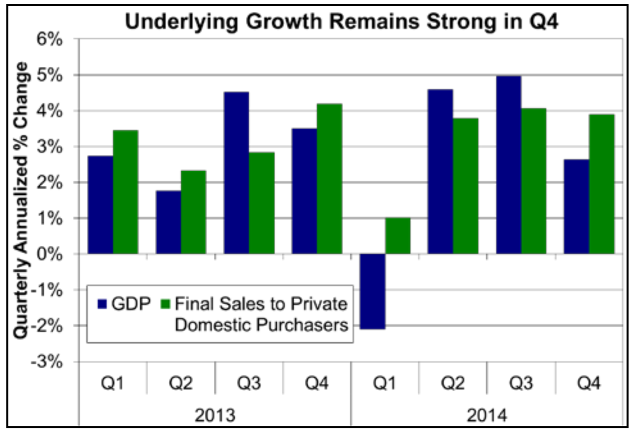
Strong Job Growth Foreshadows Solid Economic Growth

We expect that economic growth will strengthen in 2015. Our forecast points to a moderate pickup in economic growth to 2.9 percent this year from 2.5 percent in 2014. The labor market started off the year on an upbeat note, supporting our view that robust hiring and firming income growth, coupled with declining commodity prices over the past year, will lift consumer confidence, helping to boost consumer spending, manufacturing activity, and the pace of the housing recovery. However, the strength in the dollar and the relatively stronger domestic economy compared to the rest of the world will spur U.S. imports and challenge U.S. exports, weighing on growth.

Headline economic growth slowed markedly in the final quarter of 2014 from the robust pace of the prior two quarters. Underlying domestic demand remained solid, despite slowing headline growth, confirming our expectation that domestic private demand would drive growth in 2014. We expect those conditions to continue in 2015. We see risks to the forecast as balanced: Consumers and the housing market may be more resilient than we expect but external events—including recent weakening economic data from China and uncertainty regarding the Federal Reserve's first hike in the target fed funds rate—may weigh on output more than we anticipate.

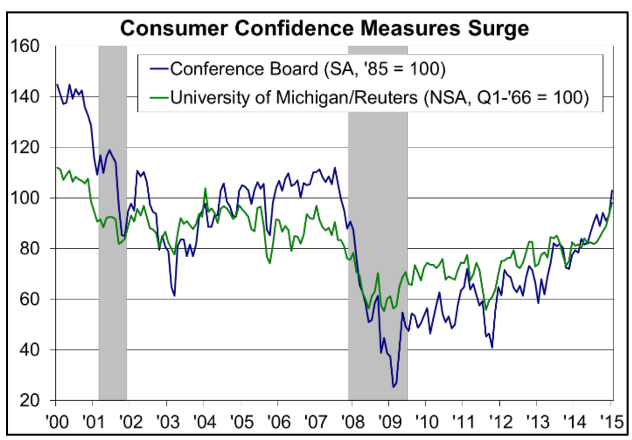


Economic Growth Slowed to End 2014 from an Above Trend Mid-Year Pace

Real gross domestic product (GDP) grew 2.6 percent annualized during the fourth quarter, four-tenths weaker than we expected in the prior forecast. Robust real consumer spending growth of 4.3 percent annualized, boosted by plunging energy prices and strong healthcare spending, was the engine of growth last quarter. The strongest consumer spending growth since the first quarter of 2006 helped to offset weak business structures spending and contracting business equipment spending. Inventory investment rose to the highest level since the third quarter of 2010, contributing 0.8 percentage points to GDP but not enough to offset the drag from trade, which subtracted about one percentage point from growth. Federal defense spending pulled back sharply as anticipated, reversing the surge in the prior quarter.

Consumer Spending Growth Should Moderate but Remain Healthy

While consumer spending growth was robust in the fourth quarter of 2014, the trajectory was not favorable for the current quarter as real consumer spending contracted 0.1 percent in December. We expect that consumer spending is slowing in the current quarter but to a still-healthy pace. Auto sales declined modestly in January to 16.6 million annualized units, in line with the average pace of the fourth quarter. Rising consumer confidence and low gasoline prices should help boost auto sales and overall consumer spending throughout 2015.



The January jobs report marks a great start for 2015. The payroll increase of 257,000 in January, combined with upward revisions to the prior two months, pushed the three-month average monthly gain to 336,000—the best since 1997. The economy created 3.2 million jobs in 2014, the strongest since 1999. Furthermore, average hourly earnings jumped 0.5 percent, the biggest gain since November 2008, pushing the year-over-year rise to 2.2 percent.

