

Economy Shifting Back to Lower Gear, As Expected

The final measure of fourth-quarter 2011 gross domestic product (GDP) showed a 3.0 percent annualized rate, accelerating from an average of 1.2 percent rate during the first three quarters of the year. Incoming data for the first quarter of 2012 have been mixed. News on the consumer front was relatively upbeat, but durable goods orders data suggest softening business investment. Construction spending was unexpectedly weak, pointing to a slowdown in both residential and nonresidential investment from the fourth quarter of 2011. Economic growth is expected to slow to slightly more than 2 percent in the first quarter of 2012.

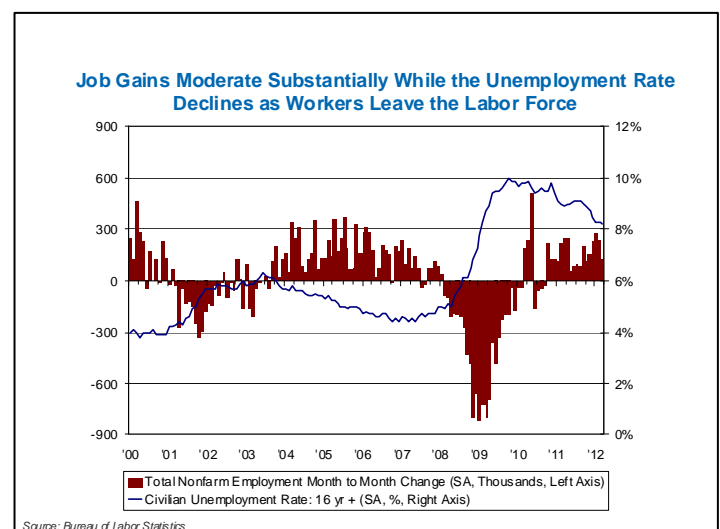
The slowdown in economic growth is not indicative of a significant deterioration in the underlying strength of economic activity, but of a fading inventory boost to GDP growth. While inventories contributed 1.8 percentage points to economic growth in the fourth quarter, inventories are expected to contribute only a small amount to growth in the first quarter of 2012. One disappointing piece of news came from the March employment report, which showed weakening momentum, as the economy created just 120,000 jobs—less than half of the average monthly gain over the prior three months and the smallest gain in five months.

The sharp slowdown in the pace of hiring was concentrated in the service sector, which posted the smallest payroll gain since last August, while manufacturing payrolls continued to rise strongly for the fourth consecutive month. Temporary hiring, generally a harbinger of future hiring, fell during March, reversing sharply from a jump the prior month. The private sector averaged 210,000 jobs the past three months. The government sector trend suggests that the persistent declines in the sector have subsided. Over the past three months, the average monthly payroll gain was 212,000, with private sector jobs averaging 210,000.

Other components of the report were mixed. Average hourly earnings increased, but the average workweek contracted. Hours worked is a leading indicator for total employment, as businesses generally add hours to existing workers before hiring new ones. There were upward revisions to prior months data in both average hourly earnings and average workweek, which helped support income during the first quarter, but the monthly pattern indicated a weakening momentum.

It is likely that the magnitude of the prior months' gains in nonfarm payrolls overstated the underlying strength of the job market, as warm winter weather pulled forward seasonal job growth. However, the setback in the employment report should not necessarily be interpreted too negatively. Other job-related data continue to show signs of improvement. For example, initial jobless claims fell during the last week of March to 357,000—a new low of the recovery and approaching the average reading of about 345,000 over the past 25 years.

The positive headline from a separate survey of households masked bearish details. The one-tenth percentage point drop in the unemployment rate to 8.2 percent, the lowest rate in over three years, is not indicative of improving labor market conditions, as it was driven by a substantial decline in the labor force that outweighed a small decline in household employment.

