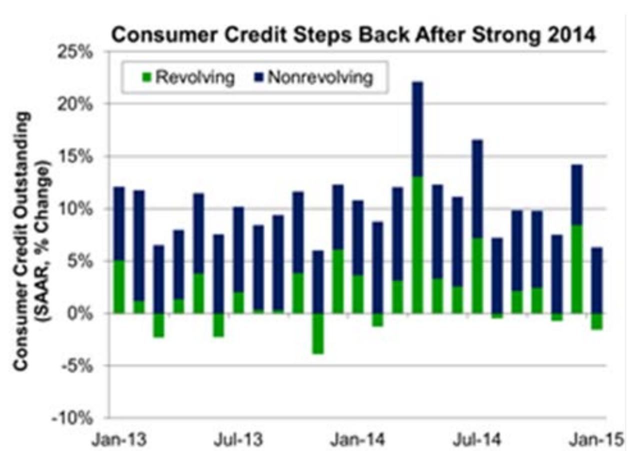
A Soft Start to 2015, but Acceleration Expected

Some special factors, including inventory drawdown, unusually high snowfall in parts of the country, and the West Coast port slowdown, have gotten 2015 off to a slower start than we had anticipated. However, we expect that much of the reduced activity will shift into the second quarter, similar to the pattern observed in the first half of 2014. Thus, we maintain our view that growth will strengthen in coming quarters and economic growth will pick up moderately this year to 2.8 percent. Labor market conditions are upbeat, and consumer and business fundamentals remain positive. Downside risks to growth are concentrated overseas—for example, slowing growth abroad and geopolitical events—and domestically due to increased volatility in financial markets as the Federal Reserve modifies its forward guidance to prepare the market for the liftoff in the target fed funds rate.

2014 Was a Slowdown From 2013

Growth slowed from 3.1 percent in 2013 to 2.4 percent in 2014, as fourth quarter economic growth received a downgrade in the Bureau of Economic Analysis' latest estimate of gross domestic product (GDP). A slower pace of inventory accumulation and a larger drag from trade than previously reported pulled fourth quarter growth down to 2.2 percent annualized from the 2.6 percent in the first estimate. Residential investment was revised slightly lower, adding just 0.1 percentage points to growth. Incoming data led us to revise lower our forecast for first quarter growth by about one half a percentage point to 2.0 percent. We expect that consumer spending will be the primary driver of growth, while residential and nonresidential investment and state and local government will contribute modestly to growth. Trade and inventory investment are likely to drag on growth during the quarter.

Consumer Spending Growth Takes a Breather as Saving Rises



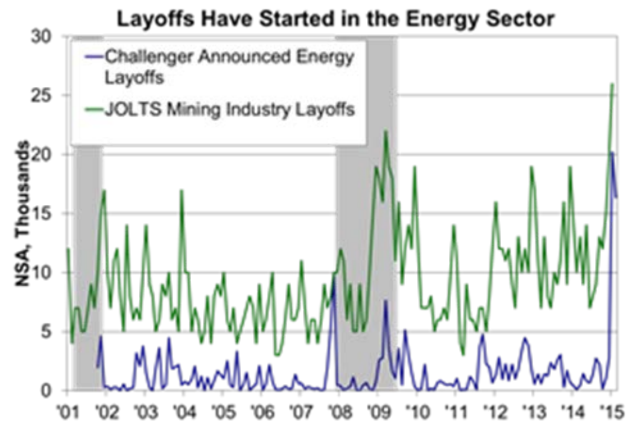
We expect real (inflation-adjusted) consumer spending growth to come in substantially weaker than the 4.2 percent annualized pace in the fourth quarter of 2014. Consumers appeared cautious to spend in January even as gasoline prices continued to fall sharply, boosting real personal income by 0.8 percent. However, real consumer spending rose at only a 0.3 percent pace, as consumers responded to the surge in income by adding to savings, pushing the saving rate up to 5.5 percent—one percentage point higher than just two months prior.

The trend in real disposable income also strengthened, jumping 0.8 percent from December and 4.2 percent from January 2014, the biggest year-over-year gain since the end of 2012. Thus, consumers have plenty of support to pick up the pace of their spending even as gasoline prices have trended up since the end of January 2015.

The decline in unit auto sales in February, the third consecutive monthly drop, suggests another month of weak durable goods spending; however, cold temperatures across the country likely spurred spending on home heating.

