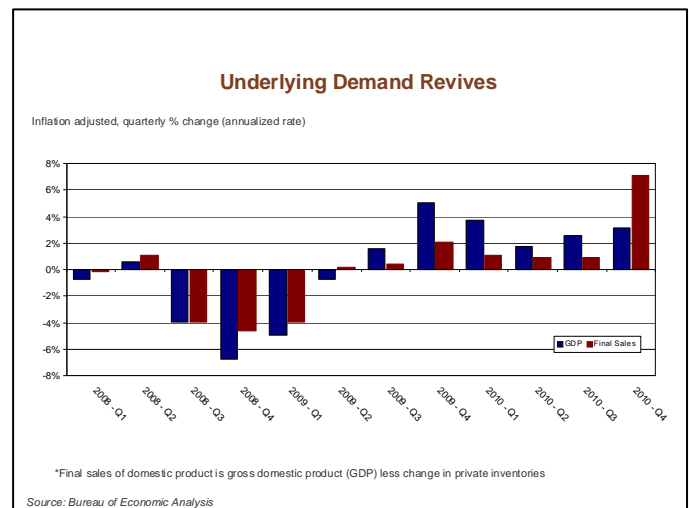
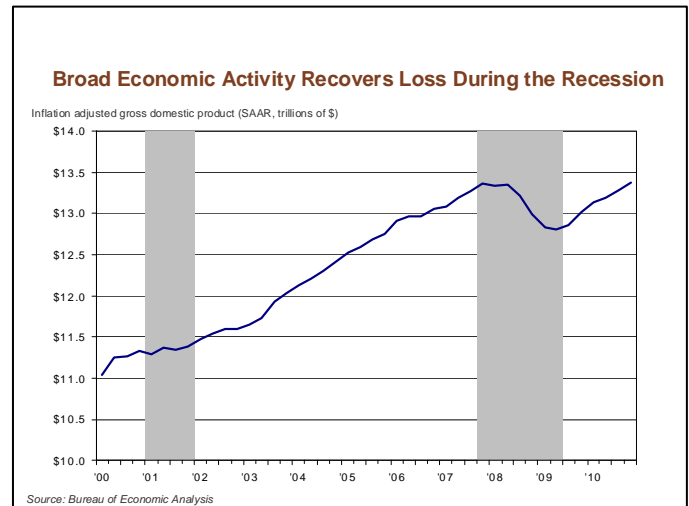


## Organic Demand Blossoms

Broad economic activity has continued to improve during the past month. Growth accelerated in the final quarter of 2010 to a 3.2 percent annualized rate from 2.6 percent in the third quarter. The pickup in growth was sufficient to push the level of real (inflation-adjusted) gross domestic product (GDP) just above the prior peak reached in the fourth quarter of 2007. After three years, the economy is embarking on a true period of expansion, finally reversing the losses experienced during the recession and putting the recovery phase behind us.

Economic growth in the fourth quarter of 2010 was relatively modest, compared with the 5 percent pace witnessed during the fourth quarter of 2009. The acceleration in economic growth in the early stages of the economic recovery was due largely to temporary drivers—inventory building, as well as the fiscal stimulus. Today, the economy’s underlying, organic demand is on much firmer footing. Consumer spending, in particular, grew by a 4.4 percent annualized rate, the fastest pace since early 2006. Final sales—GDP excluding the change in inventories—grew at a 7.1 percent annualized rate in the fourth quarter, following a gain of about 1 percent in each of the prior three quarters and marking the biggest increase since 1984. Inventories were drawn down sharply, subtracting 3.7 percentage points from growth, which should allow for a somewhat faster rate of output growth in the current quarter. Essentially, this means that underlying demand has improved sufficiently to overcome the impact of a huge inventory destocking, allowing the economy to continue to grow at an above par pace.

