

Solid Growth in First Half 2019, So the Fed...Cuts Rates?

The expansion became the longest on record this month and second quarter growth beat expectations, with real gross domestic product (GDP) posting solid 2.1 percent growth even though it decelerated from the first quarter’s robust pace. Consumer spending drove growth over the quarter and should continue to do so into the third quarter. Our short-term view of nonresidential fixed investment and government spending became less optimistic, however, resulting in a one-tenth downward revision to 1.8 percent for third quarter growth. The slightly weaker growth expected this quarter was outweighed by stronger-than-anticipated growth during the first half of the year, so our 2019 full-year forecast is now slightly more optimistic, rising by a tenth to 2.2 percent. While we continue to believe that growth will slow in 2020, we upgraded our forecast to 1.7 percent from 1.6 percent in the prior forecast as we now expect more government spending due to the recently passed budget act.

Even though our forecast for headline growth is more sanguine than it was last month, risks to our forecast are decidedly to the downside. The most serious is a further escalation of the trade war following U.S. tariffs announced at the beginning of August on \$300 billion of Chinese goods. This sent the stock market tumbling and caused a steep drop in the 10-year Treasury yield to as low as 1.6 percent, the lowest level since October 2016. The tariff announcement came a day after the Federal Reserve (Fed) cut the federal funds rate as “insurance” against downside risks, such as the trade tensions between the U.S. and China. The escalation of the trade war will likely force further rate cuts from the Fed this year, and we now expect two quarter-point rate cuts in September and December, replacing last month’s prediction of a single additional cut in December.

Residential fixed investment dragged on growth for the sixth straight quarter and was far more negative than anticipated. We expect housing activity in the third quarter to be moderate with modest growth in single-family housing starts and increasing home sales helping to push residential fixed investment into positive territory. While mortgage rates are likely to follow the recent Treasury rate decline in the third quarter, we expect the benefits to affordability will be limited as home price appreciation is expected to accelerate after five quarters of deceleration and the chronic issue of limited housing stock remains. Moreover, we expect the labor market to soften over the next year, reducing housing demand and construction.

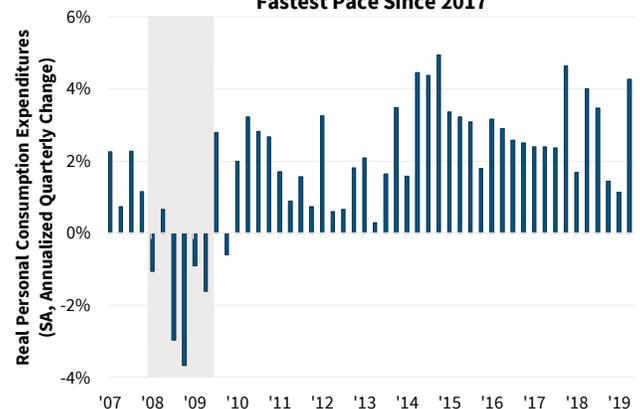
Consumer Spending Drives Growth

Personal consumption expenditures (PCE) grew 4.3 percent annualized in the second quarter, the strongest pace since the end of 2017, rebounding after two consecutive quarters of growth under 1.5 percent. The slowdown in spending during the fourth quarter of 2018 and the first quarter of 2019 was likely driven by increased uncertainty stemming from U.S.-China trade tensions, the government shutdown, and associated equity market volatility. Consumers appeared more confident in the second quarter, however, with spending on nondurable goods growing at the fastest rate in nearly sixteen years and spending on durable goods rising to the highest pace in five years.

