Fannie Mae

Economic and Strategic Research

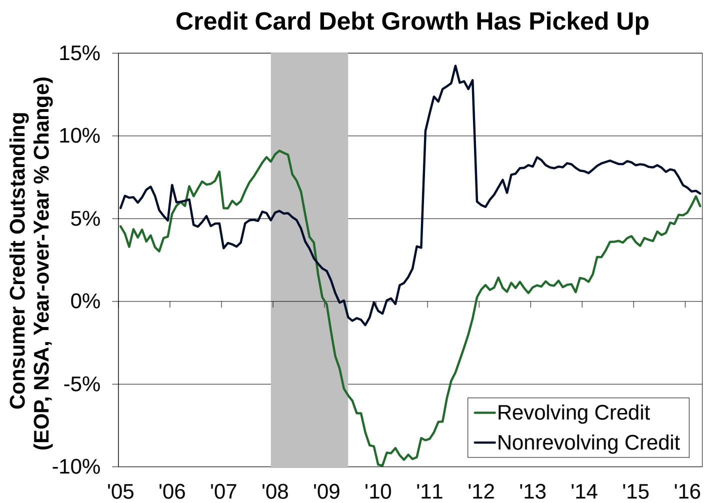
Economic Developments - June 2016

Hiring Stumbles, Raising Downside Risks

Recent data underscore the uneven nature of the current economic expansion. Encouraging signs from consumer spending and housing activity at the start of the second quarter are now tempered by what appears to be a significant loss of momentum in the labor market. We expect real gross domestic product (GDP) growth to pick up, with the last three quarters of the year averaging about 2.0 percent annualized and full-year growth moderating to 1.7 percent, the same as in the May forecast; however, downside risks are rising from a slowing trend in hiring and business investment. Risks from abroad remain heightened, including the possibilities of a devaluation of the Chinese yuan and a vote for the United Kingdom to exit the European Union.

Financial markets have seen some further broad improvement over the past month as expectations of a second Fed rate hike in June faded. Stock markets rose and credit spreads narrowed, especially for high-yield bonds. The dollar has also come off its high. The energy sector has seen some relief. West Texas Intermediate (WTI) oil prices have risen more than $20 per barrel above their recent lows, reaching over $50 per barrel on June 8th thus easing concerns about energy-related credits on bank balance sheets. The drag on non-residential investment in structures should be fading, but a quick turnaround is unlikely.

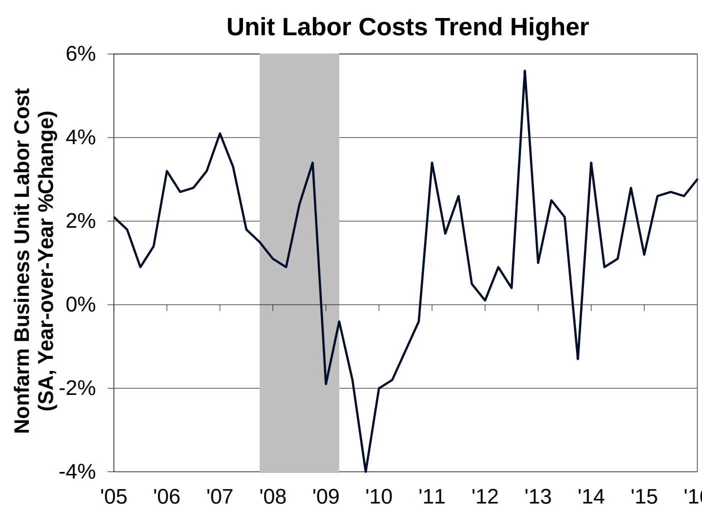
Consumers Are Decidedly Less Cautious



Consumer spending got off to a great start this quarter. Real personal consumption expenditures (PCE) jumped 0.6 percent in April, the biggest rise since August 2014, following a flat reading in March. Real personal income grew just 0.1 percent, the weakest gain since March 2015. Thus, the saving rate dropped 0.5 percentage points from March's 5.9 percent as consumers spent out of savings. Auto sales have cooled from the robust pace of late last year but remain healthy, with sales edging up to 17.45 million annualized units in May, putting the April-May average slightly higher than the first quarter average.

