



Economic Developments – September 2016

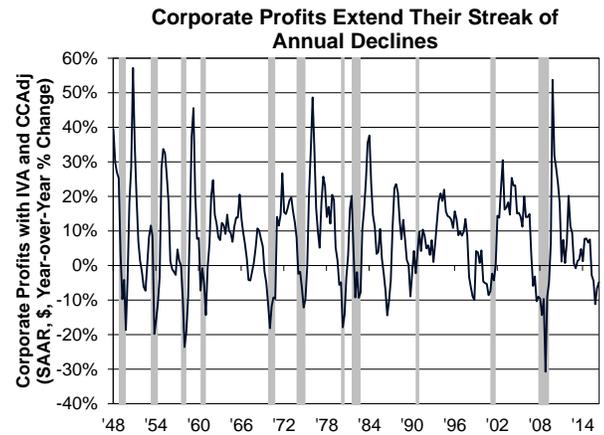
Growth on the Upswing, With a Few Emerging Soft Spots

Early estimates of annualized third quarter growth are in the area of 3.0 percent. This has got the Federal Reserve Board members chattering about fed funds target rate increases. The market is assessing the odds of an increase as having risen but not yet likely in September. At present, market expectations suggest a potential increase in December, but several months of data will be revealed before then and we remain skeptical. Economic growth is poised to accelerate to 2.6 percent in the second half of the year from 1.0 percent in the first half of the year, putting our full-year 2016 growth forecast at 1.8 percent, the same view we've held since July. We expect consumer and government spending to add to growth, inventory investment and net exports to drag on growth, and nonresidential and residential investment to be neutral for the year. Still, at less than 2.0 percent real annual growth, this is a weak economy and downside risks predominate.

For the current quarter, we project real gross domestic product (GDP) growth to accelerate to 2.9 percent annualized, with much of the pickup reflecting a rebound in inventory investment from an unsustainably low level during the first half of the year. While consumer spending is expected to remain the biggest driver of growth, another contributor should be nonresidential fixed investment, which we expect to post a modest increase following three consecutive quarterly declines. Unfortunately, we now expect residential investment to decline for the second consecutive quarter, the first such occurrence since late 2013 and early 2014.

The View in Rearview Mirror Still Looks Gloomy

The second print of second quarter gross domestic product (GDP) showed a one-tenth downgrade of economic growth to 1.1 percent annualized, largely because downward revisions to state and local government spending and inventory investment and a higher estimate for imports outweighed upward revisions to consumer spending and nonresidential investment. One piece of good news from the second estimate was a sizable upgrade to personal income growth. On a downbeat note, the report offered the first glimpse of corporate profits, which fell 1.2 percent (not annualized) after rising 3.4 percent in the first quarter. This marks the fifth quarterly drop over the last six quarters. Profits from domestic industries drove the decline while profits from the rest of the world increased, the reverse situation from the first quarter. From one year ago, corporate profits fell 4.9 percent, the fifth consecutive annual decline. Such a long string of profit declines has occurred only one other time during an expansion, in the period from the first quarter of 1986 through the first quarter of 1987.



Consumers Continue to Carry the Economy

Real consumer spending posted a solid increase of 0.3 percent in July amid the biggest gain in real personal income this year. Strong auto sales and a robust gain in utility spending from an unusually hot July helped boost overall spending. However, auto sales eased in August, dropping 5.0 percent to a 17 million unit annual rate, and the increase in spending on utilities should moderate as the weather becomes more typical. Thus, we expect consumer spending to cool this quarter to 3.0 percent annualized from a robust pace of 4.4 percent in the prior quarter.

