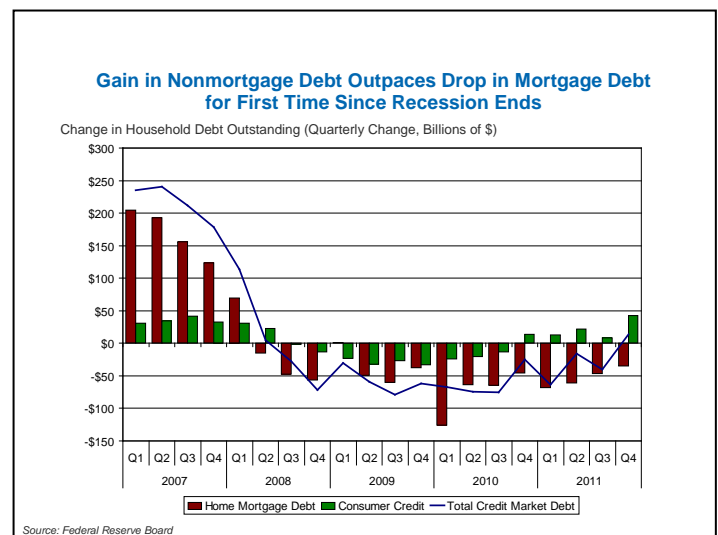
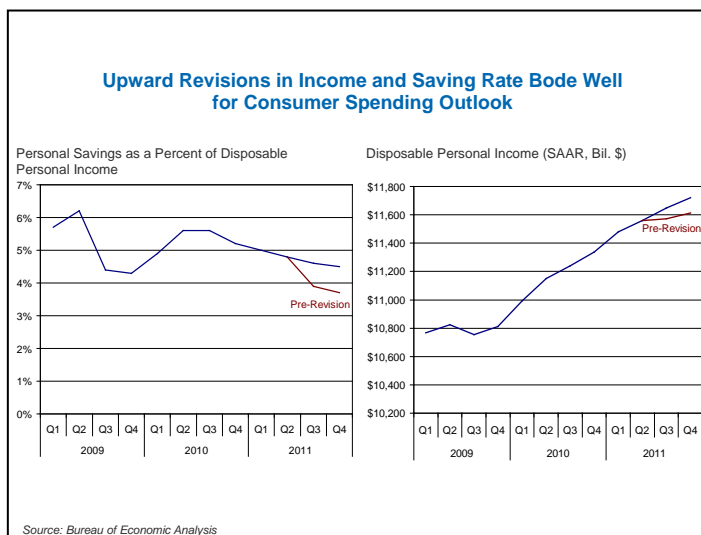


Economic Growth Continues. Let's Be Glad For That.

Incoming economic data paint a picture of a gradually improving economy. Real economic growth moved at a faster pace at the end of last year compared with previous quarters during 2011. Gross domestic product (GDP) revisions for the fourth quarter indicated a stronger underlying pace of demand with higher consumer spending and business investment, as well as less inventory buildup than previously reported. The headline economic growth was the best since the second quarter of 2010. However, inventory accumulation still accounted for about two-thirds of the increase, and growth from other sources grew at a tepid 1.1 percent annualized pace.

The most positive aspect of the GDP revisions was the upward revision to income growth, which revealed a less sharp decline in the saving rate in the second half of 2011. Increased income growth and less saving reduction imply consumer spending has stronger support in the near-term. Before the upward revision to income, it appeared that some of the growth in consumer spending in the second half of last year was fueled by a an unsustainable decline in the saving rate, which would have belied necessary household deleveraging and balance sheet improvements. Instead, consumer spending growth was fueled by a higher income trend, which is necessary in the face of rising gasoline prices.



Data from the Federal Reserve's Flows of Funds suggest that the household deleveraging process may be coming to an end, at least for nonmortgage debt. Household debt rose slightly in the fourth quarter of 2011, the first increase since the second quarter of 2008, as the gain in consumer credit outpaced the decline in mortgage debt outstanding. Deleveraging of mortgage debt, both voluntary and involuntary, has yet to establish a bottom having fallen or been flat for 15 consecutive quarters, though the decline in the fourth quarter was the smallest since the end of 2009. Consumer credit has risen for five consecutive quarters with the largest gain taking place in the fourth quarter of 2011.

