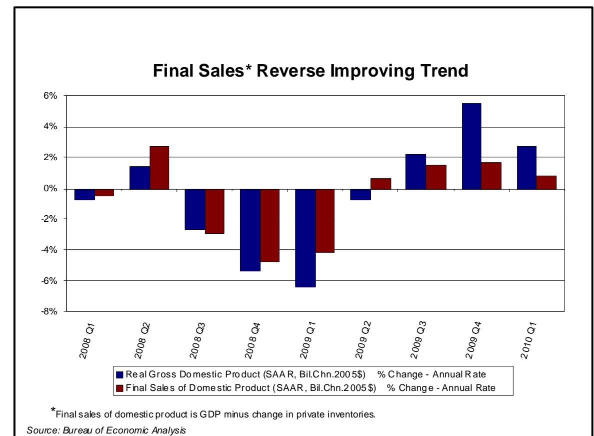
# Shifting to a Lower Gear

External and internal fundamentals have recently turned more clearly negative, leading us to take our assessment of the recovery down a notch from our prior outlook. On the external side, concerns about the sustainability of the global economic recovery have sparked market jitters around the world. Worries over European sovereign debt have not abated. Adding to fears of contagion is the concern that severe austerity measures will lead to a drastic slowdown in Europe. An expected slowdown in China is also weighing down the financial markets. The Chinese government has continued its attempt to rein in liquidity in an effort to preempt inflation, triggering fears that its soft-landing engineering could actually cause a hard landing. Internally, fiscal policy is turning from expansionary to contractionary, and uncertainty about future official actions is weighing on business and consumer sentiment. This is particularly true in the housing sector, where the end of tax credits is weighing heavily on activity.

U.S. economic data over the past month have generally been downbeat, with a barrage of dismal news on housing and consumer fundamentals calling into question the durability of the U.S. recovery. Consumer confidence has moved lower, reversing its gradual uptrend. Leading indicators of housing activity suggest that a pullback in home sales in the third quarter will likely be more significant than we initially anticipated. Most importantly, private payroll gains have weakened in recent months. While we had anticipated a slowdown in economic growth in the second half of the year (as the impacts of inventory building and fiscal stimulus wane), we now believe growth will slow by more than we previously projected. For all of 2010, we have revised lower our projected growth by four-tenths of a percentage point to 2.8 percent, and we remain on guard for a setback amid increased uncertainty and downside risks.

## Rear-view mirror picture: downgrade upon further review

Real (inflation-adjusted) gross domestic product (GDP) growth was downwardly revised by three-tenths of a percentage point in the first quarter to an annualized pace of 2.7 percent. Although small in overall magnitude, revision details had negative implications for the outlook of the economy. The contribution of inventories was revised up, while growth in real final sales (GDP minus changes in inventories) was revised down from 1.4 percent to 0.8 percent, reversing what had been an improving trend.

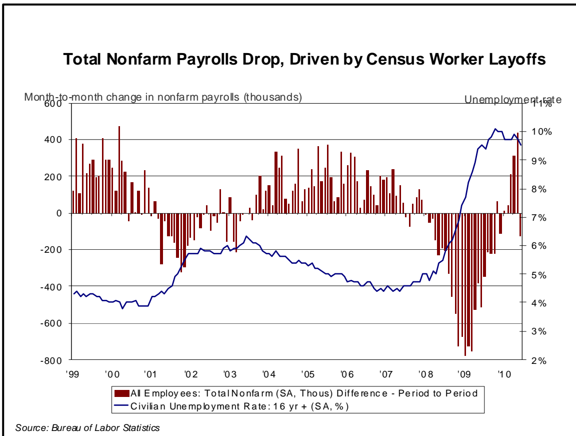


*Final sales of domestic product is GDP minus change in private inventories.
Source: Bureau of Economic Analysis

With the contribution from inventory investment expected to wane in coming quarters, strengthening growth in final sales will be essential for a sustained economic recovery. The slowdown in final sales growth was largely a result of a downward revision in consumption, lowering the forecast trajectory of household spending.