While personal income growth was revised higher during the second quarter, followed by a strong increase in July, the August jobs report points to weakening personal income gains. The report showed that hiring slowed markedly in August from the prior two months to 151,000. However, this single data point does not necessarily signal labor market weakness, given that only about 100,000 jobs need to be added monthly to hold the unemployment rate constant. The average monthly job gain over the last three months rose to 232,000, compared with just 118,000 in the three months ending in May. Details of the August report were on the weak side, however. The average workweek declined one-tenth from the July figure, which was revised lower. Thus, aggregate weekly hours (employment times the average workweek) contracted compared with the prior month. In addition, average hourly earnings edged up only 0.1 percent from July and rose 2.4 percent from one year ago, the weakest annual increase since March. Together with the slowdown in aggregate weekly hours, softer wage gains suggest weaker personal income growth in August. However, a data quirk in the August jobs report suggests that the earnings slowdown might be an aberration in the recently improving trend. The monthly gain in average hourly earnings tends to be depressed when the 15th day of the month – the date when many workers are paid – falls outside the survey reference week, which occurred in August.

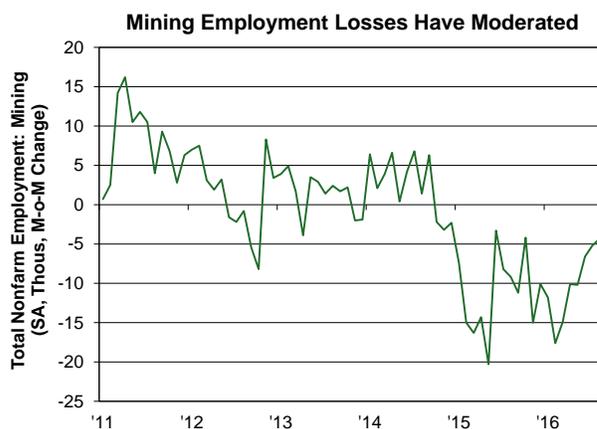
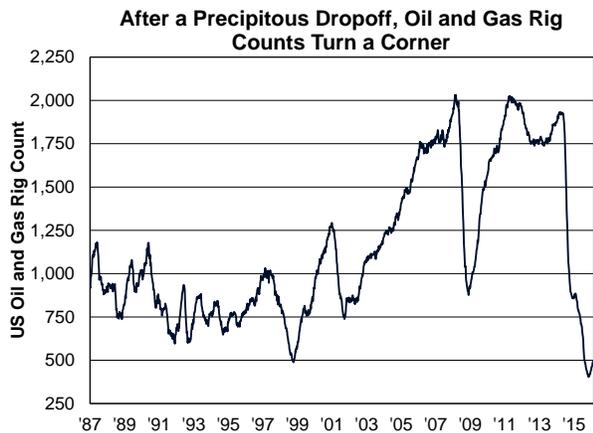


Job losses in the goods-producing sector during August, including a decline of 6,000 total construction jobs, were quite discouraging. However, residential construction employment grew by 10,800 – the biggest monthly gain since March – providing a silver lining for residential investment following bearish news on new construction spending at the start of the third quarter.

Nonresidential Investment Should Turn Around

The construction spending report showed a strong gain for business investment in structures in July, and large upward revisions in the prior quarter established a stronger trajectory moving into this quarter. Thus, we expect real nonresidential investment in structures to rise for the first time in seven quarters. Recent weakness largely reflected slumping investment in oil drilling structures and oilfield machinery triggered by the collapse of oil prices in mid-2014.

However, the drag from the sector has been fading. Recent increases in oil prices, if sustained, should facilitate a turnaround in energy-related investment in structures, helping to boost overall structure spending. The WTI crude oil price has rebounded to more than \$45 per barrel at the time of this writing. Rig counts also rebounded since reaching a trough at the end of May. Separate data on industrial production showed mining output rose in July for the second time in three months, supporting an improving picture for the energy sector. There is no end in sight to the decline in mining employment, however. The sector has lost jobs every month since October 2014, though losses have been moderating lately, with August posting the smallest decline since last October.