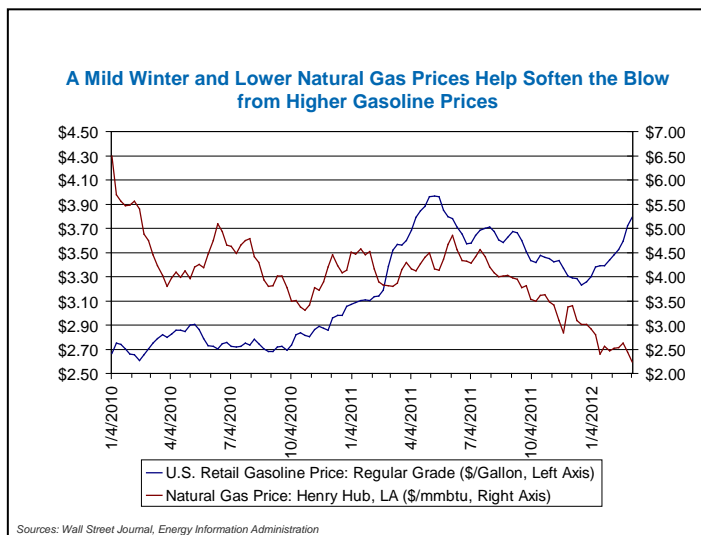
Rapid growth in student loans, which have risen four-fold since 2008, has played an important role in the rebound in consumer credit, though it has been less dominant in recent quarters. In the fourth quarter of 2011, only 35 percent of the change in consumer credit came from student loans, compared with more than 100 percent during the second half of 2010 (i.e., consumer credit excluding student loans dropped sharply during that time). Monthly data show that consumer credit continued to expand in January, driven largely by a surge in student loans, which tend to spike in January because of the disbursement of the spring semester's loans. Revolving credit, which is mainly credit card balances, tumbled in January, ending a four-month streak of increases.

Flow of Funds data showed that household assets increased by \$1.2 trillion in the fourth quarter—a partial recovery from the \$2.6 trillion decline in asset holdings in the prior quarter. The increase was driven by gains in financial assets offsetting continued declining housing wealth. We expect the ongoing healing of the household balance sheet to lend increasing support to consumer spending over time.

Our prior forecast had called for economic growth to decelerate sharply in the first quarter as inventory investment is expected to slow substantially from the unsustainable pace reported in the fourth quarter of 2011. At the same time, we had expected the underlying demand (GDP minus inventory investment) to strengthen sizably from the lackluster pace in the fourth quarter, serving to mitigate the concerns about the slowdown in the headline economic growth rate. However, recent economic reports suggest that growth in the first quarter of this year will come in even weaker than we had already anticipated—at less than two percent.

The main culprit was the soft trajectory for consumer spending, which came in flat in January for the third consecutive month. While income has been relatively strong in recent months, rising tax liabilities and slowing transfer receipts as well as higher prices have combined to depress real disposable income, which fell in January for the second time in the past three months.

This indicates that consumers were strained even before the most recent spike in gasoline prices. Gasoline prices closed in February at a higher level than a year ago, but remained lower than the peak registered in 2011. At the same time, however, natural gas prices fell sharply during the past year, remaining well below the peak recorded in 2011, which has helped soften the blow from higher gasoline prices.



So far, consumer-related activity for February has been positive. Measures of consumer confidence rose to the highest levels in a year, chain store sales posted a healthy year-over-year gain, and auto sales soared during the month to the strongest pace seen since March 2008.