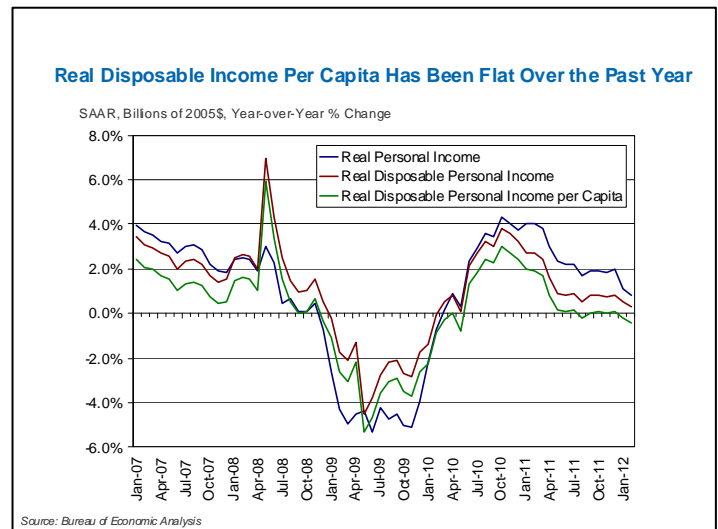
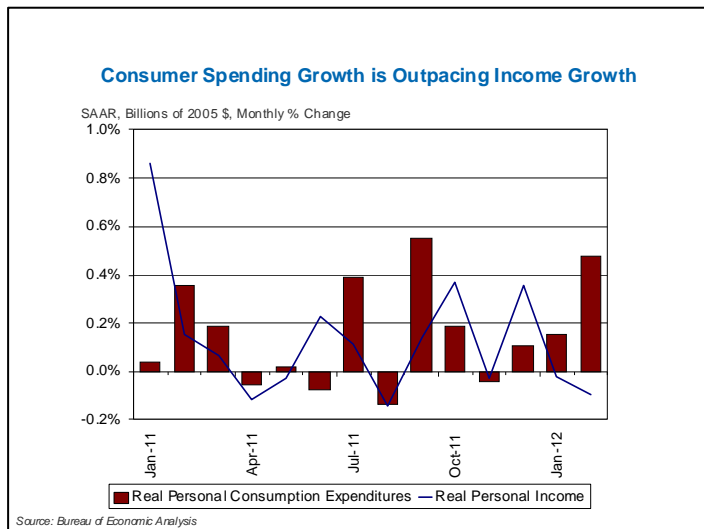


The labor force participation rate edged down and its drop over the past year has kept the unemployment rate lower than it otherwise would have been. Part of the reduction appears to be due to demographics and the aging of baby boomers, which will be permanent, while the rest is cyclical and likely to rebound as the labor market improves. Given our expectations of a monthly average job gain of approximately 190,000 jobs this year and slightly stronger gains next year, the unemployment rate is projected to trend down to about 7.5 percent by the end of 2013.

On a more positive note, the household survey showed that the number of people working part-time for economic reasons dropped sharply, marking the fifth decline during the past six months. The broadest measure of the unemployment rate, which includes part-time workers who would prefer full-time employment and discouraged workers, fell for the sixth consecutive month.

Main measures of consumer confidence were mixed in March, as the upward trend in equity markets and news of improving labor market conditions helped lift confidence, but higher gasoline prices worked against them. The Conference Board consumer confidence index fell slightly due to a decline in the expectations component while the present situation component rose to a new recovery high. The Reuters/University of Michigan consumer sentiment index increased in March for the seventh consecutive month.

Inflation adjusted consumer spending strengthened in February, rising 0.5 percent, the biggest gain since last September. Spending on autos and other durable goods was strong, while spending on services also picked up, posting the largest gain in nearly two years. There also were upward revisions to data for December and January. However, the pickup in consumer spending occurred against the backdrop of declining real income, which fell in February for the third time during the last four months.

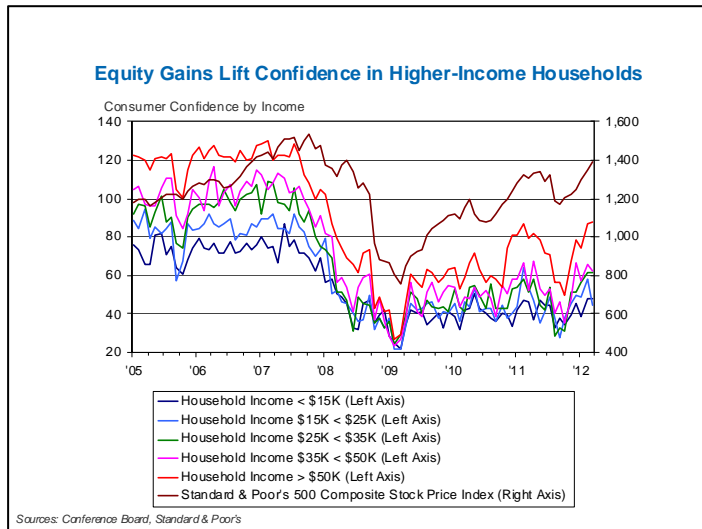


Real disposable income growth was even more anemic amid a leveling off of transfer receipts from government, and on a per capita basis it has been essentially flat over the past year.