Consumer credit data show cautious consumers, as the trend in credit growth has recently weakened following the strength witnessed throughout most of 2014. Consumer credit increased in January at the weakest pace since November 2013. Revolving credit (largely credit card debt), the volatile segment of consumer credit, dropped in January following a sizable gain during the holiday seasons, while non-revolving credit (largely student debt and auto loans) continued to expand at a fast clip. We remain confident in our forecast that consumer spending growth will pick up this year, amid improving labor market conditions, stronger income growth, elevated consumer confidence, and easing lending standards for consumer loans.

Job Growth Plows Ahead



Consumers have some cushion to support stronger spending growth, particularly with the highest saving rate since the end of 2012. Meanwhile, job growth remains solid. Despite concerns that energy job cuts, West Coast port labor disruptions, and inclement weather would weigh on February payroll growth, the February jobs report showed a pickup in net hiring to 295,000. The three-month average job gain moderated, but to a still robust 288,000. Over the past year, the economy created a remarkable 3.3 million jobs, the best since 2000. February gains were broad-based, as 65.4 percent of the 278 industries measured by the Bureau of Labor Statistics witnessed employment growth. However, the impact of declining oil prices was evident in energy sector payrolls, as mining payrolls posted the biggest job loss since the recession, falling 9,300 in February following a drop of 5,800 jobs in the prior month. The impact on the mining industry also is evident in other layoffs data during the month, including the Challenger Announced Layoffs and the Job Openings and Labor Turnover Survey (JOLTS).

The jobs report revealed some other soft spots. Wage gains were muted, with average hourly earnings edging up just 0.1 percent from January and 2.0 percent from February 2014, holding within the narrow band observed over the past two years. Low inflation and weak productivity growth suggest a breakout in wage gains to the near 4 percent pace witnessed prior to the recession is out of reach. Nonfarm productivity fell sharply in the fourth quarter of 2014, posting the first year-over-year decline since the third quarter of 2011.

Nonetheless, through the first two months of the first quarter, the payroll proxy of labor income—average hourly earnings multiplied by average hours worked—was up 5.7 percent annualized, providing some support for consumer spending in coming months. Flat year-over-year inflation, weighed down by the plunge in energy prices, means that most of the jump in labor income is real. Thus, while consumers appeared to have taken a breather at the start of the year, we expect them to spend more in coming months.

The wage component in the Employment Cost Index (ECI) showed stronger wage gains than observed in the average hourly earnings. Data from the JOLTS showed that the quits rate ticked up in January, tying its expansion best seen last October and this January, indicating high levels of worker confidence in the labor market. Historically, the ECI's wage component correlates well with the lagged quarterly series of the quits rate. Thus, the rising trend in the quits rate should foreshadow stronger wage gains later this year.

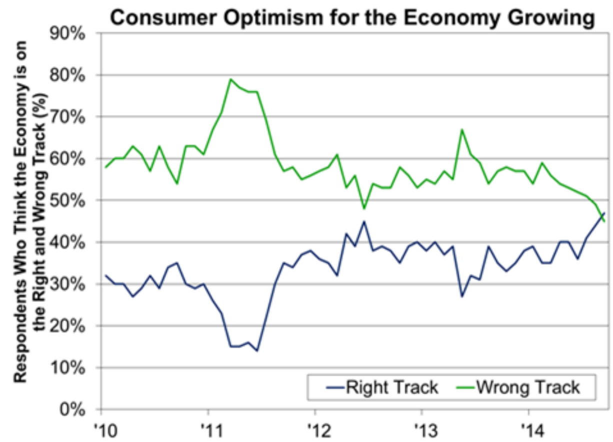
The separate household survey from the monthly jobs report showed a two-tenths drop in the unemployment rate to an expansion low of 5.5 percent. Unfortunately, the decline was largely a result of people leaving the labor force. The labor force participation rate ticked down to 62.8 percent—just one-tenth above

a more than three-decade low. A broader measure of labor underutilization known as the U-6 unemployment rate, which includes part-time workers for economic reasons and discouraged workers, fell 0.3 percentage points to 11.0 percent, the lowest reading since September 2008. The number of long-term unemployed (27 weeks or longer) also declined sizably in February and over the past year.

