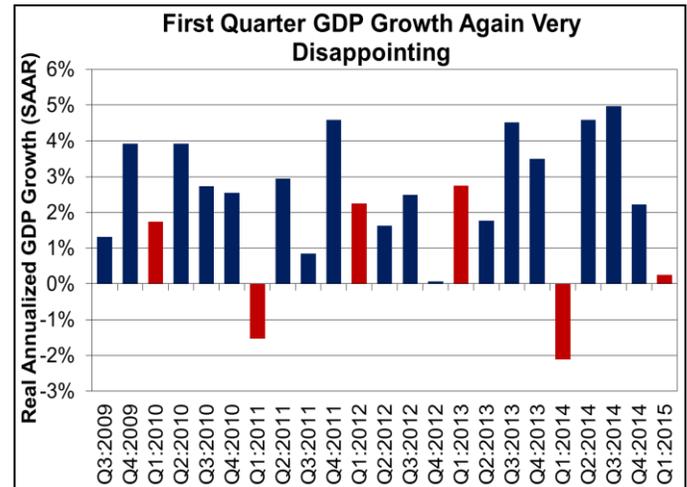


2015 Expected Growth Forecast Receives a Downgrade, But Housing Is On A Better Path

We expect a rebound in growth in the current quarter, as transitory adverse impacts dissipate, though we don't see quite as large a snapback in growth as the one witnessed a year ago, when the economy grew 4.6 percent annualized in the second quarter following the first-quarter decline. Our forecast points to a pickup in economic growth to 2.4 percent in the second quarter and further acceleration in the second half of the year to slightly more than 3.0 percent. For all of 2015, we project that the economy will grow 2.3 percent, a downgrade of 0.5 percentage points from the prior forecast and similar to the pace witnessed in 2014.

The initial print of first-quarter gross domestic product (GDP) showed that the economy barely grew, increasing just 0.2 percent. The slump is reminiscent of last year, when the first reading of the first quarter came in at 0.1 percent, only to be revised down in subsequent reports, finally coming in as a 2.1 percent decline. Data for the first quarter of 2015 released after the GDP report suggest that downward revisions are likely and real GDP may have actually contracted.

Transitory factors were partially to blame, both for this year and last. Aside from the weather, the West Coast port shutdown contributed to some adverse impacts. The economy faced more than just transitory headwinds this year, however. Negative economic fundamentals, including a much stronger dollar, have significantly hurt manufacturing and net exports. Net exports shaved 1.3 percentage points off first quarter GDP growth—the second consecutive quarter that trade subtracted at least one percentage point from growth—and will likely be a drag to the economy going forward. Declining energy-related investment in equipment and structures also weighed meaningfully on growth amid low oil prices and falling oil rig counts. Meanwhile, the unsustainable pace of real inventory investment, which exceeded \$100 billion for only the fourth time since 2000, bodes poorly for near-term growth as a likely inventory drawdown will act as a drag to GDP in coming quarters.

