

## 2014: Private Forces Move to the Fore

In our first commentary of 2014, we present a preview of the key theme that will shape our outlook for the economy and the housing and mortgage market over the coming year. We believe that reduced uncertainty on the fiscal policy and regulatory fronts and the beginning of normalization of monetary policy are setting up a foundation for the private forces to come to the fore. We believe this will lead to an acceleration of growth this year with upside potential to surpass 3.0 percent. We will expand on this theme below, but first a review of 2013.

Recapping 2013 (theme: “Transition to ‘Normal?’”), the economy started 2013 with a whimper, setting up expectations for another year of sub-par performance. Despite the Federal Reserve’s taper talk that began in early summer, causing interest rates to spike, and a fiscal impasse that ended in a partial and temporary government shutdown, the economy managed to exceed most expectations in the second half of the year. After surprising the financial markets by postponing tapering in September, the Fed announced in December that it would start to scale back the pace of its asset purchases in January, citing improvement in labor market conditions and a more balanced risk to the economic outlook. Although somewhat of a surprise, its action was well received, judging from the stock and bond market reactions as well as measures of volatility, all of which were positive. This reaction likely resulted from the modest tapering and enhanced forward guidance, which set up expectations that the Fed will keep the target fed funds rate on hold through the second half of 2015 or longer. Meanwhile, the budget agreement signed by the President in late December essentially removed the likelihood of another government shutdown and fierce debt ceiling negotiation.

### Monetary Policy: Dialing Back at Measured Pace

This month, the Fed started reducing its monthly purchases by \$10 billion, split evenly between purchases of Treasury notes and mortgage-backed securities (MBS) to \$40 billion and \$35 billion, respectively, and noted that it would further reduce the size of its monthly purchases at “measured steps,” if supported by incoming data.

If the Fed cuts its monthly purchases by \$10 billion at each Federal Open Market Committee (FOMC) meeting, it will buy approximately \$455 billion of assets—\$200 billion in MBS—on a net basis in 2014. We expect the Fed to maintain its policy of reinvesting principal payments from its holdings of agency debt and MBS into agency MBS and of rolling over maturing Treasuries.

To underscore the message that tapering is not tightening, the Fed also enhanced its forward guidance by noting that it will likely maintain the current federal funds rate target “well past” the time that the unemployment rate declines to below 6.5 percent, especially if expected inflation remains below the 2.0-percent target. This is a consequence of conclusions internal Fed research reached about the impact of long-term unemployment on economic growth. The personal consumption expenditures price index—the Fed’s preferred inflation gauge—is up just 0.9 percent in November from a year ago, well below the Fed’s 2.0-percent target and should provide flexibility to policymakers to withdraw the monetary stimulus.

While the Fed will continue to increase its balance sheet throughout this year, it appears in the early stages of a transition away from asset purchases towards forward guidance and a neutral balance sheet (neither expanding nor contracting), which we project to hit \$4.5 trillion by the end of 2014. Our forecast points to a decline in the unemployment rate to 6.5 percent in the third quarter of this year, sooner than we projected in the prior forecast; however, we expect the Fed to keep the fed funds rate on hold near zero until the third quarter of 2015—the same call we have held for some time.

Looking ahead, the size of the Fed’s balance sheet is far larger relative to economic activity than ever before, and any discussion of changing the fed funds target will necessarily invoke questions about the size of the balance sheet. In addition, the Fed has been working on a repurchase facility to manage the large supply of reserves in the system in a non-inflationary way on the return to normal.

