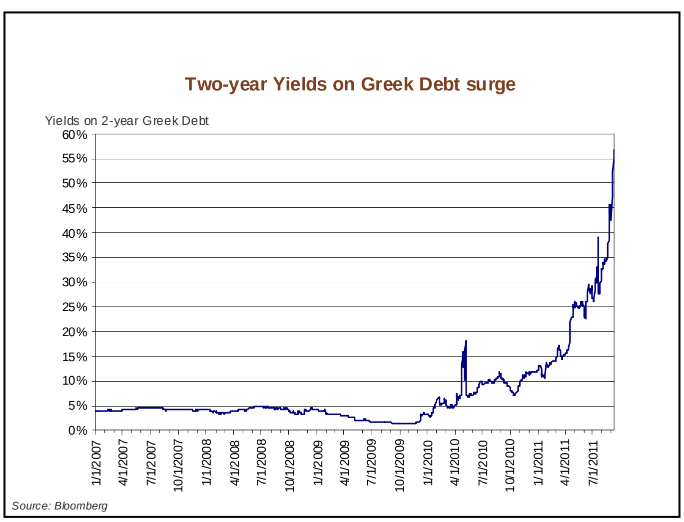
The Economy and Housing Continue To Tread Water

The current picture of the U.S. economy shows an economy on a cusp, flirting with another economic downturn after more than two years of tepid recovery from the most severe recession in the post World War II era. Earlier this year, expectations for a self-sustained expansion were the norm, with consensus forecasts showing growth for 2011 to come in at higher than three percent. Such optimism proved to be short-lived. Since the spring, economists have been downgrading their forecasts in response to a series of headwinds initially believed to be transitory, including surging energy prices and supply chain disruptions. But the headwinds kept coming: the renewed European sovereign debt crisis, the political deadlock over the debt ceiling, and the downgrade of the U.S. sovereign debt rating resulted in heightened financial market volatility, weighing on consumer and business confidence and hiring decisions. The flat-lined payroll employment in August intensified recession fears as it suggested that outright job loss might not be far behind.

While the U.S. economy nearly stalled in the first half of this year, there are signs that growth is picking up in the third quarter as gasoline prices have stabilized at lower levels and some of the impacts of the supply chain disruptions have waned. Our forecast is for continued sluggish growth at below two percent throughout 2012, not enough to bring down the unemployment rate, which we expect to remain above nine percent through most of next year. Several factors have combined to restrain growth, including impaired household balance sheets stemming from excessive debt, volatile equity prices, and continued declining home prices, a fragile financial system as depository institutions remain concerned about their capital adequacy, heightened risk aversion on the part of both businesses and households, and fiscal consolidation at all levels of government.

The recovery's fragility makes it vulnerable to any additional shocks that might cause the economy to slip back into a recession. There are many possible candidates for such a shock. Leading candidates include a deepening of the European sovereign debt crisis; a hard landing in emerging economies, especially China; and renewed unrest in the Middle East that could send oil prices surging again.

At the time of this writing, increased financial turmoil in Europe is decidedly the top risk. Fear of an imminent Greek default has roiled the markets, as financial institutions and insurers face a possibility that Greek debt would be marked down by half. As a result, yields on two-year Greek debt surged to over 50 percent.



Source: Bloomberg

Debt yields across a number of other peripheral countries also moved higher, notably in Italy, which is the third biggest country in Europe. The contagion to larger countries, combined with concern about the health of European bank balance sheets because of a lack of transparency about cross-border exposures, is a key factor behind the recent market volatility. It is clear that the European debt woes will continue to plague the financial markets until a credible, permanent solution is put into place—a tremendous challenge given the fractured political landscape in the Euro zone.