Part of the surge in final demand came from net exports, which added 3.4 percentage points to growth. While export growth was solid, reflecting stronger global economic growth, the vast improvement in net exports came from a sharp decline in imports (largely petroleum) that will likely be reversed in the first quarter. At the same time, after the massive destocking, businesses will have to increase inventory investment in early 2011. Consequently, the strength in final demand in the near-term is expected to soften from the fourth quarter pace. We expect economic growth to accelerate modestly from the pace of the fourth quarter of 2010 in coming quarters, with consumer spending being the biggest driver. Business investment will remain a strong supporter of growth, while residential investment will stop being a drag on growth on an annual basis for the first time in six years. For all of 2011, economic growth is projected to accelerate to 3.7 percent, compared with 2.8 percent in 2010. Growth could be stronger if real consumer spending continues to grow close to the pace seen in the fourth quarter rather than moderating to just slightly more than 3 percent this year as we currently project.



The economy continues to be subjected to a lot of cross currents. The solid growth so far has not yet translated into sustained strong job growth, as businesses continue to be reluctant to increase hiring. Housing activity has remained at depressed levels and home prices suffered renewed declines in the second half of 2010. Steep budget cuts and tax hikes from state and local governments are one of the threats to the projected acceleration in economic growth as they will somewhat offset the stimulative effects of the Federal government's measures, including the cut in payroll taxes. While the European debt crisis will linger, the impacts seem to be more contained than was the case a year ago. However, geopolitical risks in the Middle East have recently emerged as more significant concerns. Finally, the attempts of the emerging markets, including China and India, to cool down their economies could dampen the global growth outlook.

## **Bad Weather Clouds Employment Picture**

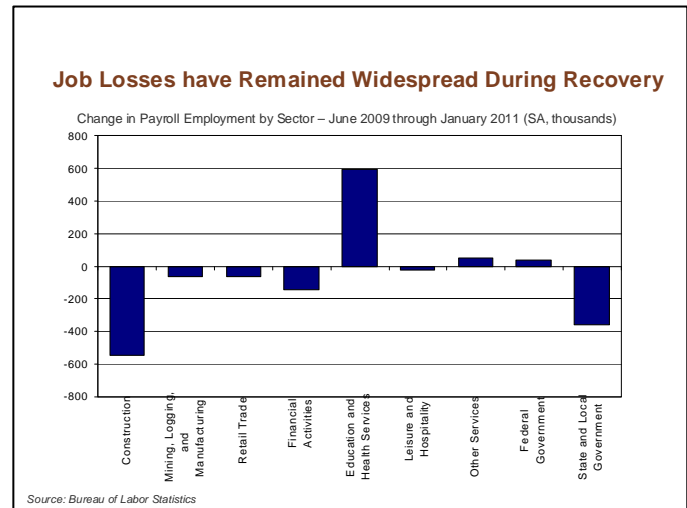
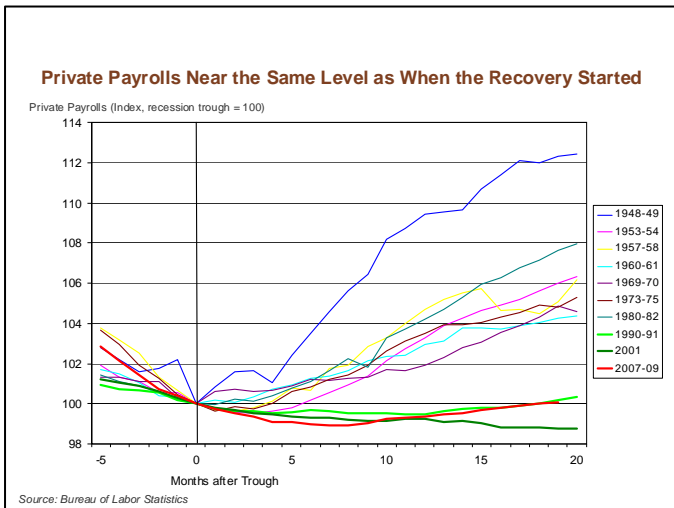
The January employment report was influenced by special factors, making it difficult to gauge the true state of the labor market. The establishment survey showed an anemic 36,000 increase in nonfarm payrolls. However, severe weather in many parts of the country likely substantially suppressed the gain. The Bureau of Labor Statistics reported that an unusually large number of employees were not at work due to bad weather.