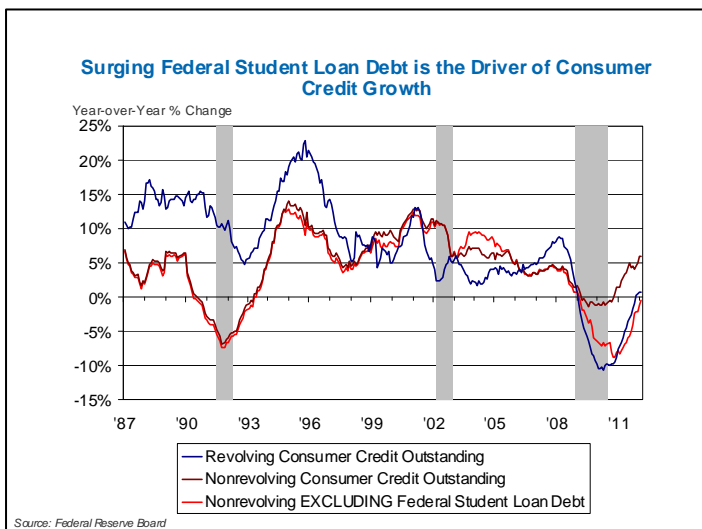
As consumers dipped into their savings to spend more, the saving rate fell sharply from 4.3 percent in January to 3.7 percent in February, reaching the lowest level since August 2009.

Incoming data suggest a slight pickup in real consumer spending in the first quarter. March auto sales eased modestly from a near-four-year high recorded in February. For the first quarter, sales had their best showing in four years. In addition, chain store sales came in strong in March, buoyed by an early Easter.

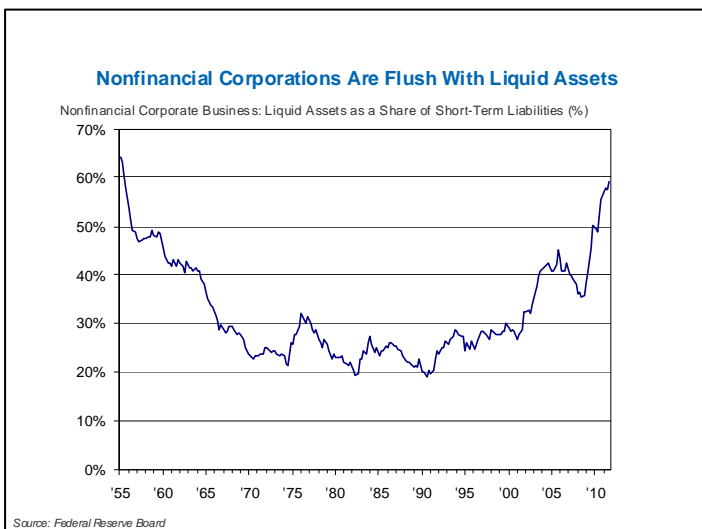
One source of support for consumers was rising equity prices during the first quarter. Stocks had their best first quarter in 14 years, with both the Dow Jones Industrial Average and Standard & Poor's 500 rising to levels last seen in May 2008. Rising equity prices helped boost consumer confidence, especially for higher-income households.



While household net worth (assets minus liabilities) has rebounded from its trough in early 2009, net worth remains more than \$8 trillion below its peak in mid-2007. This suggests that deleveraging of household debt may continue, but at a much slower pace than witnessed. The increase in spending on durable goods reflected pent-up demand for items such as autos and greater willingness to take on more consumer debt. Consumer credit continued to rebound in February, driven entirely by the nonrevolving segment (autos and student loans). Revolving consumer debt (credit cards) fell for a second consecutive month, consistent with the sharp drop in the saving rate amid strong consumer spending and subdued income seen in February.



Student loans have been a major driving force in the growth of nonrevolving credit. Other types of consumer credit are expected to grow going forward as banks are likely to become more willing to lend and as the demand for loans increases amid continued improvement in the labor market.