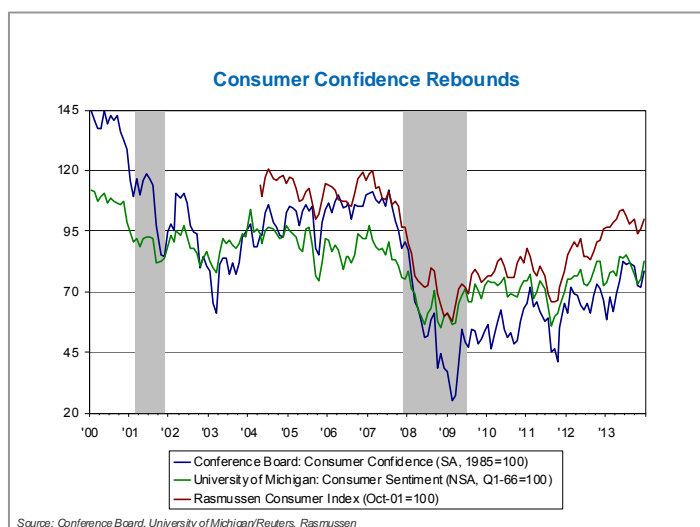
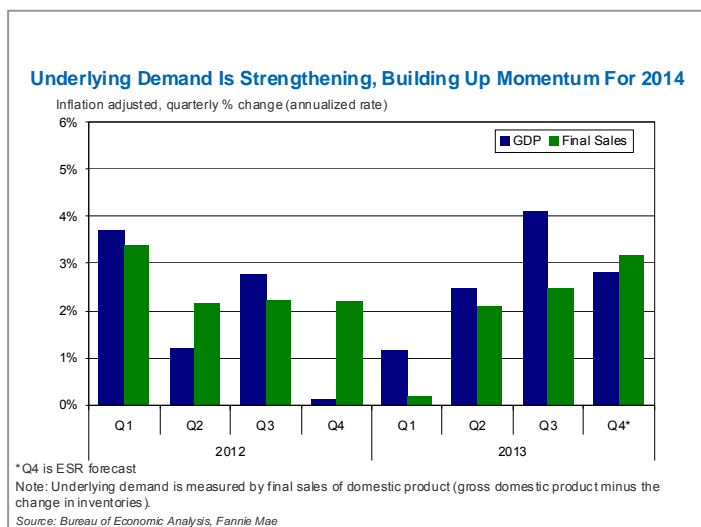
## Fiscal Policy: Lessening Headwinds

The President signed a two-year budget agreement with the Congress on spending levels. The deal significantly reduced uncertainty on the level of government spending and taxation. Scheduled federal spending cuts to take effect on January 15 were reduced by \$45 billion in fiscal 2014 and \$20 billion in fiscal 2015. The reduction in spending cuts relative to the sequestration levels under the 2011 Budget Control Act will be offset over the next 10 years by increased user fees and other spending items with no changes to entitlement programs or the income tax code. While Congress will still need to pass a detailed spending bill to extend spending authority (or a continuing resolution) before current spending authority expires on January 15 to avoid a government shutdown, we believe there is little risk that the bill will fail to pass. The agreement does not address the issue of the debt ceiling, which is expected to become binding in March, but it sets a positive tone for an orderly increase in the debt limit. However, another disruptive debate that damages consumer and business confidence cannot be ruled out and remains a downside risk.

## Economy 2013: Accelerates into 2014

After all is said and done, 2013 is likely to have been a decent year for the economy and the housing market despite the obstacles that had to be overcome. Economic growth accelerated steadily through the third quarter in 2013 from an anemic pace in the first quarter. Faster inventory accumulation was only part of the story for the 4.0-plus-percent growth pace in the third quarter. Growth in real (inflation-adjusted) final sales of domestic product—gross domestic product (GDP) minus inventory accumulation—also accelerated steadily, albeit at a modest pace. While most housing indicators were impacted negatively by the spike in mortgage rates during the summer, most of them either stabilized or rebounded by the end of the year, showing solid, broad-based year-to-date increases from a year ago.

Most incoming data have been much stronger than was anticipated in the prior forecast, and headline economic growth in the fourth quarter likely came in approximately 2.8 percent—about 1.0 percentage point more than we projected in the prior forecast. One reason for the upgrade is that the correction in inventory investment from an unsustainable buildup in the third quarter appears to have been less severe than feared. More importantly, economic reports, with an exception of the December jobs report, also portrayed strengthening domestic demand. We expect real final sales of domestic product to pick up modestly in the fourth quarter despite weaker headline economic growth.



