

# Will Consumers Be Enough to Sustain the Expansion?

The expansion celebrated its tenth anniversary this month, though we expect growth in real gross domestic product (GDP) likely slowed sharply from the first quarter’s impressive pace of 3.1 percent. We upgraded our estimate for second quarter growth by one-tenth from last month, but we are still predicting a slowdown to an annualized rate of 1.8 percent for the quarter. Personal consumption expenditures were likely stronger than our previous forecast suggested, but business fixed investment is likely to have decelerated from its first quarter pace. For the full year we maintained our 2019 GDP forecast of 2.1 percent, but we believe growth will slow in 2020 to 1.6 percent due to waning fiscal stimulus, continued uncertainty weighing on consumer and business confidence, and eventually a slowdown in consumer spending.

Since our last forecast there have been several key developments in the macroeconomy. While trade tensions between the U.S. and China remain, negotiations between the two countries resumed after the G-20 summit at the end of June, at the very least delaying the implementation of further tariffs. Jobs rebounded in June after a weak May report, dispelling fears of a significant slowdown in employment this past quarter, and both personal income and consumer spending remained solid. However, we do not believe these positive developments will prevent the Federal Reserve from cutting the federal funds rate, and we are now predicting quarter-point rate cuts in both July and December, replacing our earlier prediction of a single rate cut in September.

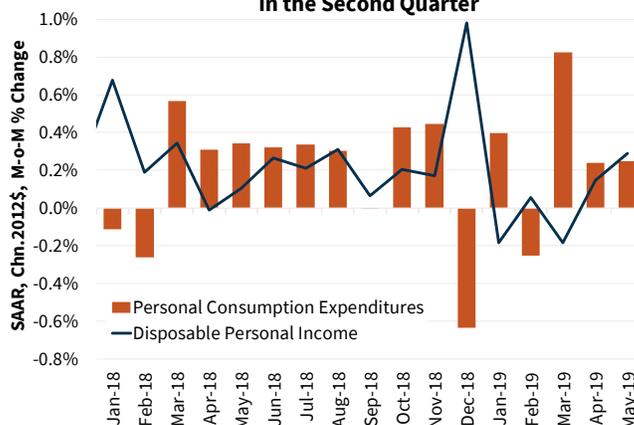
Our overall view of the housing market is one of moderate strength through the end of the year. The continued decline in mortgage rates during the second quarter and sustained strength in the labor market should support demand for home sales and construction. While recent housing data have been mixed, it is in part due to the lingering effects of last year’s slowdown, including continued slow growth in new home building. Tempering the pace of the recovery, limited housing supply remains a chronic obstacle.

## Consumer Spending Should Propel Growth

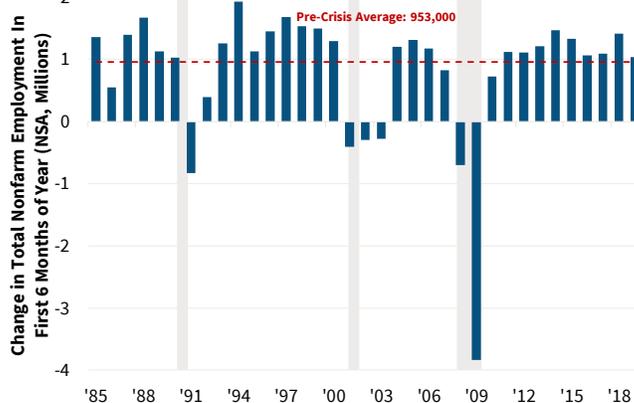
The final estimate of first quarter growth in real personal consumption expenditures (PCE) was revised downward four-tenths to 0.9 percent annualized, the weakest pace in a year, but consumer spending likely accelerated strongly and should be the bright spot of second quarter GDP growth. After two consecutive months of solid real consumer spending gains in April and May, we revised upward our second quarter forecast substantially from 2.4 percent to 3.3 percent. Our first look at June consumer spending was slightly less encouraging as light vehicle sales edged down modestly; however, the decline failed to reverse May’s impressive gain, and average monthly vehicle sales for the second quarter increased modestly from the prior quarter, a positive sign for accelerating growth in consumer spending. June was a strong month for equity prices, a further support to consumption activity. The S&P 500 rose 1.2 percent over the month and continued to climb in early July when it reached a fresh expansion best. For all of 2019 we boosted our forecast of consumer spending growth by four-tenths as continued strength in the labor and equity markets, along with strong household balance sheets, should be supportive.

