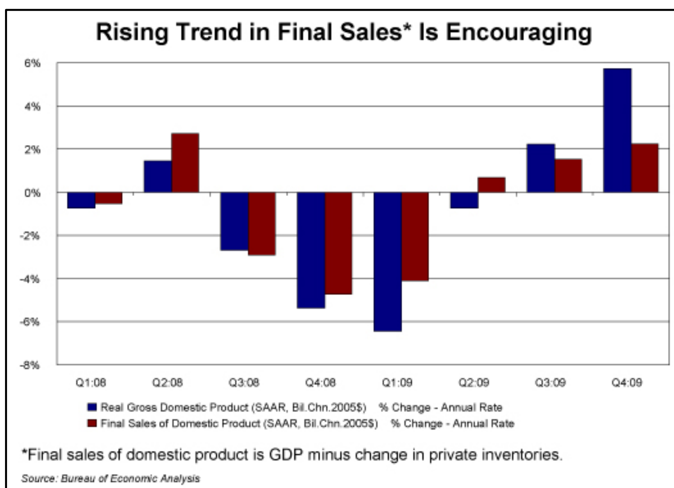
Year-End Economic Growth Rate Unsustainable

The economy grew at an annualized pace of 5.7 percent in the fourth quarter of 2009. Despite the surge in economic growth in the final quarter of 2009, growth is poised to moderate this year. The biggest driver of fourth quarter growth was a temporary inventory swing. While businesses still reduced inventories, they did so at a much slower pace than in the third quarter, leading to increased production. The slower pace of inventory liquidations added 3.4 percentage points to growth—the biggest contribution from this source in 22 years. This is not likely to be repeated any time soon. Thus, the surge in growth in the fourth quarter GDP (gross domestic product) does not change our view that this year's growth is likely to be modest by historical recovery standards at 3.2 percent.

Recovery Will Be Uneven: Manufacturing Leads

There are good reasons drawn from current data and past performance to believe that economic growth will continue this year, though it isn't guaranteed. Last year, the U.S. economy posted the largest annual drop in activity post-World War II (WWII), with real (inflation-adjusted) GDP declining 2.3 percent from 2008. Following most post-WWII recessions, the rebound was robust. This was often led by consumers and housing, two categories we believe are less likely to offer strong support this time.

What are the positives? Demand for U.S. goods and services has strengthened. Real final sales, GDP minus the change in inventories, are a better gauge of the underlying recovery path than GDP and grew at annual rate of 2.2 percent in the fourth quarter, accelerating from a 1.5 percent increase in the third quarter.



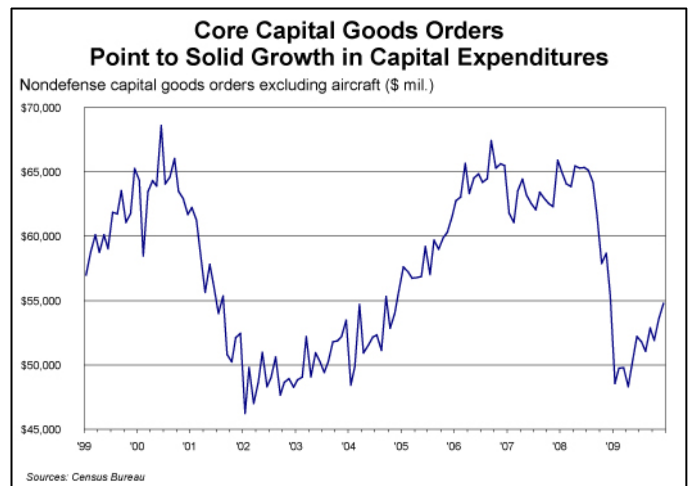
*Final sales of domestic product is GDP minus change in private inventories.
Source: Bureau of Economic Analysis

Net exports, a source of demand, performed much better than expected in the fourth quarter. Exports posted a solid gain for the second consecutive quarter, outpacing import growth. However, it is unlikely that trade will be positive for growth this year as imports will likely rebound at a stronger pace than exports. On average, net exports has been a drag on growth in the first year of a recovery since WWII.