Consumers have also shown an increased appetite for using credit cards to support spending. Growth in consumer credit balances eased but remained elevated in April, increasing $13.4 billion, less than half the pace in March, which was the largest increase in dollar terms (not adjusted for inflation) on record. Over the past year, growth in non-revolving credit (largely auto and student loans) has moderated, while growth in revolving credit (largely credit card debt) has trended up.

Businesses Face Headwinds, Weighing on Hiring and Capital Expenditures Outlook

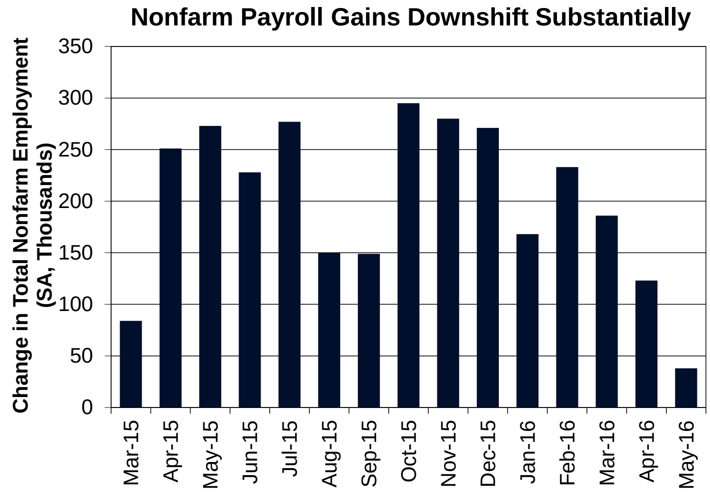


The second estimate of first quarter GDP offered the first glimpse at corporate profits, which edged up 0.3 percent, marking the first rise in three quarters. On a year-over-year basis, corporate profits fell for the third consecutive quarter. Weakness has spread beyond the energy sector, as data from publicly-traded firms in the S&P 500 also showed deteriorating profits for non-energy industries. Since their peak in the third quarter of 2014, corporate profits' majority decline has been in domestic rather than overseas markets, suggesting the problem lies in lackluster domestic demand and not just the strong dollar and weak global growth.

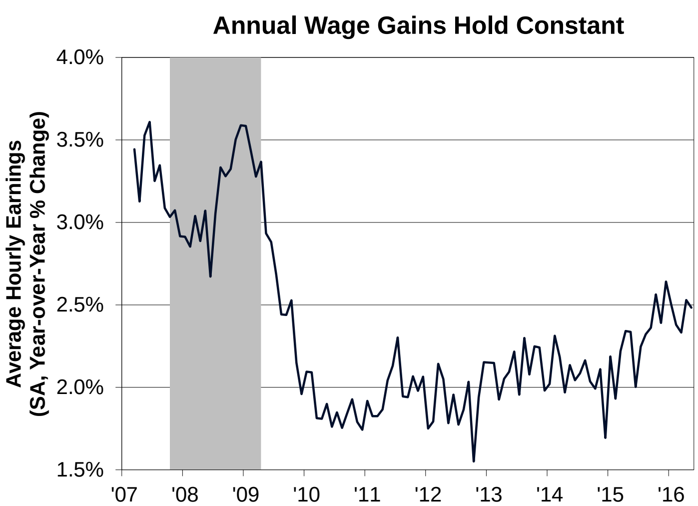
Another headwind for businesses is weak productivity, which declined during the first quarter for the second consecutive quarter. Over the past year, productivity increased 0.7 percent, continuing the trend of sub 1.0 percent growth observed since the end of 2014. Meanwhile, rising compensation led to a 4.5 percent annualized increase in unit labor costs in the first quarter, following a 5.4 percent jump in the fourth quarter. From a year ago, unit labor costs rose 3.0 percent, the biggest increase in two years. Unless businesses can turn productivity around, they have to pass rising costs along to consumers, or their profit margins will compress further, which will bode poorly for the outlook for hiring and business spending.

