Outlook for 2011: From Fragile Recovery to Firmer Expansion

A year ago, we wrote in our monthly commentary that 2010 would be a year of challenges, and many challenges there were. After a good start in the first quarter of 2010, the recovery almost stalled in the spring when the European sovereign debt crisis emerged. The labor market lost momentum amid a number of uncertainties, especially regarding government policy both in the U.S. and abroad, calling into question the sustainability of the recovery. Thanks to growing policy clarity late in the year, including monetary and tax policy, the economy has regained momentum with growth tracking at a slightly more than three percent annualized pace in the final quarter of the year.

While this would mark the fastest growth rate experienced in 2010, it was still substantially below the five percent pace seen at the end of 2009 in the early stages of the recovery. However, we are more optimistic about the health of the economy now. A year ago, the biggest driver of growth was inventory investment which contributed nearly three percentage points to growth. As a result, final sales, a better indicator of the economy's underlying strength, grew just about two percent. By contrast, final sales in the fourth quarter of 2010 are on track to more than double that pace, the fastest growth since 2006, thanks to a strong pickup in consumer demand. This will more than offset the expected and realized inventory investment drag on growth.

We expect the economy to grow by 3.6 percent in 2011, compared with an estimated 2.8 percent in 2010. The forecast for growth in 2011 is slightly stronger than our projection in December and up 0.7 percentage points since November.

The improving backdrop during the past two months prompted us to revise our growth outlook higher. In particular, consumer spending jumped, and we expect its revival to continue in 2011, with only a moderate slowdown from November and December levels. Combined with continued accommodative monetary policy, the tax bill signed into law late last year is expected to help support consumer spending and the economy during the next couple of years. Thus, 18 months after the recession officially ended, the economy is finally poised to accelerate steadily and sustain above-par growth for an extended period of time.

Compared to the rest of the economy, the housing market has remained lackluster. Home sales and housing starts have rebounded modestly from the sharp declines experienced after the homebuyer tax credit expired. By contrast, home prices have posted renewed declines after the temporary lift from the tax credit. We expect housing activity to begin recovery this year, with slightly stronger growth in the second half of the year as the labor market gains a firmer footing. Improvement in home prices will lag other housing indicators, and any positive impact will not likely be felt until late in the year or early 2012.

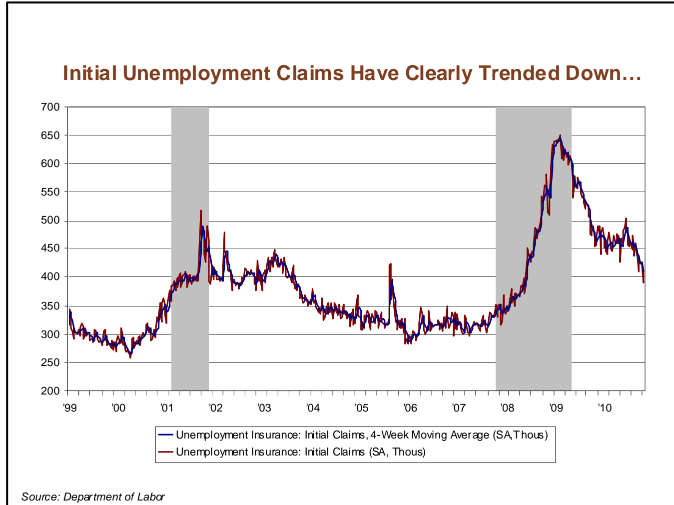
Economic Growth: Sustained, Above-Par Pace

We believe that the fundamentals determining consumer and business spending—the two most reliable drivers of growth in past economic recoveries—will improve from last year. While the manufacturing sector expansion dominated growth during the first year of the recovery, the service sector has been catching up in recent months. The Institute for Supply Management (ISM) surveys rang out 2010 with strength, signaling an improvement in both the manufacturing and the service sectors heading into 2011. The ISM manufacturing index rose to its highest level in six months, while the non-manufacturing index jumped to its highest reading since May 2006. The surveys signal more balanced growth between the two sectors, which is encouraging. Given the service sector accounts for about 90 percent of economic activity, the economy cannot accelerate on a sustained basis without a revival in activity and employment in these industries.

