

## Less Upbeat Growth Outlook for the Second Half

The first print of second quarter economic growth came in weaker than we expected in the July forecast. Furthermore, the composition of last quarter's growth was unfavorable to the outlook for the second half of the year. The strength in inventory buildup points to a larger payback for the current quarter than we anticipated, suggesting that our forecast for the current quarter was too optimistic. While the government revised higher economic growth for the first quarter, the disappointing performance of second quarter growth and less optimistic prospects for the current quarter put our full-year 2015 growth outlook at 2.1 percent—the same as in our prior forecast. Drivers of growth this year will likely be consumer spending, housing, and government spending. As the dollar has appreciated further recently, it will continue to weigh on manufacturing and trade. While declines in business investment related to oil and gas exploration and production appear to be abating, we expect renewed drops in crude oil prices to continue to create a headwind for the sector. As we are approaching the September Federal Open Market Committee (FOMC) meeting, we expect interest rate volatility to pick up in response to surprises in incoming data and Fed communications.

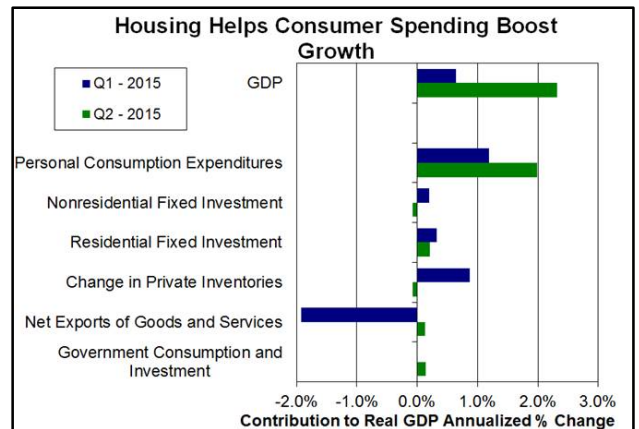
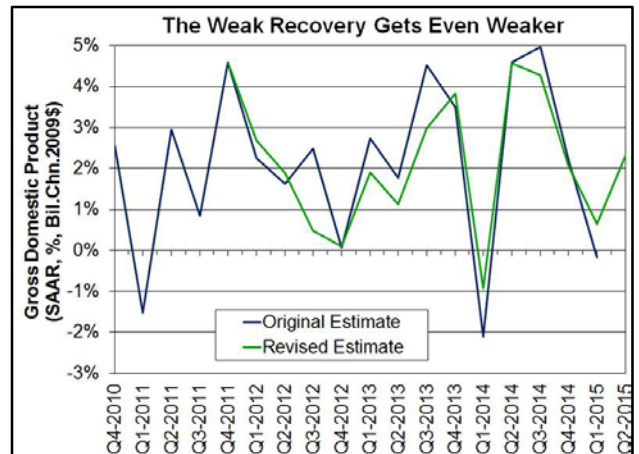
In the prior forecast, we mentioned that increased international uncertainties, including Greece's potential default and China's stock market plunge, were among downside risks to our forecast. While these concerns have receded somewhat, fundamental problems still remain. Chinese stock market volatility eased by late July, but real activity deteriorated as a private gauge of manufacturing, the July Caixin purchasing managers index, dipped further into contraction territory and reached the lowest reading in 15 months. Though Greece has accepted the latest austerity plan, implementation will be painful for the economy. Fortunately, the economy in the rest of Europe has improved, and recent spreads between peripheral debt and the German bund did not widen much at all, a stark contrast to the spike in the spreads seen in 2012, indicating limited contagion into global markets from the threat of the potential Greek exit.

### The First Half Was Not So Bad After All

The first estimate of second quarter gross domestic product (GDP) showed a 2.3 percent annualized growth rate. However, as a result of annual benchmark revisions to GDP back to 2012, the figure for the first quarter was revised up to a 0.6 percent annualized increase from a 0.2 percent drop. Despite the weaker-than-expected second quarter growth, the revision in the first quarter growth put the average growth for the first half slightly stronger than we anticipated. The revisions attempted to reduce residual seasonality that tended to cause weak reads on economic growth in the first quarters of past years. While the revisions moderated the weakness witnessed in the first quarters of 2014 and 2015, overall growth during the 2012-14 period was revised down an average of 0.3 percentage points to 2.0 percent, with most of the downward revisions occurring in 2013. At the same time, underlying inflation, as measured by the core personal consumption expenditures (PCE) deflator, was revised up to 1.7 percent from 1.5 percent.

