

## The Economy Strengthens Going into 2014; Housing Continues Its Journey Toward Normal Activity

Economic growth picked up more than our forecast in the third quarter gross domestic product (GDP) estimate. This is an encouraging development if business properly assessed demand growth. The upgrade reflected sizable inventory buildups that more than doubled the second quarter's pace—the fastest accumulation since the first quarter of 1998. If demand is less than expected, the unintended accumulation of stockpiles will lead businesses to cut back on production and quarterly GDP growth figures will slow.

Fiscal and monetary policy will still dominate but some clarity is emerging. The government shutdown ended with Congress adopting a short-term continuing resolution that funded government activities only through January 15, and suspended the debt ceiling through February 7.

This leaves open the possibility of another government shutdown if lawmakers cannot reach an agreement on how to fund the government by then, and the debt ceiling would be re-imposed on February 8, at which time the Treasury would resume "extraordinary measures" to pay its bills. The bipartisan Conference Committee charged with coming up with a framework for a budget agreement is due to report back to Congress on December 13, and could put forward a plan that reduces the required sequestration spending cuts for fiscal year 2014. At the time this forecast was produced, budget negotiation was still under way.

For monetary policy, the solid November jobs report (more below) should green-light the Federal Reserve to start tapering its asset purchases. We expect that the Fed will stop buying Treasuries and agency mortgage-backed securities (as well as reinvestment in principal) by the end of 2014, and that there will be no funds rate hikes until the third quarter of 2015.

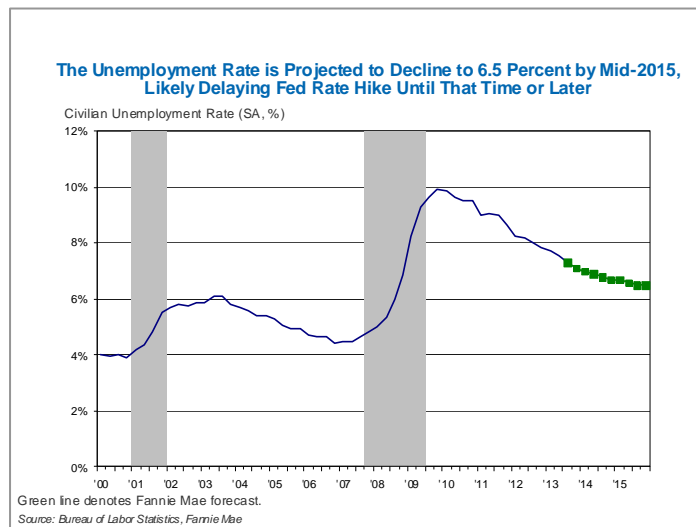
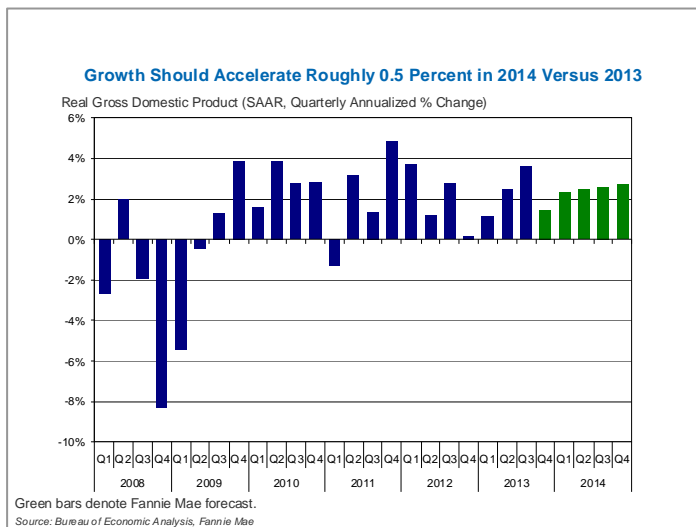
Our 2013 theme, which we unveiled at the start of the year, focused on the transitioning of housing activity to normal levels. We provide a recap of our analysis over the course of the year in the housing section.