Among a barrage of positive economic data that helped reinforce our expectation for growing momentum of economic activity into 2014 was a marked improvement in consumers' attitudes at the end of the year from the erosion associated with concerns about the government shutdown.

Even in the midst (and aftermath) of the recent fiscal impasse, consumer spending in the first two months of the fourth quarter surprised on the upside. Despite December auto sales easing from a recovery high in November, real consumer spending growth likely picked up to 3.5 percent annualized in the fourth quarter from 2.0 percent in the prior quarter.

Things are looking up on the business investment front as well. Orders for durable goods rose sharply in November and both core capital goods shipments—a proxy for business capital investment—and core capital goods orders—their leading indicator—suggest a revival in business investment in both the fourth quarter and coming quarters.

The jump in core capital goods shipments was an additional reason for an upgrade in the growth picture at the end of the year. The strong November durable goods orders echoed a jump in manufacturing output from the November industrial production report and finally ended what appeared to be a disconnect between economic data and opinions of purchasing managers such as the national manufacturing survey from the Institute for Supply Management (ISM), which started to trend up in the second half of 2013. Overall, economic reports and surveys of manufacturing activity point to a brighter outlook in the sector in 2014.

Against the backdrop of improving economic activity late in the year was the December jobs report. Following several months of strong job growth, December hiring was disappointing, as businesses closed out 2013 by adding only a net gain in payrolls of 74,000, the weakest pace in nearly three years. Moreover, the average workweek declined slightly to 34.4 from 34.5, and average hourly earnings edged up just 0.1 percent. While the unemployment rate from the survey of households fell from 7.0 percent to 6.7 percent, the lowest reading since October 2008, it was a result of declining household employment and a large drop in the size of the labor force, pulling the labor force participation rate down to a rate not witnessed since early 1978. For all of 2013, the economy created 2.19 million new jobs, compared with 2.27 million jobs in 2012.

We are hesitant to believe that the labor market has weakened materially over the past month and will require more evidence of a labor market slowdown prior to changing our view of strengthening economic growth and improving labor market conditions this year.

## Economy 2014: Slow Start Followed by Strong Growth

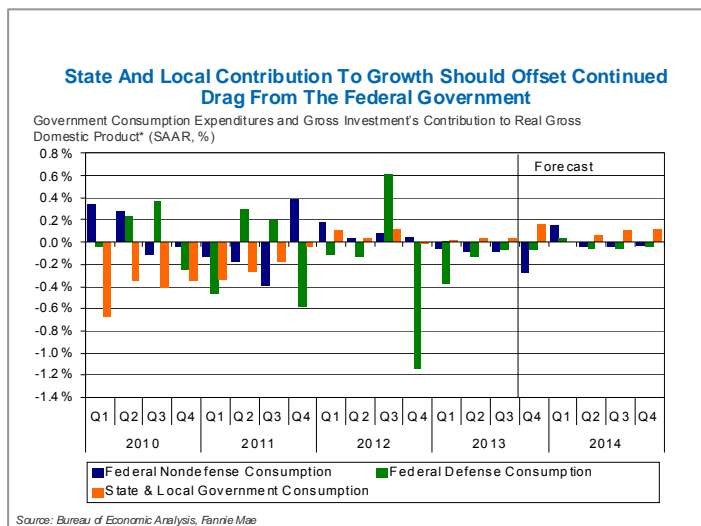
Because the bulk of inventory correction did not occur in the fourth quarter as we had expected, the inventory payback now looms over the current quarter. Economic growth should start off the year at around 2.0 percent, held back by a sharp decline in inventory investment, which we project to subtract about 1.0 percentage point from growth.

