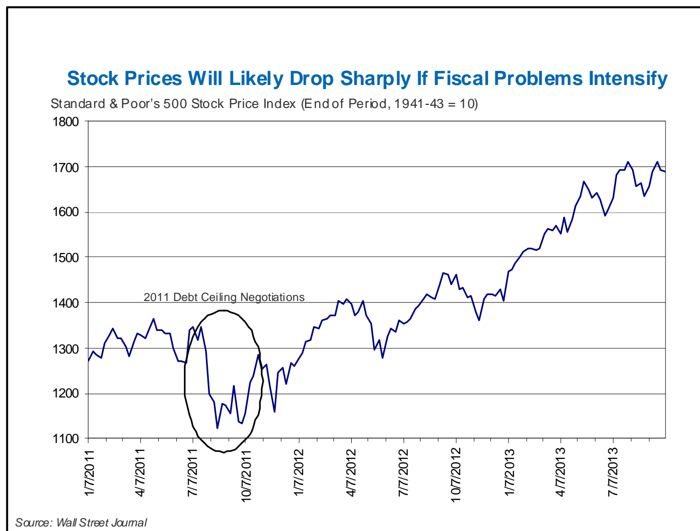
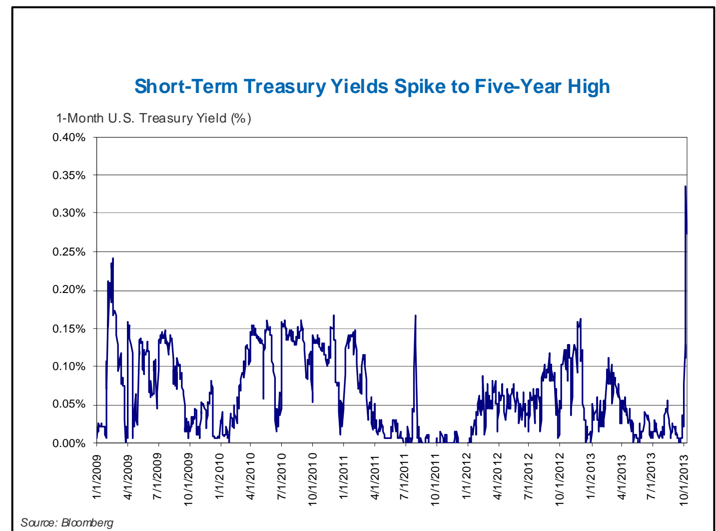
Fiscal Debate Threatens Underperforming Economy; Fed Stands Pat

Incoming economic data support our forecast that economic growth slowed in the third quarter. However, rising fiscal risks have threatened our expectation of a pickup in growth in the current quarter. As Congress failed to reach an agreement to extend the continuing resolution, which expired at the end of September, a government shutdown and the furlough of nonessential federal employees began on October 1.

The shutdown appears to roll over into another, much bigger issue—raising the debt ceiling. The odds have risen that lawmakers will fail to reach an agreement on the debt ceiling before October 17—the date the Treasury expects to exhaust extraordinary measures to extend borrowing capacity. Many market participants believe the Treasury will likely deplete its cash and face the risk of a technical default—in which Treasury misses a payment on its debt obligation—by October 31. We expect the negotiation to raise the debt ceiling to be contentious, increasing market volatility, and eroding business and consumer confidence as October progresses.

Our forecast assumes the shutdown will last between two and three weeks, followed by an increase in the debt ceiling without triggering a technical default or a downgrade of U.S. sovereign debt. Combined with slowing momentum in economic activity from the second quarter to the third, fiscal events led us to revise lower our forecast of economic growth in the final quarter by approximately one-half of a percentage point to 2.0 percent, bringing full-year growth to 1.9 percent, compared with 2.0 percent in the prior forecast. Our outlook is subject to downside risks. If Congress fails to lift the debt limit by October 17 or soon thereafter, financial market volatility will likely intensify amid a substantial sell-off in stock markets, widening risk spreads, and a plunge in confidence. During the August 2011 debt ceiling debate and the resulting downgrade of U.S. debt by Standard and Poor's, the S&P 500 composite index plunged, dropping more than 10 percent during the month, the largest one-month decline since October 2008.





