

Consumer Spending Continues to Drive the Economic Outlook

Consumer spending remains the most important force driving the continued expansion of the U.S. economy. Increases in auto and retail sales, real disposable personal income, and real personal consumption expenditures (PCE), along with an upward revision to previously reported PCE, are evidence of current consumer strength. Also encouraging, a recovery in new single-family construction spending suggests that residential fixed investment may be slightly stronger this quarter than we previously expected. As a result of these two factors, we increased our forecast for growth in real gross domestic product (GDP) by one-tenth of a percent in the third quarter, even though we revised downward our already below-consensus view of nonresidential fixed investment to a negative number. We maintained our top-line forecast for GDP growth in 2019 of 2.2 percent and revised downward our full-year 2020 forecast by one-tenth to 1.6 percent.

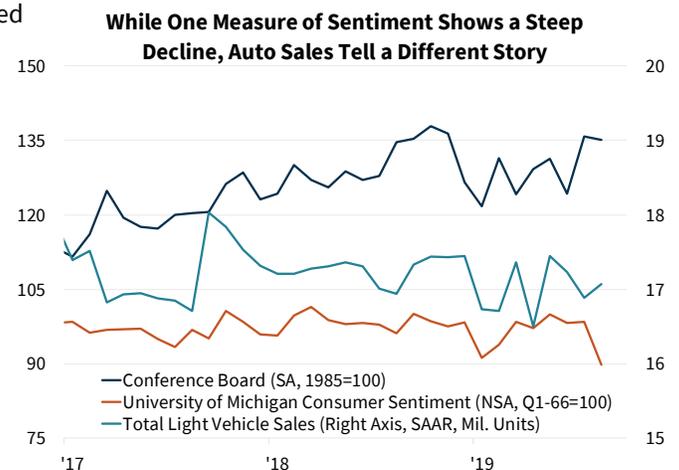
Risks to our forecast remain biased to the downside. Businesses enjoyed at least a temporary respite from further escalation of U.S.-China and other trade disputes, but the month brought both confusion in the U.K. regarding the government’s Brexit plan and renewed evidence that the U.S. manufacturing sector is not immune to the global manufacturing slowdown. Perhaps more ominous, the month also brought signs that the resilience of consumer spending may be starting to wear thin, with weak growth in employment and a sharp turn downward in consumer sentiment. The minutes of the July meeting of the Federal Open Market Committee (FOMC) confirmed that members were sensitive to downside risks — as well as the possibility of a stock market downturn — and were supportive of our forecast for two more quarter-point rate cuts in September and December.

We made no change to our forecast for total housing starts in the third quarter, with a slight increase in expected single-family starts offsetting a slightly less sanguine view of multifamily starts. Our forecast of third quarter home sales was revised downward after the National Association of REALTORS® recorded a steep drop in pending sales of existing homes. Moreover, annual home price appreciation accelerated in July, with prices increasing most in the lowest price tiers. We have incorporated slight downward revisions to our forecasts for full-year home sales in both 2019 and 2020, as well as a slight downward revision to our full-year 2020 forecast of housing starts.

Consumption and Wage Gains Remain Strong

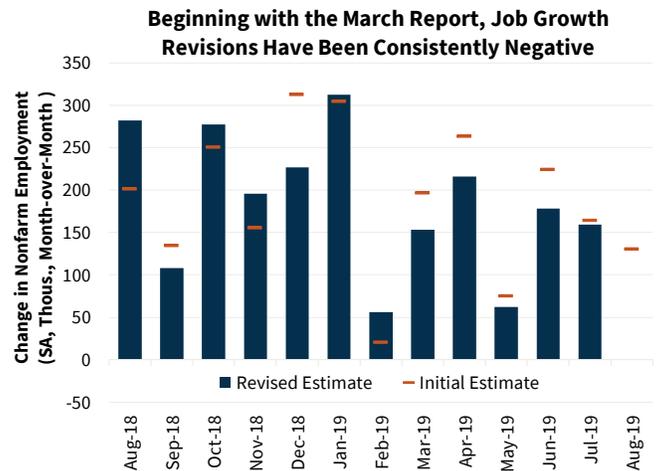
Real personal consumption expenditures (PCE) grew 0.4 percent during July, a solid performance to start the third quarter as the already strong increase reported for the second quarter was revised upward from 4.3 percent to 4.7 percent annualized. Strength in PCE came from all components, with spending on durable goods, nondurable goods, and services all increasing in July. Data on retail sales reinforced the message of strength, rising in July for the fifth straight month with growth distributed broadly among department stores, electronics and appliance stores, clothing and accessory stores, and non-store retailers.

