Fannie Mae

Economic and Strategic Research

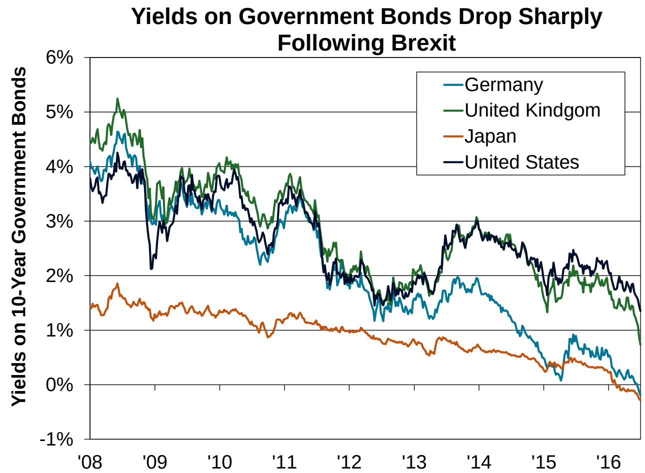
Economic Developments - July 2016

Prolonged Uncertainty Weighs on the Outlook

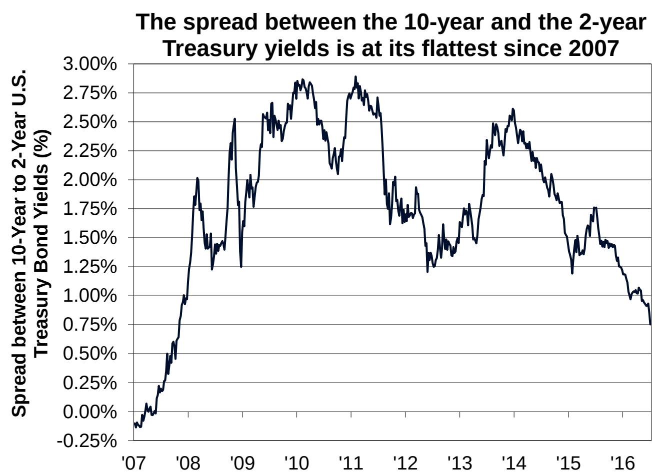
We upgraded our expectations for second quarter 2016 economic growth by three-tenths to 2.4 percent, mainly reflecting the surprisingly strong pickup in consumer spending through May. Our forecast for second-half economic growth of about 2.0 percent is the same as in the prior forecast. The full-year real gross domestic product (GDP) growth forecast is revised one-tenth higher to 1.8 percent, reflecting the slight upgrade in first quarter growth in the government's third estimate and our improving view for the second quarter. Heightened uncertainty and financial volatility associated with Brexit, as well as the uncertainty ahead of the U.S. presidential election, point to elevated downside risks to our forecast and will likely reinforce the Fed's cautious stance.

Brexit's Direct Economic Impact on the U.S. Is Likely Limited

Financial markets were surprised and reacted swiftly to the U.K.'s decision to leave the European Union (EU). Global stock indices plummeted, risk spreads widened, market volatility indices surged, and the dollar appreciated sharply against the British pound and, to a lesser extent, against the euro. Strong safe-haven flows into Treasuries led to a decline in long-term yields. This has been reinforced by the decline in short-term rates resulting from the expected slower path of Fed hikes and by investors' search for yield amid low and negative rates in Europe and Japan. The 10-year Treasury yield fell to a record low intra-day of 1.32 percent on June 6 and closed at 1.37 percent. The 10-year yield was little changed after the surprisingly strong June jobs report on July 8, but moved up to slightly more than 1.5 percent at the time of this writing.



Increasingly flat yield curves are another reflection of investors' concerns. The spread between the 10-year and the 2-year Treasury yields is at its narrowest since 2007. Investment-grade U.S. corporate bond yields and mortgage rates have declined as well. Some of the adverse conditions have since unwound, but some, including the depreciation of the British pound and downward pressure on long-term Treasury yields, have persisted. Because the U.K.'s actual exit from the EU will occur in 2019, the two-year window for negotiations will result in heightened uncertainty in the financial markets regarding the economic impact of the exit.