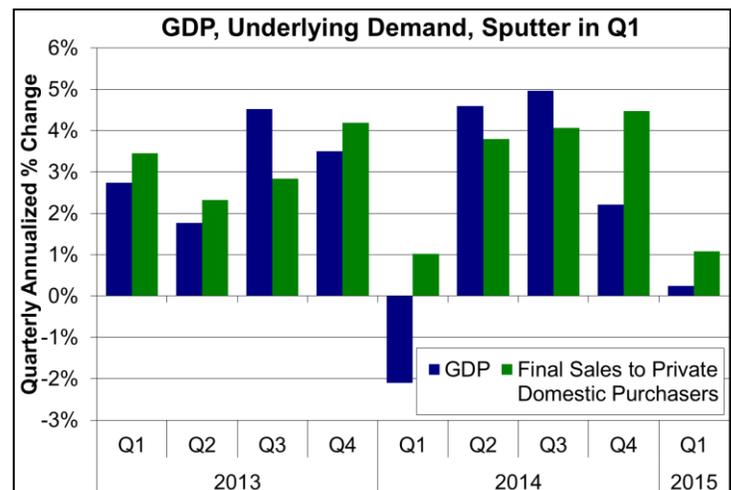


Underlying Domestic Demand Also Falters

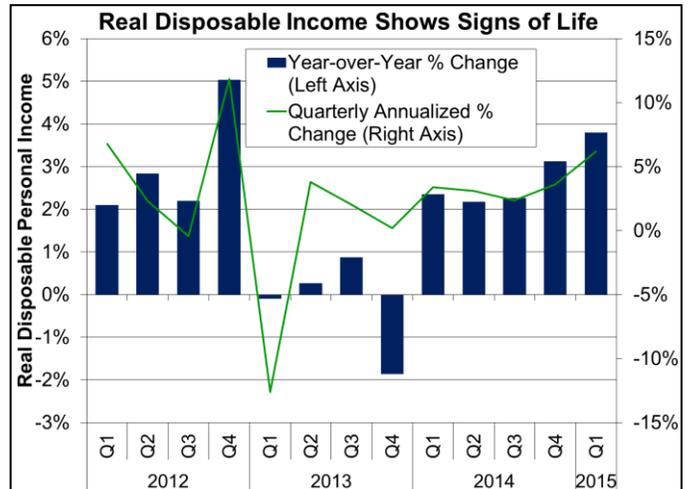
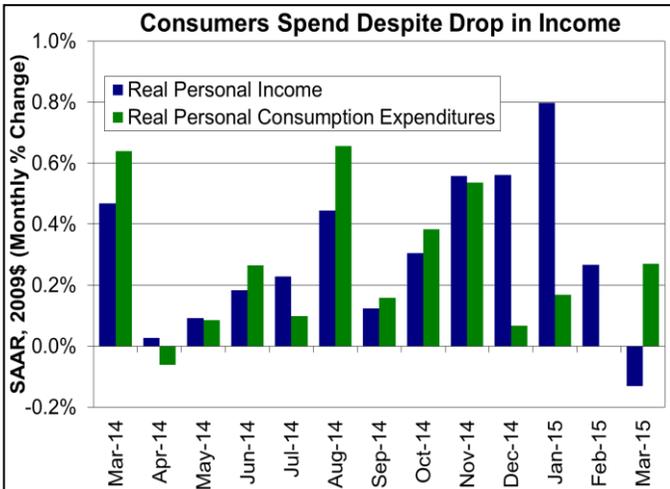
With businesses cutting investment and consumers slowing spending, growth in underlying private demand, as measured by real final sales to private domestic purchasers (GDP less inventories, net exports, and government spending), sharply moderated to 1.1 percent from 4.5 percent in the fourth quarter. The pace of underlying demand growth was similar to that during the first quarter of 2014, but we expect it to strengthen through the rest of this year.

Will Consumer Spending Rev Up To Be A Stronger Engine Of Growth?

Our improving outlook hinges on a meaningful pickup in consumer spending growth following a lackluster 1.9 percent annualized pace in the first quarter. So far, incoming data support our view. Personal consumption expenditures (PCE) strengthened at the end of the first quarter against flat personal income. As a result, the saving rate dropped in March for the first time in four months, falling 0.4 percentage points from a two-year high to 5.3 percent, and signaling that consumers have begun to spend some of the additional disposable income from declining energy prices that was previously saved. Although retail gasoline prices have risen since February, the average price has been about \$1.15 below the same period a year ago.



Adjusted for inflation, real personal income fell for the first time since December 2013, with weakness concentrated in dividend income. Meanwhile, real PCE posted the biggest rise since last November, pointing to a solid trajectory heading into the current quarter. However, auto sales disappointed, edging down in April. Still, we expect real PCE growth to accelerate sizably in the second quarter.

