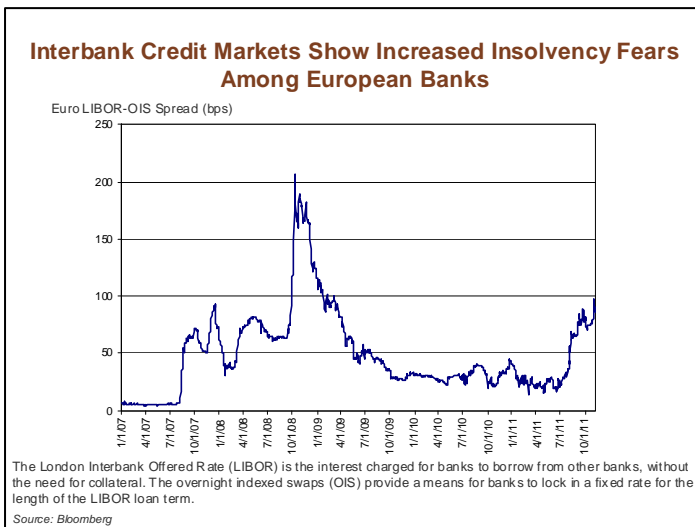


## Second-Half Growth Strengthens, but Outlook Remains Worrisome

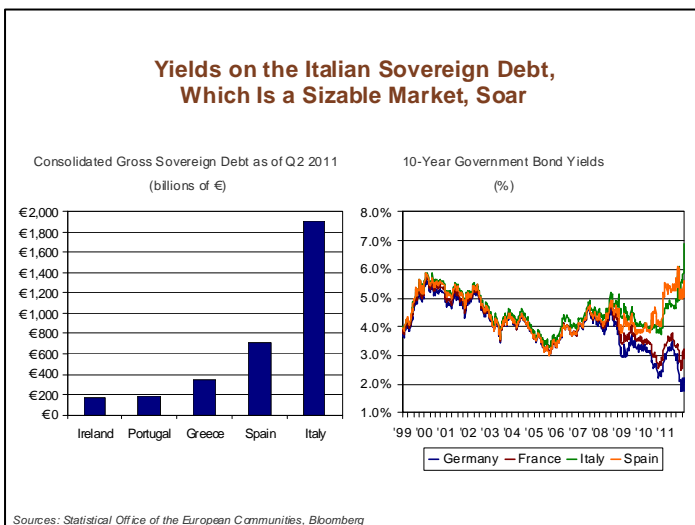
The economy expanded at a 2.5 percent annualized rate in the third quarter, after nearly stalling out during the first half of the year. While the rate was in line with market expectations, the details were more positive than expected, with solid business investment and consumer spending growth building momentum heading into the current quarter. The sizable contraction in inventories sets the stage for an inventory build heading into the holiday season. The employment report showed job gains in October and upward revisions of the prior two months' data providing another confirmation that the economy likely will skirt recession this year with a stronger second half, but return to a slower growth path in 2012.

The U.S. economy continues to be vulnerable to shocks, particularly from the ongoing financial crisis in Europe. The euro LIBOR-OIS spread reflects bank beliefs regarding default risk associated with lending to other banks. This barometer widened in August amid concerns regarding the solvency of the European banking system and exposure to Greek debt. The spread has widened from about 30 basis points in July 2011 to about 100 basis points as the time of this writing, albeit still less than half of its peak witnessed during the height of the financial crisis in November 2008.



Recent headlines from Europe have raised the specter of a disorderly default in Greece and contagion to the much-larger Italian bond market, which surpasses the volume of the outstanding debt of Greece, Ireland, Portugal, and Spain combined. This contagion fear is reflected in the surge in the 10-year yield of Italian government debt to above 7 percent in early November, the highest rate witnessed since the introduction of the euro and at approximately the level that previously forced Greece, Ireland, and Portugal to seek bailouts from the European authorities.

Such a sharp rise in borrowing costs could be critical for Italy, the euro zone's third-largest economy, significantly affecting its capacity to refinance an estimated \$400 billion in debt due next year. To make matters worse, Italy is leading a slide into recession across the whole euro zone, further undermining already stressed debt dynamics and making the imposition of further austerity politically difficult.



