

## A Long Slog to a Comeback

We expect economic growth to have decelerated from an annualized pace of 5.6 percent in the fourth quarter to 2.7 percent in the first quarter. The significant slowdown was a result of the diminishing impact of the inventory swing. At the same time we expect final demand, which is gross domestic product (GDP) minus changes in inventories, to grow just slightly slower than the fourth quarter pace. The most encouraging sign during the first two months of the year was strengthening consumer spending. However, business investment in equipment and software softened, and residential investment pulled back sharply. While exports were strong, which helped support manufacturing, trade is not expected to contribute to growth in the first quarter as imports also rose at a robust clip. Incoming data have not warranted a significant change in the outlook for the economy this year. For all of 2010, we expect economic growth to be 3.1 percent—within the narrow range of 3.0 to 3.2 percent that we have held since last September.

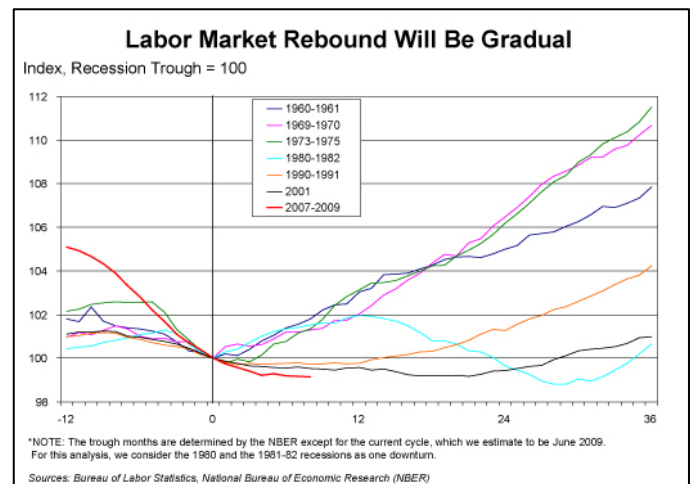
Our outlook is based on an expectation that final private demand will strengthen to replace the waning impact of the inventory swing and fiscal stimulus. For that to happen, meaningful improvement in labor market conditions must occur. Fortunately, there have been encouraging signs on that front. The fundamentals of the labor market appear to be improving as layoffs have slowed, while hiring has shown signs of life. The improvement will be gradual and uneven, and given the severity of damage done to the jobs market, it will be a long time before labor market conditions will return to the state that prevailed before the downturn.

### Jobs: A move in the right direction

March payroll employment increased 162,000—the largest gain in three years, and we believe that a string of sizable gains will follow in the coming months. Since the start of the recession in December 2007, payrolls have declined by 5.9 percent, more severe than any recession post World War II. It is not necessarily the case that the end of a recession coincides with the start of a period of sustained job creation. While the National Bureau of Economic Research (NBER) will not call an official end of the latest recession for some time, similar to their practice following previous recessions, we estimate that June 2009 was the trough of economic activity and thus the end of the recession.

Since last June, payroll employment has declined further by about 0.7 percent. It is not unusual for the economy to shed jobs for an extended period after a recession has ended. After the end of the 1990-91 and 2001 recessions, businesses postponed hiring for a long time. In 1991, payrolls continued to decline and did not return to the level reached at the trough of the recession until more than a year into the expansion. Hiring conditions were much worse during the 2001 expansion, where payrolls took more than two years before reaching the employment level prevailing at the economy's trough. These two recoveries were different from the four previous recoveries, where nonfarm payrolls decisively turned the corner within three months of recession's end. By the first anniversary of those economic recoveries, payrolls rose by two percent or more.

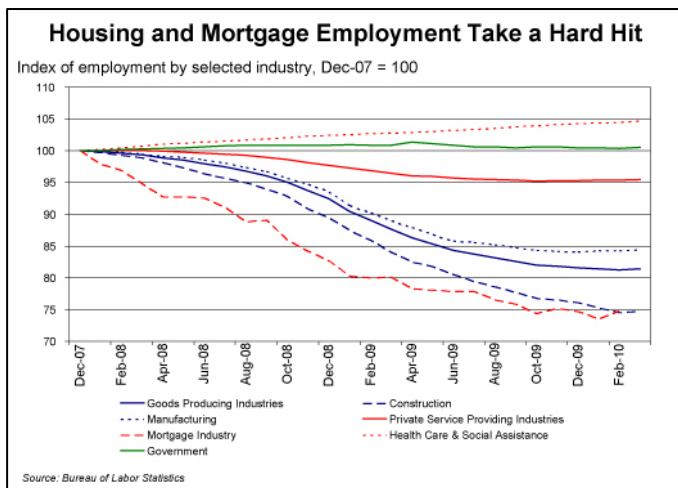
Current labor market conditions resemble conditions seen during the last two recoveries, with payrolls declining even as economic growth turned substantially positive. The sizable increase in March payrolls was encouraging but influenced by several out-of-the-ordinary factors, making it difficult to gauge the underlying trend. For example, the gain included the temporary hiring of 48,000 workers for the decennial census as well as an unwinding of February's weather-related job losses, when some workers could not get to work and were