Details of the second quarter showed that consumer spending was the biggest driver, contributing two percentage points to growth. Other main drivers included housing, which contributed to economic growth for the fifth consecutive quarter, and the government sector, which added to growth for the first time in three quarters solely because of the strength in the state and local government sector. Net exports, which subtracted 1.9 percentage points from growth in the first quarter, added modestly to growth in the second quarter.

Drags on growth included nonresidential investment, as the weakness in business investment in structures and equipment more than offset the gain in investment in intellectual property products.



Inventory investment also subtracted from growth in the second quarter as it slowed slightly from the robust pace in the first quarter, but remained at an elevated pace. We see the second quarter pace of real inventory buildup of \$110 billion as a negative for growth in the second half of this year. Since 1947, real inventory investment exceeded \$100 billion only eight times, and we believe that the unsustainable stockpiles built will come at the expense of growth in the current quarter as a potentially significant drawdown will likely occur. As a result, we trimmed our forecast of growth for the current quarter by 0.6 percentage points to 2.5 percent annualized, with consumer spending, again, being the biggest driver.

### Consumer Spending Expected to Be a Reliable Growth Engine

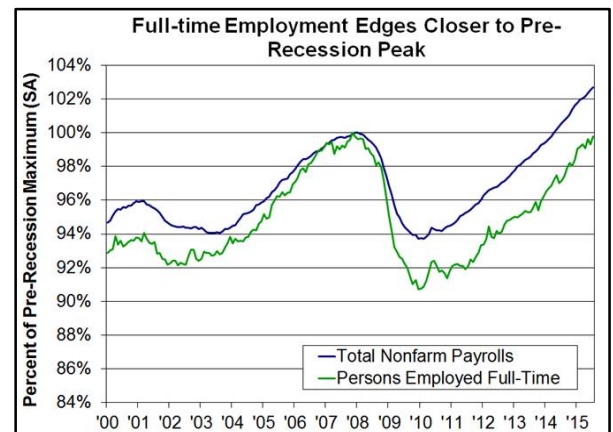
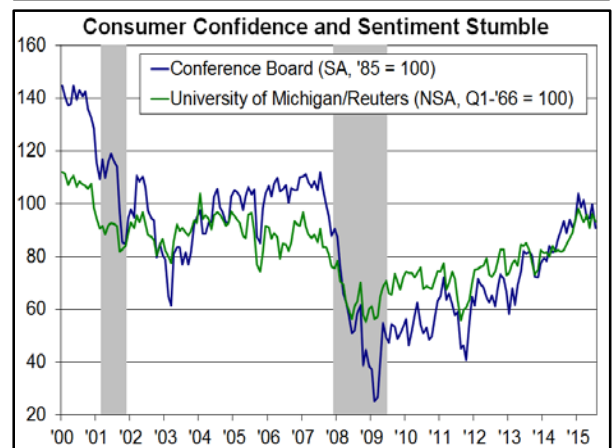
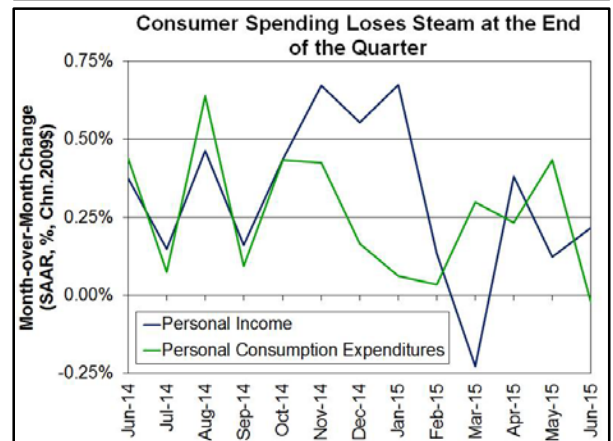
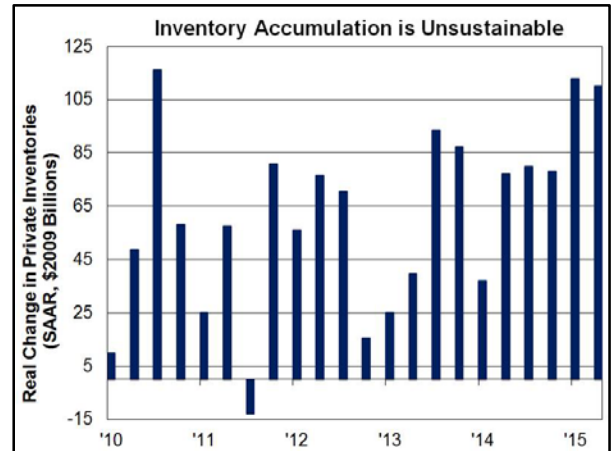
While real consumer spending picked up to 2.9 percent annualized in the second quarter from 1.7 percent in the first quarter, as we had anticipated in our July forecast, the monthly trajectory suggests that our expectation of further strengthening in the current quarter may be too optimistic. While real personal income continued to grow, rising 0.2 percent in June, real consumer spending was unchanged following a 0.4 percent increase in May. Flat real consumer spending at the end of the second quarter set up a soft trajectory for consumer spending heading into the third quarter. However, auto sales were robust in July, rising 3.3 percent to 17.6 million annualized units. Sales have been at 17 million units or more in four of the past five months, suggesting that consumers remain confident enough to purchase big-ticket items.