A better piece of news was the surge in real nonresidential investment in equipment and software, which accelerated at an annualized rate of 13.3 percent—the strongest pace since the first quarter of 2006—from 1.5 percent in the third quarter. Once businesses perceive the increase in demand for their products as strengthening sustainably, they usually start investing to sustain recent productivity gains and expand output. Incoming data suggested a solid increase in business capital expenditures.

Nondefense durable goods orders excluding aircraft—a gauge for nonresidential investment in equipment and software in the near future—increased strongly in December following a surge in November. These strong back-to-back gains indicated that nonresidential investment in equipment and software will likely be a solid source of growth in the current quarter and also provide a positive outlook for the labor market since adding workers typically follows increases in fixed investment. One cautionary note: some of the jump may be attributable to the anticipated expiration of tax deductions.

The Institute for Supply Management (ISM) manufacturing index suggested that manufacturing—a source of strength in the fourth quarter of 2009—would likely carry over into the current quarter. Manufacturing continues to gather momentum that started in the second half of 2009, according to ISM manufacturing survey, which jumped in January this year to the highest reading since August 2004. The details of the survey were encouraging: a surge in export orders for U.S. manufacturing more than offset the gain in import orders during the month. The wider gap between export and import orders suggests that trade could potentially be positive for growth again in the current quarter.



The service sector has not performed as well, however. The ISM non-manufacturing index increased slightly in January to a reading just above the break-even point between expanding and contracting activity. The non-manufacturing sector has hovered near the break-even point for about five months. This is a concern for employment since nearly 9 out of 10 workers are employed in services.

The softest spot in the economy continued to be nonresidential investment in structures, posting the fourth consecutive double-digit drop after adjusting for inflation. We believe its outlook for the rest of this year is grim, given tight credit, declining prices, rising vacancy rates, and a weak labor market. According to the January Federal Reserve's Senior Loan Officer Opinion Survey on Banks Lending Practices, banks generally stopped tightening lending standards, except for commercial real estate loans, as more banks reported further tightening of their credit standards for these loans during the fourth quarter of last year. Credit-quality deterioration in commercial real estate will impact negatively the health of the banking industry, especially for regional banks, which tend to be more heavily exposed to commercial real estate.

Consumers Save More and Pare Down Debt Usage: Positive for the Future

Consumer spending—the most important component of GDP—appeared to be losing momentum going into the current quarter. Real consumer spending increased at an annualized 2.0 percent rate in the fourth quarter, moderating from 2.8 percent in the third quarter with the expiration of the "cash for clunkers" program. The slowdown in consumer spending growth in the fourth quarter was expected but monthly data showed a discouraging trajectory, with real consumer spending ending the year with a whimper, edging up just 0.1 percent in December. Early indicators of consumer spending were mixed for January as auto sales declined in January to a level that was slightly below the fourth-quarter average, while chain-store sales were quite strong.

The December personal income and consumer spending report showed that the saving rate—personal saving as a percent of disposable income—climbed to 4.8 percent from 4.5 percent in November. For all of 2009, the saving rate averaged 4.5 percent, the highest annual level since 1998. The increase of two percentage points was the biggest annual gain since the inception of the series in 1960.

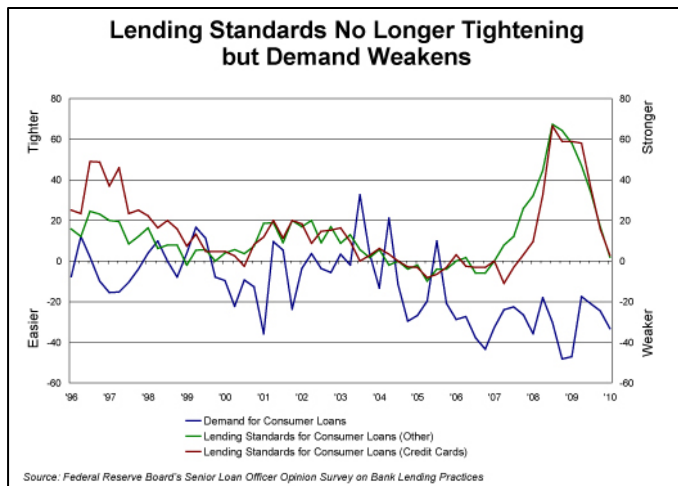
Measures of consumer confidence have gradually trended up, but a sizable improvement is unlikely until sustained job creation begins in earnest. This means a continued household focus on shoring up balance sheets. Consumers continue to deleverage as made evident in the declining trend in consumer credit outstanding (including everything but real estate loans). Consumer credit fell in December for the 11th consecutive month. From a year ago, consumer credit outstanding decreased 4.0 percent, the largest quarterly year-over-year drop since the end of WWII. The ratio of consumer credit to disposable personal income fell slightly to 22.0 percent, the same ratio seen in early 2000.