not counted in payrolls.

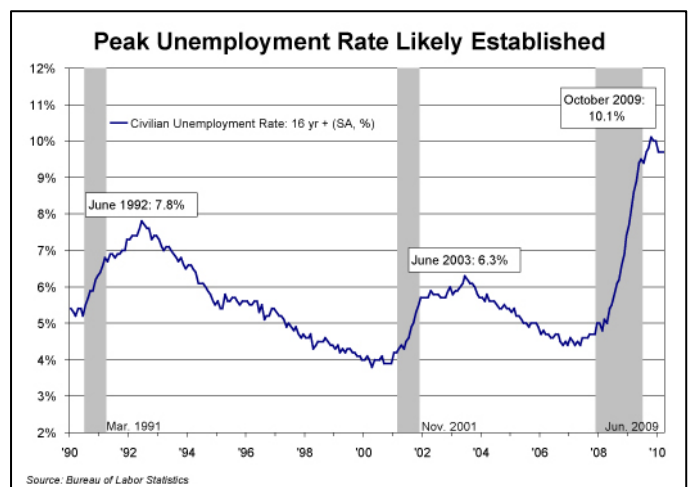
Despite these distortions, it is apparent that the fundamentals of the labor market are gradually improving. Private payrolls rose 123,000, marking the third consecutive gain and the biggest since May 2007. Revisions to previous months were positive, with February and January payrolls showing a net gain of 62,000. Also, the details of the payroll employment data, which derive from the Establishment survey, were encouraging. Manufacturers added to payrolls for a third consecutive month, while builders increased payrolls for the first time since June 2007.

The number of job losses since the start of the most recent recession varies significantly by industry. Goods-producing industries suffered more severe losses, led by sharp drops in construction and manufacturing employment, which are more sensitive to business cycles than most service-producing employment. Manufacturing has fared better than construction and appears to have turned the corner. Within service-producing industries, healthcare and social assistance has been immune to the recession, steadily adding to payrolls since August 2003 but at a slower pace. Mortgage industry employment has continued to trend down and shows no sign of reaching a trough.



The March payroll report contained positive leading indicators: temp employment posted a sixth consecutive monthly gain, and the average workweek increased, reversing the weather-related dip in the previous month. For the first quarter, aggregate weekly hours increased for the first time since the second quarter of 2007. One sour note was declining hourly earnings for all private employees, putting the year-over-year gain at just 1.8 percent after its peak of nearly 4.0 percent in mid-2007. This data series has a short history but a similar series for nonsupervisory production workers showed a comparable trend. It is likely that the new hires were paid at low wages, bringing down the average earnings, and an increasing share of new employees may continue to bring down the overall average earnings. The declining trend in earnings bodes ill for the consumer spending outlook.

A separate Household Survey showed that the unemployment rate was unchanged at 9.7 percent, reflecting an increase in employment that just kept pace with growth in the labor force. While the unemployment rate may edge up going forward, as discouraged workers decide to look for jobs again, it is more and more likely that the recent peak in the unemployment rate of 10.1 percent reached in October 2009 will be the peak rate for the cycle. If that is the case, the change in the peak-to-trough unemployment rate will be 5.1 percentage points—more than in any business cycle post World War II. This also implies that the unemployment rate



peaked only five months after our estimated June 2009 end of the recession, which is far sooner than occurred during either the 1990-91 or the 2001 recessions. In the 1990-91 recession, the unemployment rate did not peak until 15 months after the end of the recession, compared with 19 months for the 2001 recession.