The household survey showed the unemployment rate declined 0.4 percentage points to 9.0 percent. The rate has now dropped 0.8 percentage points in two months, the biggest two-month decline since 1958. The drop in the unemployment rate was a combination of more employed people and fewer people in the labor force. While workers who could not be at work because of the weather were not counted in the establishment survey, resulting in a reduction in payrolls, they were classified in the household survey as employed. After declining in each month since October, the labor force fell again by 504,000 in January, remaining below the level of a year ago. This is an unusual phenomenon in a growing economy, as we would ordinarily expect to see more people join the labor force and previously discouraged workers rejoin. The labor force participation rate dropped to 64.2 percent in January, its lowest reading since 1984. It is possible that we could see strong growth in the labor force in coming months, which could reverse some of the drop in the unemployment rate. We expect the unemployment rate to decline slowly this year, ending the year at a still high rate of 8.8 percent.

The average workweek declined 0.1 hour to 34.2 hours, perhaps attributable to the weather impact. One bright note is that average hourly earnings increased 0.4 percent, the biggest gain since the end of 2008. However, the big gain could be a result of the change in the mix of workers, as those who could not report for work during the storms were likely to be lower-wage earners.

There were some developments that pointed to improving labor market conditions. The broader measure of unemployment (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) fell from 16.7 percent in December to 16.1 percent in January, the lowest level since April 2009. In addition, the median duration of unemployment and the share of the unemployed who have been unemployed for 27 weeks or more both fell during the month.

The January data also included benchmark revisions going back to April 2009 showing that 909,000 jobs were created in 2010, 215,000 fewer jobs than initially reported. This amounted to an average monthly gain of just 76,000. From the official trough of the recession in June 2009 to January 2011, the private sector created only 94,000 jobs. It is troubling that job creation since the recession ended has been painfully tepid, especially after taking into account the massive job losses that occurred during the recession.



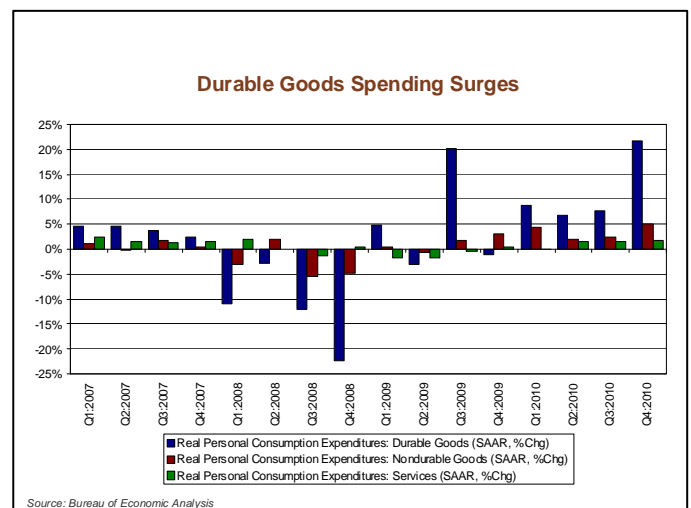
Job gains during the recovery are mostly concentrated in the areas of education and health services. Job losses, however, remain widespread, with construction taking the biggest blow.

In addition to the weather impact and benchmark revisions, in January of each year, the Bureau of Labor Statistics includes population adjustments to the estimates of the labor force. These special factors added to the difficulty in assessing underlying market conditions noted earlier. Despite the noise in the employment report, the other main indicators of the labor market, including initial jobless claims, the Institute for Supply Management (ISM) manufacturing and non-manufacturing employment indices, and strong employment gains in the household survey, suggest that the underlying trend is improving. To the extent that the weather wreaked havoc on the January nonfarm payrolls number, we should see some reversals in this month's report, assuming that the weather in February returns to the winter norm. The bottom line is that the weakness in the January payroll jobs number likely understated the wellbeing of the labor market, while the drop in the unemployment rate likely overstated it.

With the latest developments in labor market conditions, the Fed will remain cautious. In his speech in early February, Fed Chairman Ben Bernanke indicated that until we see sustained stronger job creation, we cannot consider the recovery to be truly established.

