

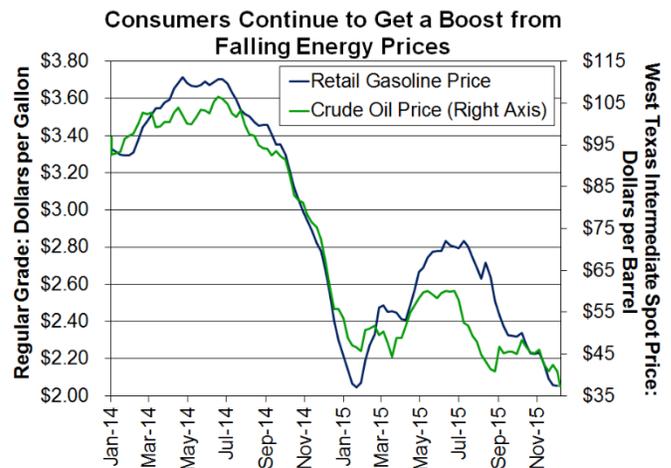
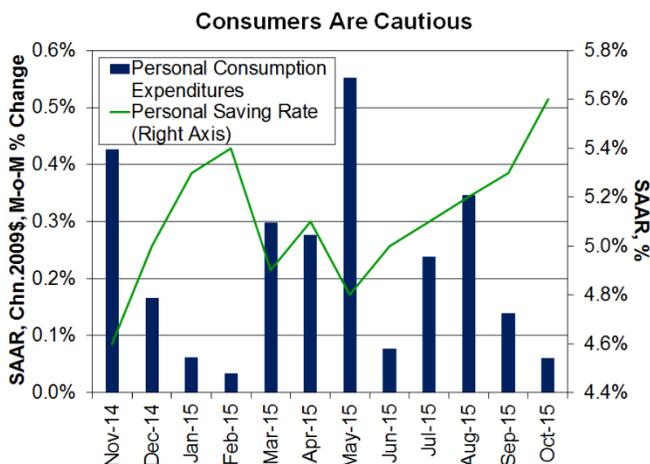
Economic Conditions Greenlight December Rate Liftoff

As 2015 draws to a close, our forecast for the second half of the year remains unchanged overall, but with economic growth shifted somewhat to the third quarter from the fourth quarter. Consumer spending will continue to underpin economic activity in the current quarter, but its growth will likely soften from the pace of the prior two quarters as consumers appear more cautious in recent months. Meanwhile, income growth has picked up amid solid job gains, boosting the saving rate and providing a foundation for a pickup in spending next year. Manufacturing, nonresidential investment in structures, and exports are struggling because of the dollar's appreciation over the past year, declining energy prices, and an ongoing inventory correction. We expect the inventory correction to be largely complete by early next year. The economic drag from the strong dollar should continue next year, but growth in residential investment should help offset lingering weakness in hard-hit sectors. The Bipartisan Budget Act of 2015 eliminated uncertainties over a government shutdown and sovereign debt default, and should provide a modest near-term stimulus. For all of 2015, we expect economic growth to register 2.2 percent before edging up to 2.4 percent in 2016, a view that we have maintained for the past couple of months. The possibility of a sharp slowdown in China and other emerging market economies, a further rise in the dollar, and geopolitical turmoil remain downside risks to growth.

Third quarter real gross domestic product (GDP) growth was revised higher by 0.6 percentage points to 2.1 percent annualized in the government's second estimate. However, the changes to the components were unfavorable for current quarter growth because the upward revisions were concentrated in inventory investment. Following an unsustainable pace of \$113.5 billion in the second quarter, inventory investment moderated to \$90.2 billion last quarter, much more than the initial estimate of \$56.8 billion. Stockpiles are still unsustainably high, and therefore a large unwind in the current quarter is likely, which would subtract considerably from growth. Besides the inventory component, upward revisions in nonresidential and residential investment roughly offset downward revisions in consumer spending and net exports. Excluding the impact of weaker inventory investment, real final sales of domestic product grew a solid 2.7 percent in the third quarter, and we expect a similar increase for the fourth quarter, indicating healthy underlying growth during the second half of 2015.

Positive Consumer Fundamentals Will Drive Growth...