Fiscal Policy: Government Shutdown Merges into Debt Ceiling Negotiations

The fiscal situation is fluid. At the time of this writing, the focus of lawmakers was on raising the debt ceiling, as House Republicans planned to put on the table a six-week extension of the nation's borrowing limit in exchange for wide-ranging negotiations on spending and other issues. So far, short-term Treasuries have taken a hit from default concerns. Treasury bills with maturities between October 17 and October 31 sold off sharply. The yield on one-month Treasury bills approached 0.35 percent, the highest in five years. We believe the odds of a technical default are very low, as the Treasury has the ability to prioritize payments and meet obligations to debt holders. However, failing to raise the debt ceiling would be an extraordinarily high-risk strategy and would likely be very costly to financial markets and consumer and business confidence, threatening the still fragile economic recovery.

Monetary Policy: Fed Maintains its Monetary Policy Posture

In contrast to our expectations and those of numerous financial market participants for the Fed to begin scaling back the pace of its asset purchases in September, the Fed stayed the course to see more evidence of sustained improvement in the economy.

Its decision to maintain the pace of its asset purchases has helped bring down long-term interest rates, which, in addition to continuing support for housing, has the added effect of cushioning some of the adverse impact of the shutdown and debt ceiling debates. However, the resulting improved financial conditions are not enough to offset some weakening in near-term momentum and fiscal headwinds.

Given increased headwinds and the lack of important economic data due to the government shutdown, hindering a clearer reading of the economy, we now expect the Fed to start tapering next year and end its asset purchase program in the second half of 2014. We expect no funds rate hikes until the third quarter of 2015, when we project that the unemployment rate will decline to approximately 6.5 percent, consistent with the current guidance that there will be no increase in the target interest rate as long as the unemployment rate is still above 6.5 percent, provided inflation expectations remain well anchored. The nomination of Janet Yellen, the current Fed Vice Chair, to replace Chairman Ben Bernanke appears to set the tone of continuity with respect to the policies that the Federal Open Market Committee (FOMC) has adopted under Chairman Bernanke. However, how the FOMC with its new leadership will conduct monetary policy in coming years, including the daunting task of unwinding the Fed's outsized balance sheet, also will be impacted by the annual voting rotation of the regional Fed Presidents and the filling of the vacant positions on the Board of Governors, including a replacement for Vice Chair Yellen.

Economy: Muddling Through the Final Quarter

The economy grew at a 2.5 percent annualized rate in the second quarter, according to the Bureau of Economic Analysis' final estimate of gross domestic product (GDP)—unchanged from the previous estimate—bringing the average growth in the first half of 2013 to 1.8 percent. The biggest driver—consumer spending—was unrevised, in contrast with our expectation of an upward revision given that the data from the Quarterly Services Survey pointed to more spending on services during the quarter, which should have lifted the momentum for service spending in the third quarter as well.