Despite the weak headline, the underlying demand should continue to strengthen. We expect headline growth to pick up to around 3.0 percent in the second quarter, and pick up slightly from there through the rest of the year. For all of 2014, economic growth should accelerate to 2.9 percent from an estimated 2.6 percent in 2013.

We believe there will be three primary boosts to growth this year. First, we expect private sector activity to accelerate, largely in the form of increased consumer spending. The lack of major tax increases (expiration of the payroll tax holiday, an increase on high-earner marginal rate, and taxes related to the Affordable Care Act which hampered growth in the first half of 2013), rebounding consumer sentiment, further healing of household balance sheets from rising equities and home prices as well as declining household debt burdens, expected improving labor market conditions, and firming income

growth should all help lift consumption. In particular, we expect average monthly payroll gains to accelerate from 183,000 in 2013 to above 200,000 this year. We expect the contribution from consumer spending to GDP growth will rise from an estimated 1.6 percentage points this year to about 2.0 percentage points in 2014. At the same time, business sentiment should also improve with better consumer demand and reduced fiscal uncertainty, adding to growth this year in the form of stronger hiring and capital investment.

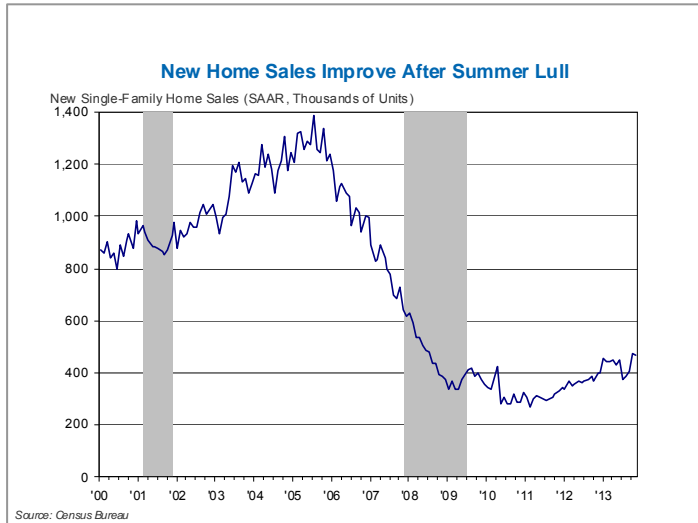
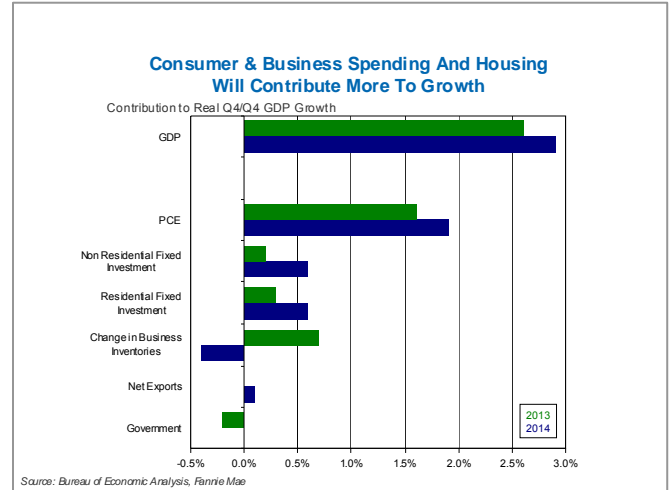
Second, we estimate that the direct drag from declining government consumption and gross investment will swing from 0.3 percentage points of GDP in 2013 to zero percentage points in 2014, as we expect a positive contribution from state and local government to outweigh the waning drag from the federal government.



The third expected boost to economic growth is the continued housing recovery, particularly in homebuilding activity. The spike in mortgage rates hurt homebuilding and home sales during the second half of 2013, and we expect housing to subtract from GDP during the final quarter of 2013—a rare occurrence as it would be the first time in three years that housing dragged on GDP. However, we expect the drag from housing to be a one-off event and homebuilding activity should overcome the soft patch, with housing’s contribution to GDP growth expected to double from 0.3 percentage points in 2013 to 0.6 percentage points in 2014.

