

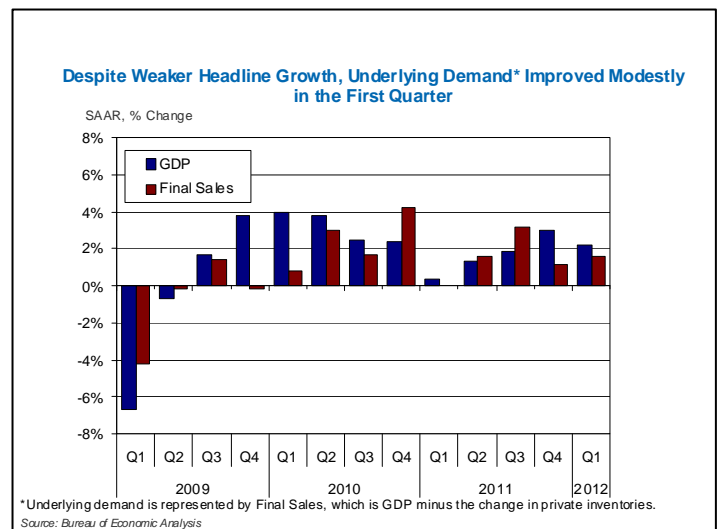
Spring Activity Cools Following Exceptionally Warm Winter

Economic growth slowed in the first quarter of 2012 to 2.2 percent at an annual rate from 3.0 percent in the final quarter of 2011, according to the first estimate of gross domestic product (GDP). The biggest driver of growth was real consumer spending, which rose a solid 2.9 percent, the best showing since the end of 2010. Business investment was bearish in the first quarter, contracting for the first time since late 2009. Business investment on equipment and software—a reliable driver of economic growth in the first three years of the current recovery—lost steam, posting the smallest gain in the entire three years of the current recovery, while business investment in structures fell sharply. Net exports were little changed from the fourth quarter, reflecting growth in both exports and imports, while government spending continued to be a big drag on economic growth. Inventory accumulation was a contributor to growth again this quarter, adding 0.6 percentage points—one full percentage point less than its contribution to GDP in the prior quarter.

One piece of encouraging news was housing, as real (inflation-adjusted) residential investment grew nearly 20 percent at an annualized rate during the first quarter, the strongest quarterly gain since the expiration of the homebuyer tax credit in 2010. Gains were solid in single-family and multifamily structures, as was spending on home improvements. Residential remodeling as a share of total residential investment has risen substantially in recent years, as many households have chosen to remodel their homes rather than move while new housing construction is anemic. In addition, many real-estate owned (REO) properties need substantial repairs before they are in move-in condition.

Despite a weakening growth headline, final sales (GDP minus the changes in inventories), which represent underlying demand in the economy, picked up modestly to 1.6 percent during the quarter from 1.3 percent in the prior quarter. While still modest, the recent pace of growth is stronger than the same time last year, and we see a better balance of upside and downside risks compared to a year ago.

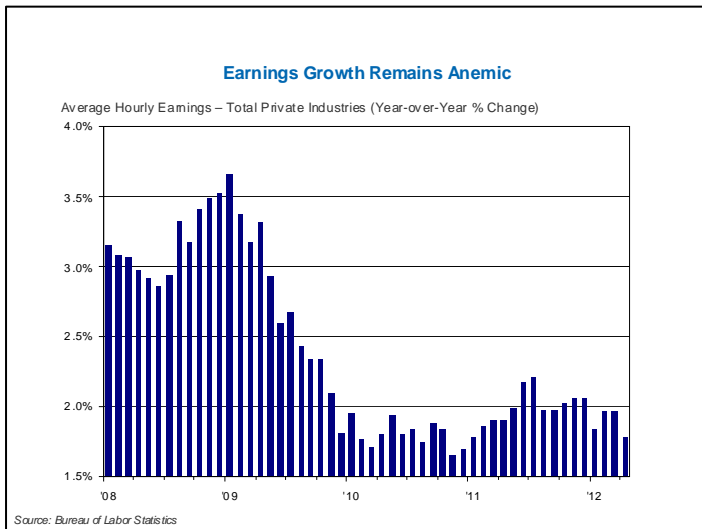
The strength in consumer spending is encouraging. However, it will likely be unsustainable going into the current quarter due to the lack of income support. Real disposable incomes rose only 0.4 percent in the first quarter, and hence the strong growth in consumer spending occurred at the expense of saving, reflected in the sharp drop in the saving rate from 4.5 percent in the fourth quarter of 2011 to 3.9 percent in the first quarter of 2012, the lowest quarterly rate since the end of 2007.



