

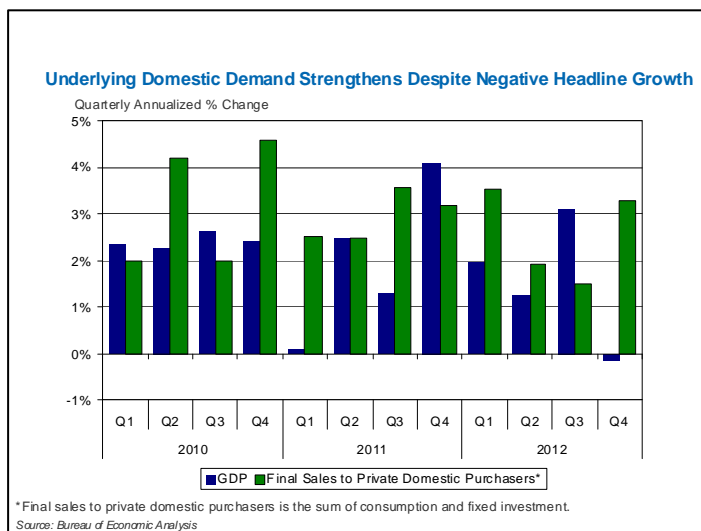
## Stuck in a Slow Growth Track

The path through 2013's first quarter fiscal travails is still not clear and will weigh to some degree on growth for the year. The debt ceiling breach seems off the table; the continuing resolution for funding government operations will be contentious and the sequestration is likely to take effect. The two elements of tax increases already implemented may be joined by more, which will increase fiscal drag, so we see no reason to revise our base forecast from last month.

On the positive side, building blocks available for stronger growth include housing, now on a sustained growth path; manufacturing, which may make increasing contributions to output domestically (but with less employment effect); and energy production (with both economic and geopolitical benefits). Barring fiscal decisions outside our current base expectations, these factors support a risk assessment that suggests that if our forecast is wrong it is likely too conservative on growth. The economy does appear to be transitioning to a slightly stronger growth path, but many headwinds remain in place.

The economy ended 2012 on a feeble note, with the first estimate of fourth quarter gross domestic product (GDP) showing a slight drop of \$5 billion in real (inflation-adjusted) GDP or 0.1 percent annualized. The first decline since the recession ended in the second quarter of 2009 does not alter our outlook for 2013 as the main culprits—a massive decline in defense spending and a sizable drop in inventory investment—were temporary drags that are unlikely to recur. Net exports also unexpectedly deteriorated. However, December trade data, released after the GDP report, suggests that the final GDP estimate will likely show slightly positive growth.

Consumer and investment demand also picked up sharply. Final sales to private domestic purchasers, the sum of consumer and investment spending rose at a strong 3.3 percent annual rate during the fourth quarter.



The pickup in private sector demand late last year defied policy uncertainties as well as disruption from Hurricane Sandy. Despite relatively strong consumer spending in the prior quarter, we expect its growth to weaken in the current quarter as a result of the increase in the payroll tax as well as the tax hike on higher-income households. On the more positive side, the recovery in the housing market appears to be gaining ground and broadening, and we expect the housing market to provide some offsetting boost to growth. On balance, economic growth should remain weak through the first half of this year.

Growth should remain subdued through the first half of this year before picking up in the second half. By the fourth quarter of 2013, we expect year-over-year growth of 2 percent, modestly accelerating from 1.5 percent in 2012 and in line with average growth since the recovery began more than three years ago. Main drivers of growth include

consumer spending, business investment in equipment and software, and residential investment. Increased taxes and reduced government spending will remain the primary drag. The global economic outlook for net exports is mixed, with Europe remaining in recession while emerging economies are strengthening. U.S. export growth slowed markedly in the second half of 2012, and we expect net exports to be a small drag to growth in 2013.