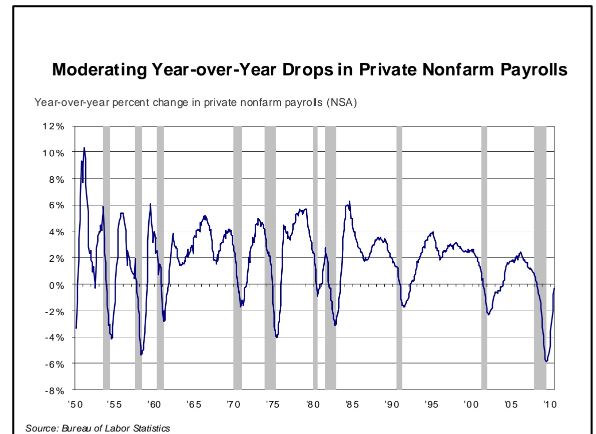
## Employment picture: losing momentum

The labor market showed solid signs of improvement in March and April of this year, with private payroll gains averaging 200,000 a month. Since the European crisis began in late April and intensified in May, it appears that the uncertainty over the outlook of the global economy has caused hesitation and caution in hiring decisions. As a result, labor market improvements fizzled out, downshifting to a lackluster performance in May and June.




Total nonfarm payrolls fell 125,000 in June following a gain of 433,000 in May. Just as temporary census hiring boosted job growth over the past few months, its reversal resulted in a decline in the headline employment figure. Because there were still nearly 350,000 census workers left on the government payroll in June, further drops in census workers are in the cards in coming months, which will weigh on total jobs growth.

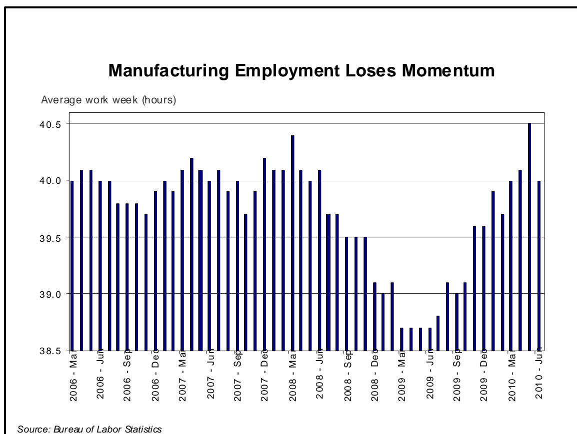
A more meaningful indicator for the health of the labor market is private employment, which increased 83,000 during the month, of which 20,500 were temporary positions. While June's gain was an acceleration from the gain of 33,000 in May, private employment remained slightly below the level of a year ago, marking the 27th consecutive month that private payrolls contracted on a year-over-year basis. The number of months of year-over-year declines so far remains shorter than the 30-month duration witnessed in the 2001 recession, which was a post-World War II record.




Other aspects of the report were also discouraging: the unemployment rate dropped only because the labor force contracted even more than employment, the workweek shrank, and average hourly earnings fell.

The unemployment rate, calculated from a separate survey of households, fell from 9.7 percent to 9.5 percent in June. This was not an indication of improving labor market conditions, because the drop resulted from individuals leaving the labor force in numbers substantially greater than the drop in household employment, presumably because they viewed the chances of being hired as receding. The fact that the labor force has fallen by nearly one million over the past two months indicates little confidence in the labor market. The employment-to-population ratio, a gauge of labor utilization, fell 0.2 percentage points to 58.5 percent, staying slightly above its December lows.

One of the most worrisome aspects was the first decline in four months in the average length of the workweek, a leading indicator of the labor market, by 0.1 hour to 34.1 hours. At this stage of the recovery, businesses should be adding hours to existing workers, not cutting them. Unless the workweek lengthens on a sustained basis, it is unlikely that businesses will increase hiring at a pace robust enough to bring down the unemployment rate.

