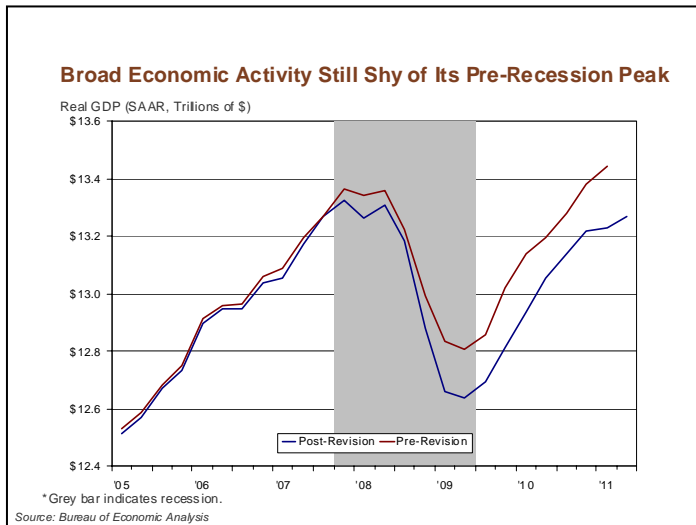


Dark Clouds Looming Over Near-term Outlook

The economy has been hit by a barrage of disappointing news during the past month, painting an unambiguously downbeat picture of overall economic activity. Annual benchmark revisions to gross domestic product (GDP) revealed a deeper recession than previously thought; fiscal turmoil in Europe created concerns over the health of banking institutions at the same time as the U.S. political system wrestled with its fiscal picture under the deadline of a debt ceiling limit; and consumers became decidedly more downbeat and reduced consumption.



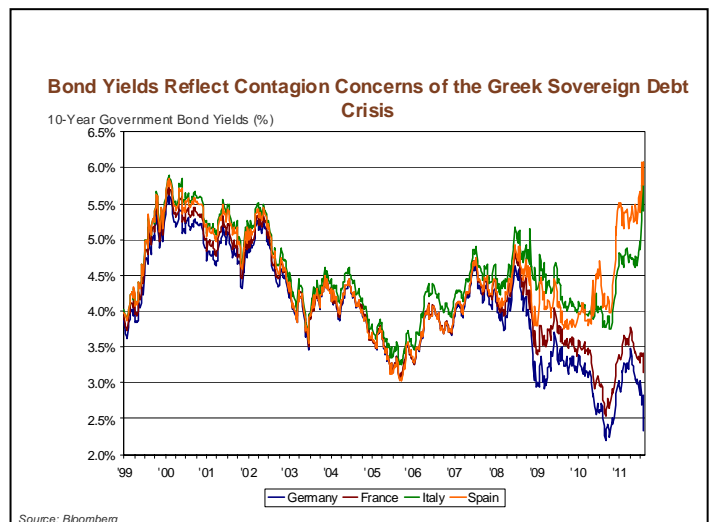
Revised real (inflation-adjusted) GDP estimates showed a decline of 5.1 percent between the fourth quarter of 2007 and the second quarter of 2009, compared with the prior estimate of a 4.1 percent decline. As it turned out, real GDP in the second quarter of 2011 was just shy of its pre-recession peak after two years of economic recovery. Previous estimates had shown that real GDP had surpassed its previous peak in the fourth quarter of 2010.

The revisions also showed a more dramatic slowdown in the first quarter of 2011 to just 0.4 percent at an annualized rate, down from an earlier estimate of a 1.9 percent gain. For the second quarter, the economy grew just 1.3 percent, as real consumer spending ground to a halt.

The recovery has clearly lost momentum: while economic growth during the past two years averaged a moderate 2.5 percent, average growth in the first half of this year fell short of one percent. Although a series of temporary factors—unusually severe weather, a surge in energy prices, and supply chain disruptions—accounted for some of the weakness, underlying economic fundamentals, especially consumer spending and hiring trends, have slowed appreciably. The impact of recent financial market volatility on household wealth is an additional setback to consumer confidence and the outlook for the housing market.