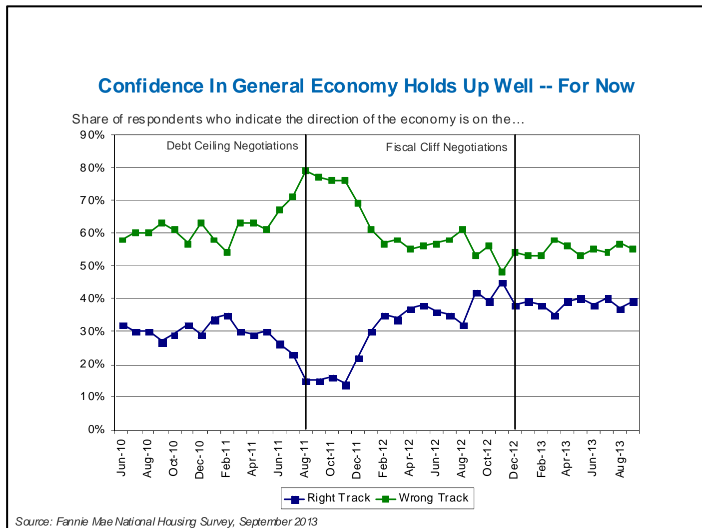
So far, data related to consumer spending pointed to moderating growth in the current quarter. Real (inflation-adjusted) consumer spending rose a modest 0.2 percent in August following an anemic 0.1 percent rise in July. Incoming data for September were discouraging. After a surge in August, auto sales disappointed in September, slipping 5.1 percent to 15.3 million annualized units. Some of the weakness for September may have resulted from the unusual timing of the Labor Day holiday, as part of this year's holiday weekend was in August. Thus, the seasonal factors may have boosted sales in August at the expense of September.

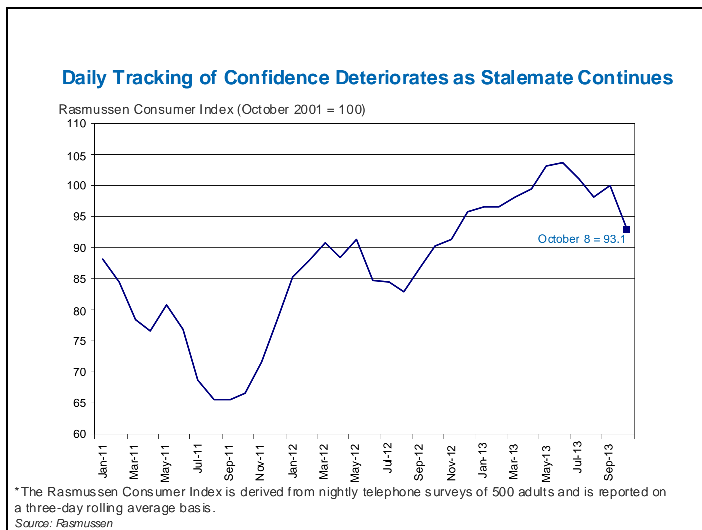
The government shutdown (an event we thought would be avoided) adds downside risks to the outlook on consumer spending. The direct economic impact of the furlough of non-essential government workers will be reflected in the current quarter GDP of the government sector in the form of reduced income and hours worked. Most estimates show a decline of between 0.10 and 0.15 percentage points in the quarterly annualized real GDP growth per week of shutdown, which would rebound when furloughed workers return to work. We expect the actual impact will be smaller given that the Department of Defense reduced the number of workers furloughed, bringing the estimated number of total affected workers from 800,000 during the first week of the shutdown to approximately 500,000. In addition, if furloughed workers are paid retroactively, similar to prior government shutdowns, it would limit the negative impact on consumer spending. There could be an indirect impact on consumer spending from a protracted shutdown through deteriorating consumer confidence and declining stock markets, but such an impact is difficult to quantify.

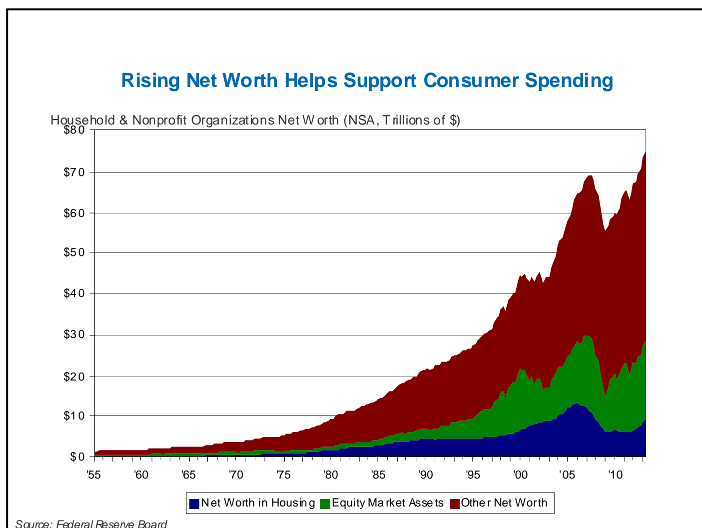
Measures of consumer attitudes also softened in September. The Conference Board consumer confidence index fell to a four-month low, due solely to a decline in the expectations component. The Reuters/University of Michigan consumer sentiment index improved between the preliminary and final readings, but was down sharply from August.

