Weak Second-Half Growth Expected to Carry Into 2011

The most severe and the longest recession post World War II ended in June 2009, according to the National Bureau for Economic Research, a private group charged with setting the official dates of the business cycles. Consumers apparently disagree, as their confidence continues to be mired at levels seen in previous recessions. Fifteen months into the recovery, economic growth has slowed substantially and the unemployment rate continues to be persistently high, remaining close to ten percent.

Economic indicators during the past month have been weak and have come in near the downwardly revised consensus, with a few upside surprises generally attributable to lowered expectations. The odds of the economy slipping back into recession have eased. The financial markets received a boost from the Federal Open Market Committee (FOMC), which noted following its September 21 meeting that inflation has been "slightly below" its desired levels, and consequently that it stands ready for further monetary easing if necessary (i.e., before deflation expectations set in). The assurance that the Fed will do more if the economy falters helped the equity markets to their best September performance (historically one of the worst months of the year) since 1939. Subsequently, influential Fed officials have shown support for additional actions to fulfill the central bank's dual mandate of full employment and price stability.

Like most market participants, we expect that the Fed will embark on a second round of quantitative easing. The first round was the Fed's asset purchase programs, which expired earlier this year after purchasing a total of $1.625 trillion of Treasurys and agency mortgage-backed securities and debt. The likely timing of the announcement appears to be at the next FOMC meeting on November 2-3. The Fed is widely expected to resume Treasury purchases, but its exact measures, the amounts it will commit, and the pace of purchases remain the subject of debate. The likely immediate impacts will be rising equity prices, declining Treasury yields, and a weaker dollar. Many of these outcomes may have already been priced into financial markets.

Needless to say, the outlook during the next year is subject to a great deal of uncertainty, both from monetary and fiscal perspectives. We expect to make adjustments to the outlook as we have more clarity, but for now, our outlook has not materially changed from the prior forecast. This implies we do not see a major impact from forthcoming quantitative easing, in the near term at least. We expect that real (inflation-adjusted) gross domestic product (GDP) grew in the third quarter at a slightly slower pace than the second-quarter annualized rate of 1.7 percent. Residential investment is expected to decline sharply—a payback following the temporary boost from the homebuyer tax credit in the second quarter. However, trade, which subtracted 3.5 percentage points from real GDP in the second quarter, likely turned around to be at least neutral to growth in the third quarter. We expect that growth will continue beneath two percent in the current quarter before picking up modestly in the first half of 2011 and strengthening in the second half, largely in line with our modest outlook for growth in consumer spending and slowly recovering bank lending. For all of 2010, we project anemic growth of 2.2 percent, followed by a 2.5 percent pace for 2011.

Labor Market: Layoffs abate but sluggish job creation continues

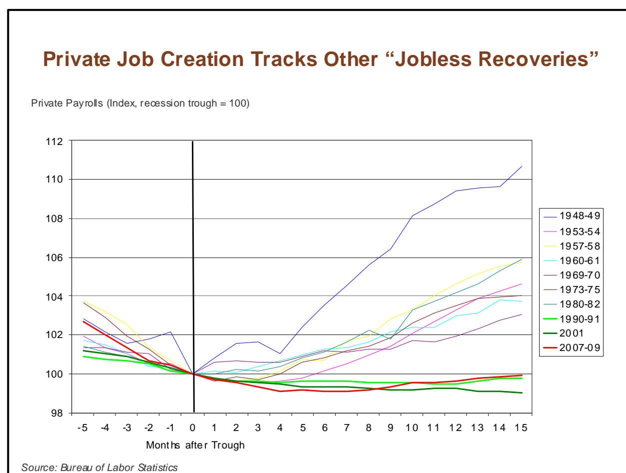
One encouraging sign in the labor market is the moderating pace of layoffs. The latest weekly initial unemployment claims data showed that layoffs dropped to the lowest reading since early July, although the level remains elevated by typical recovery standards. Job openings also have been increasing. The Job Openings and Labor Turnover Survey showed a total of 3.20 million job openings at the end of August, up from 3.14 million in July, and 2.41 million a year ago.

