Fannie Mae

Economic and Strategic Research

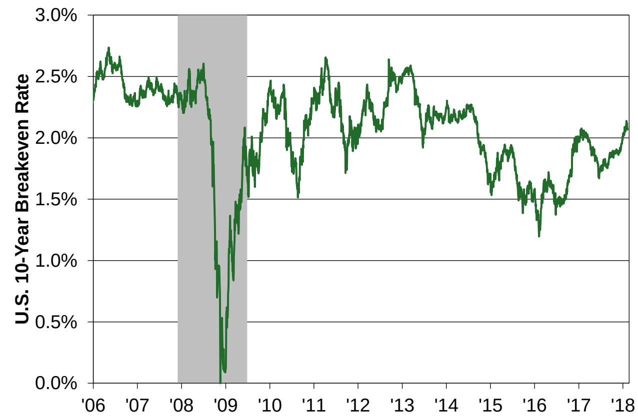
Economic Developments – February 2018

Strong Economic Activity Triggers Overheating Concerns

Economic activity gathered momentum at the end of 2017 and start of 2018. Over the past several weeks, the markets started to appreciate the broader implications of the stronger growth path and related change in the direction of monetary policy, including the reintroduction of volatility in a rising rate environment.

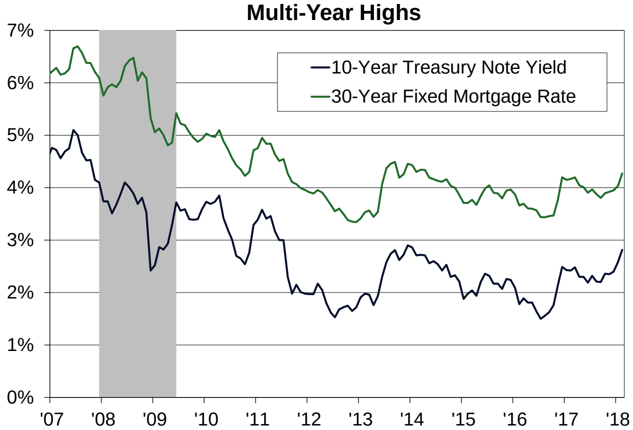
Early signs of wage acceleration fueled concerns about rising inflation, pushing market-based measures of inflation expectations such as the 10-year breakeven rate higher. Long-term interest rates jumped, with the 10-year Treasury yield surging to the highest level in four years. As of this writing, the yield on 30-year fixed-rate mortgages had increased for five consecutive weeks, reaching the highest reading since the end of 2016.

Long-Term Inflation Expectations Begin to Rise

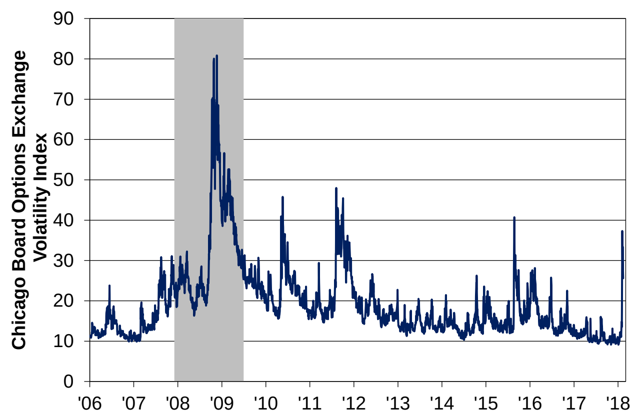


The change in the profile of long-term rate expectations triggered a spike in market volatility. Following a sustained period of calm that lured investors into short-volatility trades, the VIX Index, a measure of the stock market's expectation of volatility, soared to reach the highest level since the aftermath of the unexpected devaluation of the yuan in 2015. These developments led to a repricing of equities, sending the stock market into correction territory.

