

Amid Fiscal Policy Uncertainty, Economic Activity Continues to Underperform

The strong economic growth in the third quarter – the result of a temporary spike in Federal government defense spending and strong inventory investment – is poised to slow substantially in the fourth quarter. This sea-saw pattern highlights a continued weak underlying growth path. The seemingly healthy headline economic growth in the third quarter masked continued weakness in consumer and investment demand, and thus the resulting inventory overhang will likely dampen activity in the current quarter. Furthermore, Hurricane Sandy will suppress growth somewhat in the fourth quarter, but activity should rebound in the first quarter of 2013. However, on net, this activity will not result in growth above the current trend.

It is difficult to quantify the near-term impact of policy uncertainty stemming from the impending “fiscal cliff” – the automatic spending cuts and expiration of various tax cuts that take effect on January 1, 2013 – absent an agreement between Congress and the Administration. The consensus forecast, including the nonpartisan Congressional Budget Office (CBO), indicates that the economy will slip into recession if the entire fiscal consolidation takes place as scheduled. At the time of this writing, no development has emerged to suggest that an agreement avoiding the changes to occur January 1 is in the offing.

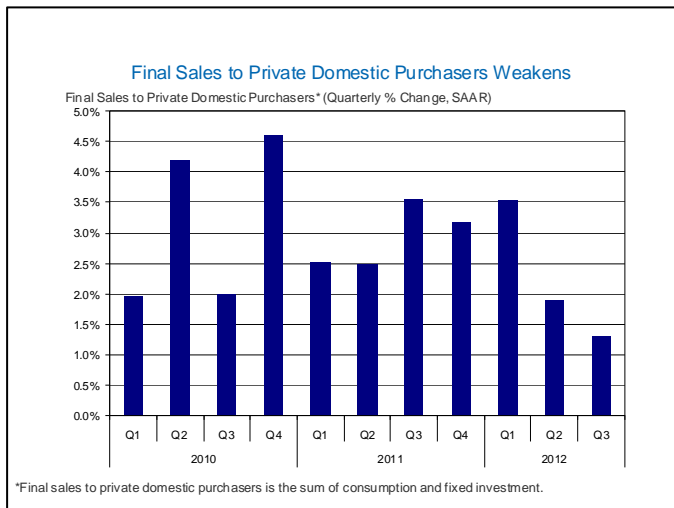
Our forecast assumes that all the parties will agree on a plan that would avoid significant aspects of the fiscal contraction. We expect that fiscal tightening will be a 1.2 percentage point drag on growth (out of nearly a 4 percentage point drag if all fiscal tightening were to go into effect). This 1.2 percentage point drag would be sufficient to keep the pace of growth restrained through the first half of next year. Once policy makers resolve the near-term fiscal and policy challenges, economic growth should begin to accelerate to its trend pace of approximately 2.5 percent in the second half of 2013 and into 2014. We expect that the economy will benefit from tailwinds from an expected self-sustaining housing recovery during the next couple of years, with gradual improvement expected in home building and sales activity as well as home prices. Several challenges besides the fiscal cliff resolution remain, including the Euro zone recession, sovereign debt crisis, and tensions in the Middle East, which could potentially lower growth by more than we expect.

The modest economic recovery and a gradual and similarly modest healing of the labor market have not deterred a solid improvement in the housing market, and recent housing indicators suggest a strengthening housing recovery. Despite the heated fiscal cliff debates, housing remains resilient, and we anticipate that the housing market will continue to gain momentum in 2013.

The revisions to the gross domestic product (GDP) report showed that real (inflation-adjusted) GDP grew at a 2.7 percent annualized pace in the third quarter, compared with the first estimate of a 2.0 percent increase. Inventory investment accounted for the majority of the upward revisions, which implies that it will likely act as a headwind, subtracting from economic growth in the fourth quarter. Another source of the favorable revision was exports. Given flat real imports, the trade gap narrowed to the smallest level witnessed in a year, an impressive gain but unlikely to sustain amid the ongoing global economic slowdown.