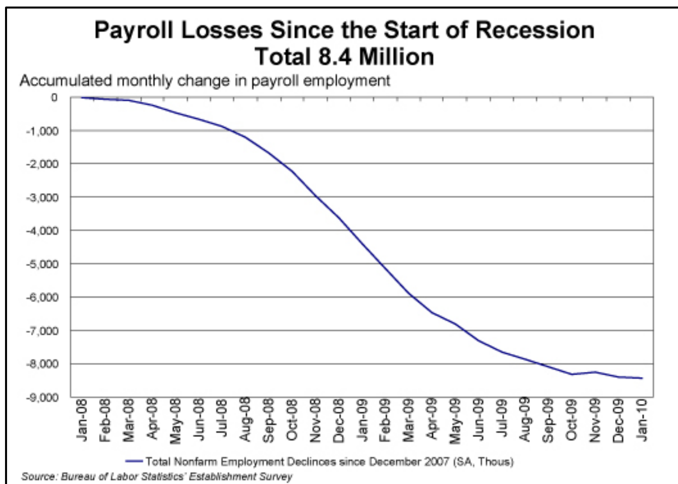
While the substantial increase in the saving rate and the decline in debt usage during the past year are a negative for today's economic growth, they should help strengthen households' fragile balance sheets, providing a cushion for

households to spend more if, as expected, the labor market improves meaningfully later in the year. This will help the economy to continue on its recovery path when the impact of the inventory swing and fiscal stimulus fades.

Lending Conditions Less Restricted: Demand Pulls Back

The weak labor market has dampened the demand for consumer loans. According to the January Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, the demand for consumer loans weakened during the past three months as businesses and consumers remained reluctant to take on additional debt. The survey indicated an improvement on the supply side. Fewer banks tightened lending standards for consumer loans in the January survey than in the November survey. For the first time in three years, more banks reported an increased willingness to make consumer installment loans. However, they have not yet reversed the substantial tightening that occurred during the past two years.





For mortgage loans, banks continued to tighten lending standards but fewer reported tightening standards in the January survey compared to the November survey. For commercial and industrial loans to medium and large firms, which are largely used for inventory financing or plant and equipment investment, lending standards were eased somewhat. This is an encouraging development as easier access to credit will likely allow firms to expand and later hire as consumer demand picks up.