Meanwhile, consumer confidence took a hit to begin the third quarter after jumping in June. Both the Conference Board's Consumer Confidence Index® and the University of Michigan Consumer Sentiment Index pulled back in July, with the former dropping 8.9 points to the lowest level since September 2014 and the latter falling 3.0 points. While the Conference Board noted that uncertainty and volatility in financial markets stemming from the situations in Greece and China might have played a role in eroding confidence, the University of Michigan concluded that survey results showed virtually no impact of such international events on the index.

### Job Creation Remains Steady

Nonfarm payrolls rose 215,000 in July. The increase was comparable to the average monthly gain of 211,000 registered during the first half of 2015. The July total employment count was 2.7 percent above the pre-recession high and, importantly, the number of full-time workers is now just 0.2 percent shy of the previous peak. Manufacturing employment showed signs of life, as factory payrolls rose 15,000, the second biggest gain this year. Mining employment declined for the seventh consecutive month, but at a more moderate pace, suggesting fading negative impact from past declines in oil prices. However, a renewed decline in oil prices raises concerns for employment in the industry, though continued losses in the mining sector won't have a significant impact on overall employment.

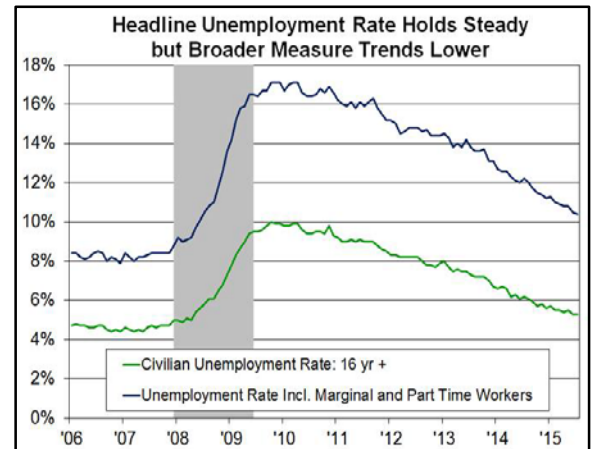
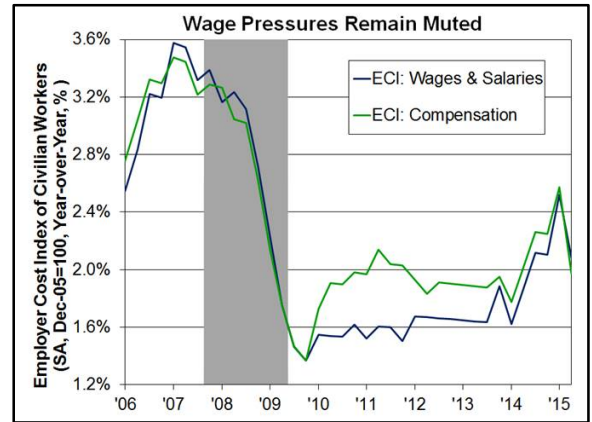
Wage pressures remain muted, as average hourly earnings for all workers rose 0.2 percent from June and 2.1 percent from July 2014. Since late 2012, 12-month average hourly earnings growth has fluctuated within a narrow band of 1.8 percent and 2.3 percent.