News from the labor market continued to be encouraging. The February jobs report was another solid release, showing an increase in nonfarm payrolls of 227,000. Upward revisions in the prior two months added 61,000 jobs, bringing average monthly job gains to a strong 245,000 during the past three months. The average monthly private payroll gain of 251,000 during the past three months was just slightly short of the pace reached in the three months ending in April 2011. However, last year, we saw this strong pace of hiring dissipate amid the shocks

from the tsunami and earthquake in Japan as well as the intensified European sovereign debt crisis. The pickup in the pace of hiring this year coincided with unseasonably warm winter weather that may have pulled forward seasonal hiring that typically begins in later months. As a result, a portion of the recent strength in the labor market may be overstating the true improving trend and some payback may occur. The extent of the impact of winter weather will be estimated following events of the forthcoming spring season.

Another positive detail in the jobs report was that hiring of temporary workers—generally a leading indicator of permanent hiring—surged by 45,000 during the month, the best showing since January 2010. In addition, after acting as a drag in the employment picture since mid-2008, it appears that state and local government payrolls may be stabilizing, with local government payrolls rising and state government payrolls declining only slightly during the month. It is too soon to call an end to the drag from the state and local governments, however, given an expected sizable fiscal drag in coming years and looming public pension shortfalls.

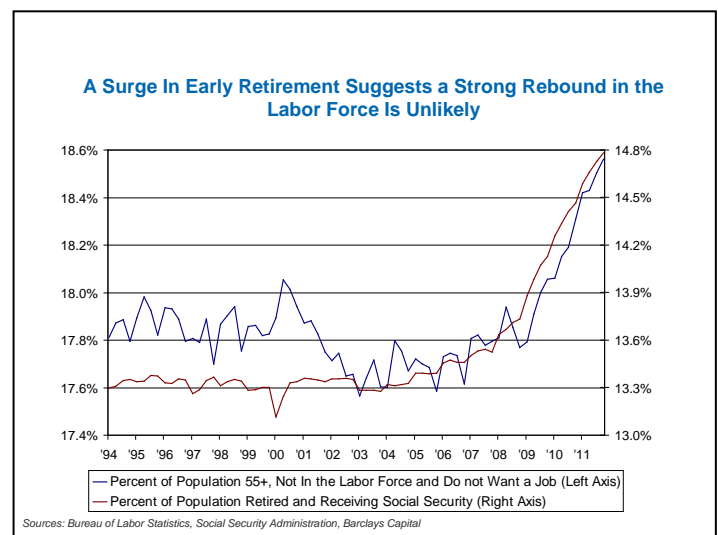
Other aspects of the employment report were less upbeat: the average workweek was unchanged, and wage growth remains anemic, ticking up only 0.1 percent during the month and 1.9 percent during the past year. The unemployment rate, calculated from the survey of households, held steady at 8.3 percent despite a jump in the number of new entrants to the labor force. The increase in the labor force is a positive development as it signals growing confidence in the market. In fact, household employment during the past three months has been the strongest in more than a decade, suggesting that the recent decline in the unemployment rate represents a genuine improvement in labor market conditions. The improving trend in household employment has been much better than that for payroll employment. Some of the strong gains in household employment may reflect a higher rate of new business formation as well as strong growth in contract workers and the self-employed, none of which is captured in the payroll survey.

The labor force participation rate, which measures the share of the working-age population that is either working or searching for employment, increased 0.2 percentage points to 63.9 percent during the month, driven primarily by the re-entry of younger workers into the labor market. This marks the largest gain since early 2010, partially reversing the downtrend recorded in 2011. We expect the unemployment rate to decline only gradually this year, remaining slightly above eight percent by the end of 2012. If the participation rate begins to trend up as discouraged workers re-enter the workforce, the fall in the jobless rate would be slower than expected. However, there is some evidence that a strong rebound in the labor force is unlikely as the decline in the labor force participation rate is likely to be structural or permanent rather than cyclical or transitory. During the past four years, there has been a surge in the share of the population aged 55 and older who are not in the labor force and do not want a job. The sharp rise in this share is consistent with the sharp rise in the proportion of the population receiving social security benefits for retired workers.

Activity outside the labor market was mixed, but overall confirmed a slowdown in near-term economic growth. The Institute for Supply Management surveys showed a slower expansion in manufacturing activity in January, but a faster pace of expansion for the service industry. Core durable goods orders posted a sharp drop in January, indicating weakening business investment in the first quarter. Construction spending unexpectedly fell and the trade deficit widened in January to its highest level in more than three years.