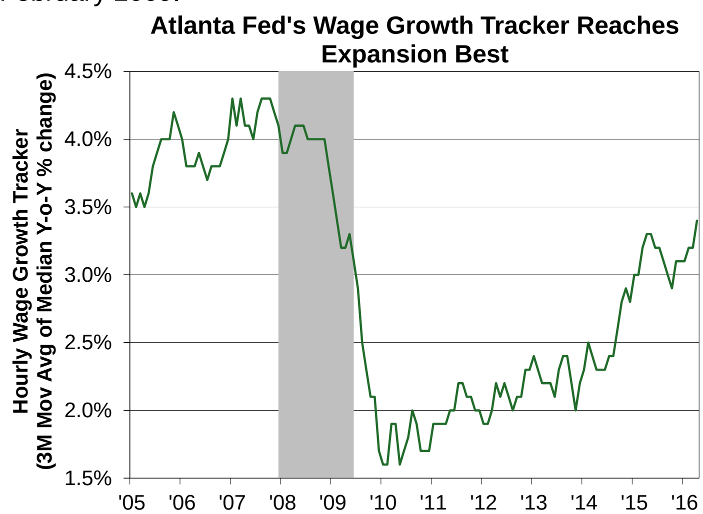
Labor Market Loses Momentum

The May jobs report fell well short of already low expectations, with nonfarm payrolls rising 38,000, markedly trending down from nearly a 300,000 gain last October. Even after accounting for the striking Verizon workers, private job gains remained at a meager 60,000. Other aspects of the report provided no offset to the bearish headline. The prior two months' payroll gains were revised lower, sending the average monthly gains over the last three months to 116,000, the weakest reading since July 2012. In addition, the average workweek was flat at 34.4 hours for the fourth consecutive month, compared with 34.6 hours at the start of the year. Developments in the average workweek bear watching, as businesses generally reduce the duration of the workweek before cutting employment. Temporary hiring, which can be a leading indicator of nonfarm payroll trends, fell in May for the fourth time in five months.



While average hourly earnings growth slowed from 0.4 percent in April to a trend-like 0.2 percent in May, the year-over-year rise remains at around 2.5 percent, near the top of the narrow range witnessed over the past three years. Another measure of wage growth — The Atlanta Fed Wage Tracker — provides a different perspective of wage pressure. Instead of taking a snapshot of hourly earnings for a sample of all wage earners and comparing the change in the average wage, the Wage Tracker measures wage increases of the same workers from one year ago. Effectively, the Wage Tracker is less susceptible to compositional or demographic changes (e.g., replacing retiring aging boomers with younger workers). The Wage Tracker, released with a two- to three-week lag to the jobs report, showed that individuals' wages rose 3.4 percent in April from a year earlier, the largest increase since February 2009.