The Conference Board's Index of Leading Indicators—a gauge of economic activity three to six months ahead—projects that the economy will shift into a higher gear in 2011. The index rose a solid 1.1 percent in November. For the three months ending in November, the index rose at an annualized rate of 8.6 percent, compared with a gain of just 0.4 percent in the prior three months.

Labor Market: Baby Steps

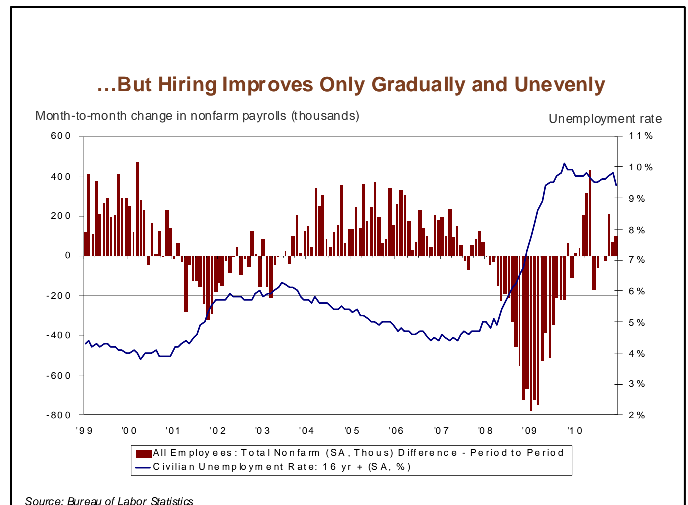
Recent indicators have pointed to improving labor market conditions, but to varying degrees. Layoffs are abating sharply. For example, the Challenger survey showed that the number of layoffs announced in December was the smallest since June 2000. A closely watched high frequency indicator—the Department of Labor's weekly initial unemployment claims—has shown a visible downtrend since August, with the four-week moving average dropping to the lowest level since July 2008.