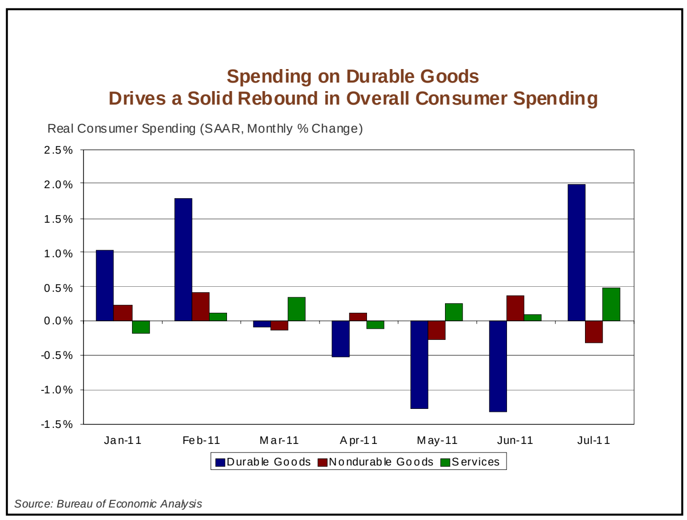
Policymakers recognize the urgency for actions to soothe the financial markets and consumers. Federal Reserve Chairman Ben Bernanke insists that the Fed has a “range of tools” that can provide additional monetary stimulus, and will continue to discuss these options at the next policy meeting later this month. The consensus view is that the Fed will announce the enactment of a new version of “operation twist,” which entails purchases of long-dated Treasuries to replace its current holdings of short-term Treasuries, while maintaining the current size of the balance sheet of about $2.84 trillion. The intended purpose of the "twisting" of the shape of the yield curve is to stimulate the demand for long-lived assets, such as housing, durable consumer goods, business capital equipment, and nonresidential real estate.

Bernanke notes that monetary policy cannot provide all the answers to the economic woes. On the fiscal policy front, the President unveiled his proposal—the American Jobs Act—which includes various temporary tax cuts aimed at raising workers' after-tax income and encouraging hiring and investing, combined with spending increases aimed at maintaining state and local employment and funding infrastructure modernization. Expectations of how effective these proposals will be, if enacted, vary significantly, largely depending on one's assumption of how much of the payroll tax cuts will be saved rather than spent. Given households' ongoing deleveraging and fear of a double-dip recession, some households may tend to save rather than spend the extra income, tempering the intended impact of stimulating aggregate demand for businesses. Temporary tax incentives for businesses may not spur hiring increases unless demand for their products picks up.

Economy: Sluggish Growth Continues with Downside Risk

Real (inflation-adjusted) gross domestic product (GDP) was revised lower to a 1.0 percent annualized gain in the second quarter of 2011 from the first print of a 1.3 percent increase. Downward revisions of inventories and exports outweighed small upward revisions on consumer spending and equipment, and software spending.

Growth is expected to pick up modestly in the current quarter as consumers showed signs of life going into the third quarter. After declining for three consecutive months ending in June, real consumer spending increased 0.5 percent in July, driven by durable goods spending on motor vehicles and parts. Spending on services also posted a strong gain, reflecting a jump in spending on utilities driven by extremely hot temperatures. Spending on non-durables fell, reversing the gain recorded in the prior month.

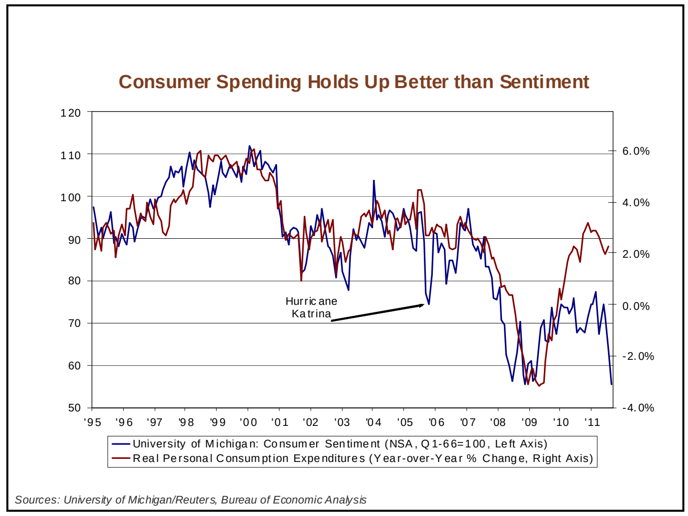


Similar to other measures of underlying inflation, the core personal consumption expenditure (PCE) price index, which excludes food and energy and is the Fed's favored measure of inflation, showed that an upward trend of inflation is in place. The core PCE rose 0.2 percent in July and 1.6 percent from a year ago. This marks the biggest year-over-year rise since May 2010. Since reaching a record low of 0.9 percent in December 2010, the year-over-year gain in the core PCE has risen steadily. Energy prices have stabilized in recent weeks and economic growth is expected to be sluggish going forward, which should help contain inflation expectations.