Data on the manufacturing sector, including for employment, continued to signal that the factory sector will remain a supporter of economic growth this year. The Institute for Supply Management (ISM) manufacturing index rebounded in March. Factory orders rose in February, and there were upward revisions to the core capital goods (nondefense capital goods excluding aircraft) data, which are used in estimating business investment in equipment and software spending in the GDP account. The factory orders report helped ease concerns of a dramatic pullback in business investment as a result of the switch from 100 percent expensing to a less generous 50 percent depreciation allowance.

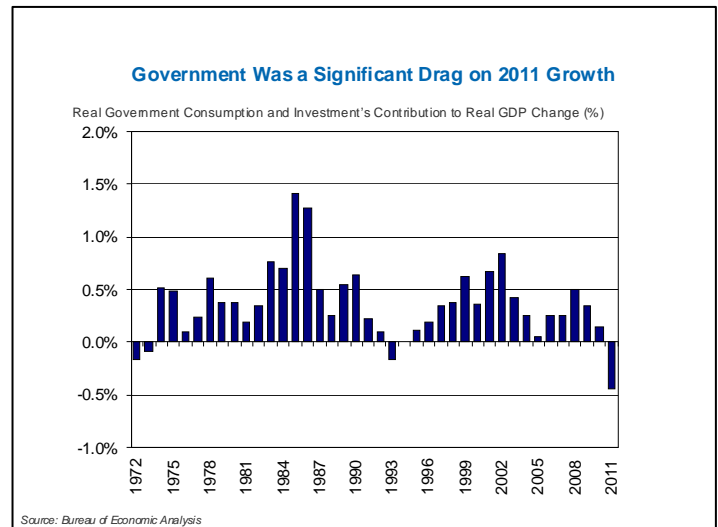
Cash flow at large nonfinancial corporations has outstripped investment spending, and corporations are effectively piling up retained earnings at an unprecedented pace, leaving themselves flush with liquid assets. Thus, nonfinancial corporations are well positioned for an acceleration in investment spending once demand picks up convincingly.

We expect economic growth to be modest this year as a number of factors combine to restrain activity. Given expected continued improvement in financial and credit conditions and continued healing in the labor market, consumer spending growth should pick up later this year.

However, a less-than-spectacular real disposable income growth trend should restrain household spending activity. Net exports are expected to contribute very little to growth in 2012. The government sector was a significant drag to growth in 2011, and in 2012 fiscal contraction by the federal government as well as ongoing cutbacks by state and local governments should continue to be a drag on growth.

Both investments in residential and nonresidential structures are expected to grow modestly this year. For all of 2012, we expect growth to pick up to 2.3 percent from 1.6 percent in 2011.

There continue to be a number of threats that could dampen growth, including additional spikes in oil prices and a harder landing in China. While the sovereign debt worries in Greece appear to have subsided, there have been renewed concerns regarding Spain, as its sovereign debt costs have risen sharply in recent weeks. Thus, the probability of intensified euro-area induced market stress remains elevated. The most likely and biggest challenge to the economy is the domestic policy environment. Under current law, the economy will be subject to intensified fiscal drags in 2013, namely the scheduled expiration of the Bush-era tax cuts and the Alternative Minimum Tax (AMT) "patch," which effectively reduces the number of taxpayers who would otherwise be subject to AMT. Other main drags include the first tranche of the \$1.2 trillion in automatic spending cuts mandated by the Budget Control Act of 2011, and the expiration of the payroll tax cuts and emergency unemployment insurance programs. In addition, the debt ceiling will need to be raised again later this year, and the negotiations surrounding that action, plus other policy options to limit the impact of the massive fiscal drags, are likely to weigh heavily on financial markets and consumer confidence, potentially dampening growth late in the year.



If major provisions in current law are implemented as legislated, the economy will have to absorb spending cuts and tax increases approaching five percent of GDP in 2013. We believe that Congress will modify many of the provisions in current law to bring about more moderate fiscal contraction in the near term. We assume that both the payroll tax holiday and emergency unemployment benefits will expire at the end of the year, but the patch for AMT, which is slated to expire at the end of December, will be renewed. We assume that the sequester of discretionary spending will be avoided in January 2013. Without legislative action, taxes will rise sharply in 2013 when the Bush-era tax cuts are slated to sunset. At the same time there will be new taxes and contributions to help pay for healthcare reform while temporary business tax breaks for investment are scheduled to expire. In addition, we assume a personal tax increase of about \$50 billion starting in January of 2013, roughly the amount that would be raised by allowing the Bush tax cuts on high-income households to sunset according to current law.