## Consumers Are Upbeat

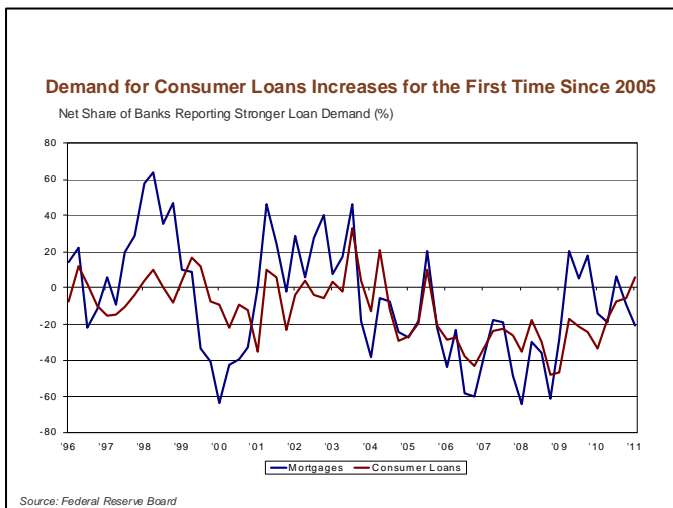
The strength in real consumer spending in the fourth quarter of 2010 came largely from durable goods, where pent-up demand has been released following the massive contraction experienced during the recession. This suggests that consumers are more confident in the condition of their personal finances, a trend seen in the main confidence measures since late last year, allowing households to be more willing to delever at a slower pace. The gain in durable goods spending was stronger than that witnessed during the third quarter of 2009, when spending on vehicles was boosted by the Cash for Clunkers program. Nondurable goods purchases also accelerated during the fourth quarter. By contrast, the gain in spending on services continued to be modest, remaining well below its long-term average of about 3.5 percent, suggesting there is more room to grow in this category.



January vehicle sales suggest that consumer spending is off to a good start in the current quarter. Sales rose to 12.6 million annualized units, their strongest pace since September 2008, excluding the Cash for Clunkers month of August 2009. While this sales pace remains well below the long-term trend of about 15-16 million units, it has rebounded substantially from the average pace of 9.5 million during the first half of 2009. Furthermore, January chain store sales posted solid gains, indicating continued strength in consumer demand.

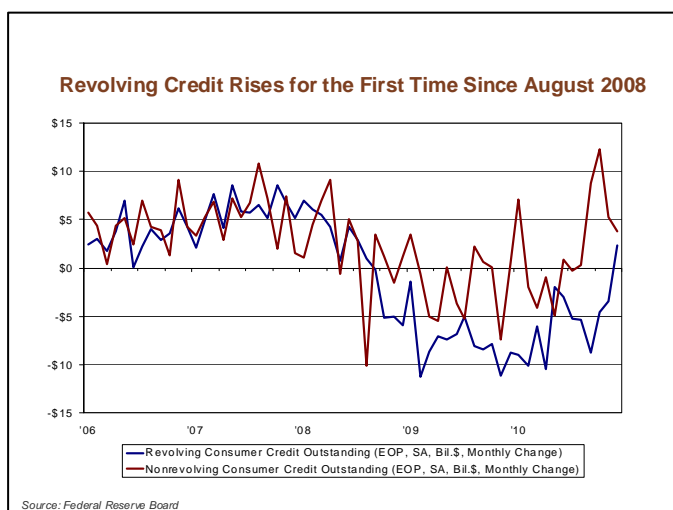
## Credit Conditions Ease

During the past year, bank lending standards for business and consumer loans have eased. According to the Federal Reserve Senior Loan Officer Opinion Survey, this trend continued during the three-month period ending in January 2011, particularly for commercial and industrial (C&I) loans and for consumer loans. Furthermore, the survey indicated improving demand, with demand for consumer and C&I loans increasing for the first time since 2005.