Consumer Confidence is a Tailwind Even With February Payback

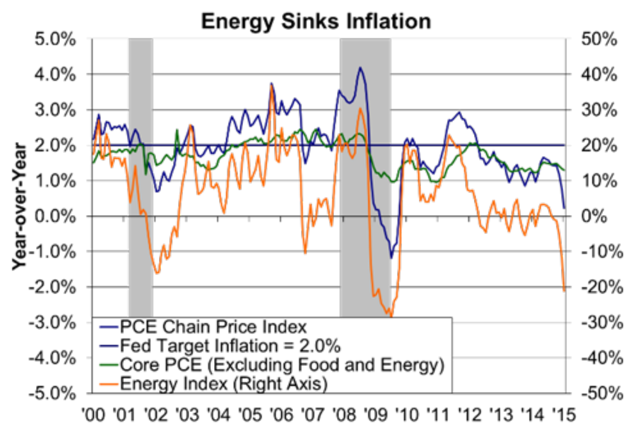
Measures of consumer confidence pulled-back in February from expansion-highs in January. The Conference Board consumer confidence index fell in February, though it still marked the second highest reading of the recovery. Both the present situation and the expectations components fell, but the latter plummeted to the lowest level since last September. Similarly, the Reuters/University of Michigan consumer sentiment index pulled back after reaching an 11-year high in January.

Bad weather and rising gasoline prices may have explained some of the rollback in confidence. Despite the rising trend in retail gasoline prices since the end of January, gasoline prices still remained close to a five-year low at the time of this writing. Given good news from the labor market and still elevated confidence levels, we are not concerned about this one-month drop. In addition, results from Fannie Mae's February 2015 National Housing Survey™ showed a marked improvement in consumers' view regarding the direction of the general economy. The share of consumers who think the economy is on the right track rose to a record high since the inception of the survey nearly five years ago and, for the first time, exceeded the share who believe the economy is on the wrong track.



The Fed Contemplates Its Inflation Forecast

Inflation measures have moved lower over the past several months, thanks to the sharp decline in oil prices and a sizable increase in the value of the dollar. The personal consumption expenditures (PCE) deflator declined 0.5 percent in January, leaving year-over-year inflation at just 0.2 percent—the lowest since October 2009. Core PCE, which excludes food and energy, ticked up 0.1 percent in January and 1.3 percent from a year ago, little changed from the year-over-year gain in December. The steady year-over-year gain in core prices should help soothe the Federal Reserve, as it occurred despite a near record decline in the medical care price index (which accounts for nearly 20 percent of the Core PCE index), reflecting one-time reductions in government reimbursements in Medicare and Medicaid for physicians and hospitals.



In her semiannual testimony to Congress in February, Fed Chair Janet Yellen largely reiterated the Fed's view that inflation will return to target "over the medium term" as the jobs market continues to improve and the transitory impacts of declining energy prices fade. In the Q&A session, Yellen noted that the Fed does not have to see higher wages before raising rates as wages are lagging, and that monetary policy has to be forward looking. We continue to expect the first hike in the target fed funds rate in September amid further broad-based central bank easing across the globe. The labor market continues to tighten, and while inflation remains well below the target, reduced slack in the economy as well as a rising trend in crude oil prices should give the Fed some assurance that inflation will gradually move up going forward.

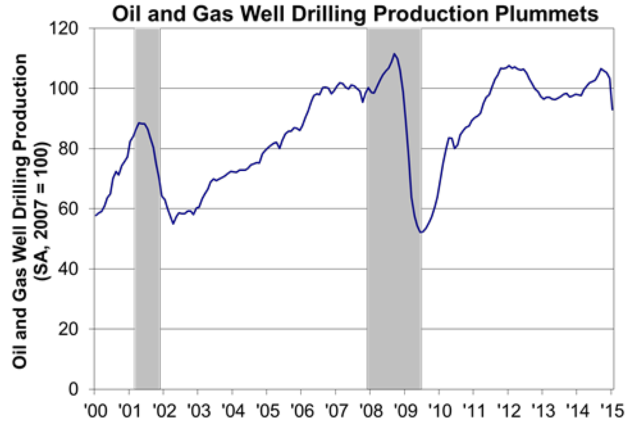
Trends in Trade Likely Muddled for Some Time

The nominal trade deficit narrowed in January, recouping more than half of the widening in December. The real goods deficit, which is an input in the calculation of GDP, narrowed slightly, as real exports posted the largest decline since December 2013 while real imports showed the biggest drop since June 2014. The labor disruptions at the West Coast ports, unresolved until mid-February, resulted in delays in processing cargoes, making it difficult to assess the underlying trend.

Manufacturing Takes a Hit

The factory sector appears to have lost momentum at the start of the year. While manufacturing, on net, has benefited from declining oil prices, export-oriented manufacturers have been hurt by the rising value of the dollar and weak global economies. Manufacturing surveys, both national and regional, pointed to slowing manufacturing expansions. For example, the Institute for Supply Management (ISM) manufacturing index fell in February for the fourth consecutive month reaching the lowest reading since January 2014, albeit remaining in expansionary territory. However, the export orders component fell again in February to the lowest level in more than two years, after slipping into contracting territory in January. Some survey respondents referenced that the West Coast port issues hurt their imports and exports. Overall, the outlook for the sector is positive as the global economy growth backdrop is projected to improve going forward while domestic demand strengthens.

