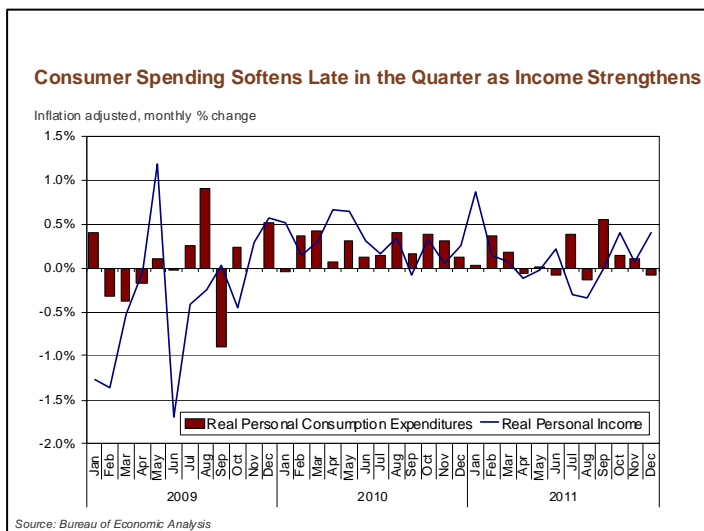
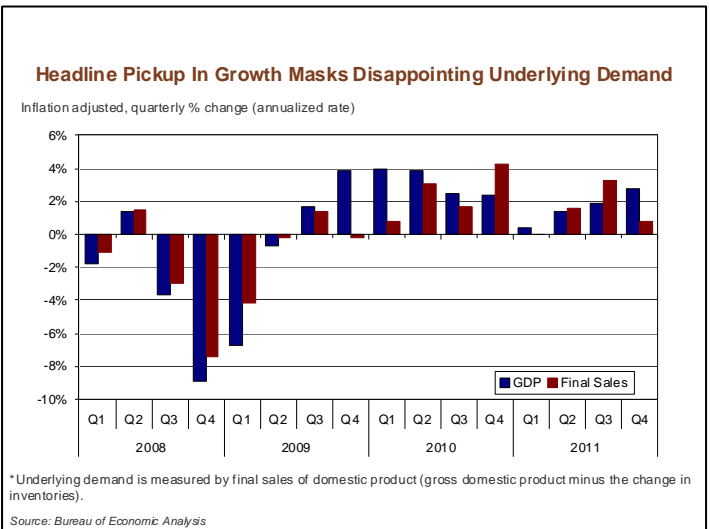


## Growth Expectations Modest at Start of Year

During the final quarter of 2011, the economy grew at the fastest pace since the second quarter of 2010. The first estimate of gross domestic product (GDP) showed that economic growth accelerated to an annualized pace of 2.8 percent—one percentage point higher than the third quarter’s pace. The strong headline growth masked weak details, as the pickup in activity came almost entirely from increased inventory investment, which contributed two percentage points out of the 2.8 percent growth. Inventory swings are not indicative of the underlying demand and the health of the economy. In fact, the underlying demand as indicated by final sales—GDP minus the change in inventories—showed the weakest gain since the first quarter of 2011.

Consumer spending improved modestly from the prior quarter. Nonresidential investment slowed dramatically from a robust pace in the third quarter, while residential investment posted a double-digit increase from depressed levels and thus added very little to growth. After adding to growth for two consecutive quarters, trade was a drag in the fourth quarter. However, the primary drag to growth in the fourth quarter was the government sector, especially the federal government, whose spending declined dramatically as a result of a plunge in defense spending.

The monthly pattern of consumer spending and personal income showed that consumers were more cautious late in the quarter, as all major components—durable goods, nondurables, and services—fell, despite a pickup in income. As a result, consumer spending is poised to start the first quarter at a level below its fourth-quarter average, and the low jumping-off point suggests a challenging picture for consumer spending in the current quarter.