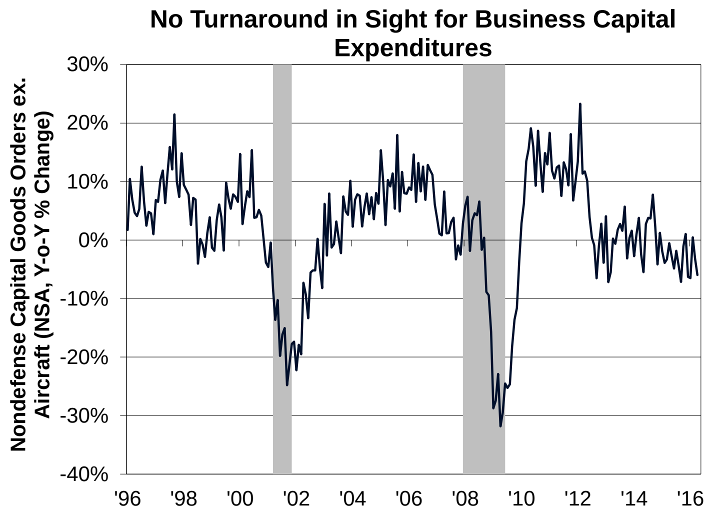




On the household survey side of the May jobs report, the headline was seemingly positive, showing the unemployment rate dropping three-tenths to 4.7 percent, the lowest level since November 2007. However, the decline reflected a large exit of workers from the labor force and not hiring strength, as the labor force participation rate retraced its recent progress, falling for the second consecutive month to a five-month low. While Fed Chair Yellen stressed in her June 6th speech that "one should never attach too much significance to any single monthly report," it is quite clear that hiring momentum has slowed since the start of the year. However, not all employment-related data have deteriorated. For example, the Job Openings and Labor Turnover Survey (JOLTS) showed relatively upbeat demand for labor in April as the job openings rate ticked up to 3.9 percent, tying the expansion high as well as the all-time high for the series that dates back to December 2000. However, other aspects of the JOLTS report were weak, including the drop in the hiring rate to the lowest level since August 2014.

Business Spending Likely to Remain in a Rut for Some Time

Business investment in equipment declined in the first quarter for the second consecutive quarter and should remain weak in coming quarters, as its leading indicator — core capital goods orders (non-defense capital goods excluding aircraft) — fell 0.6 percent in April. On a six-month basis, core capital goods orders plummeted 8.8 percent annualized in April, the worst showing in more than a year. From one year ago, core orders declined 4.4 percent. Energy explains only part of the weakness, as the non-energy portion of core orders appears to be softening as well, likely weighed down by the slump in corporate profits and the compression in margins.

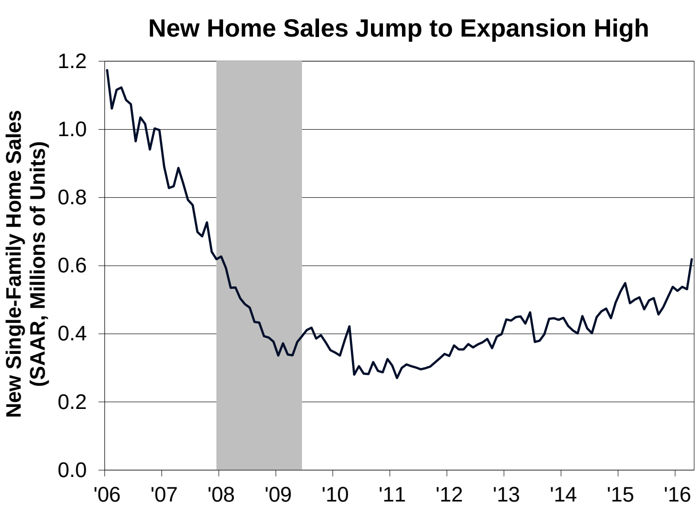


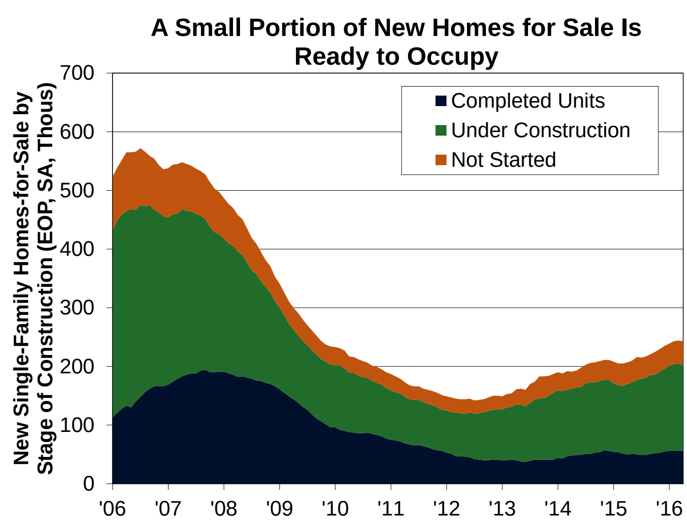
July Fed Rate Hike Requires Robust Increases in Economic Activity