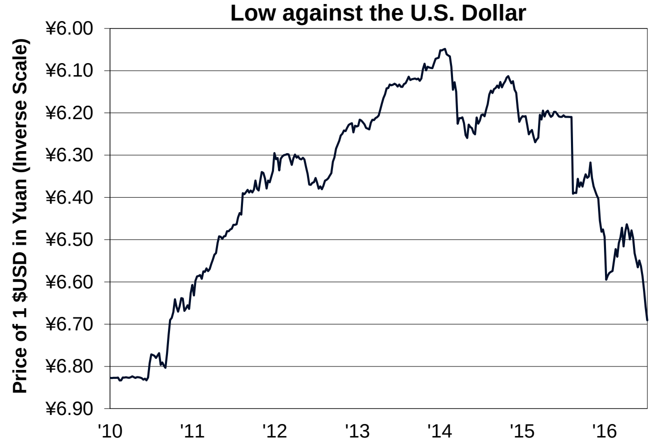


In terms of Brexit's economic impact, a moderate recession in the U.K. is likely as the resulting uncertainty affects businesses' hiring and investment decisions. This is especially important for large multinational companies and financial institutions that use London as a base of operations to serve the EU market. Some of these organizations are now likely to relocate their activities to cities on the Continent. Economic growth in the Eurozone, which is about 30 percent of the world economy, will likely slow as well. Countries around the globe are also adjusting the amount of credit exposure they will have in the U.K. Moody's estimates that the U.S. banking system's total exposure to the U.K. is $920 billion, which dwarfs its exposure to other major European countries, including France and Germany.

From a direct trade perspective, the economic impact of the U.K.'s exit on the U.S. should be limited because the U.K. accounts for less than 5.0 percent of U.S. exports. However, the Eurozone accounts for 15 percent of U.S. exports, making it the third biggest market behind Canada and Mexico. Slower global growth, combined with a stronger dollar, suggests worsening net exports; however, exports account for only about 12 percent of U.S. GDP. Barring concerns that will lead to a significant tightening of financial conditions, the negative impact of Brexit on the U.S. economy will likely be small.

One of the downside risks of Brexit is the potential instability in the Chinese Yuan. The currency depreciated 1.5 percent during the last week of June and the first week of July to the lowest level since November 2010. So far, China's financial markets have responded reasonably well compared to the stock market turmoil of last August, but there is evidence that capital flight has accelerated. The biggest risk of Brexit may be that other countries might be emboldened to leave the EU as well. It is also possible that Scotland will push for a referendum in 2019 before the U.K. formally leaves the EU and vote to leave the U.K. Other risks include tensions in the Italian and German financial sectors, which have come under more pressure since Brexit. Estimates of loan delinquencies in the Italian banking sector run to 17 percent. At least one German bank is at risk. EU troubled bank treatment rules will get a test.

The Chinese Yuan Depreciates to a Six-Year Low against the U.S. Dollar



Overall, increased political and economic uncertainty could weigh further on business spending and hiring plans, which already faced considerable headwinds from shrinking profitability, low productivity, and rising labor costs prior to the referendum.

Fed Keeps Target Rate Low for Longer

Prior to the U.K. referendum, concerns regarding the marked slowdown in job growth and the outcome of the Brexit vote contributed to the Fed's decision to remain on hold in June. Post-referendum, global headwinds from increased financial-market volatility and heightened uncertainty have reinforced the case for a cautious approach in the removal of monetary policy accommodation, which has been reflected by more dovish recent Fed communication. Prior to the Brexit vote, our expectation had been that the Fed would raise interest rates once this year, with the timing likely in September. However, in the aftermath of the vote, the risks are skewed toward an even slower rate hiking cycle. We now believe that the next rate hike will likely be in June 2017. The fed funds futures market is not fully pricing in an increase until the end of 2018.

Major central banks, including the European Central Bank and those in Japan, the U.K., New Zealand, Australia, China, and India, are in easing mode. Many other central banks abroad will likely engage in additional quantitative easing and monetary stimulus. About 13 trillion U.S. dollars equivalent of global debts now have negative rates, and this total will likely grow substantially during the second half of the year. Near-term monetary tightening in the U.S. would lead to increased divergence between the Fed and central banks in other advanced economies, which would strengthen the dollar again after its downtrend earlier in the year. This Fed is unlikely to want to increase the force of that headwind.

Consumers Save the Day

Consumer spending rose a solid 0.3 percent in May following an upward revision for April, which now shows a 0.8 percent increase, the strongest monthly gain since August 2009. The saving rate fell 0.7 percentage points during March and April to 5.3 percent in May. While the rate is well below its long-term average of over 8.0 percent (the average rate between 1960 and the mid-1980s was more than 11 percent), it is still above its 2013 to 2015 average of 4.9 percent, providing some cushion for future spending.