While real consumer spending growth posted a healthy gain of 3.0 percent annualized in the third quarter, consumers appeared cautious at the end of the quarter and more so at the start of the fourth quarter, even as personal income growth picked up. As a result, the saving rate jumped to 5.6 percent in October, the highest reading since the end of 2012. The saving rate has trended up during the second half of the year, as gasoline prices have started to show renewed declines, suggesting that households are saving part of the windfall from lower gasoline prices rather than spending it. Crude prices continued to slide, with West Texas Intermediate oil prices reaching \$37 per barrel at the time of this writing, the lowest level since February 2009, suggesting consumers will likely enjoy more savings at the pump in coming months.



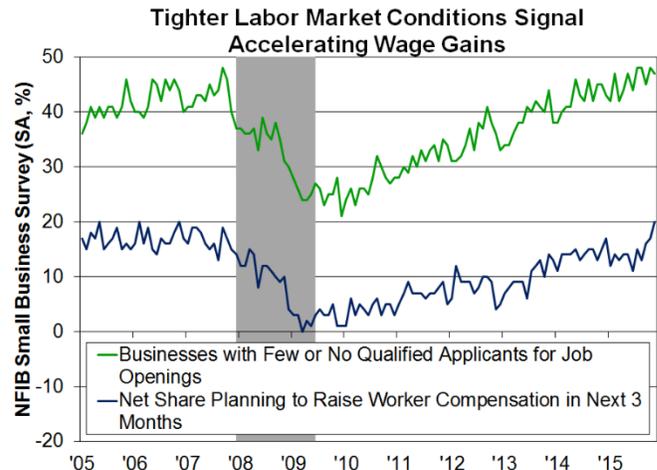
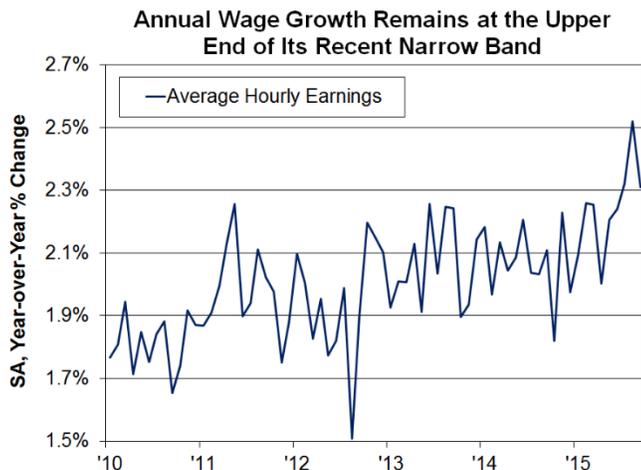
Another sign of caution among consumers in the current quarter is essentially flat revolving consumer credit (largely credit card debt) in October after a string of healthy gains. However, consumers have not shied away from borrowing for big-ticket items, as non-revolving credit (largely student and auto loans) continued to post gains similar to the average monthly increase over the past year. November auto sales remained at 18.2 million annualized units for the third

consecutive month, thanks to positive consumer fundamentals as well as growth in the driving-age population. In addition, lending standards continued to ease, according to the latest Federal Reserve Senior Loan Officer Opinion Survey. Separately, data from the Fed on the terms of credit showed that the average maturity of new car loans rose to a record 65.5 months during the third quarter of this year. Overall, economic, demographic, and lending conditions are positive for auto sales, which are poised to post an annual record high.

We expect the slowdown in consumer spending growth to be temporary. Positive fundamentals, including tightening labor market conditions and declining gasoline prices, should support consumers going forward. We expect real consumer spending growth to pick up next year from the expected 2.4 percent annualized pace in the fourth quarter, but stay below the pace seen during the third quarter.

The November jobs report revealed continued upbeat news, with nonfarm payrolls increasing 211,000. Upward revisions of 35,000 total in the prior two months boosted the average job gain over the past three months to 218,000, the best showing since July. The unemployment rate was unchanged at 5.0 percent amid the favorable backdrop of the first rise in the labor force participation rate since May. While the annual gain in average hourly earnings decelerated to 2.3 percent from 2.5 percent the prior month, it remains near the upper-end of the range observed over the past several years.

Survey data also indicate a tightening labor market. The National Federation of Independent Business (NFIB) November survey showed that a net share of 20 percent of small businesses plan to increase compensation over the next three months, the highest reading in nine years. Meanwhile, the share reporting fewer or no qualified applicants for job openings remains elevated at 47 percent.