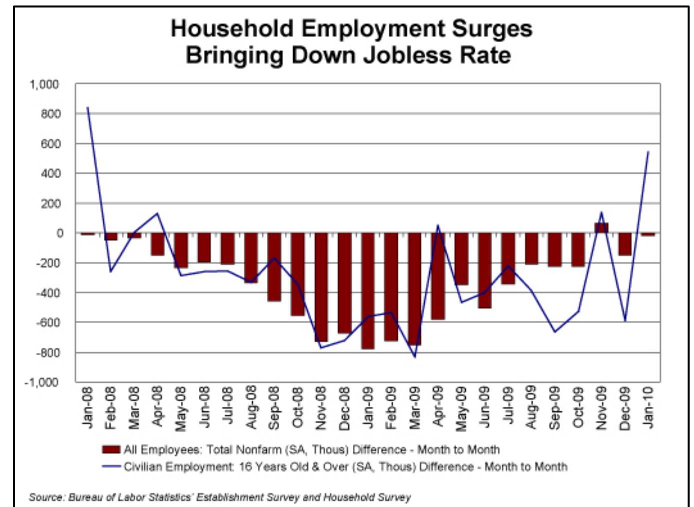
The Labor Market Gradually Improves

The January employment report suggested that the labor market is at the cusp of creating jobs. Nonfarm payrolls declined 20,000 in January, according to a survey of establishments. Manufacturing payrolls increased for the first time since January 2007, dominated by job gains in the auto industry. Construction payrolls dropped sharply, with the decline concentrated in the nonresidential sector. Retail payrolls jumped, pointing to improved consumer spending. Since the recession began in December 2007, payroll employment has declined by 8.4 million.

The unemployment rate, which is derived from a survey of households, declined from 10.0 percent to 9.7 percent in January, trending down from the 10.1 percent peak in October 2009. According to the household survey, 541,000 jobs were created in January, helping to bring down the jobless rate.

A gap between both surveys is not unusual, but it widened significantly in January. It is important not to imply underlying labor market conditions from the household survey, which has a small sample and numbers are volatile from month to month.

Leading indicators suggest that the labor market recovery is under way. First, the length of the workweek increased from 33.2 hours to 33.3 hours, trending up from a record low of 33.0 hours in October 2009. The hope is that since businesses have started to add hours to existing workers, they will need to start hiring new workers in the near future. Second, temp employment—a harbinger of permanent hiring—has posted sizable gains during the past four months. Businesses have created an average of 62,000 temporary workers per month during the last four months. This development was particularly encouraging, give recent history. The last time temp payrolls posted similar gains was in mid-2003, when temp hiring gained an average of 41,000 per month. Soon after that, total payrolls saw sustained increases.



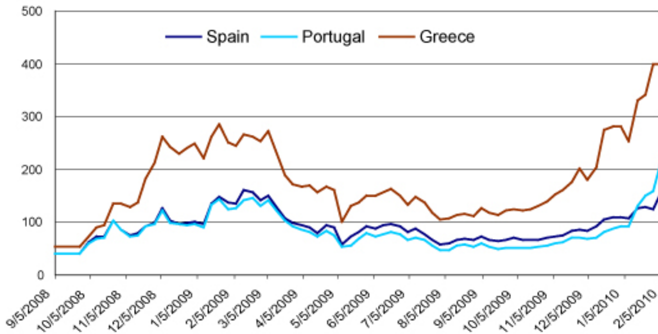
Lastly, the number of people working part-time for economic reasons posted a drastic decline of 849,000. This was the largest drop in 16 years—the second largest since record keeping began in 1955—falling from 17.3 percent to 16.5 percent during the month. This includes discouraged workers and those working part time who would rather work full time, and is the most comprehensive measure of unemployment and a better measure of labor market slack. Unfortunately, there was no solace for the long-term unemployed. The number of long-term unemployed continued to rise, increasing the average duration of unemployment to 30.2 weeks from 29.1 weeks.

During the fourth quarter, in which economic growth accelerated to the strongest pace in more than six years, the labor market shed 310,000 jobs. The disconnect between economic growth and jobs was explained by productivity growth, which surged at a 6.2 percent annual rate during the quarter. Productivity gains exceeded six percent in each of the last three quarters of 2009—an impressive but unsustainable performance, given that trend productivity growth is about 2.0 to 2.5 percent. The surge in productivity in the early stages of a recovery is not uncommon. Businesses were able to increase output while cutting employment at a turning point of a business cycle. However, at some point, hiring will have to start to ensure that production will be able to meet growing demand.

We expect residential investment will add only 0.3 percentage points to GDP in 2010, slightly less than the contribution from nonresidential investment which we believe was boosted solely from investment in equipment and software. Complete 2009 data for the primary housing indicators is now available, and we will summarize 2009 performance and outlook for 2010 later in this commentary.