Recent developments on the income front have been downbeat. Real personal income fell in July, the first drop since September 2010. Real after-tax income will be restrained in the second half of this year by a decline in transfer payments, which mostly reflects the unwinding of the American Recovery and Reinvestment Act. Unless unemployment benefits and the payroll tax cut are extended as proposed by President Obama, their expirations will be a drag on disposable income in 2012.

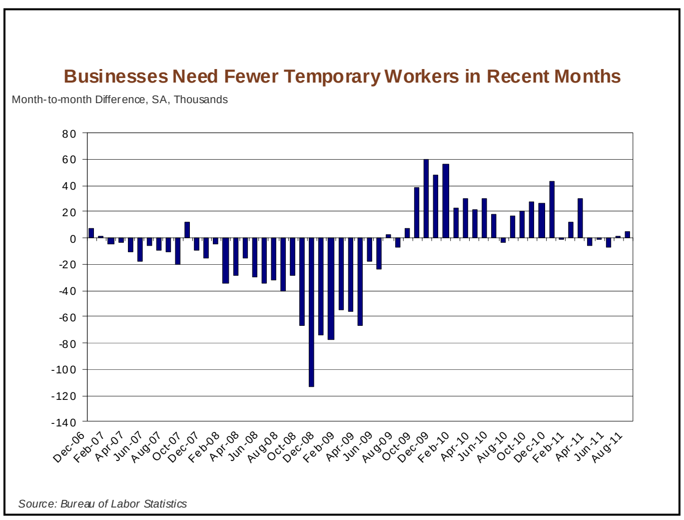
It is unlikely that the strong rebound in consumer spending will be sustained. After recovering in July and providing a boost to consumer spending, auto sales held steady in August, remaining below the first quarter's pace. While hard economic data, including consumer spending, do not yet broadly indicate an economic downturn, some confidence and opinion polls have shown dismal results consistent with those witnessed during severe recessions, posing ongoing risks to growth. For example, the Reuters/University of Michigan consumer sentiment index plummeted in August for the second consecutive month, sending the index to the fourth lowest reading on record. Similarly, the Fannie Mae National

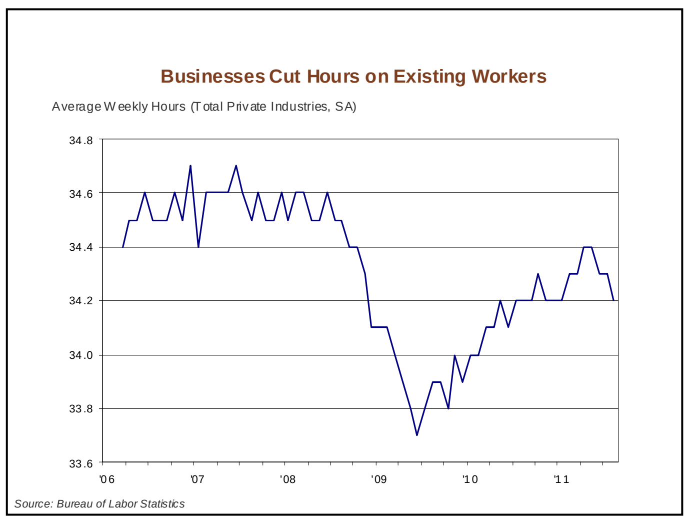
Housing Survey index, which gages consumer sentiment, also dropped dramatically for the second month in a row, with only 16 percent of respondents believing the economy is on the right track. It is possible that a large drop in sentiment can occur outside of a recession without leading the economy into a recession if it is based on temporary factors. For example, sentiment also plunged during hurricane Katrina, but the economy recovered quickly and continued to grow at a robust pace in the following year.



For sentiment to recover, however, we need strong employment and income growth, and thus the stagnant labor market is a source of concern for spending going forward. Nonfarm payrolls were flat in August, as the private sector's gain of 17,000 jobs was offset completely by a loss in government jobs. This marks the first time in nearly a year that the economy failed to add to payrolls. Moreover, payrolls during the previous two months were revised lower by 48,000, resulting in an average monthly gain of just 35,000 in the three months ending in August. The unemployment rate, calculated from a separate survey of households, held steady at 9.1 percent, reflecting large gains in both the labor force and household employment.