## Fiscal Policy: Policy Overhang Continues Through Summer

The agreement in the American Taxpayer Relief Act of 2012 (ATRA) that delayed and reduced some of the scheduled cuts by a mix of raising additional taxes and pushing some spending cuts into 2014 leaves an approximately \$40 billion cut in outlays in fiscal year 2013, or approximately \$50 to \$60 billion in calendar year 2013. The sequestration, if it occurs in full, will likely amount to a drag of 0.5 percentage points to economic growth for the rest of this year. By comparison, we

expect an approximately 0.2 percentage point drag in our forecast, as it is possible that some modified version of sequestration with less fiscal restraint will begin around the March 1 “soft” deadline, allowing Congress to continue to negotiate until March 27. At that time, absent Congressional action, the temporary spending authority—known as a continuing resolution—will expire and the government will shut down. We recognize that the possibility that sequestration will occur without alteration has increased, posing a downside risk to our outlook stemming from more fiscal austerity than currently anticipated.

The debt ceiling is now on the back burner, as Congress suspended it until May 19. The Treasury will be able to use extraordinary measures to continue to pay its bills through July or early August.

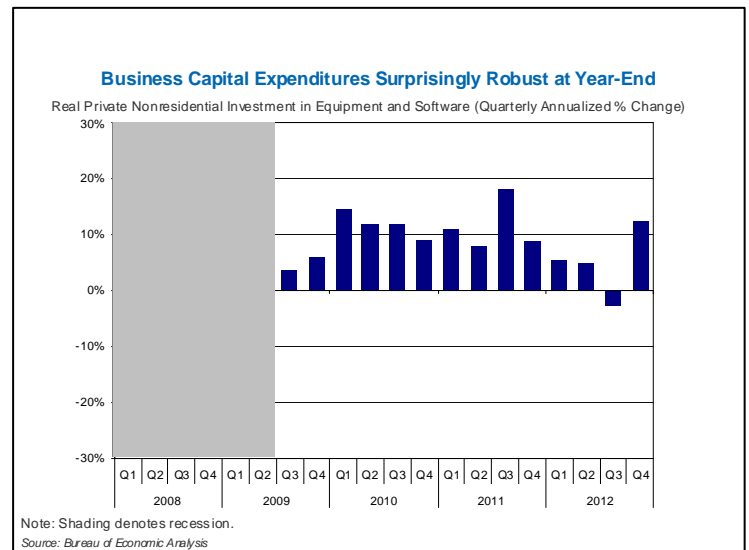
## Monetary Policy: Open-Ended QE3 Expected to Expire at End of 2013

Interest rates have been on an upward trend so far in 2013. The 10-year U.S. Treasury yield rose recently above 2 percent for the first time since April of last year. The impetus for the rise includes receding downside risks from fiscal policy, signs of easing strains in the global financial markets, and a markdown in expected duration of the Federal Reserve’s open-ended Treasury and MBS purchase program (the third round of Qualitative Easing, or QE3). We now expect that QE3 will continue only through the end of this year, with a total of approximately \$1 trillion of assets purchased, compared with our prior expectation of nearly \$1.5 trillion of open-ended assets purchased through the first quarter of 2014. The mortgage market appears to have priced in a possibility of an early end to QE3 as well, as the yield spread between the Fannie Mae 30-year current coupon and the 10-year U.S. Treasury has widened by about 20 basis points since the start of the year. As a consequence, the yield on 30-year fixed-rate mortgages is trending up, and we expect the rate to rise to approximately 4.1 percent by the end of 2013, roughly 30 basis points more than in the previous forecast. Unless the Fed changes its forward guidance of interest rates tied to its forecast of the unemployment rate and inflation targets, we continue to expect no Fed funds rate hikes until the second half of 2015. Inflation pressure has remained tame and has not sparked concerns from the Fed.

## Manufacturing and Business Investment: Building Momentum

The industrial production report showed that manufacturing output rose strongly in December for the second consecutive month to a recovery high, carrying momentum into the current quarter. For the fourth quarter, manufacturing production posted a modest pickup, reversing some of the prior quarter’s decline. Auto output rose 10 percent at an annual rate following a 2.3 percent drop in the third quarter, and production schedules indicate that the current quarter will be strong for auto output as well.