Capital Credit Conditions: Heightened Uncertainty from Global Turmoil

While the economy is on a trajectory of improvement, global capital markets are showing signs of heightened uncertainty largely related to turmoil in Europe and concerns that tightening policy in Asia could undermine the recovery. China's real GDP fourth quarter growth accelerated to 10.7 percent year-over-year from 9.1 percent in the third quarter, prompting actions to curtail bank lending. This began to unsettle markets when ongoing concerns related to Greece's double-digit fiscal deficits spread recently throughout the European Union (EU), particularly Portugal and Spain. Credit default swap rates for these countries have soared, as there is no clear mechanism within the EU to bail out these States should they lose access to credit in the financial markets. This, in turn, is a blow to the global banking system, particularly for European financial institutions.



The U.S. has regained its status as a safe haven due to these heightened uncertainties; with the euro falling to an 11-month low as its status as an alternative reserve currency is eroded by recent events. Moreover, Treasury yields have fallen despite improving economic conditions. Risky assets, notably equities, have been shaken by the news, with equity market-implied volatility climbing more than 20 percent in recent weeks.

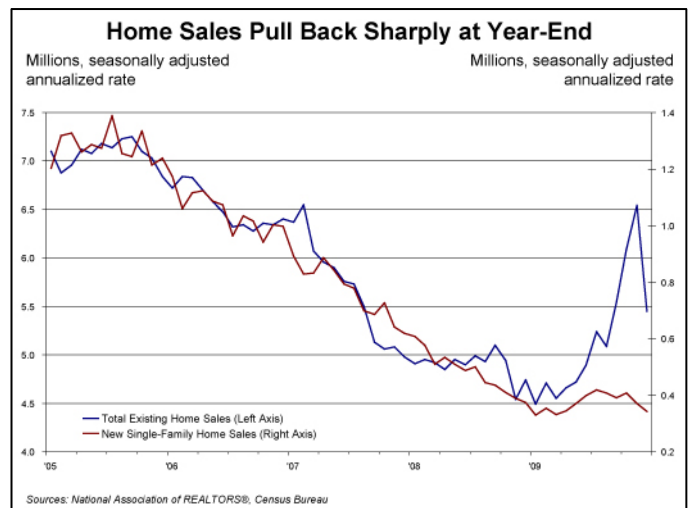
This heightened uncertainty, particularly in Europe, poses a challenge to the Fed as any indication of an exit strategy any time soon could result in a volatile market reaction. We continue to expect the Fed to end its GSE MBS purchase program on schedule at the end of March, but to keep its options open as the uncertain global environment cautions against rigidity in policy actions. We continue to expect a modest rise in MBS spreads this year as a result, as private investors are "short" these instruments due to narrow spreads and will likely return when the price is right.

Housing Market in 2009: Troughs in Activity Established

Following three years of housing recession, most measures of housing activity appeared to have troughed in early 2009 and have embarked on varying degrees of recoveries. After suffering the most severe peak-to-trough decline in six decades, single-family housing starts experienced a small, uneven rebound. While they posted steady increases through July, they have lost steam and moved sideways since. For all of 2009, single-family starts were at 443,000, a record low and an amazing plunge from a record high of 1.7 million just four years ago. Multifamily starts also fell to a record low of 110,000 for the year.

The rebound in home sales which also started in early 2009, showed starkly different pictures of the housing markets for new and existing homes. Despite historically low mortgage rates and the first-time homebuyer tax credit, the recovery in the new home market was tepid, mirroring that of single-family starts. In contrast, the existing home market soared in the second half of 2009, benefitting from distressed sales in addition to the tax credit and low mortgage rates. Both new and existing home markets suffered some payback in the final month of the year, as sales were pulled forward in a rush to beat the expiration of the tax credit, which was tentatively set at the end of November.

New home sales posted the fourth double-digit annual drop in 2009, declining 23 percent to set another record low of 373,000. Total existing home sales' sharp increase in the second half of 2009 was enough to boost sales for the year to 5.2 million, a gain of five percent and the first annual gain in four years.