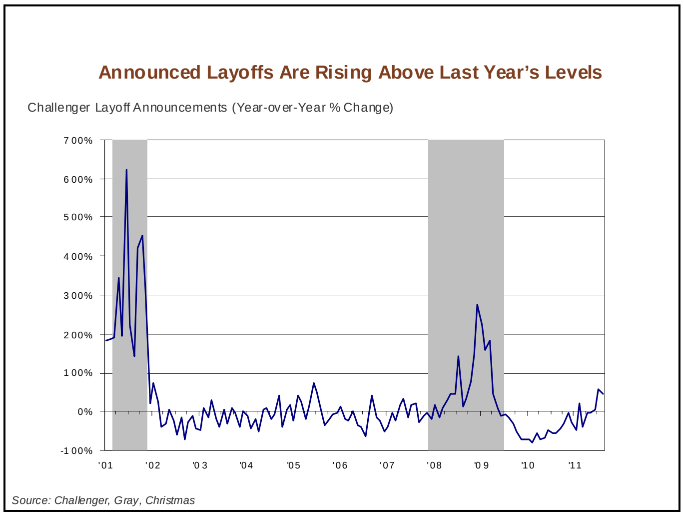
Leading indicators remain weak: employment at temporary help services rose just modestly, continuing a weakening trend seen during the last several months, and the average workweek fell as firms cut hours on existing workers.





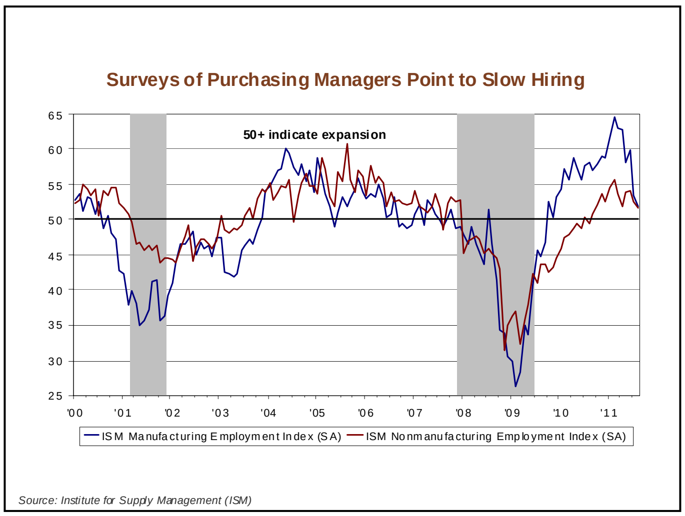
This development bodes ill for near-term hiring and labor income. The August employment report offered no silver lining. In addition to declining hours worked, average hourly earnings also dropped.

Another worrisome sign of the labor market is a rise in announced job cuts. The Challenger, Gray, and Christmas monthly report on layoff announcements showed that announced layoffs have climbed in recent months, averaging much higher than the 40,000 per month reported during the first half of the year. Announced layoffs have risen above last year's levels after remaining below their year-ago levels for most of the recovery period.



Surveys of business hiring, such as the Institute for Supply Management (ISM) surveys of purchasing managers, also indicate slowing hiring ahead. The employment component of the ISM manufacturing and nonmanufacturing surveys confirmed lackluster labor market conditions for both the manufacturing and service industries. While the indices remained slightly above 50 in August, still slightly in expansion territory, they clearly showed a substantial loss of momentum in hiring activity since their peaks in February, especially in manufacturing.

The near-term outlook for the labor market will be critical for the sustainability of the recovery. If weakness in the labor market gathers momentum, resulting in sustained job losses, consumer confidence will plummet further, paralyzing spending and sending the economy into a renewed downturn.



Housing: Remaining in a Deep Slump

The weakening economic backdrop, a persistently high unemployment rate, a tight lending environment, and fear of a double-dip recession cast a shadow over the housing market. Home purchases have been muted despite mortgage rates declining to record lows and prices at the most affordable level in a decade. Existing home sales fell in July, the third drop in the last four months to the lowest level in eight months. New home sales fell in July for the third straight month to a five-month low. Single-family starts also dropped during the month, continuing to bounce around at depressed levels, while multifamily starts rose. Builders were more reluctant to break new ground for single-family structures because of lackluster demand, reflected in their low levels of confidence, which was unchanged in August at a near record-low reading. Total construction spending posted the largest drop since the beginning of the year, driven by declining public construction spending as the fiscal stimulus faded. Single-family construction spending also fell, but multifamily construction spending rose as it started to gain the attention of large investors.

