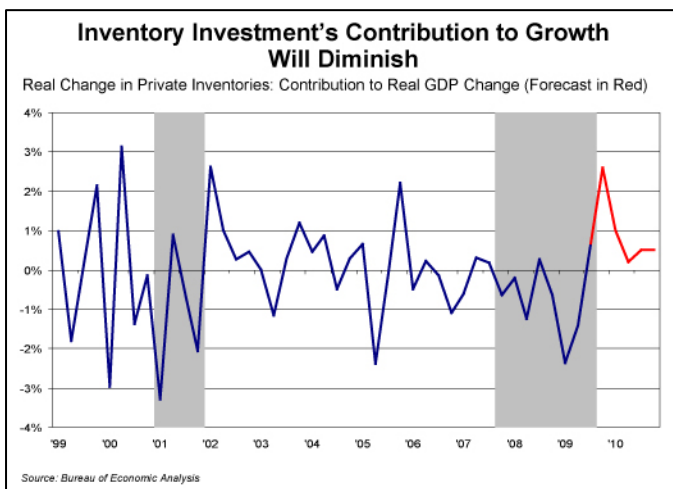


Economic Outlook for 2010: A Year of Challenges

Looking back, the economy appeared to emerge from the deepest recession since the end of World War II (WWII) at a much slower pace than previously believed. Real (inflation-adjusted) gross domestic product (GDP) grew at a 2.2 percent annualized pace in the third quarter, a downward revision from 2.8 percent in the second estimate, which was marked down from the first estimate of 3.5 percent. However, economic growth is likely to be strong for the second half of 2009, as we expect growth in the final quarter of the year to be more than double the pace of the third quarter.

Looking ahead, the expected surge in growth in the final quarter of 2009 raises the question as to whether that strength will carry on through 2010. Although we are marginally more optimistic than we were in the December forecast, we have not changed our fundamental view of the outlook. We do not believe that the expected 4.5 percent growth pace in the fourth quarter is sustainable, and see growth moderating to below four percent for all of 2010.



We believe that the primary reason for strong fourth quarter growth not continuing in 2010 is the temporary nature of the main drivers of the growth itself. The biggest driver of fourth quarter growth is inventory investment, which typically boosts economic growth in the early stages of the recovery as businesses rebuild their stockpiles following a massive liquidation during recession. We expect that inventory investment contributed to at least half of the increase in real GDP in the fourth quarter—the biggest contribution since the second quarter of 2000. Such a large contribution is not sustainable and we expect the boost to economic growth from the inventory swing to diminish going forward.

Besides the inventory cycle, the economy also benefitted substantially from the fiscal stimulus, estimated to have added approximately 1.5 percentage points to economic growth in 2009. For 2010, the contribution to real GDP will likely be halved, with all of the impact appearing in the first half of the year and nothing in the second half of the year.

Economic Growth: Sustainable and Moderate

While the temporary impact of inventory investment and the fiscal stimulus are largely responsible for the impressive gain in fourth quarter growth, we continue to view the 2010 outlook with guarded optimism. While we expect that the recovery will be sustainable, we also expect it to be a relatively modest one, at least until we see evidence that private domestic final demand—consumer and business spending—can step up to replace the drag on the economy from the removal of fiscal stimulus. At this time, the fundamentals determining consumer and business spending—usually the two most reliable drivers of growth in past economic recoveries—are pointing to moderate growth this year.

The Conference Board's Index of Leading Indicators—a gauge of economic activity three to six months ahead—confirms that the economy has embarked on a recovery path. The index surged 0.9 percent in November, marking an impressive streak of eight consecutive gains. The gain put the index at a record high, reversing all of its decline during the recession. From a year ago, the index has increased by about six percent. The year-over-year change in the index has been a good predictor for turning points of economic activity. During the six previous business cycles experienced since 1959, the year-over-year decline in the index reached its trough three quarters or less ahead of the official end of recession, with the single exception being the 1981-82 recession, where the lead time was four quarters. In the most recent recession, the year-over-year drop in the index bottomed out in the fourth quarter of 2008, which suggests that the official end of the recession (or the start of the recovery) is likely to be no later than the third quarter of 2009.