While we expect the meager recovery to continue into a third year, we have downgraded our outlook substantially for the rest of this year and next. For all of 2011, economic growth is expected to downshift to 1.4 percent from 3.1 percent in 2010—nearly a full percentage point lower than our projection in the prior forecast. Growth is expected to pick up in 2012, but only to about 2.0 percent, compared with 3.1 percent projected in the July forecast. This downgrade reflects a substantial risk of recession in coming quarters.

The sluggish pace of economic growth implies that the economy is vulnerable to additional shocks, especially the renewed concerns about the European sovereign debt crisis. This is reflected in the surge in Italian and Spanish bond yields to euro-era records in early August following an agreement in late July regarding the release of funds to Greece in the second stage of its bailout.



The clear lack of confidence in the ability of European Union (EU) leaders to tackle the sovereign debt crisis in Italy, which is the third largest economy in the EU, is a key risk to the global economic outlook.

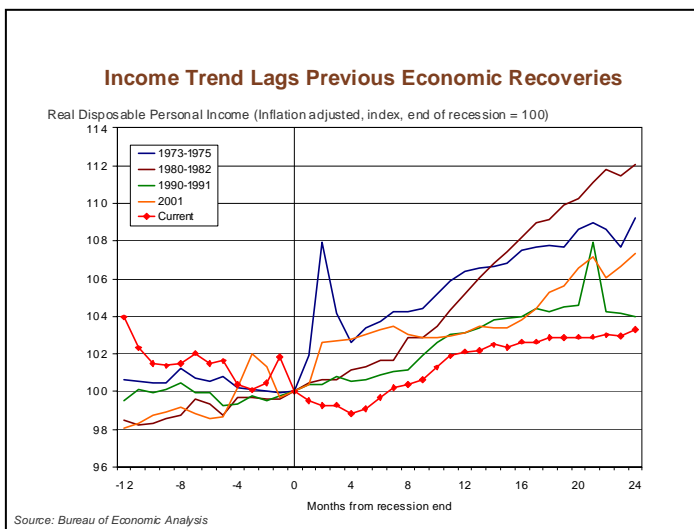
On the domestic front, U.S. economic growth at the current pace is woefully insufficient to spur sustained, robust job creation, which is necessary to meaningfully spur consumer spending and housing demand. The key factor we will be watching for the sustainability of the recovery is whether a cautious consumer will lead to anemic hiring and job losses, igniting a negative feedback loop that will eventually cause the economy to slip back in recession. The Budget Control Act is expected to have little direct fiscal drag impact in the near term, but it has created a great deal of uncertainty for the outlook after 2012. Arguing that the political parties in the U.S. are unlikely to produce a fiscal consolidation plan to address the gloomy debt picture, one rating agency—Standard & Poor's—downgraded the U.S. government's AAA sovereign credit rating to AA+. The unprecedented downgrade has not changed the current safe haven status of the Treasuries, but it has heightened fears of global recession and suggests that the problems of the sovereign debt crisis—on both sides of the Atlantic—will be around for years to come.

Economy: Muddling Along

The tepid economic growth in the second quarter of this year reflected extremely cautious consumers. Real consumer spending growth edged up at an annualized rate of just 0.1 percent following a 2.1 percent gain in the first quarter. Monthly data showed that nominal consumer spending fell 0.2 percent in June, the first decline in nearly two years. Spending was flat after adjusting for inflation as the overall price level also dropped. Consumers would rather save than spend, pushing the saving rate higher for the third consecutive month to 5.4 percent in June, the highest since September 2010. The monthly trajectory of consumer spending is worrisome. During the three months ending in June, real consumer spending has declined at a 1.1 percent annual rate. Such a drop rarely happens outside of a recession.

The primary drag on spending in recent months was the sharp decline in purchases of motor vehicles and parts, driven by the disrupted auto production supply chain as auto dealers had very little inventory to sell. July auto sales were encouraging, however, rising to 12.2 million annualized units from 11.6 million units in June, suggesting a modest rebound in spending in the current quarter.