A measure of consumer sentiment raised concern as to whether the robust consumer spending may be in danger of losing momentum. The University of Michigan Consumer Sentiment Index plunged in August by 8.6 points, the largest monthly drop since 2012, to the lowest index level since October 2016; moreover, the final reading was 2.3 points lower than the mid-month preliminary reading, suggesting that consumer confidence deteriorated in the second half of August. For several months we have regarded a stall in consumer spending as among the most significant downside risk to our forecast, but we do not yet regard the University of Michigan data as reliable evidence of such a stall. Indeed, the first available data on consumer spending in August continued the streak of strong readings, with sales of light vehicles increasing by 1.1 percent — firmly contradicting the message of the Consumer Sentiment Index, as spending on big-ticket items such as cars and trucks is particularly sensitive to consumer outlooks. A marginal decline of 0.7 points in the Conference Board Consumer Confidence Index for August was of no concern, particularly coming on the heels of an 11.5-point jump in the same index in July.



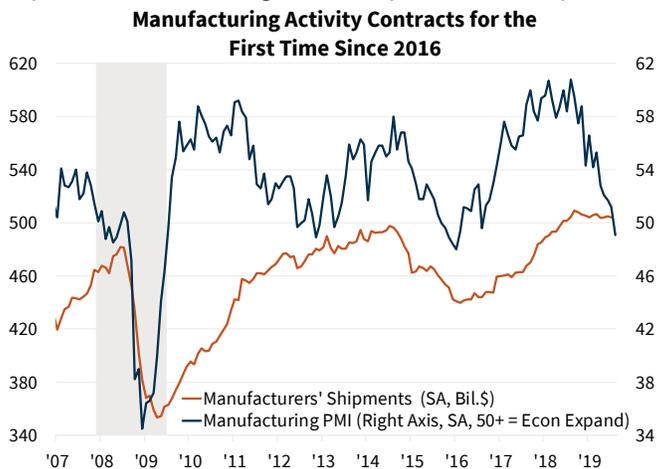


The Employment Situation report released by the Bureau of Labor Statistics (BLS) was similarly ambiguous, with weak job growth making the case that consumer spending may start to erode but an increase in average hourly earnings suggesting continued support. Nonfarm payroll employment increased by just 130,000 in August, below our expectations — and even that number was boosted by the hiring of 25,000 temporary workers for the upcoming U.S. Census. Moreover, previously reported payroll employment gains for June and July were revised downward by a combined 20,000. Downward revisions in prior month employment growth figures have historically confirmed the trend in employment slowdown, and every month’s initial job estimate has been revised downward beginning with the March report. Furthermore, revised data from the BLS’s Productivity & Costs report confirmed the preliminary indication that total hours worked during the second quarter had suffered the largest decline since the third quarter of 2009.



In response to these signs of weakness, we revised downward our forecast of employment growth for the rest of 2019 and the first quarter of 2020. On the other hand, the August employment report showed a meaningful increase in average hourly earnings, up 3.2 percent on an annual basis, along with a slight increase in the average workweek. These data provide no evidence of the kind of deterioration in wages and salaries that would lead to a reduction in consumer spending. Moreover, the labor force increased by more than a half-million, the largest increase this year, with the participation rate increasing from 63.0 percent to 63.2 percent as potential workers continued to return from the sidelines.