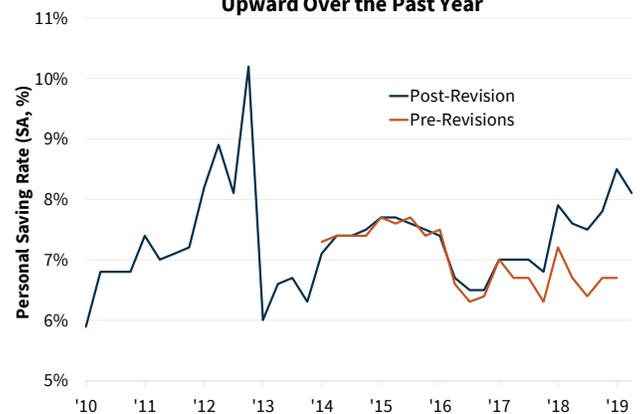
The GDP release contained annual revisions from the Bureau of Economic Analysis going back as far as 2014. A notable revision was to the saving rate, which was revised from 6.7 percent to 8.5 percent in the first quarter and remained at a solid rate of 8.1 percent in the second quarter. The higher saving rate was driven by upward revisions to wages and salaries, dividend income, and interest income. We expect consumer spending to continue to be the primary driver of growth throughout the remainder of the year; beginning in 2020, though, we expect PCE to slow to less than trend growth as trade tensions and a softening labor market prompt consumers to be more cautious in their purchases.

The July employment report showed that nonfarm payrolls increased by 164,000, in line with expectations and consistent with an economy

Real Consumer Spending Growth Posts the Fastest Pace Since 2017



Personal Saving Rate Revised Significantly Upward Over the Past Year



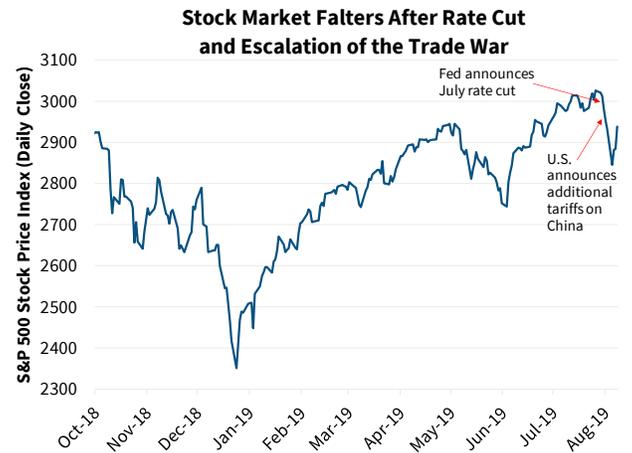


that is gradually decelerating as the current expansion lengthens. Downward revisions in the prior two months helped push the 3-month average job gain to 140,000, the lowest level in nearly two years. Encouraging details included a slight acceleration in wage growth, a steady unemployment rate, and an uptick in the labor force participation rate; 370,000 households were added to the labor force last month, the largest gain this year, as households continue to return from the sidelines. The U-6, a broad measure of labor market slack, fell this month to its lowest level since the end of 2000, and the number of people working part time but who would prefer a full-time job fell to its lowest level since 2006.

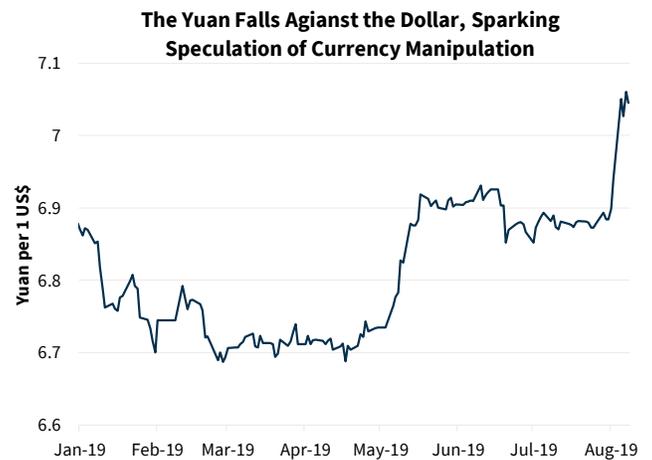
We suspect that the number of workers “on the sidelines” is dwindling and we expect to see a slowdown in payroll growth through 2020. While job growth averaged 176,000 per month in the first half of this year, that should slow to around 107,000 per month in the second half of next year, causing the unemployment rate to increase to around 4.3 percent. We expect this softening of the labor market to slowly reduce consumer confidence and spending and limit the growth of residential investment.