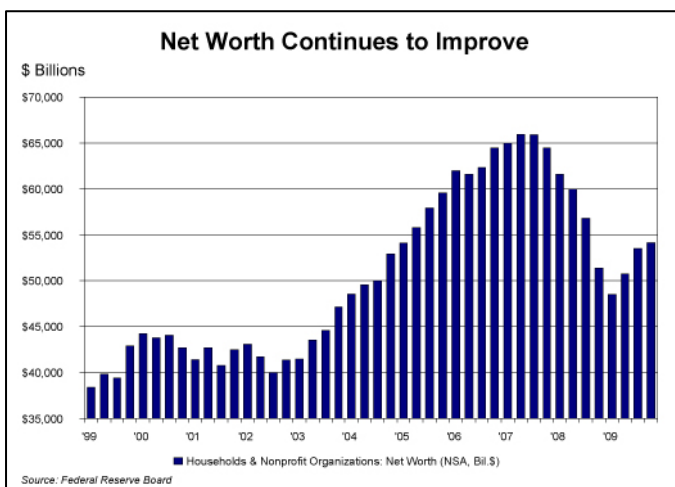
The Household Survey points to a gloomier picture of long-term unemployment. The share of those suffering unemployment longer than six months rose to a record high of 44.1 percent in March, and the mean duration of unemployment increased to 31.2 weeks. The broad measure of the unemployment rate, which includes those working part-time because they cannot find full-time jobs and those not looking for work but who want to work and are available for work, edged up to 16.9 percent from 16.8 percent in the previous month. The labor market is facing a challenge for years to come. It will take a long time for some jobs to come back. Construction employment, for example, will be hindered significantly by the likelihood of continued low levels of housing starts. During the most recent housing boom, we saw as many as two million annualized units of housing starts. Now builders are building only about 600,000 units, and it will be years before we will see the level of activity witnessed during the last housing boom. Some of the jobs lost in particular sectors may never come back as they may be relocated overseas. Thus, some of the unemployed workers will need retraining so that they can transition to careers in other industries.

For the near term, we expect the rebound in employment to be uneven, influenced by special factors. We expect job gains to accelerate substantially in the current quarter, boosted by census hiring. According to the hiring schedule released last year, the Census Bureau planned to hire 971,000 workers during the second quarter of 2010. Job gains will likely slow dramatically in the third quarter, as census workers are laid off beginning in June, before strengthening again by the end of the year. While we believe that the unemployment rate already peaked, it will remain elevated for some time as job growth will not be strong enough to quickly absorb new workers, especially previously discouraged workers, returning to the labor force.

### Consumer Spending: Surprise on the upside

Given the robust pace in overall consumer spending in the first two months of the year and strong performance of auto sales and chain store sales in March, real (inflation-adjusted) consumer spending is expected to have risen to a 3.2 percent annual rate in the first quarter, compared with our projection of 2.6 percent in the previous forecast. The first quarter's strength was surprising, given expected flat real disposable income during the period. The mismatch between consumer spending and income in this stage of recovery is not likely to continue very long, given tight credit and only gradual improvement in the labor market. This is the main reason why we believe that an increase of more than 3.0 percent in real consumer spending is unsustainable in the near term and project a modest slowdown in the coming quarters.

While continued strong consumer spending growth is not in the cards, we believe that growth should be solid. One upside for consumers is the ongoing stock market rally, which will help household net worth (assets minus liabilities) to rebound further. With the help of healing financial markets, household net worth continued to recover in the fourth quarter, rising at an annualized pace of 5.2 percent. Following double-digit increases in the second and third quarters, the gain was relatively modest. Improvement came solely from financial asset prices, with the value of real estate showing little change. Since its trough in the first quarter of 2009, household net worth has increased \$5.7 trillion, which still pales in comparison to the plunge that occurred for seven consecutive quarters through the first quarter of 2009. However, even if only a small portion, e.g., 3.0 to 5.0 percent, of the increase in wealth is used for consumption, the rebound in household net worth experienced thus far provides substantial support for consumers.



