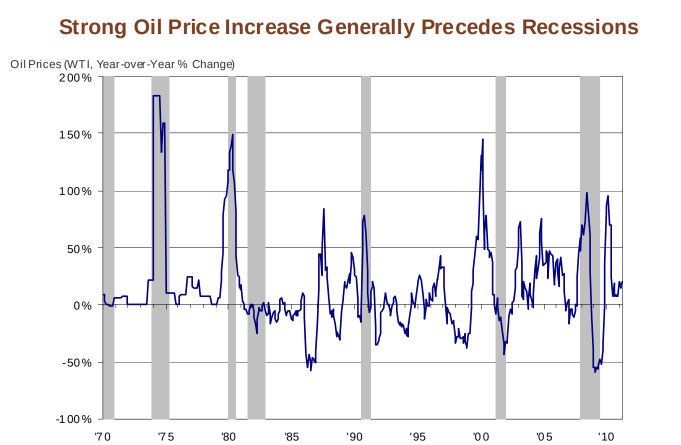
# Oil Prices Cloud Economic Outlook

Since October, we have been significantly more optimistic about the economic recovery, which has been under way since mid-2009. During the past several months, the economy has shown increasing signs of having developed a self-sustaining momentum. Both the manufacturing and service sectors are expanding at a rate associated with periods of solid economic expansion. Consumer spending showed renewed strength in the final quarter of 2010, and while it appears to have faltered somewhat at the start of this year, any negative impact was likely due to a severe winter weather effect.

Economic reports received during the past month suggest less momentum going into 2011 than previously believed, including the downward revision of economic growth in the fourth quarter of 2010 from an annualized rate of 3.2 percent to 2.8 percent. In addition, a new headwind has recently appeared on the horizon. Our previous forecast had built in to it rising oil prices stemming from the strength of the global recovery, especially in emerging markets. Crude prices have now risen by about $10 per barrel more than we expected during the past month. The recent spike is the result of a supply shock, reflecting both the reduction of shipments from Libya and the threat of further disruption associated with unrest around the Middle East.

This recent unexpected jump in oil prices has complicated the economic outlook. Since the U.S. consumes roughly seven billion barrels of oil each year, each dollar increase in the price of oil acts like a $7 billion tax on consumers, reducing their disposable income available for spending on other goods and services.

Rising oil prices also affect other components of gross domestic product (GDP), including business fixed investment and net exports. In addition, we have to consider what happens to inflation expectations and the potential for a monetary policy response. Since no one knows the magnitude and the duration of the oil price rise, there has been a considerable increase in the uncertainty about the prospects for growth this year and next.



Source: Wall Street Journal

Surges in oil prices have been associated with sharp slowdowns in economic growth since the oil price surge in the 1970s. Sustained or continued rising prices pose a threat to the current economic expansion. During the past 40 years, an increase of more than 50 percent in oil prices from the prior year has been associated with periods of recession.

Given signs of accumulating strength in the economy, if oil prices stabilize and some of the price gains are reversed, which we believe to be the most likely scenario at this point, the negative impact on economic growth will be relatively minor. However, there are risks that the turmoil will worsen, serving to weaken growth by more than we currently expect.

Another headwind is the potential for further tightening of fiscal policy. The combination of the fading fiscal stimulus from 2009, current deficit reduction measures being debated, and state and local government budget problems may have an adverse impact on the growth and employment picture in the short run. However, doing nothing to resolve the budget imbalance will lead to an unsustainable increase in the federal debt-to-GDP ratio, restraining long-term economic growth, and increasing the risk of a fiscal crisis. Given that the economy has gained momentum since last fall, except for some weather-related weakness, we do not see these two headwinds as yet having a substantial impact on growth. We expect growth to accelerate from last year's rate of 2.7

