

## Growth Slows as Credit Market Turmoil Continues

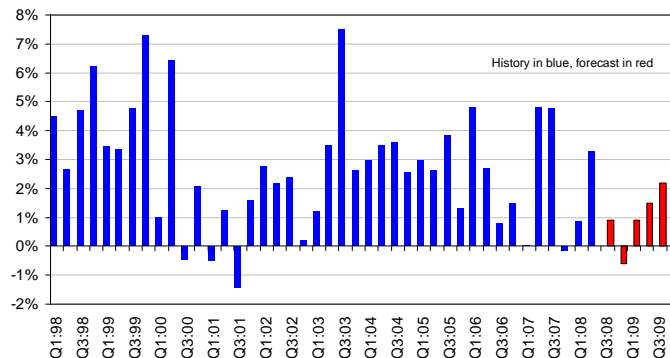
Second-half growth is expected to slow considerably relative to the first half of 2008 as the meager benefits of the stimulus package wane, credit conditions remain tight and unemployment rises. A seemingly endless barrage of troubling news emanates from financial markets and yet the economy continues to eke out gains in growth. However, this is expected to end with a small decline in GDP in the fourth quarter followed by a slow recovery to modest growth in the year ahead, not reaching the economy's potential until 2010.

Consumers, battered by declining real incomes, credit market tightening, home price declines, and elevated food and energy prices, have finally responded with declines in consumer spending in June and July after adjusting for inflation. A rise in August auto sales led an increase in consumption overall but absent autos, consumption fell again. The passage of the remaining rebate influence in the third quarter may well be followed by the first outright decline in consumer spending since 1991. Consumer confidence, which has ticked up modestly with the recent decline in energy costs, remains well below the average of last year.

Employment has been weakening since November of 2007 with a total private sector payroll decline of 772,000. In August the private sector lost 101 thousand jobs spread across all major job categories with the exception of health and education. Total hours worked is in decline as well, falling at a 1.8 percent annualized rate in the most recent quarter. Members of the National Federation of Independent Business report only 15 percent of companies with job openings, a level equal to the last two cyclical lows in labor demand. The impact of the downturn in housing continues to be felt by the economy as roughly half the private payroll loss is in real estate related positions.

The unemployment rate, derived from the household survey has risen continuously over the same time period and stands at 6.1 percent, the highest level since the last recession. The increase is due to the combined effects of an increase in the labor force and the loss of jobs. The four-week moving average of weekly claims for unemployment has been holding at around 440 thousand which is a recessionary level. Our expectation is that the

**Real GDP Annualized Growth Rate**

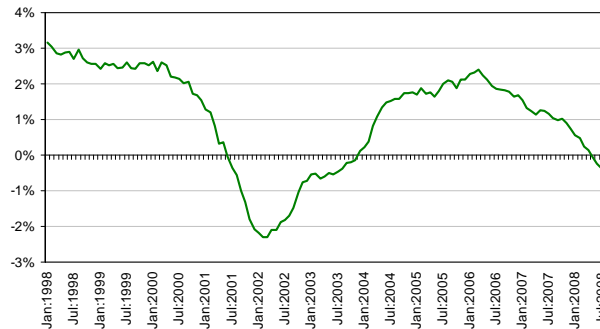


Source: Bureau of Economic Analysis

unemployment rate will rise further as the slowdown develops, rising to 6.5 percent in 2009.

Exports contributed about 90 percent of the increase in GDP in the second quarter and that is unlikely to be repeated in the next few quarters. The decline in oil prices is less a sign of reduced speculation than a signal of a global economic slowdown as US trading partners' growth slowdowns signal that the theory of a decoupling from the US by the rest of the world is not valid. The recent strengthening of the dollar was also a relative shift borne of global growth reduction rather than a sustainable strengthening of the dollar. Dollar weakness will continue to be a concern.

**Private Nonfarm Payroll Employment**  
Year/Year Percent Change



Source: Bureau of Labor Statistics

The dollar's weakness has been a concern for some time due to its potential contribution to the growth of inflation. Inflation concerns had mounted as food and energy price increases raised headline measures dramatically, increasing both consumer and business concerns about future inflation. Both headline and core inflation measures are above the levels assumed to be tolerable to the Fed over the longer term. However, the slowdown in growth combined with the reduction in energy costs is expected to dampen those pressures over the next couple of quarters. This line of reasoning is raising fears that a replay of the early days of the stagflation of the 1970s is underway with an increase in commodities prices followed by a growth recession hiding a larger underlying inflationary pressure. Since the level of inflation is nowhere near the levels of the late 1970s, the Fed's attention has been on the full-employment half of their dual mandate.