The gain in average hourly earnings recorded in the jobs report is consistent with the Employment Cost Index (ECI), a broader measure of labor compensation. The ECI for civilian workers rose just 0.2 percent in the second quarter—the smallest increase in the history of this index, which began in 1982. The wage component also rose 0.2 percent, compared with a 0.1 percent gain for benefits. The 12-month changes for the overall compensation component and the wage and salaries component eased to 2.0 percent and 2.1 percent, respectively, moderating substantially compared with the prior quarter, but on par with increases seen in the second half of 2014.

Though average hourly earnings remain soft, the July jobs report bodes well for personal income in July, as the average workweek for private employees ticked up one-tenth of an hour after being stuck at 34.5 hours for four months. The longer workweek, coupled with the rise in employment, caused the index of aggregate hours worked to jump 0.5 percent in July. The labor income proxy, the product of hourly earnings and hours worked, rose 0.7 percent, matching its best showing this year.

The unemployment rate remained steady at 5.3 percent amid little change in the number of employed persons or the size of the labor force, with the labor force participation rate remaining near a four-decade low of 62.6 percent. The broadest measure of labor utilization, the U-6, which takes into account discouraged workers and part-time persons who want full-time jobs, fell by one-tenth to 10.4 percent. While the U-6 rate reached the lowest level since June 2008 and has fallen substantially below the recession peak of 17.1 percent, it remains well above the pre-recession low of 7.9 percent.



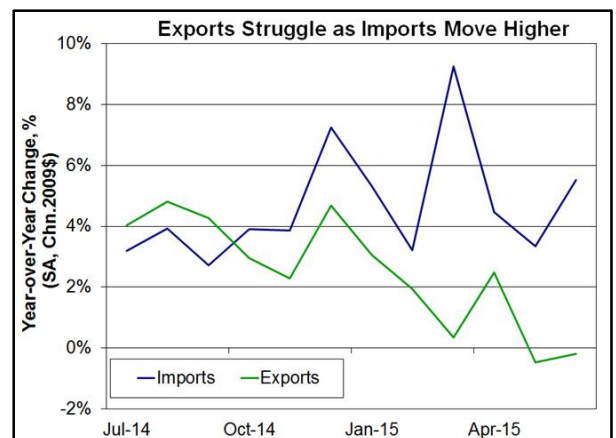
### The Fed Inches Toward a September Rate Hike

More than nine years have passed since the Fed last raised the fed funds rate. The statement following the Federal Open Market Committee (FOMC) July meeting noted that the committee is looking for “some further improvement” in the labor market before raising the target rate. We believe that the July jobs report offered sufficient evidence of labor market improvement for the Fed to move. The pace of the rate hike is expected to be very gradual, with only one 25-basis point increase this year. While the lack of wage pressure may cause some committee members to question the amount of slack in the labor market, Fed officials have said that an acceleration in wages is not a requirement for the rate hike. Meanwhile, underlying inflation, while remaining substantially below the Fed’s target, has firmed from the soft readings earlier in the year. In June, the core PCE deflator rose at a 1.6 percent annualized rate over the last six months, compared with 0.8 percent at the start of the year.

### The Dollar’s Strength Remains a Headwind

The manufacturing sector will likely continue to struggle amid a strong dollar and subdued global demand. The Institute for Supply Management (ISM) manufacturing index declined in July, sending the index to the lowest level since April. The ISM provided positive news on the service sector, however, as its nonmanufacturing index surged in July to nearly a 10-year high, suggesting that the vast majority of economic activity continued to improve.

Business investment in equipment subtracted from growth in the second quarter, but conditions appear to be improving. While the June factory orders report marked down core capital goods orders—a leading indicator of business investment in equipment—from the advance report, the increase in core orders is the first gain since March, which is encouraging for capital expenditures for the third quarter.



The strength in the dollar, which has appreciated more than 20 percent against a basket of trading partners' currencies since last June, has boosted spending power on U.S. imports, while at the same time making U.S. exports less attractive overseas. The trade deficit widened in June as nominal imports rose while exports shrunk, primarily due to a reduction in capital goods shipments overseas. The June trade deficit continued the recent trend in which real exports have struggled while imports have continued to climb higher. In June, real exports were about unchanged from the level a year ago, while real imports rose 5.5 percent. We expect this trend will continue through the rest of the year, and net exports will likely subtract from growth for the second consecutive year.