We expect growth to accelerate from the subdued pace of the first quarter, strengthening to about 2.5 percent in the second half of the year. For all of 2012, we expect growth to come in around 2.2 percent, accelerating from 1.6 percent in 2011. Businesses should continue to increase their capital spending at a healthy pace, given better credit

availability, low borrowing costs, and ample cash on hand for many firms. Investment in nonresidential structures, which fell in the fourth quarter of 2011 following solid increases in both the third and second quarters, is expected to grow moderately this year, given still-high vacancy rates for commercial properties and limited availability of financing. Net exports are not expected to add to GDP growth this year, as exports will be hampered by the slowdown in global economic growth. With expected moderate growth, businesses will likely be cautious in managing the level of their inventories and, like net exports, inventory investment also is expected to be neutral to growth this year. Residential investment should add to GDP for the first time in six years, albeit only modestly, while the government sector is expected to continue to be a drag on growth for years to come.



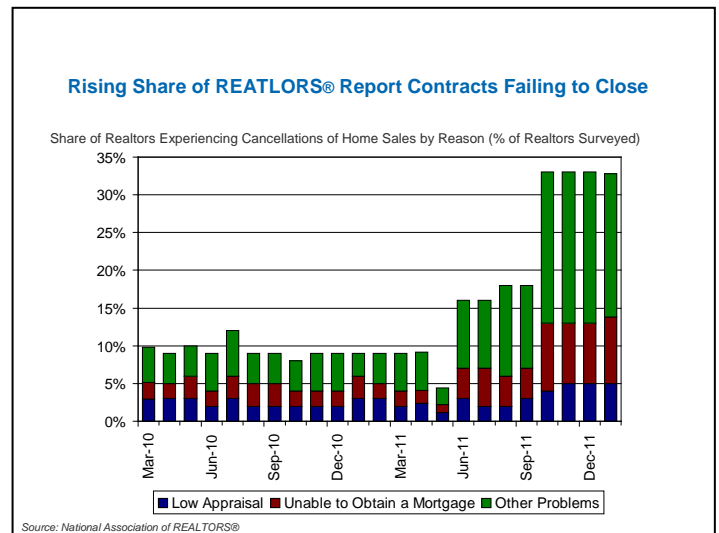
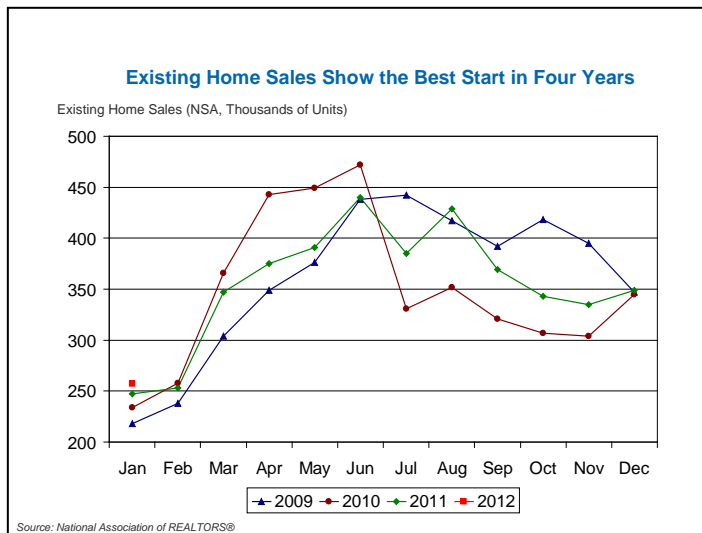
Going forward, growth is projected to slow in the first half of 2013. However, there is a great deal of uncertainty surrounding the outlook for next year, as well as the second half of 2012. The extent of fiscal tightening in 2013 remains a wild card, given the numerous categories and magnitude of the tax cuts set to expire at the end of 2012, as well as the resolution of the debt ceiling debate, which we are poised to confront later this year. We maintain our assumptions regarding fiscal policy, which we discussed in detail in prior forecasts. The uncertainty surrounding fiscal policy tightening as well as a potential deadlock in Congress or a possible downgrade of U.S. sovereign debt could again erode consumer and business confidence substantially, which could trigger a slowdown during the second half of this year—sooner than our base forecast assumes. There are upside risks to our forecast as well. If the hiring pace remains strong or strengthens, income and consumer spending could be boosted by more than we expect.