The separate household survey showed that the unemployment rate edged up one-tenth to 5.7 percent as a surge in the labor force offset a sizeable gain in employment. However, part of the jump in the labor force and employment was a result of a population adjustment and, therefore, the January rate is not directly comparable with the prior month's figures.

Consumer sentiment also improved in January. The Conference Board Consumer Confidence Index surged to the highest reading since August 2007, while the University of Michigan Consumer Sentiment Index rose during the month to reach an 11-year high. The combination of strong job gains, low gasoline prices, and rising consumer sentiment should presage a stronger trend for consumer spending in 2015.

Business Investment Takes a Breather

Business capital expenditures pulled back in the fourth quarter, in contrast to strong consumer spending, and are not expected to bounce back in the current quarter. The December factory orders report showed some evidence that declining oil prices have led to a drop in nondurable goods orders, which include oil shipments. The report also showed that core capital goods orders—a leading indicator of business investment in equipment—dropped in December for a fourth consecutive month. The Institute for Supply Management (ISM) manufacturing index weakened in January despite the net positive of declining oil price. The index continued to indicate that the sector expanded but the pace of the expansion was the weakest in a year. One notable detail was that the new export orders component fell into contraction territory reflecting weak global demand and a strong dollar.

The ISM nonmanufacturing index rose during the month, and several respondents to the survey commented that the drop in fuel prices has been positive for most industries, with mining a notable exception. The January jobs report confirmed some softness in the industry, showing a decline in payrolls in mining and logging, possibly a result of the decline in oil and commodity prices.

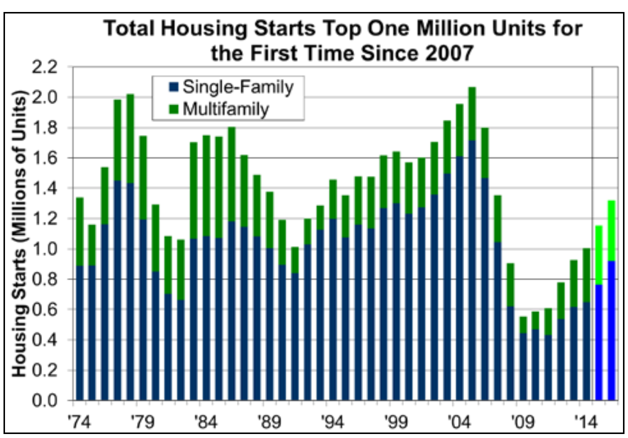
Trade Continues As A Drag On Growth

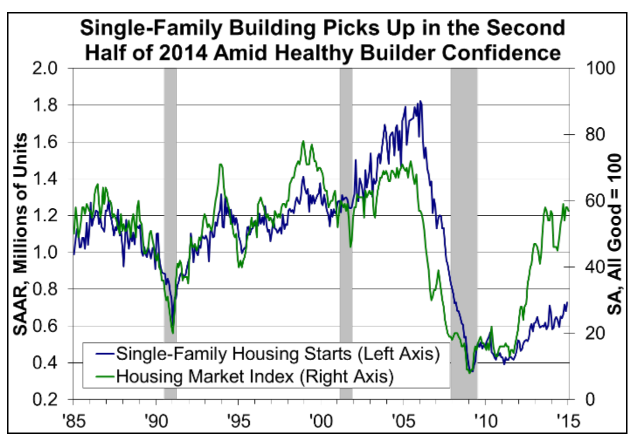
The strong dollar likely weighed on the U.S. trade deficit, which widened notably in December. Demand for foreign goods and services was strong. Imports surged following a sharp decline in November. Meanwhile, exports fell for a second consecutive month. We expect that the U.S. economy will strengthen amid a weak global economic backdrop despite the trade deficit being a drag to growth this year.

Housing Should Shift Up A Gear in 2015

December data for major housing indicators allow us to make a complete assessment of the disappointing 2014 housing market. Last year's housing recovery was an uneven one as it stumbled over many hurdles, including the lagged effect of the spike in mortgage rates during the second half of 2013, a brutal winter at the start of the year, and stubbornly anemic wage growth that continued to impede household formation. Total existing home sales fell 3.1 percent—the first drop in five years following two consecutive rises of more than 9.0 percent. Housing starts posted the fifth consecutive increase with the bulk of the improvement coming from the multifamily segment. Multifamily construction rose to pre-recession levels during the year and gained 16.0 percent for all of 2014. Single-family starts advanced by less than 5.0 percent in 2014. Together, total housing starts topped one million units for the first time since 2007, but just barely. (For more information on multifamily market conditions, read the [February 2015 Multifamily Market Commentary](#).)