The September Fannie Mae National Housing Survey showed that confidence in the general economy held up relatively well. The gap between the share of consumers who believe that the economy is on the wrong track and those who think the economy is on the right track declined to 16 percentage points, an improvement from August. The gap could widen in

October, depending on the outcome of the debt ceiling negotiations. During the debt ceiling debates in August 2011, the right track-wrong track gap widened to a survey record of 64 percentage points.







The daily Rasmussen consumer index, which has the advantage of tracking consumer attitudes in a more timely manner, showed that confidence trended down in early October and would likely dip further if the fiscal standoff continues through mid- or late-October. During the August 2011 debt ceiling debates, the index fell sharply to 65.6—eight points above its record low recorded during the 2007-2009 recession.

One source of support for consumers is the sharp increase in household net worth—assets minus liabilities—over the past year. During the second quarter of 2013, net worth rose $1.34 trillion to $74.8 trillion, supported by both financial and housing gains. Households have recovered, on a nominal basis, from the massive decline in their net worth witnessed during the recession as net worth is $5.8 trillion above its pre-recession peak reached in the third quarter of 2007.

An improving housing market has played an important role in boosting gains in household net worth. Rapid home price appreciation over the past year has helped boost the value of household real estate assets. The CoreLogic home price index, a measure used by the Federal Reserve to estimate household real estate assets, continued to post strong year-over-year gains in July and August, rising 11.9 percent and 12.4 percent, respectively. The ongoing strength in home prices points to another solid gain in housing wealth in the third quarter.

On the business front, a measure of small business confidence was little changed in September, with the National Federation of Independent Business Small Business Optimism Index edging down only slightly during the month. One notable detail was a sharp drop in the share of respondents who expect the economy to improve during the next six months. Regarding the number one problem among small business owners, 24 percent of those surveyed cited “regulations and red tape,” the highest share since early 1994 and near its record high of 27 percent seen in August 1994. “Poor sales” was cited by 17 percent of the respondents, trending down from the record high of 34 percent observed in late 2009 and early 2010 and approaching 14 percent, the series average since the inception of the monthly survey in 1986.

Incoming data during the past month were lighter than normal, as the furlough of government employees resulted in delays in economic releases, including the September jobs report. Despite the shutdown, the Department of Labor will continue to release weekly initial jobless claims, which showed that claims spiked in the most recent week, both reflecting glitches with the integration of a new computer

system in California and private sector employees being out of work in connection with the government shutdown. The four-week moving average moved higher after hitting a new low for the expansion in the prior week.

While declining layoffs suggest an ongoing and gradual improvement in labor market conditions, they do not indicate stronger hiring. Labor market data from private firm ADP showed that private payrolls rose 166,000 in September from a gain of 159,000 in August, which was revised lower from 176,000. The average monthly gain during the third quarter was slightly stronger than that in the second quarter, but still weaker than witnessed during the first quarter.

