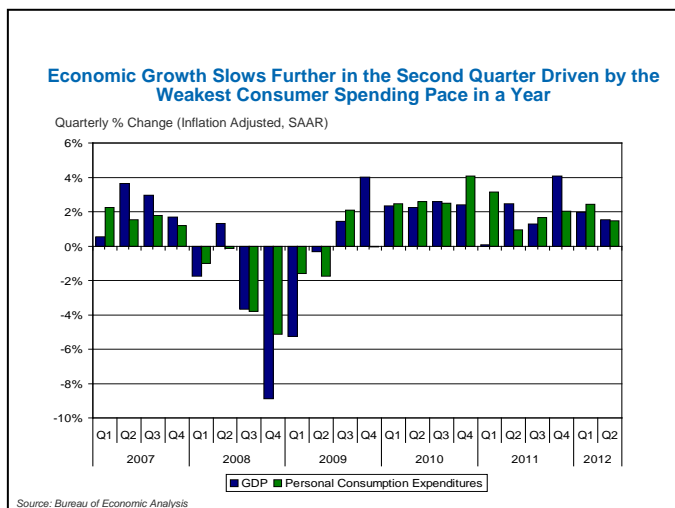


Stuck at Subpar Growth

The economy clearly lost momentum during the first half of this year. The first estimate on gross domestic product (GDP) showed that economic growth slowed further to a 1.5 percent annualized rate in the second quarter, from 2.0 percent in the first quarter and 4.1 percent in the final quarter of 2011. For the third year in a row there was a spring slowdown that threatened to resolve into a recession yet now looks to be gradually grinding back to weak sustained growth. Despite the stimulus the Federal Reserve is supplying as well as the huge federal stimulus expenditures designed to rev up growth, the results have been discouraging as is evident in consumer and small business confidence measures, which are well below long-term averages.

Inflation-adjusted consumer spending growth led the second quarter deceleration, moderating by nearly a percentage point to a one-year low of 1.5 percent.



Real nonresidential investment posted the slowest growth since the first quarter of 2011, while real residential investment moderated to half the double-digit pace recorded in the first quarter of 2012. With the ongoing global economic slowdown, net exports turned into a slight drag on growth after contributing to growth in the prior quarter, and government continued to be a drag on growth for the eighth consecutive quarter. The pace of economic growth would have been weaker if not for the pickup in inventory investment, which added 0.3 percentage points to the current quarter's GDP growth, but this will likely be given back in coming quarters.

Job growth decelerated dramatically in the second quarter from the robust pace in the first quarter but picked up in July, posting the strongest gain in five months. While the employment picture improved in July, the rest of the economy,

with the exception of housing, continues to struggle. Housing indicators have performed relatively better over the course of this year than last, confirming our view that the market has bottomed. Home sales have softened recently in line with the overall weakening in consumer activity. However, the July Fannie Mae National Housing Survey showed that consumer expectations on housing remain upbeat, supported by recent improving trends and historically low mortgage rates. Healthy job gains, if sustained, would help bolster the upward trend of consumer attitudes toward housing, which so far have been a glimmer of light amid a dimming economic outlook.

Despite a marked slowdown in economic activity, we believe that a repeat of the “stall speed” – a period of growth of one percent or less seen at the beginning of 2011, is unlikely. We expect growth to remain below 2 percent in the second half of the year, a slight downgrade from the prior forecast, leaving full-year growth at its first-half pace of 1.8 percent, with risks remaining tilted toward the downside. Despite statements from the European Central Bank that it is prepared to take a more active stance to stabilize European debt markets, the euro zone will continue to present a headwind to U.S. economic growth. Another serious challenge to the economy is the uncertainty around the domestic policy environment, including a potential fiscal drag of roughly 4 percent of GDP in 2013 under current legislation, as well as a looming debate about raising the debt ceiling around year-end.

Consumer spending ended the second quarter with a whimper, remaining unchanged in June. After adjusting for inflation, spending declined 0.1 percent, the first drop since August 2011, as spending on durable goods and services held steady while spending on nondurables fell. The drop in June sent the level of real consumer spending to below the second

quarter average, setting up a weak trajectory for the current quarter. July auto sales hinted at continued weakness in spending at the start of the third quarter, falling 2.0 percent to 14.1 million units (annualized rate).