### Crude Prices Have Dropped Again

Global oil prices have been dropping as the non-OPEC supply has not fallen meaningfully amid OPEC's increased production. The Iranian nuclear deal will not affect oil prices this year because Iran's oil sanctions will not be lifted until the end of the year, at the earliest. Given weakening global growth, concerns about demand are weighing on prices. West Texas Intermediate oil prices have fallen from \$60 per barrel toward the end of June to around \$44 per barrel at the time of this writing, but remain within the range witnessed this year. So far, retail gasoline prices haven't responded to the recent drop in crude prices.

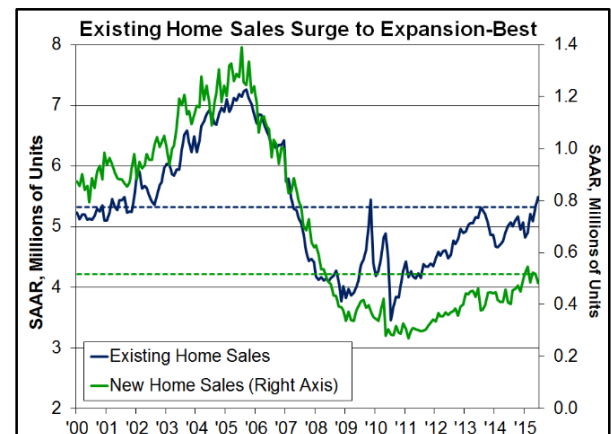
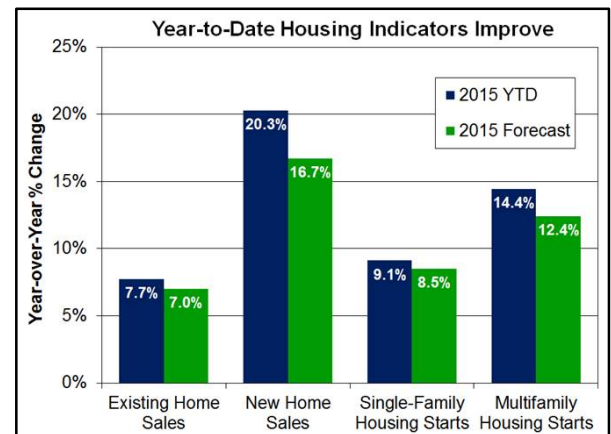
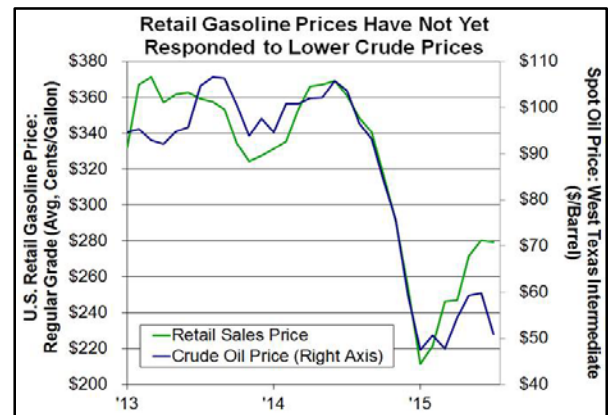
Declining oil prices took a toll on spending on private fixed structures in mining, exploration, and wells, which accounts for about 30 percent of overall nonresidential structures investment. Real spending on private fixed structures in mining, exploration, and wells subtracted 0.4 percentage points and 0.6 percentage points from growth in the first and second quarters, respectively. The industry has been adjusting to the decline in crude prices during the past year. Rig counts, an input used to estimate nonresidential investment in structures in the sector, has stabilized since July. Barring further substantial declines in oil prices, the drag on energy-related production and overall business investment in equipment should subside toward the end of this year.

### Housing Likely to Be a Bigger Contributor to Growth in 2015

Housing activity was mixed in June, but all main indicators rose through the first six months of the year compared to the same period last year, supporting our expectation of a broad-based improvement in the housing market. Existing home sales for June jumped to the strongest pace since February 2007. Inventory remains tight. The National Association of REALTORS® (NAR) noted that properties stayed on the market for an average of 34 days in June, the shortest duration since tracking began in May 2011, with 47 percent of homes sold in June staying on the market for less than a month.