Solid Gains in Consumer Spending Help Lift Q2 2016 Economic Growth

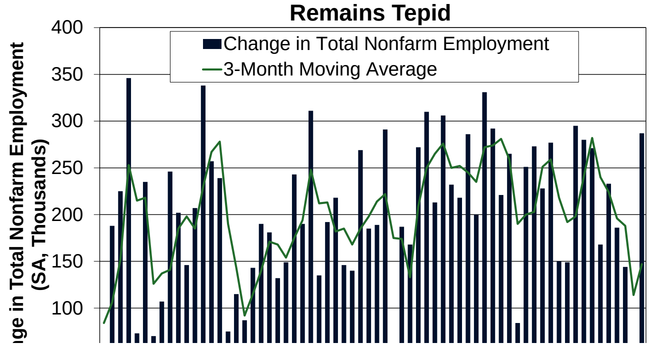
The headline and core personal consumption expenditures (PCE) deflators, the Fed's favored measures of inflation, showed muted price pressures in May, supporting the Fed's gradual approach amid increased downside risks. The core PCE, which excludes food and energy, was up 1.6 percent on a year-ago basis, the same as the prior month's gain.

Spending may have cooled in June, however, as auto sales dropped 4.5 percent, putting second quarter sales below the first quarter's pace. Even with the drop in auto sales, real consumer spending growth likely accelerated to 4.2 percent from the lackluster 1.5 percent annualized in the first quarter. This would be only the fourth time during this expansion that real spending growth has exceeded 4.0 percent. We expect real consumer spending growth to moderate to about 2.3 percent in the second half of the year, with labor market conditions key to the forecast.

Strong Rebound in Payrolls Isn't a Game Changer

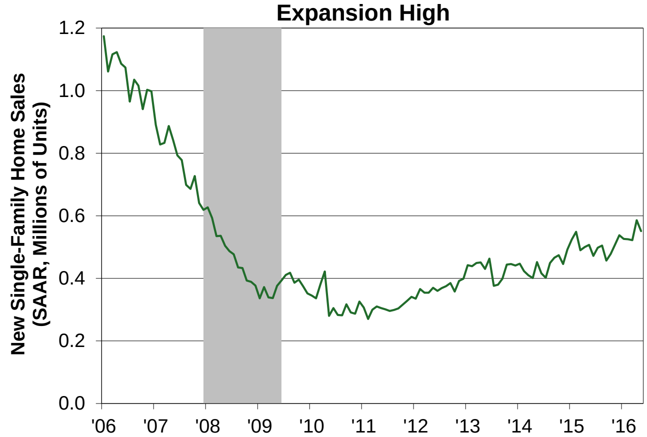
The sharp rebound in nonfarm payroll employment, which rose 287,000 in June, helped to allay recession worries but has not changed the outlook. The large gain came on the heels of a downward revision to May payrolls to a gain of just 11,000. While the hiring trend picked up in June, with the three-month moving average rising to 147,000 from 114,000 in May, it has slowed substantially from 240,000 at the start of the year. The household survey showed the unemployment rate rose two-tenths to 4.9 percent, as a large increase in the labor force outpaced a small increase in household employment.

Job Creation Jumps in June, but Hiring Trend Remains Tepid



For the second quarter, it appears that consumer and government spending contributed to GDP while net exports was neutral. Business investment, inventory investment, and housing should be a drag, with the latter likely to be a payback from a very strong performance in the first quarter. The last time residential investment subtracted from GDP was in the first quarter of 2014. For all of 2016, consumer spending is expected to drive growth, with some support from government spending and residential investment. Nonresidential investment, inventory investment, and net exports will drag on growth.

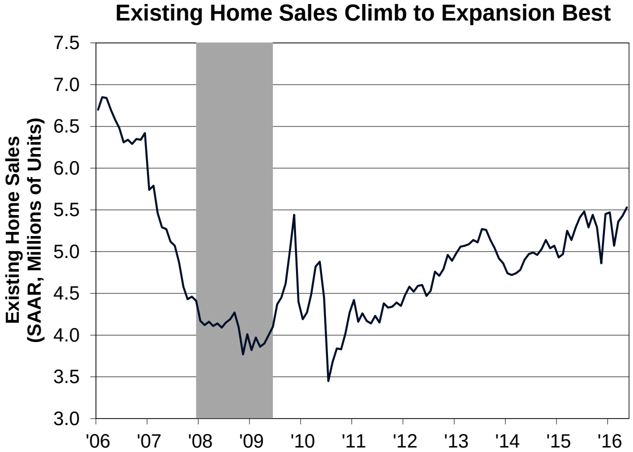
New Home Sales Pull Back from Expansion High