Long-Term Interest Rates Rise to Multi-Year Highs



Stock Market Volatility Spikes



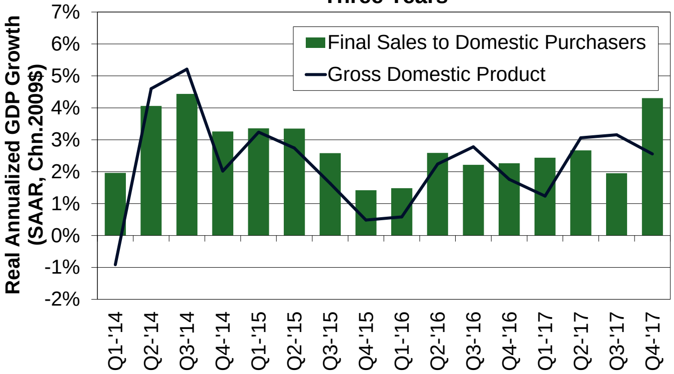
Our forecast for 2018 economic growth remains at 2.7 percent. Sustained declines in the stock market and contagions to other markets present downside risks to our forecast, but we also see some upside risk to growth stemming from fiscal policy, which added additional stimulus to the economy on top of the 2017 Tax Cuts and Jobs Act. Following an overnight government shutdown, Congress passed the Bipartisan Budget Act of 2018 that will raise discretionary spending by nearly $300 billion over the next two years and extend the debt ceiling until March 1, 2019. Combined with the Tax Act, the Budget Act will likely worsen the deficit outlook, implying a rising supply of Treasuries and higher yields.

While we expect lower tax rates to induce increased investment and labor supply, the addition of deficit-financed stimulus at a time when the economy is already near full employment is likely to stoke more concerns over rising inflationary pressure and could require more aggressive monetary actions to offset the fiscal stimulus. Thus, **Fiscal Policy and the Fed: Stimulus/Response**—our theme for 2018—underpins the health of the economic expansion.

Domestic Demand Shows Solid Momentum

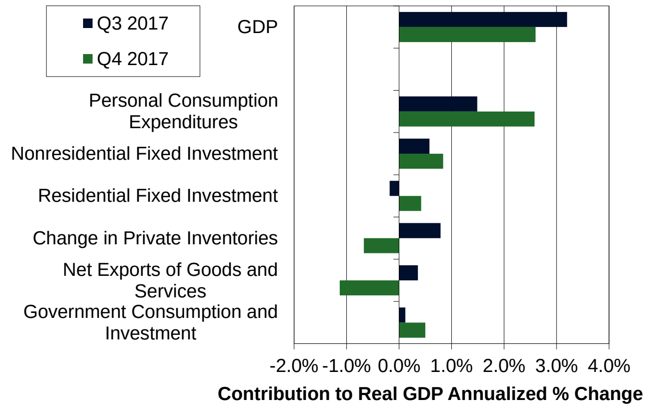
Fourth quarter real gross domestic product (GDP) growth slowed six-tenths from the third quarter to 2.6 percent annualized, as trade and inventories dragged on growth. However, the weakening headline growth masked a marked increase in domestic demand. Final sales to domestic purchasers (GDP minus trade and inventories), which is a gauge of strength in domestic demand, grew 4.3 percent annualized, the fastest pace in more than three years.

Domestic Demand Surges To Its Highest Level in Three Years



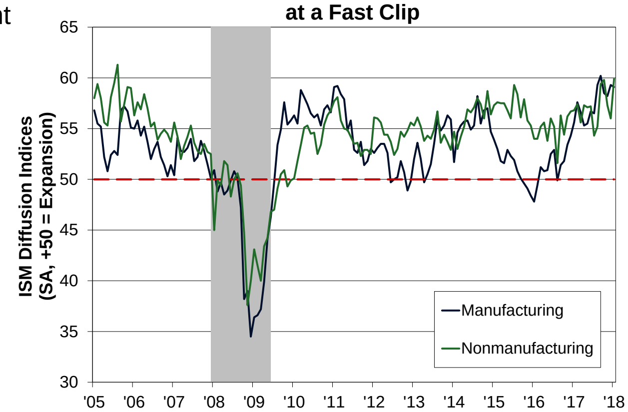
Note: Final sales to domestic purchasers is gross domestic product less net exports and change in private inventories