A relatively weak gain in manufacturing employment provided further evidence that the global manufacturing slowdown has impacted the U.S., and the Institute for Supply Management (ISM) followed suit with their Manufacturing Index dropping 2.1 points in August to 49.1, reaching “contraction” territory for the first time since August 2016. Although factory orders increased in July, manufacturers’ shipments declined—continuing a trend that has seen shipments fall at an annualized rate averaging 1.2 percent since last October. In response to softening demand for manufactured goods we trimmed slightly our expectations for third quarter growth in business inventories.



Inflation Remains Below the Fed’s Target and Business Investment Heads Lower

The minutes of the July FOMC meeting offered four reasons for the Committee’s decision to reduce the federal funds rate by 25 basis points: the first was to “better position the overall stance of policy” so that the Fed would be able to respond effectively to any deterioration in macroeconomic conditions; the second was to insure against further downside risks; the third was to boost inflation toward the Fed’s symmetric 2.0-percent target, thereby guarding against a decline in inflation expectations; and the fourth—stated implicitly—was to protect against a sharp decline in equity markets. Developments since that meeting have essentially maintained the status quo with negatives roughly balanced against positives. We have already noted continued strength in consumer spending balanced by signs of deteriorating consumer confidence, as well as slowing in labor market hiring balanced by signs of increasing hourly earnings; similarly, a renewed escalation in U.S.-China trade tensions immediately after the FOMC meeting was followed shortly afterward by an announcement that more than half of the threatened new tariffs would be delayed until December. Equity markets have accommodated these developments with what might be termed a tentative equilibrium.

Inflation data has been similarly ambiguous, with several price indices rising closer to the Fed’s target but not enough to allay the Fed’s concerns. The PCE price index increased annually by 1.4 percent in July, according to the Bureau of Economic Analysis, and the core PCE price index (excluding food and energy) gained just 1.6 percent. The consumer price index (CPI) reported by the Bureau of Labor Statistics was up 1.8 percent in July from a year earlier, though the core CPI was the only measure to rise above



the Fed's target. We continue to question whether reducing the federal funds rate can be depended upon to boost inflation as it might in a more normal economic environment. Given this uncertainty and the balance between upside and downside surprises, we are maintaining our forecast that the FOMC will implement two more cuts to the federal funds rate, by 25 basis points each in September and December.

The weakest segment of the U.S. macroeconomy is business fixed investment, and a succession of three reports from the Census Bureau supports our expectation of continued weakness. Imports of non-vehicle capital goods declined by 2.6 percent in July, while capital goods exports increased by 1.8 percent, suggesting a decline in equipment investment in the U.S. economy. The value of private nonresidential structures put in place declined by 0.8 percent in July. Shipments of durable goods contracted by 1.1 percent in July, with machinery and transportation equipment leading the decline at 1.9 percent and 2.0 percent, respectively. Contractions in the equipment and structures components of business fixed investment, coupled with the continued grounding of Boeing's 737 MAX aircraft, a 14 percent decline in rotary rig counts year-over-year responding to persistently low oil prices, and no improvement in the environment of global macroeconomic and political uncertainties, led us to reduce our already low third quarter growth forecast from positive 0.6 percent to negative 0.6 percent. Over the next three quarters, however, we expect a moderate recovery in business fixed investment driven by sustained domestic consumer demand and continued tightness in labor markets.

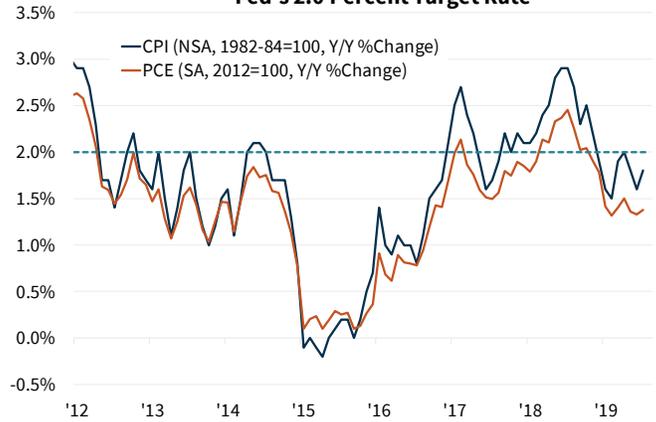
Sliver of Hope for Residential Investment?