The monthly pattern of consumer spending within the first quarter showed weakening momentum, as real consumer spending edged up just 0.1 percent in March, suggesting that spending growth will slow in the current quarter. In addition, consumers may turn more cautious in coming months in order to rebuild their savings, implying that stronger income growth will be necessary for consumer spending to remain a driver of the recovery. One upside for consumers is that gasoline prices have declined and inflation is poised to slow in the current quarter from the first quarter. In addition, the latest Senior Loan Officer Opinion Survey on Bank Lending Practices shows an increased willingness on the part of banks to lend to consumers during the past three months. The improvement in the willingness to lend, as well as the reported increase in the demand for consumer loans, should lend support to consumer borrowing going forward. In March, consumer credit outstanding excluding mortgages posted the largest monthly increase since November 2001. Revolving credit (credit cards) and nonrevolving credit (auto and student loans) advanced during the month, with about three-fourths of the gain coming from nonrevolving credit. Nonrevolving Federal government credit has trended up sharply since

certain student loans began to be distributed directly from the Federal government as part of the health care reform legislation. Following a steep decline during the recession and earlier stages of the recovery, revolving credit stabilized in late 2010 and has gradually trended higher since late 2011.

However, the outlook for the labor income trend continues to be discouraging given disappointing news from the jobs market, which showed a marked slowdown in the pace of hiring, as nonfarm payrolls rose just 115,000 in April—a six-month low. Both hours worked and average hourly earnings were flat, implying continued soft growth in labor income. During the past year, average hourly earnings rose just 1.8 percent in April, the smallest year-over-year gain since the beginning of 2011.



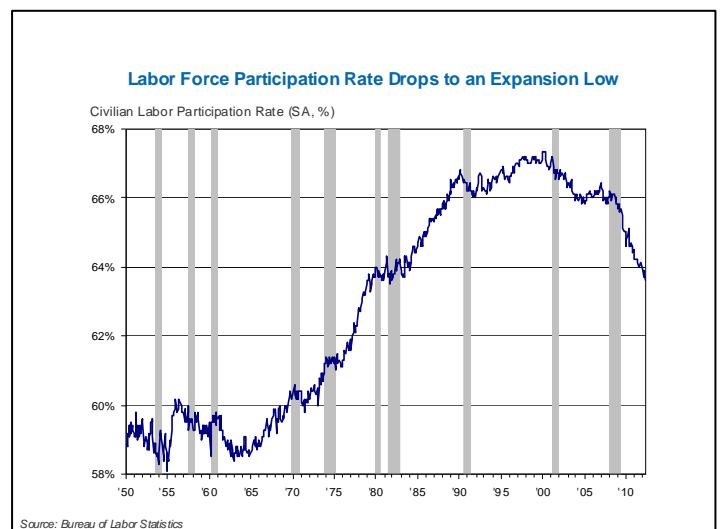
The one mildly bright note in the jobs report was a 53,000 upward revision of payrolls over the prior two months. While the monthly gain in nonfarm payrolls has averaged about 200,000 this year, the momentum is clearly weakening. Insofar as the slower pace of hiring is partly due to the payback from unusually warm winter weather, then we may see some pickup in coming months. However, it will take some time to confirm whether this will turn out to be a temporary lull or a repeat of prior years' disappointment after a promising start.

