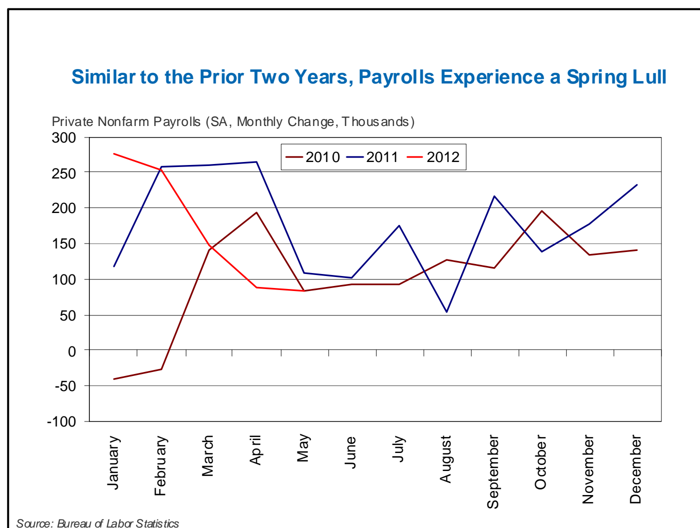
Global Political Economic Risks Rise at Mid-Year: U.S. Economy Slows

Looming U.S. fiscal problems, Europe's continued declining fiscal condition, and signs of a slowing Chinese economy have aligned with a slowdown in the U.S. economy and have led to a plateauing of consumer attitudes after a few months of improvement early in 2012. The lull in employment gains is particularly troubling as the labor department reported the fifth consecutive month of slower private payroll additions. The probability of renewed recession has not risen significantly, but the risks to growth have shifted from a balance of upside and downside risks to that of a more downside economic environment on the side of slower growth.

Economic growth was revised down to 1.9 percent at an annualized rate in the first quarter from the first estimate of 2.2 percent. The downward revisions were a result of less inventory buildup and smaller consumer and government spending, which outweighed higher business investment in equipment and software, and nonresidential investment in structures than previously reported. Despite the downgrade in headline growth, the underlying demand in the economy was essentially unchanged, at least in the rear-view mirror. Looking ahead to the second quarter, less inventory accumulation in the first quarter is marginally positive for economic growth now as inventories will be less of a drag on growth.

However, the revisions to gross domestic product (GDP) also had some negative implications for the current quarter as they included sharp downward revisions in employee compensation for the fourth quarter of 2011 and the first quarter of this year. Despite an anemic pace of income growth, consumer spending in the first quarter still posted the strongest pace since the end of 2010, as consumers drew their savings down to subsidize their purchases. The sharp decline in the saving rate is discouraging for both the condition of household balance sheets and the rate of consumer spending in coming quarters.

The biggest discouraging sign in the economy is the recent hiring trend. Year-to-date through May, nonfarm payroll gains have slowed in each month. The recent trend is reminiscent of the monthly patterns of the spring slowdowns witnessed during the last two years which, in each case, continued through the summer months.



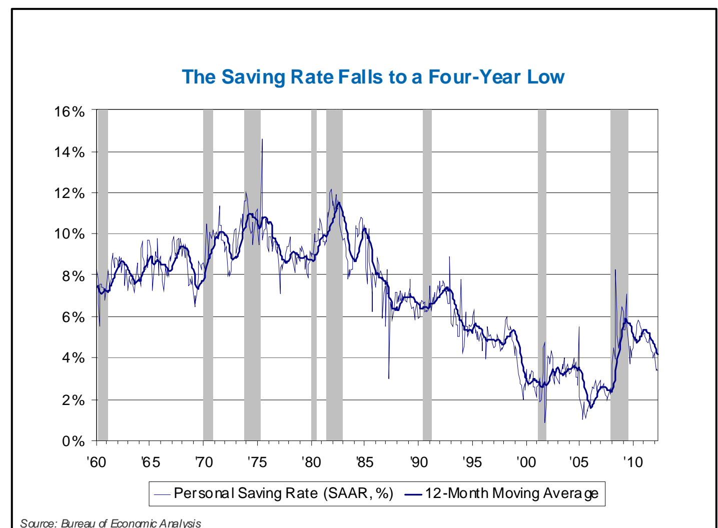
If this pattern recurs, it will pose a challenge to a meaningful economic and housing recovery later this year. There also are other challenges facing the economy, including the likely exit of Greece from the euro zone and contagion to Spain, as a well as a global growth slowdown. One other serious challenge to the economy is the uncertainty around the domestic policy environment, including the possibility of massive fiscal drag in 2013 and the debt ceiling debate that will be revisited later this year.