June’s robust jobs report showed payrolls increased by 224,000, outweighing small downward revisions to the prior two months and indicating that the labor market remains a strength of the economy. While the unemployment rate edged up slightly in June, the increase was driven by greater participation as the civilian labor force posted the largest increase of the year. The labor force participation rate ticked up slightly in June and has remained within the narrow range of 62.4 percent to 63.2 percent for nearly six years, reinforcing the

Consumer Spending Likely Picked Up Strongly in the Second Quarter



While More Than a Million Jobs Were Added in the First Half of 2019, Pace Slowed Sharply from 2018





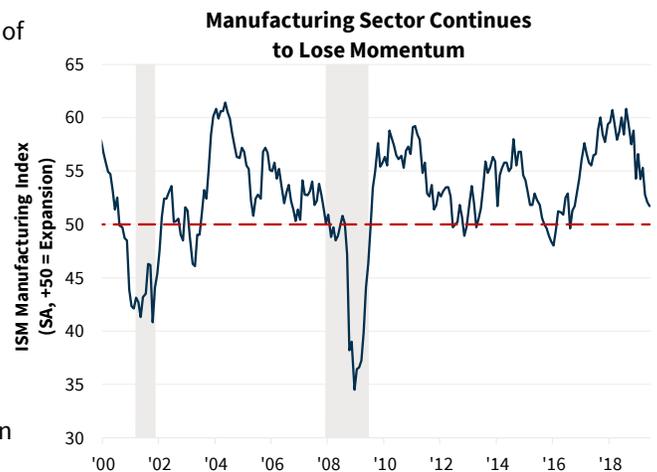
impression that participation has stabilized after trending downward for several years after the recession. The number of workers employed part-time for economic reasons declined again to just shy of the expansion low, confirming a tight labor market. However, the details of the employment report showed some signs of weakness and softening labor demand. While more than one million jobs were added in the first half of 2019, the gain was well below 2018’s robust 1.4 million jobs and the slowest pace of job growth in the first half of a year since 2010. The average workweek remained steady at 34.4 hours for the third straight month, but the annual growth in total weekly hours has fallen from 2.4 percent in January to 1.5 percent in June, the slowest pace since September 2017. Annual wage growth stalled at the slowest pace since last September, somewhat surprising given the extremely low unemployment rate. Additionally, job openings have slowed in recent months, trending downward since reaching an expansion high last November.

While consumers have been resilient to increased trade tensions and slowing global growth so far, there were some signs of weakness in consumer confidence as two measures of sentiment declined in June. The Conference Board’s Consumer Confidence Index was hit particularly hard, falling by the largest month-over-month amount in nearly seven years to reach the lowest level since September 2017. Both the present situation and expectations components eroded, though the latter declined more sharply.

### Uncertainty Weighs on Businesses

While nonresidential fixed investment was revised upward substantially for the first quarter from 2.3 percent to 4.4 percent in the final estimate, the outlook for the second quarter dampened considerably, as has our forecast for the remainder of this year. Investment in structures almost certainly dragged on growth during the second quarter as private nonresidential construction spending fell again in May, posting the first back-to-back monthly declines since the start of 2017 to reach the lowest level this year. On an annual basis, nonresidential construction spending posted the first contraction in more than a year. Investment in equipment also likely slowed as durable goods orders fell for the second consecutive month in May and shipments edged up only slightly after posting the largest decline in three years in April. The top-line decrease in orders was mainly driven by the volatile nondefense aircraft sector, related to concerns over Boeing’s 737 Max. Core capital goods shipments, which exclude the more volatile defense and aircraft orders, have risen for four of the past five months and may provide some relief. A bright spot for investment should be spending on intellectual property products, which we expect will maintain its recent strength.