Consumer Spending: Retrenchment Is Over

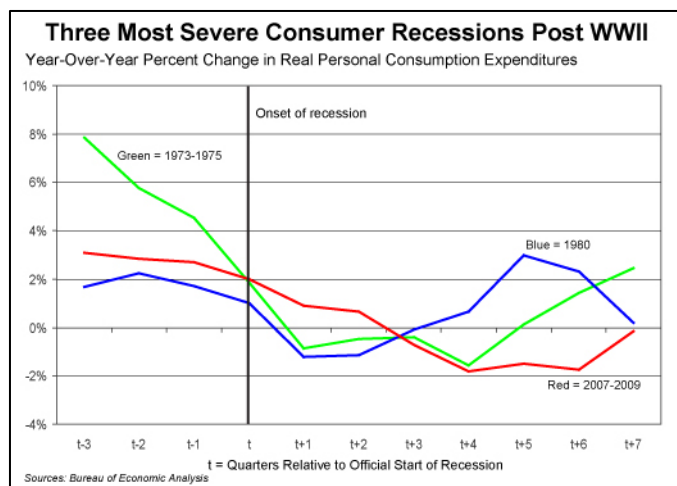
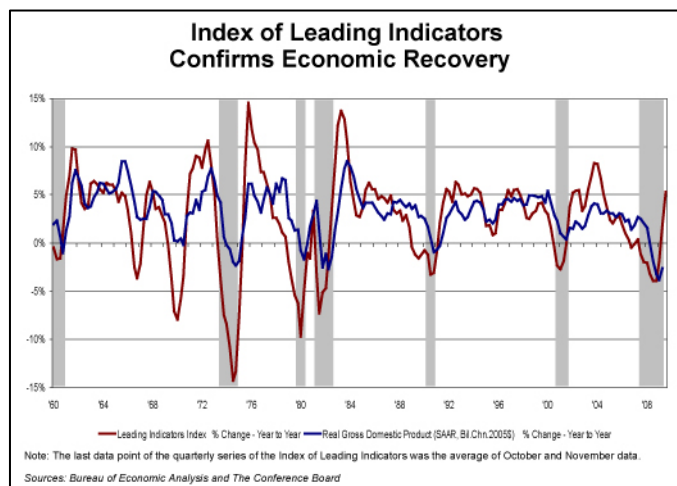
While the sharp gain in the Index of Leading Indicators since April suggests a strong economic recovery, we continue to see modest growth this year. Our cautious view depends largely on consumer spending, which suffered massive declines, especially in the second half of 2008.

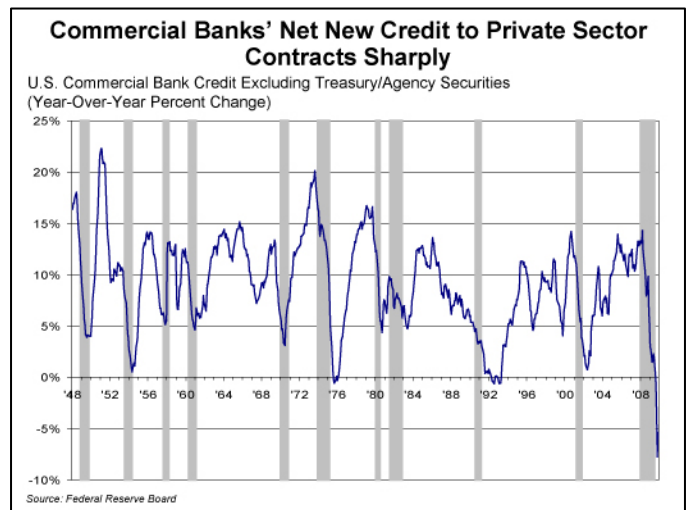
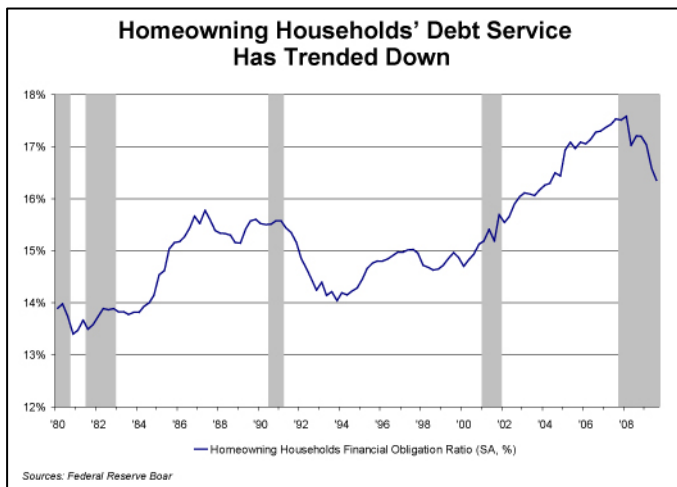
Measured in terms of peak-to-trough drops in real consumer spending, the most severe consumer recession was the 1980 recession, when the Credit Control programs were imposed to slow down credit expansion. The 2007-09 recession and the 1973-75 recession tied for second. However, in the 2007-09 recession, real consumer spending posted year-over-year declines for five consecutive quarters—the longest streak in any recession post WWII. The streak should end in the fourth quarter as monthly data showed increases from a year ago both in October and November.