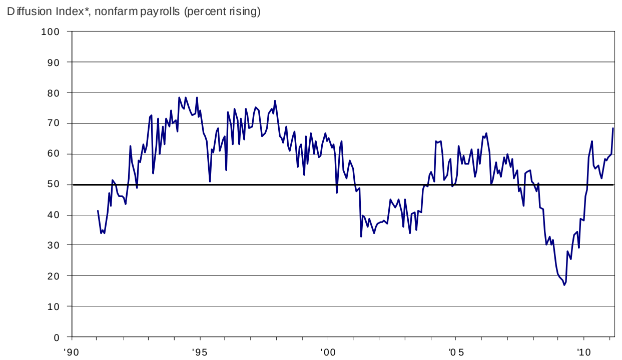
percent to 3.5 percent this year, a slight moderation from the 3.7 percent rate projected in the last forecast. The key to this outlook is the resilience of consumers who we believe will continue to drive the expansion with real consumer spending growth of around 3.0 percent this year. That said, contagion of the turmoil in the Middle East to Saudi Arabia or other major oil producers would be sufficient to derail the expansion.

## Overall Economy: Modest Expansion Continues

Nonfarm payrolls rose 192,000 in February, but part of this gain reflected a weather-related rebound following the winter storms that held down the reported payroll gain in January. Private-sector employers added 222,000 jobs, the biggest gain since April 2010. Total government employment fell by 30,000 due entirely to job cuts in state and local governments.

January and December total nonfarm payrolls were revised up to show an accumulated increase of 58,000 jobs, bringing the three-month average gain to 136,000. For private payrolls, the three-month average gain of 152,000 is the strongest since the three-month period ending January 2007, about a year before the recession started. The breadth of job creation also is encouraging, as 68.2 percent of private-sector businesses either added to payrolls or held them steady in February, the highest share since 1998.

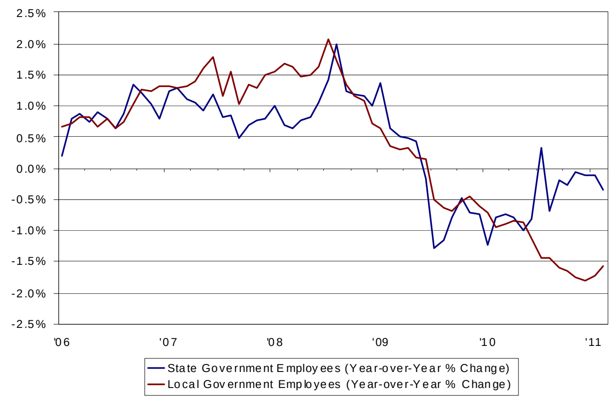
**The Breadth of Job Gains Is Encouraging**




*50 percent indicates an equal balance between industries with increasing and decreasing employment.

*Source: Bureau of Labor Statistics*

**Local Government Employment Is a Drag on Overall Job Growth**




*Source: Bureau of Labor Statistics*

The loss of local government jobs has dominated the decline in overall government jobs during the past year. Local government payrolls have plunged 377,000 since the peak in September 2008. Given ongoing budgetary challenges that will require local governments to continue to trim their budgets, we expect the sector to remain a drag on overall employment for some time.

Other aspects of the February employment report were less upbeat: average hourly earnings and the average workweek remained flat, consistent with other reports showing subdued labor costs.

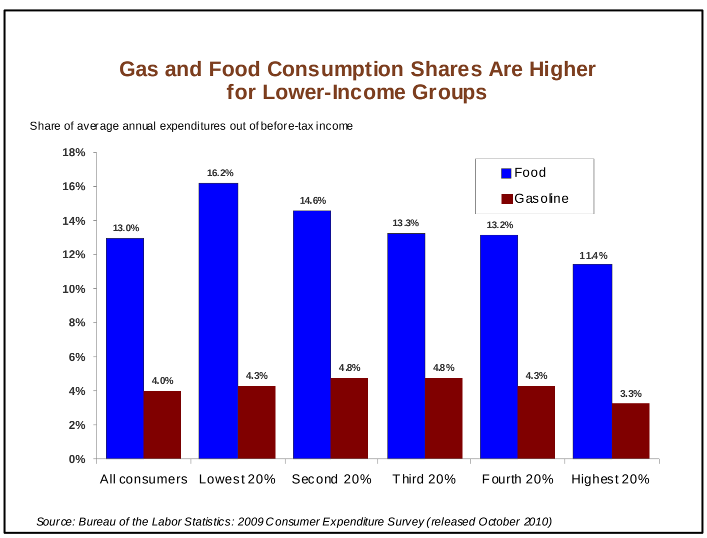
The unemployment rate, calculated from a separate household survey, fell 0.1 percentage point to 8.9 percent. This is the first time it dipped below 9 percent since April 2009, after staying above the 9 percent threshold for 21 months—the longest stretch since World War II. While the cumulative decline of 0.8 percentage points in the rate in December and January was triggered by a massive drop in the labor force, the decrease in the February unemployment rate reflects a bigger gain in household employment than an increase in the labor force. The labor force grew only 60,000 in February after dropping an accumulated 938,000 during the four months prior. Historically, an ongoing drop in the labor force is unusual.