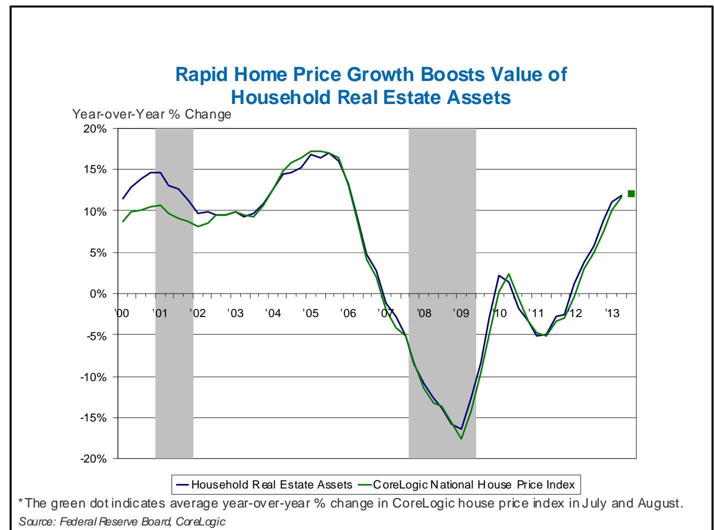
Surveys of purchasing managers showed mixed economic activity in September. The Institute for Supply Management (ISM) nonmanufacturing index—a gauge for activity in the service sector—posted the largest monthly decline since November 2008, sending the index to the lowest reading since June. By contrast, the ISM manufacturing index rose for the fourth consecutive month to the highest level since April 2011.

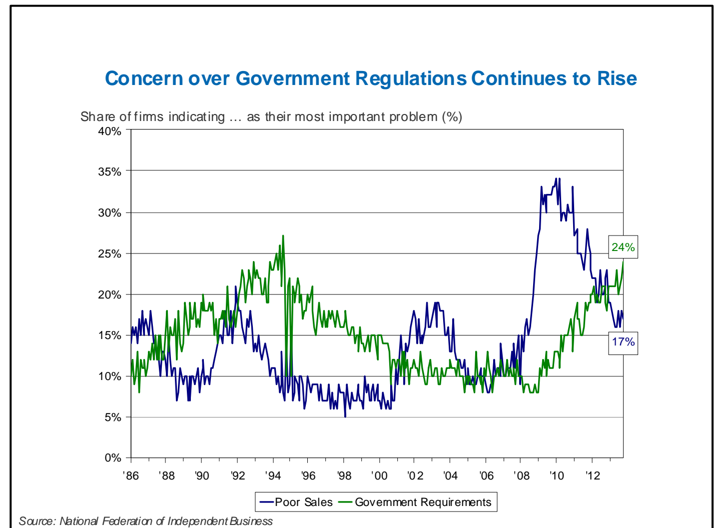
Unfortunately, the optimism in the manufacturing survey of purchasing managers during the past several months has not translated into strength in business capital investment. It appears that businesses lack confidence in consumer demand and will likely remain cautious about making capital investments. Shipments of nondefense capital goods excluding aircraft—an input used to estimate business investment in equipment and intellectual property—rose in August for the first time in three months but not enough to offset the decline in the prior month, suggesting continued weak business capital investment in the third quarter.

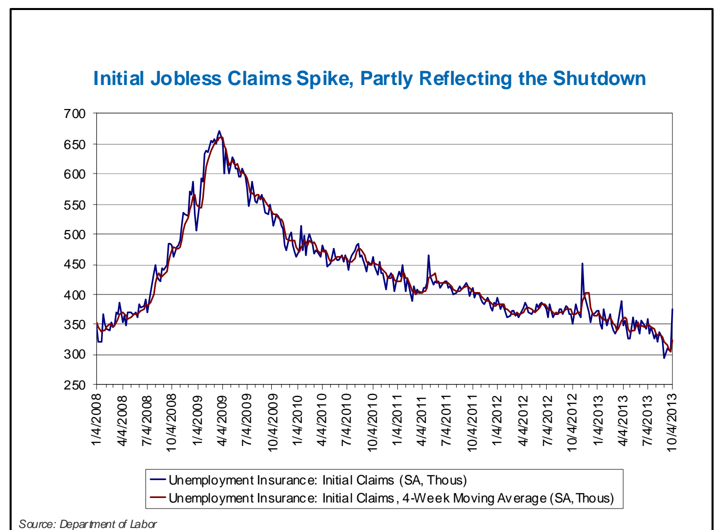
Combined with the impact of the government shutdown and rising fiscal risks, the weakening momentum in both consumer spending and business investment expected in the third quarter led us to shave our forecast of economic growth in the fourth quarter.