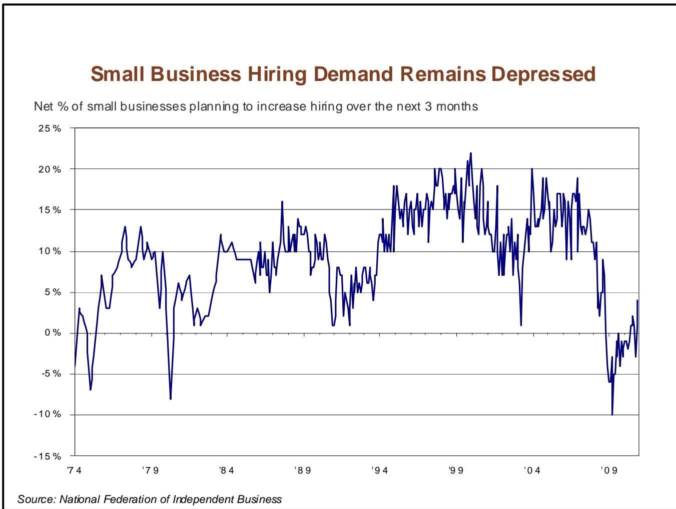


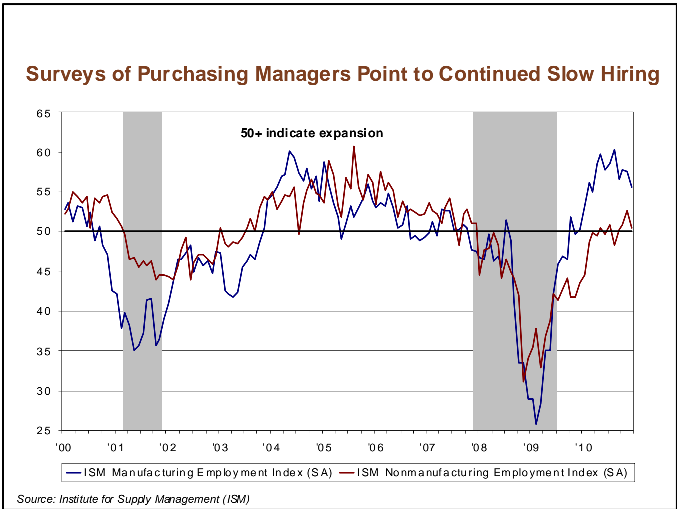
With the exception of the report from private payroll processor ADP, which showed a gain in December of nearly 300,000 private sector jobs (primarily in small- and medium-sized firms) other reports indicated only a slowly improving hiring picture. The most important employment report, released by the Bureau of Labor Statistics, showed that nonfarm payrolls rose 103,000 in December, another disappointing figure especially after the ADP estimate lifted market expectations. The silver lining was that job gains in the prior two months were revised up by 70,000. Considering the upward revisions, the gain in December was pretty much in line with expectations. For the fourth quarter, private nonfarm payroll gains averaged 128,000 per month, about the same as the average gain of 124,000 in the third quarter. For all of 2010, private nonfarm payroll gains averaged only 112,000 per month.

The unemployment rate, calculated from a separate survey of households, fell to 9.4 percent from 9.8 percent in November, as the labor force plunged along with a modest gain in employment. The 0.4 percentage point drop in the rate is quite unusual (not seen since April 1998). The household survey has a relatively small sample compared with the survey of establishments from which payroll data are derived. The large drop is suspect and we expect some reversal in the months ahead although "boomer" retirements will have a downward impact on labor force growth.

Other surveys of businesses' hiring plans are consistent with a gradual improvement in the pace of hiring. The National Federation of Independent Business (NFIB) monthly survey of small and independent business owners showed that the Index of Small Business Optimism rose in November, albeit remaining in recession territory. The employment component indicated that a net four percent of businesses planned to increase hiring during the next three months. While this level indicates extremely weak hiring trends, it has been improving in recent months: the index was in negative territory (e.g., more businesses planned to reduce their workforce than increase it) for most of the period between late 2008 and early 2010.





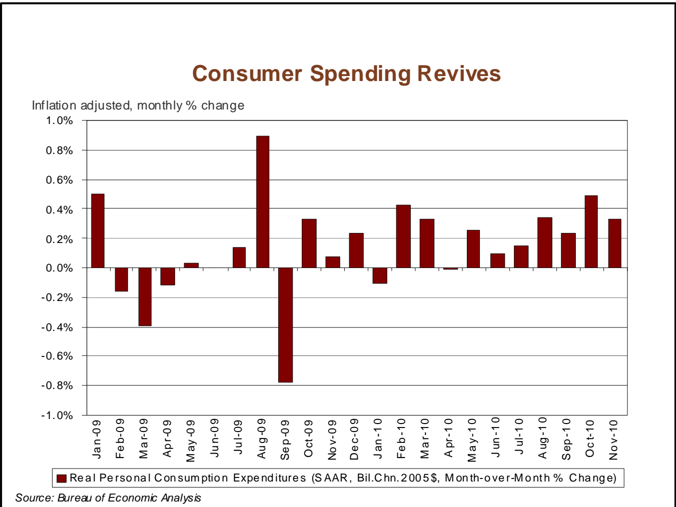


While the ISM surveys suggested faster expansion in both manufacturing and service activity at the end of 2010, the employment components contracted during December. The manufacturing survey showed an increase in employment but at a slower pace than that seen in the early stages of the recovery. By contrast, non-manufacturing employment (which includes the construction industry in the ISM survey) has been growing at a much slower pace.