This improvement is supported by weekly data on commercial bank loans outstanding. After plunging in late 2008 and 2009, C&I loans on bank balance sheets flattened during most of 2010 before starting to turn up during the past couple of months. This is encouraging, given that C&I loans are usually a lagging indicator of the business cycle. Their revival supports the notion that credit conditions will continue to improve going forward.

Small businesses' perceptions of credit availability have begun to stabilize as well, according to the National Federation of Independent Business survey of business optimism in January. The share of small business owners reporting that credit was harder to get continued to trend down from its peak in May 2009.



The latest data on consumer credit added to the evidence that consumers are more willing to use credit to finance their spending. Consumer credit outstanding increased 0.3 percent in December, driven by growth in both revolving credit (largely credit cards) and nonrevolving credit (mostly auto loans). While nonrevolving credit has been rising in recent months, the December increase in revolving credit marked the first monthly increase for this component since August 2008.

Real estate remains an exception to the improving credit picture as underwriting standards have shown little improvement in this category. While the demand for commercial real estate loans increased for a second consecutive quarter to its highest level since 2005, there was no change reported in lending standards in January. Weekly data showed that commercial lending volumes continue to

contract. Conditions were not better for residential mortgages: standards tightened somewhat further compared with the prior three months, while loan demand continued to contract.

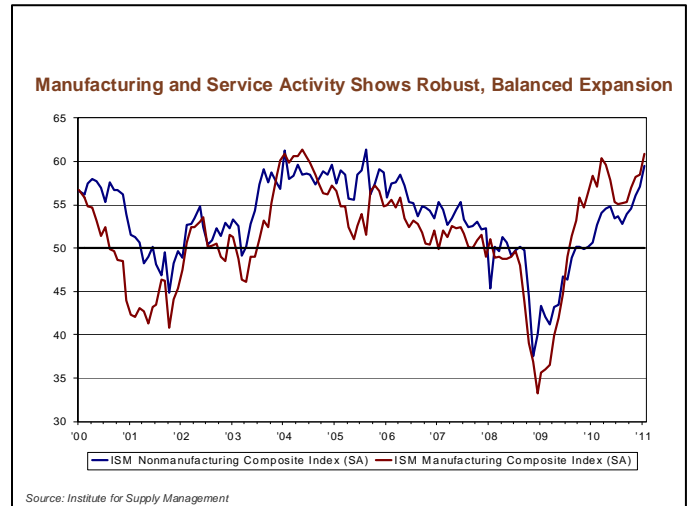
The Fed survey contained a special question regarding the banks' outlook for delinquencies and charge-offs for different loan categories in 2011. Banks were more optimistic compared with prior years, expecting improvements in delinquency and charge-off rates during 2011 in every major loan category. Overall, credit conditions, credit demand, and performance have improved and should provide a more conducive financial environment for economic growth this year.

## Manufacturing and Services Thrive

Signs of accelerating growth in early 2011 are evident in the ISM manufacturing and non-manufacturing surveys. The manufacturing index increased 2.3 points in January to 60.8, the highest reading since 2004. (Readings above 50 indicate an expansion). The details of the survey, including forward-looking components, were bullish. One notable component is the employment index, which jumped to its highest level since 1973. Its strength is consistent with the January employment report, showing an increase of 49,000 manufacturing payrolls, the biggest gain in more than 12 years.

Continued robust manufacturing activity is encouraging. This suggests that manufacturing, which was the rare bright spot in early stages of the recovery, will continue to play an important role in supporting growth this year, supported by strong exports and business investment.