Overall, there are grounds for optimism about labor market conditions, including notable declines in initial jobless claims. In addition, hiring plans from several surveys of businesses also have improved. For example, small businesses' hiring plans increased slightly in February, according to a National Federation of Independent Business survey. Plans by firms to increase hiring during the next three months rose by two points to 5 percent. While this level is still historically low, it is 15 points higher than the recession low of negative 10 percent in March 2009. In addition, the share of small business owners reporting hard-to-fill job openings rose two points to 15 percent.

We mentioned earlier that consumers will be the key to a solid expansion. However, real consumer spending got off to a slow start this year after a robust increase of more than four percent at an annualized rate in the final quarter of 2010. Despite the jump in personal income, reflecting the reduced employee contributions for social security authorized under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, real consumer spending edged down in January—the first monthly drop in nine months. We believe that spending was distorted by the storms in many parts of the country and that February spending will likely show a rebound. The strong increase in auto sales in February indicates that consumer buying has not yet been affected materially by higher oil prices. Sales rose to a seasonally adjusted annualized rate of 13.4 million units, marking the strongest pace since August 2008, excluding the sales in August 2009 when sales were boosted by the Cash for Clunkers program. Vehicle sales have now risen for six consecutive months and February's gain was the largest since March 2010. The strength in auto sales should be reflected in broader measures of February consumer spending.

Consumers have been much more optimistic in recent months. The Conference Board reported that consumer confidence rose for the fifth consecutive month in February, surging to the highest reading in three years. Spending intentions remain encouraging. Plans to purchase a car during the next six months rose to a record high, tripling the rate recorded earlier this year. Although plans to buy a home during the next six months fell to 4.4 percent from 5.2 percent in January, it has remained well above the sub-two percent readings witnessed during the summer of 2010. Similarly, the Reuters/University of Michigan Consumer Sentiment Index also rose in February to the highest reading in three years. However, these survey results were collected before the surge in oil prices, which may weigh on sentiment in coming months.

The negative impact of rising oil prices will likely be uneven: greater for lower-income consumers than for upper-income consumers. Like food, the shares of gasoline consumption are higher for lower-income groups than upper-income groups.