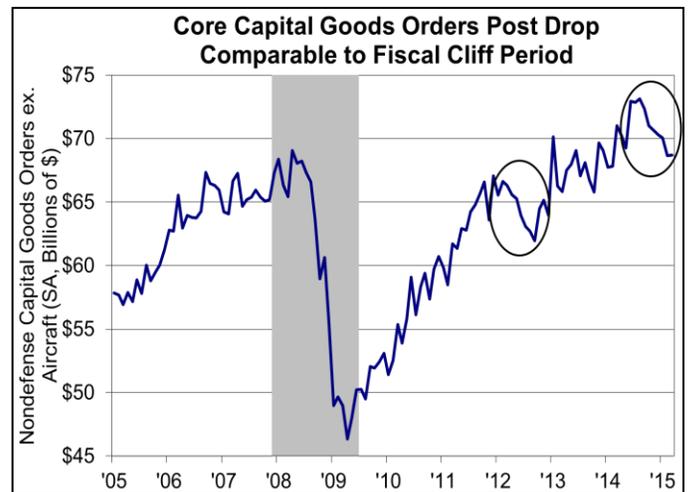


Real personal disposable income also dropped slightly in March; however, the 6.2 percent annualized gain for the quarter marks the strongest quarterly growth since the fourth quarter of 2012, when bonus and investment income was pulled forward to avoid higher taxes in 2013. Among several measures of income, real personal disposable income has a good track record as a driver of consumer spending.

Other consumer fundamentals are also positive. Household balance sheets are in good shape, with net worth rising for six consecutive years to a level that is 22 percent higher than its pre-recession high. With home prices continuing to rise at a healthy clip, housing wealth is rising along with financial wealth, and fewer homeowners have negative equity positions. Meanwhile, the share of income used to service debt payment is near a 35-year low, which may allow consumers to incur more debt to finance their spending going forward. Thus, we remain comfortable with our forecast of a pickup in consumer spending.

Manufacturing Will Likely Remain Under Pressure

Spending on business equipment barely eked out a gain during the first quarter; however, we can hardly blame transitory factors for the weakness as core capital goods orders, a forward-looking indicator, have trended down substantially after their recent peak in August 2014. Core capital goods orders edged up 0.1 percent in April, the first rise in seven months. The last time we saw similar weakness was in March 2012, amid the political gridlock and looming fiscal cliff that eroded business confidence, resulting in seven consecutive monthly declines in core orders. In the current period, the culprits weighing on business capital expenditures—the strong dollar and declining energy prices—will likely have a lingering impact for some time, and thus a strong snapback as witnessed at the beginning of 2013 is unlikely.



The industrial production report corroborated the impact of the headwinds from the strong dollar and low energy prices. Mining output fell in March for the third consecutive month and the fifth time over the last six months, while manufacturing output edged up during the month, posting the first rise since last November.

Surveys of purchasing managers suggest limited improvement in manufacturing activity in the near term. The Institute for Supply Management (ISM) manufacturing index was flat in April, remaining slightly in expansion territory (a reading of 50 or more indicates expanding manufacturing activity). The index has not posted a gain since last October. Anecdotal evidence in the comment section pointed to unwinding impacts of the port shutdown, which was consistent with the jump in the exports index, which crossed over into expansion territory for the first time this year.

Service Industry Marches on

By contrast, the ISM nonmanufacturing index rose in April, reaching the highest level since last November. Since the service industry accounts for the bulk of overall economic activity, the improvement in the nonmanufacturing index supports a rebound in economic growth. One notable weakness in the survey was a sharp drop in the export orders index, which fell into contractionary territory and the lowest level in more than a year, suggesting that exports will likely weaken in coming months.

Job Growth Back on its Feet after March Stumble

The rebound in nonfarm payroll growth in April to 223,000 suggests that the anemic increase in March, which was revised lower to 85,000, was an aberration. The unemployment rate ticked down to 5.4 percent amid the uptick in the labor force participation rate to 62.8 percent. Wage gains remain muted, with average hourly earnings increasing just 0.1 percent on the month while the year-over-year gain remains trend-like at 2.2 percent. The trend in average hourly earnings has not yet followed the wages and salaries component in the Employment Cost Index (ECI), a broader measure of labor compensation, which tracks both wages and salaries (including bonuses, incentive earnings, and commission payments) and controls for the mix of employment by occupation and industry. In the first quarter of 2015, the ECI rose 0.7 percent from the fourth quarter. The year-over-year gain of 2.6 percent, the biggest rise in six years, was significantly stronger than the roughly 2.0 percent annual gains recorded between the second quarter of 2010 and the second quarter of 2014. The wages and salaries component has moved similarly.