### **Economic Growth: A Brief Slowdown Before Picking Up Over the Course of 2014**

In its second estimate, the Bureau of Economic Analysis upgraded real (inflation-adjusted) gross domestic product (GDP) for the third quarter of 2013 by 0.8 percentage points to 3.6 percent annualized. The improvement was more than accounted for by the upward revision to inventory investment, bringing its contribution to 1.7 percentage points—0.9 percentage points more than initially reported. Consumer spending growth received a slight downgrade, remaining the weakest since the final quarter of 2009, and business capital spending was revised higher from a small decline to flat—still the second worst showing in the current recovery. Net exports and government spending were revised slightly higher, each adding less than one-tenth to real GDP during the quarter.

We expect economic growth to slow sharply to 1.5 percent in the current quarter from a big inventory investment payback due to the likely unsustainable pace in the third quarter as well as from the government shutdown, which we estimate reduced the quarter's economic growth by about two-tenths. Despite an expected sizable slowdown in top-line growth, we expect domestic demand to strengthen, which would build momentum heading into 2014. We expect that the bulk of the correction in the pace of inventory accumulation will likely occur in the fourth quarter. At the same time, we continue to expect that the *direct* drag from declining government (combined federal and state & local) consumption and gross investment will swing from a subtraction of 0.3 percentage points from growth this year to neutral in 2014.

As the impact of fiscal tightening from tax increases, and to a lesser extent, cuts in government spending wanes amid continued improving labor market conditions, consumer spending growth should pick up with the rise in disposable income. While we expect that the emergency unemployment benefits will expire in January as scheduled under current law, the impact should be modest given the steadily declining trend in the number of recipients. Similarly, we believe that



negative impact on investment spending amid stronger consumer demand. In addition, we expect the housing recovery to continue, helping to boost overall economic growth. For all of 2014, we expect growth to rise to 2.7 percent from an estimated pace of 2.2 percent in 2013 and 2.0 percent in 2012.

### Labor Market: Solid Back-to-Back Performance

The November jobs report was unequivocally strong as nonfarm payroll rose 203,000 amid solid gains in hours worked and average hourly earnings. Combined with upward revisions of 8,000 jobs in the prior two months, the average monthly gain during the three months ending in November was 193,000 jobs, up from 166,000, the average monthly gain in the prior three months.