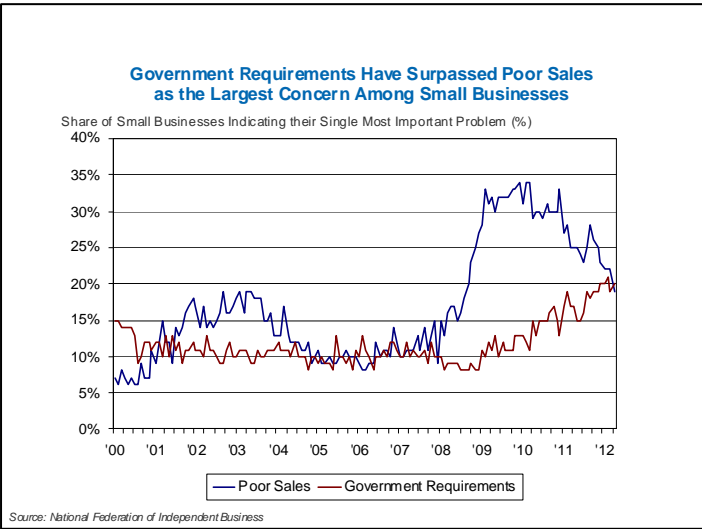
The survey of households showed that the unemployment rate dipped 0.1 percentage points to 8.1 percent, marking ten consecutive months without an increase. The seemingly good news masks the true level of distress in the market, as April's decline in the unemployment rate was the result of a plunge in the labor force that outpaced the drop

in household employment—the same unfavorable combination witnessed in March. The labor force participation rate—the share of the working-age population that is working or looking for work—slipped for a second consecutive month, reaching a new recovery low of 63.6 percent, the lowest level in three decades.

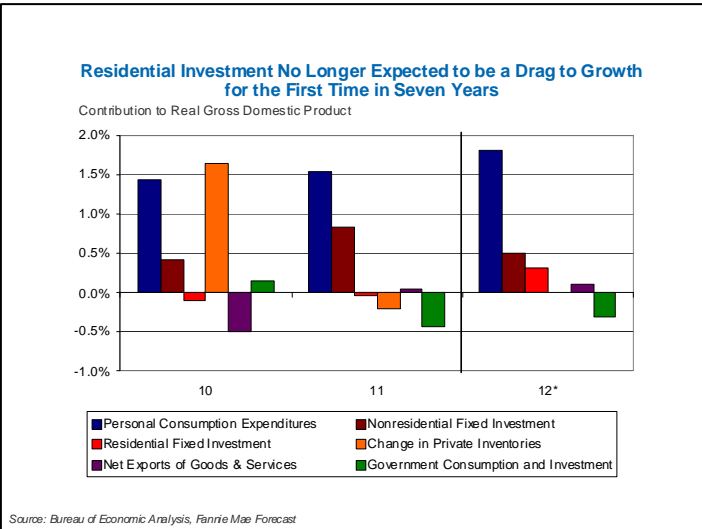
Some of the decline in the labor force participation rate may be attributed to structural factors, including the increase in early retirement and disability, as well as a mismatch of skills between employers and available workers. However, some of the decline in the participation rate, especially among those 35-54 years old, is due to discouraged workers who will likely re-enter the market once it strengthens, which could cause the unemployment rate to go back up. We expect the impact of the latter to be small and project that the unemployment rate will continue to trend down gradually, reaching just below 8 percent by the end of the year.

Weakening labor market conditions are in line with a slowdown reported in some other April data. The Institute for Supply Management (ISM) nonmanufacturing index fell during April, signaling some slowdown in service activity early in the second quarter. However, the ISM manufacturing index surprised to the upside, rising to the highest reading reported since last June. Measures of consumer confidence were little changed in April. The Conference Board consumer confidence index dropped for a second consecutive month, edging down 0.3 points, and the Reuters/University of Michigan consumer sentiment index