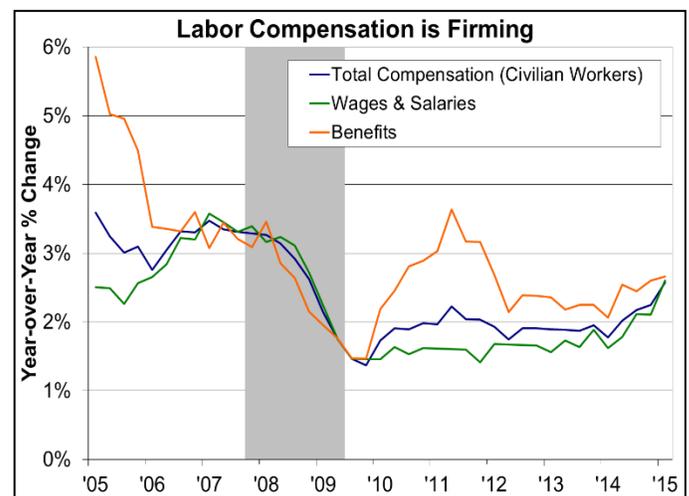
Odds of a Later Liftoff Rise

In its statement following the April Federal Open Market Committee (FOMC) meeting, Fed officials acknowledged weaknesses in economic activity during the first quarter but largely attributed it to “transitory factors.” The statement noted that inflation should climb gradually as the impact of declines in energy and import prices fades. The mention of import prices was new in the April statement—an explicit reference to the appreciation in the dollar. The Fed’s favored inflation measure—the PCE price index—showed stabilization in the pace of inflation, albeit at an anemic rate. It advanced 0.1 percent in March and 0.3 percent from a year ago, the second consecutive rises for both the month-over-month and year-over-year gains. The core PCE price index, which excludes food and energy prices, edged up 0.1 percent from February and rose 1.3 percent year-over-year for the fourth consecutive month.

The forward-looking FOMC statement was unchanged, confirming that policy decisions will be made on a meeting-by-meeting basis. Other central banks were more active than the Fed. Sweden’s Riksbank held its main policy rate steady at negative 0.25 percent at its April meeting while increasing its bond purchases. The People’s Republic of China cut interest rates and the reserve requirement ratio in March and May, respectively, and we expect more to come.

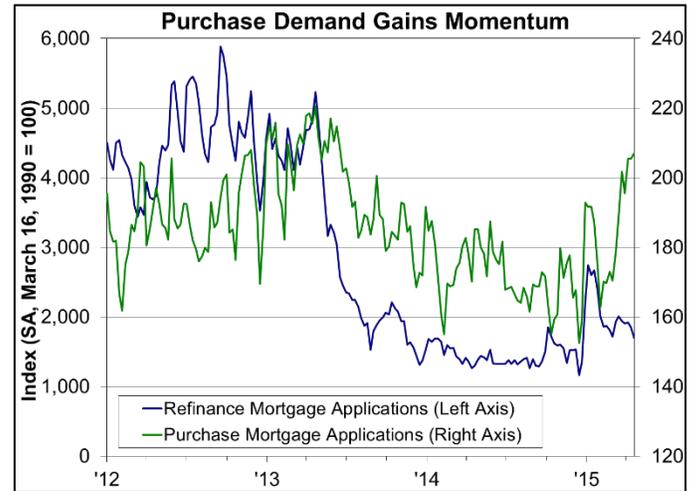
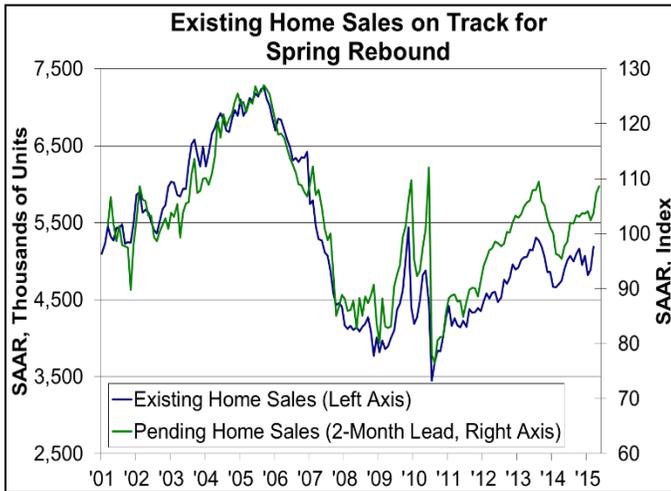
While inflation continues to run below the Fed’s target, it appears to have bottomed as crude oil prices have trended up from their lows in January 2015. Meanwhile, the pickup in the ECI and the continued decline in the unemployment rate point to a tighter labor market. Thus, we continue to hold our call for a September liftoff in the fed funds rate but see risks skewed toward a later hike, given the loss of momentum in economic activity in the first quarter.