Housing: An Uneven Recovery Continues

Housing indicators showed some improvement late last year. However, more recent data indicate some loss of momentum, underscoring the uneven nature of the current housing recovery. Existing home sales slipped in February after a strong showing in January, and pending home sales or contract signings of existing homes fell slightly in February, but remained near their one-year high. New home sales also fell for the second consecutive month in February, and January's sales were revised substantially lower. The number of new homes available for sale was unchanged, matching the lowest level on record. The months' supply of new homes edged up to 5.8 months, broadly in line with its long-term average of about 6 months and less than half its January 2009 peak of 12.2 months.

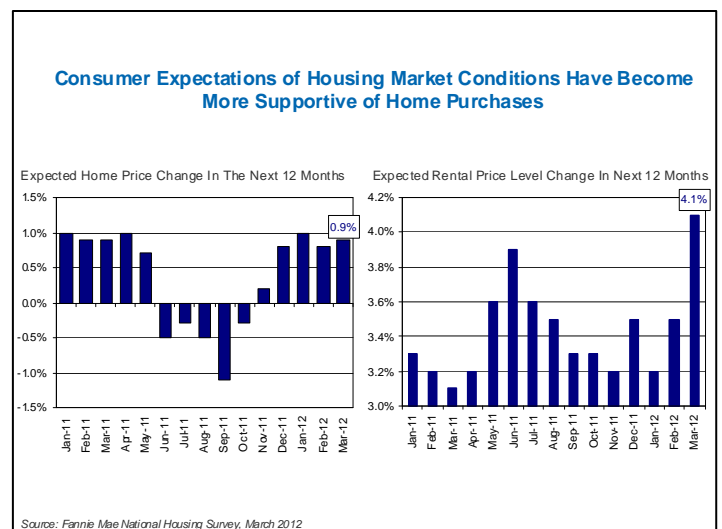
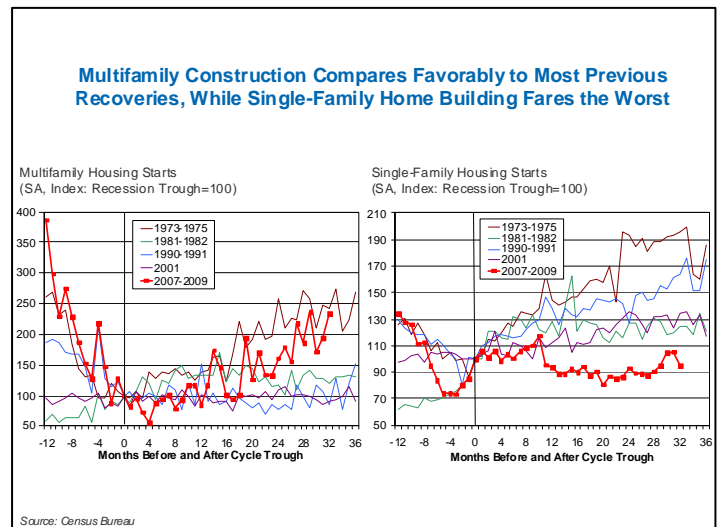
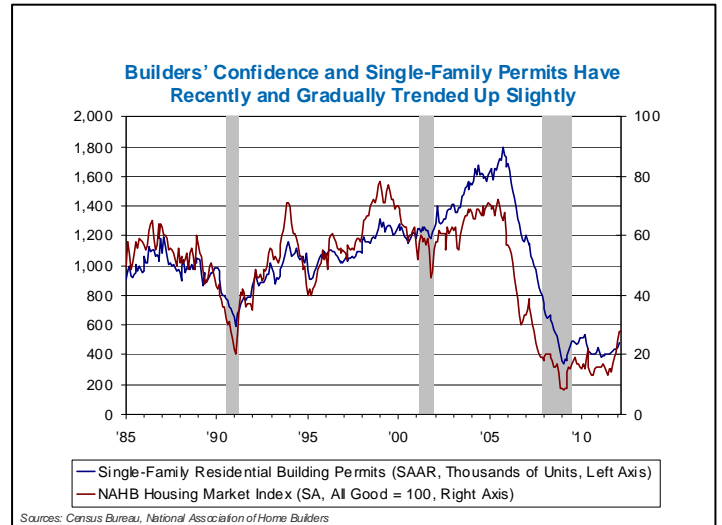
Weekly mortgage purchase applications, a one-to-two-month leading indicator of home sales, weakened in February, with the average purchase index for the month declining sizably following modest drops in the prior two months. However, purchase applications rebounded strongly in March, reaching the levels seen last December.