The main concern regarding the labor market is that hiring growth has decelerated after a relatively strong showing in the spring—prior to the European sovereign debt crisis. With economic growth slowing, job creation also has been tepid, and not enough to bring down the unemployment rate. Total nonfarm payrolls fell 95,000 in September, dragged down by the winding down of temporary Census jobs and layoffs by state and local governments. The decline in local government employment, a result of ongoing budget strains, was the largest in almost 30 years. Private payrolls rose by 64,000,

moderating from the gains of 93,000 in August and 117,000 in July (note that both the prior months' estimates were revised up a combined 36,000). For the third quarter, private payrolls rose 274,000, compared with 353,000 in the second quarter. The employment report also showed flat average hourly earnings and flat average workweek.

So far, private job creation in the current recovery has been more similar to the previous two recoveries (which were dubbed "jobless recoveries"), rather than earlier recoveries. Fifteen months into the recovery, private payrolls remain below the level at the start of the recovery, which echoes the 1991 and 2001 recoveries. Both the current recovery and the 1991 recovery fared better than the 2001 recovery, which saw a bigger decline in private payrolls at this stage of the recovery.

However, comparing the extent of job losses during the last recession of 7.5 million with 1.2 million in the 1990-1991 recession and 2.1 million in the 2001 recession, the current labor market recovery can be considered the most dismal, even when considering the growth in total size of the labor force over time.

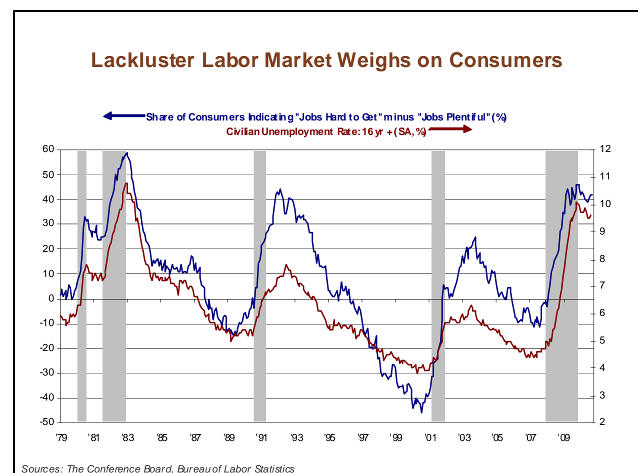


The unemployment rate remained at 9.6 percent for a second consecutive month in September, as the gain in household employment roughly offset the increase in the labor force. The rate has been above 9.0 percent since May 2008, the longest such period since data collection began in 1948. The broader measure of unemployment, which accounts for discouraged people who have stopped looking for work or part-time workers who prefer full-time jobs, rose to 17.1 percent. This marked the highest rate in the broad gauge of labor underutilization since April 2010, down just slightly from the October 2009 record high of 17.4 percent.

Consumer Spending: Slow but steady

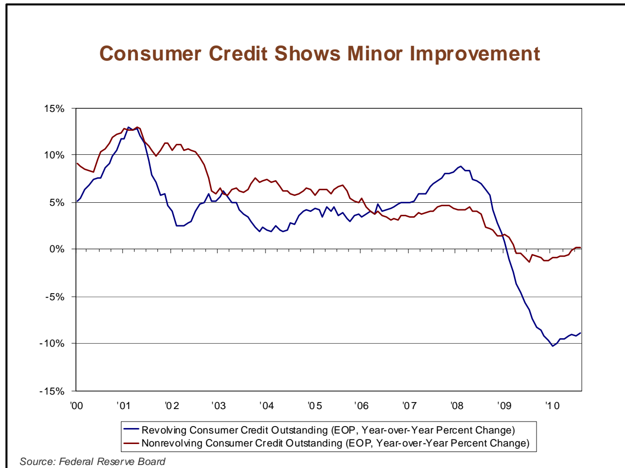
Inflation-adjusted consumer spending showed a modest gain in August and is tracking to slow just modestly in the third quarter from the 2.2 percent annualized pace of the second quarter. Measures of consumer confidence were mixed in September. The Conference Board's Consumer Confidence Index fell sharply to the lowest reading since February 2010—the level seen in prior recessions. The large drop reflected bearish views on the labor market. Consumers' assessment of the labor market deteriorated during the month, with the share of consumers finding jobs "harder to get" rising and the share finding jobs "easier to get" declining. Historically, the difference between the two shares tracks the unemployment rate quite well, suggesting that the jobless rate will remain elevated for some time.