The impact of the European sovereign debt crisis is evident in the response to a special question in the October Federal Reserve Senior Loan Officer Survey on Lending Practices, which addressed changes in banks' lending standards and in the demand for bank loans from businesses and households during the past three months. A large number of both domestic and foreign banks indicated they had tightened standards on loans to European banks and their affiliates or subsidiaries. The response suggests that the U.S. financial system is not immune to European financial market developments.

Europe is not the only headwind, however. The debate over fiscal policy in the U.S. continues to be heated. Whatever the outcome of the “super committee” deliberations due on November 23, the plan to reach an agreement to reduce the deficit by at least \$1.2 trillion over the next 10 years starting January 2013 has the potential to roil the financial markets as well as consumer and business sentiment.

As fiscal tightening and policy uncertainty are still in the cards, our outlook for next year is little changed from the previous forecast. While we upgrade our view for the current quarter, we continue to see softened economic growth in 2012. There has been no substantial improvement in the underlying fundamentals that could provide the impetus to a sustained firming in growth beyond the second half of this year.

## The Second-Half Pickup in U.S. Growth is Unlikely to Sustain Into 2012

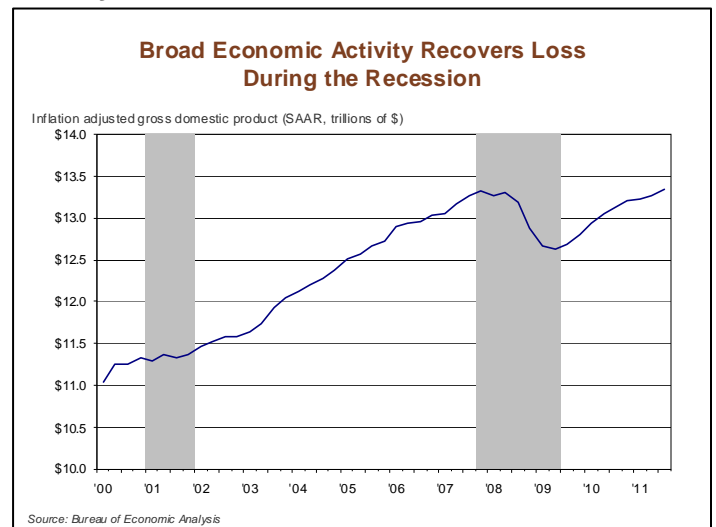
Real GDP finally surpassed its pre-recession level fifteen quarters after the prior peak.

Given the depth of the downturn and the tepid growth experienced since the trough, the recovery process has been excruciatingly slow. Real GDP finally surpassed its pre-recession level in the third quarter, fifteen quarters after the prior peak. For previous business cycles since World War II, it took an average of five quarters for real GDP to reach the prior peak.

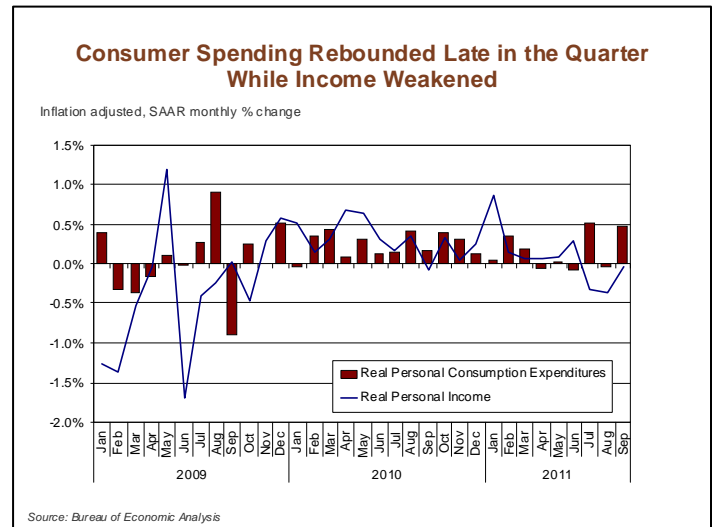
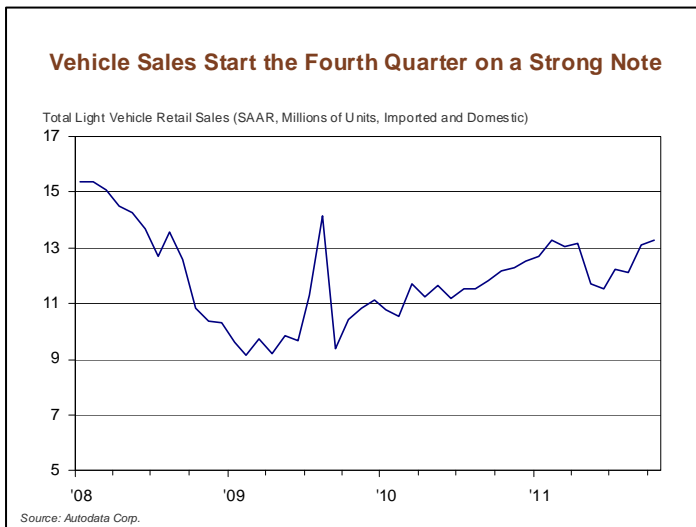
The strength in third-quarter business investment and consumer spending amid a sharp inventory correction helped boost final sales to a 3.6 percent annualized rate. Final sales (GDP minus the change in inventories) are considered a measure indicative of underlying demand.