One bump on the road for consumers was the summer's stock market swoon. The Fed's Financial Accounts of the United States for the third quarter showed household net worth fell from a record high in the second quarter—the first drop in four years—as the decline in stocks outweighed gains in the value of real estate and other financial assets. Stocks have regained most of their lost ground, however, so the decline in net worth is likely to be an aberration.

...Against Headwinds

An increase in manufacturing output in October, the only gain in the past six months, provided a tentative sign of a manufacturing turnaround. However, surveys of purchasing managers were downbeat in November. The Institute for Supply Management (ISM) manufacturing index dipped below the 50-mark threshold, indicating contracting activity for the first time in three years. The November jobs report corroborated the weakness in the ISM index, showing that manufacturing payrolls fell for the third time over the past four months.

Elsewhere in the goods-producing sector, the energy industry continued to shed jobs, with mining and logging employment declining 11,000 from October and 123,000 (about 14 percent) from last November. Driven by a sharp drop in oil and gas rig counts, mining investment (which includes gas and oil extraction) continued to decline in the third quarter, weighing on overall nonresidential investment in structures. However, the pace of decline has moderated significantly over the past year. Outside of oil and gas drilling structures, investment has been strong for commercial and healthcare structures and manufacturing facilities. Business spending on equipment also has softened over the past year, but, similar to the decline in investment in structures, the weakness is concentrated in commodity-producing industries.

Trade will likely be a drag on growth again in the fourth quarter. The real trade deficit widened in October as real exports fell more than real imports. We expect the strong dollar and lackluster growth abroad to continue to weigh on exports while stronger domestic growth should support import demand. We expect that net exports will continue to be a drag on growth through 2017, although to a diminishing extent over time.

Conditions Support a Gradual Pace of Tightening, Starting Now

If the Fed hikes the fed funds rate at the December Federal Open Market Committee meeting, its policy will diverge from that of other major central banks. For example, at its December meeting, the European Central Bank lowered its deposit rate and extended quantitative easing until at least March 2017. In addition, the Bank of Japan and the People's Bank of China are expected to ease further within the next few months. How this policy divergence will impact currencies and capital flows remains to be seen. A large shock to financial markets, especially in emerging markets, similar to that experienced during the "taper tantrum" presents some risk to the outlook, but we believe the odds of a sizable disruption are small.

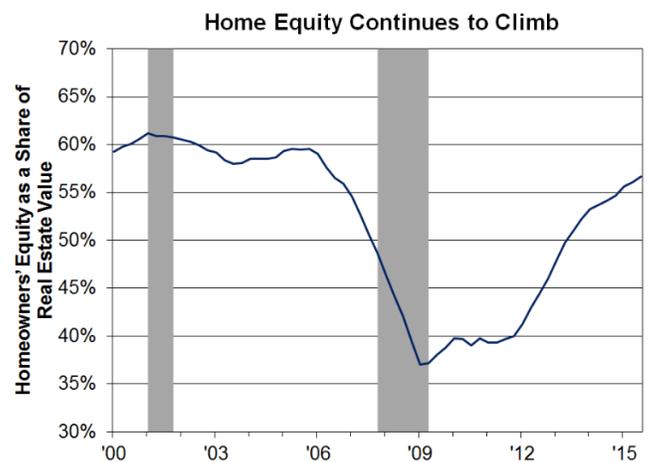
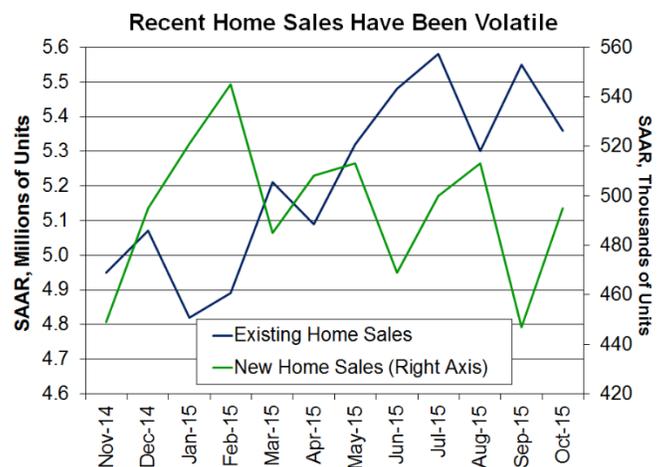
After the liftoff is out of the way, attention will shift to the path of interest rates. Fed officials have communicated that the pace of tightening will be gradual. We expect three fed funds rate hikes in 2016 followed by two more increases in 2017. Shrinking the Fed's balance sheet, which contains more than \$4 trillion of securities, is also an important aspect of normalizing monetary policy. The Fed has said that it plans to allow its balance sheet to deflate naturally by ending its reinvestment program at some point after the first rate hike. Based on the Federal Reserve Bank of New York's October Survey of Primary Dealers, the consensus among the Fed's primary securities dealers is that the program will end nine months after liftoff. The longer the Fed holds onto securities in its portfolio, especially Treasuries, the longer it will exert downward pressure on long-term rates. We expect to have more clarity on this issue in the near future.