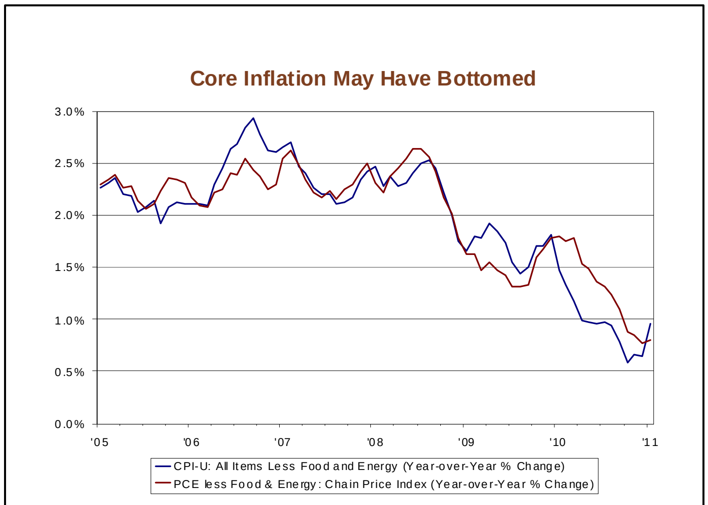



Manufacturing activity has shown no signs of cooling. The Institute of Supply Management (ISM) manufacturing index rose to 61.4 in February, matching the 25-year high reached in May 2004. The details were encouraging—in particular, the new orders index edged up to the highest reading since January 2004, and exports orders rose to the highest level since 1988. The best news, however, was seen in the employment index, which jumped 2.8 points for the second consecutive month to the highest reading since 1973. The large gain was consistent with the February employment report, which showed a robust increase in manufacturing payrolls of 33,000. The inventories measure fell into contracting territory, and the combination of strong new orders and slower inventory accumulation indicates that manufacturing growth should remain robust in the coming months. The ISM survey and the manufacturing component of the industrial production data show renewed strength in the factory sector in recent months.

One economic indicator suggests that business capital spending weakened substantially in January. While overall factory orders increased, core capital goods orders—a leading indicator of business investment in equipment and software—fell 6.2 percent. During the past year, these data have developed a pattern showing that the first month of each quarter tends to be substantially weaker than the other two months of the quarter due to problems with the seasonal adjustment of the data. Thus, for this month, we discount the softness of core capital goods orders—tracking the current quarter's strength using the January data alone would likely understate the underlying trend.

The service industry expanded at a faster pace in February to the highest level since August 2005 and the fourth highest reading on record going back to 1997, according to the ISM nonmanufacturing index. Both ISM surveys show an economy with a substantial amount of momentum. This is key to sustained expansion, particularly as 90 percent of the workforce is in services.

As mentioned above, an increase in oil prices is a risk to overall economic activity, especially in regard to its impact on consumers. Sustained oil price shock typically leads to economic slowdown or recession. While the economy's resilience has improved, sustained increases in oil prices may have a negative impact. Higher oil prices are not only a drag on economic growth, they also lead to higher inflation. The critical question regarding inflation is whether the increase in inflation is temporary or long-lasting. Unless there is spillover into core inflation and wages, rising oil prices will only have a temporary impact on headline inflation. Core inflation, as measured by the consumer price index (CPI) or personal consumption expenditures (PCE) price index excluding food and energy, hovered around 0.8 to 0.9 percent in January on a year-over-year basis, down from about 2.5 percent in 2008.

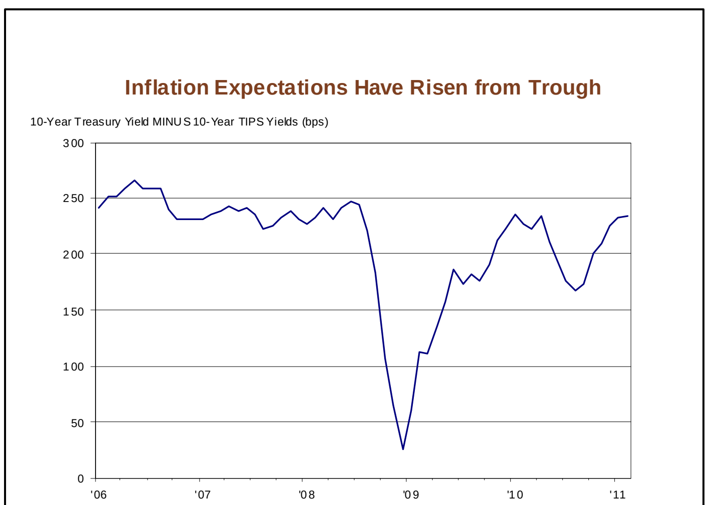


Sources: Bureau of Labor Statistics, Bureau of Economic Analysis

Core inflation is likely to have bottomed or be near the bottom, supported by the rising rent components that account for one-third of the measure. The rising trends in the rental component of core inflation are consistent with higher rents seen in many apartment surveys.

In his testimony before Congress this month, Fed Chairman Ben Bernanke indicated that the Fed expects only a temporary and modest rise in inflation—in part because a large amount of slack still prevails in the labor market. Our forecast points to a bump up in headline inflation in the first half of this year followed by a return back into a 1.5 percent to 2 percent range afterwards.