The upside for the job market is that business balance sheets are very healthy. Profits have risen substantially as businesses managed to cut costs (largely labor costs). At the same time, cash holdings relative to short-term liabilities have surged to record levels. If history is a guide, hiring should soon follow as businesses can no longer increase their profits by continuing to cut costs and raise productivity. After a year and a half into a recovery, increasing revenues and production to meet rising demand will require hiring.

Consumer Spending: Leading the Way to Stronger Expansion

Households continue to deleverage or pare down their debt usage, as they suffered an unprecedented decline in net worth during the recession. However, the pace of deleveraging has slowed, resulting in a sharp pickup in consumer spending late last year. Auto sales rose strongly in November and December, boosting the fourth quarter sales growth rate in that sector to 29 percent, compared with 8 percent in the third quarter. The jump in auto sales, as well as in other durable goods spending, points to rising confidence among consumers and suggests robust consumer spending in the fourth quarter. Although data for real (inflation-adjusted) consumer spending in the third quarter were revised lower, gains in October and November were solid and are now tracking to grow at more than four percent at an annualized rate in the fourth quarter.

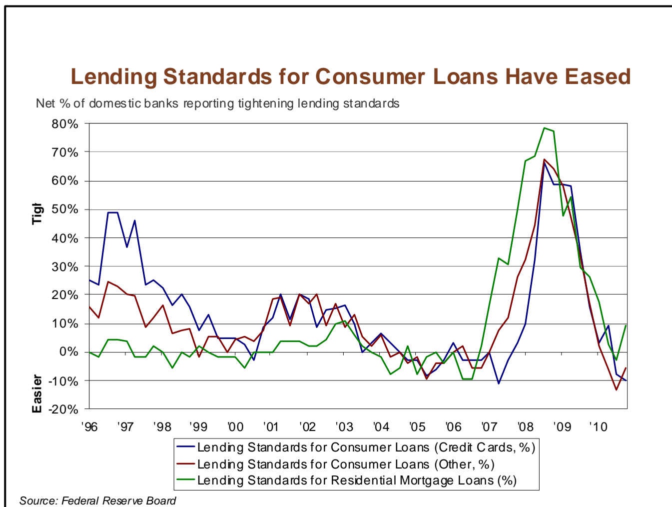


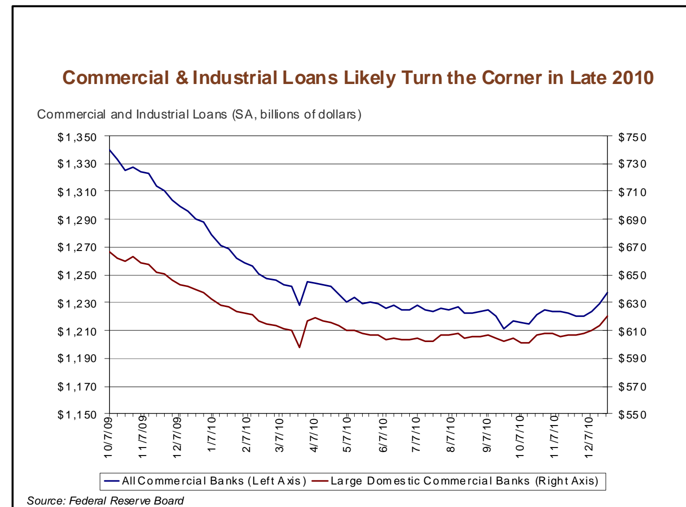
Consumers have become more confident, according to the Reuters/University of Michigan Survey of Consumer Sentiment, which rose in December to the highest level since June 2010. Rising stock markets likely played an important role in lifting sentiment. Since the middle of 2010, the rise in equity prices has added about $2.5 trillion to consumer wealth.

Not all measures of consumer attitudes showed a significant improvement. The Conference Board's measure of consumer confidence, which is more sensitive to labor market conditions than financial conditions, disappointed in December. Given another weak December employment report, confidence will likely remain soft. Consumers have reasons to be cautiously optimistic: rising stock markets and improving economic

activity have helped support confidence, but slow hiring, continued declining home prices, rising gasoline prices, and rising interest rates still weigh on them.