The steady pickup in final sales is encouraging, indicating a strengthening in the trend of economic activity.

Incoming data suggest that growth in the current quarter will likely rival the third quarter. Both the Institute for Supply Management (ISM) manufacturing and nonmanufacturing indices edged down, but remained in expansionary territory with the average reading for the two ISM indices in October about equal to their third-quarter average. Business investment grew at a robust clip in September, and the surge in core capital goods orders, a leading indicator of business investment, suggests that any near-term spending slowdown will be gradual. The recent strength in core capital goods orders may have reflected businesses taking advantage of the 100 percent depreciation allowance on new equipment purchases, a tax break slated to expire at the end of December. Thus, some pullback in business investment early next year seems likely.



Consumer spending was resilient in the third quarter, despite poor income fundamentals and eroding confidence. Consumer spending was the biggest driver of growth and the strength in spending was not due to a rebound in autos from fading supply chain disruptions. In fact, spending on autos and parts fell modestly. Spending on other durable goods and on services, which posted the biggest gain since mid-2006, drove the overall gain. Spending on autos and parts will likely post an increase in the current quarter, as auto sales picked up in October, putting the sales pace sharply above their third-quarter average. However, the supply chain disruptions related to the flooding in Thailand, which has shut down several parts manufacturing plants, have reduced production plans for the fourth quarter and the resulting shortages of inventory may restrain sales in coming months.



Monthly data indicated that consumer spending strengthened late in the third quarter, rising 0.5 percent after adjustment for inflation, leaving real consumer spending at the start of the fourth quarter at a higher level than the average of the third quarter. However, soft trends in real disposable income through September could temper the pickup in momentum in spending.

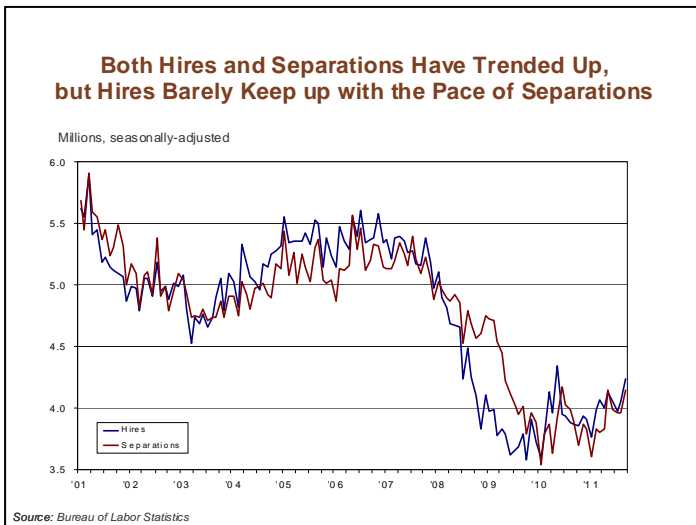
The pickup in consumer spending occurred despite the biggest drop in real personal disposable income since the third quarter of 2009, resulting in a full percentage point decline in the saving rate to 4.1 percent in the third quarter. The large decline argues for less consumer spending in the current quarter.