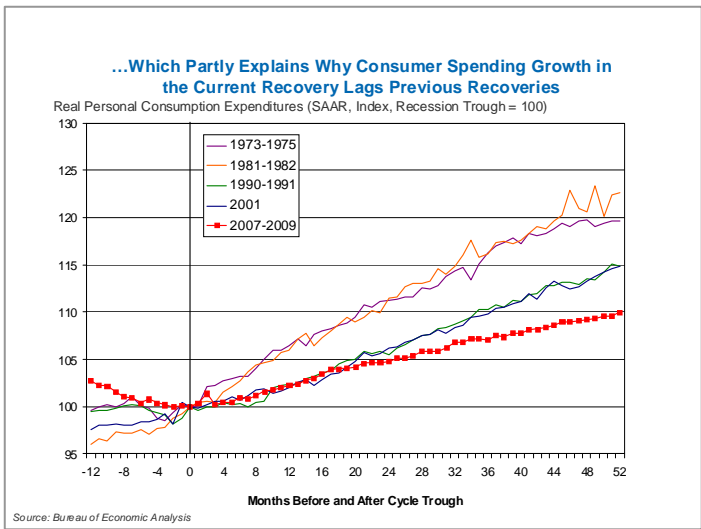
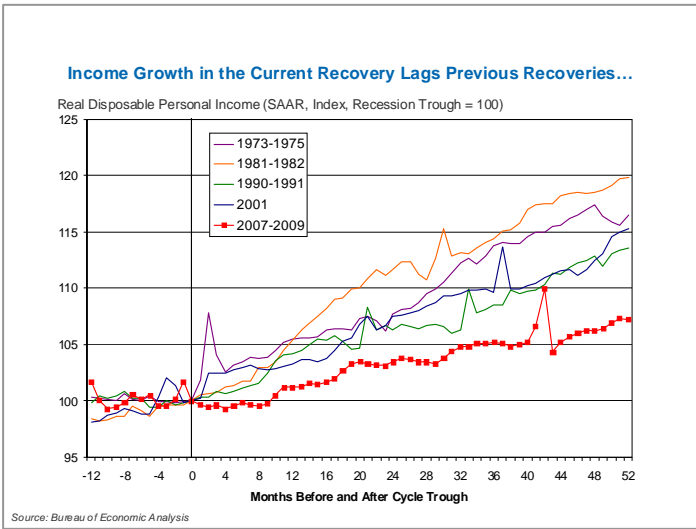
The household survey also was solid, partly reflecting a reversal of the impact of the government shutdown in the prior month, showing a three-tenths drop in the unemployment rate to 7.0 percent, as the biggest gain in household employment in 13 years far outpaced a large gain in the number of the people joining the labor force. The labor force participation rate rebounded two-tenths to 63.0 percent after declining four-tenths in October and six-tenths during the past year. We expect the participation rate to stabilize at around this level over the next year, while the unemployment rate trends down to 6.7 percent and 6.5 percent by the end of 2014 and mid-2015, respectively.

### Consumer Fundamentals: Looking Brighter

Some good news has emerged on the consumer front. The GDP report revised higher real disposable income growth in the third and second quarters, which boosted the saving rate in the third quarter by three-tenths to 5.0 percent. Despite the upgrade, real disposable income in the current recovery continues to lag previous recoveries, which partly explains why consumer spending in the current recovery also lags behind previous recoveries.

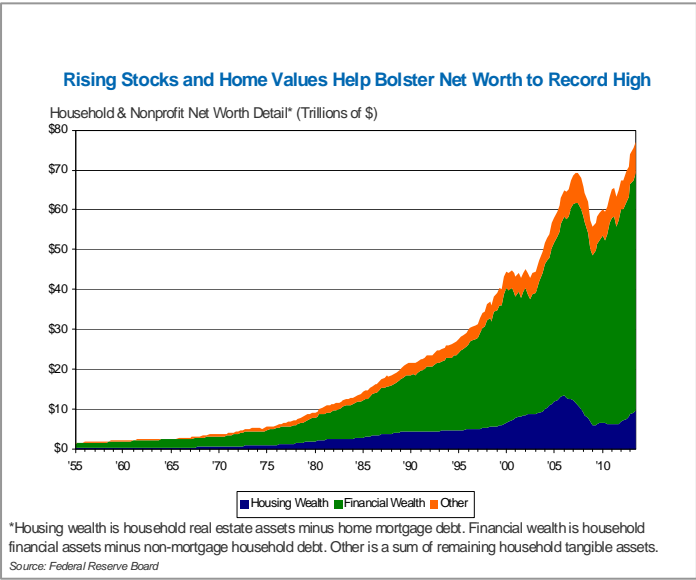
While the monthly data showed that real personal income fell in October—partly reflecting the government shutdown and a statistical anomaly in farm income—real consumer spending rose a strong 0.3 percent, building up momentum for a pickup in consumer spending in the fourth quarter. In addition, the November jobs report showed solid gains in hours worked and earnings, pointing to stronger growth in wage-and-salary income. Auto sales also jumped during the month to 16.4 million units annualized—the best showing since February 2007.