Consumers also face tighter lending standards than those in place before the recession, although lending standards for consumer loans (credit cards and other consumer loans excluding mortgages) have eased in recent quarters, according to the Federal Reserve Senior Loan Officer Survey on Bank Lending Practices. Fewer banks reported tightening their standards than those reporting loosening their standards. Mortgage loans were an exception: the pace of tightening picked up again during the fourth quarter of 2010.

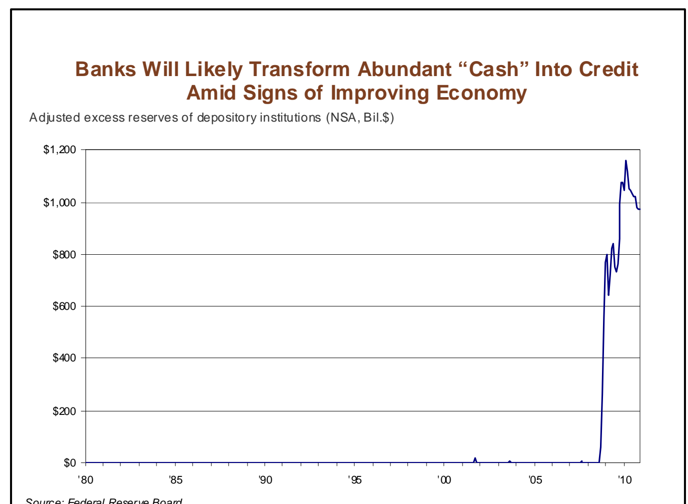




The impact of easing lending standards on consumer loans will not be visible overnight. Weekly bank credit data have yet to show significant increases in loans to consumers and businesses. However, there are signs that the decline in some types of lending may be ending. For example, commercial and industrial loans, which showed no growth for most of 2010, appeared to have turned up late last year.

Our outlook on consumer spending has a large impact on our outlook for overall economic growth. It is unlikely that the robust consumer spending growth expected for the fourth quarter of 2010 will be sustainable at that level. Combined with factors weighing on consumers previously mentioned, income growth will remain slow due to the expected gradual improvement in labor market conditions. However, we expect real consumer spending growth to slow only modestly to approximately three percent.

In addition to continued improvement in the labor market; bank lending is key. Banks are still holding a trillion dollars of excess reserves (essentially cash), and we expect them to transform some of those reserves into loans as risk appetite increases amid signs of an improving economy. The volume of excess reserves adds upside growth potential to our forecast if these excess reserves are rapidly unleashed and transformed into bank loans. This was a discussion among the members of the Federal Open Market Committee (FOMC) who noted that a sharp increase in lending could emerge given the easy monetary policy stance in place, according to the minutes of the December FOMC meeting.



Nonresidential Investment: Temporary Slowdown

Nonresidential investment is tracking to be anemic in the fourth quarter of 2010 following annualized double-digit gains in the prior two quarters. This is due primarily to strong business investment in equipment and software amid declining investment in nonresidential structures. Recent data suggest that the setback in business investment will only be temporary. The November factory goods report showed that nondefense capital goods orders excluding aircraft, a proxy of future business investment in equipment and software, rose 2.6 percent, reversing most of the large drop reported in the prior month. It appears that the tax breaks for business investment could not have come at a more opportune time. The new tax advantages embedded in the tax bill, which include a provision to allow expensing of new equipment for one year followed by another year of 50 percent bonus depreciation, should help support solid growth in business investment during the next two years. By contrast, we expect nonresidential investment in structures to continue to decline through the rest of the year.