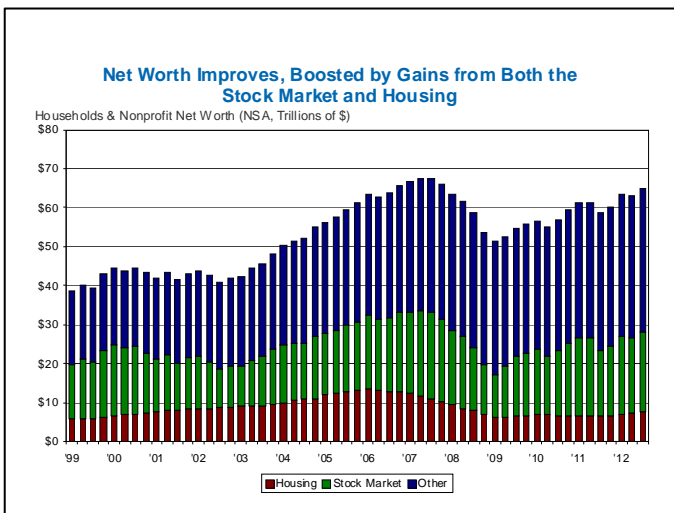
While demand from abroad was stronger, domestic demand was substantially weaker. The most worrisome aspect of the revisions came from a downgrade of real consumer spending growth by 0.6 percentage points to 1.4 percent and a downward revision of nonresidential business investment by nearly 1 percentage point to a decline of 2.2 percent.

Despite the stronger headline in economic growth, final sales to private domestic purchasers – the sum of consumer spending and fixed investment and a gauge of private domestic demand – moderated substantially to the weakest pace since late 2009.



The GDP revisions also showed that income trends were weaker than initially reported, with downward revisions in wages, salaries, and the saving rate in both the second and third quarters. This has a negative implication for near-term economic growth, as weaker income trends will provide less support for consumer spending going forward.

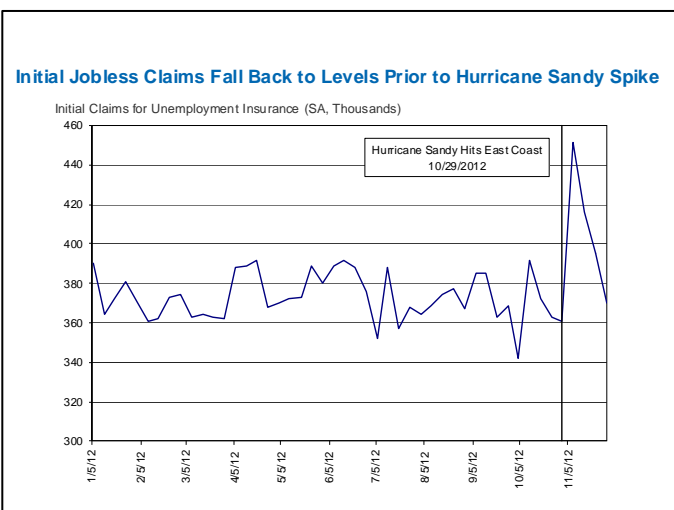
Incoming data for consumer fundamentals at the start of the fourth quarter continued to be soft. Both real personal income and consumer spending fell in October. Some of the weakness in consumer spending probably reflects the disruptive impacts of Hurricane Sandy and thus some rebound during the quarter is possible, as already seen in auto sales. Following a sharp decline in October, November auto sales jumped to the strongest pace since December 2007.



One source of support for households is their strengthening balance sheets. The latest data from the Federal Reserve Board's Flow of Funds showed that, following a modest decline in the second quarter of this year, households' net worth – assets minus liabilities – rose \$1.7 trillion in the third quarter, boosted by gains from both the stock market and real estate values amid declining household debt.

Another boost to consumers is declining gasoline prices. The national average retail price of gasoline peaked at a monthly average \$3.91 per gallon in September and is now running about 50 cents per gallon lower.

Despite a rebound in auto sales and the improving household net worth and inflation outlook, a weak trajectory of consumer spending and income has led us to revise lower our forecast of consumer spending in the current quarter by nearly half a percentage point to 1.5 percent. Incoming data, including a larger-than-expected inventory accumulation and weaker consumer and investment demand in the third quarter, suggest that economic growth in the fourth quarter will moderate to a tepid pace of 1.5 percent.