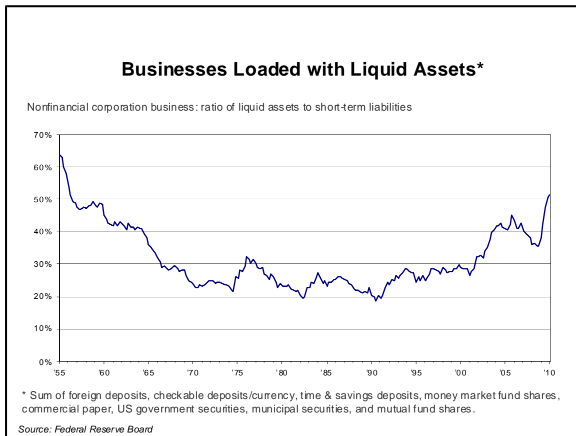



The bulk of the drop came from the manufacturing sector, for which the average work week fell by one-half an hour—an unusually large drop, typically seen only in recession. As a result, it is likely that industrial output contracted in June. The June employment report provided some evidence of a slowdown in manufacturing activity. Manufacturers only posted a net gain of 6,000 payrolls—the smallest since the sector started to create jobs in January of this year.

With private employment rising but the workweek shrinking, the index of aggregate weekly hours, which measures total hours worked in the private sector and is a proxy for economic growth, fell 0.2 percent in June—the first drop since the weather-distorted decline in February.

For the second quarter, the index of aggregate weekly hours rose at an annualized pace of 3.3 percent, accelerating from the 2.4 percent gain in the first quarter. This supports our estimate for accelerated economic growth in the second quarter. However, the June drop in the index indicates a loss of momentum as we enter the third quarter.

Furthermore, average hourly earnings fell 0.1 percent, reversing the recent improving trend. The decline, combined with reduced hours worked, indicated slower growth of wages and salaries. With the slide in the equity markets since late April and continued weak labor markets, consumer fundamentals have deteriorated, constraining spending growth going forward.




Corporate profits, a leading indicator of business investment and hiring, continued on a strong path. So far, businesses have been willing to spend capital on equipment, with May core durable goods orders, a leading indicator of business investment in equipment and software, posting a robust gain. Businesses have been building cash, and it appears that very liquid businesses have favored investing in capital rather than labor. During the first quarter, liquid assets (largely deposits, money market fund shares, and Treasury securities) as a share of short-term liabilities for nonfinancial corporations continued to rise sharply, reaching the highest level since the mid-1950s. It appears that businesses are not motivated to increase hiring in the face of uncertainty stemming from the durability of demand, government regulations, future labor costs and tax liabilities. However, without improving job and income prospects, consumers will likely continue the process of deleveraging, constraining spending growth.

## Consumers: turning more cautious

Consumers continued to receive income support from the fiscal stimulus in the second quarter, and income growth is poised to pick up from the first quarter. Real personal income grew 0.5 percent in May for the second consecutive month, about the same pace as real personal income excluding government transfer payments. This should help to support consumption. Consumer spending started the second quarter with little momentum, remaining flat in April. While spending picked up in May, early indicators point to soft June spending, as vehicle sales fell to the slowest pace since February and chain-store sales showed moderate growth. For the second quarter, we expect consumer spending growth to slow modestly from the first quarter's pace with further moderation in the second half of the year, in line with reduced income support from the fiscal stimulus and deteriorating consumer fundamentals.

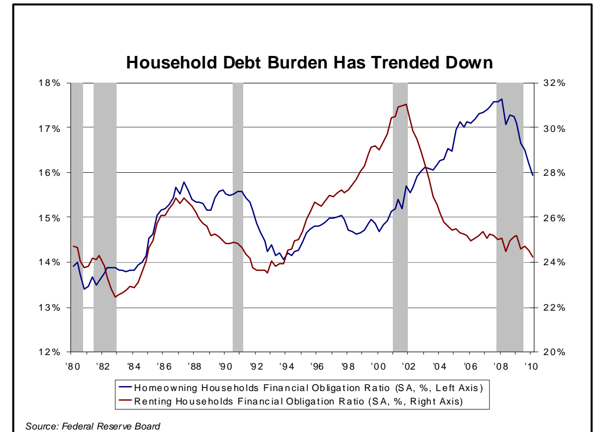
While consumer confidence has trended higher from its record lows last year, it has so far been unable to break above the low levels consistent with previous recessions. After three consecutive gains, the Conference Board consumer confidence index fell sharply in June, reversing most of the gains from the prior two months. Consumers expressed more concern about the outlook for jobs, stock markets and incomes. Buying plans for homes, appliances, and autos fell during the month, with plans to buy autos slipping to near record lows.