Long-term interest rates have moved up in recent weeks in response to external events, including the German bund selloffs and rising crude prices. We expect increased volatility in interest rates in coming months as financial markets anticipate tightening U.S. monetary policy. However, continued monetary policy easing by many central banks around the globe should provide ample liquidity to the market, keeping fixed mortgage rates mostly below 4.0 percent this year.

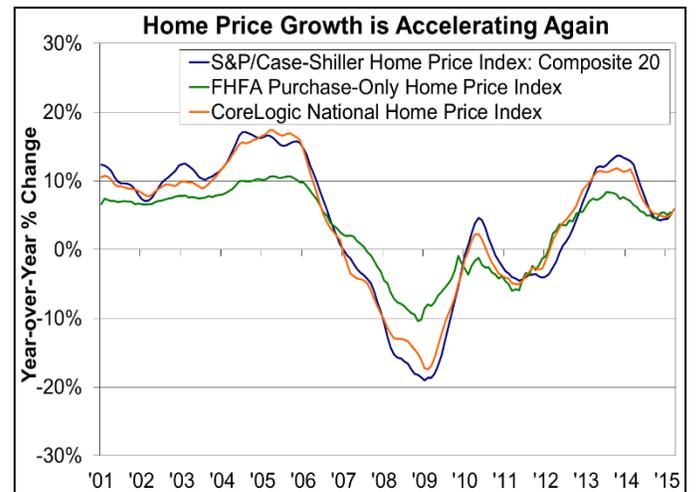


Housing Builds Momentum

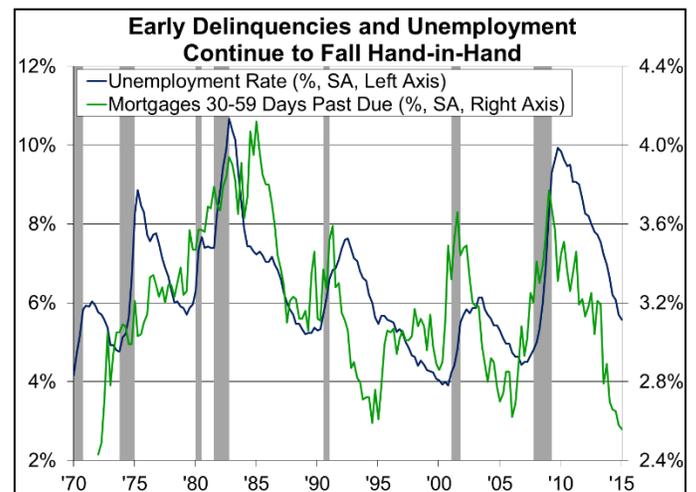
Home sales were mixed during the first quarter. Existing home sales jumped in March to the highest level since mid-2013 when the “Taper Tantrum” choked off budding housing market activity. Despite the strong showing at the end of the quarter, existing home sales fell slightly from the fourth quarter of 2014. New single-family home sales pulled back in March but closed the first quarter with the strongest pace since 2008. Leading indicators suggest a strong spring season. Pending home sales increased in March for a third consecutive month amid upward revisions to an already strong increase in February. Another leading indicator of home sales—purchase mortgage applications—edged up during the first week of May to a fresh high since June 2013.



One soft spot is single-family homebuilding. After contracting sharply in February, housing starts rebounded only slightly in March, and following nearly six years of recovery, spending on private single-family construction remains stuck near 1998 levels. Poor performance for homebuilding and existing home sales led to a relatively flat contribution of residential investment to GDP in the first quarter. However, builder confidence picked up in April, and the inventory of new homes for sale remains lean. Combined with continued declining distressed sales, the tight inventory has helped support strong home price gains. Following moderating price growth reported for much of 2014, the budding acceleration in annual home price appreciation in January and February witnessed in many home price measures firmed in March, according to CoreLogic. We expect these conditions to lead to increased residential construction in coming months.