Consumer credit data from the Federal Reserve showed that total consumer credit (excluding mortgages) posted the biggest gain in October since May, as consumers pushed their credit card debt to a three-year high—perhaps a signal of their willingness to boost spending into the holiday season. The gain came during the government shutdown, however, which may have reflected the fact that some of the government workers temporarily without paychecks used credit cards to support their spending, and intended to pay off the debt once they received their back pay. Despite the October rise, revolving credit has remained just \$23 billion above its recent trough in April 2011.



Consumer attitudes appeared to have recovered in early December from concerns associated with the government shutdown. The preliminary reading of the Reuters/University of Michigan consumer sentiment index rose sharply in early December to the highest reading since July.

In addition to improving labor market conditions, household balance sheets continue to heal. Federal Reserve data for the third quarter Financial Accounts of the U.S. (formerly the Flow of Funds report) showed that household net worth—assets minus liabilities—increased \$1.9 trillion, marking the eighth consecutive quarterly increase, to \$77.3 trillion thanks to rises in equities and home prices.



Notably from the report, household mortgage debt posted the first increase since the first quarter of 2008, signaling that the more than five-year mortgage deleveraging process is stabilizing.

Economic theory suggests that the traditional wealth effect from rising household net worth should help boost consumer spending growth. However, adjusted for inflation, evaluating the distributional aspects of wealth, and taking it down to the household level, we expect the positive wealth effect during the current recovery will be more limited than witnessed in previous recoveries. (For more details, see Brian Hughes-Cromwick, [“An Uneven Recovery in Household Wealth, Fannie Mae Housing Insights,”](#) December 2013).

Given improving consumer fundamentals, we expect real consumer spending growth to pick up about 1.0 percentage point in the current quarter from the third quarter’s anemic pace of 1.4 percent and strengthen gradually throughout 2014.

## Manufacturing Activity: Improving From the Spring and Summer Lull

A survey of purchasing managers continued to be upbeat in November, with the Institute for Supply Management (ISM) manufacturing index rising for the sixth consecutive month, showing the fastest expansion since April 2011. Manufacturing payrolls from the November jobs report corroborated the rosy picture from the ISM survey, as they jumped during the month, surpassing the 12 million mark for the first time since April 2009.

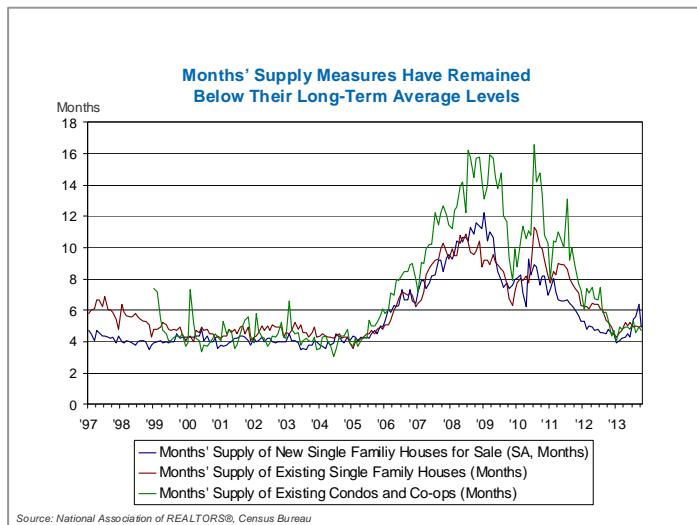
Manufacturing production from the industrial production report also continued to improve, rising in October for the third consecutive month. In response to the upside surprise in November auto sales, we expect a solid increase in motor vehicle assemblies and continued rising manufacturing output for the current quarter.

There has been weakness in some spots in the sector, however. Factory orders fell in October, as orders for nondurable goods dropped, while the previously reported orders for durable goods were revised higher to show a more moderate decline. Core capital goods orders—nondefense capital goods excluding aircraft and a key gauge for future business capital spending—were revised up for both September and October. However, they fell for the third time in four months, suggesting continued soft business capital spending in early 2014.