Manufacturing activity improved at the start of the year, according to the Institute for Supply Management (ISM) manufacturing survey, which jumped nearly 3 percentage points to 53.1 percent in January—the best showing since last April (a reading of over 50 indicates expansion). One big upside surprise in the fourth quarter GDP report was the strength in business investment in equipment software (capital expenditures or Capex), which posted the biggest gain in a year, despite the uncertainty regarding fiscal policy around that time.



December factory orders showed that core capital goods orders—a leading indicator of Capex—jumped at a robust 27 percent annualized rate over the last three months of 2012, suggesting that Capex will continue to rise in the current quarter and be a driver of growth again this year, given the extension of the 50 percent bonus depreciation of Capex for one more year. However, slowing growth in corporate profits will keep Capex growth much more moderate than the pace witnessed in the early stages of the recovery.

## Employment: Better Labor Market Picture than Previously Thought

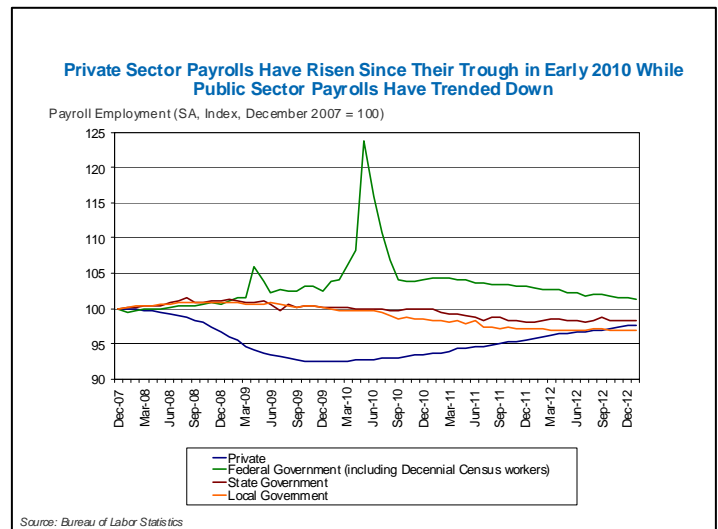
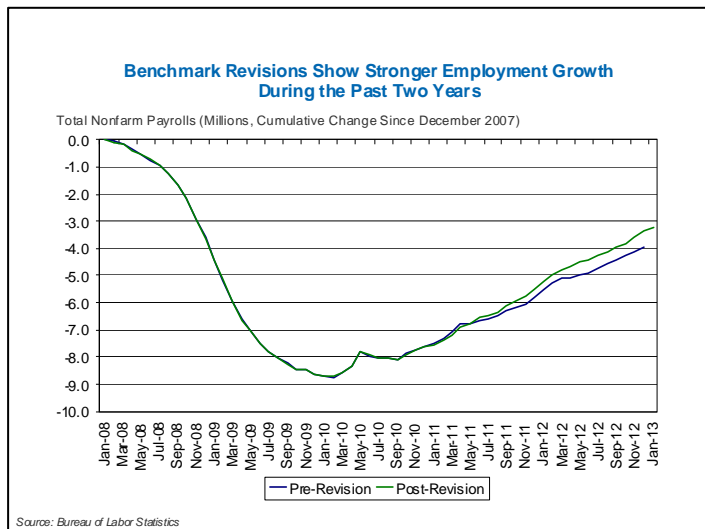
The labor market lost a bit of momentum at the start of 2013, but the recent trend was healthier than previously reported. Total nonfarm payrolls grew by 157,000 in January, while previous months’ gains were revised higher, partly because of

annual benchmark revisions. As a result, the average monthly gain in the fourth quarter of 2012 was roughly 200,000 for total nonfarm payrolls and 225,000 for private payrolls. The household survey was discouraging, as the unemployment rate ticked up one-tenth to 7.9 percent, the first rise in three months. We expect the unemployment rate to trend down very gradually, reaching 6.5 percent by mid-2015.