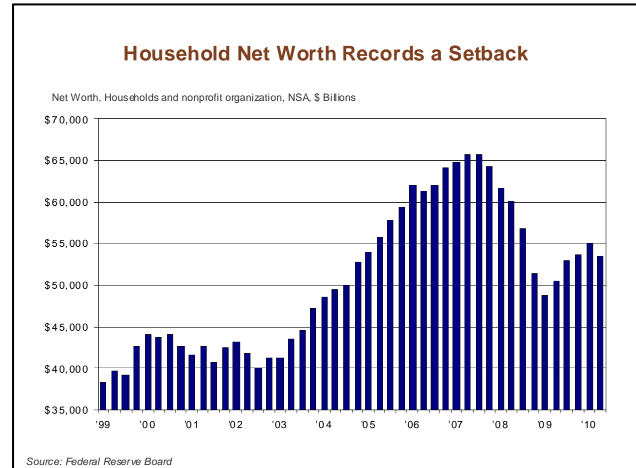
Another popular measure of consumer confidence, the Reuters/University of Michigan Consumer Sentiment Index, was much less discouraging, falling only slightly during the month. This measure is sensitive to household finances, and the rebound in the stock market in September appeared to help soothe consumers.



The persistently weak hiring and sluggish income growth prospects will continue to dampen the outlook for consumer spending and the economy. Household deleveraging is likely to continue for some time. According to the second quarter Federal Reserve Flow of Funds, household debt, including mortgage debt and consumer debt, declined for the seventh consecutive quarter, although part of the reduction was due to charge-offs rather than belt-tightening.

Monthly data of consumer credit outstanding (excluding mortgages) showed a continued decline in August, but the pace of decline during the past year has been moderating. Of the two major components of consumer credit, nonrevolving credit (largely autos) has shown better improvement than revolving credit (credit cards). Nonrevolving credit posted a gain from a year ago for the second consecutive month, while revolving credit continued to show a sizable drop from a year ago.

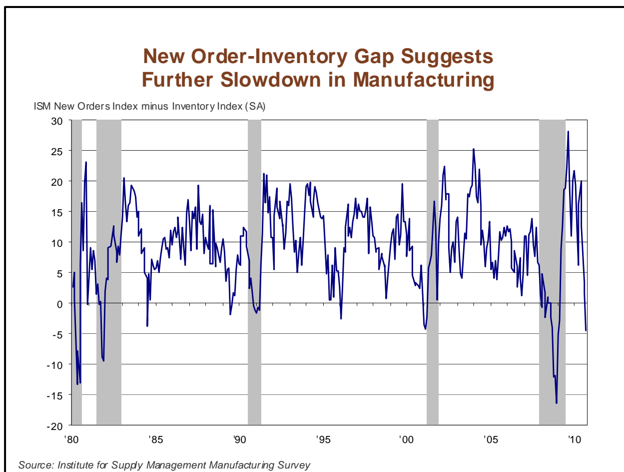




Consumers will likely continue to focus on repairing their balance sheets, which were severely damaged by the recession and the housing downturn, before they feel more comfortable spending. After rising for four consecutive quarters, household net worth (assets minus liabilities) dropped by $1.5 trillion in the second quarter of this year, due largely to declines in the value of financial assets—especially in stocks and mutual funds. This will probably be reversed in the third quarter data given the stock market upturn. While household net worth overall has rebounded since the second quarter of 2009, the gain so far has been relatively modest, dwarfed by the $17 trillion drop experienced during the recession.

Manufacturing Activity: Cooling off

Manufacturing activity, the main driver of the current economic recovery, continued to grow in September, but at a moderating pace. The Institute for Supply Management (ISM) manufacturing index fell nearly two points to 54.4, marking the fourth drop in the last five months. However, the index remains above 50—the level indicating an expansion. The headline index is a composite of several sub-indices, including the new-orders index, a leading indicator of manufacturing activity. The trend in new orders is worrisome, as the index fell for the fourth consecutive month to the lowest reading since April 2009. On the other hand, inventories, another component of the headline index, rose for the fourth consecutive month. The difference between the two series, a proxy for future production, is negative for the first time since February 2009. The negative gap is uncommon during periods of economic expansion and it suggests some weakness in industrial production ahead.



While support to manufacturing from the inventory cycle may be dwindling, business investment will likely keep the sector expanding in the near term. The upward revision in the notoriously volatile durable goods orders report suggests that business investment is not as weak as previously reported. Core capital goods orders posted a strong increase in August, and an upward revision showed a less pronounced drop in July.