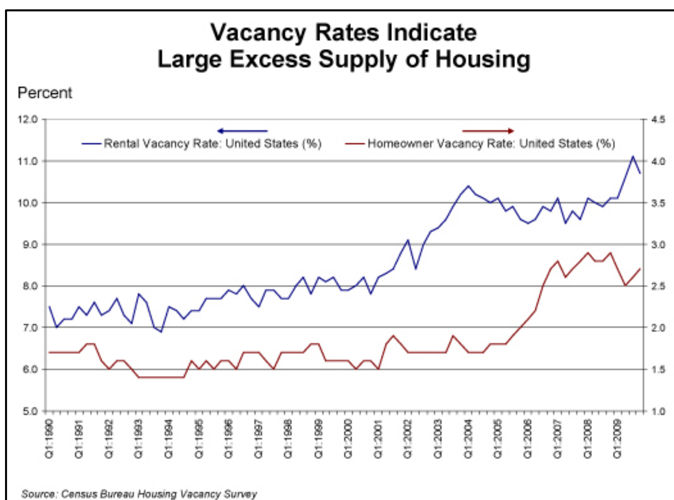


The median price for total existing homes as reported by the National Association of REALTORS® was up in December from a year ago for the first time since August 2007. The reason for the gain was likely a change in the mix of sales. With the reported declining share of first-time buyers in December, the distribution of home prices shifted toward more expensive homes. We believe home price measures that track repeat sales of the same house over time are a better indicator of home price trends than average or median home prices because they are not distorted by the mix of sales of low- and high-priced homes.

However, the performance of home prices for these measures for the whole 2009 year is not yet known at the time of this writing. Measures of seasonally-adjusted home prices in November showed mixed results. The Loan Performance Home Price Index fell for the third consecutive month, the Standard & Poor's/Case-Shiller Home Price Indices rose for the sixth consecutive month (albeit at a slower pace than during the summer) and the Federal Housing Finance Agency (FHFA) Purchase Only Index posted a second straight gain. The FHFA measure was the only one showing a year-over-year increase, its first since September 2007.

Even with record declines in homebuilding activity, the housing market continued to face a significant imbalance, which will continue to put downward pressure on home prices. The Housing Vacancy Survey, which offers the most comprehensive measures of housing inventory, showed mixed results. The homeowner vacancy rate, which measures the share of units typically occupied by owners that are for sale and vacant, edged up from 2.6 percent in the third quarter to 2.7 percent in the fourth quarter. The rate is about one percentage point higher than its long-term average, suggesting nearly 800,000 units of excess supply of for-sale and vacant homes.

In contrast, the supply in the rental markets declined in the fourth quarter. The rental vacancy rate fell 0.4 percentage points to 10.7 percent from a record 11.1 percent in the third quarter. We estimate that the rate is about three percentage points higher than its historical norm, indicating an excess supply of 1.2 million units of vacant homes for rent at the end of last year.

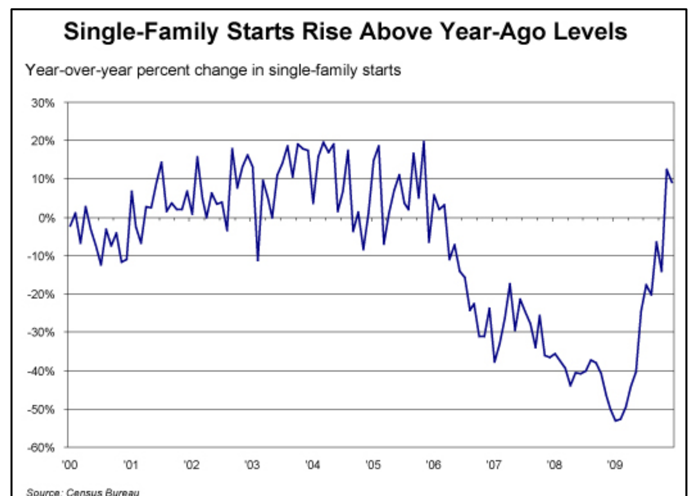


These units may come back into the owner-occupied space at some point when market conditions improve, as some of these units may belong to reluctant landlords. This potential supply of homes for sale could put further downward pressure on home prices. In any event, the excess supply of rental units is putting downward pressure on rents, making the user costs of renting more attractive relative to that for owning, depressing owner-occupied housing demand.