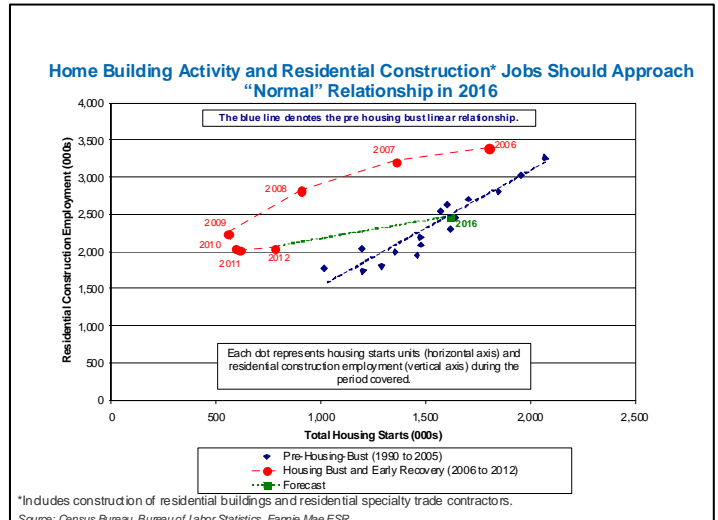
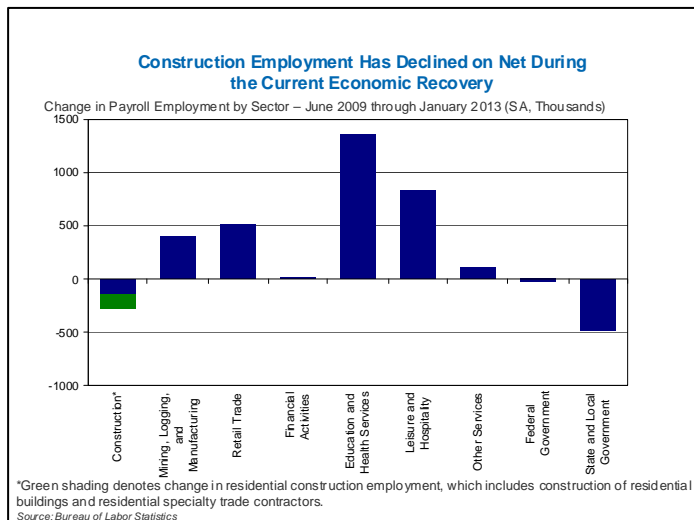
Although the recent trend in payrolls is at odds with the headline economic growth in the fourth quarter of 2012, the healthy average monthly gain in private payrolls in the fourth quarter is consistent with robust growth in Capex in the GDP report, suggesting that uncertainty over fiscal policy did not hurt businesses' hiring and investing as feared.

The benchmark revisions to nonfarm payrolls showed that the pace of job creation was stronger than previously believed, as they added a total of 335,000 jobs in 2012, sending total job gains to 2.2 million new jobs for the year. The upward revisions implied that the labor market was resilient, capable of withstanding shocks including the European debt crisis, fiscal policy concerns, and natural disasters. From the start of the recession through the end of last year, total job losses totaled 3.6 million, remaining sizable but smaller than the 4 million figure recorded before the benchmark revisions.

Private sector employment troughed in early 2010 and has trended up since but remains approximately 2.3 percent below the level at the onset of the recession. Meanwhile, all levels of government employment have trended down.



Of the private industries, only construction payrolls have remained below the level at the start of the economic recovery, reflecting unprecedented lackluster homebuilding activity, while financial service activities employment showed only a slight gain. The industries that experienced the strongest job growth since the recession ended are education, health services, leisure, and hospitality.



In the January commentary, we noted that we will analyze a number of aspects of the economy throughout 2013 as they “transition to normal.” In the prior month’s analysis, we projected that homebuilding activity will return to normal by 2016. The return to normal building activity also implies an increase in residential construction employment, which we expect to increase by approximately 412,000 jobs, or 20 percent, between 2012 and 2016.