On a more positive note, personal income rose 0.5 percent in June, driven by a strong increase in wages and salaries during the month. With nominal disposable income growth outpacing growth in nominal spending, the saving rate rose 0.4 percentage points to 4.4 percent, reversing much of the decline recorded in the second half of 2011. The pickup in the saving rate of 0.8 percentage points in just two months suggests that consumers have become much more cautious amid a slowdown in hiring.

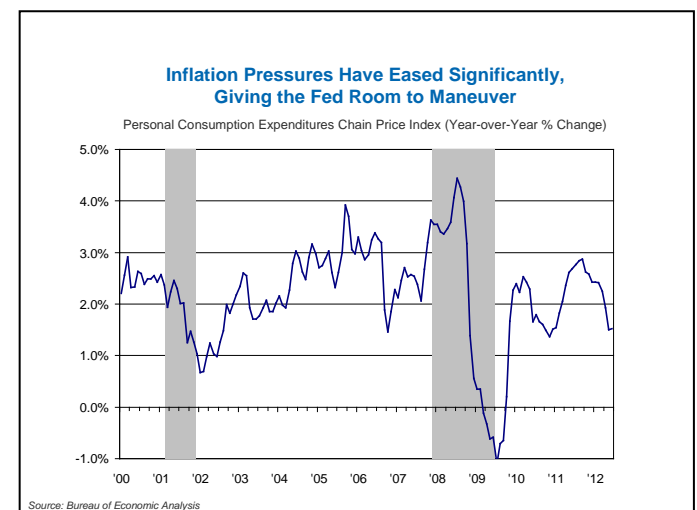
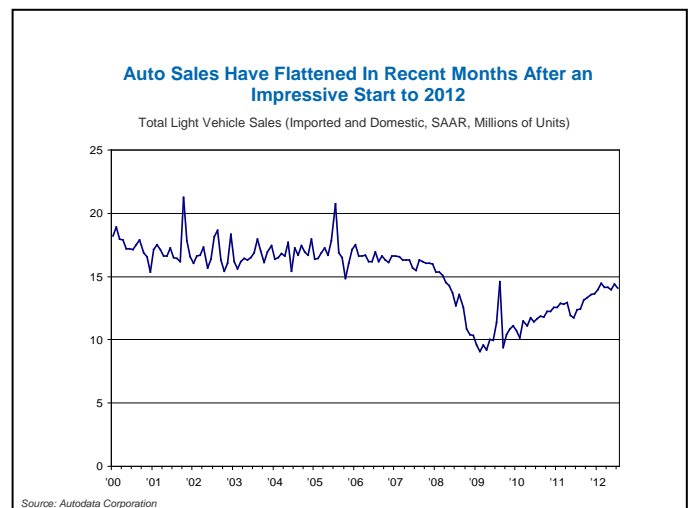
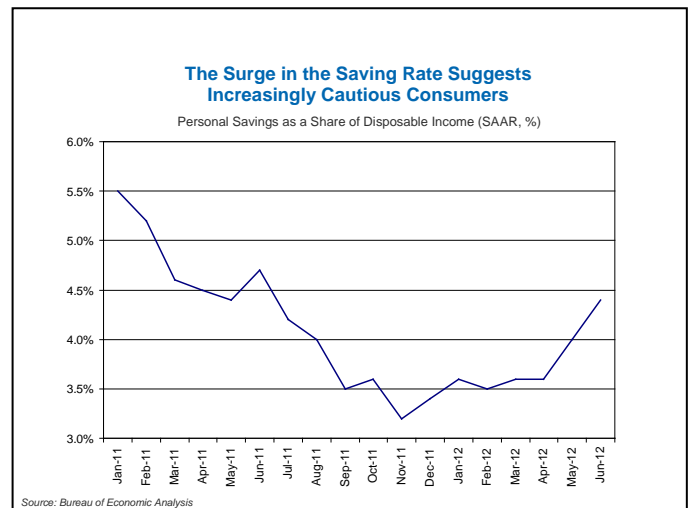
While the build-up in saving is negative for consumer spending in the near term, it helps households establish a cushion against financial setbacks and build up their balance sheet, which is positive for spending in the longer term.