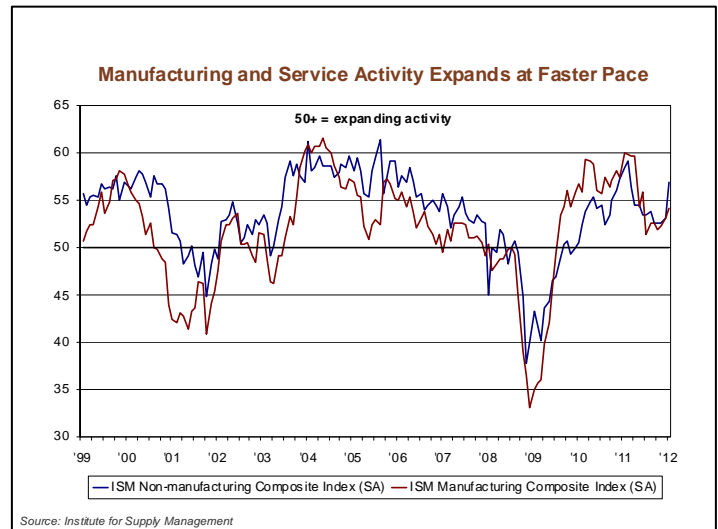
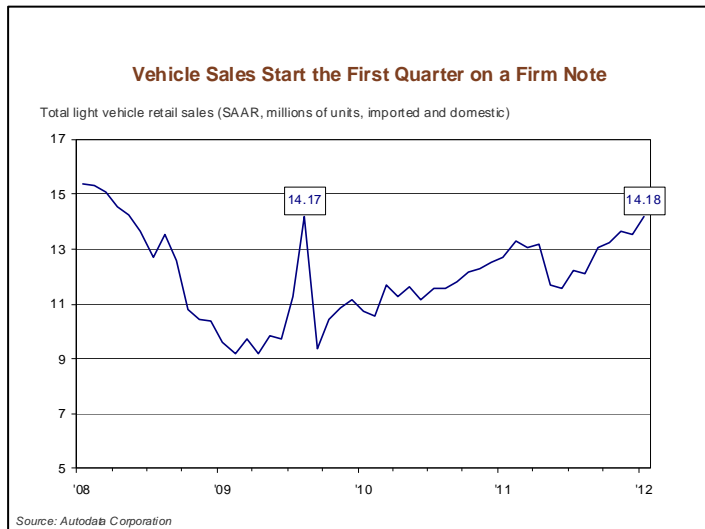
As consumers cut back their spending despite rising income, the saving rate—saving as a percent of disposable income—jumped to 4.0 percent from 3.5 percent in November, the biggest gain since April 2010. Real (inflation-adjusted) personal disposable income growth was anemic over the course of 2011. Consumers struggled to maintain their spending by lowering their saving rate, which declined to an annual average of 4.4 percent from 5.3 percent in 2010. The trend in consumer credit (excluding mortgages) strengthened during the final months of 2011, indicating that consumers were willing to incur credit card debt, at least during the holiday season. For the year as a whole, however, nonrevolving credit (auto and student loans) remained the primary driver of the increase in consumer credit. Going forward, income will remain the primary driver of consumer spending, which will continue to

be restrained until the job market experiences sustained, robust growth.

## Near-Term Growth: Underlying Demand Should Strengthen Despite Expected Weak Headlines for Current Quarter

The economy started 2012 with solid momentum, as incoming data were generally encouraging. Vehicle sales rose to a cycle high in January, edging above the cash-for-clunkers sales level of August 2009, translating to solid growth in consumer spending on motor vehicles and parts in the current quarter.