In contrast, data related to equipment spending continue to be weak. The factory orders report showed a third consecutive drop in core durable goods shipments (excluding defense and aircraft orders), a component used to estimate business investment in equipment. Core capital goods orders, a forward-looking indicator, showed some improvement, posting the first back-to-back gains this year. The turnaround in business investment in equipment will be gradual, given the erosion in corporate profits. The trend in productivity, which fell in the second quarter for the third consecutive quarter and posted the first annual decline in three years, has negative implications for the profit outlook, as low productivity tends to boost unit labor costs. Thus, businesses are in a bit of a catch-22: Weak business investment contributes to low productivity and weak corporate earnings, but at the same time, declining profits make it harder for firms to increase their capital expenditures.

More recent news on the factory sector from a survey of purchase managers took an unexpected turn for the worse, with the Institute for Supply Management (ISM) manufacturing index slipping 3.2 points to 49.4 in August (any reading greater than 50 indicates an expansion). This marks the first time manufacturing slipped into





contraction territory since February. Weaknesses were broad-based, with two important components – production and new orders – falling below the 50 threshold.

Not only did the manufacturing sector stumble in August, but the service sector also hit a snag as the ISM nonmanufacturing index posted its largest monthly decline since 2008, dropping 4.1 points to 51.4 – the lowest level since early 2010. Since the inception of the two ISM series, August was the only month during an expansion when both indices dropped by more than three points. The other two times occurred at the end of the 2001 recession and in the middle of the last recession. A single month of data is not cause for alarm, but we do need to track related data closely in the near term for any corroborating signs of deteriorating fundamentals

A Rate Hike Is Around the Corner – Said the Fed

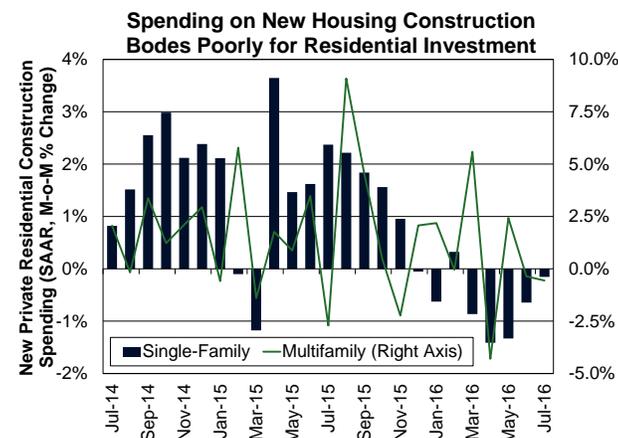
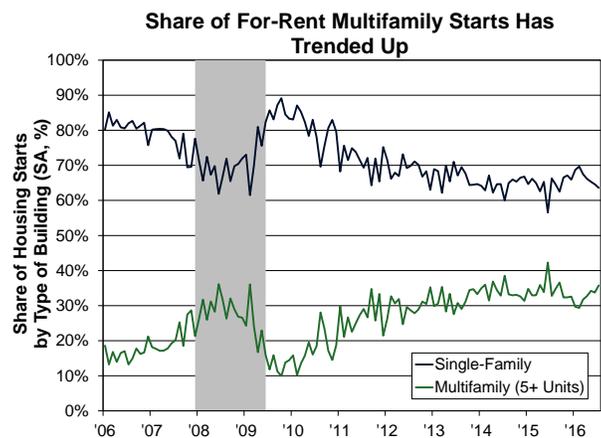
Despite recent attempts by Fed officials to convince the market that economic conditions are ripe for a rate hike, we believe the August jobs report did not pass the high bar needed for a target rate increase at this month's Federal Open Market Committee (FOMC) meeting. Bearish news on the ISM surveys also dampened the urgency of a rate increase. In addition, the underlying trend in the personal consumption expenditures (PCE) deflator, the Fed's favored measure of inflation, continues to run below the Fed's 2.0 percent target. The overall PCE price index was flat in July, and the core index rose just 0.1 percent. The annual increase in the overall index slowed to 0.8 percent, the lowest reading since March, while the year-over-year rise in the core PCE price index remained at 1.6 percent for the fifth consecutive month. Because the Fed rarely surprises the market with a rate hike, it will likely increase communications signaling that it intends to raise the target rate this year, in hopes that the fed funds futures will price in a rate hike. At the time of this writing, the fed funds futures' odds of a September rate hike were 36 percent. Since 1989, the Fed has raised rates only five times when the futures market priced less than 40 percent odds of a hike within three weeks of an FOMC meeting, according to Gluskin Sheff and Associates. Given current economic conditions and more important data to come between now and the December meeting, we continue to hold our call of no rate hike in 2016.