Labor market conditions and income trends will largely determine the path of consumer spending growth going forward. The October employment report from a survey of establishments was mixed. Total nonfarm payrolls posted a paltry gain of 80,000, with private payrolls rising by 104,000. However, the prior two months' private payrolls were upwardly revised by just more than 100,000 jobs.

After remaining at 9.1 percent for three consecutive months, the unemployment rate ticked down one-tenth to 9.0 percent in October, as household employment posted a strong gain for the third consecutive month, more than offsetting the number of people entering the labor force. A broader measure of the unemployment rate that includes discouraged workers and those working part-time for economic reasons also declined from 16.5 percent to 16.2 percent during the month. The employment-population ratio, which has remained at depressed levels throughout the recovery, has improved modestly in each of the past three months.

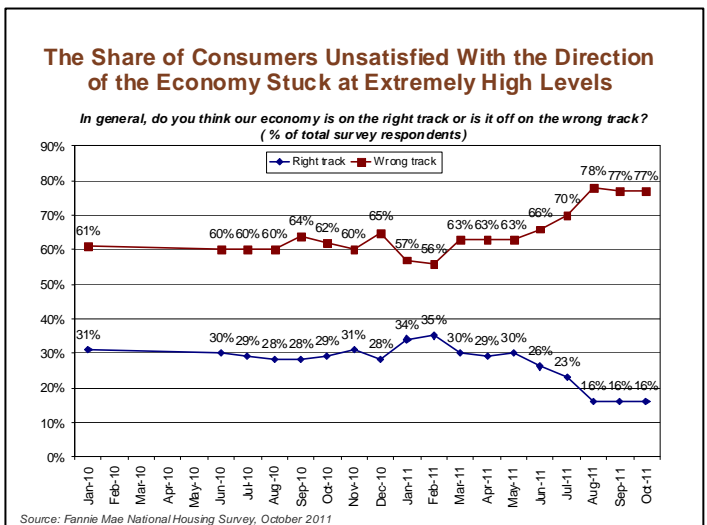
The Bureau of Labor Statistics (BLS) Job Openings and Labor Turnover Survey (JOLTS), an alternative gauge of labor market conditions showed continued gradual improvement for the labor market in September. (It is released with a one-

month lag). The number of available jobs grew by 225,000 in September to the highest reading since the second half of 2008. Openings increased or stabilized across most industries, except construction. Meanwhile, hires rose to 4.245 million while separations (including quits, layoffs, and retirements) increased to 4.149 million workers, resulting in the small net job gain of less than 100,000. Since the beginning of this year, both hires and separations have trended up, but hires have barely kept pace with separations. The number of quits reached a new high for the recovery in September. This is a positive aspect of the labor market as it implies that people feel more confident about their abilities to find more favorable jobs.



The outlook for consumer spending also will depend in part on whether current programs that effect after tax income will expire at the beginning of the year as scheduled, including the 2 percent payroll tax cut and emergency unemployment benefits. For the latter, personal income for about 3.5 million unemployed workers is expected to decline by approximately \$57 billion upon expiration. Unless Congress acts, the funding for those benefits will run out at the beginning of 2012 and unemployed workers will begin to move off the rolls.

The main measures of consumer confidence, including the Conference Board consumer confidence index and the Reuters/University of Michigan consumer sentiment index, remained at depressed levels in October. The Fannie Mae National Housing Survey also showed that the more positive economic headlines over the past month have failed to lift consumers' moods. While their views regarding their personal finances and the direction of the economy have not deteriorated further, it is discouraging to see the lack of appreciable improvement after overall sentiment took a hit during the debt ceiling debate in August.



## Housing: Improvement Expected to be Woefully Slow Through Next Year

The fact that sentiment appears to be in a holding pattern at depressed levels is a cause for concern regarding the development of the housing market. Existing home sales fell in September, driven by a large drop in sales in the West. The National Association of REALTORS® indicated that the reduction in loan limits that took effect at the beginning of October drove the surge in sales in the region in August and their subsequent decline in September.