To repair their damaged balance sheets, consumers continue to deleverage, focusing on increasing savings and paying down existing debt. The saving rate increased in May to 4.0 percent, the highest level since September 2009. Consumer credit outstanding continued to contract, with the sharp drop in May marking the fourth consecutive monthly decline. Since the end of 2008, consumer credit has recorded increases in only two months.

The deleveraging process has helped ease households' financial burden.  During the first quarter, the household financial obligation ratio, which measures debt and other financial payments as a share of disposable income, dropped for the fifth consecutive quarter to the lowest level since mid-2000.

Financial obligation ratio trends differ significantly between homeowner and renter households.  The ratio for renters is significantly higher than that for homeowners, as renters tend to have lower incomes and correspondingly higher debt obligations as a share of their disposable incomes.

Debt burden for renters peaked at the end of 2001, then fell sharply through 2004 as interest rates trended down substantially.  While the ratio for renters continues to edge down (reflecting ongoing declines in consumer credit outstanding), the pace of decline has slowed.  In the first quarter, financial obligations for renters fell to the lowest reading since mid-1995.



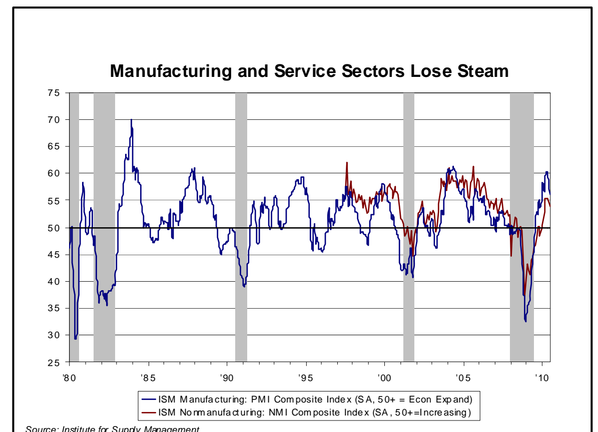
Source: Federal Reserve Board

In contrast, financial obligations for homeowners peaked much later (early 2008).  As mortgage rates fell significantly in the early part of the decade, households took on more mortgage debt, causing mortgage debt outstanding to rise at a rapid clip.  Since its peak, the ratio for homeowners has dropped sharply, reaching the lowest reading since 2002, reflecting an ongoing shrinking of mortgage debt outstanding through household deleveraging, loan modifications, and rising charge-offs.

Overall, household financial positions have improved over the past year.  If the labor market and wage and salary income trends continue to gradually improve, better financial positions should help support real consumer spending growth of about 2.5 percent in the second half of the year, which is somewhat lower than our projected pace in the previous forecast.

## Manufacturing and service sectors: losing steam

Manufacturing has been a big driver of economic growth during this recovery, benefiting from the inventory cycle.  Rising inventory investment, a temporary source of stimulus in the early stages of an economic recovery, contributed to more than half of economic growth during the three quarters ending in the first quarter of 2010.  Support from this factor is widely expected to fade in the second half of 2010, which should cool manufacturing activity.  Signs of a slowdown in manufacturing activity emerged at the end of the second quarter.  The Institute for Supply Management (ISM) manufacturing index fell in June but is still well into expansion territory.  The decline was driven by a sharp drop in the new orders component, a leading indicator of the factory sector.  Combined with a shorter manufacturing work week, the ISM survey suggests that the expansion in activity will continue to trend down going forward, although the slowdown will be from a historically high level.