While the gain in homebuilding employment will be roughly three times greater than the pace of total job growth during this period, it will not erase all homebuilding job losses incurred during the housing bust. In 2016, the number of residential construction jobs is forecast to remain nearly 1 million fewer than at the peak of the housing boom. This is because the higher level of employment was driven by the overbuilding prior to the onset of the downturn.

## Income: Surging Before Plummeting after Tax Hikes

Disposable personal income jumped 2.7 percent in December, as businesses rushed to pay out dividends and bonuses ahead of the anticipated tax increases.

Excluding these factors, disposable personal income increased just 0.4 percent. The surge in income pushed the saving rate up to an above-trend 6.5 percent from 4.1 percent in the prior month. We expect income and the saving rate to pull back, as the effect of the one-off jump unwinds and as the tax hikes took effect at the start of this year.

## Consumer Spending: Poised to Slow

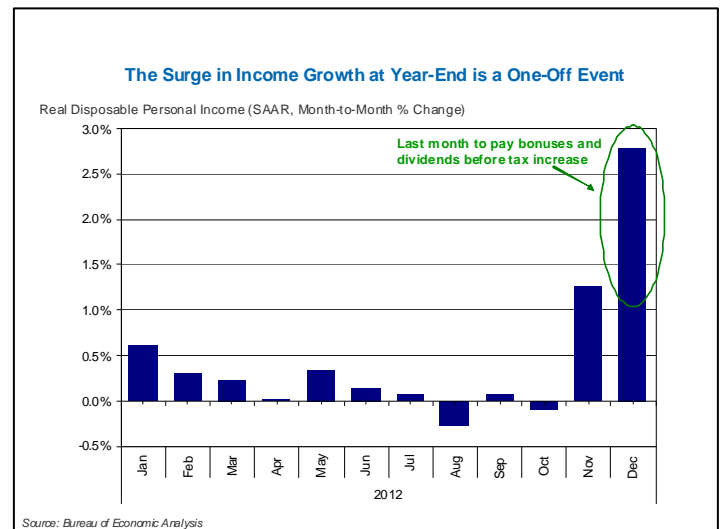
Both real and nominal personal consumption expenditures increased 0.2 percent in December, boosted by spending on motor vehicles. For the fourth quarter, real consumer spending growth accelerated to 2.2 percent annualized from 1.6 percent in the prior quarter. Despite decent auto sales in January—slightly lower than the December sales pace but higher than the monthly average of the fourth quarter—we expect consumer spending growth to slow to slightly over 1 percent, as the tax hikes from the expiration of the payroll tax holiday, institution of new healthcare taxes, and other tax rate hikes on higher-income households take a bite out of income.

Measures of consumer confidence took a hit late last year, partly reflecting lower expected take-home pay, but the signals were mixed in January. The Conference Board’s consumer confidence index continued its three-month plunge by dropping more than 8 percentage points to 58.6 percent, the lowest level in more than a year. The index of consumers expecting an increase in income less those expecting a decline plunged to the lowest level since the recession. By contrast, the Reuters/University of Michigan consumer sentiment index rose between the preliminary and final January reports and also between December and January, albeit modestly. Despite the gain in the headline, details in the survey showed some concerns over the tax hikes, as sentiment regarding current personal finances fell, with the weakness coming from lower-income respondents.

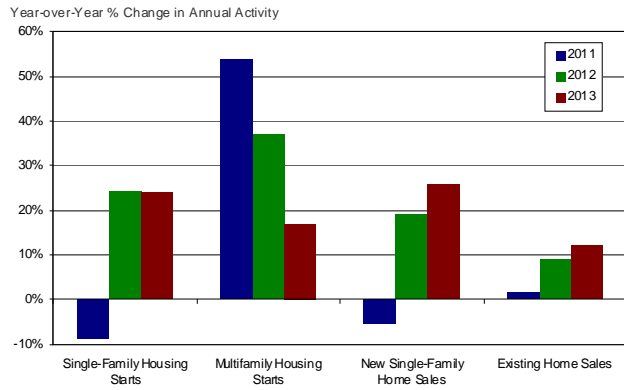
## Housing: Broadening and Durable Recovery Under Way

Housing underpinned the broader economy in 2012, particularly the pickup in construction. However, while homebuilding activity strengthened at the end of the year, new and existing home sales weakened. Leading indicators such as pending home sales and building permits also pulled back, suggesting some softening momentum in the near term. Aside from the month-to-month volatility, all housing indicators performed quite well in 2012 compared with 2011, and housing fundamentals suggest a continuing solid housing recovery this year.