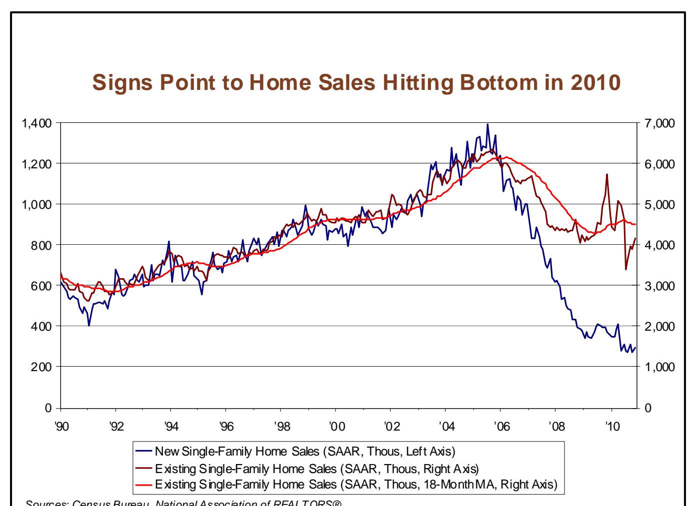
Housing Market: Organic Recovery In Sight?

2010 was not a prosperous year for housing. The homebuyer tax credits pulled forward housing demand into late 2009 and early 2010, and the market suffered a huge hangover after the credits expired. With the high unemployment rate and concerns about job security, few potential homebuyers took advantage of the record high affordability brought about by low mortgage rates and declining home prices.

Also during 2010, a still-large excess supply of housing continued to plague the market. While the inventory of vacant homes for sale and for rent appear to be stabilizing, according to the Bureau of the Census Housing Vacancy Survey, they remain significantly above their normal levels and are expected to continue to exert downward price pressure. The same can be said about the shadow supply from seriously delinquent mortgages and REOs not yet on the market, which indicates that a great deal of supply is still in the pipeline. According to the FOMC minutes, committee members expressed concern that the elevated supply of homes available for sale and the overhang of foreclosed homes will contribute to further drops in home prices, reducing household wealth, and thus restraining growth in consumer spending.

As much as a third of existing home sales are distressed sales (short or foreclosure sales) which sell at deep discounts compared to standard transactions. Faced with fierce competition from distressed sales, new home sales have languished. Sluggish demand and tight financing have continued to suppress home building activity.

Year-to-date single-family existing home sales through November were 5.9 percent below sales during the same period of 2009. By contrast, year-to-date condo sales posted a 1.7 percent gain. New home sales fared much worse than existing home sales, posting a year-to-date decline of 14.9 percent. While both new and existing home sales experienced their fifth consecutive yearly decline in 2010, activity improved late in the year, albeit from depressed levels. To put this into perspective, single-family existing home sales are running at the 1998 pace, while new home sales, as well as single-family starts, are running near record lows. (We exclude condo sales in the adjacent chart because of their shorter history and we also present a moving average for the single-family existing homes series to smooth out the spikes from the first-time homebuyer tax credit and its extension and expansion).



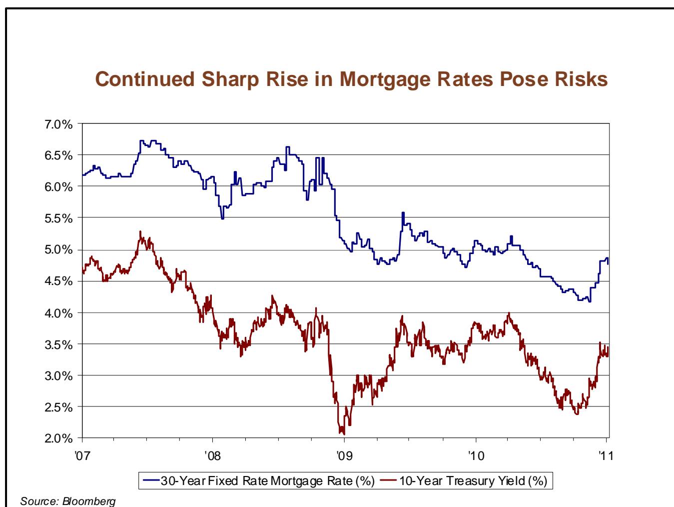
Sales of new and total existing homes each increased approximately 5.5 percent in November. Near-term leading indicators of home sales point to additional gains. After posting the biggest jump on record back to 2001, pending home sales (i.e., contract signings of existing homes, which usually lead closings by 1 to 2 months) rose further in November. Purchase mortgage applications from the

