

Uncertainty Rattles Financial Markets

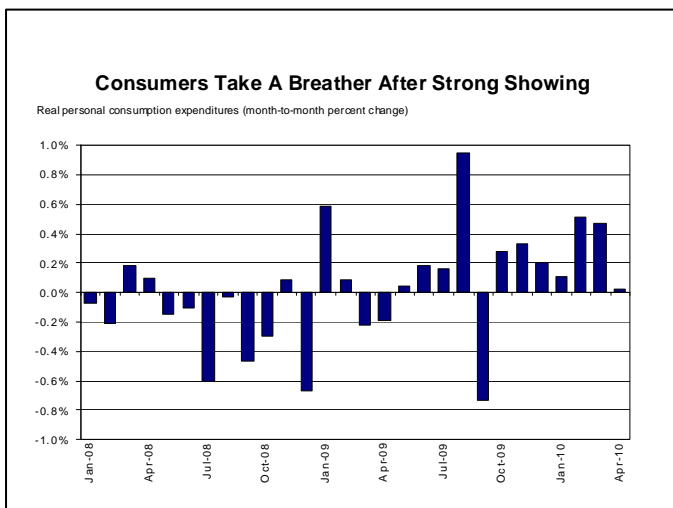
In the May forecast, we assumed that the debt crisis in Greece would be contained and not lead to broad contagion to other peripheral European countries, thereby having only a small impact on economic growth in the U.S. that could easily be offset by other positive developments. However, concerns over sovereign debt have not abated and have spread to other periphery countries, notably Spain following a downgrade of its government bonds in late May. It is clear that the underlying fiscal crisis in Europe will likely remain unresolved for some time, and increasing fiscal consolidation as well as rising funding costs present headwinds to the European economies going forward. New fear of credit crisis contagion also emerged from Hungary over the reported high probability of default on its debt. These concerns have led to a sell-off in stock markets around the globe and widening risk spreads.

Adding insult to injury was a disappointing jobs report showing anemic private payroll gains in May. These recent developments raise some doubt about the view that a strengthening labor market would create self-sustaining momentum that could overcome market risk aversion, fading fiscal stimulus, and the waning of the inventory cycle.

While we cannot rule out a broadening of the sovereign debt crisis which may lead to defaults or restructuring of debt of several countries in Europe, we believe that the odds are relatively low. We maintain our view that the economic recovery is durable. However, our projected modest recovery has become even more modest for this year. We revised lower our projections of exports and consumer spending, given the prospect of slower global growth, an increased risk premium, and heightened volatility. In addition, we believe a stock market pullback and labor market concerns will continue to weigh on consumer confidence, restraining spending growth.

Consumers take a breather

Economic data during the past month have generally come in weaker than expected. Real (inflation-adjusted) gross domestic product (GDP) in the first quarter was revised modestly lower to a 3.0 percent annualized rate from 3.2 percent reported earlier. Real consumer spending growth was revised fractionally lower to an annualized rate of 3.5 percent. Monthly data showed that consumer spending growth strengthened late in the first quarter but lost steam early in the second quarter, with real consumer spending nearly unchanged in April from March's level following two robust monthly gains.



The flat reading in real consumer spending may have been a result of several unusual factors. These included an early Easter, which pulled forward some retail sales into March. In addition, some of the rebates on energy efficient appliances may have pulled demand into the first quarter, resulting in a pullback in the second quarter.

