

Economic and Mortgage Market Developments

Second half growth is expected to be weak. Real GDP growth averaged 1.4 percent in the first half, supported by strong international trade numbers and consumer spending (which was lifted slightly by the fiscal stimulus package). Growth is expected to fall off to 0.6 percent annualized growth in the second half. This slowdown reflects continued housing market weakening, deterioration in credit markets and spillovers from high food and energy prices that will likely reduce consumer spending.

Growth may get some support from inventory rebuilding and the remainder of the fiscal stimulus package in the third quarter before slowing again in the fourth quarter. However, it is clear that the stimulus was at best a minor plus for the economy. Even though energy prices are easing, the fourth quarter slowdown could be substantial.

GDP should resume strengthening again in early 2009 as the drag from the housing market dissipates, but the continued drag of food and fuel on household budgets could temper it. The outlook for weak growth should push the unemployment rate up to 6.3 percent in the middle of 2009.

Inflation will remain a concern throughout the year. Much depends on the dollar and energy prices. While energy prices have fallen-off in early August, they remain well above year-ago levels. Headline inflation has been running well above comfort levels and the Fed is counting on the slowing global economy to do its work in reducing inflationary pressures. The dollar has gained recently on the euro, but again, remains weak. While the weak dollar will support rising net exports, which contributes to growth, it also contributes to inflationary pressures.

While the core inflation rate remains relatively contained, it is above the Fed's long term comfort zone. Headline inflation remains elevated and high commodity prices and the weak dollar will continue to put upward pressure on inflation throughout the forecast horizon. While weak growth in the economy and slack in the labor market will work to moderate inflation, the other factors mentioned above should keep inflation elevated, though not at the recent level.

Interest rate policy is unchanged. We do not expect any further easing in the federal funds rate in the forecast horizon. The Federal Open Market Committee held the federal funds rate at 2 percent at its latest meeting and reiterated that upside risks to inflation are a concern, although its statement was slightly less hawkish. The current funds rate is accommodative, and therefore we expect that the Federal Reserve will gradually begin to increase rates in the first part of 2009 if a stronger economic growth path seems certain. With elevated headline inflation through the middle of 2008 there has been pressure on the Fed to tighten this year. However, recent declines in energy costs combined with productivity gains and the expected slowing of growth in the fourth quarter will likely allow them to stay on hold.

The housing market remains weak. Home sales fell again in June, but were in line with our expectations. We expect that 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. We expect single-family housing starts to fall by nearly 40 percent and total home sales to decline by about 14 percent in 2008. We expect that the bottom in sales activity will occur late this year and that we should see sustained modest gains beginning in 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. These elements will continue to put downward pressure on house prices and this pressure is likely to extend through 2009. The tight credit conditions will continue to be a drag on the inventory reduction process as marginal credits are denied.

Mortgage credit conditions remain tight. The July Senior Loan Officer Survey from the Fed showed banks continued to tighten lending standards on nearly all types of credit over the previous three months. Tighter credit conditions can also be seen in mortgage rates, which have increased over the past month due in part to higher inflation, but also to a higher risk premium on mortgages. This risk premium can be seen in spreads of prime mortgage to treasuries, which have continued to widen in recent months. Continued credit tightness should dampen mortgage originations in the near term.

Mortgage volumes continue to slow. The projected decline in home sales and prices will likely lead to a 25-percent decline in purchase originations to \$0.9 trillion in 2008 (the lowest level since 2001). Tighter credit standards combined with expected continued home price declines will continue to discourage borrowers and investors. We expect refinancing to remain proportionally high this year, at about 51 percent of mortgage originations, with a volume of almost \$1 trillion. 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 11 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 2.3 percent in 2008 and to slow a bit more in 2009.

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Economics and Mortgage Market Analysis
August 14, 2008

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Economic and Mortgage Market Forecast: August 2008