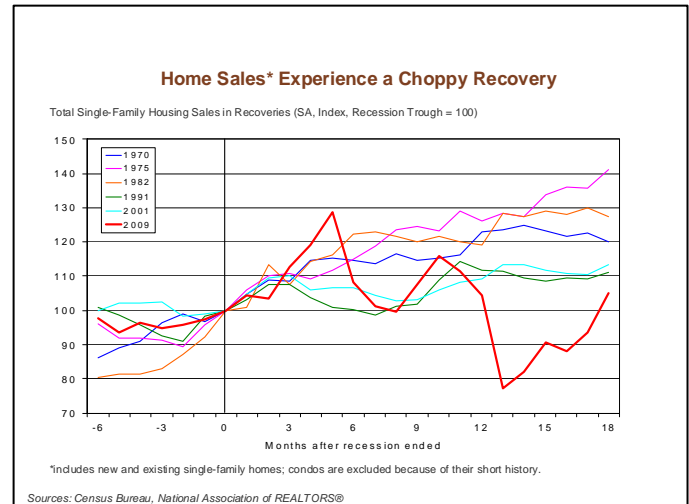
The services industry had lagged manufacturing substantially during the first year of the recovery. While the manufacturing index has been in expansion territory since August 2009, the ISM non-manufacturing index hovered around the 50 threshold until early 2010. However, since the final quarter of 2010, the non-manufacturing index has strengthened substantially and is now catching up with the manufacturing index as it rose to a new high for the recovery of 59.4 in January. The surge during the past several months indicates that the pickup in economic growth is more balanced between the two sectors. The broadening in the recovery is necessary to produce the sustained strong economic growth we are projecting.



## Housing Market Lags the Rest of the Economy

Nineteen months after the recession ended, the housing market is still struggling to gain traction. After suffering four consecutive double-digit annual declines, including plunging 38.8 percent to a record low in 2009, homebuilding activity posted an increase in 2010, with total housing starts rising 6.1 percent to 588,000 units. Both single-family and multifamily starts rose for the year.

One housing indicator that had a dismal performance last year was new home sales, which suffered a 14.2 percent drop to 321,000 annualized units, the fifth straight annual decline. Existing home sales continued to perform better than those of new homes. Following an increase of 5.0 percent in 2009, thanks to the first-time homebuyer tax credit that boosted sales late in the year, total existing home sales reversed the gain in 2010, falling 4.8 percent to 4.91 million annualized units. 2010 was a similarly rocky road for the existing housing market compared to previous economic recoveries. The extended and expanded homebuyer tax credit helped spur sales in the second quarter but sales dropped sharply in the third quarter, after the tax credit was no longer available.



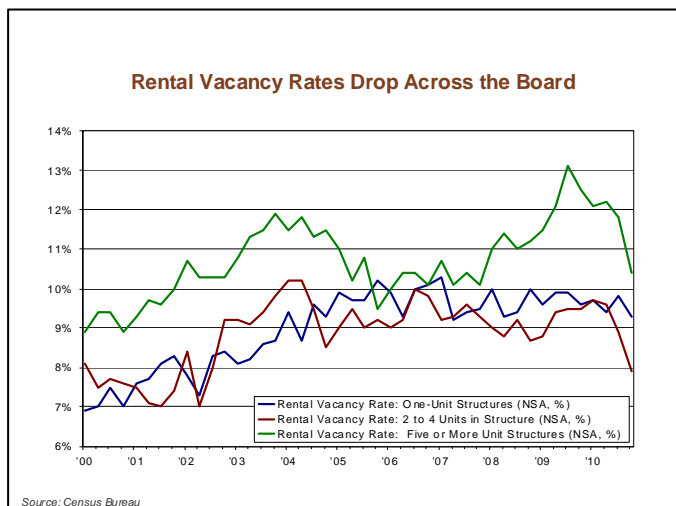
In 2009 we had expected home sales to trough and start their gradual recovery in 2010. However, the pullback in sales after the tax credits expired in 2010 was much more severe than we had anticipated. Total existing home sales slipped to a cycle low of 3.84 million annualized in July 2010, while new home sales fell to a record low of 274,000 annualized units in August of that year. Sales, especially in the existing home market, improved late last year amid historically high affordability, indicating that the foreclosure issues had little impact on activity.

One positive sign in the housing market is that the excess supply of housing appears to have peaked. With little home building activity, the inventory of new homes is quite lean. For all of 2010, the number of new homes available for sale fell to 191,000 units, just above the record low of 190,000 established in 1967. Given the slow pace of new home sales and the still-large inventory of vacant homes for sale, builders have been disciplined, perhaps reflecting a combination of both a lack of demand for new projects as well as continued tight lending standards for construction loans.