Housing activity started off strong in the third quarter, in line with our expectations. Existing home sales rose 2.5 percent in July to 5.42 million annualized units, the second highest sales pace since April 2018, while new single-family and multifamily residential construction spending rose 0.9 percent, the largest gain since May 2018. Additionally, retail sales at home improvement stores, a proxy for home remodeling spending, ticked up in July. Together, these positive developments suggest a modest rebound in residential fixed investment in the third quarter, which would end six consecutive quarters of declines.

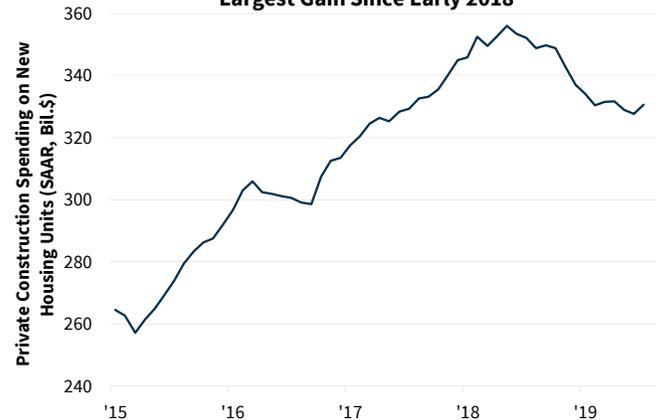
Demand factors for home sales remain on solid footing. While uncertainty over U.S.-China trade tensions and financial market volatility may dampen sentiment, continued employment growth and solid wage gains combined with low mortgage rates should be supportive going forward. The Fannie Mae Home Purchase Sentiment Index (HPSI) inched up in August to 93.8, a new survey high, suggesting continued buying interest on the part of consumers.

As of this writing, the 30-year fixed mortgage rates sits at 3.49 percent, the lowest weekly level since October 2016 and only 18 basis points above the lowest level of the expansion (seen in November 2012). With rates declining almost an entire percent and a half from the peak last November, fewer homeowners have mortgages at rates lower than current market levels, meaning homeowners are less likely to feel "locked in" to their current mortgage. In the coming months more owners may be enticed to list their homes for sale, helping to support existing home sales. However, our attitudinal survey work does not suggest enough of a shift in the existing home supply to alleviate overall supply constraints.

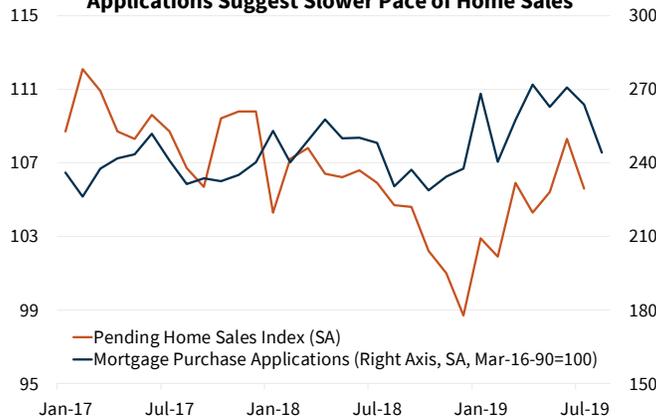
Inflation Measures Still Well Below Fed's 2.0 Percent Target Rate



Construction Spending Posts Second Largest Gain Since Early 2018



Drops in Pending Home Sales and Purchase Applications Suggest Slower Pace of Home Sales