We expect business capital spending to firm after the first quarter amid reduced fiscal uncertainty and a stronger economy that will outweigh the negative effect of the expiration of bonus expensing provisions. Business investment in structures should also strengthen, in response to gradually improving commercial real estate markets and the surge in spending on mining and exploration, partly related to the fracking boom. However, because of its small share in GDP, we do not expect nonresidential investment in structures to contribute much to GDP growth over the next couple of years.

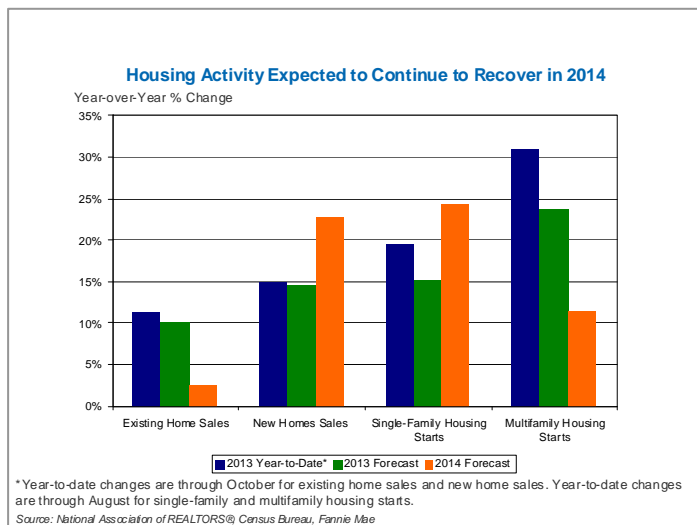
### Trade: Modest Contributor to Economic Growth

As we mentioned earlier, net exports contributed slightly to GDP in the third quarter. In October, the real trade deficit narrowed as a strong growth in exports, reflecting growing demand from abroad, exceeded a slight gain in imports, suggesting that net exports will contribute to growth in the fourth quarter. For next year, the recent rise in the dollar and firming domestic demand, which would help boost imports, should cause net exports to add only modestly to GDP.



### Housing: Continued Marching Toward Normal

The momentum of the housing market recovery has slowed since the spike in mortgage rates in May. Pending home sales (contract signings of existing homes) declined for the fifth consecutive month in October and are lower than they were a year ago for the second straight month, breaking a streak of 28 months of year-over-year gains. By contrast, new home sales (which, the same as pending home sales, are also recorded at contract signings rather than at closings), rebounded sharply, surging more than 25 percent, though not enough to push sales above their June level reached before the summer slump or the recovery-high pace witnessed in January. Existing home sales, which are recorded at closings, declined in October for the second consecutive month. Despite varying sales' pace in recent new and existing home sales, their months' supply measures have remain below their long-term average levels.