Developments in the labor market will play an important role in consumer spending. Any improvement will likely be gradual this year. Nonfarm payrolls fell 85,000 in December, rounding out job loss to 4.2 million for all of 2009. The unemployment rate in December was unchanged at 10.0 percent. The rate would have been much larger if not for a huge drop in the number of people looking for work during the month.

Until the labor market improves substantially, consumers will continue to experience job insecurity and sluggish growth in wage income. Because of the massive decline in net worth from the peak in 2007, households are saving more of their current income to pay down debts and build up assets. The saving rate—personal saving as a percent of disposable income—has trended up from its recent low of less than one percent in April 2008 to nearly five percent by late 2009. We expect that the rising trend will continue, with the rate reaching slightly more than five percent by the end of this year, constraining consumer spending growth.

Although household net worth rebounded in the second and third quarters, the gain is dwarfed compared with the drastic drop suffered earlier. Consumers will continue to deleverage, which will help financially-strapped households. According to debt service data from the Federal Reserve, low interest rates and debt reduction have combined to bring down households' financial burden during the past two years, especially for homeownership households. The Financial Obligation Ratio for homeownership households fell to 16.4 percent in the third quarter of 2009, the fourth consecutive quarterly drop. This measure is an estimate of the ratio of financial obligations payments to disposable personal income. It includes payments on mortgage debt, homeowners' insurance, and property taxes, as well as payments on consumer debt and automobile leases. This ratio has declined by about one percentage point from its peak in the first quarter of 2008. The decline in household debt burden and the increase in the saving rate during the past two years will provide some cushion for a faster pace of consumer spending growth later in the year, ensuring the durability of the economic recovery.





Another factor that should restrain consumer spending growth is the availability of credit to the private sector. Despite improving financial conditions and a massive amount of liquidity injected into the financial system by the Fed during the past year, commercial bank credit provided to the private sector drastically declined from a year ago. This measure of bank credit includes all loans to consumers and businesses, and securities held by banks, excluding Treasury and agency securities. The decline was unprecedented, including during previous severe recessions, even when adjusted for inflation. While part of the drop in credit reflects reduced demand from businesses and consumers, we believe a sizable portion of the decline also may have reflected banks' unwillingness to lend.

According to the latest Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practice released in October 2009, more than half of the domestic banks continued to report they were less willing to make consumer loans. The situation, however, has improved significantly from late 2008. Banks' unwillingness to lend may have been partly a result of their desire to increase capital to ensure an adequate capitalization, especially given widely expected increases in the losses associated with commercial real estate this year. Unless bank lending improves substantially throughout the year, credit restraint will likely constrain consumer spending growth and hiring by small businesses and, ultimately, the strength of the recovery.

Net Exports: Not Adding to Growth

Exports are strengthening, thanks largely to the global economic recovery. The decline in the dollar also helps to support exports as it makes U.S. products less expensive in foreign currencies. However, we do not expect net exports to narrow and contribute to economic growth this year. In the early stages of recovery in the U.S., imports generally grow faster than exports, widening the trade deficit.

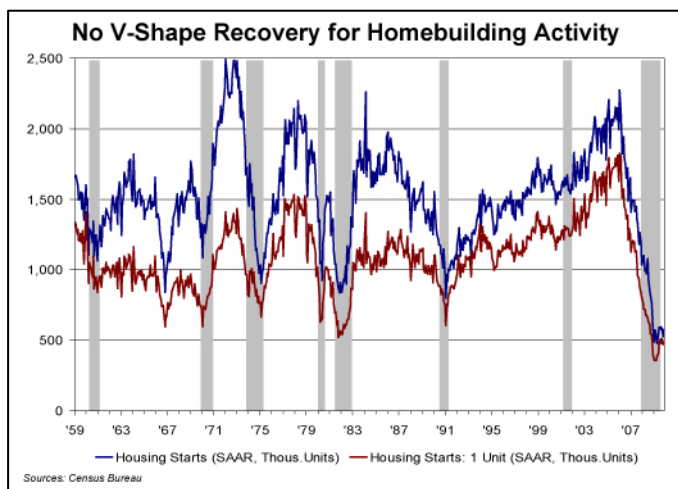
Nonresidential Investment: Increases Solely from CapEx

The manufacturing sector is making a gradual comeback. Businesses have begun to invest in new equipment and software again, according to the indicator used as a gauge for capital investment in equipment and software (CapEx). Since their trough in April 2009, orders for nondefense capital goods excluding aircraft, a proxy for CapEx, have risen at an annual rate of more than 15 percent. However, the level continued to be lower than a year ago so we expect CapEx to play a small role in this year's recovery.