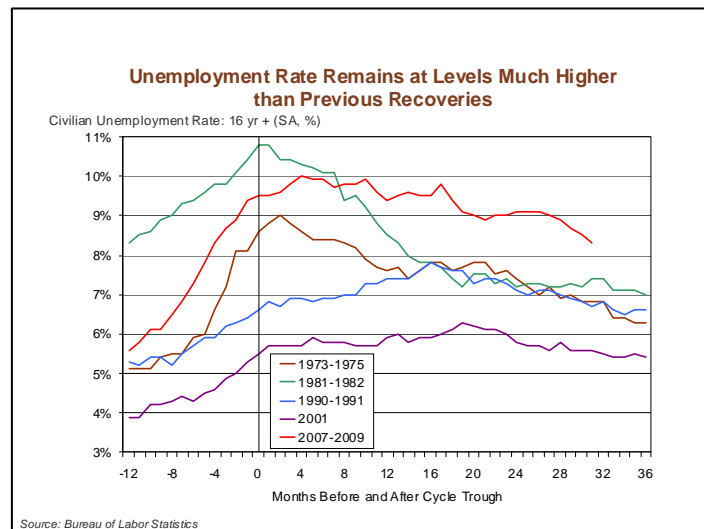
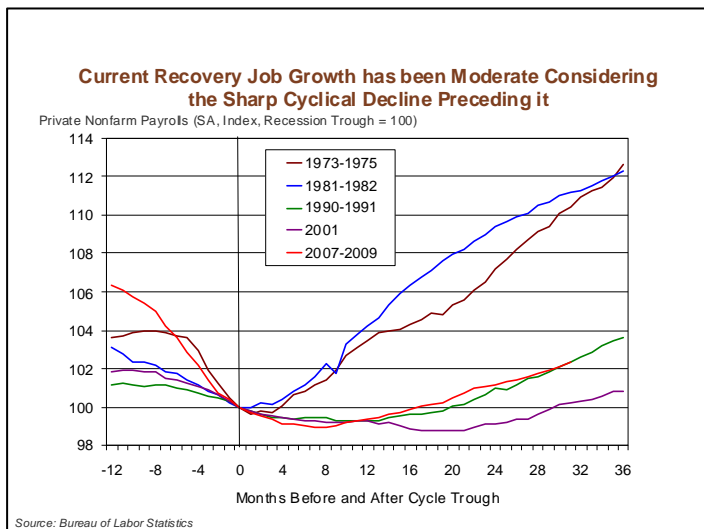
The Institute for Supply Management (ISM) showed strong advances in both its manufacturing and nonmanufacturing indices in January. The latter, which is a gauge for service activity, posted an impressive gain, sending the index to its highest level since February 2011, well into expansion territory.



Measures of consumer confidence have trended up since plunging last summer. However, retail gasoline prices, which declined during the last few months of 2011, rose in early 2012, taking away one of the supports for household spending.

Most important to consumers is labor market conditions, which have strengthened over the past few months. The January employment report was positive in every aspect. Nonfarm payrolls posted a strong increase of 243,000 amid upward revisions for the prior months. Job growth was widespread across industries, even in construction, which recorded a solid gain for the second consecutive month. Average hourly earnings and hours worked, especially in manufacturing, also rose. The unemployment rate, estimated from the Household Survey, fell to 8.3 percent from 8.5 percent as the large increase in employment outweighed a growing number of people joining the workforce—indicating a genuine improvement in the labor market. We expect the unemployment rate to remain near its current level throughout the year.

After losing about 7.5 million jobs during the recession, the economy has added nearly 2 million jobs since the recovery began two and a half years ago. The payroll employment trend in the current recovery showed a similar performance to the 1991 recovery, but better than the 2001 recovery. These gains are considered anemic given the massive job losses that preceded them. Meanwhile, the unemployment rate has remained elevated during the current economic recovery, well above the trend in other recoveries since the mid-1970s.



The strengthening employment picture added to a broad spectrum of labor market indicators, showing that the healing in the job market is gaining traction. For example, initial unemployment claims, which were choppy around the holiday season, have clearly trended down, signaling improvement in the labor market relative to the earlier stages of the recovery. The four-week moving average in claims has remained below the 400,000 mark for 13 weeks, indicating healthier market conditions and marking the longest streak in the recovery since the 8-week string witnessed last spring.

Other measures from the Job Openings and Labor Turnover Survey (JOLTS) also pointed to improving labor market conditions in December. (The survey is reported with a longer lag than other labor market indicators). While the hiring and separation rates were little-changed during the month, the number of job openings rose sharply, showing the job opening rate matching a three-year high witnessed in September 2011.

Despite encouraging incoming data, we expect growth in the current quarter to downshift from the fourth-quarter pace. As mentioned earlier, a substantial contribution from faster inventory accumulation largely boosted growth in the fourth quarter. However, this is unlikely to be repeated, and as a result we expect the fading of the lift from inventory rebuilding to moderate the growth rate to about 2 percent in the first quarter. The expected slowdown in headline growth will not be indicative of a deteriorating economy if final sales pick up substantially at the same time, as we believe they are poised to do.