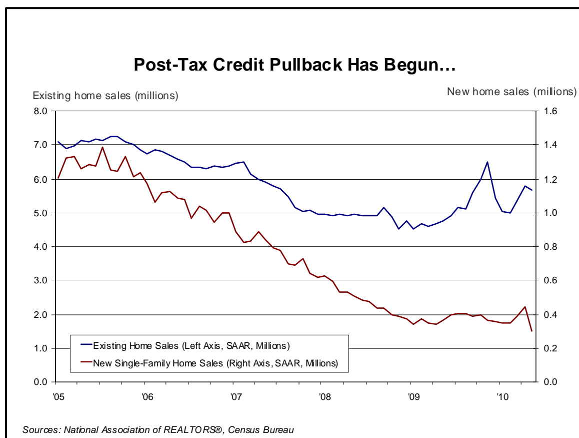


Source: Institute for Supply Management

The ISM survey for nonmanufacturing activity also suffered a setback.  The service industry had been expanding since January but at a relatively subdued pace compared with manufacturing.  However, after remaining flat for three consecutive months, the ISM nonmanufacturing index dropped in June. One notable aspect of the nonmanufacturing survey was the employment component.  Since the start of the recession in December 2007, the employment component reached into expansionary territory only once (and just barely) in May 2010.  In June, the employment component resumed its contracting trend.  Overall, both ISM surveys endorse the view that the economy will slow down in the second half of the year.

## Housing: a renewed setback

The payback from the end of the homebuyer credit has started to take hold. Single-family starts and permits fell sharply in May. Characteristically volatile multifamily starts and permits, which are unaffected by the tax credit, were up in May, suggesting that the apartment market may soon reach bottom.



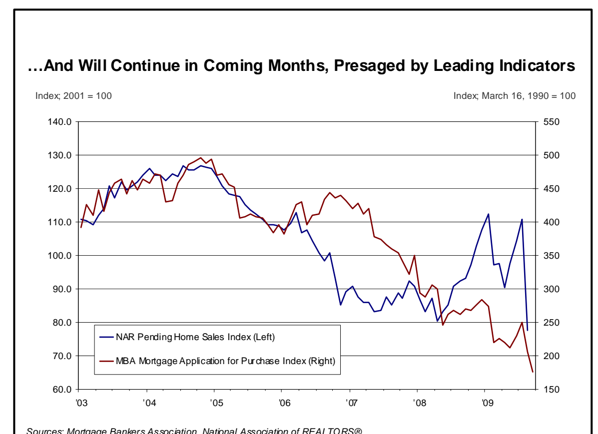

New home sales, which are recorded at contract signings, plunged 33 percent to their lowest level on record on the heels of the contract signing deadline to qualify for the tax credit. Previous months' data were also revised substantially lower. The dismal performance helped explain the sharp drop in builders' confidence in June, according to the National Association of Home Builders/Well Fargo Home builder sentiment index.

Existing home sales were not expected to fall off until after June, the original tax credit deadline for closings—now extended by Congress to the end of September. However, sales surprisingly fell in May, although this could be due in part to a backlog of closings and, if so, June sales could post a sizable increase.

The near-term outlook for the housing market looks bleak, according to leading indicators. Since the end of April, mortgage applications have fallen by over 40 percent, reaching the lowest levels seen since early 1997. Pending home sales, which are recorded at contract signings, posted a 30 percent drop in May to the lowest level on record. Given recent developments in the housing and labor markets, we have increased substantially our projected pullback of home sales in the third quarter and reduced our assessment for a rebound in the fourth quarter. For all of 2010, home sales should be basically flat.

Adding to the long list of declining indicators since the end of the tax credit, construction spending fell in May, as declining private construction spending outweighed rising activity by the public sector. Private residential construction spending fell modestly, as a large drop in multifamily construction spending more than offset spending on single-family homes. After increasing in April for the first time in over a year, private nonresidential construction spending resumed its downtrend in May.

Thanks to the tax credit, residential investment appears to have rebounded in the second quarter of 2010 from a sharp drop in the first quarter of 2010. However, incoming housing data strongly suggest that the rebound will be short-lived, and residential investment will turn into a drag to economic growth again in the third quarter. For all of 2010, we expect residential investment to be neutral to economic growth—neither a contributor nor a drag. The role of residential investment in this economic recovery is quite unusual: historically, housing has had a significant role in leading the economy out of a recession. During the first two quarters of each economic recovery since 1947, real residential investment contributed over one percentage point, on average, to economic growth. So far for the current economic recovery, which we estimate to have begun in the third quarter of 2009, real residential investment has contributed only about 0.5 percentage points to real GDP. We expect the recovery in residential investment to be uneven for some time.