Equity Markets Rocked by Less Accommodative Fed Rhetoric and Escalation of Trade Tensions

A significant equity market correction would likely reduce consumer spending by eroding household wealth and consumer confidence. After being spurred to all-time highs by the strong second quarter GDP report, financial markets stumbled in early August after the Federal Open Market Committee (FOMC) announced the Fed would cut the federal funds target rate by only a quarter point to 2.00-2.25 percent and conclude the reduction in its balance sheet in August, two months earlier than previously indicated. During the post-meeting press conference Chairman Powell emphasized that the outlook for the economy remained favorable with a solid labor market and strong consumer spending. Therefore, he framed the first rate cut since 2008 as insurance “against downside risks from weak global growth and trade policy uncertainty” as well as to help boost inflation closer to the 2.0 percent target. Powell described the rate reduction as a “mid-cycle adjustment to policy” and made clear that this action should not be interpreted as guaranteeing the start of a sustained easing period. Investors, who had expected a continued “dovish” tone leading to further cuts later this year, took Powell’s statement instead as a more “hawkish” stance; after the announcement the S&P 500 closed down 1.2 percent and the U.S. dollar reached a two-year high.



A day after the FOMC meeting, the U.S. administration announced a 10 percent tariff on the \$300 billion of Chinese imports that had previously been levy-free, to take effect on September 1. These tariffs include more consumer goods than previous rounds, so there could be a larger effect on consumer sentiment, consumption, and inflation. Unsurprisingly, the shock hit equity markets hard with most indices falling around 4 percent in the week following the announcement. China’s retaliation came swiftly, primarily in the form of currency devaluation when the central bank allowed the renminbi (official Chinese currency) to fall more than two percent in just three days, to the lowest level since the Great Recession. Additionally, China halted all purchases of American agricultural products. Markets stabilized and improved marginally when China took steps to contain the yuan’s slide and issued a public statement denying the use of the “exchange rate as a tool to deal with trade disputes.” While the U.S. still plans to host a Chinese trade delegation in September, we believe the achievement of a meaningful deal will be delayed until at least late 2020, close to the next presidential election.



The rate cut and escalation of trade tensions sparked a global reaction, with central banks in India, New Zealand, and Thailand lowering rates in early August and Brazil and South Korea suggesting similar moves to come. Geopolitical uncertainty was also exacerbated by the mass strike in Hong Kong, the election of Boris Johnson (a Conservative working to leave the E.U. as quickly as possible even if that means a “no-deal Brexit”) as the UK Prime Minister, the U.K.’s GDP contracting in the second quarter for the first time since 2012, and the E.U.’s clash with Italy over its ever-increasing debt. Despite solid domestic economic data so far this

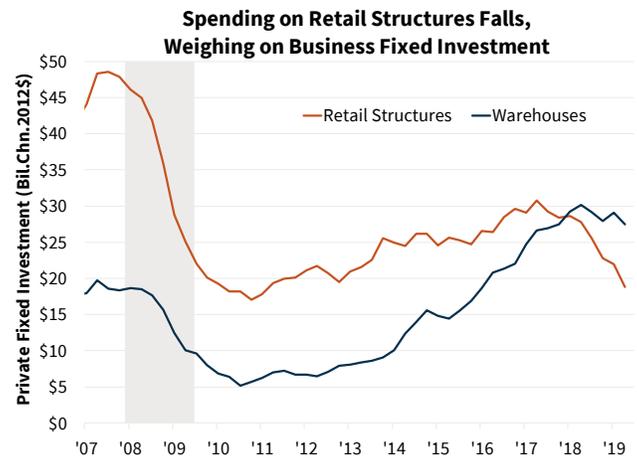


year, increased uncertainties surrounding the trade war, its potential effects on business and consumer sentiment, and geopolitical risks abroad lead us to believe the Fed will cut rates in September and again in December before pausing in 2020.