Exports and Inventories Drag on Economic Growth



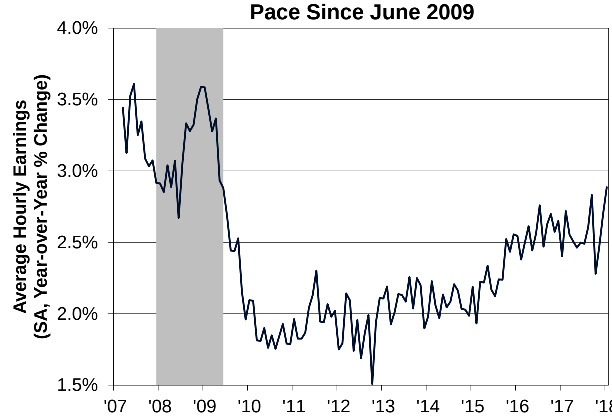
Real consumer spending grew 3.8 percent annualized, the biggest increase since the second quarter of 2016, and added 2.6 percentage points to growth, a contribution more than 1 percentage point greater than in the third quarter. Outlays on durable goods drove the gain, reflecting the surge in auto sales to replace hurricane-damaged vehicles. Residential investment rose the most since early 2016 and added to growth for the first time in three quarters. Nonresidential investment and government spending also contributed more to growth than in the prior quarter. Notably, business investment in equipment showed back-to-back double-digit gains, registering the strongest increase in more than three years. For all of 2017, the economy grew 2.5 percent, the best performance since 2014.

Manufacturing and Service Activities Expand at a Fast Clip



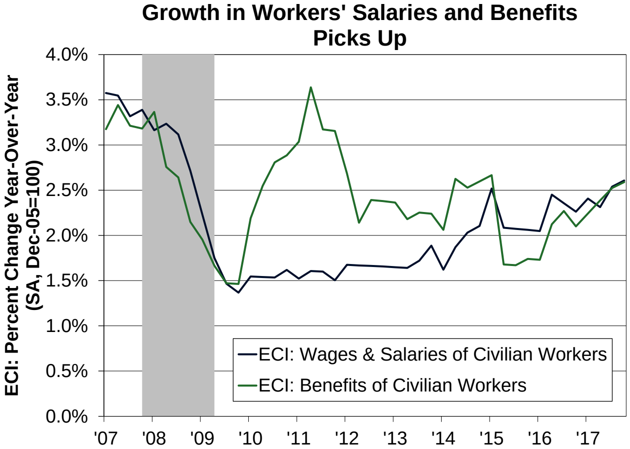
Economic fundamentals remained solid in January. Surveys of purchasing managers indicate strong expansion in both the manufacturing and service sectors. The Institute for Supply Management (ISM) Manufacturing Index edged down but stayed just shy of September's 13-year high, while the ISM Nonmanufacturing Index jumped to the highest level since August 2005.

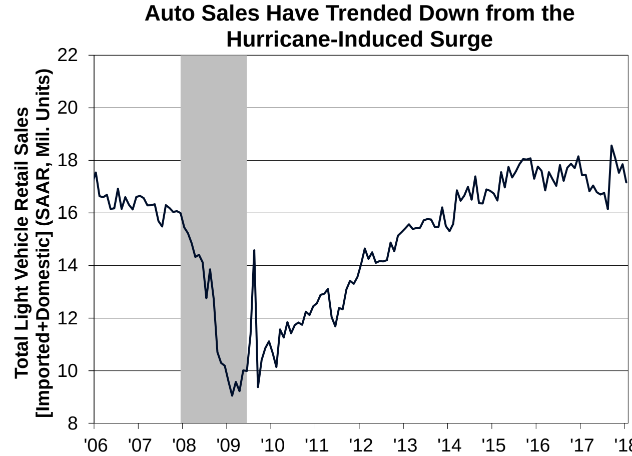
Annual Wage Growth Jumps to the Fastest Pace Since June 2009