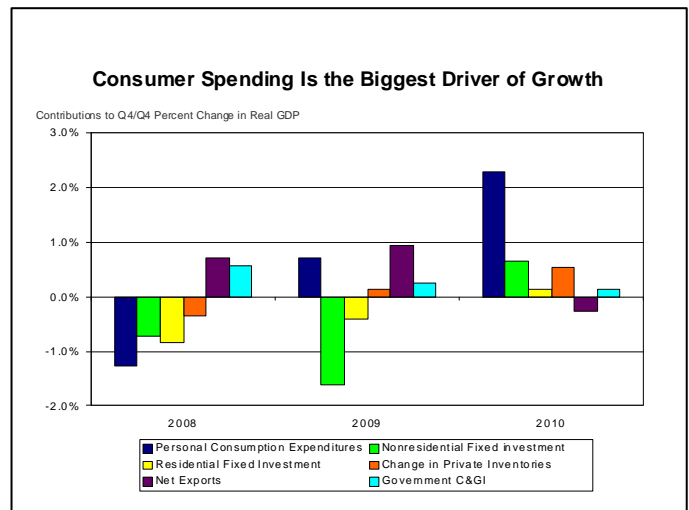
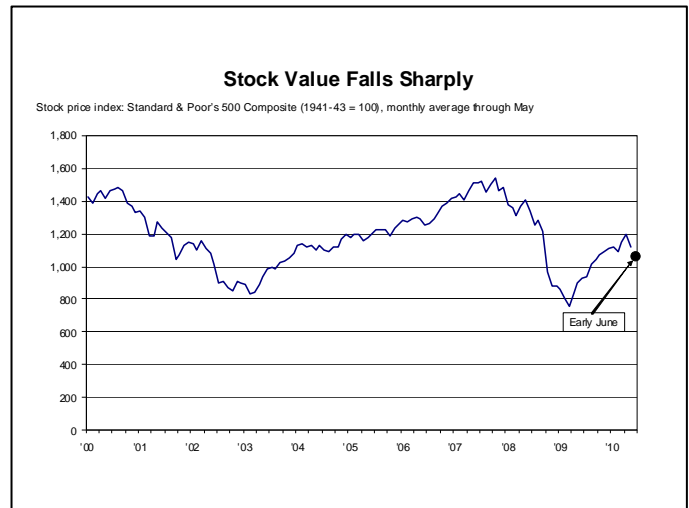
With strong spending late in the first quarter, real spending in the second quarter is on track to grow by about three percent at an annualized rate despite the soft reading in April. Leading indicators for May point to continued caution on the part of consumers, with both auto sales and chain store sales posting modest gains. Consumer spending will likely moderate in the second half of the year, presaged by the ongoing stock market correction. Since its recent peak in late April, the broad stock market value has dropped by more than ten percent. For

example, after peaking on April 23, the S&P trended down sharply, falling in early June to the lowest reading since November 2009. The index had recovered somewhat at the time of this writing.

Rising equity prices since their trough in March 2009 have helped household net worth rebound after a massive decline during the recession. According the Federal Reserve Board's Flow of Funds, between the first quarter of 2009 and the first quarter of 2010, household net worth increased by \$6.3 trillion, with more than half coming from rising equity value. The wealth effect from rising stock prices, which helped boost consumer spending, will now work in reverse and adversely impact the consumer spending outlook. However, equity prices remain approximately 60 percent above their trough.

By contrast, the personal income trend looks rosier. Real disposable income rose 0.5 percent in April. Real disposable income excluding transfer income, a better indicator of underlying economic conditions, increased 0.6 percent during the month. In addition, oil price futures have moved substantially lower in response to expected slower global demand amid the turmoil in Europe. We believe this will result in higher disposable income. Stronger wage and salary income, combined with lower oil prices, should partially offset the impact of declining household net worth and support consumer spending in the near term.

We expect consumer spending growth to moderate from the strong pace in the first quarter to slightly below three percent in the second half of the year. Consumer spending is expected to be the biggest driver of economic growth, contributing more than two percentage points to the projected 3.2 percent real GDP growth in 2010.



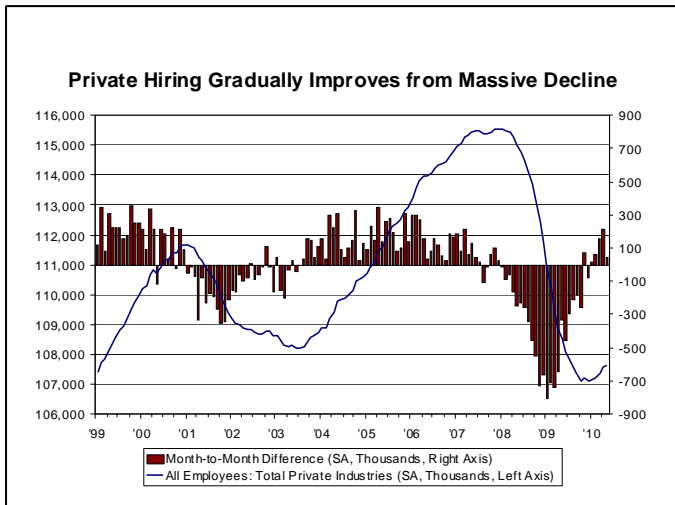
Lackluster private sector payrolls strike a disappointing blow