Leading indicators for home sales point to subdued housing demand. Respondents to the Fannie Mae National Housing Survey indicate a continued shift of sentiment toward renting and away from ownership, at least in the near term. In the second quarter, 26 percent of Americans were worried about their job stability. When combined with the 9 percent of unemployed households, more than a third of the potential workforce was worried about their employment status – hardly a strong support for housing demand.

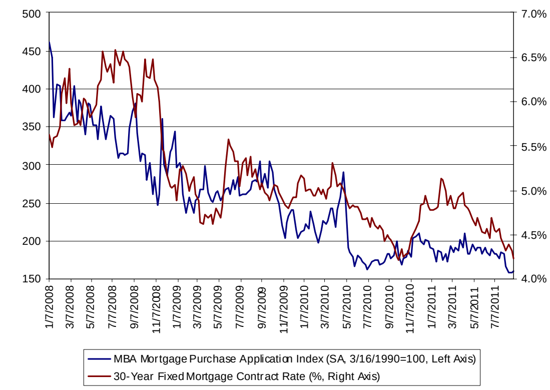
After rising for two consecutive months, pending home sales (contract signings of existing homes) fell in July, which bodes poorly for existing home sales in August and September. Pending home sales generally lead the existing home sales data by one or two months. However, the link between contract signings and closings has weakened lately such that the gains in pending home sales in recent months have not materialized into contract signings. Low appraisals compared to contract prices and concerns about the economy may have led to contract cancellations and delays. Also, some contracts have had to be cancelled because the potential buyers could not sell their current homes.

The outlook for purchase mortgage demand, which is generally indicative of demand for non-distressed properties, is even more downbeat, as mortgage applications have trended down through early September, hovering at the lowest level since the end of 1996.

The spring-summer selling season and declines in the distressed share of sales pushed the main measures of non-seasonally adjusted home prices higher in the second quarter. These factors will likely turn against price performance later this year, and home prices are expected to resume their decline in the second half of 2011.

Deteriorating economic conditions this year have begun to affect mortgage performance. The Mortgage Bankers Association reported that mortgage delinquencies rose in the second quarter for the second consecutive quarter after declining sharply in the prior three quarters. The increase in overall delinquencies was driven by the sharp rise in short-term delinquency rates.

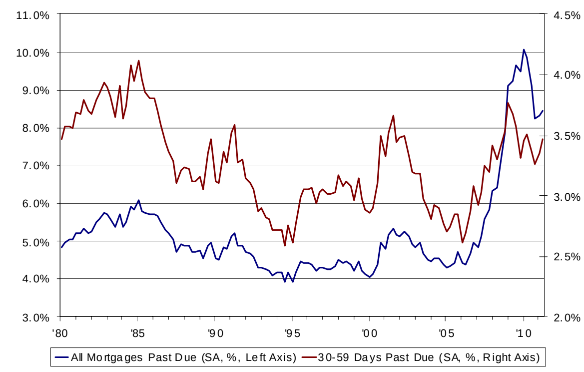
Purchase Mortgage Demand Sinks Despite Record Low Mortgage Rates



Source: Mortgage Bankers Association

Long-term Treasury yields have tumbled during the past month in response to growing concerns that the economic recovery has lost traction. At the time of this writing, concerns about Greece's potential default triggered another flight to safety, pushing the yield on the 10-year Treasury note down to a record low close of 1.92 percent. We expect the yield to hover at approximately 2.2 to 2.3 percent in coming quarters, keeping mortgage rates at around 4.2 percent through the first half of next year.