The U.S. economy has proved to be resilient, however, as displayed by continued growth during the past eleven quarters, albeit unevenly, through shocks that included a devastating natural disaster, a spike in oil prices, and an intensified European sovereign debt crisis. With an ongoing decline in oil prices and interest rates, the U.S. economy and the financial markets are less vulnerable to shocks than they were a year ago, when growth nearly stalled as consumers sharply pared down their spending growth. We expect that moderate growth will continue in coming quarters, and for all of 2012, growth is projected to come in at 2.2 percent.

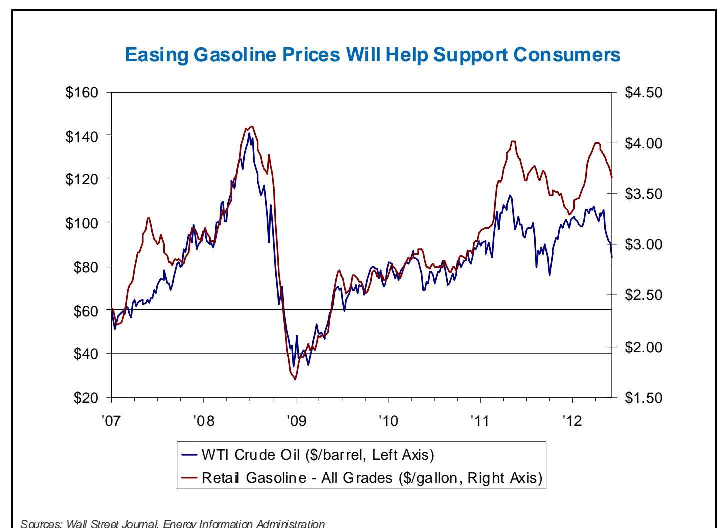
While our forecast this year and next year has not changed materially, risk to the forecast is now tilted to the downside rather than balanced between upside and downside as had been the case in previous months' forecasts. Our view is based on the assumption that hiring will pick up in coming months, reversing the decelerating trend. In addition, we assume that European policymakers will take bold steps to prevent contagion to Spain or other peripheries from Greece's exit from the euro zone, should that occur. As this goes to press, Spain has received a commitment from the European Union of up to €100 billion (about $125 billion) in loans to support its troubled bank sector. The outcome of the Greek election on June 17 remains uncertain, and it is not clear if this amount of support to Spain is a sufficient firewall should a new Greek government not stand by the commitments made in its last loan deal. As to the risk from a massive fiscal drag, we continue to assume that Congress will modify many of the provisions in current law to bring about more moderate fiscal contraction in the near term.

Consumers remain the key to the outlook. One headwind facing household spending is sluggish income growth. After the downward revisions to wage and salary income from the GDP report, real (inflation-adjusted) disposable income grew at a 0.2 percent annualized rate in the fourth quarter (compared with initially reported growth of 1.7 percent). In the first quarter of 2012, growth continued to be anemic at 0.4 percent. During the four quarters ending in the first quarter of this year, real disposable income grew only 0.2 percent.

Real income started the current quarter weakly, rising by 0.2 percent. Meanwhile, real consumer spending increased 0.3 percent in April. With spending outpacing income, the saving rate ticked down one-tenth to 3.4 percent, matching February's reading, which was the lowest in more than four years. The recent trend in the saving rate suggests that consumers might need to moderate their spending unless income growth picks up.