The impact of Hurricane Sandy may distort a wide range of economic data during the fourth quarter. After surging by 90,000 in the wake of the hurricane, initial jobless claims have dropped by 81,000 over three consecutive weeks to 370,000 – near the levels seen prior to the hurricane and for much of 2012. This suggests that, while Hurricane Sandy caused some temporary disruptions in claims data, the underlying strength has been essentially unchanged.

The headline November jobs report showing total nonfarm payroll gains of 146,000 surprised on the upside, considering expectations that the hurricane would disrupt hiring in affected areas during the month based on a spike in initial claims. The Bureau of Labor Statistics reported no substantive hurricane impact on the November estimates. The regional data, not yet released at the time of this writing, may allow for a better assessment of possible impacts of the hurricane. Details

from the November report were less encouraging than the headline because of downward revisions of 49,000 in payrolls in the prior two months and flat average weekly hours. Overall, the economy has created an average of 139,000 jobs in each of the past six months, which is consistent with our view of ongoing modest economic growth and slow healing in the labor market.

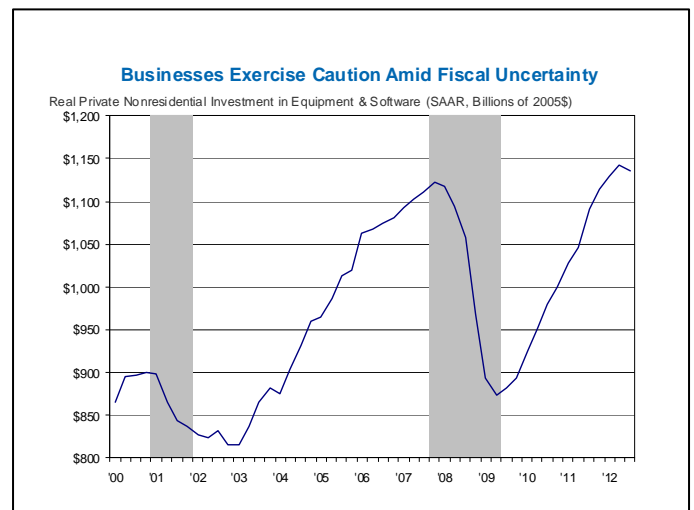
The seemingly upbeat headline from a separate survey of households of a 0.2 percentage point decline in the unemployment rate to 7.7 percent – the lowest in nearly four years – was the result of a substantial drop in the number of workers joining the labor force, which exceeded a decline in employment. Reversing the improvement in the prior month, the labor force participation rate dropped to 63.6 percent from 63.8 percent, just 0.1 percentage point above a 30-year low.

The uncertainty about the fiscal cliff may already have had a negative impact on businesses, inhibiting them from making investment decisions, according to anecdotal evidence. The beige book – a summary of anecdotal information on current economic conditions from the 12 Federal Reserve Districts – indicated that, during the reporting period of October through mid-November, businesses and their customers were waiting for the outcome of federal budget negotiations before making decisions. Most districts reported either a slowdown or a contraction in manufacturing, and some districts reported concern about the 2013 outlook, due partially to the uncertainty regarding the outcome of the fiscal cliff.

The Institute for Supply Management (ISM) manufacturing survey indicated that manufacturing activity contracted in November, with the index declining to the lowest level since 2009. The details were bearish, showing declines in new orders and employment during the month, with the employment component falling into contraction territory for the first time in more than three years. The ISM also noted that survey respondents expressed concern regarding “how and when the fiscal cliff issue will be resolved.”

Businesses have been more cautious in their investment decisions and were visibly hesitant in investing in additional capacity. The revised third quarter GDP report showed that business investment in equipment and software fell for the first time since the second quarter of 2009, when the economy emerged from the recession.

Core capital goods shipments – a gauge of business investment in the current quarter – continued to move lower in October, suggesting another decline in business investment in capital in the fourth quarter. Core capital goods orders, a leading indicator of business investment, suggest some stabilization in coming quarters, as they increased in October at a healthy clip after declining in September for the third time in four months. Given the recent development in the ISM manufacturing survey, a softening in core capital goods orders later in the year is possible, and we remain cautious about business investment trends early next year.