The most crucial fundamental support of consumer spending, real disposable personal income, has clearly been lagging the trend seen in previous recoveries, despite policy support including payroll tax cuts and emergency unemployment benefits. Real disposable income has largely moved sideways during the past year.



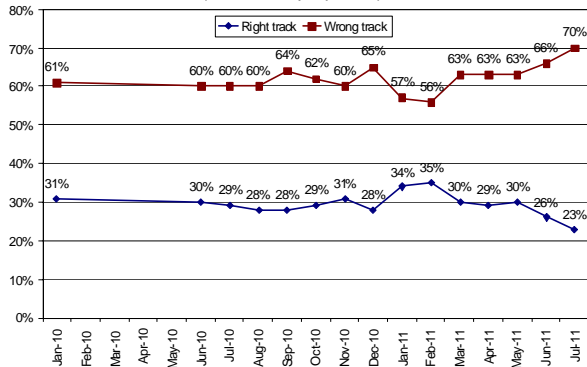
Household financial wealth, another support for consumer spending, deteriorated sharply in July and early August. This deterioration was due to the stock market sell-offs, driven by signs of deteriorating economic activity in the U.S. and abroad; the sovereign debt crisis in Europe; and the debt ceiling gridlock and the resulting downgrade of the Treasuries. These factors have combined to heighten fears of a new global recession, wiping out nearly two trillion dollars of stock market value.

Most measures of consumer confidence deteriorated in July. For example, the Reuters/University of Michigan consumer sentiment index posted a sharp decline, sending the index to its lowest level since March 2009. The Fannie Mae July 2011 National Housing Survey showed that consumers are growing more pessimistic about the economy: 70 percent said the economy is on the wrong track, up from 57 percent

at the start of 2011; and only 23 percent said the economy is on the right track.

Consumers Are Growing More Pessimistic about the Economy

In general, do you think our economy is on the right track or is it off on the wrong track?
(% of total survey respondents)



Source: Fannie Mae July 2011 National Housing Survey

While the Conference Board consumer confidence index improved modestly in July, consumer assessment of the current state of the labor market deteriorated during the month, with more consumers reporting jobs hard-to-get and fewer reporting jobs plentiful. Confidence among small businesses eroded in July for the fifth consecutive month to a ten month low, according to the National Federation of Independent Business. Small business hiring plans (based on expected hiring plans during the next three months) remained at depressed levels.

The July employment report was positive relative to expectations, though modest. Nonfarm payrolls rose by 117,000, with upward revisions totaling 56,000 in the prior two months. Private employment increased 154,000, while government employment fell 37,000, all in the state and

local sectors, likely driven by the Minnesota state shutdown. Manufacturing jobs rebounded, with half of the gain coming from the auto sector as automakers ramped up production to replenish dwindling inventories. Construction added 8,000 jobs, all in the nonresidential sector.

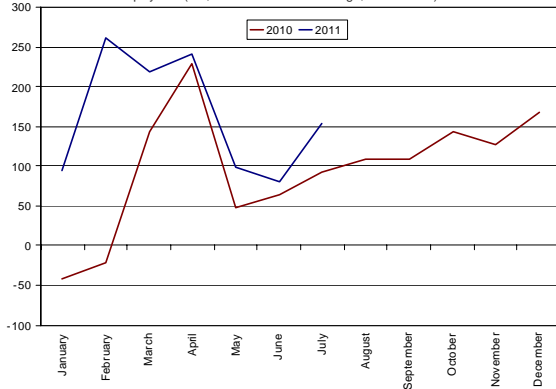
The pattern of private payrolls so far this year has been similar to that of last year, with payrolls rising at the beginning of the year, but then stalling in the spring before rebounding in early summer. During 2010, while private payrolls improved during the course of the summer through the rest that year, the gain remained weaker than the pace witnessed earlier that year.