Housing Roundup

Housing data for the single-family market were generally weak in July. While total housing starts increased, single-family starts were little changed, and permits fell to the weakest pace since last September. By contrast, multifamily starts (two units or more) rose for the third time in four months and permits increased for the fourth consecutive month. With recent trends in homebuilding activity favoring the rental market, the share of starts in for-rent multifamily buildings (five or more unit structures) has trended up after its recent trough in February. (For more information on rental market conditions, read the [September 2016 Multifamily Market Commentary](#)).

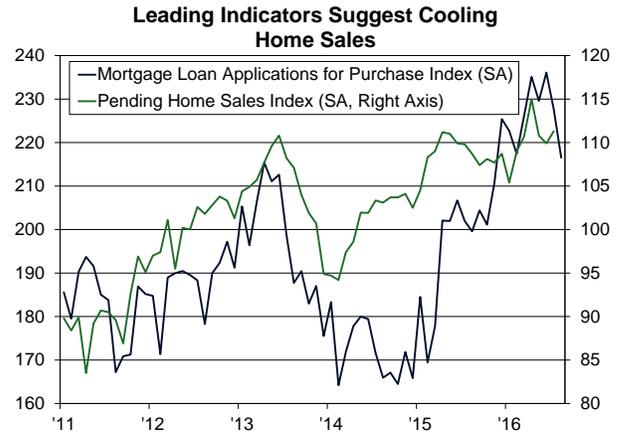
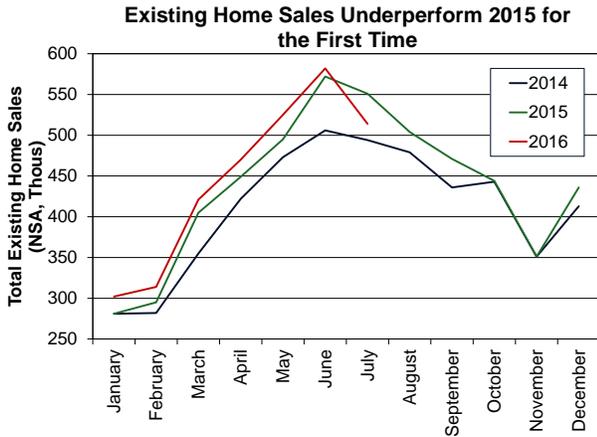
The construction spending report, which includes the dollar value of new single-family and multifamily construction, was much more bearish for residential investment than suggested by the number of housing units started. Construction spending on new single-family structures fell in July for the fifth consecutive month, while that for new multifamily structures dropped for the second straight month. The reason for the recent decline in construction spending is the drop in the average cost per unit of housing starts, especially for the single-family segment. Another reason we marked down our forecast of real residential investment this quarter to a modest decline from a moderate gain in the prior forecast was the large drop in existing home sales in July of 3.2 percent. Because residential investment includes broker commissions, the decline in July existing home sales, which account for the vast majority of home sales, adds headwinds for residential investment for this quarter.