One supporting factor in the housing market's favor is mortgage rates. The housing market has benefitted from a flight to quality into U.S. Treasuries as well as agency MBS, which has helped to push mortgage rates lower. The benchmark 10-

year Treasury yield has dropped from this year's high of four percent on April 5, reaching below three percent in late June. Staying below five percent for nine consecutive weeks, 30-year fixed-rate mortgage yields are now among the lowest on record.

The key to the housing market performance going forward is the labor market. As long as households are concerned about job security, affordability will not be the biggest driver of housing demand. Another significant factor that will keep the turnover rate of homes for years to come below the levels seen prior to the housing bust is the number of homeowners whose mortgages are significantly underwater. Borrowers with a mortgage loan-to-value (LTV) of 125 percent or more totaled nearly five million in the first quarter of 2010, according to First American CoreLogic. These homeowners are unlikely to prepay their mortgages regardless of how attractive mortgage rates are. This also has a negative implication for the outlook of the labor market, as it is an obstacle for skilled workers to relocate because they cannot afford to take losses on their homes.

## The Fed: on extended hold in the face of headwinds

Given signs of a slowdown in economic growth and a declining underlying inflation trend, it is likely that the Fed will remain on hold for at least another year.

The June Federal Open Market Committee statement suggested that it is concerned about the durability of the recovery, given developments abroad (i.e., the European sovereign debt crisis) as well as deflation risk. The Fed cited several headwinds facing the economy, including high unemployment, weak income growth, weak residential construction, continued declining commercial real estate construction, contracting bank lending as financial conditions have become less supportive, and businesses' reluctance to hire.

Tight bank lending is a critical issue for small businesses. Unlike big corporations, small businesses have no access to the bond market and have to rely on commercial banks for financing. With a limited ability to expand, small business hiring will likely remain subdued for some time.

## Mortgage production: no avalanche of refinancing (yet)

Since our June forecast, mortgage rates have declined further. We expect the 30-year fixed mortgage rate yield to remain near its current level, averaging about 4.6 percent for the rest of year. This projected level will not be low enough to trigger a refinance boom of a similar size to the one experienced in the spring of 2009. While the bulk of mortgage debt outstanding at present has a refinance incentive of at least 50 basis points, the pool of homeowners that qualify for prepayment will be limited for several reasons: homeowners face tight lending standards, they are significantly underwater, they have second liens, or they have poor credit history. Many homeowners have already refinanced at favorable rates and may not want to incur the transaction costs and cash outlay associated with the refinance process yet again. As a result, we have revised higher our projected refinance originations only moderately from the June forecast.

With lower projected home sales and a modestly worsening home-price trend for 2010, we have revised lower our estimate of purchase mortgage originations. For all of 2010, total mortgage originations are projected to decline to $1.40 trillion from an estimated $1.92 trillion in 2009, with a refinance share of 56 percent. Total single-family mortgage debt outstanding is projected to decline by 3.9 percent, accelerating from a 1.9 percent decline in 2009.

Doug Duncan and Orawin T. Velz
Economics and Mortgage Market Analysis
July 12, 2010

*Opinions, analyses, estimates, forecasts and other views of Fannie Mae's Economics and Mortgage Market Analysis (EMMA) group included in these materials should not be construed as indicating Fannie Mae's business prospects or expected results, are based on a number of assumptions, and are subject to change without notice. How this information affects Fannie Mae will depend on many factors. Although the EMMA group bases its opinions, analyses, estimates, forecasts and other views on information it considers reliable, it does not guarantee that the information provided in these materials is accurate, current or suitable for any particular purpose. Changes in the assumptions or the information underlying these views could produce materially different results. The analyses, opinions, estimates, forecasts and other views published by the EMMA group represent the views of that group as of the date indicated and do not necessarily represent the views of Fannie Mae or its management.*