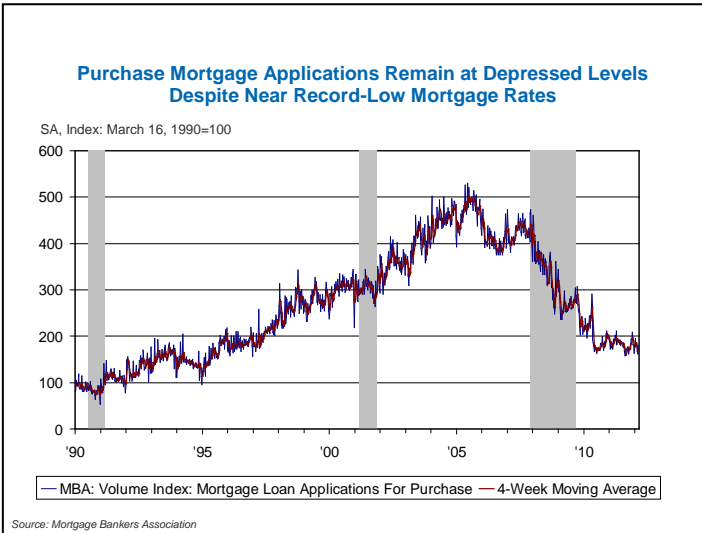
The tone of incoming data and continued gains in hiring during the past three months help to reduce the risks that the recovery will falter this year. However, many economic challenges remain and our forecast indicates that the housing market is still far from a strong recovery.

Housing: Tailwind Ahead?

Recent housing indicators have improved. Existing home sales rose in January and have gained about 27 percent at an annualized rate during the past six months. It is encouraging that actual sales (not seasonally adjusted) posted the highest level for January in four years.

Pending home sales, or contract signings of existing homes—a one- to two-month leading indicator of existing home sales (recorded at closings)—rose in January to the highest level since April 2010. This is a signal that housing demand may continue to improve going into the spring season. There are reasons to be cautious, however. A survey of REALTORS® showed that in recent months a rising share of contracts failed to close. One reason cited was failure of potential homebuyers to qualify for loans as lending standards remain tight. Another reason was that appraised values have come in below the agreed-upon sales price, forcing the buyer to lower the price or the seller to make a larger down payment in order to hold the deal together.



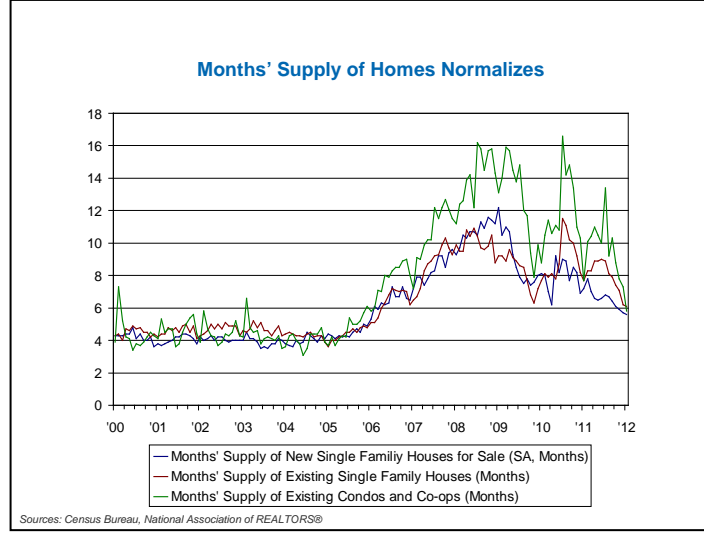
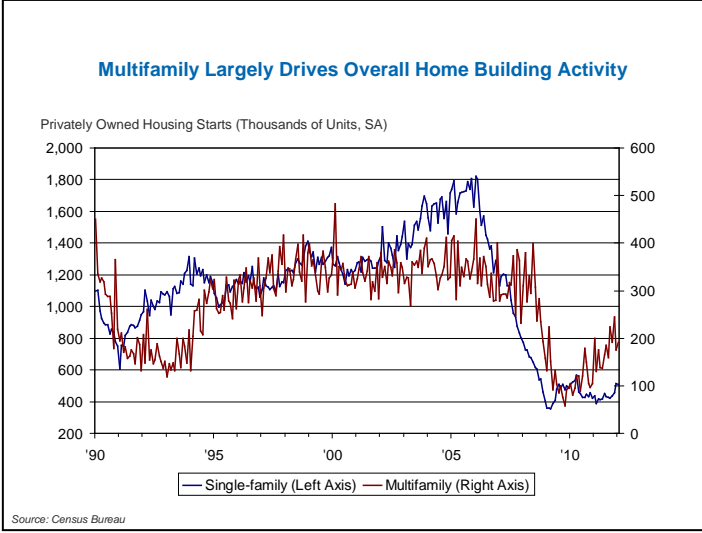