The labor market also started the year strong. January's job gain of 200,000 was nearly 20,000 more than the average monthly gain in 2017. For financial markets, the game changer from the report was the acceleration in annual wage gains to 2.9 percent, the strongest pace since June 2009, which resulted in a "tantrum" in Treasury yields. The household survey was uneventful as the unemployment and the labor force participation rates were flat for the fourth consecutive month at 4.1 percent and 62.7 percent, respectively. The broadest measure of labor underutilization (the U-6 rate), which includes discouraged workers as well as part-time workers who prefer full-time jobs, ticked up one-tenth to 8.2 percent. We remain convinced that slack remains in the labor market and expect that hours worked will increase and more people will enter the labor force as wage gains firm amid rising demand for labor.

Signs of a pickup in wage growth were also present outside of the jobs report. The Employment Cost Index, which is a measure of labor compensation that also includes bonuses and benefits, increased during the fourth quarter at the fastest annual pace of the expansion, thanks to the biggest annual wage gain in nine years. Despite signs of faster wage growth, we expect that inflation will remain well-anchored. The passage of the Tax Act should help spur faster capital expenditures and productivity growth, keeping unit labor cost contained.





We expect real GDP to grow 2.7 percent annualized this quarter, little changed from the prior forecast. Consumers will likely notice increases in their disposable income as their tax withholdings decline. However, we expect real consumer spending growth to moderate from last quarter's unsustainable pace. Auto sales have been trending down after the surge last September, retreating in January for the third time in four months. After contributing 0.4 percentage points to GDP growth in the fourth quarter, the most in six years, motor vehicles and parts should drag on growth going forward. We also expect the increases in residential investment and business equipment spending to moderate from the double-digit gains last quarter. However, inventory investment should strengthen from an anemic pace, helping offset slowing domestic demand growth amid a continued drag from trade.

The Market Continues to Fully Price in A March Rate Hike

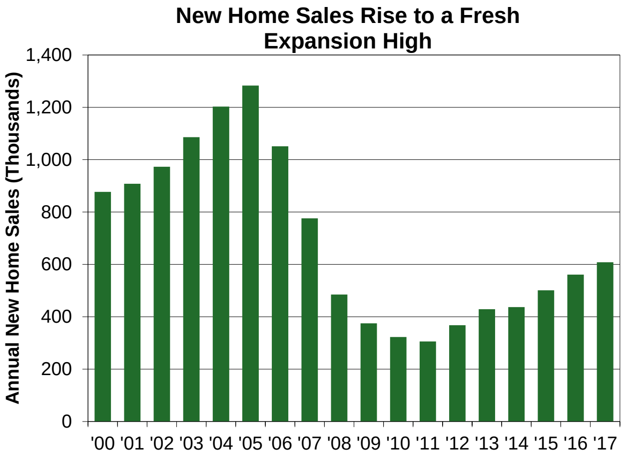
In the statement following the January Federal Open Market Committee meeting, the Committee noted that inflation remains below the 2.0 target, but also remarked that market-based measures of inflation expectations have risen recently. The annual increase in the personal consumption expenditures (PCE) deflator, the Fed's preferred measure of inflation, decelerated slightly in December to 1.7 percent. We expect the PCE deflator to remain below the Fed target this year. Barring protracted deterioration in financial conditions, the Fed is expected to raise the fed funds rate in March, a move fully priced in by the fed funds futures market, and we expect two more hikes this year in June and December. The consensus view is that the new Fed Chair Powell will largely represent policy continuity of a gradual monetary policy normalization.