To gauge the amount of excess supply for the broad real estate market, we use data from the Housing Vacancy Survey, which offers the most comprehensive measures of vacant homes for sale and for rent. The survey showed mixed results at the end of 2010. After showing signs of stabilization during the past year, the homeowner vacancy rate, which measures the share of owner-occupied housing units that are vacant and for sale, edged up to 2.7 percent in the fourth quarter of 2010 from 2.5 percent in the prior quarter. The rate has remained close to the record high of 2.9 percent reached two years ago and is still about 1 percentage point higher than its long-term average, consistent with a still-large excess supply and ongoing softness in home prices.

In contrast, the rental vacancy rate fell sharply to 9.4 percent in the fourth quarter of 2010 from 10.3 percent in the third quarter. The large drop, the biggest since early 1966, sent the rate to its lowest level since the first quarter of 2003. However, the rate remains high by historical standards, only 1.7 percentage points below its peak in the third quarter of 2009. Nevertheless, the decline in the vacancy rate during the past year should help support rents, which have been rising according to many surveys. The Consumer Price Index data also points to rising rents in recent months, and should help to provide upward pressure on core inflation as the rent component accounts for about one-third of the core measure.

The decline in rental vacancy rates in the fourth quarter was experienced across all categories of structures, but most of the drop was in multi-unit structures, which account for about two-thirds of rental vacancies. The drop during the past year was most pronounced in structures with five or more units, which have experienced a decline of 2.1 percentage points, compared with just 0.3 percentage points for one-unit structures. Overall, developments in vacancy rates during the past year indicate that the excess supply of housing is being worked off slowly. The decline in rental vacancy rates for large structures is consistent with private surveys of apartment vacancies, showing improving multifamily fundamentals during 2010. (For more information on current multifamily market conditions, read the [February 2011 Multifamily Market Commentary](#)).



The downtrend in the rental vacancy rate is consistent with the downward trend in the homeownership rate, which implies that a rising share of households have chosen renting over owning. In the fourth quarter of 2010, the homeownership rate fell to 66.5 percent, its lowest level in 12 years and down from a peak of 69.2 percent in late 2004. This rate is expected to decline further based on the elevated level of seriously delinquent loans in the market, which we estimate to be about 4.5 million loans currently.



Homebuilding activity should continue to improve modestly. For all of 2011, we expect total housing starts to increase by about 16 percent to 692,000. While this may seem like a strong increase, the levels of starts will remain anemic compared with their long-term trend.

We believe that total home sales hit bottom last year; however, a strong rebound this year is unlikely, given the amount of excess supply and shadow supply that still needs to be worked off. While home sales ended the year on a strong note, leading near-term indicators suggest that sales will soften in the first quarter. After rising in November and December, mortgage applications to purchase homes dropped sharply in January. Given a gradual improvement in the labor market and moderately rising mortgage rates, we expect total home sales to increase by about 7 percent this year, compared with a 5 percent increase in the prior forecast. While we do not think that the very strong end-of-year increase is sustainable, it lifted the trajectory of sales expected this year.

Long-term interest rates have been under pressure of late. The yield on the 10-year Treasury issue has risen from 2.5 percent in October 2010 to a little above 3.5 percent currently. Stronger economic activity, together with concerns about the large federal budget deficit, are the likely culprits. We expect mortgage rates to rise steadily to about 5.5 percent by the end of 2011. Sharper increases in mortgage rates are a source of concern. However, if they are accompanied by stronger-than-expected job growth, the projected gain in sales is still likely. Measures of home prices have posted renewed declines after the tax credit resulted in gains during the second quarter of 2010. Home prices are a lagging indicator of the housing market, and thus we expect them to be the last to improve.

Stronger home sales and more moderate declines in home prices are projected to boost purchase mortgage originations in 2011 for the first time in four years, while rising mortgage rates will hurt refinancing incentives. We project that the refinance share of mortgage originations will fall to 35 percent of a projected total originations volume of \$1.03 trillion. Total single-family mortgage debt outstanding is projected to decline by about 2 percent.

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Doug Duncan and Orwin T. Velz  
Economics and Mortgage Market Analysis  
February 10, 2011

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