The Fed will track closely both wage rate increases and inflation expectations in determining their policy settings. Inflation expectations can be monitored on a daily basis by observing the yield spreads between 5-year and 10-year maturity Treasury issues and the yield spreads of Inflation-Protected Securities (TIPS). Those spreads began to increase last August when the Fed first mentioned the possibility of the second round of large scale asset purchases or quantitative easing (QE2). The 10-year spread is currently below 250 basis points, remaining narrower than the spreads prevailing before the 2007-8 financial crisis.



Source: Federal Reserve Board

Barring a rise in wage rates or inflation expectations, we expect the Fed to leave the funds rate near zero for the reminder of the year. We also expect the Fed to end the current round of QE2 at the end of June, as scheduled. Even so, monetary policy in the U.S. will be relatively accommodative compared with other countries. Interest rates have already been on the rise in many emerging markets as policymakers attempt to combat rising inflation. It is widely believed that the European Central Bank will start raising interest rates in the Eurozone next month.

## Housing Market: Modest Recovery from Depressed Levels

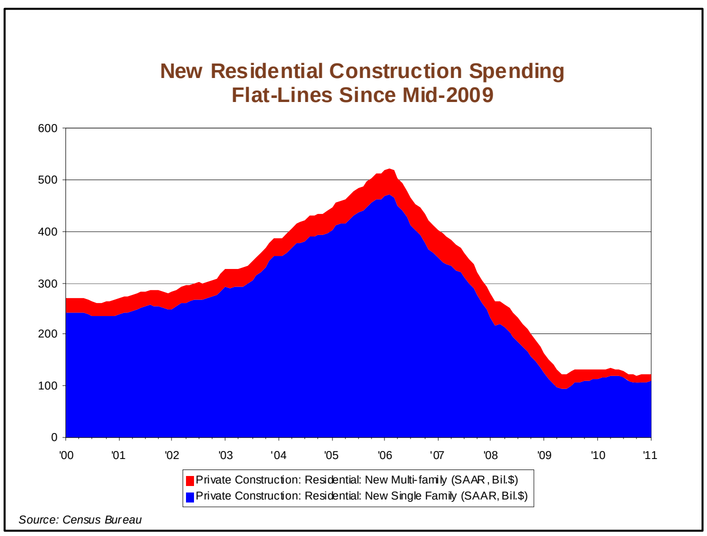
The housing market continues to face a bumpy road to recovery. Sales of existing homes have risen during five of the past six months, and in January were up by 39 percent since reaching their cycle's low last July. However, the bulk of the gain has come from distressed sales. According to the National Association of REALTORS®, the share of distressed sales rose to 37 percent in January 2011, trending up from 32 percent in June and July of 2010. The foreclosure delays late last year will likely keep the inventory of foreclosed homes elevated in coming months. Accordingly, new home sales continue to struggle as they have a difficult time competing with distressed sales and, in turn, continue to bounce along the near the bottom of the range—a range that has been in place since the expiration of the homebuyer tax credit in the middle of last year.

We expect home sales to remain soft in the near term, given uninspiring leading indicators. Following a 7.9 percent drop in January, purchase mortgage applications fell another 3.3 percent in February, due largely to interest rates rising above five percent for a couple of weeks during February. New home sales are likely to disappoint during the critical spring season, which bodes poorly for home building activity. Homebuilders' confidence in February continues to remain stuck at a depressed level of 16—the fourth consecutive month at that level (a reading of 50 means half of the builders surveyed report improving conditions).

Pending home sales, or contract signings of existing home sales which normally turn into home sales in one or two months, fell 2.8 percent in January, and there were significant downward revisions to previous months' data. The 2 percent increase originally reported for December was later revised to show a drop of 3.2 percent.

Underlying trends in homebuilding activity remain weak. Total housing starts rose sharply in January solely from a surge in starts in the volatile multifamily sector. Single-family starts fell to the lowest level since May 2009. Single-family permits also fell during the month, partially reversing the large gain in the prior month induced by building code changes in some states that became effective this year.