Consumer credit has posted gains in the last eight months, suggesting that the household deleveraging process is slowing. The increase in total consumer credit supports expectations of future growth in consumer spending. However, the gain was largely in non-revolving credit (auto and student loans), which has increased at a solid clip since the middle of 2010. Revolving credit (largely credit cards) has softened in recent months, up only 0.6 percent at an annualized rate during the last six months.

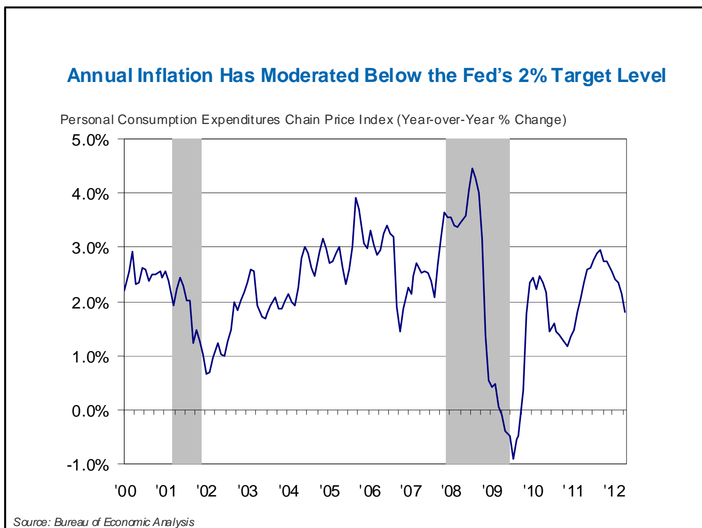


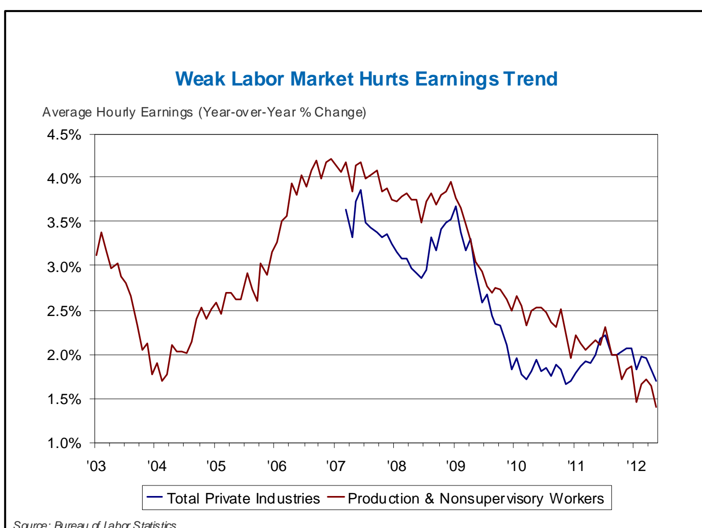
During the past month, financial conditions also have deteriorated sharply as the European sovereign debt crisis has intensified. Sovereign risk spreads in the peripheral euro-zone countries as well as risk spreads on corporate bonds widened, global equity markets fell sharply, and the VIX—a gauge for market volatility—rose to its highest level since December 2011. One upside for consumers is that the global economic slowdown has brought crude oil prices down, falling to about $83 per barrel at the time of this writing—nearly 25 percent below the peak in February. The drop in gasoline prices acts like a tax cut that boosts disposable income, and the support from easing gas prices should help cushion the impact of weakening nominal income and strained financial conditions on consumer spending.

Declining energy prices during the past several months have helped to bring overall inflation down. The Fed's inflation target, the price index tied to consumer spending, was unchanged during the month and was up 1.8 percent from a year ago, the smallest year-over-year gain in more than a year. Continued weakness in the labor market and the resulting lack of labor cost pressures also is expected to keep core inflation contained.

The moderating inflation trend allows the Fed some wiggle room to maneuver should additional easing be needed. The loss of momentum in labor market conditions and the significant downside risk associated with the European sovereign debt crisis have increased the likelihood of an additional monetary easing, including an extension of Operation Twist, where the Fed sells short-term securities and uses the proceeds to buy long-term securities, and a further expansion in the Fed's balance sheet – quantitative easing or QE3 – through purchases of agency mortgage-backed securities or long-term Treasuries.