Temporary census hiring distorted the true picture of the labor market in May. Headline job creation was the strongest in more than ten years, with nonfarm payrolls rising by 431,000—but 410,000 of those jobs were temporary census jobs. Private nonfarm payrolls posted a paltry gain of 41,000. March and April employment numbers were revised lower by 22,000. Job creation in the private sector would have been great news at the end of 2009, but after gains of 218,000 in April and 158,000 in March, the financial markets expected continued solid increases.

The slowdown in job growth was broad-based across industries, except in manufacturing, which experienced its fifth consecutive monthly gain. Builders shed 35,000—nearly offsetting the total gain during the prior two months. Private employment in the services sector posted a gain of 37,000, moderating substantially from an increase of 156,000 in the prior month. Industries experiencing net losses in jobs include retail and financial services. More than half of the jobs lost in financial services came from real estate-related jobs.

On a somewhat brighter note, the average workweek lengthened to 34.2 hours—the longest workweek in 18 months. In addition, average hourly earnings increased 0.3 percent during the month and were 1.9 percent above the level a year ago. Temporary employment—a leading indicator of the labor market—posted another increase. The longer work week and gains in temporary hiring signal that firms continue to be reluctant to hire full-time employees but, historically, these developments are usually followed by sustained increases in employment.

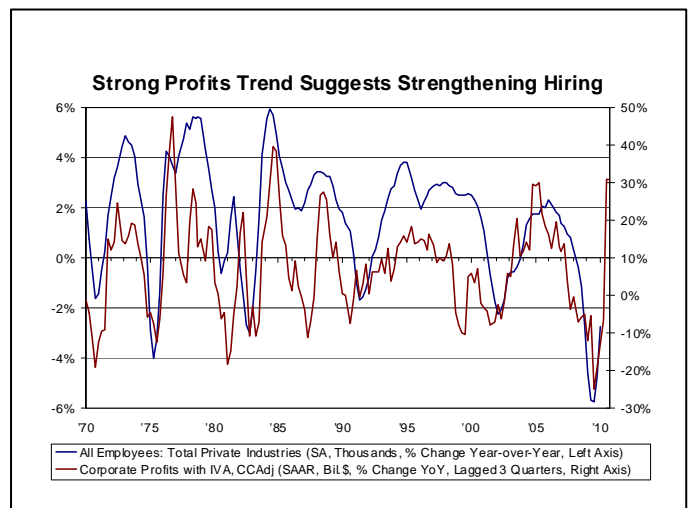
Private employment is the key for a sustained economic recovery. It appears that private employment troughed in December 2009 after peaking in December 2007, showing a peak-to-trough drop of 7.3 percent. So far, payroll gain in the private sector has been sluggish, showing an increase of only 0.5 percent from its trough.



The movement in the unemployment rate from a separate survey of households has, once again, shown that the rate can be a misleading indicator of labor market conditions. The unemployment rate edged down to 9.7 percent from 9.9 percent, as the drop in the labor force outweighed the drop in employment. This was a reversal of the prior month, where despite a large gain in employment, a bigger increase in the labor force led to an increase in the unemployment rate. The broad unemployment rate, which includes discouraged workers and those working part-time but who want full-time work, dropped to 16.6 percent, the lowest level since January. However, the average duration of unemployment continues to rise, reaching 34.4 weeks, a record high, up from 33.0 weeks in April and 22.9 weeks a year ago. The long-term unemployment rate is a cause for concern and presents a real