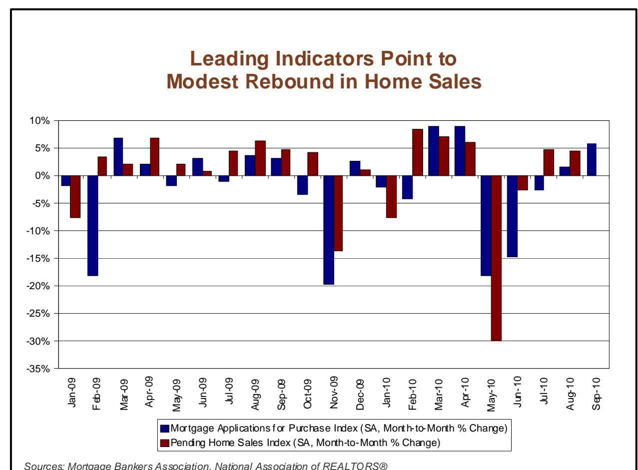
The report assuaged concerns that the manufacturing recovery was rapidly losing momentum and provided assurance that business investment should continue to be a major driver of the recovery for the rest of this year, albeit with a smaller contribution than in previous quarters. The Business Roundtable's survey of CEOs supports that notion. In the third quarter, 49 percent of executives said they planned to spend more on equipment during the next six months, up from 43 percent in the prior survey and the highest reading since the first quarter of 2006.

Counteracting signs of fading manufacturing expansion, the service sector grew at a faster pace in September, according to the ISM nonmanufacturing survey. However, both the ISM surveys continue to show that the expansion in the service industry has lagged behind manufacturing during the current recovery.

Housing Market: Stabilizing at depressed levels

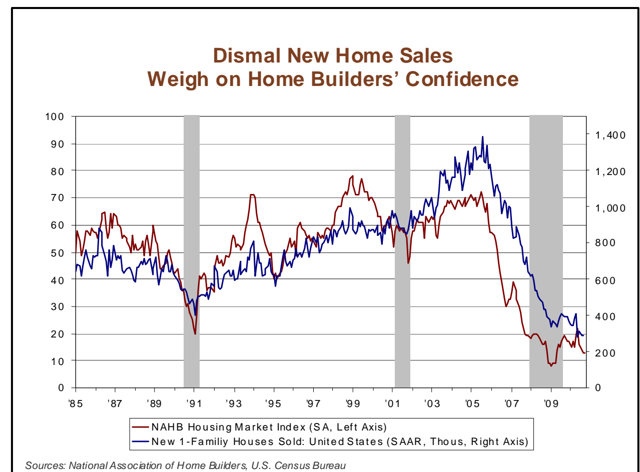
After collapsing in July, total existing home sales rebounded in August, marking the first increase in four months. New-home sales remained unchanged during the month at the second lowest level on record (only the figure reported in May was lower). Leading indicators suggest that housing is poised to resume a slow, grinding recovery. After dropping for three consecutive months, purchase applications in the Mortgage Bankers Association Weekly Survey of Mortgage Applications rebounded modestly in August and September. Weekly data showed they continued to rise in early October, reaching the highest level since the expiration of the tax credit. Pending home sales, which measure contract signings of existing home sales, also posted modest gains in June and July after dropping to record lows in May.

Home sales will likely be soft until the labor market strengthens. As a result, home building activity should remain weak. Both single-family and multifamily starts rose in August but single-family permits fell for the fifth consecutive month, suggesting limited gains in activity in the near term. Home builders' confidence remained stuck at a 17-month low level, according to the National Association of Home Builders' Housing Market Index. The rise in multifamily starts is consistent with the rise being observed in rental markets as seen in renter expectations during the next 12 months. (For more information on current national attitudes and expectations for homeownership and renting, read the article by Doug Duncan titled *Households Still Want to Own a Home, But Are Increasingly Cautious*).