Weakness in the manufacturing sector has added to mounting worries of slowing business investment. A May rise in industrial production was driven almost entirely by a weather-related surge in utilities, while the gain in the manufacturing index was an anemic 0.2 percent. The PMI® survey of purchasing managers showed manufacturing continued to lose momentum in June, with the index remaining in “growth” territory but declining to its lowest level since October 2016. The softness in manufacturing data is unlikely to abate in the near term as factory orders fell in May for the third time in four months, while the new orders component of the ISM Manufacturing Index lost its “growth” reading for the first time since December 2015. Service sector activity also disappointed, according to the ISM Nonmanufacturing Index, coming in at the slowest pace of expansion in nearly two years in June.



While small business optimism rose on average during the second quarter, sentiment declined sharply in June, driven by businesses curbing spending and a more negative outlook on sales and earnings. Business uncertainty in June posted the largest monthly gain since the Presidential election and reached the highest level in two years. Confirming the tight labor market, the share of firms reporting that their single most important problem was cost of labor rose to an expansion high of 10 percent, while quality of labor remained the most prevalent response at 21 percent—but if continued uncertainty erodes business confidence, we expect both investment and hiring are likely to be delayed or curtailed.

### The U.S. and China Strike a Truce...For Now

After a three-month standoff, the U.S. and Chinese governments agreed to resume trade talks following June’s G-20 summit. With trade talks beginning anew, the U.S. agreed not to levy additional tariffs during negotiations and to soften its stance on Huawei,

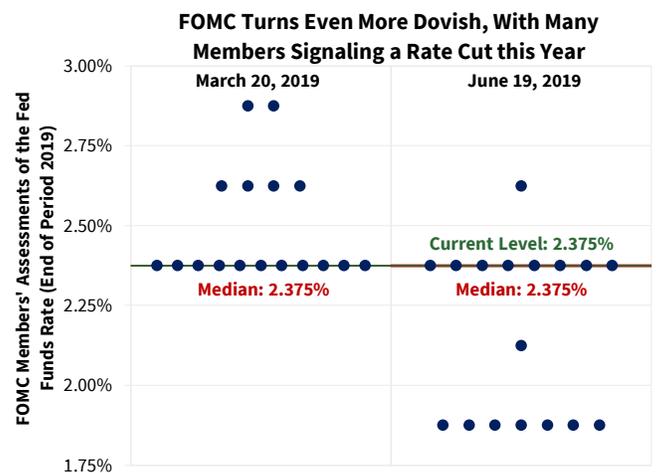


China’s largest telecommunications company, which the U.S. had placed on its “Entities List,” making it difficult for the company to conduct business with American counterparts. In return, China pledged to resume buying U.S. agricultural products. However, the 25 percent tariff on \$200 billion of Chinese imports enacted by the U.S. in May, and China’s retaliatory tariff of 25 percent on \$60 billion of U.S. imports, are still in effect. China’s leadership has repeatedly stated that it would not agree to a trade deal while any tariffs on Chinese goods are employed by the U.S., while the U.S. administration has staunchly rejected rolling back any existing tariffs. This faceoff suggests that a trade deal will not be reached this year and that, going forward, consumer and business sentiment will be weighed down further.

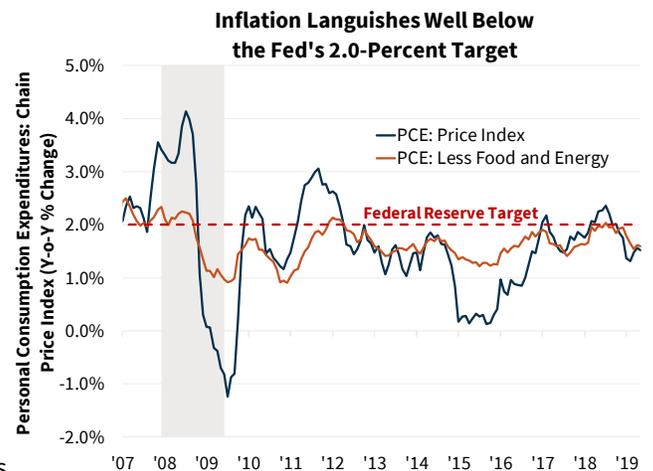
If talks break down completely, we believe the U.S. will follow through on imposing a 25 percent tariff on the remaining \$300 billion of Chinese imports. This would encompass more consumer products than previous rounds of tariffs, affecting items such as cell phones, computers, and clothing, and potentially pushing inflation higher. China would have only about \$10 billion in U.S. imports left to levy tariffs on, but the Chinese government could retaliate in other ways, such as increasing regulatory obstacles for U.S. businesses attempting to operate in China. In the absence of countervailing monetary policy or other supportive factors, a complete breakdown in trade negotiations would likely trigger some degree of financial turmoil, limiting investment and growth.