While the rebound in nonfarm payrolls is encouraging, it is clear that the labor market has lost momentum in recent months. In the three months ending in July, the average monthly gain was 72,000, compared with 215,000 in the prior three months.

The underlying dynamics in the labor market remain poor. The seeming improvement in the unemployment rate of 0.1 percent to 9.1 percent, calculated from a separate survey of households, was due to a decline in the number of people looking for work. The decline in the labor force totaled more than 400,000 in June and July, while household employment has declined in three of the last four months.

Similar to Last Year, Nonfarm Payrolls Rebound After a Spring Lull

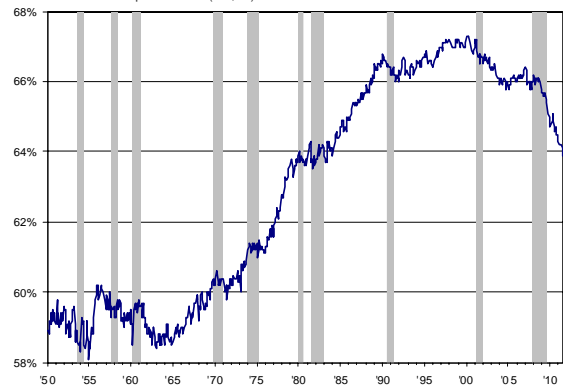
Private nonfarm payrolls (SA, Month-to-Month Change, Thousands)



Source: Bureau of Labor Statistics

Labor Participation Rate Trends Down Sharply in the Current Recovery

Civilian Labor Participation Rate (SA, %)



Source: Bureau of Labor Statistics

The participation rate—the share of people who are working or looking for jobs—declined to 63.9 percent, a new cycle low. The rate has dropped precipitously during the recession and during the modest recovery to its lowest reading since the early 1980s. The decline in participation reflects the increasing number of discouraged people who have given up looking for jobs.

The broadest measure of labor market slack—the employment-population ratio or the share of the working-age population that is employed—shows a similar trend. The rate also fell to a cycle low of 58.1 percent in July, the lowest rate in 28 years. An economy experiencing sub-par growth will be unable to generate enough strong job creation to absorb millions of unemployed, resulting in persistent underutilized resources and chronic long-term unemployment.

Overall labor market conditions, especially the lack of sustained, meaningful job gains, remain deeply troubling for the consumer spending trend for the rest of this year and next. The weak pace of job growth is insufficient to reduce the enormous slack in the labor market. We estimate that the economy needs to create an average of 115,000 to 125,000 jobs a month just to keep the unemployment rate steady due to growth in the labor force. Thus, we expect the unemployment rate to pick up in the second half of 2011 and remain above 9 percent through most of 2012. A decline in the unemployment rate stemming from a further decline in the labor force is possible, but will not be viewed as a sign of improving labor market conditions.

With a deteriorating outlook for the global economy and an associated lower demand for energy, crude oil prices have dropped, hovering at slightly over \$80 per barrel at the time of this writing after remaining above \$95 per barrel in July. This should give consumers some relief via lower gasoline prices in the current quarter. However, with nearly two trillion dollars of household wealth lost during the past month, consumer spending growth should remain subdued as the deleveraging process continues. In addition, given the mood toward fiscal austerity among some lawmakers, it is not clear whether there will be an extension of the payroll tax cuts and emergency unemployment benefits that are scheduled to expire at the end of this year.

The expansion of credit is crucial to support economic growth, and continued deleveraging of consumer debt, especially revolving consumer debt (largely credit cards), and mortgage debt will keep economic growth sub-par for some time.

With consumer spending, roughly 70 percent of the economy, likely remaining weak in the face of shrinking government spending, it is up to investment and exports to keep the economy growing. The decline in the dollar should help support exports, but slowing global growth could dampen the extent of the boost we receive from overseas. Unfortunately, this can be seen in the recent data, as the bright spot of the economic recovery, manufacturing, appears to have weakened in June. The factory orders report indicated weakening growth in business investment in equipment and software, and the industrial production report revealed flat manufacturing output.