Looking beyond the first quarter, we expect growth to trend up modestly through the rest of 2012. Improving labor market conditions provide encouragement that the uptrend in consumer confidence will continue and will at some point be reflected in a firmer trend in consumer spending. The strong gains in core capital goods orders seen in late 2011 helped temper concerns of a sharp slowdown in near-term business investment after the expiration of the generous 100 percent depreciation allowance tax benefit, and healthy corporate profits will likely support businesses' demand for capital expenditures this year. Business fixed investment in structures should stabilize this year as the commercial real estate market gradually improves, while residential investment is expected to start contributing to growth, albeit modestly, for the first time in seven years.

Economic growth will remain constrained by various headwinds. In addition to an expected decline in net exports from the global slowdown, the U.S. economy also will be subject to an increase in fiscal drag, including the fading of federal spending from the stimulus and a decline in defense spending for operations in Iraq and Afghanistan.

For all of 2012, we expect economic growth to accelerate to 2.3 percent from 1.6 percent in 2011. Risks to the forecast are more balanced between the upside and the downside since the January forecast. The economy appears to be more resilient than in previous months, and should be less vulnerable to shocks, including any spillover from the European

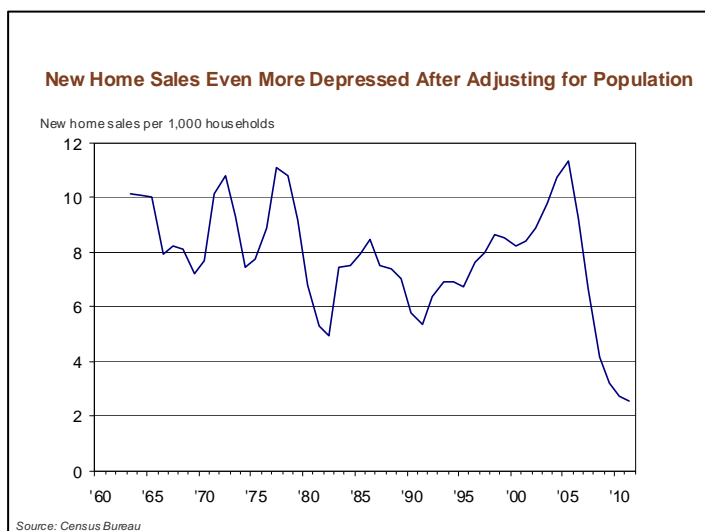
sovereign debt crisis. A geopolitical event stemming from the tension in the Middle East has the potential to cause a spike in oil prices, spoiling an otherwise more optimistic outlook than was the case last year.

We noted in last month's commentary that 2012 is the year of the political economy. Thus, there is a great deal of uncertainty surrounding our forecast. We continue to assume that the payroll tax holiday and extended unemployment benefits (which add up to an approximately \$150 billion hit to income if they expire at the end of February as currently scheduled) will be extended through the entire year.

There are several tax policies scheduled to expire at the end of this year that will act as a substantial drag to growth if changes are not enacted, including the payroll tax cut and emergency unemployment benefits, which we assume will be extended through the end of this year, and the Bush-era tax cuts, which are worth about \$250 billion. In addition, as a result of the failure of the Joint Select Committee to reach an agreement late last year, the automatic federal budget cuts (or sequestration) of around \$100 billion per year are slated to take effect at the beginning of 2013. If this occurs, federal spending will decline further, which also will negatively impact business investment spending, particularly in defense-related industries. We continue to expect that Congress will come to a new agreement and sequestration will be avoided. Finally, there is a decent chance of some type of fiscal reform next year, as the debt limit will once again need to be addressed by early 2013 if not sooner. Thus, how current law is changed will impact the economic outlook for both this year and next, and in the meantime, uncertainty could potentially restrain activity toward the end of 2012.

## Housing: Continued Healing

Housing indicators also showed signs of improvement late last year. Existing home sales rose in December for the third consecutive month, ending 2011 at about the same level as at the start of the year. Despite a strong fourth-quarter performance amid record low mortgage rates, existing home sales rose a modest 1.7 percent in 2011 from 2010. New home sales fell in December after three consecutive monthly gains, and 2011 proved to be another dismal year, as annual sales fell for the sixth consecutive year to 302,000—the smallest number since the inception of the series in 1963. Adjusting for population, there were only about two and a half new homes sold for every one thousand households last year, compared with more than eleven during the boom in 2005.