As distressed sales shares typically decrease month over month in May due to seasonal factors, NAR reported that distressed sales dropped to new lows in June, accounting for only 8 percent of the market, the lowest share since record-keeping began in late 2008. CoreLogic data showed a similar trend, reporting that distressed sales declined to 9.9 percent of total home sales in May, the lowest for the month of May since 2007.

In contrast to the strength in existing home sales, new home sales dropped sharply in June, and sales in the prior three months were revised down significantly. Leading indicators suggest some weakness for near-term home sales. The NAR pending home sales index fell in June for the first time this year. While the purchase mortgage application index rose during the last week of July, it remains below recent highs reached in June and early July. The



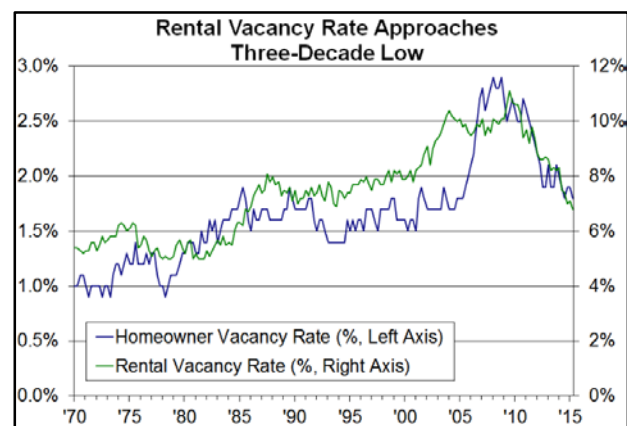
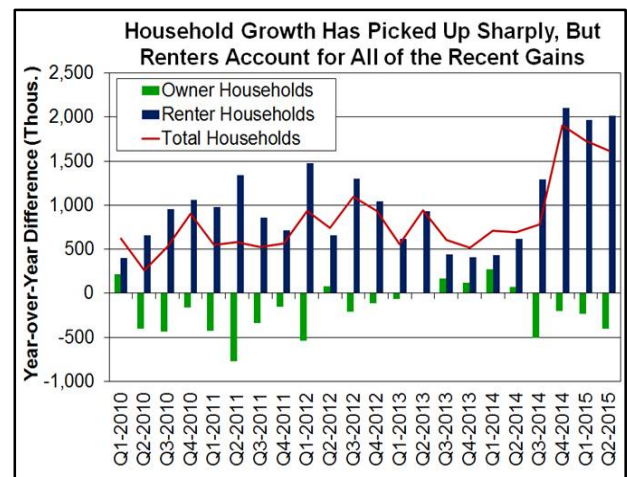
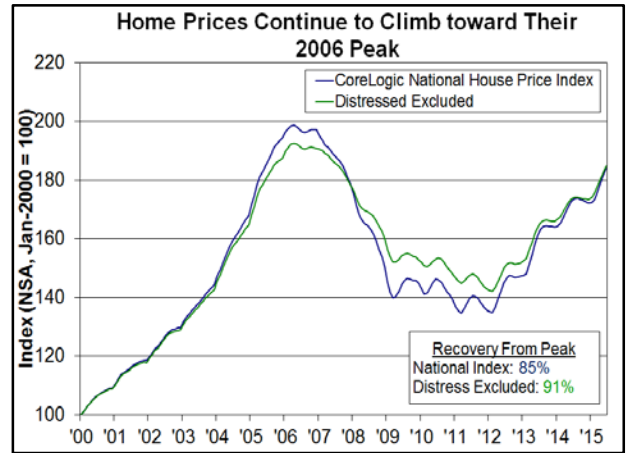
home sales outlook remains healthy compared to last year, however, as pending home sales remain above year-ago levels for the tenth consecutive month, and by a healthy margin, while average purchase applications for July were nearly 18 percent higher than in July 2014.