New single-family home sales posted a modest 1.2 percent gain following two straight double-digit annual gains. Homebuilder sentiment in the first half of the year reflected the lackluster building and sales activity, sliding sharply early in the year before rebounding in the second half, remaining largely flat for all of 2014.



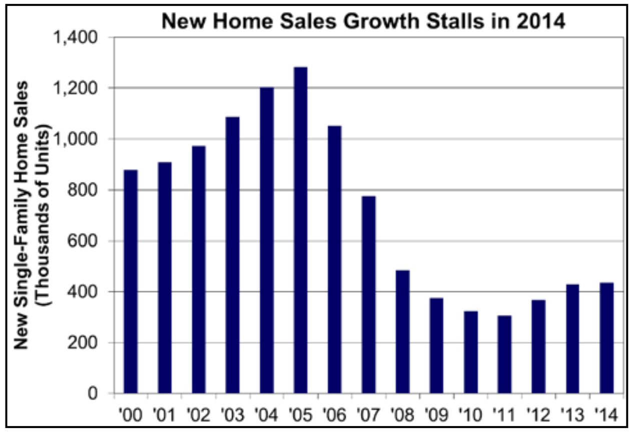


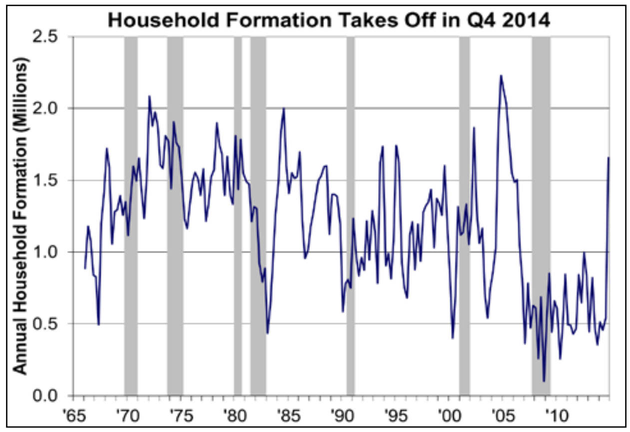
Other aspects of the housing market were mixed. An estimate of the number of households from the Census Bureau's Housing Vacancy Survey (HVS) showed that household growth, which over the past eight years has averaged barely half of the long-term annual average pace of about 1.2 million, surged in the fourth quarter last year. The dramatic jump in the number of households coincided with the surge in occupied rental units and the sharp drop in the rental vacancy rate during the quarter to 7.0 percent—the lowest rate since 1993. The sizable quarterly drop in the HVS vacancy rate was at odds with other sources of vacancy rates, so we are skeptical of the magnitude but encouraged by the direction. Meanwhile, because on net the increased households formed were new renter households, the homeownership rate continued to decline to a two-decade low of 64.0 percent by year-end. Details by age groups showed a substantial drop in the homeownership rate in young adults—households under age 35—sending the rate to the lowest level since record-keeping began in 1982.

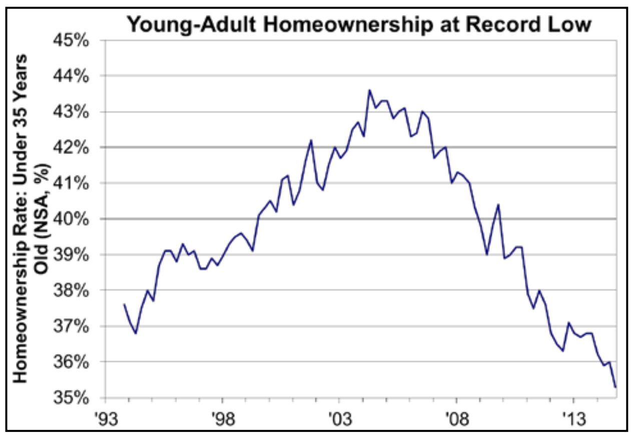
Home price gains moderated as expected in 2014 from the robust pace of the prior year. The price gains accumulated since 2012 have allowed the number of underwater properties to decline steadily, while loan performance has improved further—though the serious delinquency rate remains elevated compared to historical norms.