Housing: Recovery Temporarily Interrupted but Not Derailed

Recent declines in long-term interest rates should help support the housing market. After closing at a two-year high of 2.99 percent on September 5, the yield on 10-year Treasuries has dropped, holding around 2.7 percent at the time of this writing. Data from Freddie Mac showed that the average rate for a 30-year fixed-rate mortgage for the second week of October was 4.23 percent. While the rate is 35 basis points lower than its recent peak, it has remained nearly 90 basis points above the rate in early May before





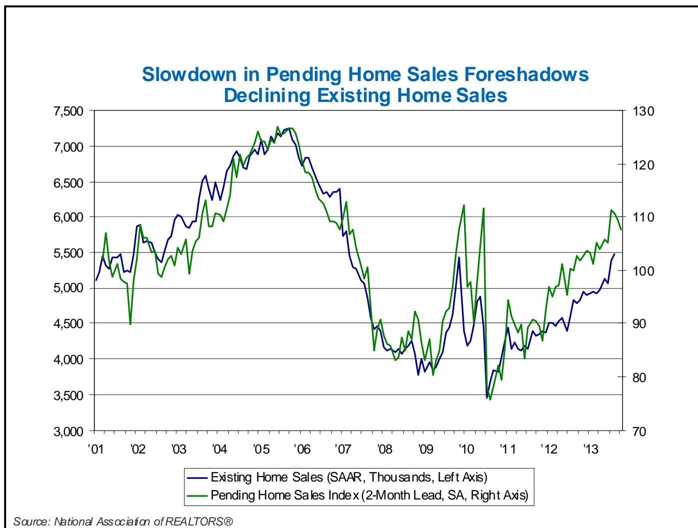


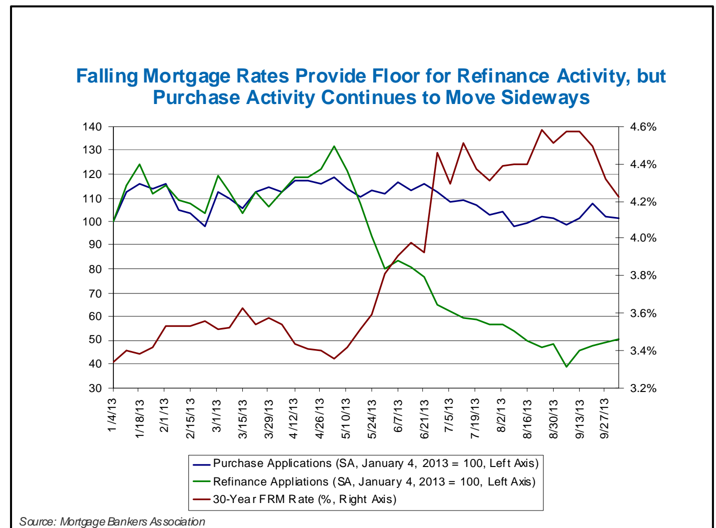
the Fed's tapering talk began. We expect mortgage rates to rise gradually this year, averaging 4.4 percent in the fourth quarter of 2013 and 5.0 percent a year from now—about 20 to 30 basis points lower than our projected path in the September forecast.

Incoming housing indicators were generally positive. Existing home sales rose to their highest level in more than six years, likely reflecting a rush to buy before mortgage rates rose even further. After jumping in May when mortgage rates started to rise, pending home sales, which measure contract signings of existing homes and are a leading indicator of existing home sales, declined in August for a third consecutive month, suggesting a pullback in sales in the fourth quarter.