Nonresidential investment in structures is expected to falter through the rest of the year, facing high vacancy rates, declining prices, and limited access to credit. The expected slow job creation will adversely impact the commercial real estate environment for some time, which bodes poorly for performance of commercial real estate loans. Overall, nonresidential investment in equipment, software, and structures should rebound modestly for all of 2010. Nonresidential investment is expected to grow at a faster pace in 2011, as the commercial real estate sector should turn the corner by then.

Residential Investment: Rebound from Depressed Levels

We expect the rebound in residential investment, which started in the second half of 2009, to continue this year at a stronger pace than last year. We expect the recovery in homebuilding will be weak relative to past recoveries, given the current excess measured supply and pent-up supply of housing. Housing starts troughed in April 2009, while single-family starts have risen about 35 percent from their record low in February 2009. After strong increases in the first half of 2009, single-family starts have moved sideways in recent months. Both single-family and multifamily starts have remained at the levels below their troughs in previous post-WWII recessions.

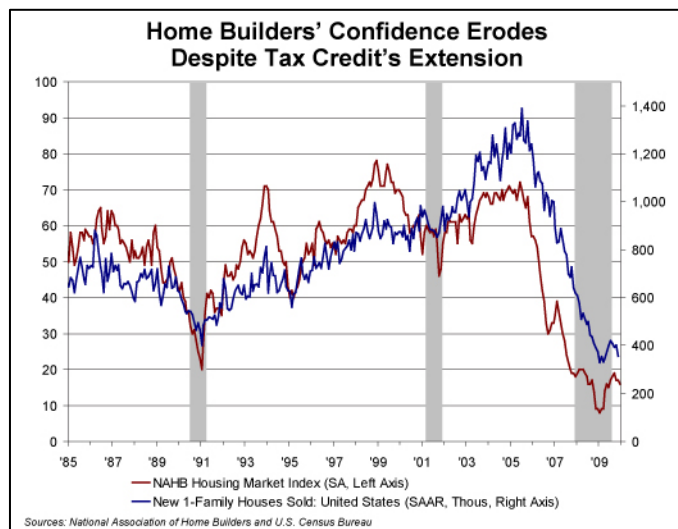


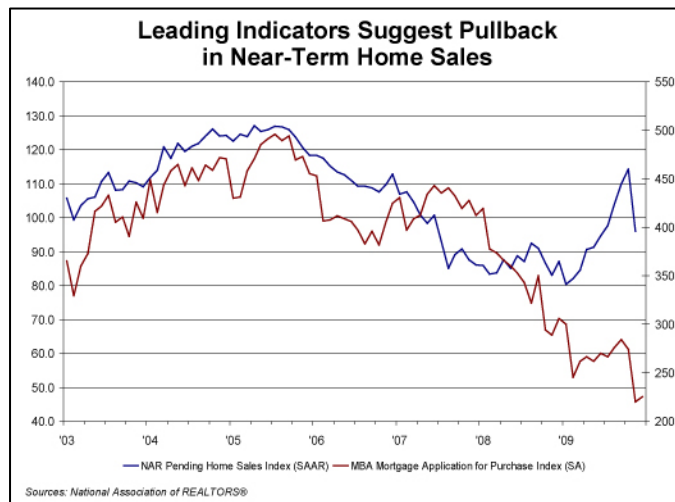
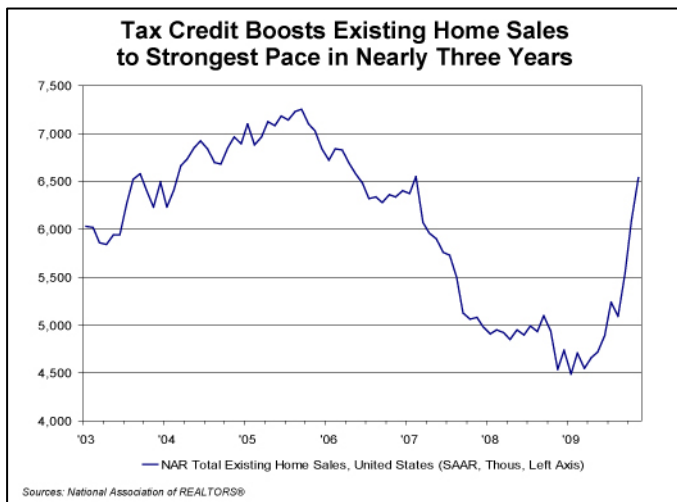
While inventories of unsold homes have declined significantly during the past year for both new and existing homes, there is still a substantial number of vacant homes on the market. We estimate that there are as many as two million units of excess supply of vacant homes on the market for sale or for rent. In addition, there may be at least 500,000 units of vacant homes that are held off the market beyond the normal level. These vacant units, as well as mortgages that are seriously delinquent (those that are 90 days or more past due or are in the foreclosure process), represent the shadow supply of homes. Together, they add up to about five million units that could be put in the market in coming years. While some of the current seriously delinquent loans will be cured, the delinquency rate is expected to rise for some time, adding to the number of loans in the foreclosure process. These units of