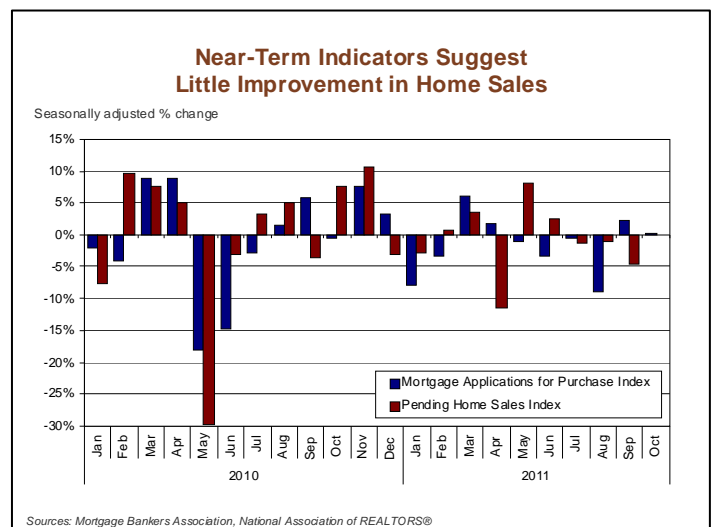
Third quarter existing home sales averaged below the level attained in the second quarter level. Year-to-date sales through September were little changed from the pace witnessed during the same period in 2010. The drop in home sales contracts in September along with weak purchase mortgage applications in September through mid-October presages a lackluster sales performance in the fourth quarter. However, purchase mortgage applications have trended up during the second half of October and in early November. We expect that 2011 existing home sales will be little changed from 2010 with 2012 existing home sales only slightly higher.

New home sales rose in September for the first time in five months after essentially moving sideways since the expiration of the homebuyer tax credit for contract signings in April 2010. Through the first three quarters of this year, new home sales have been about 8.6 percent below the pace achieved during the same period in 2010. Home builders were more optimistic in October, but sentiment remains at depressed levels. We project a drop of six percent in new home sales in 2011 followed by a gain of about six percent in 2012.

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Homebuilding activity increased in September, driven by a surge in multifamily starts, which tend to be volatile. Single-family starts also increased modestly but, like new home sales, have been flat since the expiration of the homebuyer tax credit. The low level of new construction has greatly reduced inventory, bringing the months' supply (inventory-sales ratio) to 6.2 months in September, comparable to its long-term average and far below the 2009 peak of 12.2 months. However, even with this lean inventory, builders find it difficult to compete with distressed properties in the existing home market, which reports supply of around 9 months. The excess supply in the existing home market will likely persist over the coming years as distressed properties continue to enter the market.

The Bureau of the Census' Housing Vacancy Survey's homeowner vacancy rate, which measures the share of housing units that are typically owner-occupied but are vacant and for sale, ticked down to 2.4 percent from 2.5 percent in the second quarter. However, the rental vacancy rate, the share of rental housing units that are vacant and available for rent, rose to 9.8 percent from 9.2 percent.



It is well-known among housing analysts that the figures reported in this survey are at odds with those from the decennial Census and other surveys from the Census. The Census Bureau acknowledges the discrepancies and cautions against making comparisons among survey results. The jump in the rental vacancy rate in the third quarter contradicts private surveys of multifamily market conditions, which show improving vacancies and growing rents. (For more information on the pickup in multifamily construction in response to improving fundamentals, read the [November 2011 Multifamily Market Commentary](#)).

After posting strings of gains during strong seasonal months, the main measures of home prices fell in August. Home prices are expected to trend lower for the rest of the year, given weak housing demand and a potential rise in the share of distressed sales. The October Fannie Mae National Housing survey shows that consumers' outlook for the housing market has remained downbeat, as they expect home prices to decline over the next year, extending the streak of negative outlooks to five consecutive months.

Given the lack of appreciable improvement in the housing market despite declining mortgage rates to near record low levels, the housing market continues to be a focus of policymakers. The administration announced modifications to the Home Affordable Refinance Program (HARP) in late October to make it easier for some borrowers to refinance loans. This includes removing the 125 percent loan-to-value (LTV) cap, reducing risk-based pricing and eliminating it entirely for those refinancing into a shorter-term mortgage, waiving certain representation and warranty requirements and thereby reducing put-back risks, and allowing automated appraisals in many cases to reduce closing costs. HARP, which continues to be restricted to pre-June 2009 originations, is extended to the end of 2013, and detailed guidance was provided on November 15.