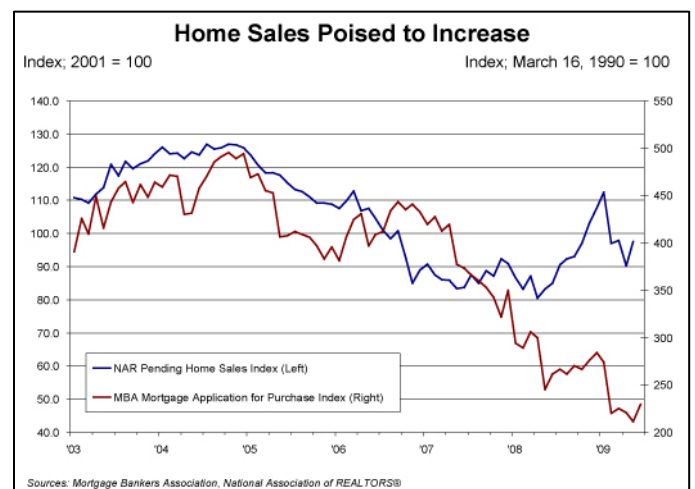
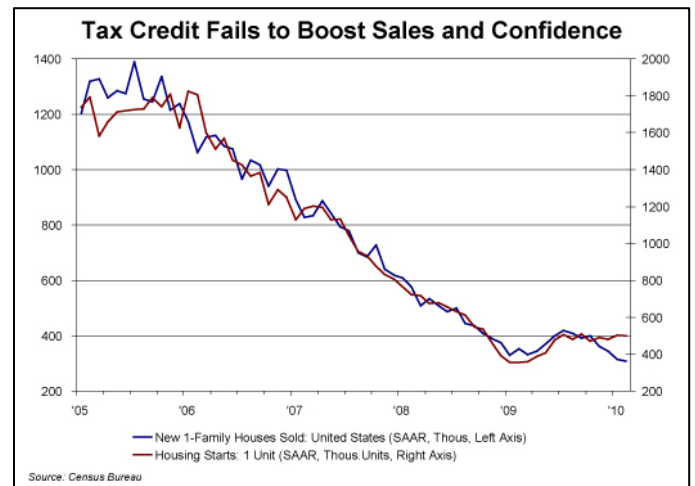
In the first quarter of this year, the stock market increased further, with the S&P 500 gaining 4.9 percent. The Russell 2000, a broader measure, experienced even better improvement at nearly 9.0 percent. We expect household net worth to continue to improve for the rest of the year, boosted by further, albeit slower, gains in the stock market. This will help support consumers in light of tight credit conditions and the weak labor market. Solid consumer spending growth, though slowing from the first quarter, is the key to our projected economic growth of a bit more than 3.0 percent this year.

## Housing: Choppy recovery

Recent major housing indicators have been bearish. Housing starts fell in February, led by a large drop in multifamily starts, while single-family starts fell slightly. During the past six months, single-family starts have basically moved sideways, hovering near an annualized level of 500,000. While they remained well above their record low reached in February 2009, they are a far cry from their record high of more than 1.8 million annualized rate recorded in February 2006. Lackluster homebuilding activity is one of the reasons for a relatively modest recovery. However, a much-below trend level of activity is necessary to restore balance to the housing market given soft demand for new homes. The fourth consecutive drop in new home sales in February brought sales to another record low.

The downward trend in new home sales explains the homebuilders' sour mood. The National Association of Home Builders/Wells Fargo Housing Market Index—a gauge of builders' assessments of the demand for new homes—saw a renewed decline in March. Despite the looming deadline of the second tax credit, which requires a signed contract by April 30 and settlement by June 30, builders saw no rush in new home buying. Both components gauging current sales conditions and traffic of prospective buyers fell. The component gauging sales expectations in the next six months also declined, which was to be expected given that the tax credit is scheduled to expire soon. Builders cited the lack of available credit for new projects, tough competition from the continual flow of distressed properties for sale, in some cases below production cost, and concerns over job security as factors weighing on confidence.

Existing home sales posted their third consecutive drop in February. However, the near-term outlook is brightening, as augured by improving leading indicators of home sales. Pending home sales, which measure contract signings of existing homes, surged in February. Another leading indicator also suggests increasing sales in coming months: purchase applications have trended up beginning in late February and have risen nearly 25 percent in the last six weeks. Existing home sales should strengthen substantially in the second quarter, as more homebuyers rush to beat the expiring tax credit. With the tax credit pulling forward some sales into the first half of this year, we expect sales to pull back in the third quarter. If the labor market improves substantially as we anticipate in the fourth quarter, home sales should rebound and begin a self-sustaining recovery without the help of a tax subsidy.



Even with an expected gain in March total home sales, sales for the first quarter are likely to be much lower than we projected earlier, causing us to revise downward the trajectory of sales going forward. For all of 2010, we project about a 6.0 percent increase in sales, compared with a 9.0 percent increase projected in the previous forecast.