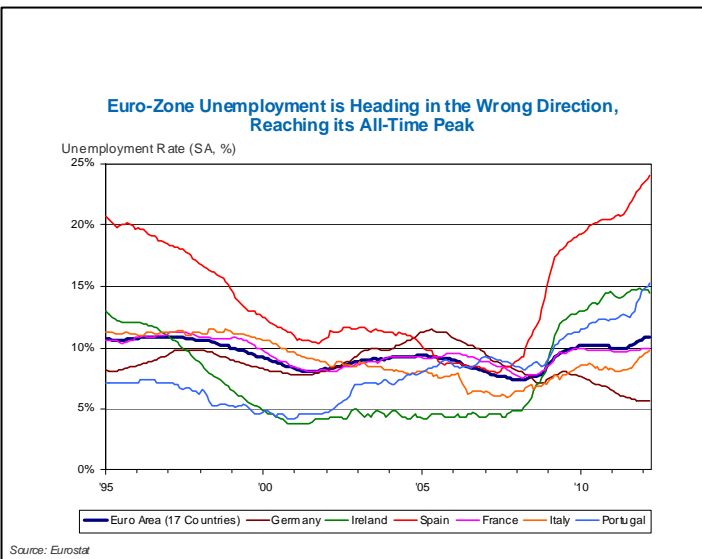




rose 0.2 points, extending the streak of gains at eight months. On the business side, after falling in March for the first time in seven months, confidence among small businesses improved in April, more than reversing the March decline, according to the National Federation of Independent Business optimism index. One notable takeaway from the survey was that the share of firms highlighting poor sales as their single most important problem continued to decline, falling to 19 percent, the lowest share since August of 2008. Government requirements have been trending up as the most important concern since late 2008 and surpassed poor sales in April for the first time in the survey's history.



Overall, incoming data suggest that growth will continue to be sluggish in the current quarter, and the pace of activity should firm just slightly in the second half of the year. For all of 2012, we expect growth to come in at 2.3 percent—little changed from the view we have held since the beginning of the year. Consumer spending will remain the biggest driver of growth, followed by nonresidential investment, which is entirely from investment in equipment and software, and not from structures. The housing market is expected to improve gradually this year, and residential investment should add to GDP for the first time in seven years. Other main components are expected to add little or nothing to growth, while government is expected to remain a main drag again this year.



We continue to see a number of threats that could dampen growth. There remains substantial risk that investors will lose confidence in the ability of Europe to solve its problems over the intermediate term. Sovereign debt yields in Europe's periphery again widened sharply recently, as both French and Greek elections indicated waning public support for austerity, igniting fears that the sovereign debt crisis could develop into a more significant credit crisis that could spill over to countries around the globe. The situation is particularly acute in Greece, as election results there were ambiguous, and a failure to form a new coalition government could lead to a new round of elections in June with difficult-to-foresee consequences. In addition, there was renewed concern regarding Spain, as its sovereign debt rating was recently downgraded and its unemployment rate jumped close to a record high in March. For the euro zone as a whole, the unemployment rate reached a record high as the region slipped into recession once again.

Another challenge to the economy is uncertainty around the domestic policy environment, as under current law, the economy will be subject to intensified fiscal drags in 2013.

In addition, the debt ceiling will need to be raised again later this year, and the political dynamics surrounding that action, plus the debate over policy options to limit the impact of the large fiscal drags, including delays of spending cuts, are likely to weigh heavily on financial markets and consumer confidence, potentially dampening growth late in the year. We maintain our assumptions regarding fiscal policy, which we discussed in detail in the April forecast, that presume that much of the near-term fiscal drag will be postponed.

Housing: Promising Start

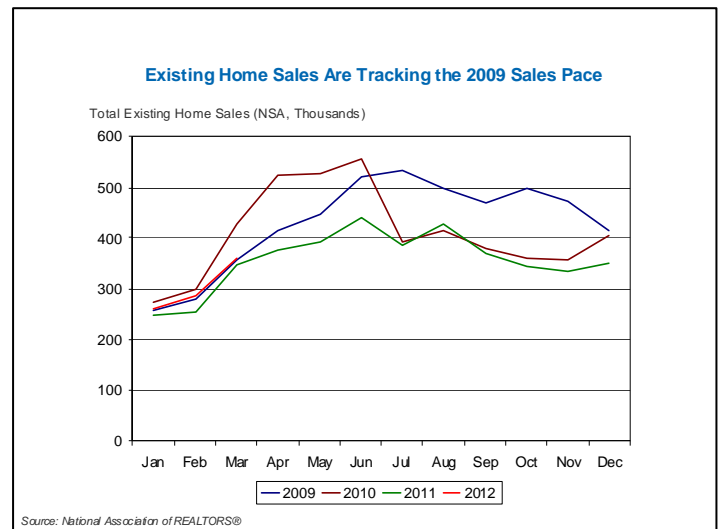
News on housing activity generally indicated a strong showing for the first quarter that substantially outpaced performance during the same period last year. However, mirroring many economic indicators, the monthly pattern suggests some loss of momentum late in the quarter. This also could partly be the result of unusually warm weather at the start of the year that pulled some housing activity forward. After a robust gain in January, existing home sales fell in March for the second consecutive month. Despite back-to-back monthly declines, sales rose at a 20 percent annualized pace in the first quarter. Year-to-date sales through the first quarter also were much stronger than sales during the same period last year—tracking about the same pace as in 2009, but below the homebuyer tax credit-boosted pace in 2010.