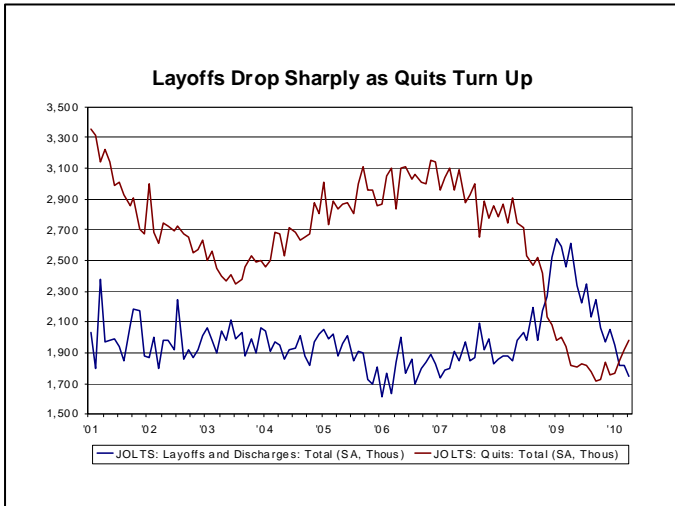
challenge, as it suggests a mismatch of skills and a lower long-term trend in household income.

Payroll data can be volatile from month to month and can be subjected to large revisions. It is too early to conclude that the soft private payroll gain in May has established a trend of weakening private sector job creation. Fundamentals for hiring have remained strong. Consumer spending has strengthened steadily during the past three quarters. Corporate profits, a leading indicator of business investment and hiring, increased in the first quarter of 2010 for the fifth consecutive quarter. During the past year, profits have risen by about 31 percent. Historically, strong corporate profits lead to sustained increases in employment with a lag of about two to three quarters.



So far, small businesses have been slow to create jobs, but the outlook may improve in the near future. Small businesses' confidence rose in May to its highest reading since September 2008, according to the National Federation of Independent Businesses Index of Small Business Optimism. Details on employment indicated that businesses continued to cut jobs during the month. There was one positive detail: hiring plans for the next three months were positive, with the number of firms planning to increase employment rising to 1.0 percent from minus 1.0 percent in April. This measure had been zero or negative for 19 straight months.

The Job Openings and Labor Turnover Survey (JOLTS), which lags the payroll report by one month, can shed additional light on labor market conditions. The survey showed that total private job openings increased by nearly 300,000 in April from March. Since their trough in July 2009, job openings have increased by about 32 percent. Another encouraging aspect of the report was the continuing decline in job separations. The involuntary component of job separations, i.e., layoffs, fell to their lowest level since January, 2007. The other component—voluntary separations or quits—increased during the month and was about 16 percent higher than their trough in September 2009.



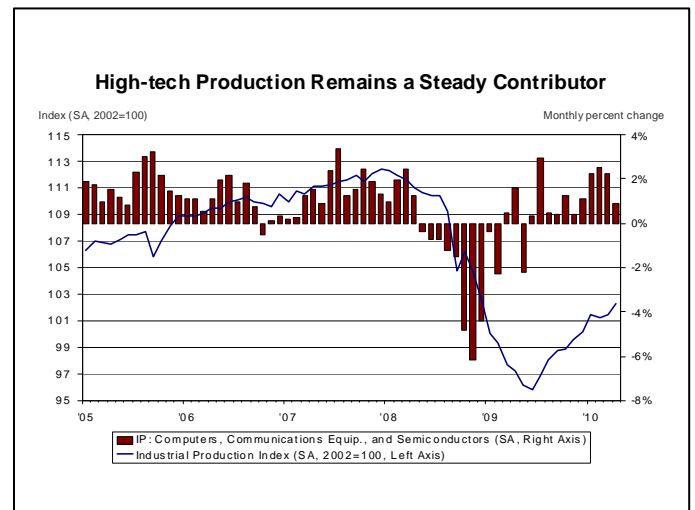
A survey from Challenger, Grey, and Christmas also showed that announced layoffs dropped off significantly in May to pre-recession levels. This survey focuses on big businesses, however, which tend to fare better than small businesses in a downturn. The layoff numbers from these surveys appear to be at odds with the weekly initial unemployment claims, which have remained elevated, averaging about 460,000 during April and May of this year, compared with about 320,000 in early 2007. Historically, initial jobless claims should be much lower, in the 300,000 to 350,000 range, to be consistent with payroll gains seen during the past several months. One exception was in early 1983, when the economy started to rebound from two severe back-to-back recessions. During that time, monthly job gains averaged about 300,000 while initial jobless claims averaged about 460,000.