Home price measures have been sending mixed signals recently. We continue to see more moderate declines in home prices this year; however, the shadow inventory of homes, homes that are not yet on the market but will likely come on the market at some point, continues to pose risks. In the minutes from the March Federal Open Market Committee (FOMC) meeting, committee members expressed concerns that the foreclosure rate could remain elevated or even move higher in coming quarters. Consequently, this could potentially add supply to the already large inventory of vacant homes, posing downside risks to home prices.

Two recent initiatives by the administration to address rising delinquencies and stem foreclosures, if successful, will help to reduce shadow inventory. These include FHA refinancing of underwater mortgages and an enhancement to the Home Affordable Modification Program (HAMP) to address principal write-downs and unemployed homeowners. It will be some time before we see indications of how effective the programs will be in reducing strategic defaults and the shadow supply of housing but we currently believe that these measures will reduce downside risks to the housing market.

### **Residential and Nonresidential Investment: Temporary weakness**

Given the patterns of homebuilding and sales activity in January and February, residential investment appears to have fallen in the first quarter after gaining in the third and fourth quarters of last year. We expect it to increase modestly in the current quarter and going forward. For all of 2010, we expect residential investment to add just 0.2 percentage points to GDP—still an improvement after subtracting from GDP during the past four years. For nonresidential investment in structures, we expect the decline to extend through next year as commercial real estate will continue to face tight lending standards even when standards in other sectors ease.

We expect nonresidential investment in equipment and software to make a smaller contribution to GDP in the first quarter of this year than in the prior quarter, given incoming data on durable goods orders and shipments. Shipments of nondefense capital goods excluding aircraft—the proxy for equipment and software spending for the current quarter—were relatively flat for January and February, after adjustment for inflation, compared with a double-digit gain in the fourth quarter of last year. The recovery in the factory sector is not facing any major threat, however, as orders of nondefense capital goods excluding aircraft—the proxy for equipment and software spending in coming quarters—posted a solid gain in February.

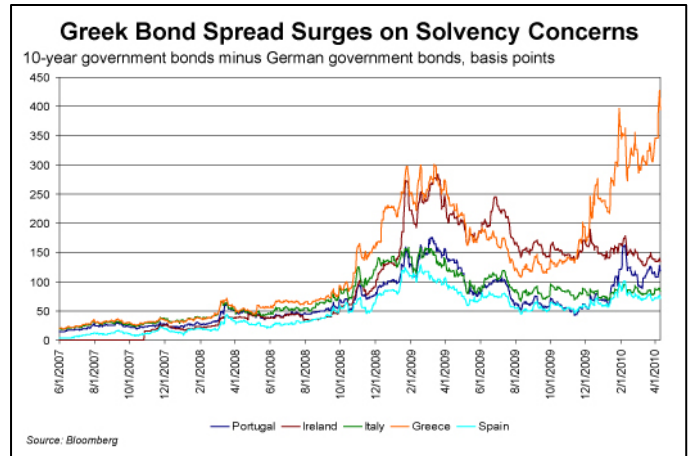
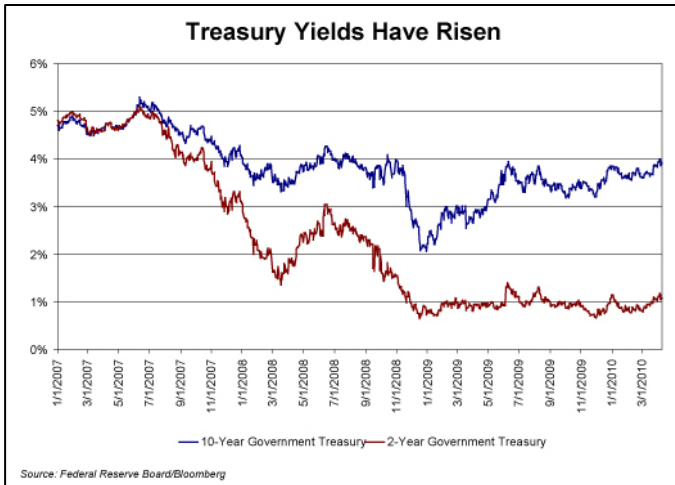
Other reports showed that manufacturing continues to move in the right direction. The Institute for Supply Management (ISM) manufacturing index advanced in March, planting firmly in the strong-growth zone. Details were impressive: production and new orders components showed solid gains, and export orders surged to its strongest reading since 1989. In addition, the employment component showed expanding manufacturing jobs during five of the last six months.