Conditions failed to improve in July, according to the Institute for Supply Management (ISM) manufacturing survey. The ISM manufacturing index fell 4.4 points to 50.9 in July, the lowest level in two years and barely in expansion territory, as signified by readings above 50. The details were worrisome, as a leading indicator component, the index tracking new orders, declined to below 50. The ISM nonmanufacturing index, a counterpart for the service industry, fell to 52.7 in July, returning to the level seen in April of this year, which was the lowest reading since February 2010. The orders index dropped to the lowest level since August 2009. Both the ISM manufacturing and nonmanufacturing indices suggest that economic activity in July did not pick up meaningfully from the anemic pace experienced in the second quarter.

Housing and Mortgage Markets: Weaker Economy Leads to Softer Housing, but Refinance Activity Helps Support Mortgage Volume

Both single-family and multifamily homebuilding activity was up sharply in June. Year-to-date multifamily starts have been hovering more than 50 percent above the depressed levels experienced during the first half of last year, supported by an ongoing decline in the homeownership rate. In contrast, existing home sales have lost some momentum in recent months. Sales fell in June for the third consecutive month to a seven month low. For the second quarter, sales dropped nearly 20 percent at an annualized rate. The share of distressed sales also declined during the quarter, albeit remaining at elevated rates.

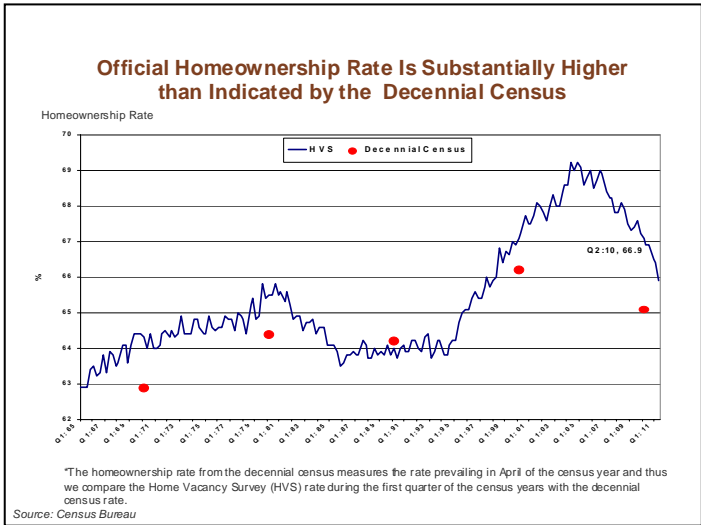
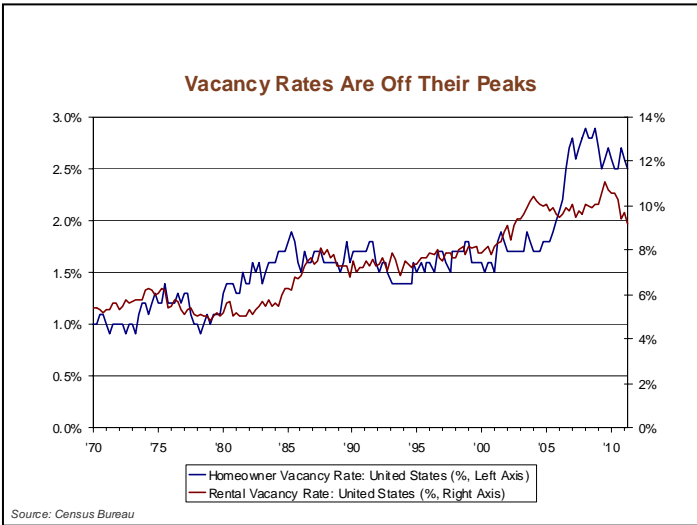
Even though existing home sales have slowed recently, main measures of home prices have firmed in the second quarter. However, the improvement was largely due to a seasonality effect, which is expected to reverse and drive home prices down in the second half of the year.