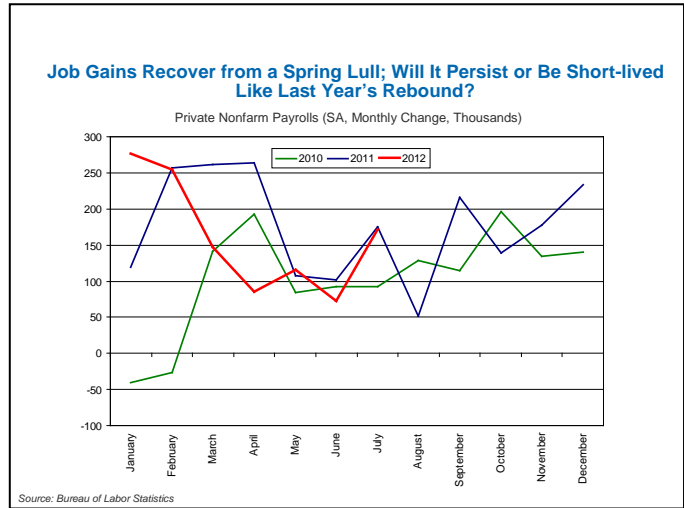
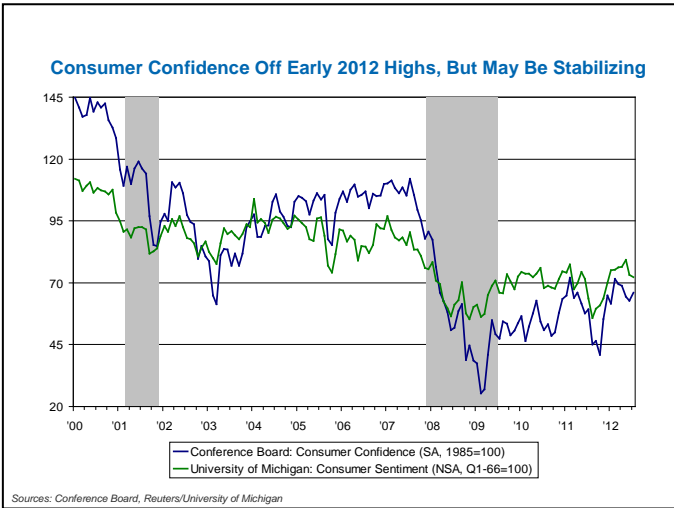
Adjusting for taxes and inflation, real disposable income has continued to recover, rising at a 3.8 percent annual rate over the three months ending in June, on the back of declining gasoline prices. While the recent strength in real disposable income may be unsustainable, it should help provide some resiliency to the picture for future spending in the face of downside risks.

The price index tied to consumer spending—the personal consumption expenditures price index—edged up 0.1 percent in June. From a year ago, prices rose 1.5 percent, well within the Fed's inflation target of 2.0 percent. Essentially, inflationary pressure is muted, which should give the Fed room to maneuver if it deems further easing is necessary.

Measures of consumer confidence were mixed in July. The Conference Board Consumer Confidence Index showed signs of stabilization, rebounding in July for the first time in five months, but the Reuters/University of Michigan consumer sentiment index fell in July for the second consecutive month. While confidence measures have given back their gains from earlier this year they remain well above the levels of late 2011, following the debt ceiling debate.

The improving employment picture should help ease consumer fears that the economic expansion will grind to a halt. Nonfarm payrolls rose by 163,000 in July. A jump in nonfarm payrolls also occurred in July 2011 only to fizzle away in August 2011. For 2012, there was a one-time factor boosting the overall gain, which occurred in the motor vehicle sector because the usual temporary shutdowns were delayed or cancelled. It is likely that businesses will continue to take a cautious stance in hiring in the face of domestic and foreign fiscal uncertainties, which could make the July pace of hiring unsustainable.