We believe that a July rate increase would require a meaningful rebound in the labor market that indicates the May weakness was just an aberration. Yellen noted in her speech that low inflation and inflation expectations are sources of concern. If inflation expectations move lower, it will call into question how quickly inflation will return to the Fed's 2.0 percent target. The Fed's favored inflation gauge offered no signals that inflation pressure is brewing. While the headline PCE deflator rose 0.3 percent in April, the biggest gain since May 2015, as a result of a second consecutive monthly rise in energy prices, underlying inflation remained well contained. The core PCE deflator, which excludes food and energy, was up 0.2 percent from March and 1.6 percent from last April. The annual increase in April was the same as in the prior month, but slightly below the 1.7 percent gain recorded for both January and February. Our base case remains one Fed rate hike this year in September.

Housing Roundup

April housing data showed healthy spring activity, and suggested perhaps an even stronger summer. New home sales surged to the strongest pace since January 2008, and upward revisions put year-to-date sales about 10 percent higher than sales over the same period in 2015. If this positive development persists, it will bode well for single-family building activity, especially when only a small portion of new homes for sale is ready-to-occupy completed units.

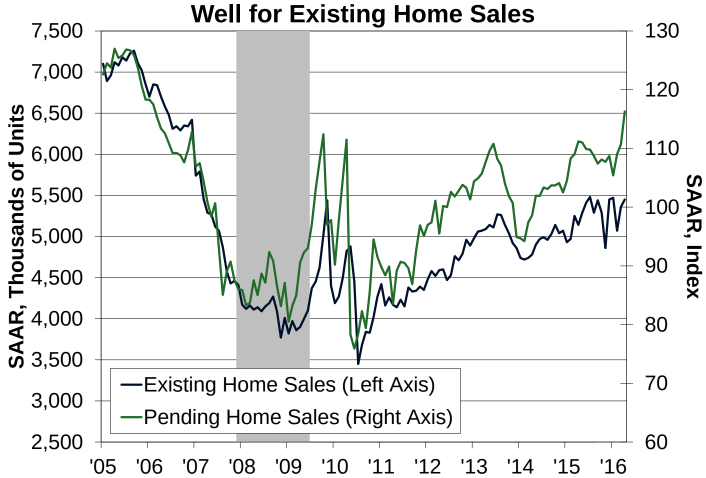




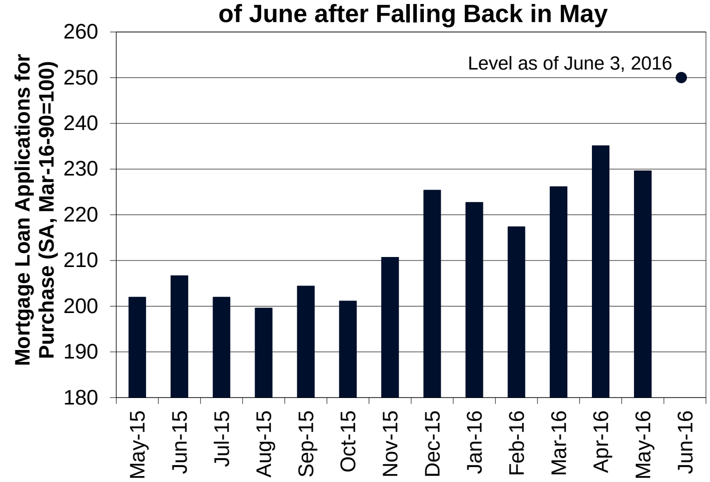
However, the May jobs report recorded the second consecutive month of job losses in residential construction, a factor that could weigh on the outlook for the sector. Recent weakness in construction hiring points to a shortage of skilled labor rather than a deterioration in demand. The JOLTS showed that the demand for construction workers remained elevated in April, as the job openings rate edged down only slightly from an expansion high in March. While housing starts rebounded in April, multifamily starts largely drove the increase. (For more information on multifamily market conditions, read the June 2016 Multifamily Market Commentary).