Deteriorating Labor Market Reverses Improving Mortgage Performance



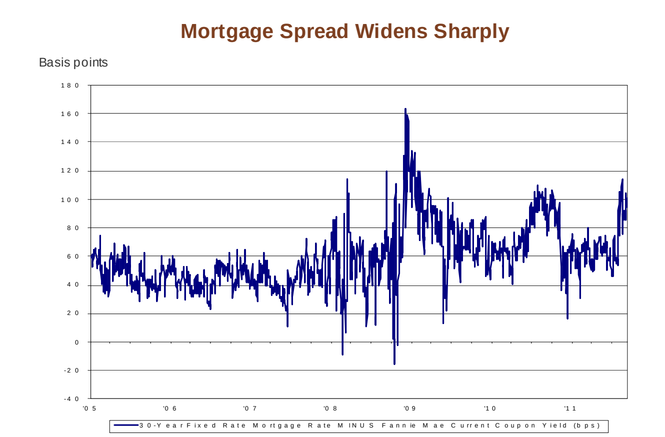
Source: Mortgage Bankers Association

Given the worsening labor market and declining consumer confidence, low mortgage rates are not expected to boost home sales, which we project to be relatively flat during the second half of 2011. While the second half of the year's performance will show an improvement compared with the same period in 2010, it is only because last year's sales suffered a significant pullback from the expiration of the homebuyer tax credit. For all of 2011, we expect existing home sales to be little changed from last year's levels. New home sales and single-family starts are expected to decline by about 5 percent and 11 percent, respectively. While the number of new homes available for sale has steadily declined to record low levels, the new home market continues to face competition from the substantial supply of existing homes currently in the foreclosure process, which are sold at large discounts, giving home builders little incentive and financing to start new construction projects. The rental housing market continues to be a rare bright spot. With the demand for housing shifting toward renting, voluntarily or otherwise, rents have been rising as multifamily construction lags demand. We raised our projection of multifamily starts for the rest of this year and next year, as we expect that builders will increase the supply to meet rising rental housing demand. Interest in multifamily mortgages also increased during the first half of 2011. (For more information on multifamily lending, read the *September 2011 Multifamily Market Commentary*).

As of September 8, 2011, the average rate for a 30-year fixed rate loan dropped to 4.12 percent. Mortgage rates this low would normally lead to massive refinancing. However, many factors hinder the ability of many borrowers to refinance. On the borrowers' side, negative equity and credit impairment are major hurdles as mortgage originators will continue to avoid refinancing high-risk borrowers because of the “reps and warrants” risk that the loans will be put back (i.e., lenders who sell the loans to Fannie Mae and Freddie Mac can be forced to buy them back in the event of default if underwriting defects are found). There also are upfront costs to refinancing, which cash-conserving households may not wish to lay out. Alternatively, financing those costs into the new loan increase the total loan balance, thus working against the desire to deleverage. Similarly, extending the loan term has an adverse effect on the deleveraging urge.

In addition, this is the third time in the past few years that mortgage rates have declined to similar low levels, and there are already signs of fatigue in borrowers’ interest to refinance their current mortgages, as refi applications have lost ground, falling substantially in recent weeks despite continued falling mortgage rates to near record lows. Concerns about job security may have also made borrowers who are in the money to refinance (those with loan coupon rates at least 50 basis points higher than the prevailing mortgage rates) to be more reluctant to spend on up-front closing costs during this time of increased uncertainty.

On the lender side, capacity constraint is a major issue, as evidenced by widening mortgage spreads. Some lenders choose to keep mortgage rates from declining in order to limit mortgage application volume to an amount that can be handled. For example, the primary/secondary spread, such as the difference between the yields in 30-year fixed rate mortgages and Fannie Mae current coupon, have widened substantially to about 100 basis points in early September.



Sources: Fannie Mae, Freddie Mac

Speculation about a government-sponsored grand scale refinance program also helped to widen mortgage spreads, but that could change once the specifics of the program are known. While the Administration indicated that it will work with the Federal Housing Finance Agency (FHFA), Fannie Mae, Freddie Mac, major lenders, and industry leaders to help more borrowers benefit from historically low interest rates, no details have yet been released. The recent statement from the FHFA clarified that the effort will be focused on enhancing the efficacy of the existing Home Affordable Refinance Program (HARP) for current HARP-eligible borrowers, which appeared to have dampened expectations of a massive refinance activity.

With no appreciable changes in projected housing activity, our forecast of single-family mortgage originations remains close to the August forecast. Our projected path for mortgage rates is somewhat lower than in the prior forecast, and, consequently, we raised, moderately, our projected refinance volume for the coming quarters. For all of 2011, total single-family mortgage originations are projected to decline to $1.20 trillion from an estimated $1.51 trillion in 2010, with a refinance share of 67 percent. Total single-family mortgage debt outstanding should fall further by 2.6 percent after a 3.0 percent decline in 2010.

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