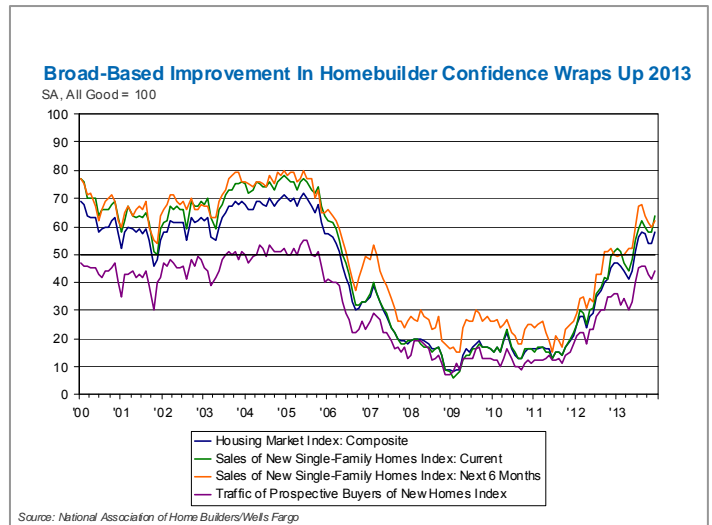
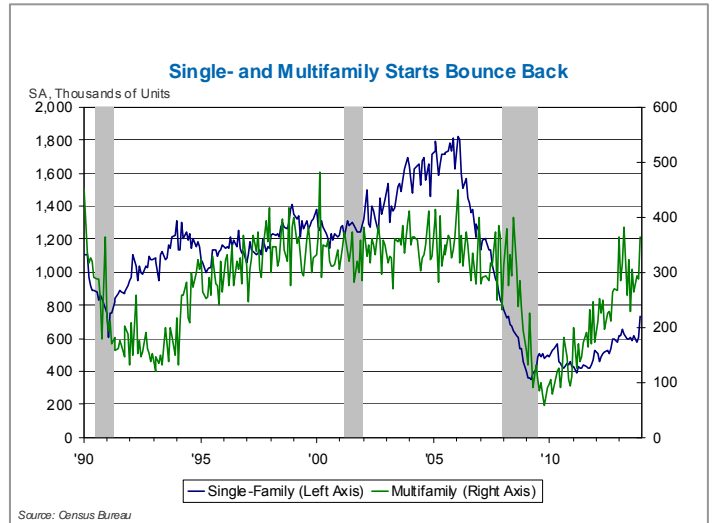
### Housing: Rising Activity Amid Moderating Home Price Appreciation

Despite the rise in mortgage rates since May and the resulting pause in activity during the summer, home sales, home prices, and housing starts and permits posted strong gains in 2013. Many housing indicators rebounded later in the year, suggesting that the negative impact of rising mortgage rates on housing activity was only temporary, consistent with continued recovery in the housing market in 2014.



After plunging in July, new home sales—which record contract signings—rebounded in August and September, erasing some of the drop in sales induced by the rate spike. In October, sales jumped to the highest level since July 2008, and despite a small pullback in November, new home sales remain near recovery highs.