### After Fed’s Dovish Shift, We Expect July Rate Cut

At its June meeting, the Federal Open Market Committee (FOMC) maintained the current federal funds rate target of 2.25 percent while promising to “act as appropriate to sustain the expansion,” a notable shift away from the previous emphasis on remaining “patient.” The Fed noted increased uncertainties around the FOMC’s economic outlook, with Chairman Powell—at that time and then again in his semiannual testimonies before the U.S. House Financial Services Committee and the U.S. Senate Banking Committee in early July—emphasizing muted inflation, weak manufacturing production, and “cross-currents, including trade developments and global growth,” as sources of concern. Sentiment among FOMC members during the June meeting shifted sharply in the direction of a rate cut, highlighted by St. Louis Fed President James Bullard’s vote in favor of an immediate reduction, the first dissent during Powell’s tenure as Chairman. Eight of the seventeen participants said they expect to see a lower federal funds rate by the end of 2019, with seven of them expecting the rate at the end of this year to be 50 basis points lower than the current rate.



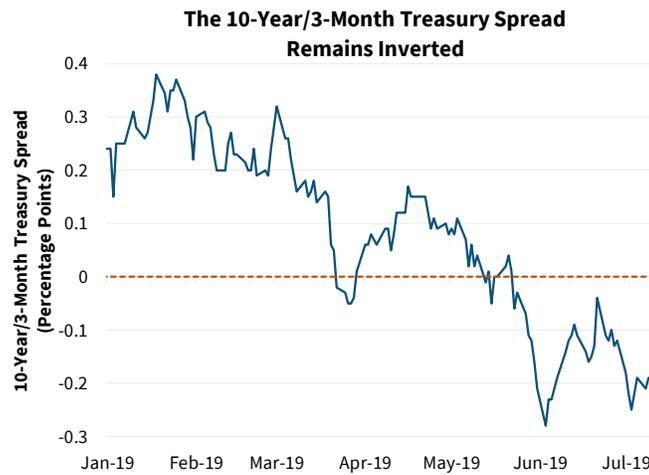
Of equal significance, the June FOMC meeting also saw a reduction in inflation projections, with the forecast for 2019 PCE inflation being reduced from 1.8 percent as of the March meeting to 1.5 percent following the June meeting. In his July testimony, Chairman Powell, abandoning his earlier statements that weakness in inflation could be attributed to “transitory” factors, reiterated that both headline and core (excluding food and energy) PCE inflation were well below the Fed’s “symmetric” target of 2 percent and warned that low inflation risks were becoming more persistent. Contributing to low inflation is the strong U.S. dollar, which helps to make imports cheaper. While the U.S. dollar slipped modestly in June, it remained at a historically elevated level and rallied in early July after the positive jobs report. If the Fed cuts rates later this month as we expect, the dollar could weaken, helping to push up inflation measures.



The inversion of the yield curve that began in late May has continued, with the 10-year/3-month Treasury spread at 19 basis points as of this writing. While the Fed has downplayed the importance of an inverted yield curve as a recession predictor, this development is widely considered either a sign of overly tight monetary policy or of an expected slowdown in economic activity, and risks causing further erosion of business confidence and investment. Additionally, the current environment of negative longer-term interest rates in many major economies contributes to downward pressure on longer-term rates in the U.S. as well.