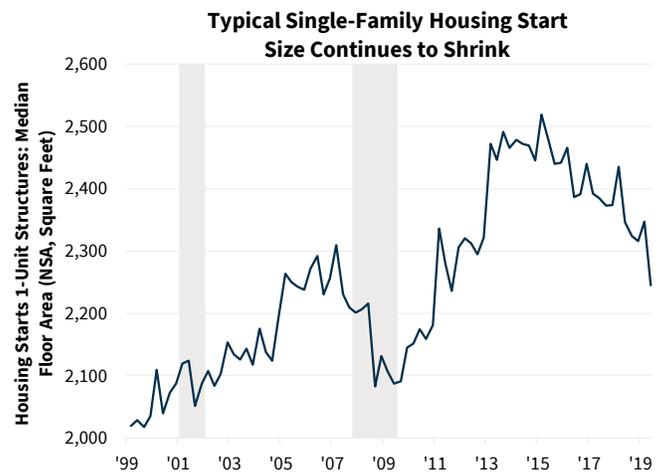




Inventories of existing homes for sale, after ten months of year-over-year gains, fell in July for the second straight month, down 1.6 percent from a year prior to reach the lowest July reading since the series began. We believe a pullback in existing home sales is likely, particularly since a July decline in pending sales almost completely erased June’s gain. We expect declines in August and September to dampen third quarter sales as pending sales tend to lead existing sales by about 45 days. Furthermore, in August the average number of purchase mortgage applications posted the largest decline since February, suggesting a weakening sales pace in September and early October. The paucity of listings has prevented home sales from responding to lower interest rates as strongly as they have in the past. Given the weak response to lower rates to date, we revised slightly downward our existing sales forecast over the coming quarters, and we now we expect 2019 existing sales to fall a modest 0.3 percent from 2018 levels.

The lack of existing home inventory is supportive of new construction. We continue to expect single-family housing starts to move modestly upward through the remainder of the year, even as builders continue to face labor and land constraints. New sales will also trend upward, but at a slower pace than starts, as year-to-date sales have been bolstered by home builders drawing down excess inventory of previously started homes that had built up at the end of last year. In coming months homebuilders will have to rely more heavily on starts to fulfill sales demand, and sales will be increasingly limited by the pace of construction.

Refreshingly, homebuilders seem to be increasingly focused on entry-level products, the segment of the housing market most undersupplied given the strength of entry-level demand. The median square footage of new single-family construction fell 4.3 percent in the second quarter to the lowest level since 2011. This trend will help affordability, especially for first-time homebuyers. Building smaller homes does have the downside of being more labor intensive per dollar of construction; this, combined with the ongoing scarcity of construction labor, has been a factor in keeping residential fixed investment from boosting the overall economy in recent quarters. Given the supply and demand fundamentals, the decline in mortgage rates has been a price accelerator exacerbating the affordability challenge for entry-level buyers.



Multifamily housing data were mixed in July with the volatile starts measure plummeting to the lowest level in nearly two years, while permits rebounded from a sharp decline in June. Low rental vacancy rates and the recent acceleration of renter household annual growth in the second quarter will be supportive of multifamily building going forward. Combined with low construction loan rates, we expect healthy multifamily construction in the coming quarters even if somewhat less than the strong pace seen at the beginning of this year. For more information on multifamily market conditions, read the [September 2019 Multifamily Market Commentary](#).

We have updated our estimate of single-family (1- to 4-unit properties) mortgage originations for the prior two years based on our annual benchmarking to the newly released Home Mortgage Disclosure Act (HMDA) data. We revised higher our estimated purchase originations in 2017 and 2018, resulting in an upwardly revised path for purchase originations in 2019 and 2020 as well. The benchmarking also resulted in higher refinance originations in 2017 and 2018, with the refinance share of total originations unchanged at 36 percent in 2017 and revised upward by 1 percentage point in 2018 to 30 percent.

The decline in our mortgage rate forecast since last month led us to revise upward our forecasts of refinance originations in both 2019 and 2020. Given our improved view of purchase originations from HMDA revisions and rate-driven refinance originations, we now expect total originations to rise by 11.6 percent from 2018 to \$1.97 trillion in 2019, with a refinance share of 35 percent. Looking ahead to 2020, we expect total originations to decline by 6.8 percent from this year to \$1.84 trillion as projected declines in refinance activity outpace essentially flat purchase activity, with the refinance share dropping to 31 percent.

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: Conference Board, University of Michigan, Autodata, Bureau of Labor Statistics, Census Bureau, Institute for Supply Management, Bureau of Economic Analysis, National Association of REALTORS®, Mortgage Bankers Association, Fannie Mae ESR Group.

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