Housing Roundup

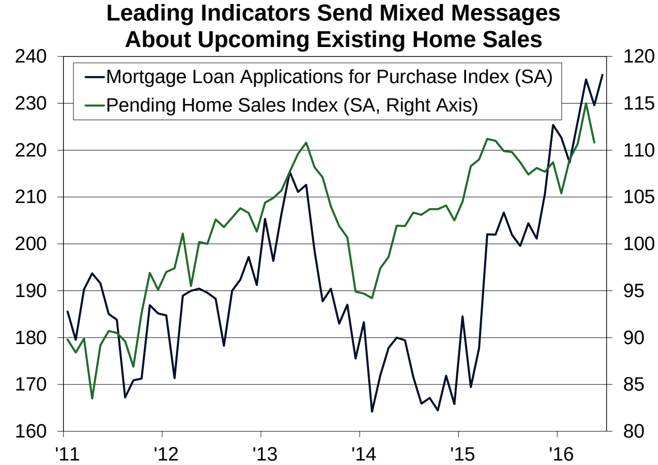
Brexit should be a positive for the housing and mortgage market in the near term because it has helped bring down U.S. long-term interest rates. Home sales through May point to continued modest housing expansion. New home sales pulled back 6.0 percent from April, but the drop was a payback from a double-digit surge in the prior month, with the end result being that May sales remained elevated at the second-best level of the expansion. Existing home sales rose 1.8 percent from April to the highest level in more than nine years. The number of homes for sale fell 5.7 percent from a year ago, marking the largest year-over-year drop since last October.

Existing Home Sales Climb to Expansion Best



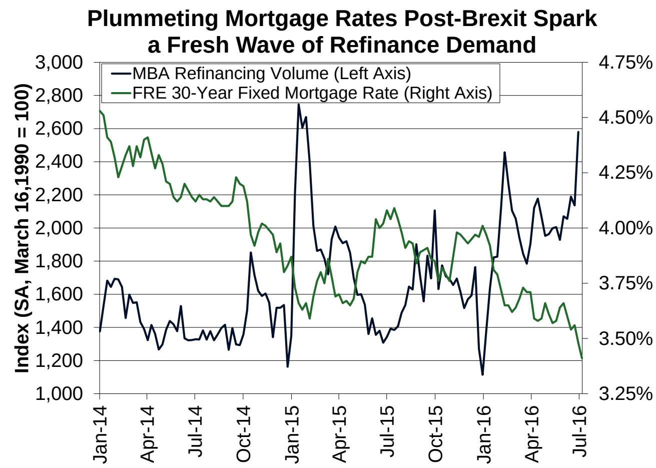
Existing Home Sales Inventory Post Largest Year-over-Year Drop Since October 2015

Year-to-date new and existing home sales through May were 7.1 percent and 5.6 percent, respectively, higher than sales over the same period in 2015. Leading indicators for existing home sales presented a mixed picture of sales in the summer. Pending home sales fell 3.7 percent in May from a decade high reached in April and posted a year-over-year drop for the first time in almost two years. On the other hand, after a drop in May, average purchase mortgage applications for June rose to the highest monthly reading since April 2010, boosted by the surge during the first week of the month. Purchase applications dropped in the last three weeks of June but rebounded during the first week of July.



One downside risk for housing is single-family homebuilding, which appears to have lost momentum in the second quarter. Spending on new single-family construction fell in May for the third consecutive month, and single-family permits declined for the second time over the last three months. By contrast, multifamily permits rose in May for a second consecutive month. (For more information on multifamily market conditions, read the July 2016 Multifamily Market Commentary). Without relief from new construction, single-family housing inventory will likely remain tight, boosting home prices and constraining affordability.

Our forecast for the path for mortgage rates through the end of 2016 is about 20 basis points lower than the prior forecast, with 30-year fixed mortgage rates averaging just 3.5 percent during the fourth quarter of 2016. We believe low inventory is translating interest rate declines into strong home price appreciation. We don't expect a big boost in home sales from the recent drop in mortgage rates. We did revise our home sales forecast modestly higher, largely because of stronger-than-expected spring sales, which sent the trajectory higher for third quarter sales. The drop in rates should boost refinance originations in the second half of the year. In the first week following the U.K. referendum, refinance applications soared to the highest level in almost a year and half, jumping nearly 21 percent. We now project a 2.2 percent rise in total mortgage originations to $1.75 trillion in 2016, versus a projected 2.8 percent drop in the prior forecast. The refinance share should come in at 42 percent in 2016, compared with 40 percent in the prior forecast and 46 percent in 2015. While the mortgage market is tilting more toward purchase originations, the change is much more gradual than we had originally thought at the start of the year.



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, Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, National Association of REALTORS®, Mortgage Bankers Association, Freddie Mac*

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