With improving housing market conditions in the fourth quarter, homebuilder sentiment rose in January for the fourth consecutive month to a recovery high. Although housing starts and permits each declined in December, the drop was entirely due to a decline in multifamily following strong gains in the prior month. For all of 2011, single-family starts dropped about six percent to a record low. By contrast, the multifamily segment of the housing market performed quite well during 2011: Multifamily housing starts rose over fifty percent, while apartment sales also posted a similar gain. (For more information on multifamily market conditions including the trend in sales of apartment properties in 2011, read the [February 2012 Multifamily Market Commentary](#)).

Leading indicators of home sales suggest that near-term improvement in sales will be modest: Pending home sales dropped in December while purchase mortgage applications have been quite choppy—down in December, spiking in the first half of January, and pulling back in the second half of January.

The Federal Reserve Senior Loan Officer Opinion Survey provides another perspective on mortgage demand. The January survey, which covered the developments in the prior three months, showed that a net 1.3 percent of respondents indicated stronger demand for residential mortgages. Although this was down from 11.4 percent in the prior survey, it

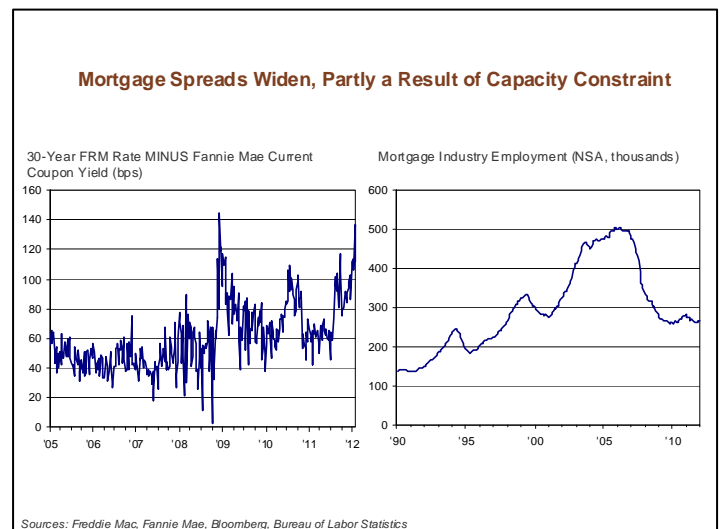
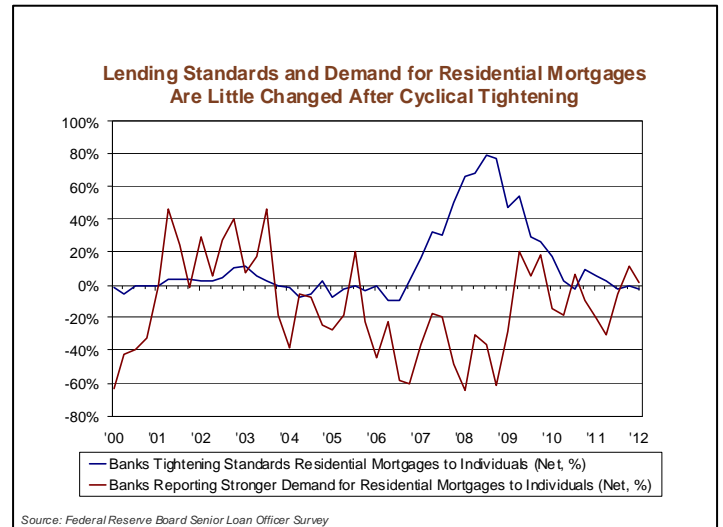
marked the first time that there were consecutive quarterly increases in mortgage demand since the very early stages of the recovery. At the same time, lending standards, which had been significantly less tight compared with those during the financial crisis, have not changed materially over the past year and are unlikely to loosen materially going forward, given the ongoing lack of private securitization.

A gauge for excess supply and shadow supply from the Bureau of the Census Housing Vacancy Survey also showed improvement during the final quarter of the year. Both the homeowner and the rental vacancy rates fell, and the number of vacant homes held off market (for reasons other than for occasional use or temporary occupancy) plunged during the quarter. The data from this survey are noisy and the change from quarter to quarter can be quite volatile. However, the underlying trend over the past year suggests that the inventory of vacant homes has moved in the right direction, albeit remaining substantially above its long-term trend.