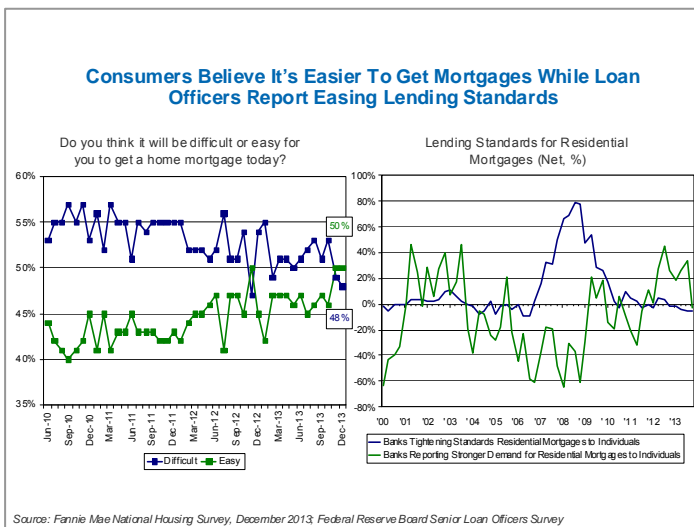
Recent trends in new home sales bode well for homebuilding activity, which also bounced back convincingly near the end of 2013. Housing starts rose in November for a second consecutive month to a recovery high, with large increases in both single-family and multifamily starts, surpassing the 1 million mark for only the second time in the current recovery. The outlook for activity remains good this year, as permits fell modestly in November but still remained over 1 million units. While multifamily permits edged down from a five-and-a-half-year high in October, single-family permits rose to the highest level since April 2008.



The improvement in new home sales and homebuilding activity has helped boost builders' confidence, with the National Association of Home Builders (NAHB) Housing Market Index rising four points in December, erasing the setback in the prior three months. All three of the components—current sales, expected sales over the next six months, and sales traffic—showed significant increases, with the former rising to the highest reading since December 2005.

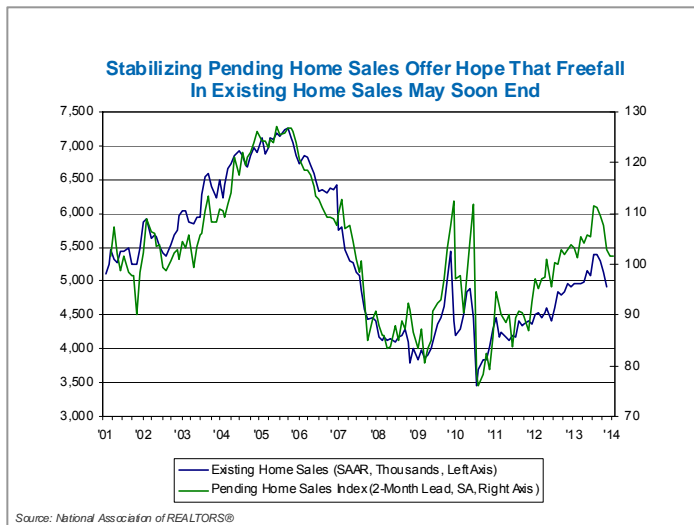
The new home market has benefitted from declining competition from foreclosures and distressed sales. With increased momentum late in 2013, we expect both new home sales and housing starts to post double-digit rises again this year amid an improving employment picture, rising confidence and high pent-up demand.

As home builders' confidence and general consumer confidence have rebounded, plans to buy homes also improved. For example, the Conference Board's survey of consumer confidence showed that the share of consumers who plan to buy a home rose to 6.9 percent in December, up from 5.0 percent in the prior month. In addition, the results from [December Fannie Mae National Housing Survey](#) also showed that consumers' housing attitudes recovered from the dip that coincided with the contentious debates over fiscal policy in the prior two months.