One justification for upcoming rate cuts cited by the Fed is to stimulate inflation, which has consistently averaged less than the Fed's 2.0 percent symmetric target. In June the PCE deflator, the Fed's preferred measure of inflation, grew 1.4 percent year-over-year, the second slowest pace of growth since the 2016 presidential election. Core PCE inflation (excluding volatile food and energy prices) accelerated slightly but remained well below target. The traditional Fed view is that a lower federal funds rate will increase demand for goods and services, thus boosting prices and spurring inflation. In a global environment where more than \$14 trillion of sovereign debt is earning negative interest rates, it remains to be seen whether this policy can be effective.

Muted Business Investment Expected, but Government Spending Picks Up

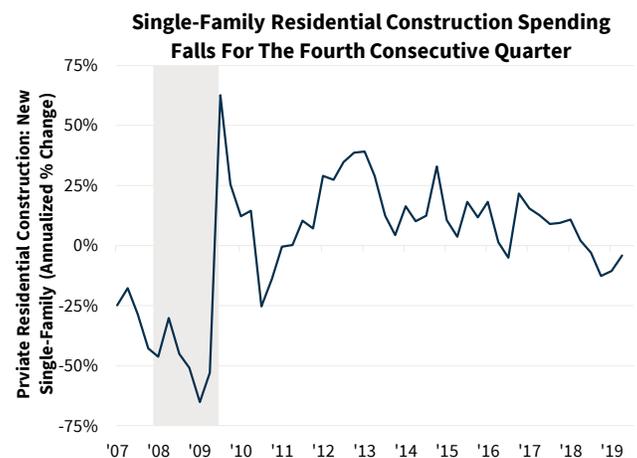
The grounding of Boeing's 737 MAX aircraft has continued to drag on equipment spending, while trade wars, geopolitical tensions, and market volatility create an environment unconducive to business investment. Nonresidential fixed investment showed negative growth in the second quarter for the first time in three years, with a steep decline in structures investment. Investment in retail structures has been particularly weak, falling to the lowest level in eight years. For most of the past few years spending on warehouses partially offset the decline in retail investment, but over the past year warehouse investment has trended down for the first time in nearly a decade. We expect nonresidential fixed investment to be muted for the remainder of the year as businesses maintain caution in the face of an extraordinary set of challenges and uncertainties.



In contrast, government expenditures grew strongly in the second quarter, posting the largest contribution to GDP of the expansion. This owed mostly to a surge in federal nondefense spending; the government shutdown impacted federal government compensation levels during the final quarter of 2018 and the first quarter of this year and the surge in the second quarter reflects a return to normal operations. State and local spending remained elevated, but May and June brought a slowdown in state and local construction. After two quarters of solid growth, we expect that government consumption and investment will pull back this quarter but then come back strong in the final quarter of 2019 and the first half of 2020 due to the newly passed Bipartisan Budget Act of 2019. The bill increases limits for both defense and nondefense spending in fiscal years 2020 and 2021 and suspends the public debt limit through July 2021. This near-term fiscal stimulus resulted in a modest upward revision to our 2020 growth forecast, specifically in the first half of next year. As the stimulus fades, however, we expect growth to slow and the labor market to sputter.