Mortgage Bankers Association Weekly Survey of Mortgage Applications, another leading indicator of home sales, rose 7.7 percent in November, the biggest monthly increase since April, and advanced another 3.3 percent in December. A recent pickup in activity helped soothe concerns that the foreclosure problems might derail the housing recovery.

The housing market remains at risk given the ongoing foreclosure controversy and further declines in home prices which will likely push more homeowners underwater. Underwater mortgages present a hurdle to the housing recovery and to the well-being of the overall economy. Negative equity makes it difficult for homeowners to purchase new homes or to refinance their current mortgages. In addition, it hinders homeowners from taking better job opportunities that would entail a long commute.

Tighter lending standards also present an obstacle for the housing market. As mentioned earlier, the Federal Reserve Senior Loan Officer Survey on Bank Lending Practices showed easing lending standards for most categories of loans with the notable exception of mortgage loans in the consumer loan category. *(See chart on page 4: Lending Standards for Consumers Have Eased.)*

Rising mortgage rates, which increased by about 70 basis points between mid-November 2010 and the end of December 2010, are a source of concern for the housing market. However, if rising interest rates are largely a result of an improving economy and the labor market, rather than an increase in inflation expectations or concerns about the federal deficit (which we believe to be the case), then home sales will likely increase even without any additional government policy support.



We do not expect an additional sharp up-tick in mortgage rates this year. Nor do we expect the Fed to start hiking short-term interest rates during this year, as we expect unemployment will remain high and core inflation low. Fixed mortgage rates are projected to rise throughout the year but to remain below 5.5 percent. We expect total home sales to increase by about 5 percent in 2011. Total housing starts will likely see better gains, rising by about 18 percent. However, larger increases in mortgage rates without a corresponding acceleration in job gains would pose a risk to the housing recovery.

For all of 2011, total mortgage originations are projected to decline to $1.04 trillion from an estimated $1.53 trillion in 2010, with a refinance share of 37 percent. Total single-family mortgage debt outstanding is projected to decline by 2.7 percent in 2011, compared with an estimated 2.6 percent drop in 2010.

Risks to the Forecast: More Balanced Upside and Downside in 2011

We viewed the risk in our forecast for 2010 as skewed to the downside, sometimes significantly. As the economy lost momentum in the spring, we estimated the odds that the economy could slip back into recession to be as high as one-third. Today, we believe that the odds have receded to negligible levels, and the risks around the current forecast are now more balanced.

Near-term downside risks to the forecast include those we experienced last year. The state and local budget crisis could intensify, requiring drastic fiscal adjustments. Europe will continue to grapple with sovereign debt concerns and austerity measures. If the Chinese economy decelerates sharply in response to government policies attempting to slow its overheated economy, it could bring about a slowdown in economic growth here in the U.S. and elsewhere.

The forecast is subject to upside risks as well. If the labor market improves faster than we expect or if bank lending takes off sharply, it will lead to stronger consumer and investment spending growth. This also could lead to a surge in household formation and greater than expected improvement in housing markets.

Longer term, the U.S. has to tackle the federal deficit, which is on track to reach $1.3 trillion or about nine percent of GDP in fiscal 2011—about the same as fiscal 2010. We believe this deficit pace is unsustainable. Unless the Administration and Congress act to reduce the deficit and the accumulating debt, long-term economic growth is threatened. There is a threat of a backlash on the part of global investors who may be concerned that the U.S. will monetize the deficit, driving up inflation. The resulting rise in interest rates and weaker dollar would reduce longer-term prosperity for the U.S. economy.

Doug Duncan and Orawin T. Velz
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