Pending home sales, which measure contract signings of existing homes and thus are a leading indicator of existing home sales, suggest a stabilizing market in coming months as they rose in June for the third time in the last four months. However, there are reasons for caution regarding this upward trend as the link between contract signings and closings has weakened lately. Low appraisals compared to contract prices and heightened uncertainty about the durability of the economic recovery may have led to reported increases in the number of contract cancellations. Another leading indicator, purchase mortgage applications, has moved sideways, hovering at depressed levels during the past six months.

New home sales fell in June for the second consecutive month. For the second quarter, sales averaged higher than the first quarter, but remained depressed by historical standards: the second quarter selling pace is still the fourth lowest quarterly level on record. The inventory of new homes is very lean, with the inventory of new homes available for sale falling again in June to a fresh record low. Despite a weaker pace of sales in June, the inventory-sales ratio, a measure of the supply-demand imbalance, fell to 6.3 months, close to its long-term average. However, weakening housing demand could reverse the ongoing improvement in the housing imbalance.

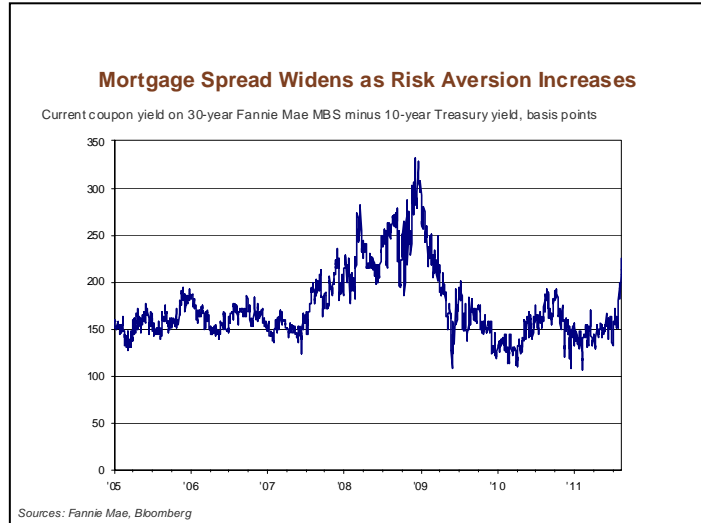
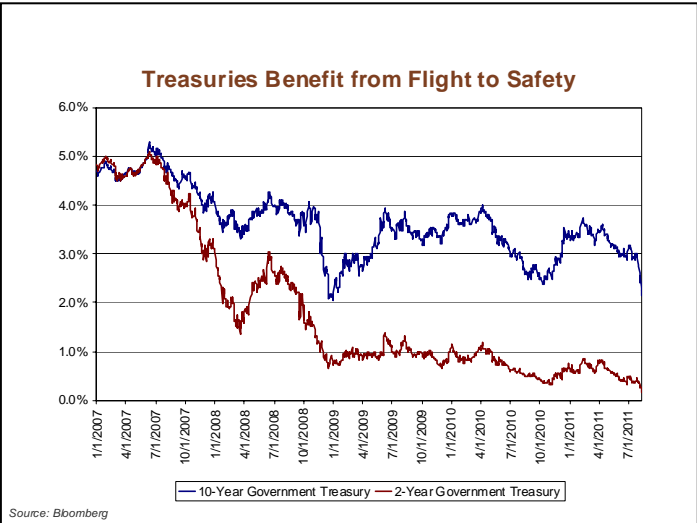
There also is encouraging news on the excess supply of housing outside of the new home market. The Housing Vacancy Survey (HVS) suggests that the excess supply of housing appears to have peaked and has steadily trended down, especially in the rental segment of the housing market. The rental vacancy rate—the share of rental housing that is vacant and for rent—plunged from 9.7 percent to 9.2 percent in the second quarter of 2011, the lowest rate in nine years. (For more information on multifamily market conditions, read the [August 2011 Multifamily Market Commentary](#)). The improvement on the owner-occupied side has been limited. The homeowner vacancy rate—the share of owner-occupied housing that is vacant and for sale—edged down to 2.5 percent from 2.6 percent in the first quarter. The rate has been hovering around this range for the past two years and remains elevated by historical standards.