Manufacturing remains a bright spot

Manufacturing was the highlight of the April industrial production report, posting a second consecutive strong output gain. The high-technology segment showed a solid gain, albeit moderating from the strong gains of previous months. High-tech output, which includes computer, communications equipment, and semiconductors, has been a consistent positive contributor to the rebound in industrial production from a record low reached during the recession, thanks to the need to repair and replace dilapidated equipment.

Because industrial production has recovered from very depressed levels, there is still a lot of idle capacity. The capacity utilization rate, a gauge of inflationary pressure, has climbed steadily to 73.7 in April from a record low of 68.3 in June 2009, but this is well below its long-term average of around 80.

Other manufacturing data suggested continued strong business investment. New orders for durable goods posted a solid increase in April, boosted by volatile aircraft orders. Core capital goods (nondefense capital goods excluding aircraft) retreated during the month after strong gains in the prior two months. Overall, core capital goods have risen by about 21 percent from a year ago—the largest gain since the inception of the series in 1992. This measure is a leading indicator for business investment in equipment and software. The trend during the past several months points to a positive outlook for business investment.



A survey of manufacturing for the nation showed that activity continued to expand in May. The Institute for Supply Management (ISM) manufacturing index edged down from the April level, which was the highest reading since June 2004. Overall activity remains in a robust expansion. Key components, including the orders, production, and employment indexes, continue to show strong readings. It appears that manufacturing maintains its solid momentum in the current quarter.

Tax credits temporarily boost housing indicators

Most housing indicators showed the impact of the tax credits. Single-family starts posted a double-digit gain in April, marking the fourth consecutive monthly increase. In contrast, multifamily starts fell to the third lowest level on record as the sector continues to face challenges from tight financing and high rental vacancy rates. Strong single-family

homebuilding activity may have been boosted by the tax credits and unusually warm weather. The outlook has become cloudy, however, presaged by a double-digit drop in single-family permits. This bodes poorly for the construction employment trend. After two consecutive monthly gains, construction employment resumed its decline in May.

April total construction spending posted its biggest jump since August 2000. Both private residential and nonresidential construction spending increased. The increase in single-family residential spending was the strongest in eight months, while the drop in multifamily construction spending was the smallest in more than a year. Nonresidential construction rose for the first time in 13 months as increases across several categories offset drops in commercial and office construction.

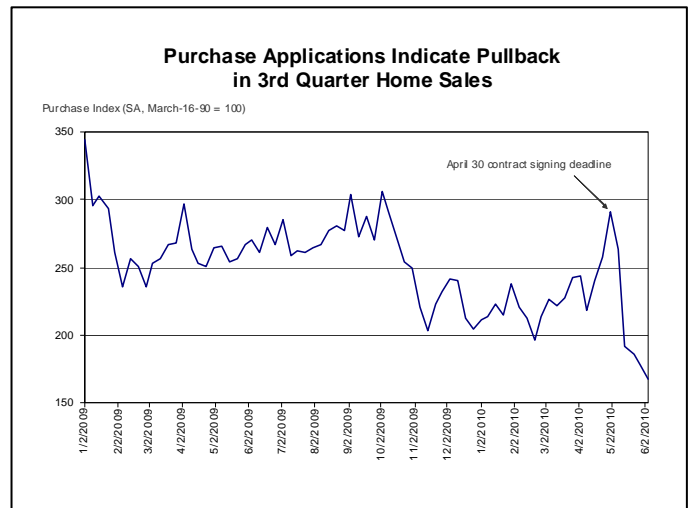
Total construction spending peaked in March 2006. Its recent low was in February 2010 and perhaps it is too soon to tell whether total construction spending has reached bottom. We expect residential construction spending to increase moderately going forward while nonresidential construction spending should continue to decline through most of 2011.

The tax credits boosted home sales significantly in April. New home sales jumped nearly 15 percent in April, following a 30-percent surge in the prior month. New home sales are recorded at closing, so it is likely that the bulk of the gains came from homebuyers rushing to sign contracts before the deadline on April 30. However, as many as 25 percent of homes sold during the month had not been started and more than 30 percent were under construction. Thus, some of these homes are unlikely to be eligible for the tax credits, which require the completion of homes by June 30.