	07.1	07.2	07.3	07.4	08.1	08.2	08.3	08.4	09.1	09.2	09.3	09.4	2006	2007	2008	2009
Macroeconomic Variables																
Real GDP (%) (chain-weight)	0.1	4.8	4.8	-0.2	0.9	1.9	1.1	0.1	1.7	2.0	2.4	2.5	2.4	2.3	1.0	2.2
Unemployment Rate (%)	4.5	4.5	4.7	4.8	4.9	5.3	5.8	6.0	6.1	6.2	6.3	6.2	4.6	4.6	5.5	6.2
Consumer Price Inflation (%)	3.7	4.6	2.8	5.0	4.3	5.0	6.1	3.3	3.2	3.1	3.0	3.0	1.9	4.0	4.7	3.1
Consumer Price Inflation (% year-over-year)	2.4	2.6	2.4	4.0	4.2	4.3	5.1	4.7	4.4	3.9	3.1	3.1	3.2	2.9	4.6	3.6
Interest Rates																
Fed. Funds (%)	5.26	5.25	5.07	4.50	3.18	2.09	2.00	2.00	2.04	2.44	2.91	3.45	4.96	5.02	2.32	2.71
1 yr. T-Note (%)	5.01	4.93	4.52	3.62	2.10	2.07	2.35	2.56	2.69	2.98	3.19	3.39	4.93	4.52	2.27	3.06
10 yr. T-Note (%)	4.68	4.85	4.73	4.26	3.66	3.89	4.01	4.19	4.36	4.47	4.53	4.59	4.79	4.63	3.94	4.49
FRM Rate (%)	6.22	6.37	6.55	6.23	5.88	6.09	6.47	6.47	6.46	6.45	6.44	6.43	6.41	6.34	6.23	6.44
ARM Rate (%)	5.47	5.55	5.68	5.55	5.13	5.20	5.29	5.43	5.39	5.35	5.38	5.43	5.53	5.56	5.26	5.39
Housing and Mortgage Markets																
<u>Housing Starts (thous.)</u>	1,453	1,460	1,298	1,151	1,053	1,016	865	860	894	956	1,000	1,041	1,801	1,354	948	973
Single family	1,163	1,160	986	826	728	670	610	595	630	680	715	745	1,465	1,046	651	693
percent change													-14.6%	-28.6%	-37.8%	6.4%
Multifamily	290	300	311	325	325	345	255	265	264	276	285	296	336	308	298	280
New Home Sales (thous.)	838	852	731	651	561	535	516	512	536	571	595	615	1,051	774	531	579
percent change													-18.1%	-26.4%	-31.4%	9.0%
Total Existing Home Sales (thous.)	6,363	5,870	5,457	4,997	4,953	4,913	4,821	4,788	4,853	4,990	5,140	5,251	6,478	5,652	4,869	5,058
percent change													-8.5%	-12.8%	-13.9%	3.9%
Total Home Sales (new + existing)	7,202	6,722	6,187	5,647	5,514	5,448	5,337	5,300	5,389	5,561	5,735	5,866	7,529	6,426	5,400	5,637
percent change													-9.9%	-14.7%	-16.0%	4.4%
<u>Home Prices (NSA, thous. \$)</u>																
Median new	255.9	241.0	241.0	237.0	235.7	234.0	226.6	216.3	217.6	216.8	211.3	203.7	246.5	247.9	228.2	212.4
Median total existing	213.9	223.9	221.2	207.5	198.5	208.1	201.1	189.4	183.2	192.8	187.4	178.4	221.9	219.0	199.2	185.4
OFHEO HPI (% change from year ago)	4.4%	3.5%	2.1%	0.9%	0.0%	-3.8%	-5.5%	-6.6%	-5.8%	-5.7%	-5.2%	-4.5%	5.6%	0.9%	-6.6%	-4.5%
<u>Mortgage Originations (bill. \$, 1-4 fam.)</u>																
Purchase	612	741	609	580	522	564	435	397	348	447	458	425	2,851	2,543	1,918	1,678
Refinancing	274	376	341	260	194	279	257	212	166	256	255	222	1,447	1,250	942	900
Refi Share (%)	55.3%	49.3%	44.0%	55.2%	62.9%	50.6%	40.8%	46.7%	52.3%	42.6%	44.3%	47.8%	49.3%	50.8%	50.9%	46.4%
Liquidations (bill. \$)	422	552	479	448	452	483	384	365	335	384	397	379	1,928	1,900	1,684	1,495
Mortg. Debt Outstdg. (bill. \$, 1-4 fam. 1st Lien)	9,581	9,771	9,902	10,033	10,103	10,184	10,235	10,267	10,280	10,343	10,404	10,450	9,391	10,033	10,267	10,450
% change	8.4%	8.2%	5.5%	5.4%	2.8%	3.2%	2.0%	1.2%	0.5%	2.5%	2.4%	1.8%	10.9%	6.8%	2.3%	1.8%
Mortg. Debt Outstdg. (bill. \$, 1-4 fam., 1st + 2nd Lien)	10,652	10,862	11,016	11,158	11,227	11,316	11,373	11,408	11,423	11,493	11,560	11,612	10,452	11,158	11,408	11,612
% change	7.9%	8.1%	5.8%	5.3%	2.5%	3.2%	2.0%	1.2%	0.5%	2.5%	2.4%	1.8%	11.4%	6.8%	2.2%	1.8%
ARM Share of Conventional Applications (% of #)	21.4%	19.0%	17.9%	13.1%	10.5%	8.9%	9.9%	10.4%	11.7%	12.5%	12.5%	12.3%	28.6%	17.8%	9.9%	12.2%

August 14, 2008

Notes: Interest rate forecasts are based on rates from August 1, 2008. Numbers in bold italics represent Fannie Mae Economics and Mortgage Market Analysis estimates and/or forecasts.

Source: Actuals: Census, Bureau of Labor Statistics, Federal Reserve, Mortgage Bankers Association, National Association of Realtors, OFHEO, Forecasts: Fannie Mae Economics and Mortgage Market Analysis