One of the key developments for the housing market last year was the general consensus that home prices, on a national basis, bottomed earlier in the year and continued to build momentum, exhibiting robust year-over-year gains unseen since the housing boom. While prices usually weaken in the winter months, the CoreLogic house price index (non-seasonally adjusted) defied seasonal weakness, rising 0.4 percent in December from November, and 8.3 percent from last year—the biggest gain since May 2006.

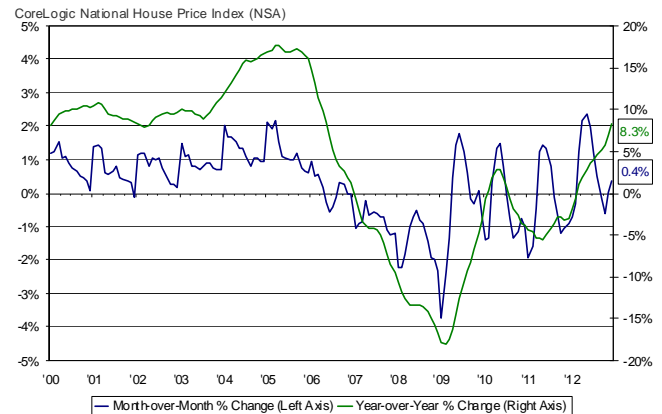


**After Rising Substantially in 2012, New Home Construction and Home Sales Are Poised to Improve Further in 2013**



Sources: Census Bureau, National Association of REALTORS®, Fannie Mae ESR

**Home Prices End the Year on a Firm Note**



Source: CoreLogic

The main driver for the strength of home prices is the rapid decline in the inventory of homes available for sale. Total inventory of both single-family new and existing homes is at the lowest level since December 1994. The combination of delays in the foreclosure process and strong investor demand has greatly reduced the inventory of distressed properties. The pace of distressed sales has slowed substantially over the past year, with the distressed sales share of total existing home sales dropping to 24 percent at the end of 2012 from 32 percent witnessed a year ago, according to the National Association of REALTORS®. In addition to the declining share of distressed sales, a shift toward short sales also has helped boost home prices.

Positive home price expectations are a crucial factor for a continued broadening housing recovery. The [Fannie Mae January National Housing Survey](#) showed consumer home price expectations hovering near the strongest levels recorded in the survey's two-and-a-half-year history. The belief that home prices are on the rise provides an incentive for potential homebuyers to get into the market especially with expectations of interest rate increases on the rise.

While there is still a large pipeline of mortgages that are more than 90 days past due or in the foreclosure process, which potentially could add to the supply of housing, the process will likely be very gradual, especially in judicial states. In some areas, such as Phoenix, the inventory fell sharply last year, driven by investor demand, including institutional investors who bought distressed properties in bulk with the intention of renting them for a few years until home prices begin to rise sufficiently to take capital gains.

Continued lean inventory and the increase in the rate of household formation amid an improving labor market bode well for homebuilding activity and residential construction employment. Thus, we expect housing to be a bigger contributor to growth going forward. So far in the housing recovery, multifamily building has been a brighter spot than the single-family segment, supported by the decline in the homeownership rate amid tight mortgage underwriting and a rising number of households with blemished credit. (For more information on multifamily market conditions, including recent trends in rents, read the [February 2013 Multifamily Market Commentary](#).)

One unknown on the supply side of the market is how many borrowers who owe more on their house than its current market value would offer it for sale if they weren't underwater. The share of survey respondents saying it is a good time to sell continues to rise suggesting that house price increases may be readying more current homeowners to offer their homes for sale.