While lagging the recovery in the manufacturing sector, the service sector, which covers nearly 90 percent of the economy, is now building momentum, according to the ISM non-manufacturing index. This index moved up in March, showing a solid expansion and the best performance since May 2006. Both ISM indices point to a more balanced picture of the economic recovery.

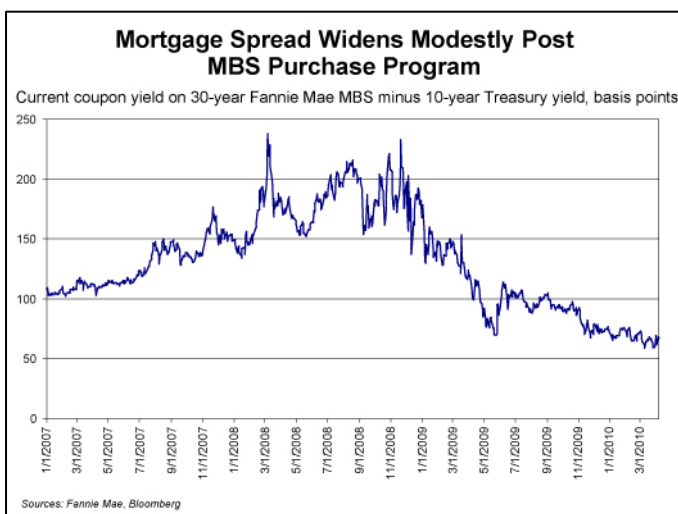
### **Financial Conditions: Some moderate risks**

General credit conditions have continued to improve. Since the March 16 FOMC meeting, long-term Treasuries have trended up, with the 10-year yield touching 4.0 percent on April 5 for the first time since October 2008. Short-term Treasury yields have moved up as well. The yield curve has remained steep, as seen by the spread between the two- and ten-year yields. The increase in Treasury yields likely reflected, in part, stronger incoming data and more confidence in the durability of the economic recovery. However, concerns over the huge federal deficit also could play a role.

Treasury yields moved lower somewhat in recent days as concerns heighten over Greece's sovereign credit risk related to double-digit fiscal deficits. Fitch Ratings cut Greece's debt ratings to the lowest investment grade, ramping up its borrowing costs to new highs. On April 8, the spread of the 10-year Greek bond over its German counterpart widened to 462 basis points. It tumbled about 50 basis points a few days later, when Greece received a promise of a bailout from other European countries and from the International Monetary Fund to help cover its financing needs and avoid a default.



With rising Treasury yields from mid-March, the effective fed funds rate also has risen to between 17 and 20 basis points during the first week of April. The rate hovered around 12 basis points between October and February. The futures market for fed funds priced in a 25 basis point rate hike by late 2010. Despite that, we maintain that the Fed will likely keep interest rates on hold for the rest of the year. The minutes of the March FOMC meeting showed that the Fed remains guarded on the outlook of the economy. It suggests that the “extended period” phrase is not tied to a specific timeframe but to economic conditions. That is, changing conditions, e.g., stronger growth or rising core inflation, could lead to a shift in the timing of monetary policy. The Fed is likely to err on the side of caution and will act only when there is strong evidence that keeping interest rates extraordinarily low is no longer necessary, as it noted that the risks of an early start to tightening are greater than those associated with a later one.



While the Fed continues to view inflation as “subdued over the near term,” some members noted that inflation risks “might be tilted to the upside” given the large fiscal deficits and accommodative monetary policy stance.

As we anticipated, with the end of the Fed’s MBS purchase program, mortgage spreads—such as the spread between the conventional conforming second market yield on Fannie Mae securities and Treasury yields—have widened only modestly. The widening spread, coupled with the increase in the 10-year Treasury yield, has led to the highest mortgage rates in eight months.

## **Mortgage Production in 2010: Sharp drop from refi activity**

We believe that the recent pickup in mortgage rates will not be sustained. Our view on mortgage rates is little changed from the previous forecast. We lowered our forecast of purchase originations due to lower projected home sales. Still, they are expected to post an increase for the first time in five years. For all of 2010, total mortgage originations are projected to decline to \$1.28 trillion from an estimated \$1.92 trillion in 2009, with a refinance share of 44 percent. Mortgage debt outstanding for 1-to-4 single-family properties fell 1.9 percent in 2009 and we expect the decline to continue in 2010 for the third consecutive year but at a more moderate pace of 1.6 percent.

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Economics and Mortgage Market Analysis

April 10, 2010

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