The longer the inversion remains, the more likely that it will have direct real effects on growth via tighter bank lending, as banks find it increasingly difficult to profit from borrowing on the short end of the curve and lending on the long end.



Even with temporary relief in trade tensions and a solid employment report in June, the fed funds futures market continues to price in the near-certainty of a rate cut in July and 50 to 75 basis points of cuts by December. Given the Fed’s highly dovish shift at its June meeting and Chairman Powell’s equally dovish testimony, along with persistent below-target inflation and the continued inversion of the yield curve, we now believe the Fed will cut rates in July and could end the reduction of its balance sheet as early as that same meeting. Reducing rates in July should give the Fed enough leeway to maintain its “patient” stance long enough to see whether economic growth conditions stabilize. We currently forecast that conditions will lead the FOMC to cut rates by another 25 basis points in December. We will continue to monitor conditions for both upside and downside risks to that forecast.

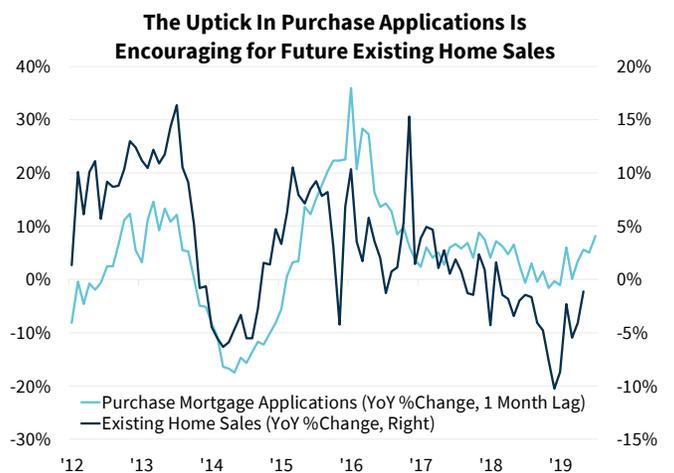
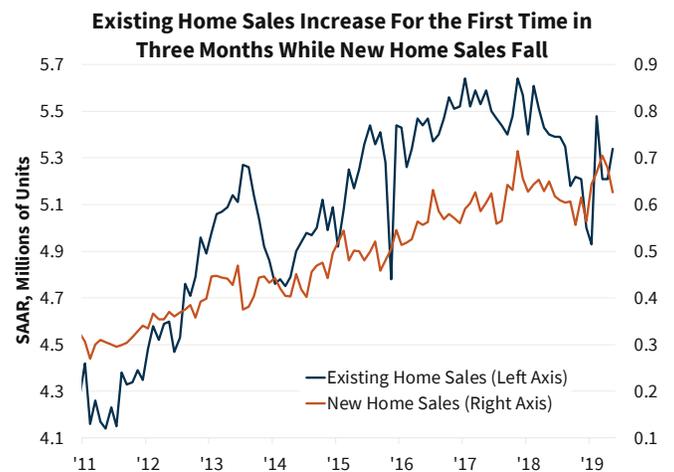
### Housing Has Room to Improve

Home sales diverged in May as sales of existing homes rose while sales of new homes declined, both in line with our expectations. Existing single-family home sales increased 2.5 percent to the second highest sales pace of the year. We continue to believe that existing sales in the second quarter were about 2.0 percent higher on a seasonally-adjusted basis than in the first quarter, and that third quarter sales will gain an additional 2.0 percent before peaking during the fourth quarter. Lower mortgage rates and a modest rise in inventories of homes for sale should help support an increase in existing sales.

Homebuyer sentiment has improved significantly after last year’s slowdown. Fannie Mae’s Home Purchase Sentiment Index® declined slightly in June, but not enough to reverse a large increase in May, and, on a quarterly basis, reached its highest level in a year. Purchase mortgage applications, while inherently volatile, have also continued to trend upwards in recent months indicating continued sales momentum for the latter half of the year. Still, the chronically limited supply of homes for sale, particularly those priced more modestly, will likely temper sales through the remainder of the year and into 2020, especially if job growth and consumer confidence wane.