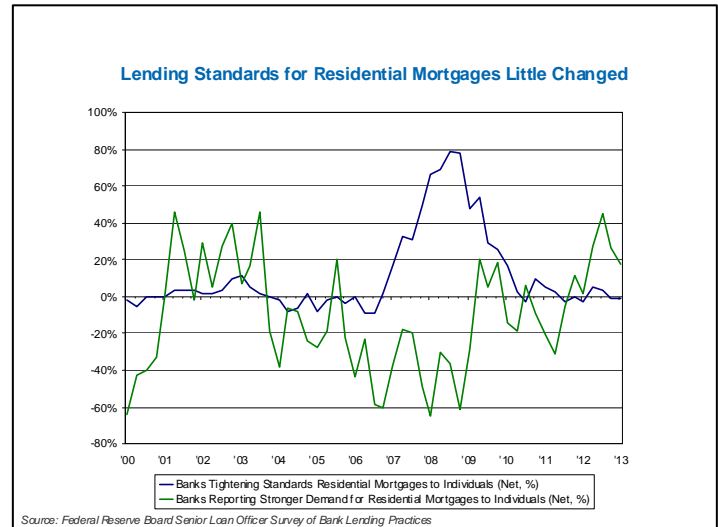
A crucial factor for the housing recovery to reach a normal level of activity is credit availability. The latest Federal Reserve Senior Loan Officer Survey showed that while lending standards were less tight in 2009 and 2010, they were little changed since then through January of this year. It is unlikely that they will ease substantially this year.

Given our expectations of continued improvement in housing starts, home sales, and home prices in 2013, we project that purchase mortgage originations will rise to \$628 billion from a forecast of \$530 billion in 2012. However, rising mortgage rates will sharply reduce refinance originations. The drop in projected refinance originations is more pronounced now than in our prior forecast as our projected mortgage rates paths are roughly 30 basis points higher. Refinance originations

should decline to \$880 billion from a projected \$1.4 trillion in 2012, resulting in a refi share of 58 percent in 2013. Our forecast assumes that the Home Affordable Refinance Program (HARP) will expire at the end of 2013 as scheduled. We expect that the single-family mortgage debt outstanding will decline an additional 1 percent in 2013, following an estimated 2.8 percent decline in 2012.

While we expect the housing recovery to continue to firm going forward, the housing market will continue to face challenges in coming years. One piece of evidence that obtaining mortgages will likely be more difficult and costly is the continued rise in FHA mortgage insurance premium (MIP), with a scheduled 10-basis point increase going into effect in April. This will hurt first-time homebuyers more than repeat buyers because they are more likely to use FHA mortgages. However, the impact will spill over to existing homebuyers as well since a healthy flow of first-time homebuyers allows existing homebuyers to trade up. The increase in the MIP also will create a hurdle for some FHA refinancees who obtained mortgages after June 2009. In the conventional conforming space, further rises in guarantee fees also would increase the cost of obtaining a mortgage.

Finally, in January the Consumer Financial Protection Bureau (CFPB) finalized the rule on Qualified Mortgage (QM), which was a part of the Dodd-Frank legislation to protect consumers from the most risky features of the mortgage market—including interest-only, negative amortization, and balloon mortgages. It also protects lenders from litigation as they can claim “safe harbor” from future litigation given they followed certain guidelines, including the borrower’s ability to repay criteria, which set a maximum 43 percent back-end debt-to-income ratio (DTI). Given that the rule allows up to seven-year exclusion (or at the end of GSE Conservatorship—whichever occurs first) to loans that meet GSE and FHA underwriting guidelines, even if they exceed the 43 percent DTI, we expect that the QM rule will not substantially limit access to mortgages in the near or intermediate term. While jumbo loans do not qualify for the exclusion since they cannot be financed by the GSEs and FHA, our estimate shows that they account for a small portion of the overall mortgage market.



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**Doug Duncan, Orwin T. Velz, and Brian Hughes-Cromwick**  
**Economic and Strategic Research**  
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