Strong Housing Sentiment Does Little in the Face of Limited Supply

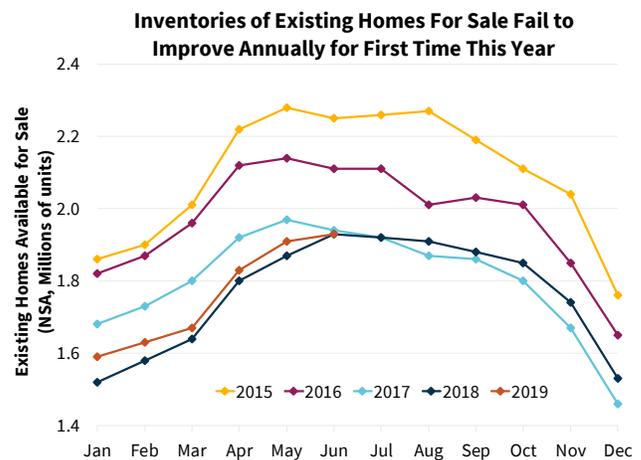
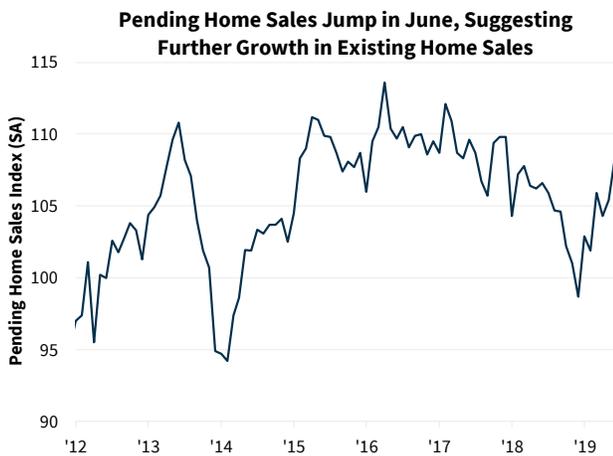
Even while second quarter GDP growth was better than expected, housing activity fell 1.5 percent on an annualized basis and dragged on growth for the sixth consecutive quarter. After surging at the beginning of the year, single-family housing starts pulled back in the second quarter. This, combined with homebuilders' continued trend toward smaller homes, weighed on the total dollar value of single-family construction. Growth in single-family construction has declined over the past year, but deceleration was fastest at the end of 2018 and has eased over the past two quarters. Going forward, we project single-family construction spending to turn modestly positive as starts perk up during the latter half of this year. Multifamily construction was the bright spot of the second quarter and the sole driver of an overall increase in housing starts but was not enough to counter single-family weakness, as multifamily starts contribute less to residential investment per unit. For more information on multifamily market conditions, please see the [August 2019 Multifamily Market Commentary](#).





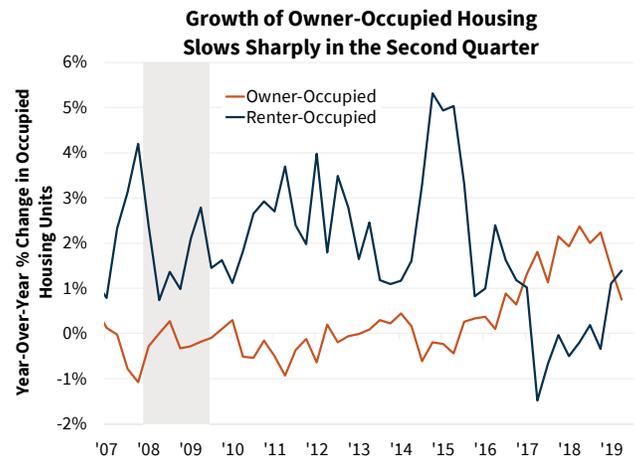
Residential improvement spending also fell over the second quarter for the first time in a year. Major renovations often come shortly before or after a home sale, so improvements are highly correlated with total home sales and house price growth. Given our view of modestly rising home sales through the first quarter of 2020, we predict improvements spending will increase. During the second half of 2019 residential fixed investment should edge up into positive territory, modestly contributing to GDP growth as starts, broker commissions, and improvements spending begin to improve slightly.