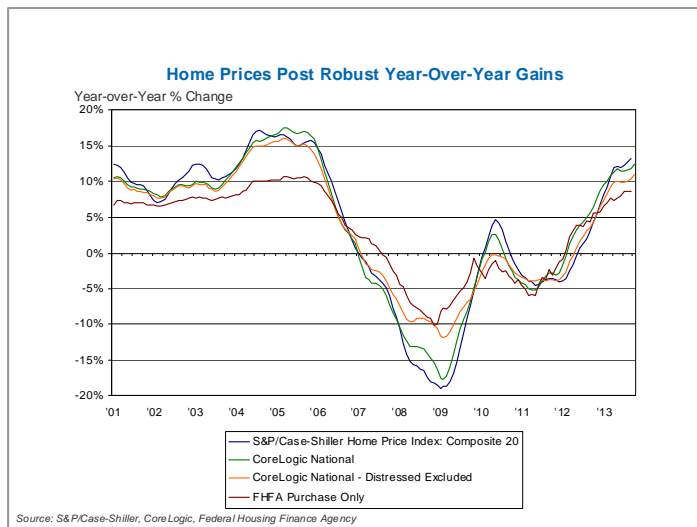


Of all the housing activity, performance in single-family homebuilding has been the most disappointing this year. After jumping to the recovery peak of 652,000 units in February, single-family starts have been trending down. While September and October housing starts data were not available until December 18 because of the government shutdown, data on housing permits through October—which have flat lined since June—suggest single-family starts may remain lackluster in the fourth quarter. However, multifamily permits posted a double-digit increase in October for a second straight month, sending total housing permits to a recovery high. (For more information on multifamily market conditions, read the [December 2013 Multifamily Market Commentary.](#)) Meanwhile, homebuilder sentiment held steady in November but below its August peak.

One factor holding back an even stronger rebound in home construction could be the tight availability of acquisition, development, and construction (AD&C) loans. Although lending conditions have been improving gradually, according to the survey by the National Association of Home Builders (NAHB), the current stock of residential AD&C loans still stood about 80 percent below its peak reached during the first quarter of 2008. The NAHB survey also indicated that land development loans face tighter lending standards than residential construction loans.

All housing activity has posted significant year-to-date gains. We expect continued improvement in activity in 2014 at a varying pace.

The performance of various home price measures based on repeat-sales transactions so far in 2013 was impressive. The annual increase in the CoreLogic index was 12.5 percent through October (11.0 percent excluding distressed sales), compared with 8.5 percent and 13.3 percent for the FHFA purchase-only and the Case-Shiller 20-city composite indices, respectively, through September.



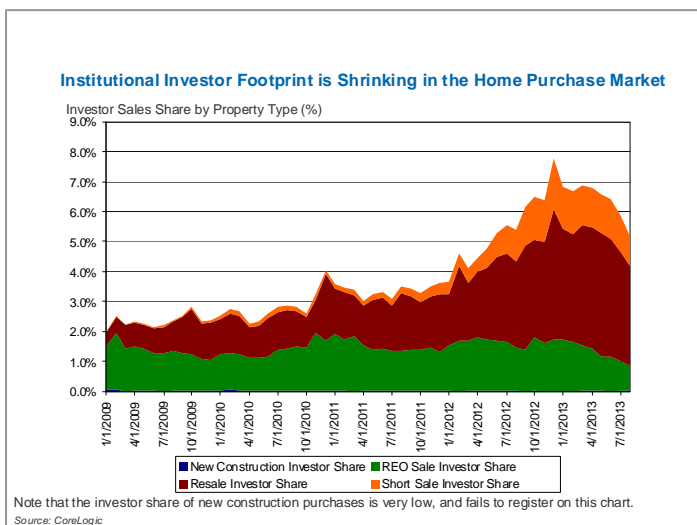
We expect house prices at the national level to move higher as the months' supply measures have remained below historical norms, indicating little excess supply in the overall market. In addition, shadow supply has been improving, indicated by declining seriously delinquent loans, loans in the foreclosure process, and under-water properties, which will reduce downward pressure on home prices.

While we expect home prices to rise further, the pace of appreciation should moderate going forward, partly due to declining investor demand, especially by institutional investors, in line with our forecast of a relatively modest gain in existing home sales in 2014.

Consumer expectations regarding home price growth continued to cool in November for the fourth consecutive month, according to the [Fannie Mae National Housing Survey](#). In addition, the share of consumers who expect home prices to go up in the next 12 months has trended down steadily during the past several months, reaching 45 percent—12 percentage points lower than the survey's peak in June.

On the mortgage finance front, there are several proposed and implemented policy changes and credit trends that will affect lending activity next year. Lending standards for mortgages have gradually, though not dramatically, eased over the past year. Originator capacity has declined as lenders have prepared for the ending in the refi boom that started in mid-2011. The mortgage industry has been preparing for the Qualified Mortgage (QM) rules, which will take effect on January 10. Most industry analysts do not see a significant broad market impact from the changes.