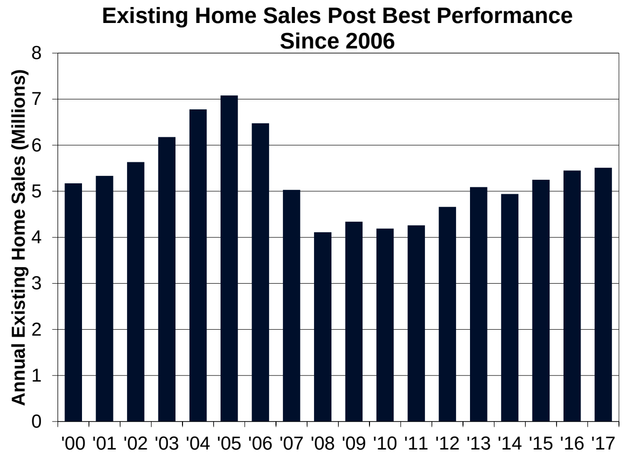
Mortgage interest rates are likely to feel the impact of three factors over the course of the year, all of which ultimately point in the direction of higher rates and wider spreads. First, as the Fed MBS portfolio runs off, we expect to see marginal investors picking up the volume requiring higher yields after mid-year. Second, the higher rate environment is intensifying industry competition and reducing profit margins, as noted in our Mortgage Lender Sentiment Survey. This competition may temporarily compress spreads resulting in industry downsizing that reduces capacity and ultimately results in wider spreads that restore profit margins for survivors. Third, just as Fed portfolio purchases enabled a market adjustment to a higher guaranty fee structure that more accurately reflected market risks, we believe the Fed departure will leave this structure in place in the higher interest rate environment.

This expected higher mortgage rate environment, if sustained, implies a significant reduction in refinance volume, as is already being made evident via competitive pressures. This is the refi story. The impact on the home purchase market will depend on the pace of rate adjustment. Recalling the evidence from the "Taper Tantrum" of 2013, the home purchase market does not respond well to large, rapid moves in mortgage rates. However, if rates move up in reasonable alignment with household income growth, the home purchase market can do well in a rising rate environment.

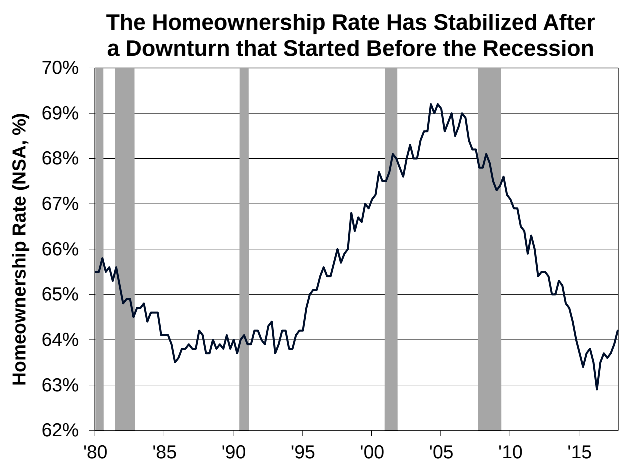
Housing Roundup

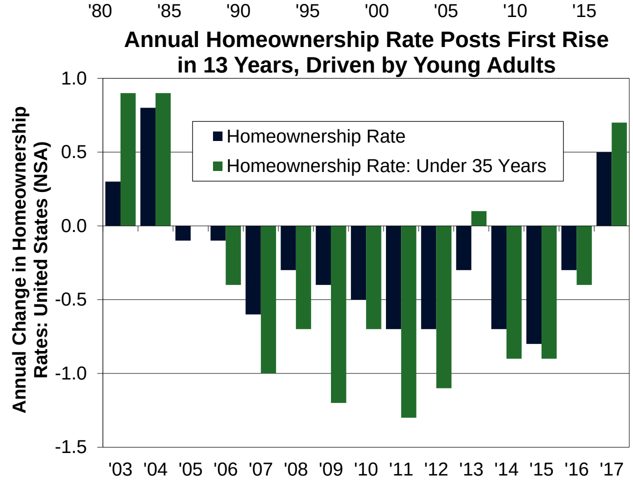
Homebuilding activity was mixed at the end of 2017 as single-family housing starts posted the worst monthly drop in almost three years, while multifamily starts rose for the third time in four months. However, for all of 2017, single-family starts rose to the highest level since 2007, while multifamily starts fell for the second consecutive year. Both new and existing home sales decreased in December, but annual average sales posted the best performances since 2007 and 2006, respectively.