Year-to-date sales through August were nearly 12 percent above those during the same period last year. Even with a projected sharp decline for sales through the rest of the year, we project that existing home sales will rise by about 10 percent in 2013 from 2012, slightly stronger than our previous forecast.

Meanwhile, a measure of homebuilders' confidence from the National Association of Home Builders remained at a recovery high in September, with the measure of prospective buyer traffic posting a gain, despite continued rising mortgage rates through the first half of the month. While homebuilders' confidence averaged much higher in the third quarter than in the second quarter, new home sales will likely show a decline in the third quarter, despite a rebound in August. During the first eight months of the year, new home sales were about 20 percent above the pace during the same time last year, and we expect the full-year gain to be approximately 18 percent, the same as in the prior forecast.

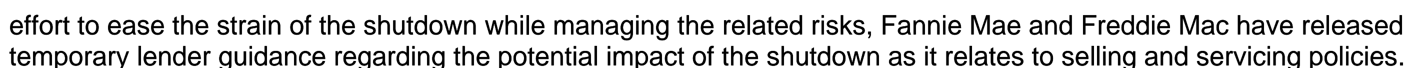




After several months of disappointing data, single-family starts rebounded in August to the highest level since February, and single-family permits rose for the fourth time in the last five months to a recovery high. Both multifamily starts and permits fell in August. While single-family activity has moved sideways this year, multifamily starts have declined sharply from their recovery peak seen earlier this year following rapid rises in prior years. (For more information on multifamily market conditions, read the October 2013 Multifamily Market Commentary.)

While we do not expect the recent decline in mortgage rates to revive the refinance boom, it should provide another window of opportunity for some homeowners to refinance. Data from the Mortgage Bankers Association showed increased refinance activity as refinance applications rose during the first week of October for the fourth consecutive week. Purchase activity has seen limited improvement, however. A highly contentious debt ceiling debate will likely bring mortgage rates down even lower and could spark another mini refinancing boom, but it could be at the expense of the purchase market.

With our expectation that the shutdown will last less than a month and the debt ceiling will be raised, the impact on the mortgage market likely will be limited. The FHA and VA continue to process new loans despite reduced staff, and lenders with delegated authority will endorse new loans independent of the FHA. Nevertheless, the shutdown likely will impact some housing activity, including the pace of FHA endorsements for small FHA lenders as well as Ginnie Mae issuance. In addition, industry players may experience shutdown-related processing issues or exercise caution amid uncertainty. In an



effort to ease the strain of the shutdown while managing the related risks, Fannie Mae and Freddie Mac have released temporary lender guidance regarding the potential impact of the shutdown as it relates to selling and servicing policies.

As mentioned earlier, measures of home prices such as the CoreLogic home price index continue to show rapid year-over-year gains; however; we expect the gains to moderate in coming months. Given the rapid home price appreciation year to date, we revised higher our forecast of home prices for this year and next year. As a result of an annual benchmark to recently released data from the 2012 Home Mortgage Disclosure Act (HMDA), we revised higher our estimate of total mortgage originations in 2012 by $127 billion to $2.15 trillion. Coupled with the projected decline in mortgage rates, the upgrade in mortgage production volume in 2012 led to higher trajectories for mortgage originations in 2013 and 2014. For all of 2013, we expect total mortgage originations to decline about 15 percent to $1.83 trillion, with the refinance share dropping 10 percentage points from an estimated 72 percent in 2012. With expected rising mortgage rates through 2014, refinancing originations are projected to decline further, outweighing the expected increase in purchase mortgage originations, bringing total mortgage originations down to $1.36 trillion in 2014. Total single-family mortgage debt outstanding fell 1.8 percent annualized in the second quarter against our expectation of an increase, leading us to downgrade our forecast. For 2013, we expect mortgage debt outstanding to post a small decline, marking the sixth consecutive annual drop.

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For details of the analysis please contact Patrick at patrick_a_simmons@fanniemae.com.

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