Another worrisome aspect of the housing market is the lack of sustained improvement in purchase mortgage demand. While mortgage rates have hovered near their record lows, purchase mortgage applications have remained at depressed levels. Investors and other all-cash buyers continue to play a sizable role in supporting sales in battered housing markets. The trend in purchase mortgage applications suggests continued sluggish organic demand (e.g., for non-distressed sales) despite historically low mortgage rates.

New home sales fell slightly in January following upward revisions to the data from the prior three months. It appears that new home sales bottomed in mid-2011 and have improved gradually since then. One positive aspect in the housing market is the sharp decline in the inventory of new

homes, thanks to anemic new construction activity in the single-family segment. Much of the increase in homebuilding activity during the past year has occurred in the multifamily market. (For more information on multifamily market conditions including multifamily mortgage activity in 2011, read the [March 2012 Multifamily Market Commentary](#)). While single-family construction has shown signs of life in recent months, it remains at depressed levels.

The limited home building activity has allowed the months' supply to decline over time despite still-weak demand for new home sales. The months' supply for new homes was down to 5.6 months in January, the lowest reading since early 2006 and well below its long-term average of about six months. In the existing home market, the measures of months' supply for single-family homes and for condos also have fallen sharply during the past year.



However, the reported months' supply for existing homes is not seasonally adjusted and is not an accurate measure of a demand-supply balance for the overall housing market because homeowners can put their homes on the market or remove the listings at any time for any reason. For example, active listings on the Multiple Listing Services can decline because many homeowners decide to take their homes off the market because of deteriorating market conditions, and thus the decline in inventory is not necessarily indicative of an improving market. Two broader measures that gauge the excess supply of housing are the homeowner and rental vacancy rates. While both rates have trended down during the past year, they remain above their historical norms, signaling that the number of vacant homes for sale and for rent remains above the levels associated with normal housing market conditions.

Distressed sales continued to account for more than a third of sales in January, according to a survey by the National Association of REALTORS®. The high share of distressed sales in the slower winter season has contributed to recent home price weakness. Although major economic and housing indicators improved during the fourth quarter of 2011, the main measures of home prices ended the year on a weak note. Both the S&P/Case-Shiller national home price index and the CoreLogic index declined sharply in the final quarter of 2011, breaking through new lows and posting the worst showing since 2008.