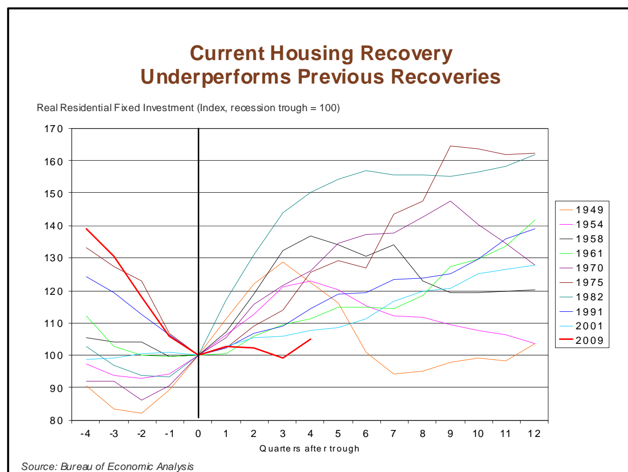
Home builders saw no improvement in current sales or expectations of sales during the next six months and a slight deterioration in the traffic of prospective buyers. They cited reluctant consumers amid a weak labor market and the large number of foreclosed properties on the market as the two leading obstacles to the new home market.

These conditions are unlikely to improve substantially this year, which will keep residential investment weak. Total construction spending increased in July, boosted by public construction spending. Private residential construction spending fell for the fourth straight month in July, while private nonresidential construction spending resumed its downtrend after rising in June for the first time in 16 months. Real residential investment is on track to drop by over 30 percent at an annualized pace in the third quarter, more than offsetting the gain in the second quarter that was boosted by the homebuyer tax credit.



Our forecast for housing activity has not changed much from the previous forecast. However, the foreclosure process problems and pause on foreclosures pose a risk to our outlook of the housing market as they create uncertainty for potential homebuyers. Foreclosed homes account for a substantial part of the existing home market and therefore a pause on foreclosures, if it spreads widely enough through the nation, has the potential to suppress home sales in the near term and interfere with the housing recovery.

Until we know more about the extent of the market disruption, we expect total housing starts to increase in 2010 by about six percent from 2009's record-low level. Total home sales this year are projected to decline by about seven percent from 2009. Residential investment is expected to be a slight drag to economic growth in 2010, extending the streak to an unprecedented five years. Such weakness in residential real estate at this stage of the recovery is rare. The housing recovery, as measured by the rebound in real residential investment during the first year of the overall economic recovery, is the weakest since the end of World War II.



Various home price measures softened in July as expected, showing a payback from the homebuyer tax credit as home sales plummeted. The CoreLogic Home Price Index, the Case-Shiller Composite 20 Index, and the FHFA Purchase-Only Home Price Index all posted declines on a seasonally adjusted basis. However, on a year-over-year basis, these measures showed different pictures of home price trends. The Case-Shiller index continued to show a gain, albeit the smallest in four months, while the CoreLogic index was relatively flat after five months of year-over-year gains. The FHFA index continued to decline from its year-ago level, showing the biggest drop since February. Since September 2007, this index has only once shown a year-over-year gain. Our forecast anticipates a modest decline in home prices into 2011, essentially taking back the price gains induced by the temporary tax credit.

Mortgage Market: Refinancing loses steam

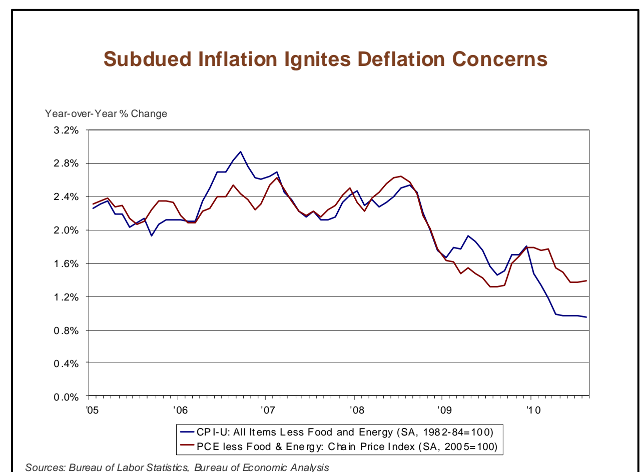
While purchase mortgage applications have trended up gradually in the wake of the drop-off at the expiration of the homebuyer tax credit, refinance applications have dropped for five consecutive weeks since reaching a 15-month high at the end of August, despite record low mortgage rates. After declining earlier in the summer, the 10-year Treasury yield hovered around 2.50 percent and 2.75 percent in September before dipping toward 2.35 percent in early October as speculation regarding a second round of quantitative easing increased amid news of disappointing labor market data. Our forecast shows mortgage rates hovering around current levels of 4.3 percent through most of 2011, similar to the previous forecast, given our outlook for sub-par but steady growth through most of next year. There is, however, a downside risk to

the mortgage rate outlook that arises from the expected forthcoming quantitative easing, which has the potential to boost mortgage production somewhat in late 2010 and early 2011, especially for refinance originations.