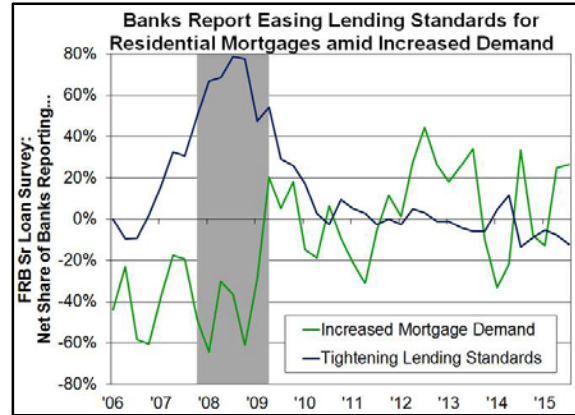
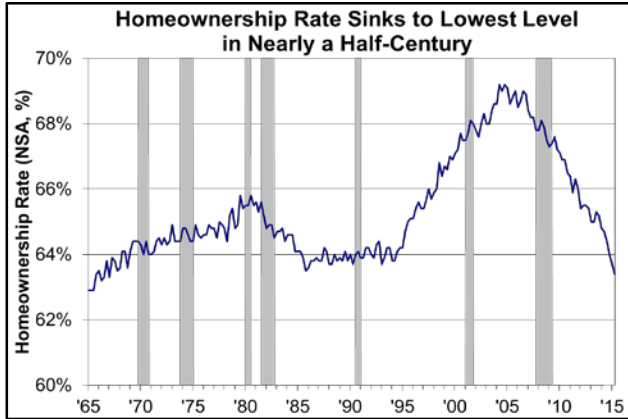
Solid total home sales and lean inventories have supported strong home price appreciation. The CoreLogic national home price index (not seasonally adjusted)—the measure used by the Fed to estimate the value of owner-occupied real estate—rose 1.7 percent in June, marking six consecutive monthly gains. On a year-over-year basis, prices increased 6.5 percent, the largest gain since June 2014. Still, prices are 7.4 percent below the series peak reached in April 2006.

Improving consumer fundamentals, especially steady job growth and rising household net worth, have helped boost household formation. According to the Census Bureau's Housing Vacancy Survey, the number of households increased by 1.6 million in the second quarter from a year ago, marking the third consecutive quarter of robust year-over-year household growth. However, all of the net gain in household formation over the past year was due to rental households. As a result, the rental vacancy rate has been declining, reaching 6.8 percent—the lowest rate since 1985. The decline in rental vacancies to historically low levels is putting upward pressure on rents and providing a tailwind to new multifamily construction and residential investment. (For more information on multifamily market conditions, read the [August 2015 Multifamily Market Commentary](#).) Meanwhile, the homeownership rate continued to trend down, falling 0.3 percentage points in the second quarter to 63.4 percent—the lowest level since 1967.

Despite downbeat news on the homeownership rate, there has been some positive news for the owner-occupied market. Fixed mortgage rates declined during the last week of July for the third consecutive week to 3.91 percent, marking the lowest level since early June, according to Freddie Mac. We expect mortgage rates to be little changed during the rest of 2015, given ongoing international uncertainties, continued monetary easing around the globe, and expected slow pace of monetary tightening by the Fed. Mortgage rates are likely to trend up gradually next year, averaging 4.3 percent during the final quarter of 2016. Meanwhile, the Fed's Senior Loan Officer Opinion Survey for the three months ending in July showed strengthening demand for mortgages, especially for GSE and government loans. And, for the fifth quarter in a row, banks reported easing mortgage credit. We expect low mortgage rates and gradually loosening credit to help support the housing market recovery even as the Fed begins to hike rates.

Given that incoming data for existing home sales have been stronger than we expected and single-family housing starts and new home sales have been disappointing, we upgraded our forecast of existing home sales and downgraded projected single-family starts and new home sales. We expect total housing starts to increase about 10 percent and total home sales to rise nearly 8.0 percent in 2015. We also marked down our projected purchase and refinance originations. For all of 2015, we expect total mortgage originations to increase approximately 20 percent to \$1.42 trillion, compared with a 24 percent gain in the prior forecast, with the refinance share remaining at 47 percent.





August 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, the Conference Board, The University of Michigan, Bureau of Labor Statistics, Census Bureau, Bloomberg, The National Association of REALTORS®, The National Association of Home Builders, The Federal Reserve Board

*Opinions, analyses, estimates, forecasts and other views of Fannie Mae's Economic & 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  
 Richard Koss, Director

Mark Palim, VP  
 Frank Shaw, Business Analyst  
 Hamilton Fout, Director