual consumer inflation, measured by the Consumer Price Index, slowed in December to 1.9 percent, driven by a 0.3 percent drop in energy prices. However, core inflation, which excludes more volatile food and energy prices, held steady at 2.2 percent. Since March 2018 core inflation has fluctuated within a narrow range of 2.1 percent to 2.4 percent, suggesting that inflationary pressures remain contained and supporting the Fed's decision to be patient.

Financial conditions tightened considerably in the fourth quarter of 2018, according to the Federal Reserve Bank of Chicago's National Financial Conditions Index (NFCI), and weighed on economic growth prospects. Since the start of 2019, financial conditions have eased, helped along by a more dovish Fed. Easing financial

Headline Consumer Inflation Decelerates As Core Inflation Remains Steady



Financial Conditions Have Eased to Start 2019



conditions support economic growth by lowering borrowing costs and fostering investment. However, they could also encourage excessive debt accumulation backed by over-valued collateral amid an appearance of increased market liquidity.

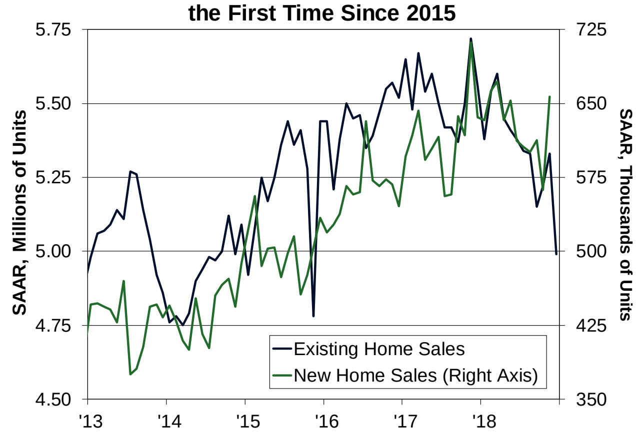
Home Sales in 2019 Look a Lot Like 2018

In December, sales of existing homes fell 6.4 percent to 4.99 million (seasonally adjusted annualized rate), the first time since November 2015 that sales were below the 5.0 million level. In November, new home sales rose by 16.9 percent to 657,000.

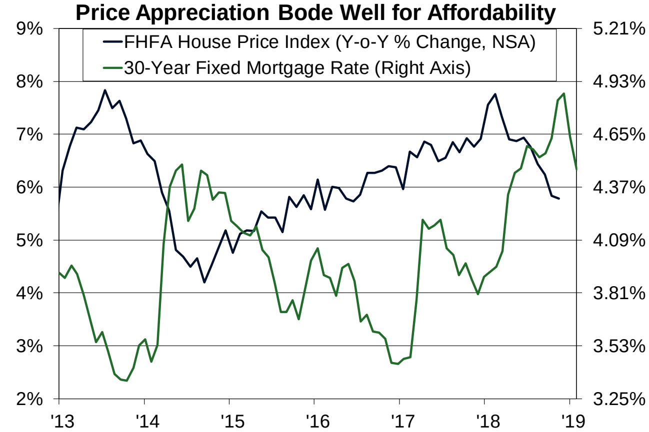
Home buying conditions are trending in a favorable direction. A strong labor market supports housing demand and an 18-basis point decline in mortgage rates over January, as well as slower house price appreciation, supports affordability. Annual growth in the Federal Housing Finance Agency's Purchase-Only House Price Index remained at 5.8 percent in November, staying below 6.0 percent for the second consecutive month after exceeding or equaling 6.0 percent for the prior two years. Fannie Mae's Home Purchase Sentiment Index (HPSI) increased 1.2 points in January to 84.7, suggesting potential buyers are a bit more optimistic. However, the HPSI remains 4.8 points below its level from a year ago.

Consistent with slower annual house price appreciation, the inventory of existing homes for sale (not seasonally adjusted) rose from a year ago for the fifth consecutive month in December to the fastest annual growth rate since October 2014. The months' supply of homes rose to 3.7 months in December from 3.2 months in December 2017. However, a reading below 6.0 months typically indicates a shortage. The number of new homes for sale rose 15.1 percent over the year ending in November and the months' supply rose from 4.9 months last November to 6.0 months this November.

Existing Home Sales Fall Below 5.0 Million for the First Time Since 2015



Declining Mortgage Rates and Slowing Home Price Appreciation Bode Well for Affordability



Single-family construction is expected to end the year on a soft note. Single-family starts fell 4.6 percent to 824,000 in November. While the government shutdown has delayed further updates on new residential construction, single-family permits, which typically lag starts by approximately one month, rose only 0.1 percent in November to a seasonally adjusted annual rate of 848,000.

Pending home sales fell 2.2 percent in December, suggesting that weakness in existing home sales will continue early in 2019 in spite of favorable home buying conditions. However, a 12.8 percent increase in average purchase mortgage applications in January offers some hope for home sales entering the spring buying season. In recent weeks, purchase mortgage applications have returned a portion of these gains, suggesting that any jump in home sales may be short-lived.

Our February forecast downgraded home sales and thus contributed to lower expectations for purchase mortgage originations in 2018 and 2019. Expected purchase mortgage originations were revised lower in 2018 and 2019 to $1.147 trillion and $1.181 trillion, respectively. Projected refinance originations were raised to $431 billion in 2019 in response to our modestly lower interest rate forecast. The 30-year fixed mortgage rate in 2019 is now expected to average 4.4 percent, one-tenth below our January forecast. On net, we lowered our expectation for total single-family mortgage originations by approximately $3 billion to $1.611 trillion, which is 0.2 percent above the $1.608 trillion in total single-family originations in 2018.

For information on multifamily market conditions, please see the February 2019 Multifamily Market Commentary.

Note: Projected single-family mortgage origination volumes are as of February 15, 2019.

Economic & Strategic Research (ESR) Group

February 11, 2019

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: *Autodata, Census Bureau, Institute for Supply Management, Bureau of Labor Statistics, Federal Reserve Bank of Chicago, National Association of REALTORS®, Federal Housing Finance Agency, Freddie Mac*

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