As our economic outlook has not changed materially, we continue to maintain our views on monetary policy: we expect Operation Twist to be completed at the end of June as announced; we expect the target Fed funds rate to remain unchanged until at least late 2014; and we do not expect an asset purchase program. Additional easing is on the table, but will likely require significant deterioration in the economy to be implemented. However, it is unclear that any such actions by the Fed will have an appreciable positive impact on growth.





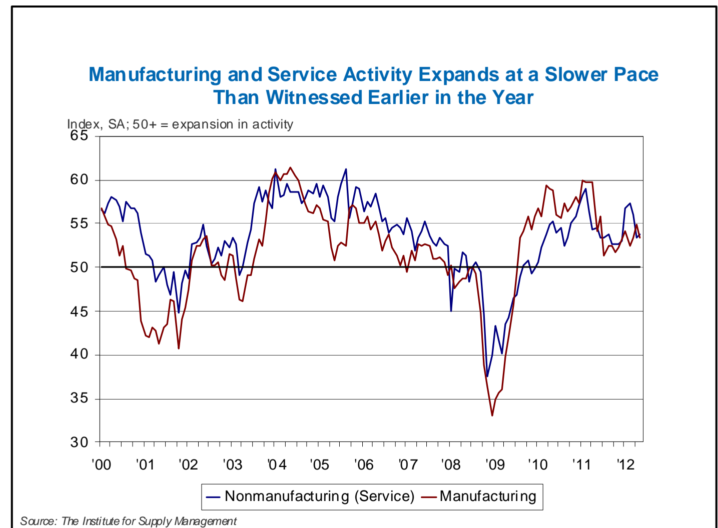
Despite declining gasoline prices, there were signs of a softening in consumer spending. Following a strong sales pace in the fourth quarter that continued through April, auto sales slipped in May to the weakest pace this year. We expect consumer fundamentals will continue to be restrained by the weak labor market, which remained in a decelerating trend in May, with nonfarm payrolls growing by a 12-month low of 69,000. It is now less convincing to frame the weakness as just a payback to warm winter weather. Rather, it appears increasingly likely that labor market fundamentals have deteriorated amid the slowdown in the global economy and the intensified European sovereign debt crisis, which likely made businesses more cautious.

In his testimony before Congress on the economic outlook in early June, Fed chairman Ben Bernanke noted weather-related payback and seasonal adjustment issues, but reiterated his theory delivered earlier this year that strong gains in hiring late last year and early this year were "catch-up hiring." That is, businesses may have aggressively laid off workers earlier in the cycle, prompting them to catch up later on—a process that has largely been completed.

The May establishment survey was universally bearish, as previous months' gains were revised lower by 49,000, resulting in an average monthly payroll gain in the three months ending in May of just 96,000, far below the 252,000 average monthly gain reported in the three months ending in February. In addition, average weekly hours, a leading indicator of hiring, contracted while average hourly earnings barely rose during the month, showing an anemic year-over-year gain. Such a combination bodes poorly for growth in labor income and thus consumer spending.

A separate survey of households paints a more mixed picture of the labor market as it showed that the unemployment rate ticked up one-tenth to 8.2 percent, the first rise in almost a year. However, the increase was driven by a surge in re-entrants into the labor force—a positive development—that outweighed a sizable gain in household employment.

Other recent reports also point to signs of slipping momentum in economic activity. Manufacturing activity expanded at a slower pace, with the Institute for Supply Management (ISM) manufacturing index declining in May. Service activity was essentially flat during the month, with the ISM nonmanufacturing index remaining well below the first-quarter average.



Business investment in equipment and software spending grew at a tepid pace during the first quarter after posting robust growth in 2010 and 2011. Its leading indicator—core durable goods orders (nondefense, excluding aircraft)—declined in April for the second consecutive month and the third drop in the last four months, suggesting another quarter of soft business investment spending. We believe that the slowdown in business investment is primarily the result of caution on the part of businesses due to worries about future demand, as weaker activity from Europe, China, and other emerging markets is already being reflected in sales and earnings. This trend is discouraging, given the $2.4 trillion of cash businesses held on corporate balance sheets in the first quarter. Nonresidential investment in structures is likely to decline in the current quarter for the third consecutive quarter.