Total construction spending showed a weak start for the first quarter of 2011, falling 0.7 percent in January. Nonresidential construction spending led the decline. Like many economic indicators for January, the results were likely impacted by the severe winter weather. The picture for residential spending was seemingly healthy, rising by 5.1 percent. However, the gain was largely a result of a surge in home improvement. Construction spending excluding improvements—a better measure of underlying trends than total construction spending—fell 2.6 percent. Single-family new construction spending edged up slightly while multifamily new construction spending dropped. The combined nominal value of single-family and multifamily construction spending continues to remain at a depressed level, where it has been since mid-2009.



Source: Census Bureau

Public spending was unchanged during the month following three consecutive monthly drops. Weakness in this sector will likely continue given the poor state of state and local government finances.

Sluggish sales, a still-large supply of excess inventory, and the rising share of distressed sales have combined to weigh on prices. A variety of house price measures have shown renewed declines since the end of the home buyer tax credit.

Continued declining home prices in the fourth quarter increased the number of underwater mortgages modestly to 11.1 million, according to CoreLogic. The bulk of underwater mortgages are concentrated in five states: Nevada, Arizona, Florida, Michigan, and California. The loans in these states account for about 31 percent of the nation, but they represent about 46 percent of underwater mortgages.

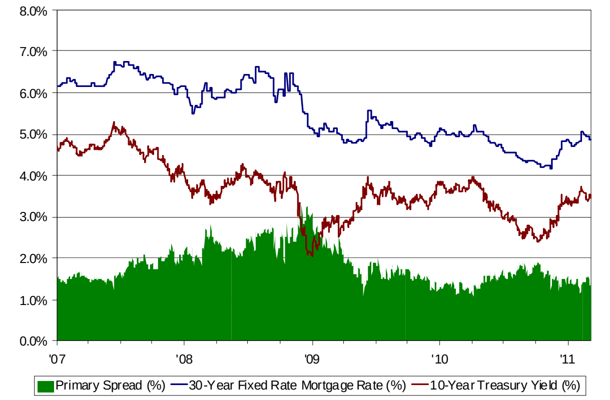
We expect home prices to continue to decline modestly on a national basis before stabilizing later in 2011. The Fannie Mae National Housing Survey for the fourth quarter of 2010 showed that respondents expect home prices to be little changed in 2011. However, respondents expect rents to rise from last year.

Improving multifamily fundamentals, including the steady decline in the rental vacancy rate since its peak in the third quarter of 2009, have helped support rents. (For more information on current multifamily market conditions, including multifamily mortgage activity in 2010, read the *March 2011 Multifamily Market Commentary*). The sharp decline in the rental vacancy rate in the fourth quarter of last year, the biggest drop since 1966, points to a sizable drop in the excess supply of vacant homes for rent. Moreover, the decline also was across properties with various numbers of units: 1 unit, 2-4 units, and 5 units or more properties. Traditionally, more rental households live in properties with 1-4 units than those with 5 or more units.

In addition, the shadow inventory appears to have peaked in 2009. The serious delinquency rate from the Mortgage Bankers Association National Delinquency Survey, which includes loans that are 90 days or more past due or in the foreclosure process, rose to a record high in the final quarter of 2009 and has since trended down, albeit to an elevated level, at the end of 2010.

We estimate that there are fewer than 4.5 million seriously delinquent loans, compared with over 5 million loans at the end of 2009. Not all of the homes backed by these loans represent future supply, however. Some of them will be cured or modified, and others are already on the market. Short-term delinquency rates also have improved. Since peaking in the first quarter of 2009, the delinquency rate for loans that are between 30 days and 59 days past due has declined to the lowest level since the fourth quarter of 2007.