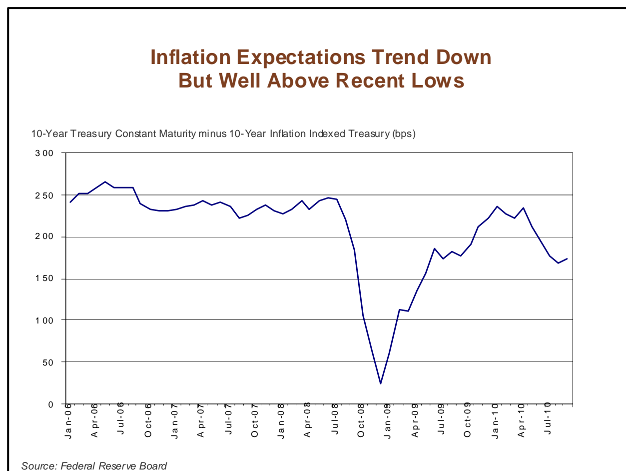
For all of 2010, total mortgage originations are projected to decline to $1.5 trillion from an estimated $1.9 trillion in 2009, with a refinance share of 65 percent. Total single-family mortgage debt outstanding is projected to decline by 3.1 percent, compared with a 1.9 percent decline in 2009.

Fed: Dual mandate cited for second round of quantitative easing

While the unemployment rate has remained high in the presence of weak growth, inflation has been historically low. The inflation measure tied to personal consumption spending (PCE) continues to be tame, with the core PCE price index (the Fed's preferred measure, which excludes food and energy) increasing 0.1 percent in August and 1.4 percent from a year ago. Another popular measure of underlying inflation, the core consumer price index (CPI), shows even more muted inflation trends, rising less than one percent from a year ago since April.



Inflation expectations, as measured by the spread between the yields on Treasuries and Treasury Inflation Protected Securities (TIPS), have trended down steadily since spring. However, they remain well above the levels seen in late 2008 during the depths of the financial crisis.



Recent inflation trends have sparked deflationary concerns for the Fed, supporting arguments for another round of quantitative easing. Fed Chairman Bernanke's speech at Jackson Hole in late August provided a strong signal that an additional monetary easing is likely should the economy falter further. The September FOMC statement heightened that speculation because it was the first time that the Fed noted that inflation is running below levels consistent with its mandate to promote maximum employment and price stability.

The strongest hint of quantitative easing came in a speech in late September by New York Fed President William Dudley (also the Vice Chairman of the FOMC). He argued that current economic conditions are "unacceptable" and that further action is likely to be warranted unless the outlook for the labor market and inflation improves materially. Thus, in Dudley's view, deteriorations in economic conditions are not necessary to justify an easing. Instead, further quantitative easing should be implemented unless conditions improve sufficiently.

While not all Fed officials agree that further actions are needed or will be effective, Chairman Bernanke said in a speech early this month that further asset purchases could be helpful in easing financial conditions. Given these developments, an announcement of some form of quantitative easing appears to be certain, but specifics remain to be seen and thus its impact is uncertain. If consumers believe this could lower mortgage rates, the delay in announcement or market response may suppress mortgage activity somewhat in the short run.

Besides uncertainty stemming from monetary policy, another main source of uncertainty is fiscal policy. The scheduled expiration at the end of this year of the tax cuts put in place in 2001 and 2003, and almost all of the tax relief provided in the American Recovery and Reinvestment Act of 2009 (ARRA), means household and business planning horizons likely have been disrupted. We believe this has contributed to financially conservative behaviors by both households and

businesses. In addition, the current program of expanded unemployment benefits is slated to expire at the end of November.

Externally, European countries continue to struggle to repair their finances and prevent a collapse of their banking systems after a sovereign debt crisis that has roiled markets. The Basel response to the crisis combined with the financial reform bill in the U.S. will likely constrain credit growth with a knock-on effect on the U.S. economy. The debate over the Chinese currency and exchange rates will likely continue going forward. All these factors will combine to create a great deal of uncertainty hanging over financial markets and posing substantial challenges and risks to the outlook.

Doug Duncan and Orawin T. Velz
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