The share of households that own (the homeownership rate) slipped further to 67.3 percent seasonally adjusted in the fourth quarter of 2009—the lowest rate since the second quarter of 2000. This rate is expected to decline further based on the level of delinquent loans in the market.

Housing Market in 2010: Recovery Continues

There are reasons to be hopeful about the outlook for the housing market this year. Unusually harsh winter weather likely contributed to some of the large drop in single-family housing starts in December. Despite the slip at the end of the year, single-family starts posted back-to-back gains by the end of 2009.

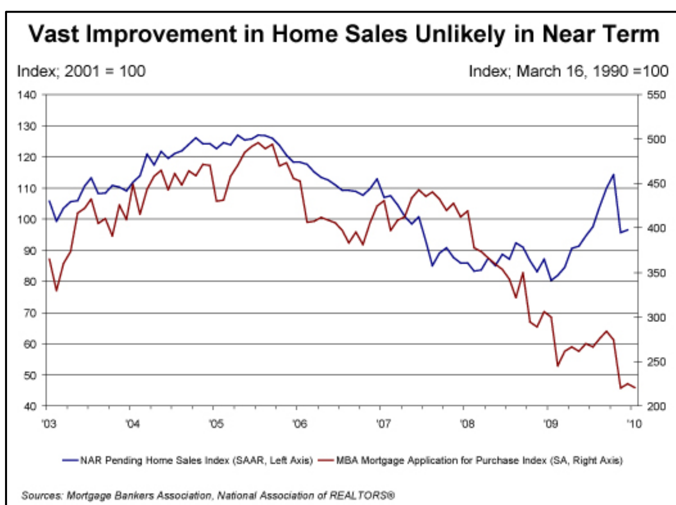


It is likely that homebuilding activity started the year on a positive note and is on its way to post an annual increase for the first time in five years. Single-family permits—a leading indicator of starts—pointed to a rebound in the near term as permits were well above starts at the end of the year.

There also are reasons to be cautious about the strength of the near-term outlook. Home builders' confidence has been

going nowhere of late, according to the National Association of Home Builders/Wells Fargo Housing Market Index, which fell in January to the lowest reading since June 2009. Despite the extension of the tax credit, there hasn't been much for home builders to smile about. New home sales have been sluggish, excess supply of housing has remained elevated, financing for construction loans continues to be constrained, and rising foreclosure rates threaten to add more homes to the market supply, putting downward pressure on home prices and construction demand. For all of 2010, we expect total housing starts to increase by 38 percent to 755,000.

Looking ahead at home sales, the main question is how much the expanded tax credit that applies to repeat buyers will spur sales this year. Leading near-term indicators suggest that the tax credit may have less of an impact this year. Mortgage applications to purchase homes have moved up in recent weeks but have remained near their lowest level since 1997. The pending home sales index, which measures contract signings for existing homes, was relatively flat in December after plunging 16.7 percent in November.



We still expect that the expansion in the tax credit will help support sales in the first half of this year, albeit at a slower pace than the fourth quarter average. Sales are likely to pull back in the third quarter as the tax credit expires. However, the extent of the pull back will largely depend on mortgage rates and, more importantly, labor market conditions. If job creation strengthens during the fourth quarter as we are expecting, the drop in sales will be small enough such that overall home sales would see a double-digit gain, projected to be about 12 percent for all of 2010. Home prices should post further declines but at a more moderate pace this year than last year.

Stronger home sales and more moderate declines in home prices will likely boost purchase mortgage originations this year for the first time in five years, while rising mortgage rates will hurt refinancing incentives. We project that the refinance share of mortgage originations will fall to 44 percent of a projected total originations volume of $1.34 trillion. Along with an on-going deleveraging of other consumer debt, mortgage debt outstanding is projected to decline this year by about 1.7 percent—the third consecutive annual drop.

Doug Duncan, Orawin T. Velz, and Richard A. Koss

Economics and Mortgage Market Analysis

February 10, 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. 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.