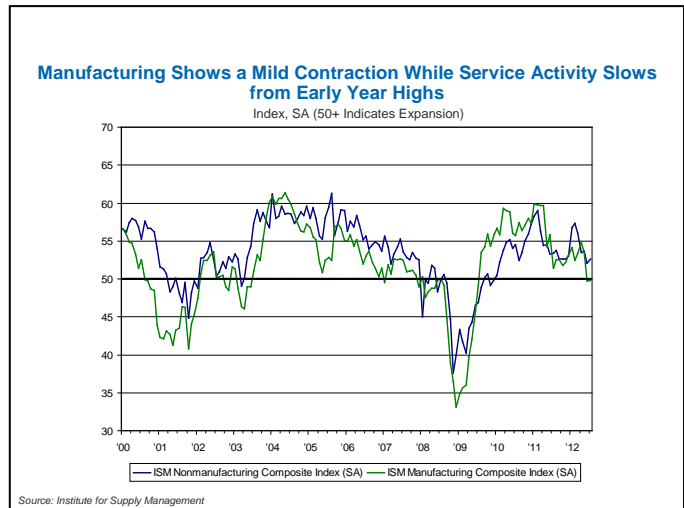


Other aspects of the report were less impressive. The average workweek was unchanged at 34.5 hours, and average hourly earnings for all private employees edged up just 0.1 percent from June and 1.7 percent from a year ago—the smallest gain on record since the inception of the series in 2007. The breadth of job gains also deteriorated during the month, as the diffusion index fell to an eight-month low.

The results from the household survey were downbeat. The uptick in the unemployment rate for the second time in three months to 8.3 percent was due to declining household employment that outpaced a shrinking labor force. The broadest measure of unemployment—which includes marginally attached jobseekers and those working part-time for economic reasons—rose one-tenth of a percentage point to 15.0 percent, its highest level since January. Another measure of the slack of the labor market, the employment-to-population ratio, fell two-tenths of a percentage point to near the cycle low of 58.4 percent and 5 percentage points below the pre-recession peak.

The support for ongoing gains in employment remains tenuous. The Institute for Supply Management (ISM) manufacturing index was little changed in July, remaining in mild contraction territory, confirming that the global economic slowdown is affecting businesses in the U.S. The ISM nonmanufacturing index was slightly higher in July after a large drop in the prior month but the level is still below its average of the second quarter. One notable result from these two surveys is that the employment components continued to deteriorate in July, which is at odds with the relatively upbeat employment report.

Business investment in equipment and software growth will likely slow in the current quarter, in line with firms' expectations of reduced demand. Its leading indicator—nondefense capital goods orders excluding aircraft—fell in June for the third time in the last four months. Investment on nonresidential structures, which barely grew in the first quarter, should pick up only modestly during the rest of the year, as high vacancy rates and limited financing will continue to restrain this sector. While the slowdown in global growth should restrain U.S. exports, as reflected in the weakness in the export orders component of the ISM surveys, the weak domestic economy also should limit import growth, and for the year, the foreign sector should contribute slightly to real GDP.



Finally, federal, state, and local government spending is expected to continue to be a drag to growth this year. For 2013, the extent of the fiscal contraction—spending cuts and tax increases—is highly uncertain. We continue to assume that not all of the possible tax increases will occur and expect no large across-the-board sequestration in 2013, as it is now generally believed that the economy is too fragile to withstand such a large fiscal contraction. According to the Congressional Budget Office (CBO) estimate, the impact on the economy of the full fiscal contraction scheduled under current law is roughly 4 percentage points on GDP growth. We assume that the payroll tax holiday and federal emergency unemployment benefits will expire at the end of the year while we expect extensions of the Alternative Minimum Tax (AMT) patch and the so-called “doc fix” adjustment to Medicare reimbursement rates. For the Bush tax cuts, we assume that they will not sunset at the end of this year as legislated, except for the top marginal rate taxpayers. In all, we estimate that for 2013, the drag on GDP growth from the fiscal contraction will total roughly 1 percentage point.

How much the Federal Reserve thinks it can do to stimulate growth (as opposed to the measureable effect of its actions) remains to be seen. We expect an announcement of additional easing at the September Fed Board meeting, which will likely contain additional actions in the mortgage space, perhaps mainly in this space. Another 50 basis-point drop in mortgage rates would undoubtedly spur additional refinances. A word of caution, though, as a look back to the 2003 refinance boom that occurred in a healthy economy saw only 50 percent of borrowers with a mortgage in the money (for example, borrowers who would see financial benefit from refinancing into a lower mortgage rate by lowering their current rate approximately 50 basis points or more) actually refinance. Additionally, those lower rates may add to purchase mortgage demand, albeit incrementally, since they have been flat for some time. That said, the Fed has had some impact on housing.