The strong sales pace, combined with the lowest level of inventories of homes available for sale since September 1968, brought down the months' supply of new homes from 6.2 months to 5.0 months, the lowest reading since December 2005. While the number of new homes available for sale is at historically low levels, there is still a significant excess supply of vacant homes for sale. A large number of seriously delinquent mortgages also presents a huge shadow inventory. In addition, the lower than average months' supply is unlikely to last, as home sales are expected to drop off sharply in coming months, presaged by the 42-percent decline in purchase applications since April 30.

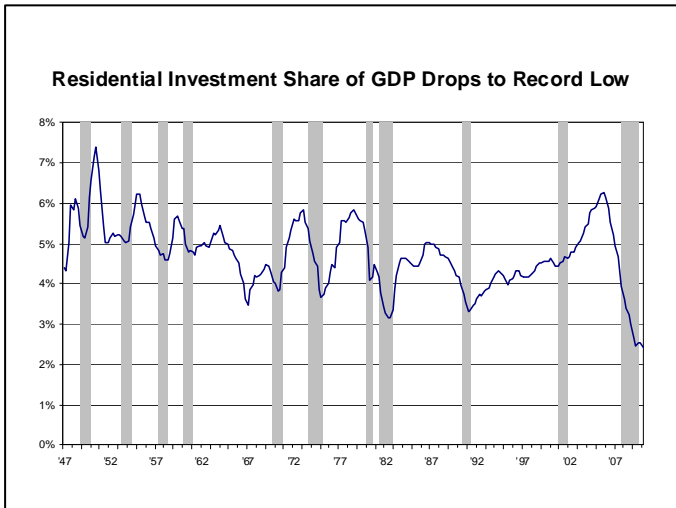
One encouraging, albeit small, sign for the housing market was that home builders' confidence continued to advance in May, despite the passing of the tax credit deadline for contract signing. The National Association of Home Builders/Wells Fargo Housing Market Index increased to the highest reading since August 2007. All three components—current sales condition, sales expectations in the next six months, and traffic of prospective buyers—moved higher during the month.

Existing home sales also jumped in April. While we expect new home sales to start showing a pullback in May, existing home sales, which are recorded at closing, are all but certain to increase further in May and perhaps in June. Sales with a binding contract signed by April 30 are not eligible for the tax credits if they are closed after June 30. Pending home sales, which measure contract-signings of existing homes, posted a sizable gain in April for the third consecutive month. Like new home sales, pending home sales are expected to drop off in May.



Expected stronger housing activity in the second quarter, including homebuilding activity and real estate commissions, will help boost residential investment, which dropped sharply in the first quarter after posting two consecutive quarterly increases. Despite some pullback in housing activity projected in the third quarter, we expect continued increases in residential investment for the rest of the year. While we expect housing starts to post a 29 percent gain this year and total home sales to rise by nearly six percent, these gains are from very depressed levels. As a share of GDP, residential investment fell to a record low of 2.43 percent in the first quarter of 2010. (Refer again to Chart 3: Consumer Spending Is

the Biggest Driver of Growth). With declining influence on GDP, residential investment is expected to barely add to GDP in 2010.