New home sales tumbled in March. However, large upward revisions sizably reduced the reported January sales decline, and turned a modest drop in February into a large gain. Year-to-date, new single-family home sales through the first quarter were up nearly 17 percent from 2011. The inventory of new homes for sale continued to fall, reaching a fresh record low since the inception of data in 1963. Inventories have declined or held steady on a seasonally adjusted basis for every month since April 2007. The months' supply ticked up to 5.3 months from 5.0 months in February, remaining well below the historical average of 6.2 months.

After plummeting in February, single-family starts were little changed in March, while multifamily fell sharply after two strong increases in the prior two months. (For more information on multifamily market conditions, including multifamily market trends through the first quarter of 2012, read the [May 2012 Multifamily Market Commentary](#)). For the first quarter, single-family and multifamily starts were up 17 percent and 25 percent, respectively, ahead of the pace reported during the same period last year. Despite improving home building activity, the level of new construction has remained at depressed levels by historical standards, especially for new single-family construction. Single-family starts fell to a record low in 2011, and teardowns likely erased much of that addition to the housing stock.

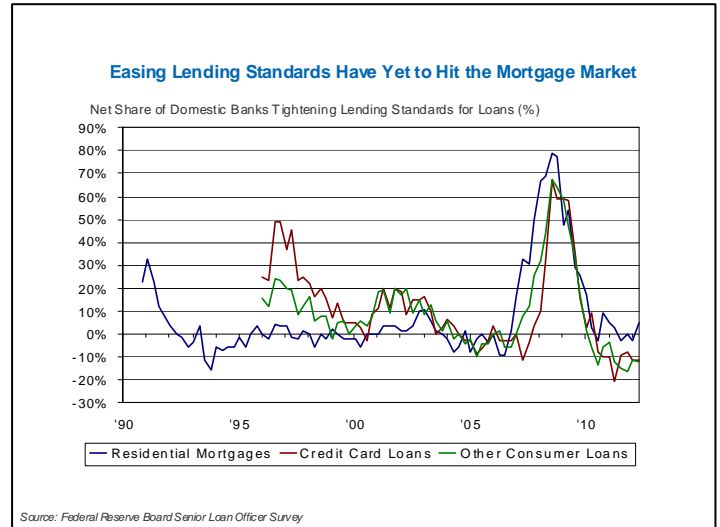
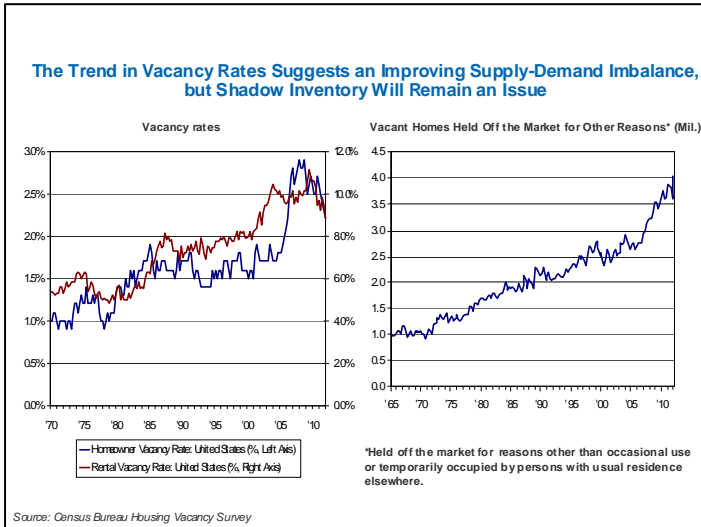
As a result of very little new construction for single-family homes coming on line, as well as a shift in the tenure choice toward renting, vacancy rates in both the for-sale market and especially the rental market continued to decline during the first quarter, according to the Census Bureau Housing Vacancy Survey (HVS). The rental vacancy rate trended down from its peak in the third quarter of 2009 to the lowest level in nearly ten years. This was due to the substantial increase in the number of renter households since the housing downturn amid the decline in the number of owner households. The vacancy rate for homes for sale has gradually trended down, helped in part by increased investor activity that is converting for-sale housing stock into rentals. The expected pickup in household formation after persistently below-trend rates will help reduce the excess supply of housing going forward.