**Rates Are Rising, but the Primary Spread Remains Steady**




*Source: Bloomberg*

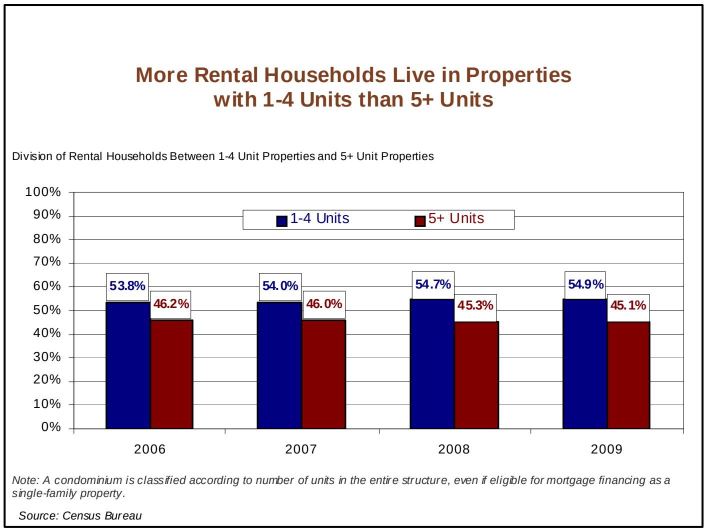
**Americans do not Expect Home Prices to Recover in 2011 and Expect an Increase in Home Rental Prices**

| | GP % | | |
|---|---|---|---|
| | Q4-2010 | Q3-2010 | June '10 |
| Expected overall home price change for 2011 | +0.4 | -0.1 | +0.9 |
| Expected overall home rental price change for 2011 | +2.8 | +2.8 | +3.6 |

*GP – General Population*

*Source: Fannie Mae National Housing Survey, Q4 2010*

After rising by nearly six percent in 2010, the first gain in five years, homebuilding activity should continue to improve modestly this year. For all of 2011, we expect total housing starts to increase by 10.6 percent, with a substantially stronger gain in multifamily starts. This is a downward revision from the gain of about 18 percent in the prior forecast, all in single-family starts, in response to a lack of improvement in single-family fundamentals during the past several months. Home sales should rebound moderately this year with the expected improvement in labor market conditions. We expect total home sales to rise by nearly 7 percent from depressed levels. However, the housing market will continue to face the headwinds from rising mortgage rates. While rates have drifted lower in recent weeks thanks to a flight to quality amid the turmoil in the Middle East, we still expect them to trend up through the rest of the year, reaching about 5.5 percent by year end.




Another headwind is lending standards, which continue to be tightening steadily in the FHA space in the form of increased mortgage insurance premiums. Next month, the annual insurance premium will rise by another 25 basis points, representing a cumulative increase of 60 basis points since last September. Furthermore, Treasury Secretary Timothy Geithner reiterated in his testimony this month the main theme of the recent white paper on GSEs: the withdrawal of government support for the mortgage market. While no specifics have yet been released, in the near-term this amounts to the possibility of new tightening measures, including the scheduled reduction in temporary conforming loan limits, and possible higher g-fees (guarantee fees charged by GSEs to lenders for bundling, servicing, selling, and reporting MBS to investors).

Expected rising mortgage rates throughout this year and tighter lending standards will keep prepayments subdued. The refinance share of the dollar volume of mortgage loans trended down steadily to about 63 percent in February from more than 81 percent between August and October 2010, and we expect it to continue to decline through the rest of the year. Projected modest increases in home sales, combined with expected moderation in the pace of decline in home prices, should combine to push purchase mortgage originations up later this year after falling for the past five years. For all of 2011, total mortgage originations should decline to $1.03 trillion from an estimated $1.53 trillion in 2010. The refinance share is projected to decline to 36 percent from an estimated 65 percent in 2010. Along with an on-going deleveraging of other consumer debt, we expect total single-family mortgage debt outstanding to fall by 2.1 percent—moderating from a drop of 2.9 percent in 2010.

Following completion of the March Economic Outlook, the events in Japan unfolded and are still unfolding. This information was not included in Commentary and Forecasts, but may have an impact on the forecast outlook. Dimensions of the impact will be described in the April Economic Outlook Commentary and reflected in the Forecast numbers.

Doug Duncan and Orawin T. Velz
Economics and Mortgage Market Analysis
March 10, 2011