Housing Roundup

Recent housing data support our view that residential investment will help fill the void created by other struggling segments in the economy. Private residential construction spending started the fourth quarter on a strong note, posting a solid gain in October for both the single-family and multifamily segments. However, home sales, which also affect residential investment through broker commissions, were mixed during the month. Existing home sales posted a steep drop, while new home sales rebounded sharply amid sizable downward revisions in prior months.

Home price growth has continued to strengthen. For example, the CoreLogic home price index, which is the Fed's preferred measure, showed the biggest year-over-year gain in October since last June. Strong home price appreciation has helped boost the value of home equity. The Financial Accounts of the United States showed that homeowners' equity as a share of the value of real estate rose by 0.6 percentage points in the third quarter to 56.7 percent. While the share has risen substantially from its record low of about 37 percent in 2009, it still remains below its pre-recession peak.

A limited inventory of homes for sale, which puts upward pressure on prices, may also be partially responsible for the recent softening in home sales. Inventory has been extremely low partly because of a slow supply response in the single-family segment. Several factors contribute to the sluggish single-family building activity. While builders' access to credit has improved over the years, it remains historically tight, especially for the purchase or development of land. This has driven up the price of the remaining lot inventory and prevented large-scale speculative construction in many markets. Labor shortage also is



a primary factor, as many construction workers found jobs in other industries during the downturn or left the workforce altogether, resulting in a loss of many skilled workers. After reaching a record low of 142,000 in July 2012, the number of new homes for sale has gradually risen, but still remains historically low.

The lack of inventory is more problematic for the existing home market. The for-sale inventory has increased on a year-over-year basis only twice this year, and the drop of 4.5 percent in October was the largest in over two years. One reason for lean inventories is that institutional investors are holding housing units as rentals, thanks to high rental demand. (For more information on rental market conditions, read the [December 2015 Multifamily Market Commentary](#)). We do not expect the inventory crunch to ease substantially next year, and the situation could get worse if geographic mobility declines or if homeowners are locked in with low interest rate mortgages in a rising rate environment.



Home sales will likely remain subdued in the near term. After posting two consecutive monthly declines, pending home sales, which typically lead closings by one to two months, were little changed in October. The recent trend in purchase mortgage applications—another leading indicator of home sales—reinforces the pending home sales data, as the average monthly reading for October fell for the third time over the past four months. Despite recent volatility, home sales are poised to increase 7.4 percent this year to 5.8 million units, the best performance since 2007.

Housing demand is looking up going into next year, however. Purchase mortgage applications rose every week in November, except for one week when they fell slightly. The rebound in purchase applications supports our forecast that sales will pick up in the first quarter of next year after a slight pullback this quarter. Given our expectation of a slow pace of Fed tightening and continued monetary easing in major central banks abroad, mortgage rates should move up only slowly, with the yield on 30-year fixed-rate mortgages averaging 4.1 percent during the final quarter of 2016, the same as in our previous forecast, up from 3.9 percent this quarter. For all of 2016, we expect total home sales to rise 3.9 percent, more moderate than this year's increase. Our 2016 sales outlook is shaped by our expectations of a gradual rise in interest rates, continued healthy home price gains, and moderate income growth. Continued easing of mortgage lending standards, combined with a positive household formation outlook, should help the housing sector to expand further.

Our mortgage production forecast is the same as in the prior month. We project that total mortgage originations will rise approximately 32 percent this year to \$1.71 trillion, before declining 18 percent and 1 percent in 2016 and 2017, respectively. The refinance share is expected to trend down from 46 percent this year to 32 percent in 2016 and 28 percent in 2017.

December 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, Bloomberg, Department of Energy, Bureau of Labor Statistics, National Federation of Independent Business, the National Association of REALTORS®, Census Bureau, Federal Reserve Board

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