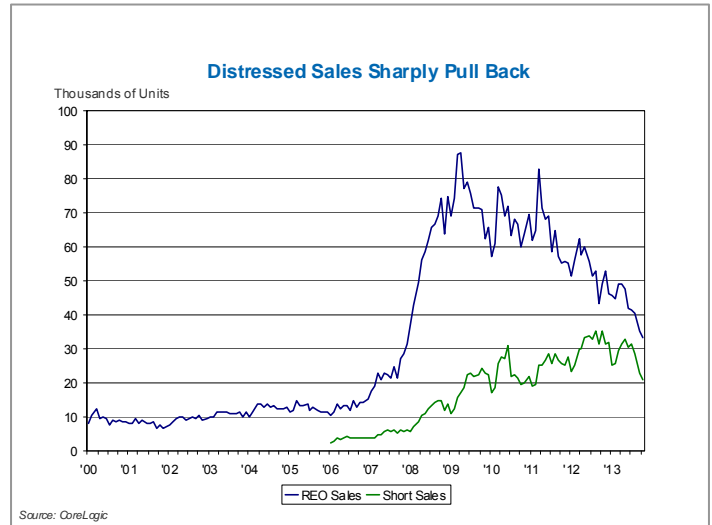
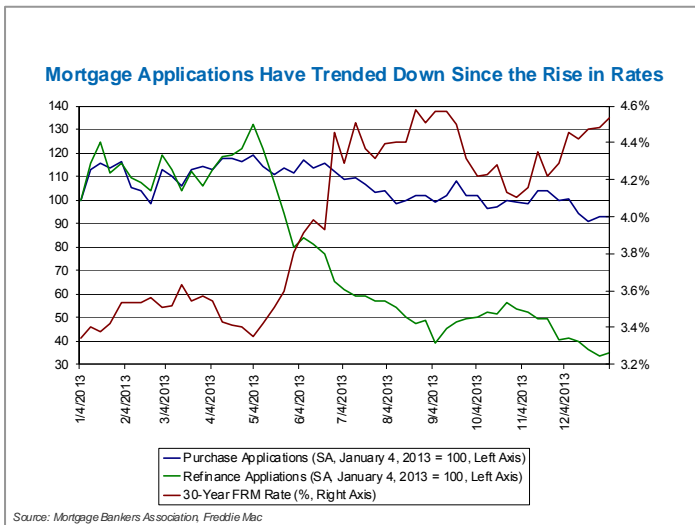
One encouraging development from the Fannie Mae survey is that consumer attitudes about the ease of getting a mortgage are at their highest level in the survey's three-and-a-half-year history. This result is consistent with the Federal Reserve's survey of senior loan officers who reported that they have eased lending standards for residential mortgages over the past year and thus should offset some negative impact stemming from the current higher interest rate environment.

One worrisome aspect of the housing market is existing home sales, which have not yet shown a rebound from the impact of rising mortgage rates. In November, existing home sales fell for the third consecutive month to the lowest level in 2013, and since June, existing home sales posted an increase only once. Pending home sales or contract signings of existing homes fell in October for the fifth consecutive month but appear to have stabilized in November with a small increase.



However, purchase mortgage applications have trended down sharply through the end of the year, remaining about 22 percent below their recent peak in early May before mortgage rates started to trend up.

The continued decline in purchase applications underscores weak organic demand for mortgages in the face of declining REO and short sales, which are popular among investors. Until we feel comfortable that organic housing demand from first-time homebuyers and trade-up buyers can step up to replace investor demand as bargain-priced properties are dwindling, we remain cautious on the outlook for existing home sales this year and expect only a modest rise of about 2.0 percent.



Home price gains also showed signs of moderating on the month-to-month basis, partly because of seasonal factors, though the year-over-year gains remain strong. For example, the CoreLogic house price index—a measure used by the Federal Reserve to estimate housing wealth in the Financial Accounts of the U.S.—rose 11.8 percent in November from a year ago, the ninth straight month of double-digit annual returns. We expect home price gains to moderate this year, consistent with our anticipated modest rise in existing home sales.

Long-term interest rates moved up following the Fed’s tapering announcement and generally strong economic data, with the yield on 10-year Treasuries hovering around 3.0 percent. However, the yield dropped about 10 basis points following the release of the December employment report. The yield on 30-year fixed mortgage rates started 2014 at around 4.5 percent and we expect it to rise gradually over the course of the year, reaching about 5.1 percent by the end of this year. For all of 2014, as refinance originations continue to drop in response to rising mortgage rates, we expect total mortgage originations to decline roughly 31 percent to \$1.26 trillion, with the refinance share falling to 37 percent from an estimated 62 percent in 2013. We expect mortgage debt outstanding to post a small increase in 2014, breaking a streak of six consecutive annual declines through 2013.

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