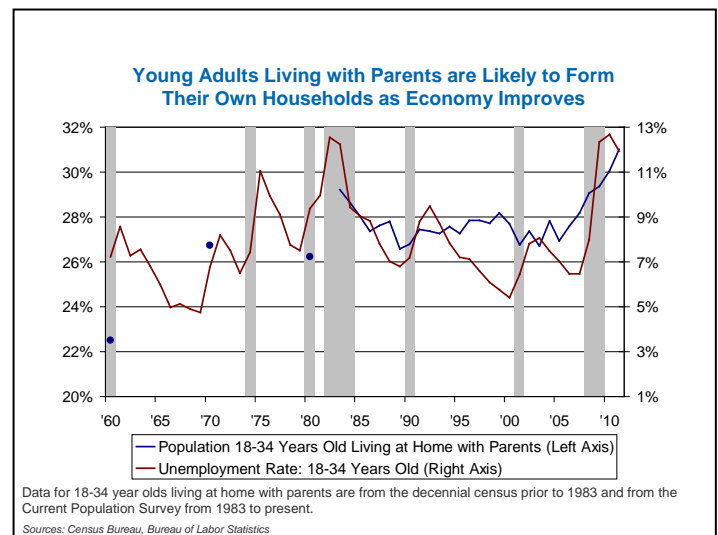
While the inflow of delinquent loans into the foreclosure pipeline has slowed during the past couple of years, foreclosure inventory has remained elevated. The recent Attorney General Settlement helped clarify the legal requirements for a valid foreclosure and some market participants expect that it will help unclog the pipeline going forward. In turn, increased competition from distressed properties would likely put renewed downward pressure on home prices as we enter the busier sales season. However, implementation details from the settlement are not final, and it is unclear how much the foreclosure to liquidation pace can be sped up in judicial states. In any case, while the clearing of the foreclosure pipeline may hurt home prices in the short run, it will likely help the markets recover over time as the shadow supply will come to weigh less on home prices.

The improving labor market is expected to help turn one of the headwinds in the housing market into a tailwind. Since the recession, the rate of household formation has been anemic, running well below the average increase of about 1.1 to 1.2 million households per year. Much of the decline can be explained by a slower rate of immigration as well as by a slower rate of household formation for young adults, who tend to delay forming households and double-up with parents or friends during tough economic times.

If the economy continues to improve as we expect, household growth will likely rebound, partly because young adults will be able to afford to form their own households. However, this group is likely to have limited funds for down payments and some may be burdened with student loan payments, as many of them went back to school in a difficult labor market. Thus, the most likely tenure choice for young adults who form their first household will be to rent rather than own. During the second half of the last decade, single-family rental units as a share of the renter-occupied stock rose from 30.8 percent to 33.5 percent—the largest increase among all rental property types. (For more information on single-family rental housing, read the [Fannie Mae Data Note: Single-Family Rental Housing—The Fastest Growing Component of the Rental Market](#)).

Increased demand for rental housing would help reduce the excess supply of vacant homes for rent and perhaps help convert some of the vacant homes for sale to rental units, decreasing the excess supply of vacant homes for sale, and, in effect, accelerating the stabilization of the overall housing market.

We continue to expect that low mortgage rates will help support housing affordability, with the yield on 30-year fixed-rate mortgages rising gradually to just slightly more than four percent by the end of 2012. The primary/secondary mortgage spread continues to hover near record levels and should remain wide, thanks to higher capital costs from Basel III, higher guaranty, and capacity constraints.



Our housing forecast is little changed from the February forecast. Total home sales are expected to rise by about seven percent in 2012 from very low levels in 2011. This modest increase in home sales, combined with expected moderating declines in home prices, should help produce a small increase in purchase mortgage originations. We revised higher our projection of refinance originations from the prior forecast, partly as a result of the announced series of FHA Mortgage Insurance Premium (MIP) fee changes. In the second half of 2012, we expect increased refinance activity due to better refinance incentives on pre-June 2009 FHA loans. While post-June 2009 FHA loans now face an additional hurdle to refinance, we expect the changes to the FHA MIP to result in more refinance originations this year than previously projected.

For all of 2012, total mortgage originations are projected to decline to \$1.14 trillion from an estimated \$1.36 trillion in 2011, with the refinance share dropping from an estimated 66 percent in 2011 to 58 percent in 2012. Total single-family mortgage debt outstanding is expected to post a fifth consecutive annual drop, falling by 0.8 percent in 2012, moderating substantially from the 2.2 percent decrease reported for 2011.

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Economic & Strategic Research
March 12, 2012

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