Signs of a slowdown in global growth were reflected in the April trade deficit. Although the trade gap narrowed, it was because imports fell more than exports, which marked the first drop in five months. Exports to the euro zone fell on a year-to-year basis in April, the first such decline since December 2009, which is to be expected given the financial crisis that is under way. Weakness in exports should continue given an ongoing slowdown in growth abroad. We expect that trade will likely be neutral to growth in the current quarter as well as for all of 2012.

Overall, incoming data suggest continued moderate growth through the rest of the year, supported by consumer spending, residential investment, and business investment in equipment and software. In addition to trade, inventory investment and nonresidential investment in structures should be essentially neutral to growth, adding little or nothing to GDP this year. All levels of government are expected to remain a primary drag to growth, with federal spending likely providing most of the drag.

Housing: Cautious Optimism for Continued Gradual Healing

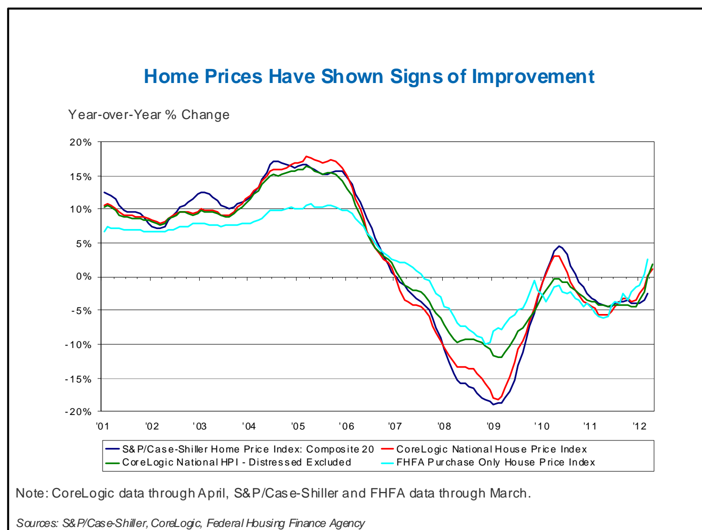
New single-family home sales and single-family housing starts dipped to record lows last year. In the first quarter, the single-family housing sector appeared to be turning the corner, reflecting the extraordinarily slow pace of new construction and delays in foreclosures, which have combined to bring about a more balanced housing market. The monthly pattern of housing indicators during the first quarter suggests some loss of momentum late in the quarter, partly because of unusually warm weather at the start of the year that pulled some housing activity forward.

However, April data for existing home sales, new home sales, and single-family starts showed healthy rebounds, suggesting that the housing recovery is on track moving through the second quarter. Home builder confidence, as measured by the National Association of Home Builders/Wells Fargo Housing Market Index, rose in May to the highest reading in five years. So far this year, housing activity is running well ahead of last year's pace. Year-to-date total existing home sales through April were 7 percent above the level during the same period last year, compared with 16 percent for new home sales and 19 percent for single-family starts. Multifamily starts continued to fare substantially better

than the single-family segment, with year-to-date building activity running more than 40 percent ahead of last year's activity. The sector should continue to perform well this year, as fundamentals continue to improve, with rising rents and net absorption far outpacing completions. (For more information on multifamily market conditions including recent trends in rents, read the *June 2012 Multifamily Market Commentary*).