Low oil prices are another factor weighing on manufacturing and on the energy sector in particular, which has already materialized in layoffs data. The negative impact also is evident in the industrial output data. Manufacturing output, which accounts for about two-thirds of industrial production, rose only slightly in January. The plunge in oil prices showed up in mining production, which fell for the third time in four months, as output related to drilling oil and gas wells plummeted. The total capacity utilization rate held steady at 79.4 percent, weighed down by the drop in the capacity utilization rate in mining operations, which fell one percentage point in January and three percentage points since June.

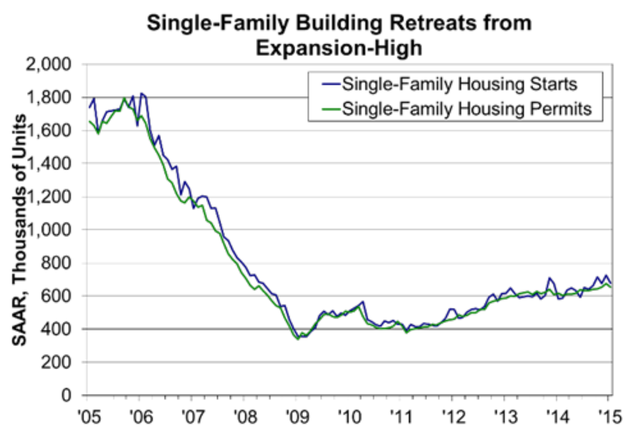


Meanwhile, reduced oil prices also weighed on nondurable goods orders (which include petroleum refinery shipments) in the factory orders report. However, the details on durable goods orders offered some renewed optimism for business investment as core durable goods, a leading indicator of business equipment spending, rose in January for the first time in five months. If the improvement persists in coming months, it would suggest that business investment may be turning the corner after essentially flattening in the fourth quarter of last year.

By contrast, the January construction spending report showed a sharp drop in private nonresidential construction spending, the first decline in seven months, which suggests weak growth in nonresidential investment in structures in the current quarter.

Soggy Housing at the Start of the Year

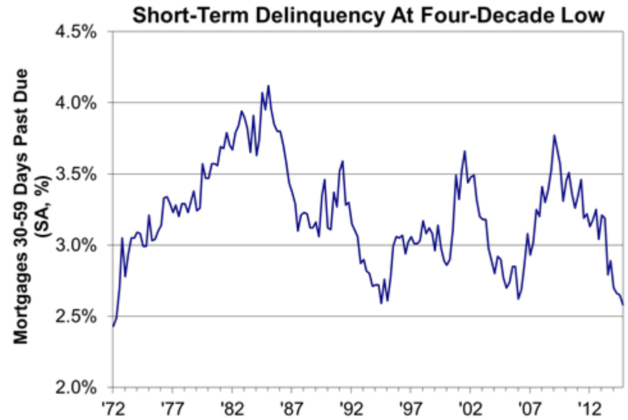
Early housing indicators for 2015 flattened at best or weakened, supporting our forecast that real residential investment growth will weaken in the current quarter from the fourth quarter of last year. Single-family starts declined sharply in January, nearly reversing the surge in the prior month, and their leading indicator, single-family building permits, also fell. Homebuilders were less optimistic in February in light of the sector's lackluster performance. The Wells Fargo/National Association of Home Builders Housing Market Index edged down for the second consecutive month, moving below the average reading witnessed during the second half of 2014. The component measuring traffic of prospective buyers was particularly downbeat, which makes sense given the severe winter weather in much of the country. By contrast, multifamily starts and permits increased during the month, continuing the theme that the sector has been driving the housing recovery, performing in the current expansion at a level consistent with activity witnessed prior to the recession. (For more information on multifamily market conditions, read the March 2015 Multifamily Market Commentary).



New home sales were essentially flat in January from the December pace, which was an expansion-high, while existing home sales declined sharply during the month. However, pending home sales picked up in January, giving hope that the roughly 7.0 percent cumulative decline in existing home sales since October will stabilize in coming months.