Strong home price gains have helped improve equity positions and loan performance of single-family residential properties. The Mortgage Bankers Association (MBA) National Delinquency Survey showed that delinquency rates and the share of loans in foreclosure continued to improve during the first quarter, with many measures at or approaching prerecession levels. Foreclosure starts ticked down to 0.45 percent, which, according to the MBA, is at its long-run average. Early stage delinquency edged down to the lowest level since 1972, reflecting tightening labor market conditions and the overall current quality of mortgage debt outstanding.



Lending standards continue to show signs of modest easing. Consistent with recent policy changes for the Federal Housing Administration (FHA) and the Government-Sponsored Enterprises (GSEs), the Federal Reserve Board Senior Loan

Officer Opinion Survey showed continued loosening in mortgage lending standards in the three months ending in April, with the exception of subprime mortgages. A large majority of banks indicated loosening lending standards for GSE and government mortgages. The first quarter [Fannie Mae Mortgage Lender Sentiment Survey™](#) showed that the majority of lenders surveyed believed that the GSEs' 97 percent LTV products and the reduction in FHA's mortgage insurance premiums (MIP) will benefit consumers and lenders, with about two out of three lenders surveyed expecting that these changes will somewhat increase mortgage originations.

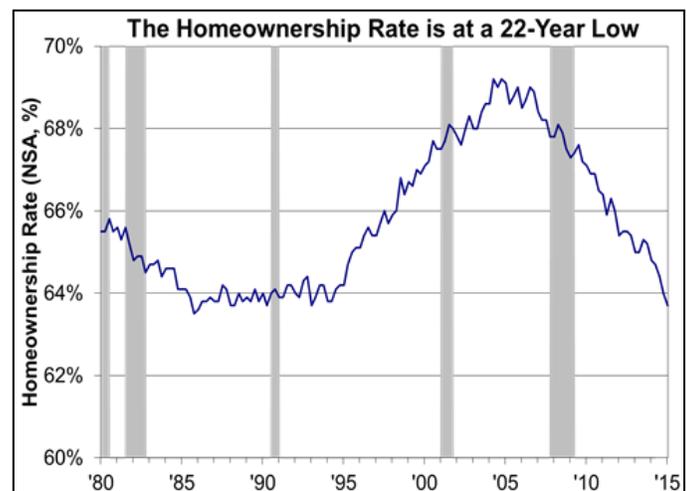
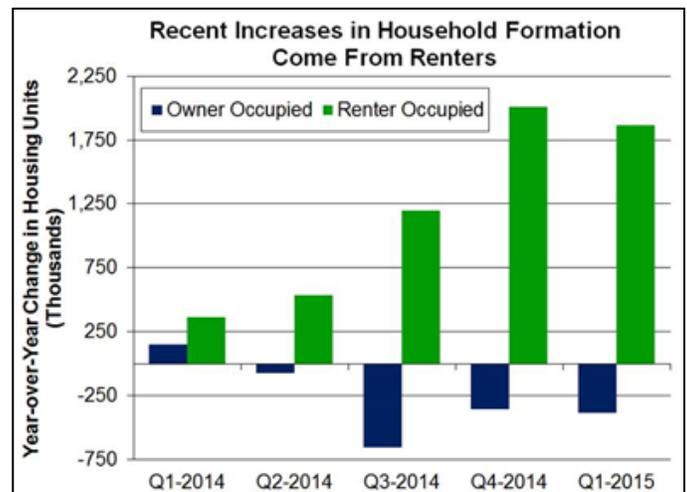
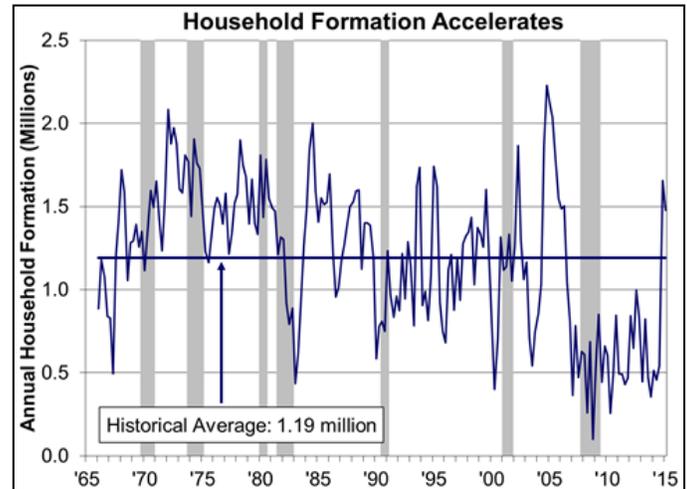
As we mentioned earlier, despite economic growth grinding to a halt, real disposable income growth picked up during the first quarter, and we expect ongoing improvement to help boost household formation and lift housing activity. After rising by 1.7 million in the fourth quarter of 2014 from a year earlier, the number of households posted another strong year-over-year increase of 1.5 million in the first quarter of 2015. However, with all of the net increase coming from renters, the homeownership rate declined a remarkable 1.1 percentage points over the past year to the lowest reading since the early 1990s—fully erasing the gains witnessed between 1995 and 2005.