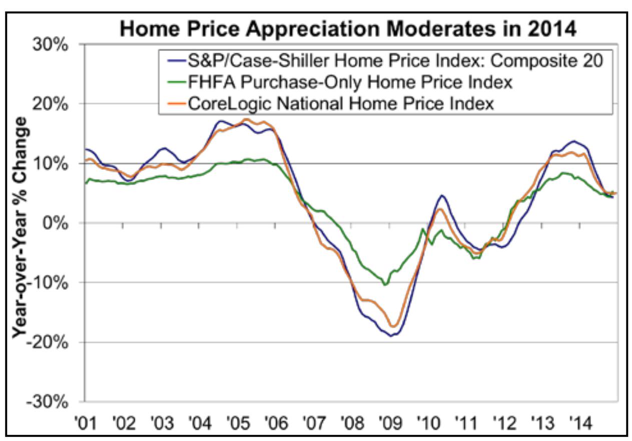
Real home prices, as measured by the CoreLogic House Price Index deflated by the Consumer Price Index (less shelter), rebounded strongly over the past two years, posting a gain of approximately 10.0 percent and 5.0 percent in 2013 and 2014, respectively. The pace of real home price appreciation significantly outstripped the increase in real median household income, which edged up just 0.3 percent in 2013, the most recent data available from the Census Bureau Current Population Survey (CPS). When income growth persistently lags behind house price changes, housing affordability suffers unless mortgage rates decline substantially. Long-term mortgage rates are expected to trend up this year, underscoring the need for income growth to accelerate to create a healthy environment for the housing market.

Declining oil prices, which pushed inflation expectations lower, and weakness in the economies abroad, which ignited a flight to quality to long-term Treasuries, led to declining mortgage rates in the second half of 2014. The decline in mortgage rates to a generational low once again helped stabilize housing affordability, which plummeted when mortgage rates surged, driven by the Fed officials' talk of tapering QE3, in the early summer of 2013. Despite weakness in some spots in the housing market at the end of the year, including the December drop in the pending home sales index to its lowest reading since April 2014, current housing fundamentals have generally been more favorable to home buying and we expect some tailwinds for housing this year. The Federal Reserve's January Senior Loan Officer Opinion Survey, which summarized conditions in the prior three months, showed that most banks noted no change in lending standards for both commercial and consumer loans. However, some reported









tightening in the oil and gas sector. Several large banks eased standards for residential mortgages amid slightly weaker demand. Results for residential mortgages from the Fed survey are in line with the fourth quarter Fannie Mae Mortgage Lender Sentiment Survey™, which showed that larger lenders were more likely to report credit easing than tightening.

We expect a few key factors—the backdrop of strong hiring and income growth, stabilized housing affordability, modestly easing lending standards, and declining shadow inventory from the drop in the seriously delinquent rate and the share of underwater properties—to translate into improving housing demand and a broad-based improvement in the housing recovery in 2015. Weak global growth and geopolitical headwinds should limit the rise in long-term interest rates, even though we continue to anticipate that the Fed will begin to hike short-term interest rates this year. The Freddie Mac yield for 30-year fixed-rate mortgages averaged 3.66 percent—the lowest since May 2013—at the time this article went to print. We expect a gradual rise, with the rate remaining below 4.5 percent by the end of 2016, supporting the housing recovery.

The decline in mortgage rates to below 4.0 percent over the past several months has ignited refinance interest, especially for FHA loans, which received an extra boost from the 50 basis point cut in mortgage insurance premiums. Purchase applications also have moved up after dropping in December to nearly a two-decade low.

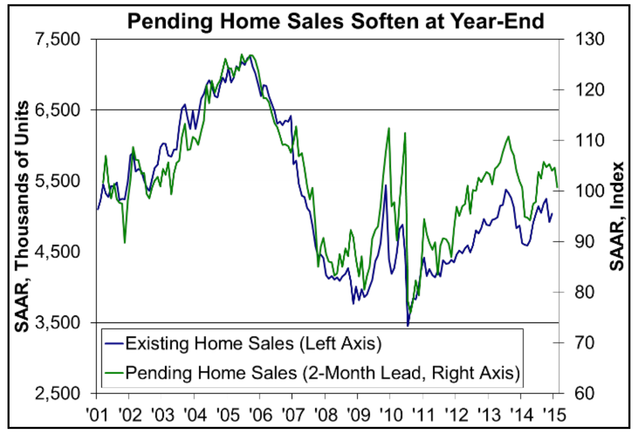
We estimate that total single-family mortgage originations dropped approximately 36.0 percent in 2014 to $1.19 trillion—a slight upward revision from the prior forecast due to an upgrade in both purchase and refinance originations to reflect incoming data for 2015, about $100 billion higher than in the prior forecast due to a more optimistic refinance projection. The refinance share is projected to edge up from an estimated 43.0 percent in 2014 to 45.0 percent in 2015, compared with a slight drop in the previous forecast. Total single-family mortgage debt outstanding should be relatively flat in 2015 before a gradual pickup in 2016 and 2017.