Several Fed officials have recently indicated an inclination to provide more support for housing. For example, Fed Governor Tarullo stated that more purchases of mortgage-backed securities (MBS) "should move back up toward the top of the list" of policy options. Despite more discussions regarding a new round of large-scale agency MBS purchases by the Fed, The Federal Open Market Committee (FOMC) kept monetary policy unchanged at its meeting earlier this month. The Fed reiterated its expectation to keep interest rates low through mid-2013. It also will continue "Operation Twist" (with the objective of reducing interest rate spreads between MBS and Treasuries in an effort to help support refinance and home purchase activity) and reinvest MBS and agency debt runoff in the mortgage market. The statement following the meeting was little changed from that made after the prior meeting. The Fed struck a slightly more upbeat tone, as it noted the pickup in economic activity in the third quarter, but kept the language on the labor and housing markets downbeat. The Fed also released an updated economic forecast showing a downgrade in economic conditions compared with its previous forecast released in June, and continued to note "significant downside risk" to the outlook.

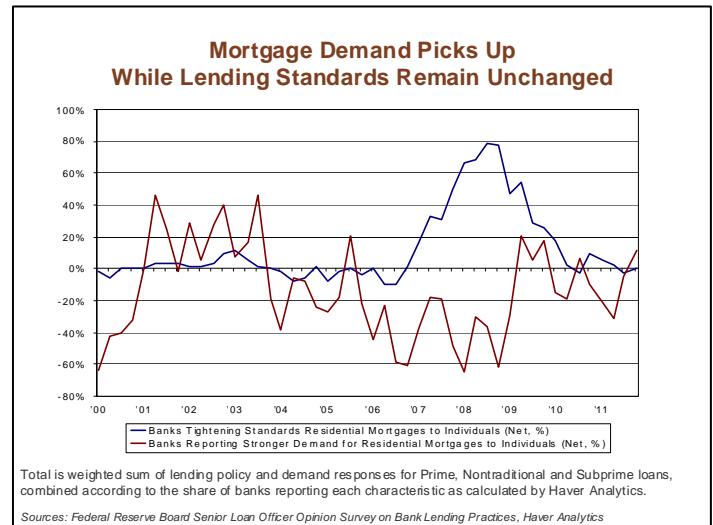
One notable point was a dissent from Chicago Fed president Evans, who supported additional policy accommodation, marking the first time a dissent for more policy support has occurred since Boston Fed president Rosengren did so in late 2007. Chairman Bernanke stated in the press conference following the FOMC meeting that additional purchases of MBS are a "viable option" to help the housing industry and the economy if conditions warrant. It is likely that additional purchase of MBS will play a role if the Fed decides to expand its balance sheet again.

We continue to expect that the Fed will keep the 0 fed funds rate policy through all of 2013. For long-term interest rates, yields on 10-year Treasuries have fallen to about 2 percent at the time of this writing, as anxiety about soaring Italian bond yields to euro-era highs has boosted risk aversion and a corresponding flight to quality. Given the expected sluggish pace of economic growth next year, we expect the 10-year Treasury yield to move up only gradually, bringing the 30-year fixed mortgage rate up to slightly more than four percent by the end of 2012.



The latest Federal Reserve Senior Loan Officer Survey showed that lending standards for residential mortgages were unchanged. However, demand picked up, with more banks reporting an increase in demand than those reporting a decline for the first time in more than a year. This probably reflects the increase in refinancing activity rather than any significant increase in purchases.

For all of 2011, total single-family mortgage originations are projected to decline to \$1.30 trillion from an estimated \$1.69 trillion in 2010, with the refinance share at 69 percent. For next year, we expect total mortgage originations to decline to \$988 billion as the decline in refi originations offsets a modest increase in purchase mortgage originations. The refi share should decline to 53 percent. Total single-family mortgage debt outstanding is expected to decline by an additional 1.6 percent following a projected 2.3 percent decline in 2011.




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Doug Duncan and Orawin T. Velz  
Economics and Mortgage Market Analysis  
November 10, 2011

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