New single-family home sales fell for the second consecutive month in May after spiking earlier this year to near the business cycle high. The earlier jump was fueled in part by builders offering discounts on a growing inventory of previously started homes for sale that had accumulated during last year’s sales slowdown. Much of that supply has now been sold off, and at least some sales pullback was likely. In the coming quarters, we continue to view the underlying sales trend as modestly positive, despite the recent pullback, and expect a gradual increase in new home sales for the remainder of the year.

Like new sales, single-family starts also fell in May. As builders draw down inventories they must increase starts even if sales growth is moderate. Indeed, we have now seen inventories of previously started homes for sale decline for four months.

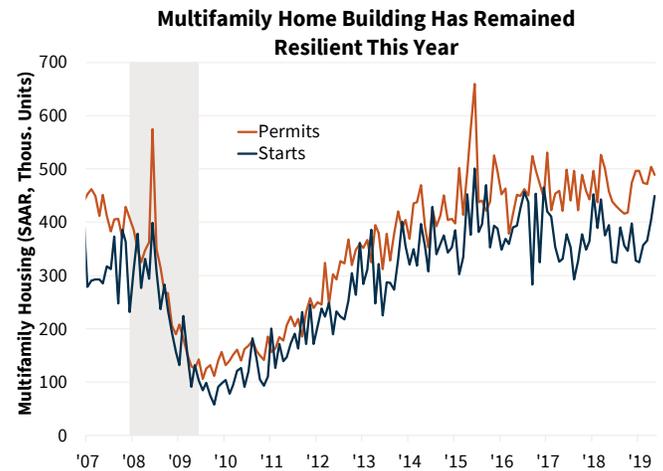




Moreover, single-family permits, which provide an underlying indicator of construction trends, rose 3.1 percent in May, the first monthly increase of the year and largest since last September, while the share of homes sold that have yet to be started has risen for two months. We expect single-family starts to accelerate modestly but more quickly than the pace of sales over the next quarter.

With lower mortgage rates taking effect, the deceleration in house price growth that was so prominent over the past year may be pausing. The most recent reading in April of the S&P CoreLogic Case-Shiller Home Price Index measured annual house price growth of 3.5 percent, down only two-tenths from March. The CoreLogic National House Price Index, with a more recent reading from May, accelerated on an annual basis for the first time in fourteen months from 3.3 percent in April to 3.6 percent. We now expect house prices, as measured by the quarterly FHFA Purchase Only Index, to grow 5.4 percent this year, up from our previous forecast of 4.6 percent. Despite a stronger comparative pace, we still expect deceleration to 3.7 percent growth for 2020.

Construction activity in the multifamily housing sector continues to show strong resilience this year. Multifamily starts data are notoriously volatile, but the figure surged nearly 11 percent both in April and in May. While permits, which tend to be more stable, pulled back slightly in May, they remained near a one-year high. In light of this continued strength, we have materially revised upward our forecast for multifamily starts in the second quarter and included more modest increases for the remaining quarters of this year. For the full year, we expect multifamily starts to be slightly higher than in 2018. For more information on multifamily market conditions, please see the [July 2019 Multifamily Market Commentary](#).



Mortgage rates have continued to decline. The 30-year fixed mortgage rate averaged 3.80 percent in June, down from 4.07 percent in May and the seventh straight month of decline, according to Freddie Mac. As of this writing, mortgage rates are 3.75 percent, the second lowest level since November 2016 and more than a percentage point lower than their recent peak of 4.94 percent in November. This continued decline in mortgage rates and our upwardly revised view on house price growth have led us to increase our forecast for single-family mortgage originations for the remainder of the year. We now expect total originations to rise 7.0 percent from 2018 to \$1.75 trillion, and we expect refinances to account for 32 percent of total mortgage originations in 2019, up from 29 percent in 2018.

## Economic & Strategic Research (ESR) Group

July 10, 2019

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, Bureau of Labor Statistics, Institute of Supply Management, Federal Reserve, National Association of REALTORS®, Census Bureau, Mortgage Bankers Association, Fannie Mae ESR Group.

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