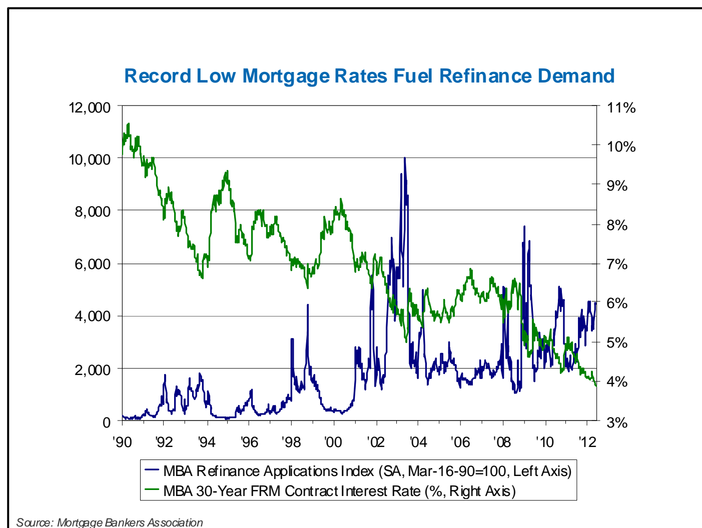
Recent data on home prices have been generally encouraging. Main measures of home prices have firmed in recent months, as the share of distressed sales has declined in a strong seasonal period. Despite the recent encouraging trend, we continue to expect that home prices on a national basis will decline further before stabilizing in 2013.

Yields on longer-term Treasuries tumbled to a record low, with the 10-year yield declining to below 1.5 percent in early June, thanks to a flight to quality prompted by renewed concerns regarding the turmoil in Europe and signs of an appreciable slowdown in the domestic labor market. The yield has moved up somewhat since then, with the 10-year yield trading at 1.6 percent as of this writing. Meanwhile, the yield on 30-year fixed-rate mortgages reached a record low of 3.7 percent in early June, according to the Freddie Mac Primary Mortgage Market Survey. Low mortgage rates will remain a support to the housing market, as we expect them to remain near their current levels through this year, suppressed by moderate economic growth and a benign inflation outlook.



Note: CoreLogic data through April, S&P/Case-Shiller and FHFA data through March.

Sources: S&P/Case-Shiller, CoreLogic, Federal Housing Finance Agency

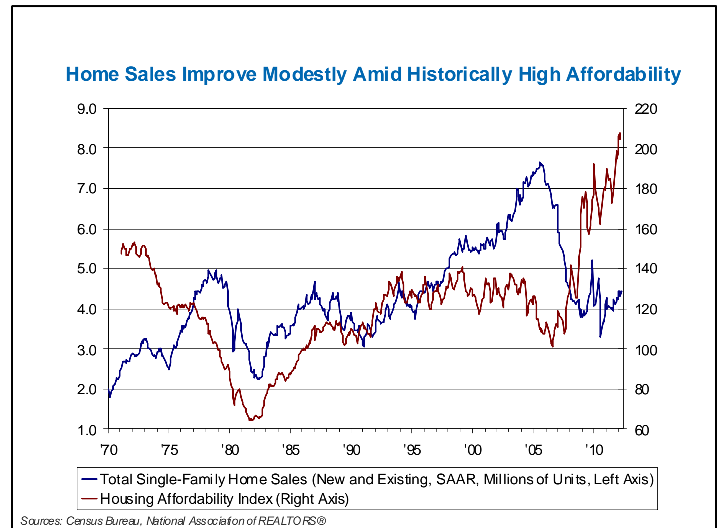


Source: Mortgage Bankers Association

Lower mortgage rates have boosted interest in refinancing, with mortgage applications for refinancing rising to the highest level since February—although activity is still below the levels seen during the fall of 2010. Mortgage refinancing is one of the channels through which declining interest rates can help boost economic activity. For many, refinancing lowers their monthly mortgage payment, freeing up cash that can be used for other goods and services. However, household desire to deleverage as well as an inability to extract equity from their homes due to substantial declines in home prices has limited the immediate stimulative effect of refinancing on the economy even while it strengthens household finances longer term. (For more details on the impact of refinancing on the economy see *FM Commentary: Refinancing Helps Many Households Restore Their Financial Health*).