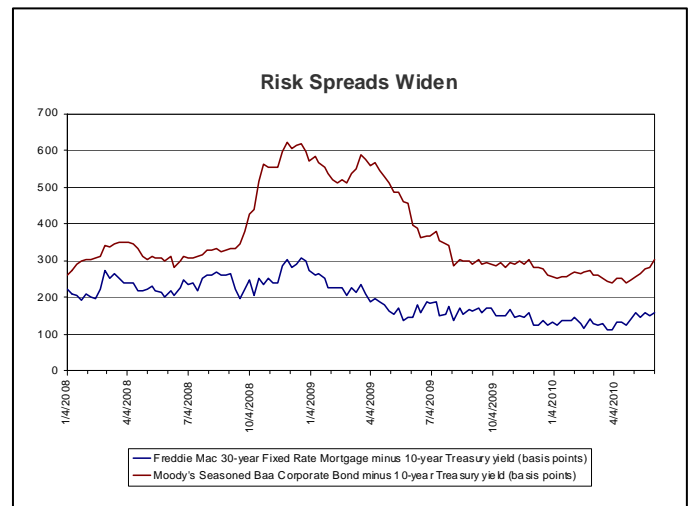


Financial conditions continue to show signs of stress

Developments in Europe continue to weigh on financial markets around the globe. Investors have turned bearish. Increased fears and uncertainty that the downside risks could derail the global recovery have been reflected in the surge in the equity market Volatility Index (VIX). Liquidity also has dried up. After holding in the 0.25 percent range for an extended period through March, the 3-month dollar LIBOR (London Interbank Offered Rate), a gauge of liquidity and market stress, rose sharply, hovering around 0.54 percent in early June. Increased risk aversion has led to a flight to quality, bringing down Treasury yields. Offsetting the benefit of lower Treasury yields is widening credit spreads.

While spreads have widened during the past six weeks, they have remained much narrower than those seen in the last year. For example, the spread between BAA and 10-year Treasury yields widened to 290 basis points in early June—about 50 basis points higher than the spread at the end of April. The spread was more than 600 basis points at the end of 2008. Mortgage spreads have fared much better than other risk spreads. For example, the spread between 30-year fixed rate mortgage and 10-year Treasury yields widened by about 20 basis points since the end of April.

Inflationary pressures remain contained, with core inflation dipping to a 47-year low in April. This, coupled with concerns over the turmoil in Europe, will likely keep the Fed from raising rates well into 2011. The minutes of the April 27-28 Federal Open Market Committee meeting showed that some committee members were concerned that the European crisis could slow the recovery in the U.S. With low inflation, the Fed can afford to sit back to assess how the crisis is resolved before pulling the trigger on interest rates. As a result of recent financial market developments, our expectation of the first rate hike is delayed to mid-2011 from the first quarter of that year.



The minutes also showed that a majority of members preferred that the Fed begin selling assets, including the Fed's holding of agency MBS, "some time" after the first rate hike to ensure that the recovery is on firm footing before taking an action that might disrupt markets. Some members suggested laying out a schedule of sales while others suggested selling sooner rather than later. Given recent heightened downside risks, we believe that the Fed is more likely to sell assets later rather than sooner. If the Fed begins asset sales and the economy takes a turn for the worse, it may have to reverse course to start buying again—an action that the Fed will want to avoid.

Declining mortgage rates spur near-term refinancing activity

Declines in fixed mortgage rates to about 4.9 percent in May helped boost refinance applications during the month, which will lead to increased refinance originations late in the second quarter and early in the third quarter. As a result, we upwardly revised our projection of refinance originations, albeit moderately. Despite historically low mortgage rates, a big refinance boom is unlikely at current levels. Since the beginning of 2009, there have been several occasions where rates were at or below currently prevailing rates, effectively lowering the rate at which borrowers would be “in-the-money” to refinance. As lending standards have remained tight, there are significant barriers to refinancing, including high loan-to-value ratios, low credit scores, and uncertainty about job prospects.

Our outlook calls for the fixed mortgage rate to hover around 5.0 percent for the rest of year. Unless the rate moves closer to 4.5 percent than 5.0 percent, we do not expect that the recent surge in refinance activity will be sustained. Signs of waning interest in refinancing have already emerged. After four consecutive weekly gains, refinance applications posted a 14-percent drop in early June, even though the fixed mortgage rate edged lower.

Our 2010 outlook on home sales and home prices, and thus purchase mortgage originations, were little changed from the May forecast at \$698 billion, while our projected refinance originations were increased by about \$90 billion from the May forecast to \$669. For all of 2010, total mortgage originations are projected to decline to \$1.37 trillion from an estimated \$1.92 trillion in 2009. The purchase-refinance mix is projected to be nearly balanced, with a refinance share of 49 percent.

Mortgage debt outstanding (MDO) for 1-to-4 unit single-family properties fell at an annualized rate of 4.0 percent in the first quarter—marking the eighth consecutive quarterly drop and the biggest since data collection began in 1952. The ongoing decline reflects charge-offs as well as household deleveraging, which also occurs for non-mortgage debt. Since its peak in the first quarter of 2008, single-family MDO has fallen by nearly \$500 billion. We expect it to continue to decline through the rest of the year. For all of 2010, MDO is projected to decline by 3.8 percent, accelerating from a 1.9-percent decline in 2009.

Doug Duncan and Orwin T. Velz
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