Existing home sales posted a second consecutive monthly gain in April, reaching a level just below the expansion-best posted last July. Year-to-date existing home sales are 5.5 percent above the level during the same period last year. Leading indicators point to strong sales this summer. Pending home sales rose for the third consecutive month in April to reach the highest level in more than a decade, and average monthly purchase mortgage applications advanced at a good clip. While purchase applications dropped during May, they rebounded sharply in the first week of June.

A Decade High in Pending Home Sales Bodes Well for Existing Home Sales



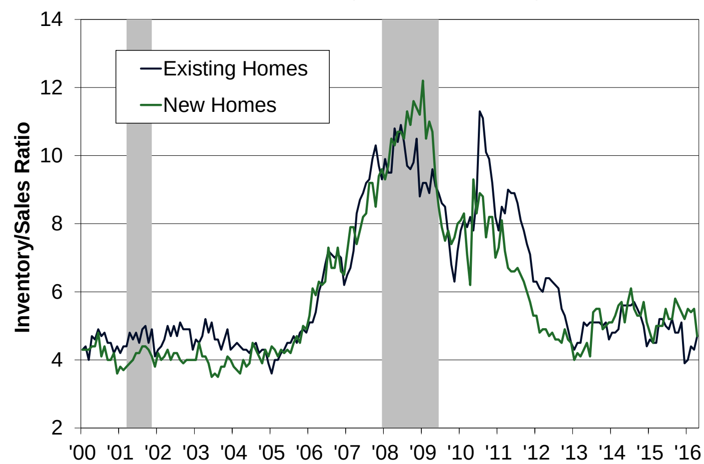
Purchase Applications Jump in the First Week of June after Falling Back in May



The inventory picture hasn't improved much and could play a role in restraining sales. The months' supply readings for both new and existing home sales were 4.7 months in April, well below their year-ago levels, contributing to continued strong home price appreciation and constrained affordability. Fundamentals continue to support a moderate housing expansion this year. Mortgage rates will likely remain low, household formation is gradually improving, real disposable income is rising, and lenders continue to report easing lending standards on residential mortgage loans.

Our forecast for mortgage rates is the same as the prior forecast, with 30-year fixed mortgage rates averaging 3.7 percent during the fourth quarter of 2016. Because of the surge in April new home sales and upward revisions, we revised higher our projected sales for the rest of the year. We also raised slightly our forecast for existing home sales for this quarter. Still, total home sales for 2016 are expected to increase at only about half of the 2015 gain of 7.0 percent, a view we've held since the start of the year. We revised lower our forecast of refinance originations for the first quarter but slightly upgraded our near-term outlook. For all of 2016, we expect total mortgage originations to decline 2.8 percent from 2015 to $1.67 trillion, as the drop in refinance originations more than offsets the rise in purchase originations. The refinance share should drop 6.0 percentage points to 40 percent.

Months' Supply Measures Stay Low



Economic & Strategic Research (ESR) Group
June 8, 2016

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: *Federal Reserve Board, Bureau of Labor Statistics, Census Bureau, Atlanta Federal Reserve Bank, National Association of REALTORS®, Mortgage Bankers Association*

Note for Atlanta Fed Wage Tracker: *To calculate the wage growth series, the Fed matches the hourly earnings of individuals observed in both the current month and 12 months earlier and computes the median of the distribution of individual 12-month wage changes for each month. The final step is to smooth the data using a three-month moving average.*

ESR Macroeconomic Forecast Team

Doug Duncan, SVP and Chief Economist
Orawin T. Velz, Director
Hamilton Fout, Director
Mark Palim, VP
Frank Shaw, Analyst