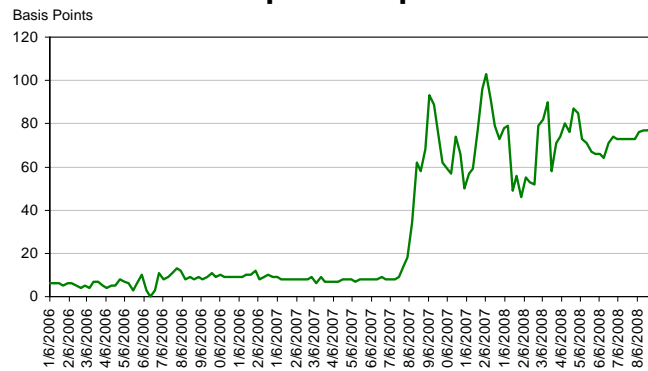
The Federal Reserve Board is on hold on interest rates until at least early 2009 barring additional dramatic downdrafts to economic growth. They have been undertaking an historic array of activities to continue to enhance the liquidity of the financial markets in the face of the repeated blows to the economy from the deleveraging of financial institutions underway since the onset of the housing meltdown. The current Federal Funds Rate target of 2 percent is expected to remain in place until the March 2009 meeting but of course the pace of events in recent weeks could change that as the impacts of the financial market turmoil play out.

Credit markets are far from sanguine as the deleveraging of financial institutions continues with storied firms failing, being merged or acquired, or being placed into conservatorship. Consumer credit card and nonrevolving credit (nonmortgage) growth

has slowed significantly as banks reduced available lines, raised rates and fees, and tightened credit qualifications. Part of the slowdown in auto sales has been a result of the tightening of credit conditions by the auto companies and the elimination of some credit programs altogether.

While headline interest rates have fallen in mortgage markets recently, credit conditions have simultaneously tightened. The flight to quality in financial markets has held treasury rates at very low levels, meaning effective spreads widened. There are still significant concerns among financial institutions regarding the basic health of trading partners and short term spreads remain very wide.

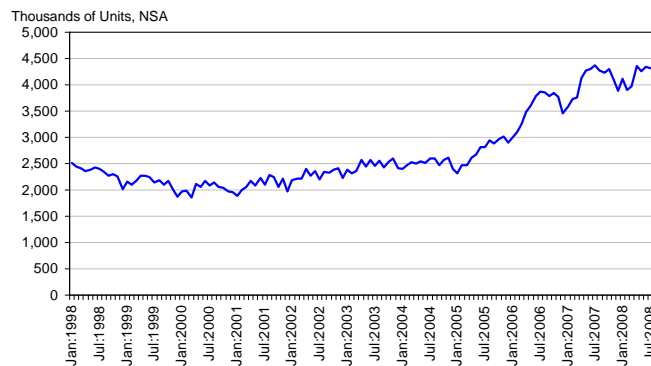
### 3-Month LIBOR-3-Month Overnight Index Swap Rate Spread



Source: Financial Times, Bloomberg

Of course, the trigger for the credit market meltdown was the onset of the housing market collapse, the related house price declines, foreclosure increases, and securities losses based on the leverage embedded in securities backed by mortgages. It is still not clear how near the bottom we are. The combination of a weak economy, stalled or declining employment, and ongoing dislocations in credit markets will continue to slow housing starts and sales this year and into next year. We expect single-family housing starts to fall by nearly 40 percent and total home sales to decline by about 16 percent in 2008. This will make the decline in starts the largest such decline since World War II.

### Supply of New and Existing Single-family Homes on the Market



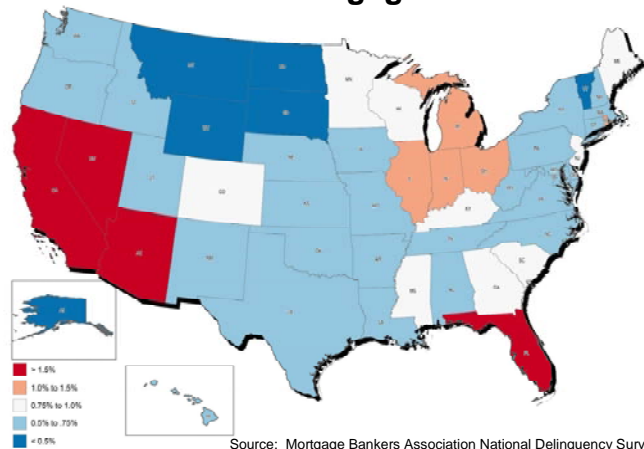
Source: Census Bureau, National Association of REALTORS®

Home sales increased slightly in July and were in line with our expectations. They have been basically flat for the last several months but remain at weak levels. We expect that

the bottom in sales activity will occur late this year or early next year and that we should see sales growth by the end of 2009. The total number of unsold homes remains near record levels and the number of vacant homes for sale remains high. The months' supply (inventory/sales ratio) is also still at very high levels. It is important to note that household formation rates are running ahead of new construction so an easing of credit conditions could rapidly improve the market.