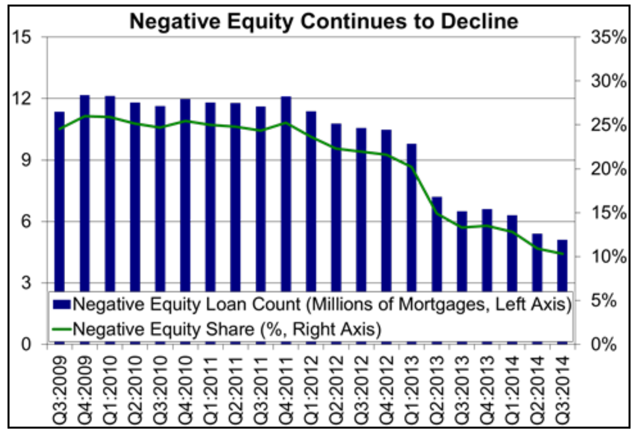
February 10, 2015
Economic & Strategic Research (ESR) Group

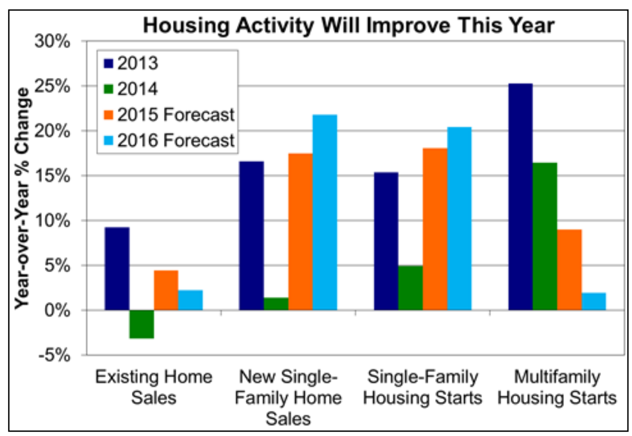
For a snapshot of macroeconomic and housing data between the monthly forecasts, please read ESR's Economic and Housing Weekly Notes.

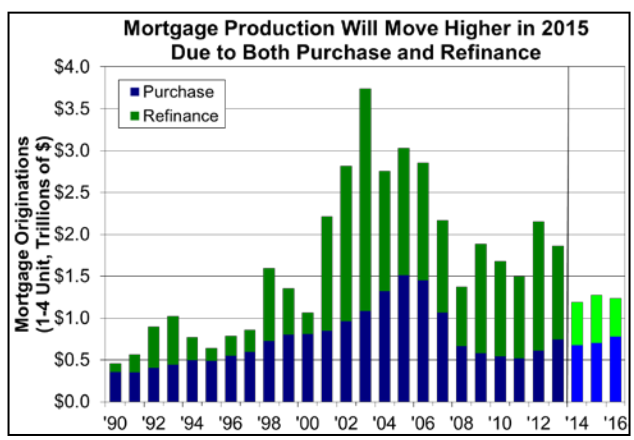
Sources for chart data: *Bureau of Economic Analysis, Energy Information Administration/Chicago Mercantile Exchange, Federal Reserve Board, Bureau of Labor Statistics, Census Bureau, National Association of REALTORS®, National Association of Home Builders, Mortgage Bankers Association, Federal Housing Finance Agency, Fannie Mae Economic & Strategic Research (ESR) Group*

Opinions, analyses, estimates, forecasts and other views of Fannie Mae's Economic and Strategic Research (ESR) group included in these materials should not be construed as indicating Fannie Mae's business prospects or expected results, are based on a number of assumptions, and are subject to change without notice. How this information affects Fannie Mae will depend on many factors. Although the ESR group bases its opinions, analyses, estimates, forecasts and other views on information it considers reliable, it does not guarantee that the information provided in these materials is accurate, current or suitable for any particular purpose. Changes in the assumptions or the information underlying these views could produce materially different results. The analyses, opinions, estimates, forecasts and other views published by the ESR group represent the views of that group as of the date indicated and do not necessarily represent the views of Fannie Mae or its









management.

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