The ongoing shift of tenure choice from owning to renting, partly aided by the continued flow of foreclosures, is evident in the declining trend in the homeownership rate, which fell to 65.5 percent in the first quarter, returning to levels last seen in 1997.



Housing will continue to face many challenges. While the HVS suggests declining inventory of homes available for sale and for rent, it also reports continued rising numbers of vacant homes that are held off the market. Combined with the still elevated number of seriously delinquent loans, the current environment indicates that the shadow inventory will remain an issue for the housing recovery in coming years. The overhang of the shadow inventory will continue to weigh on home prices.

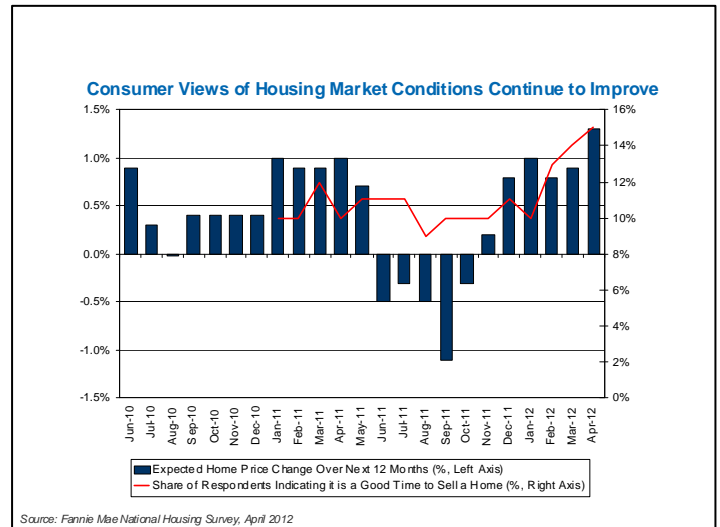
In addition, lending standards remain tight for mortgages. While the latest Federal Reserve Senior Loan Officer Survey indicated stronger loan demand along with an easing in bank lending standards for consumer loans, lending standards have not eased in the mortgage space.




One positive for the housing market is record low mortgage rates. Concern over the election results from Greece and France, which signals opposition to austerity, resulted in a renewed flight to safety toward the Treasury market. The yield on the 10-year Treasury note declined to slightly above 1.8 percent at the time of this writing and the main surveys of mortgage rates showed rates continuing to break fresh record lows since these surveys began. Ongoing modest growth and headwinds from Europe and domestic fiscal policy should serve to keep interest rates low. The yield on 30-year fixed rate mortgages is expected to rise slowly back toward 4.0 percent by the end of the year.

Consumer views of housing market conditions have become more supportive of home purchases, according to Fannie Mae's April 2012 National Housing Survey, which shows a continued gradual improvement in consumer sentiment and their outlook for home prices. On average, consumers expect home prices to increase 1.3 percent over the next twelve months, marking the sixth consecutive positive home price expectations and the biggest gain in the history of the survey. In addition, after flatlining at depressed levels for over a year, a growing share of consumers indicate that it is a good time to sell, suggesting rising optimism about the housing market.

Some measures of home prices, including the February Case-Shiller house price indices, have shown moderating declines. Others even showed some firming. For example, after declining for seven consecutive months, the CoreLogic® home price index rose for the first time in March. The index excluding distressed sales jumped





during the month, posting the largest monthly gain since March 2005. While the trend in home prices has recently improved, thanks in part to seasonality, we expect that home prices on a national basis will decline further before stabilizing in 2013.

Like our view on the overall economy, our outlook for housing activity has undergone little change in recent months. We continue to expect total home sales to rise by slightly more than 7 percent in 2012 and housing starts to increase by nearly 20 percent, with a stronger gain for the multifamily segment as newly formed households are more likely to become renters. We continue to project a modest increase in purchase originations for this year. On the refinance side, we raised our projected refinance originations in response to stronger-than-expected volumes witnessed year to date, as well as to the somewhat lower mortgage rates we now project this year.

For all of 2012, total mortgage originations should decline only modestly to \$1.31 trillion from an estimated \$1.36 trillion in 2011, with a refinance share of 64 percent, slightly lower than our estimated share for 2011. Total single-family mortgage debt outstanding is expected to be little changed in 2012 from last year's level.

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Economics and Strategic Research
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