Delinquencies and foreclosures are still rising and it does not yet appear that the pace of the increase has abated. This is a regional matter as 14 states had either flat or declining rates of new foreclosure starts according to the June 30, 2008 data of the Mortgage Bankers Association. This reasonably good news was offset by still accelerating foreclosure start rates in California and Florida. These two states represent over 18 percent of the housing market. It appears that the foreclosure inventory in California may be starting to clear faster. Upwards of half the sales may be being funded by FHA insured loans.

### Foreclosures Started as Percent of All Mortgages: 2008:Q2

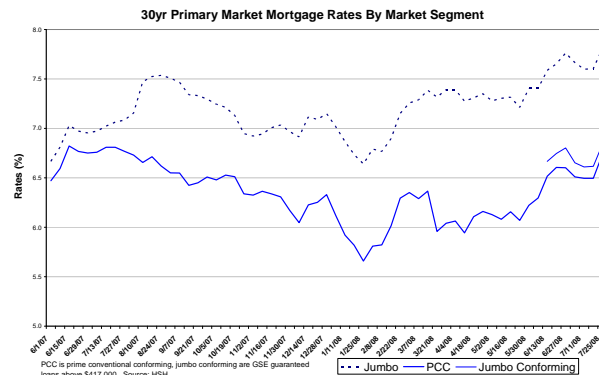


Source: Mortgage Bankers Association National Delinquency Survey

Credit spreads remained tight in August and into early September. The spread between the 10-year Treasury and the 30-year fixed-rate mortgage rate hovered around 265 basis points into early September though they fell back a bit but to still high levels as events in the financial markets unfolded. Spreads for the new jumbo conforming loans and for jumbos above those levels were even wider with no signs of narrowing on a sustained basis.

### 30-Year Fixed Rate Mortgage Rates

These various housing market elements will continue to put downward pressure on house prices and this pressure is likely to extend through 2009 and into 2010. All of the public house price measures have roughly similar paths of decline through 2009.



PCC is prime conventional conforming, jumbo conforming are GSE guaranteed loans above \$417,000. Source: HSH

Continued price declines and credit tightness should dampen mortgage originations in the near term. Combined with the projected decline in home sales and prices, this will likely lead to a 25-percent decline in purchase originations to \$0.9 trillion in 2008 (the lowest level since 2001). Purchase originations will likely fall by another 7 percent in 2009 as declines in home prices linger.

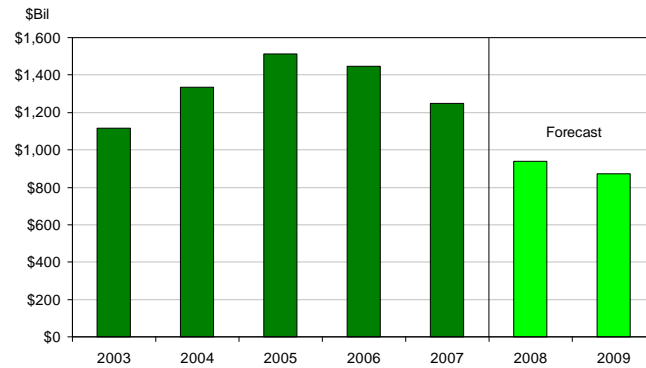
We expect refinancing to remain proportionally high this year, at about 50 percent of mortgage originations. Refinancing will be buoyed by borrowers (especially those with upwardly-adjusting ARMs), taking advantage of the still-low fixed-rate mortgage rates. The ARM share of the number of

mortgage applications is expected to stay fairly constant at about 10 to 13 percent as consumers forgo the spread between fixed- and adjustable-rate mortgages.

Growth in single-family mortgage debt outstanding (MDO) is projected to slow dramatically this year with the slowdown in purchase originations and expected slowdown in cash-out refinancing and other mortgage equity withdrawal. We expect single-family MDO growth to be 1.9 percent in 2008 and to slow a bit more in 2009.

Doug Duncan and Molly R. Boesel  
Economics & Mortgage Market Analysis  
September 15, 2008

### One-to-Four Family Purchase Originations



Source: Fannie Mae estimates, forecast

*Opinions, analyses, estimates, forecasts and other views of Fannie Mae's Economics & Mortgage Market Analysis (EMMA) 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. Although the EMMA 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 EMMA 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.*