pent-up supply suggest a potential for downward pressure on home prices in the future, and support the view that a sharp recovery in housing starts is unlikely.

Builders' confidence, as measured by the National Association of Home Builders/Wells Fargo Housing Market Index, indicates that a sharp increase in home building activity is not in the cards. Since reaching its record low in January 2009, the index has rebounded but the December reading has remained as low as the levels seen in the 1981-82 recession. The confidence levels reflect the disappointing performance of new home sales, which has not seen much of an improvement since reaching a record low in January 2009. Sales dropped sharply in November, in response to the first-time homebuyer tax credit, which was originally set to expire at the end of that month. Sales have remained below levels attained in 2008.

In contrast, total existing home sales have increased significantly in 2009, especially in October and November, when the gains were the two biggest on record, putting sales at about 47 percent above the levels in 2008. The surge in sales reflected a rush from first-time homebuyers to close deals before the tax credit was originally set to expire, with first-time homebuyers accounting for about half the purchase market during September through November of last year, according to the National Association of REALTORS®. While the new home market has had a tough time competing with bargain-priced distressed homes, the existing home market has benefitted greatly from them. Distressed sales continued to constitute a significant share, accounting for about one-third of total sales—but somewhat below the 45 percent share recorded earlier in the year.





Pending home sales, which measure contract signings for existing homes, dropped sharply in November, according to the National Association of REALTORS® Pending Home Sales Index. The sharp drop in the index, which is a one-to-two month leading indicator of existing home sales, suggests a sizable decline in total existing home sales in the near term. Another leading indicator of home sales—the purchase index in the Weekly Survey of Mortgage Applications from the Mortgage Bankers Association—confirms a pullback in sales early this year.

The expansion in the homebuyer tax credit to all buyers for contracts signed before the end of April 2010 should help support home sales through the first half of the year. However, we expect this year's sales pace to pull back from an unsustainable fourth quarter average as we believe that the first-time homebuyer tax credit has pulled forward some of the housing demand from 2010 into 2009. We believe there is likely to be a drop in sales in the second half of the year as the tax credit expires. However, if the labor market improves meaningfully as expected by year-end, the drop in the second half would be small. In addition, many people may be looking to buy if they believe that affordability would likely increase as mortgage rates trend up and home prices are at or near bottom. For all of 2010, we project that total home sales will increase about eleven percent. Home prices are expected to fall further this year but at a more moderate pace than in 2009.

We expect a moderate contribution to real GDP from residential real estate investment, especially in the first quarter of 2010, when residential investment growth is projected to moderate significantly from the pace in the prior quarter. For all of 2010, we expect its contribution to economic growth to be about 0.5 percentage points, given an expected gradual recovery in housing starts from very depressed levels and a healthy gain in home sales (and thus an increase in real estate commissions, which are a main component of residential investment in addition to spending on new home construction and on home improvement). While this expected contribution is small by historical standards of past recoveries, it would put an end to a three-year period of residential investment being a drag to economic growth.