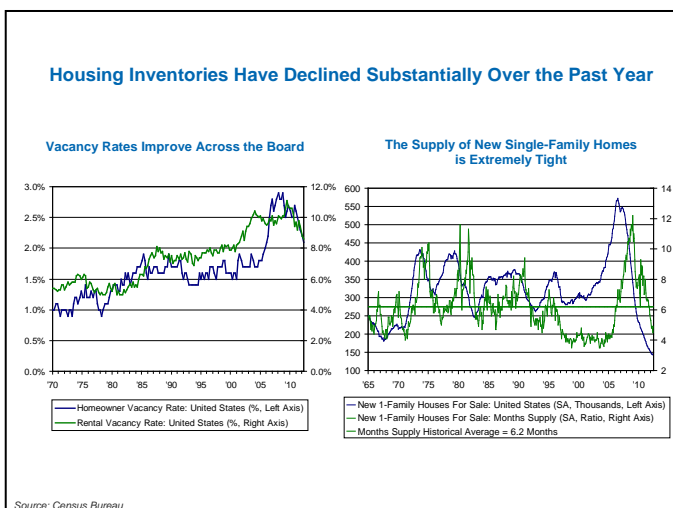
Housing: Bottom Reached, on Track for a Gradual, Durable Recovery

Despite a slowdown in the overall economy, the housing market has continued to recover, rising significantly above year-ago levels, and confirming our view that the market has troughed and a gradual recovery is under way. Sizable gains will be off of very low bases, however. Housing inventories have declined substantially over the past year, reflected in the downtrend in both the homeowner and rental vacancy rates—a gauge for excess supply in the housing market. For the new home market, the number of homes available for sale totaled just 144,000 units in June, near May’s all-time record low of 143,000 units. The months’ supply for new homes was 4.9 months in June, well below the long-term average of 6.2 months.

Tighter supply in some areas has allowed homebuilding activity to rise. Single-family housing starts rose in June for the fourth consecutive month, while multifamily increased for the second time in the last three months. During the first six months of this year, single-family starts were 21 percent above the level during the same period last year, compared with 42 percent for multifamily. We expect construction activity to continue to advance at a healthy pace, with single-family and multifamily starts rising by 20 and 30 percent, respectively, in 2012 from 2011. (For more information on multifamily

market conditions and preliminary trends showing continued expansion for the sector, read the [August 2012 Multifamily Market Commentary](#)). With continued gains in other components of residential investment, including broker commissions and home improvement, we expect that residential investment will contribute about 0.2 percentage points to real GDP this year—the first annual contribution since 2005.

Despite the rising trend in home sales since late 2011, the recovery will likely be modest and bumpy. Existing home sales have risen by as much as 29 percent since their trough in mid-2010, while new home sales have risen by as much as 35 percent since reaching a record low last year. However, both new and existing home sales in June posted significant declines, dropping to 5-month and 8-month lows, respectively.



Near-term leading indicators suggest continued soft activity. Pending home sales, which are based on contract signings, fell for the second time in three months in June, and purchase mortgage applications have largely been moving sideways since March.

Unlike our forecast of the overall economy, which has been downgraded over the past two months, our forecast for 2012 home sales has not changed materially this year. We continue to expect an increase in home sales of approximately 9 percent over 2011. Meanwhile, our outlook for home prices has improved modestly. With excess supply and seriously delinquent mortgages trending down from their peaks (although the soft employment picture contributed to a small pickup in the delinquency rate in the second quarter for the first time in a year), as well as a declining share of distressed sales in the spring selling season, home prices have moved higher in recent months and most measures now show positive annual gains.