July data showed that existing home sales underperformed 2015 for the first time. However, year-to-date sales are still 2.6 percent more than sales during the same period last year. Leading indicators don't suggest a rebound in home sales in the near term. Pending home sales rose just 1.3 percent in July, and

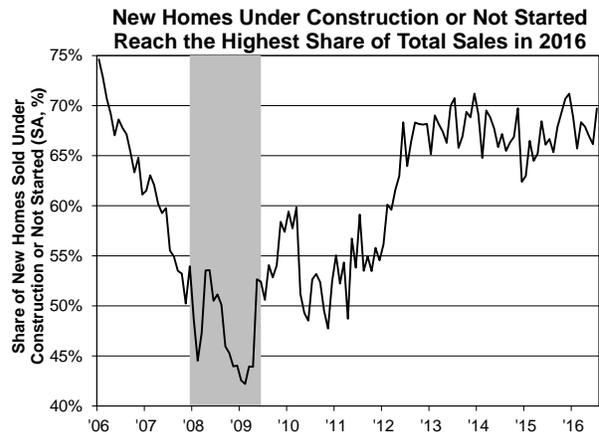
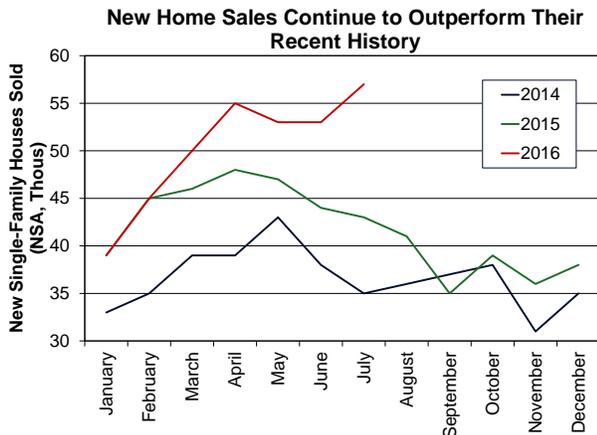




data for June were revised from a slight gain to a modest drop. Meanwhile, average monthly purchase mortgage applications fell in August for the second consecutive month to the lowest reading since last November.



One thing that hasn't improved for the housing market is the for-sale inventory, which has been tight since 2013. In July, the number of existing homes for sale was down 5.8 percent on a year-over-year basis and was at the lowest level for any July since 2002. Lean inventory continues to support home price gains, with annual increases for various measures coming in between 5.0 percent and 6.0 percent this summer. Rising home prices improve homeowners' equity positions and mortgage performance but impede potential first-time homebuyers, especially because home price appreciation at the low-end of the housing market has continued to outpace the average gain.



One bright spot for the housing market in July was the 12.4 percent jump in new home sales, the largest increase since mid-2014, putting sales at an expansion best. New home sales data, which record contract signings, are volatile from month to month and are subject to large revisions, and thus we are hesitant to read too much into the data. Nonetheless, the new home sales trend has strengthened markedly, significantly outperforming activity in recent years. If the improving trend holds up, it should brighten the outlook for single-family homebuilding, especially when the share of new home sales that are under construction or not started has climbed to nearly 70 percent.

Our forecasts for mortgage rates, housing starts, home sales, home price appreciation, and purchase mortgage originations are little changed from last month. We revised higher our projected refinance mortgage originations by \$50 billion for the second half of the year due to higher than expected volumes at the start of the third quarter. For all of 2016, we expect total mortgage originations to rise 5.4 percent from 2015 to \$1.8 trillion, with the refinance share declining slightly to 44 percent.

Economic & Strategic Research (ESR) Group

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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: Bureau of Economic Analysis, Bureau of Labor Statistics, Baker Hughes, Institute for Supply Management, National Association of REALTORS®, Mortgage Bankers Association, and Census Bureau



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ESR Macroeconomic Forecast Team

Doug Duncan, SVP and Chief Economist
Orwin T. Velz, Director
Hamilton Fout, Director

Mark Palim, VP and Deputy Chief Economist
Frank Shaw, Economist