For 2017, total home sales rose by less than 2 percent despite mortgage rates that averaged just 4 percent and the strongest economy in three years. The principal factor restraining home sales last year was the lack of supply. The year-over-year decline in the for-sale inventory of existing homes, which accounted for 90 percent of total home sales in 2017, continued unabated. Given the most recent trends, supply appears unlikely to expand sufficiently to make a difference in sales this year. The number of existing homes for sale registered a double-digit annual percentage drop in December, sending the months' supply to 3.2 months, the lowest reading since the inception of the series in 1999. There could be some relief for homebuilding activity. The cut in the corporate tax rate from 35 percent to 21 percent will benefit homebuilders, especially large ones who already own developable lots and can respond to increased demand quickly. The increased profit margins could spur construction of mid-priced and low-priced homes, whose supply has been limited. However, the shortages of labor and land and rising material prices will limit how fast builders can increase supply. Over the past several years, tight inventories have helped boost home price appreciation well past income gains, creating home purchase affordability challenges. Unfortunately, we do not expect much relief on the home price front this year.





Because long-term interest rates rose more than we expected at the start of 2018, we revised our interest rate forecast upward. We now expect the yield on 30-year fixed-rate mortgages to average 4.4 percent during the fourth quarter of this year, 30 basis points higher than the prior forecast. Despite the higher rate projection, our forecasts for homebuilding activity and home sales are little changed from the prior forecast. The Tax Act will provide a boost to disposable household income, which should counteract the declining affordability from rising mortgage rates. The Act also removes some of the tax subsidy of homeownership, especially for high-priced homes, and will likely hurt price appreciation at the upper end of the market. However, the Act's overall impact should be positive for demand for moderately priced homes, despite the doubling of the standard deduction that reduces the tax incentive to buy.

Demographics is one positive for the owner-occupied housing market. As the millennials age amid a growing economy, they have accelerated their homeownership attainment, helping to boost the overall homeownership rate. The fourth quarter Housing Vacancy Survey supported our view that the national homeownership rate finally stabilized last year following sustained declines that started prior to the recession. For 2017, the average homeownership rate rose 0.5 percentage points to 63.9 percent, driven by the biggest gain in the homeownership rate for those under 35 years old since 2004.

For all of 2018, we expect single-family starts to rise 8.6 percent, similar to the increase in 2017, amid a modest drop in multifamily starts. Total home sales should increase about 3 percent in 2018 with roughly the same pace of home price appreciation as in 2017. We project that purchase mortgage originations will rise about 5 percent to $1.19 trillion in 2018, little changed from the January forecast. However, with a higher interest rate forecast, our refinance originations projection was revised lower by about 7 percent from the level in the January forecast to $498 billion—a drop of 29 percent in 2018 from the 2017 level—compared with a 22 percent decline in the prior forecast. The refinance share should decline 8 percentage points to 30 percent in 2018.

For information on multifamily market conditions, read the February 2018 Multifamily Market Commentary.

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: *Bloomberg, Federal Reserve Board, Freddie Mac, Chicago Board Options Exchange, Bureau of Economic Analysis, Institute for Supply Management, Bureau of Labor Statistics, AutoData, Census Bureau, and National Association of REALTORS®*

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