Existing home sales rose over the second quarter, though they were somewhat weaker in June than expected. Signs point to a strong pace of sales in July as the National Association of Realtors Pending Sales Index jumped in June by 2.8 percent. Pending sales tend to lead closings by about 45 days. In addition, the Fannie Mae [Home Purchase Sentiment Index](#) hit a new survey high in July, suggesting strong buying interest. Despite positive sentiment and a continued decline in mortgage rates over the month, purchase mortgage applications have declined in every week since mid-July. The likely cause of this decline is the persistent issue of limited housing supply, which restricts the potential for a sustained growth in home sales. On a year-over-year basis inventories of existing homes for sale, which rose steadily over the past year, were unchanged in June, tying the lowest level seen in any June since the series began in 2000. While we believe home sales will improve in the third quarter, we modestly revised downward our forecast for existing home sales over the remainder of the year, and we now expect an annual decline of 0.1 percent in contrast to our previous forecast of a modest increase of 0.2 percent.



While new home sales improved in June, large downward revisions were made to the period between March and May. This overall lower path of new sales suggests homebuilders did not draw down inventories during the first half of the year as much as we previously believed and thus have larger inventories of homes already started. Given this new information we slightly increased our forecasted pace of new home sales over the second half of the year while also lowering our forecast for single-family housing starts due to builders being able to draw on this larger supply. Still, we expect modest growth in starts going forward. Building permits, which tend to be less volatile than starts, have edged up for two consecutive months, and the number of new homes sold that have yet to be started surged at the end of the second quarter to the highest level since November 2017, suggesting that builders will soon have to increase the pace of starts.

With the pace of home sales over the first half of the year significantly slower compared to 2018, it was no surprise that the Census Bureau's Housing Vacancy Survey (HVS) showed a second consecutive quarterly decline in the homeownership rate, to the lowest level since the end of 2017. The pace of owner-occupied household growth decelerated sharply, while the pace of renter-occupied households accelerated for the second straight quarter to the fastest pace in nearly three years. Prior to this year, rental occupied units had declined in six of the prior seven quarters. The survey also showed the rental vacancy rate tick down to 6.8 percent in the second quarter, just above the expansion low, which is supportive of continued strength in multifamily construction, though we do not expect the impressive pace observed in the second quarter to endure.





Low Mortgage Rates Prop Up Refinances

The Federal Reserve Board's Senior Loan Officer Opinion Survey showed easing lending standards for residential mortgages in the three months ending in July. The Fed survey also showed the largest net share of banks reporting higher residential mortgage demand in seven years, likely attributable to the plunge in mortgage rates. This is consistent with Fannie Mae's second quarter [Mortgage Lender Sentiment Survey](#)[®], which showed a modest net easing of credit standards, though the pace of easing has decelerated, and increased demand for both purchase and refinance mortgages.

Mortgage rates continue to decline. The 30-year fixed mortgage rate averaged 3.77 percent in July, down from 3.80 percent in June, according to Freddie Mac. As of this writing, mortgage rates had declined even further to 3.60 percent, the lowest level since November 2016 and down considerably from their recent peak of 4.94 percent this past November. This continued slide in mortgage rates led us to increase our forecast for single-family mortgage originations for the remainder of the year. We now expect total single-family originations to rise 12.3 percent from 2018 to \$1.84 trillion, driven largely by refinances, which we project will account for 35 percent of total mortgage originations in 2019, up from 29 percent in 2018. This is largely because many mortgages are now considered "in the money," meaning borrowers could save significantly by refinancing to a lower rate. We currently estimate that approximately 35 percent of outstanding mortgages, or about \$3.6 trillion of unpaid principal balance, would experience a significant benefit from refinancing. Supporting our upgraded originations forecast is significant growth in refinance applications. While refinance applications pulled back slightly in July, they remained at the second highest level since October 2016 and 123 percent higher than average applications in December 2018.

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, Standard & Poor's, Wall Street Journal, Census Bureau, National Association of REALTORS[®], Fannie Mae ESR Group.

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