The downtrend in the rental vacancy rate is consistent with the declining trend in the homeownership rate, which indicates that a rising share of households have shifted to renting over owning. The HVS showed that the homeownership rate fell from 66.4 percent the first quarter to 65.9 percent in the second quarter, marking the lowest level since the first quarter of 1998. The rate is expected to trend down further based on the elevated level of seriously delinquent loans in the market. We should note that the 2010 results from this survey, which has quite a small sample, were higher than those derived from the 2010 decennial census. While the homeownership rates from the two sources have always differed somewhat, the discrepancy grew significantly in 2010.



Given the coverage of the decennial census, the true homeownership rate is likely much lower than the reported rate from the HVS, which is considered the official rate. On the other hand, housing inventory also may be lower than officially reported. Both the homeowner and rental vacancy rates from the HVS in 2010 also were higher than those reported in the 2010 decennial census. These discrepancies underscore the difficulty in forecasting the long-term demand and supply of housing, as well as the time required for the housing market to normalize.

Given a renewed decline in business and consumer confidence and a softening hiring trend, we expect housing activity to weaken along with the overall economy, despite the recent declines in long-term interest rates. With rising recession fears, Treasury yields have trended down sharply, as investors seek the safety of U.S. government debt, despite its downgrade. Following the Federal Open Market Committee (FOMC) meeting on August 9th, when the Fed announced that it intends to keep the Fed funds rate near zero until at least mid-2013 as its view on the economy has deteriorated, the 10-year Treasury yield plunged by 25 basis points, touching 2.03 percent before closing the day at 2.25 percent. The message is clear that the Fed expects that the recovery will remain fragile and require policy accommodation for as long as two more years.



With increased risk aversion, mortgage spreads, such as the spread between the conventional conforming secondary market yield on Fannie Mae securities and Treasury yields, have widened. Despite the widening spread, mortgage rates have trended down, hovering around the lowest level seen this year.

We expect mortgage rates to move up just slightly during the course of the year amid sluggish economic growth, to about 4.5 percent by the end of 2011. Lower mortgage rates should help spur refinance activity somewhat, as tight lending standards and the lack of equity remain hurdles for many homeowners who are in the money to refinance. We believe that mortgage rates would have to dip to 4.25 percent or below for a sustained period to ignite a significant refinance boom, but capacity constraints may limit the extent to which such activity will occur. To the extent that we see refinancings pick up, this will serve as a modest offset to the headwinds facing household finances.

Lower mortgage rates are not expected to boost housing demand, which will likely remain sluggish until we see sustained, strong employment gains. We expect multifamily starts to increase in 2011 from depressed levels of last year, but we revised lower projections of single-family starts and home sales for the rest of this year and next. Single-family starts are expected to decline about 11 percent this year, while total home sales should rise by less than 1 percent. With modest improvement in home sales in 2012 and only a gradual improvement in inventory, we expect home prices to resume their declines in the second half of 2011 before stabilizing in early 2012. There is some risk that the stabilization in home prices will be delayed if the labor markets deteriorate further.

For all of 2011, total mortgage originations are projected to decline to \$1.09 trillion from an estimated \$1.51 trillion in 2010. The refinance share is projected to be 63 percent, compared with 54 percent in the prior forecast, as a result of an upgrade in projected refinance mortgage originations and a downgrade in expected purchase originations. We expect fixed mortgage rates to settle somewhat higher than the approximately 4.3 percent rates seen at the time of this writing, but there is some upside risk to our refinance originations forecast if rates continue to move lower. We expect total single-family mortgage debt outstanding to fall an additional 2.7 percent this year, moderating slightly from a drop of 3.0 percent in 2010.

Doug Duncan and Orawin T. Velz
Economics and Mortgage Market Analysis
August 10, 2011

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