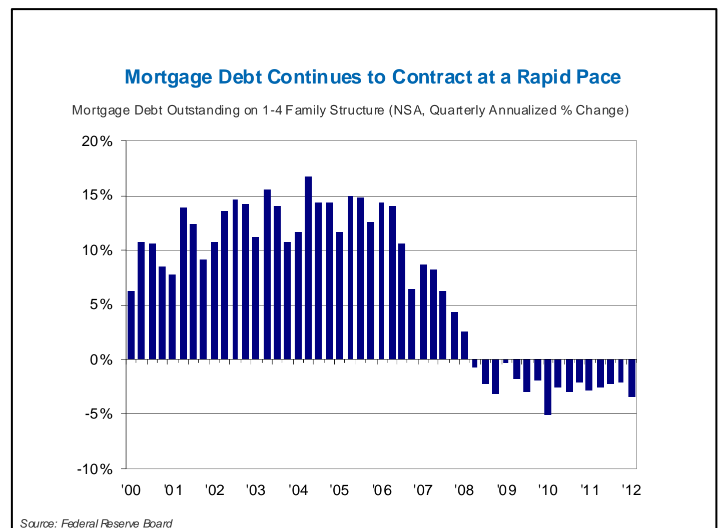
Leading indicators of home sales suggest some near-term softening, however. Purchase mortgage applications dropped sharply in the first half of April, largely reflecting the increase in the FHA mortgage insurance premium. After rebounding later in April and in early May, they resumed their declines, slipping for four consecutive weeks. Meanwhile, contract signings of existing homes tumbled in April for the first time this year. The recent slowdown in the momentum in the labor market as well as increased uncertainty surrounding Europe that could threaten the economic recovery presents a headwind for the housing market, but it should not derail the housing recovery if hiring picks up again as expected.

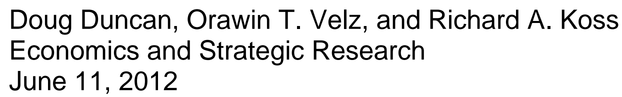
Besides the decelerating trend in hiring, the housing market continues to face challenges, including the persistently elevated share of loans in foreclosure, which has been little changed from its record high, suggesting that the overhang of shadow inventory will continue to weigh on home prices. An uncertain outlook for home prices and damaged household balance sheets also hold back housing demand. In addition, while lending standards in mortgages have been eased since the significant tightening in 2008 and 2009, according to the Federal Reserve survey of senior loan officers, they have remained historically tight. Tight lending standards also have been reflected in the rise in average FICO scores for purchase loans for FHA as well as Fannie Mae and Freddie Mac, according to data from CoreLogic. These factors help explain why record-high affordability conditions stemming from declining mortgage rates and home prices have not substantially boosted home sales. The tight relationship between affordability and home sales observed prior to the year 2000 has clearly broken down.



During the first quarter, residential investment posted the strongest quarterly gain since the expiration of the homebuyer tax credit in 2010, with solid growth in single-family and multifamily structures, as well as spending on home improvements. It contributed about 0.4 percentage points to first-quarter GDP, nearly double its contribution in the fourth quarter. We expect continued positive contribution through the rest of this year, as homebuilding activity is projected to rise by 21 percent—a strong increase, but from a very depressed base—driven by multifamily construction. Total home sales should rise by 8 percent, helping to boost broker commission, which is a part of residential investment. Another component of residential investment—home improvement—also should post a healthy gain, as many of the foreclosed homes will need a fix-up to transform them into rental or owner-occupied units.

Our mortgage originations forecast is little changed from the previous outlook. We expect purchase mortgage originations to rise modestly this year from last year while refinance originations should decline only slightly. For all of 2012, total mortgage originations are projected to decline to $1.34 trillion—only a slight drop from last year's estimated level. The refi share is expected to be 64 percent, compared with an estimated 66 percent in 2011. The Flow of Funds data showed that total single-family mortgage debt continued to contract, due in part to foreclosures. After dropping for 15 consecutive quarters, the pace of decline has yet to moderate, as single-family mortgage debt outstanding fell at a 3.4 percent annualized rate in the first quarter—the biggest drop in two years. We expect total single-family mortgage debt to post the fifth consecutive annual drop, falling by 1.5 percent in 2012, compared with a 2.5 percent drop in 2011.





Doug Duncan, Orawin T. Velz, and Richard A. Koss
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