Mortgage Market Outlook

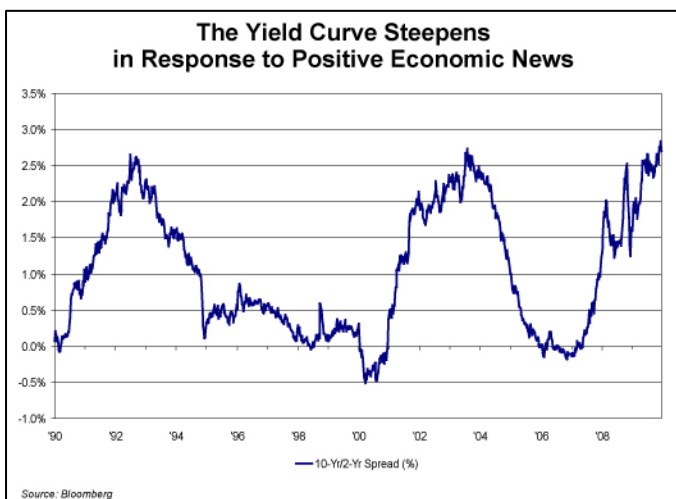
Our views on mortgage production have not changed fundamentally during the last few months. Stronger home sales and rising mortgage rates will favor the purchase mortgage market in 2010. We project that the refinance share of mortgage originations will fall to 43 percent of a projected total originations volume of \$1.35 trillion. Along with on-going deleveraging of other consumer debt, mortgage debt outstanding is projected to decline this year by about two percent—the third consecutive annual drop.

Risks to the Forecast

While the forecast will be vulnerable to additional negative shocks, we believe that there are more risks to the forecast of economic growth on the upside than the downside. The most likely source for a stronger recovery than anticipated is consumer spending, which accounts for about 70 percent of GDP. The economy could begin to create jobs sooner and more strongly than we expect, supporting solid growth in income. In addition, home prices could trough and rebound sooner than we expect, creating a bigger rebound in household wealth from earlier drastic declines. Finally, lending conditions could improve faster than expected, supporting final demand across a number of categories. One or a combination of these scenarios would drive up consumer confidence, boosting household spending and economic growth more than we are currently projecting.

Stronger economic growth would cause long-term interest rates to increase sharply, which would hurt the refinance market. However, a stronger labor market and higher income and consumer confidence will brighten the outlook for home sales and mortgage performance, helping to offset the impact of higher mortgage rates.

Already, recent strong economic reports have led to an increase in long-term interest rates, steepening the yield curve. Short-term interest rates have remained low, as the Fed continues to communicate that it will keep policy accommodative for an extended period. As a result, the yield curve has steepened substantially. For example, the spread between the 10-year and the 2-year Treasury yields has trended up significantly to record high levels.



Longer-Term Challenges

Looking beyond this year, the economy may face challenges from several fronts. The labor market is likely to go through a structural change. Some of the job losses during the recession, including those in manufacturing, may never come back. Many of the unemployed will need new training so that they can be equipped with skills for careers in different industries. This will require significant time and resources. Another challenge comes from the increase in the federal debt, potentially affecting investor confidence in our ability to repay national debt and currency valuation.

Another concern is whether the Fed will be behind the curve on inflation. This could potentially lead to increased inflation expectations and higher long-term interest rates, which would

impede economic growth and raise the cost of funding the federal deficit. Some Fed officials have recently expressed concerns regarding inflation risks. According to the minutes of the December Federal Open Market Committee released on January 6, committee members split on their views about inflation: some viewed the risks to inflation outlook as roughly balanced; some viewed them as tilted to the downside; but others viewed them as tilted to the upside, especially in the medium term, as they believed that concerns about the monetary policy stimulus and a huge federal budget deficit could potentially lead to rising inflation expectations. Recent data supports the last view, according to one proxy of inflation expectations. The spread between the 10-year Treasury and the 10-year Treasury Inflation Protected Securities (TIPS) has risen in recent weeks, reaching near the level seen prior to the onset of the August 2007 financial crisis of 2.5 percentage points. The spread was close to zero during the financial crisis in the fall of 2008.

In the prior episode of Fed easing that started in 2001, the U.S. Central Bank was criticized for leaving the Fed funds rate at one percent for too long, helping to fuel the housing boom that later turned into the biggest housing recession post WWII. With a stubborn double-digit unemployment rate, calls are increasing for additional government measures to stimulate job growth. At the same time, rising inflation expectations and concerns about adding to an already daunting level of federal debt act as constraints on any new actions. As a consequence, 2010 will be a year of tremendous challenges to policymakers.

Doug Duncan and Orawin T. Velz
Economics and Mortgage Market Analysis
January 8, 2010

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