Single-family housing starts declined sharply in February, reversing their gains during the previous two months, while multifamily permits posted a strong increase for a second consecutive month. So far in this economic recovery, multifamily home building has performed relatively better than most previous recoveries. (For more information on multifamily market conditions including multifamily mortgage debt outstanding in 2011, read the [April 2012 Multifamily Market Commentary](#)). At the same time, single-family homebuilding has performed worse than any of the previous four economic expansions.

On a more positive note on the single-family housing side, permits increased for the fifth consecutive month in February and home builder confidence held steady in March, nearly doubling between mid-2011 and March of this year.

The component gauging builders' confidence used to measure expected home sales over the next six months rose in March, up nearly 20 points in just six months and posting the highest reading since June 2007. These leading indicators suggest improvement in coming months in the single-family housing market. The March Fannie Mae National Housing Survey suggests that consumer expectations of housing market conditions have become more supportive of home purchases. Expectations of rising home prices over the next year appear to be gaining traction, with expectations of increased home prices extending for the fifth consecutive month. At the same time, consumers' rent expectations for the next year continue to rise, reaching their record high level since monthly tracking began in June 2010.

Through the fourth quarter of 2011, residential investment contributed to overall economic growth for three consecutive quarters, the first time that has occurred since 2005. Incoming data for the first quarter suggest continued positive but smaller contribution than that in the fourth quarter of last year. Private residential construction spending disappointed in February, as single-family construction spending fell for the first time since May 2011. Despite the drop in February, single-family construction spending was above its level a year ago, the fifth consecutive year-over-year gain following 13 months of negative readings. The decline in single-family construction was roughly offset by increases in multifamily



construction spending and home improvements, keeping private residential spending unchanged.

Measures of home prices showed continued declines early this year, but year-over-year drops have moderated, suggesting that, for a broad segment of the market, home prices have stabilized. Distressed sales continue to weigh on home prices. Excluding distressed sales, the home price picture is encouraging. For example, the CoreLogic home price index showed a two percent year-over-year drop in home prices in February, but the decline was less than half that when distressed sales were excluded. We expect that more distressed properties will come on the market this year, given the recent agreement between state attorneys general and the nation's large mortgage servicers, which we expect will keep putting downward pressure on home prices this year.

We continue to expect the first rate hike by the Fed to happen in late 2014, the same as indicated in the current forward guidance by the central bank, and for the Fed to complete "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) in June as previously announced. Additionally, we do not expect the Fed to implement another round of large scale asset purchase or the third round of quantitative easing (QE3). Market participants appeared to have priced out the possibility of QE3 after the release of the March 13 Federal Open Market Committee (FOMC) meeting minutes, as it seemed that there was less support from FOMC members than in prior meetings. However, the weak March employment report served as a reminder that circumstances can change quickly and additional easing cannot be ruled out.

Yields on 10-year Treasuries climbed in March from near record low levels, in response to the improving outlook for Europe and better domestic data, which brightened prospects for riskier assets. Renewed concerns over the surge in Spanish and Italian bond yields and weaker economic data in the U.S., including the March employment report, caused Treasury yields to move lower in early April, with the 10-year yield declining to below two percent at the time of this writing. We expect that continued modest growth, combined with the highly uncertain political landscape, will keep long-term Treasury yields and mortgage rates low. The yield on 30-year fixed rate mortgages should rise only modestly, reaching about 4.2 percent by the end of the year, continuing to provide support for the housing market.

With inventories of new homes at all-time lows, single-family starts should rise from their record low in 2011. For all of 2012, we expect total housing starts to increase nearly 20 percent from 2011, with a substantially stronger increase in multifamily starts than in single-family starts, and we expect residential investment to contribute about 0.2 percentage points to overall GDP growth, the first year of positive contribution in seven years. New home sales are projected to rise by about eleven percent from a record low recorded in 2011, compared with about an 8 percent gain for existing home sales.

The modest increase in home sales, combined with expected moderating declines in home prices, should help produce a small increase in purchase mortgage originations. For all of 2012, total mortgage originations are projected to decline to \$1.26 trillion from an estimated \$1.36 trillion in 2011, with the refi share dropping from an estimated 66 percent in 2011 to 63 percent in 2012. Total single-family mortgage debt outstanding should post a slight drop, falling by 0.5 percent in 2012, compared with a decline of 2.2 percent in 2011.

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