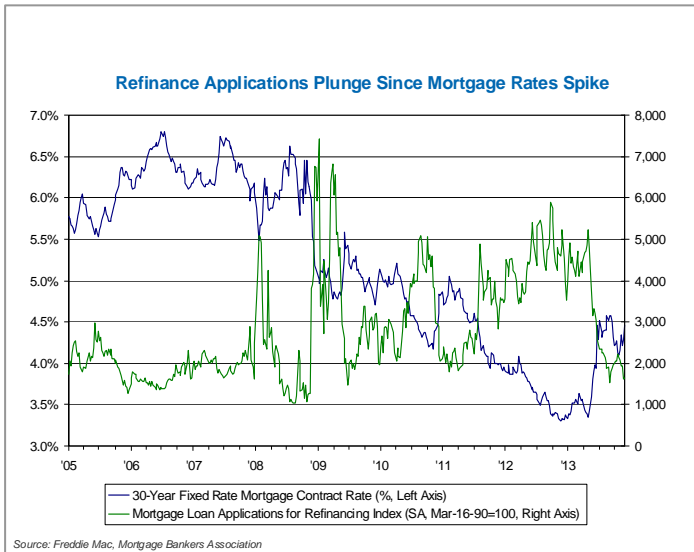
Our forecast of mortgage rates was little changed from the previous forecast, with the yield on the 30-year fixed rate



mortgage rising to 4.9 percent by the end of 2014, and our projected home sales are also similar to our November forecast. For mortgage production volume, we revised lower our estimate of refinance mortgage originations in the current quarter and early next year, given the larger-than-expected decline in refinance applications over the past few months and a rebound in interest rates.



As a result, the refi share of originations should decline to below 50 percent in the current quarter—signaling that the mortgage market has finally switched from a refi market to a purchase market.



For all of 2013, we estimate that total single-family mortgage originations will decline approximately 15 percent to \$1.82 trillion, with the refinance share dropping 10 percentage points from an estimated 72 percent in 2012. Total mortgage originations should drop another 28 percent in 2014 to \$1.32 trillion, with the refi share declining further to 39 percent—the lowest since 2000. For mortgage debt, the latest data from the Fed showed that total single-family mortgage debt outstanding rose 0.5 percent annualized in the third quarter. We expect it to post a slight drop for all of 2013 before rising modestly in 2014—the first rise in seven years.

Finally, in our monthly commentary over the course of the year, we analyzed a number of aspects of the economy, and in particular housing indicators, as they transition to normal.<sup>1</sup> While some housing indicators have had disappointing performance this year, we believe that their recovery will continue in 2014, on track to reach normal levels in the same timeframe we anticipated.

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Economic and Strategic Research  
December 10, 2013

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<sup>1</sup> We anticipate that most housing indicators will reach normal levels by 2016. In the [January Developments](#), we projected that, by 2016, total housing starts would reach 1.6 million units, a pace consistent with sustainable rates of household growth, vacancies, and demolition. We also predicted that existing home sales would trend up to nearly 6 million units and reach 4.3 percent of the housing stock, a normal rate of turnover. In the [February Developments](#), we forecasted that residential construction employment will approach its normal relationship with residential homebuilding activity by 2016, resulting in about 400,000 additional homebuilding jobs. Our [April Developments](#) showed that all underwater properties at the end of 2012, except those with loan-to-value ratios above 120 percent, will likely regain their positive equity positions by 2016. The [June Developments](#) projected that new home sales will rise steadily and reach normal levels by 2016, when new home sales per 1,000 population approaches 2.7 percent. In the [August Developments](#), we forecasted that residential investment as a share of gross domestic product will trend up, reaching its long-run average by 2016. One key metric—home builder confidence—has already returned to its long-term average, as noted in the [August Developments](#). Home purchase affordability will remain above the level we deem to be normal through 2017, whereas the geographic breadth of job gains will likely remain below levels typical of economic expansions for years to come (see [May Developments](#) and [September Developments](#), respectively).