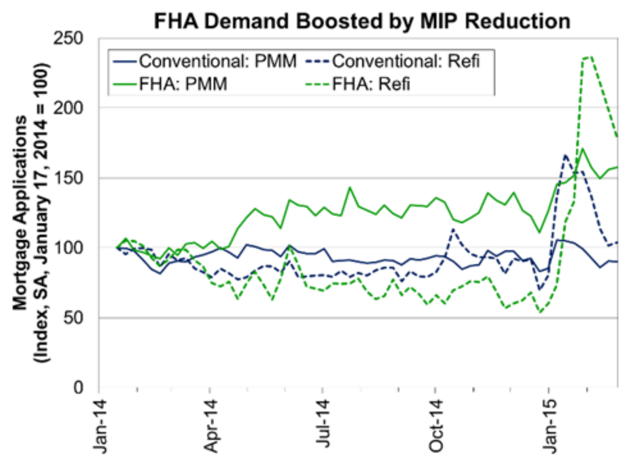
Even as sales volumes faltered at the outset of the year, new and existing home inventory remains tight, supporting home price growth. Measures of home prices held up well near the end of 2014, and some measures even showed strengthening gains. For example, the CoreLogic national home price index (not seasonally-adjusted) increased 1.1 percent in January, breaking four consecutive months of decline. Year-over-year growth in home prices also accelerated in January after slowing down for 10 consecutive months, rising to 5.7 percent.

Loan performance continued to improve during the final quarter of 2014. The Mortgage Bankers Association National Delinquency Survey highlighted the link between rapid improvements in the labor market and sharply lower early-stage delinquency, which stood at the lowest rate since the 1970s. Late-stage delinquency continued to march lower, albeit remaining historically high.

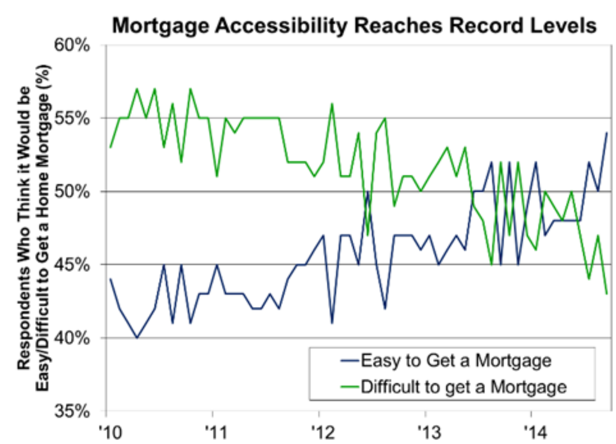


Long-term interest rates moved higher in response to the strength in the February jobs report. However, global monetary easing will continue to pressure long-term rates. When the Fed hikes rates later this year as we expect, the yield curve should flatten as shorter-term rates will likely rise faster than longer-term rates.

Mortgage applications have leveled off following the surge at the start of the year. The boom in refinancing applications, in particular, has lost momentum as mortgage rates have moved off their recent lows in late January. Refinancing demand still remains at a level higher than at any point last year. After seeing a similar spike to start the year, purchase mortgage applications have lost over half of the ground gained earlier in the year. Meanwhile, FHA continued to outperform conventional demand, supported by the recent reduction in FHA mortgage insurance premiums (MIPs).



Our forecast for housing indicators is little changed from the prior forecast. We maintain our belief that once upbeat hiring translates into stronger income growth, which we expect to occur, a stronger housing recovery will follow. Housing also should receive an additional tailwind in the mortgage market. The Fannie Mae Mortgage Lender Sentiment Survey™ showed that lenders believed that lending standards have eased, and the February Fannie Mae National Housing Survey™ showed that a record high percentage of consumers believed that it is easy to get a mortgage.



We expect a broad-based housing recovery, with housing starts and home sales rising by approximately 15 and 6 percent, respectively. We project that total single-family mortgage originations will rise nearly 5 percent in 2015 to $1.24 trillion before declining modestly in 2016. The refinance share should fall from 45 percent in 2015 to 35 percent in 2016. Our forecast points to a slight increase in total single-family mortgage debt outstanding in 2015 before a gradual acceleration in 2016.

March 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; Federal Reserve Board; Challenger, Gray & Christmas, Inc.; Bureau of Labor Statistics; Fannie Mae National Housing Survey™, February 2015; Bureau of the Census; National Association of REALTORS®; Mortgage Bankers Association*

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ESR Macroeconomic Forecast Team
Doug Duncan, SVP and Chief Economist
Orawin T. Velz, Director
Brian Hughes-Cromwick, Economist
Mark Palim, VP
Richard Koss, Director
Hamilton Fout, Director
Frank Shaw, Business Analyst