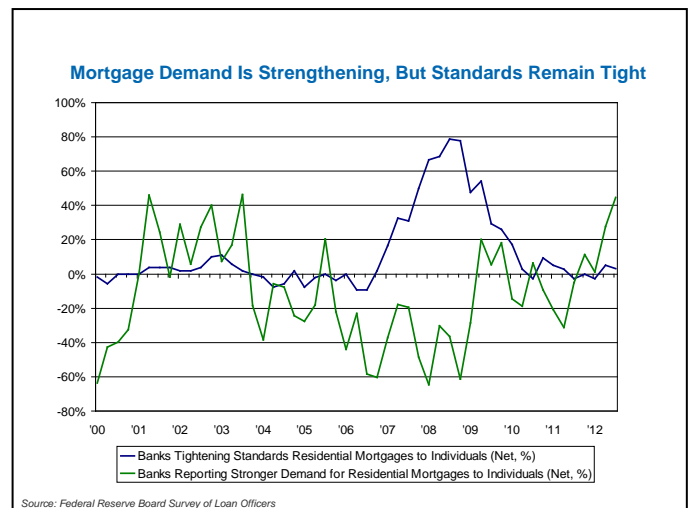
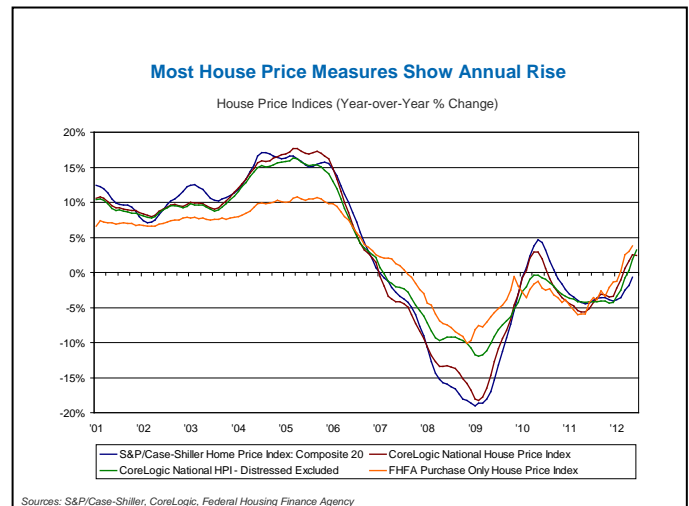
At the time of this writing, the only main home price measure released for June is from CoreLogic, which posted an increase for the fourth consecutive month. For the second quarter, prices (not seasonally-adjusted) rose at a 21.7 percent annualized pace—the strongest gain since the first quarter of 2005. Since the CoreLogic home price measure is used by the Federal Reserve in the Flow of Funds accounts, the strength in home prices bodes well for household net worth for the second quarter.


Other home price measures are likely to show sizable gains in the second quarter. We believe that home prices on the national basis may decline again through early 2013 but will not fall below their first quarter level, if current market trends continue. Consumers' belief that home prices bottomed early this year should provide a lift to consumer confidence in general and buoy expectations for further strengthening in the housing recovery next year.

There remain several factors that will combine to keep the pace of the housing recovery modest, however. The level of foreclosures remains elevated, suggesting a steady flow of distressed properties into the market over coming years. The gradual yet slow recovery in the labor market and the overall economy will restrain the rate of household formation. Moreover, mortgage credit is tight and should remain so, given the great magnitude of uncertainty in the regulatory landscape. The Senior Loan Officer Opinion Survey for lending conditions in the three months ending in July indicated stronger demand for mortgage loans, with a net 45 percent of banks reporting improving demand, the highest reading since 2003. (The survey does not separate purchase and refinance demand.)

By contrast, mortgage lending standards showed no sign of easing, with the percentage of banks reporting tighter lending standards slightly outweighing the percentage reporting looser standards. This share has been moving sideways since 2010.

Since declining to a record low of 1.43 percent in late July, the 10-year Treasury yield has moved up, partly because of improving economic data, trading around 1.70 percent at the time of this writing. Given expected sluggish growth and the ongoing concerns from the European debt crisis, we do not expect the rising trend to persist. Low mortgage rates will





remain a support for the housing and mortgage market this year, especially for refinance activity. For all of 2012, total mortgage originations are projected to rise to \$1.52 trillion from an estimated \$1.36 trillion in 2011, with a refinance share of 67 percent. Total single-family mortgage debt outstanding should decline by 1.2 percent in 2012, moderating from a 2.5 percent drop in 2011.

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Economic and Strategic Research
August 10, 2012

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