With strong demand for rental properties, construction activity responded, reflected in the V-shape rise in multifamily starts in contrast to the L-shape trend in single-family starts in the current expansion. Multifamily starts rebounded sharply after the recession ended, rising to prerecession levels during last summer but pulling back this year. We expect the recent drop in multifamily starts to be temporary. Rents have been rising at a healthy clip and should help to support the sector. (For more information on multifamily market conditions, read the [May 2015 Multifamily Market Commentary](#).)

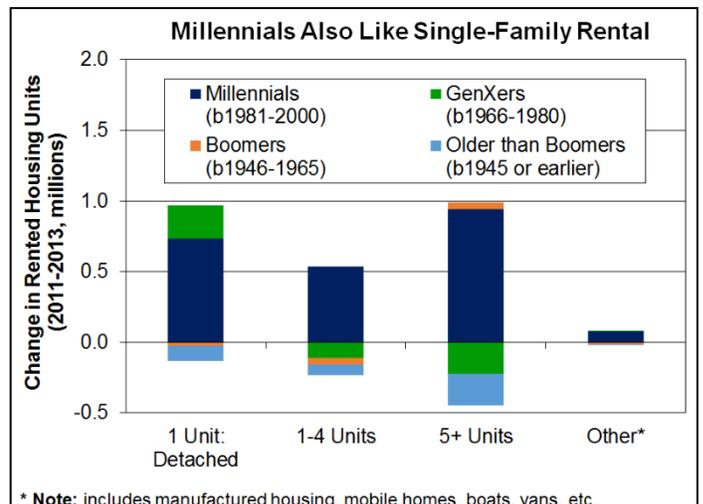
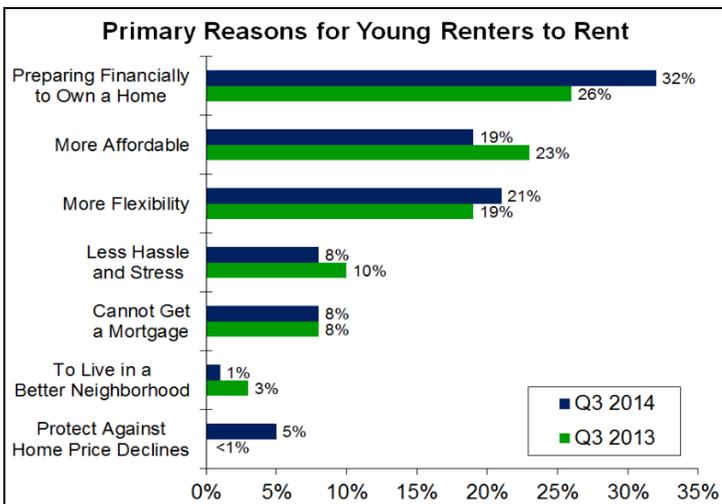
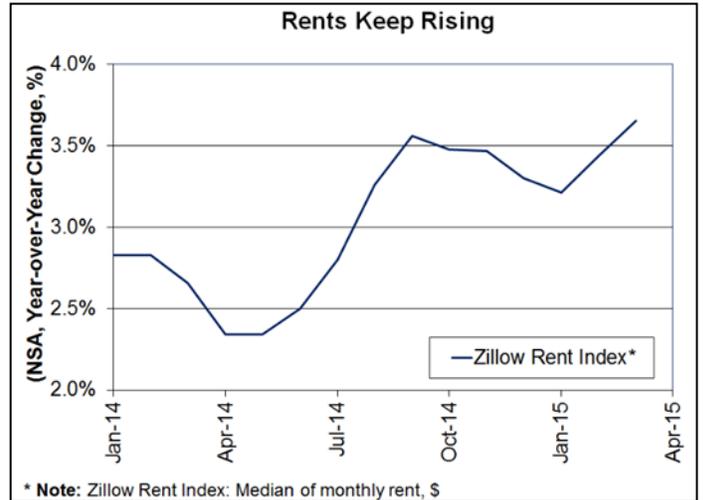
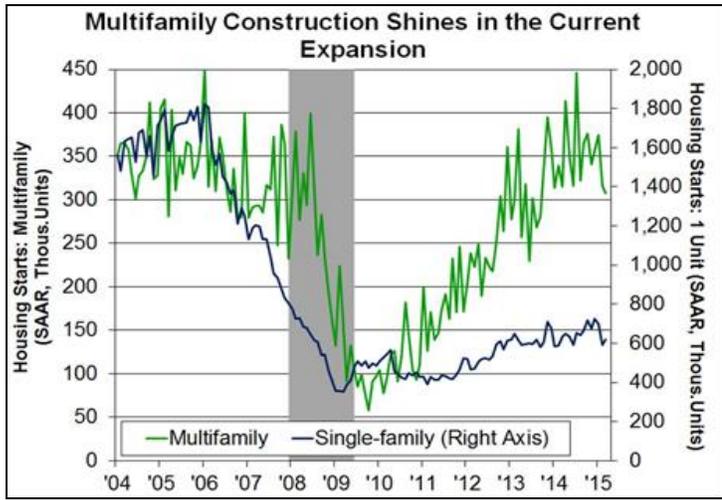
Millennials—those who are currently aged 15-34 years old—are facing a lot of headwinds, including student loan debt, sluggish income growth, and relatively tight lending standards, to switch their tenure choice from renting to owning. According to the [Fannie Mae National Housing Survey](#), young renters age 18-39 chose renting to owning for many reasons, both economic and non-economic. For the third year in a row, the number one primary reason for renting is to prepare financially to own a home, suggesting that young renters still aspire to homeownership. The Census Bureau American Community Survey indicated that millennials' rental preference is broad-based across single-family homes and apartments.

The recent faster pace of household formation, even if all the gains are in renter households, is encouraging. If income growth continues to improve as we expect, many households should, at some point, switch from renting to owning, especially considering that mortgage rates remain historically low and underwriting standards are becoming more favorable for first-time homebuyers.

Despite some disappointment during the first quarter, housing indicators performed better this year than last year, when the weather weighed heavily on activity. Single-family starts, multifamily starts, new home sales, and existing home sales were 4.4, 2.9, 10.6, and 6.6 percent, respectively, stronger than in the first quarter of 2014. So far, housing activity is in line with our forecast of a moderate but broad-based improvement in 2015.



While our forecast of total home sales is little changed, the outlook for mortgage production continues to be more upbeat, given strong incoming data for both purchase and refinance originations. We expect mortgage originations to increase approximately 23 percent this year to \$1.46 trillion—an upgrade from an expected increase of about 14 percent in the prior forecast. We expect the refinance share to rise to 48 percent from our estimate of 43 percent for 2014.



May 11, 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, Census Bureau, Institute for Supply Management, Bureau of Labor Statistics, National Association of REALTORS, Mortgage Bankers Association, S&P/Case-Shiller, Federal Housing Finance Agency, CoreLogic, Zillow, Fannie Mae National Housing Survey.

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