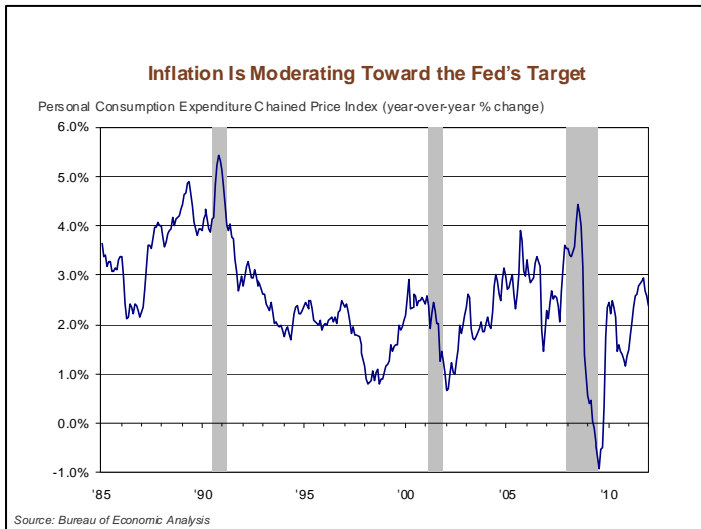
One housing indicator that continues to languish is home prices, which deteriorated further in late 2011, as more distressed sales came onto the market in a weak seasonal period. Expectations of further declines in home prices will remain a challenge for the housing market. However, that may be changing. One positive for the housing market is that consumer sentiment continues to rebound to the level witnessed around a year ago. The strengthening employment picture provides encouragement that the improving trend in consumer confidence will continue. Our Fannie Mae January 2012 National Housing Survey showed that consumers are gradually growing more optimistic about the housing market, as they expect home prices to rise over the next year, extending the streak of rising home price expectations to four months.

Mortgage rates will remain a support to the housing market, suppressed by moderate economic growth and the low inflation outlook. Short-term interest rates will likely remain low for a sustained period of time. At the January Federal Open Market Committee meeting, the Fed extended its pledge to keep interest rates low through late 2014. We expect mortgage rates to remain near their record lows through this year, hovering around four percent despite a widening primary/secondary spread.

The primary/secondary spread, which serves as a buffer to allow servicers to control their pipelines, widened further this month, showing the biggest gap since the financial crisis. Lower mortgage rates have boosted interest in refinancing, with mortgage applications remaining near the high end of the range seen in last fall's refi wave—although activity is still below the levels seen during fall 2010. Anecdotally, several servicers have indicated that mortgage applications, including those for the expanded Home Affordable Refinance Program (HARP), have overwhelmed capacity amid declining mortgage industry employment, which remains near a 10-year low. In addition, the Administration has announced several initiatives to stabilize the housing market, including changes to the Home Affordable Modification Program



(HAMP) and extending a HARP-like refinancing program to borrowers whose loans are not currently guaranteed by one of the GSEs (which requires Congressional approval). Even if some of these initiatives are not put into effect, capacity constraints will likely be an ongoing issue this year.



For the first time, the Fed announced an explicit inflation goal of an annual increase of 2 percent in the personal consumption expenditure price index, but it did not specify a target for the unemployment rate, the other leg of its dual mandate. While inflation is now above the target, it has been declining and will likely slow further going forward, as commodity prices moderate and unit labor costs rise only modestly.

Our housing forecast is slightly more optimistic than the January forecast. Home sales are projected to increase by about 7 percent, while the decline in home prices should moderate. Thus, we expect purchase mortgage originations to rise modestly. At the same time, refinance originations should decline sharply. For all of 2012, total mortgage originations are projected to decline to \$1.05 trillion from an

estimated \$1.36 trillion in 2011, with the refi share dropping from an estimated 66 percent in 2011 to 54 percent in 2012. Total single-family mortgage debt outstanding should post a fifth consecutive annual drop, falling by 1.1 percent in 2012, moderating from an estimated 2.4 percent decrease in 2011.

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Economics and Strategic Research  
February, 2012

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