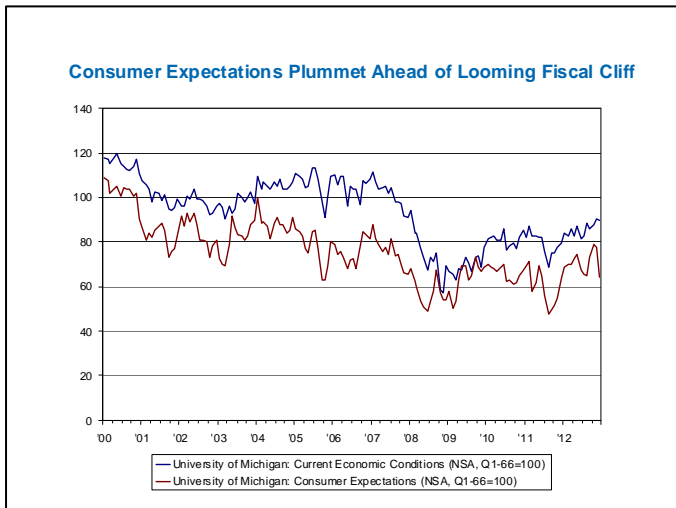


The ISM nonmanufacturing survey showed that the service sector performed much better than manufacturing during the month, expanding at a faster pace in November. A comment in its press release indicated that Hurricane Sandy boosted business activity substantially in the wholesale trade segment, including delivering emergency equipment and supplies to the affected areas.

The drag on economic activity from uncertainties regarding the fiscal cliff is very difficult to gauge, in part due to a discrepancy between business and consumer behavior. Through November, consumers did not exhibit the same degree of caution as businesses – measures of consumer sentiment were largely unfazed by the uncertainty regarding the outcome of the fiscal cliff. The Conference Board’s consumer confidence index rose in November for the third consecutive

month to the highest level in nearly five years, while the Reuters/University of Michigan consumer sentiment index rose for the fourth straight month to a more than five-year high.

However, the gap between business and consumer concern may be narrowing. The preliminary Reuters/University of Michigan survey in early December provided some evidence that the anxiety regarding fiscal matters has started to affect the psyche of consumers, as sentiment plummeted by 8.2 points to its lowest level since August, driven by the plunge in the expectations component, which reached its lowest level since December 2011.



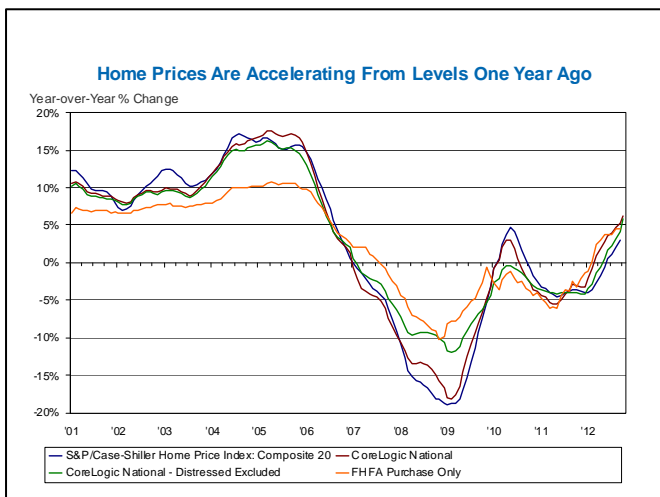
The declines in sentiment were more pronounced for higher-income consumers, with households in the top 10 percent of the income distribution experiencing the largest declines in confidence of more than 20 points. Two sources of bad news cited by consumers were unemployment and possible tax hikes. The Reuters/University of Michigan noted that the elevated level of anxiety about fiscal policy echoed that which was experienced in the summer of 2011 during the debt ceiling debate.

Overall, we expect economic growth in the current quarter to moderate downward from its pace reported in the prior quarter. However, given the effects stemming from Hurricane Sandy and from uncertainties regarding fiscal policy, the near-term picture will remain murky for some time. We believe that the risks to our projected near-term growth of below 2 percent are balanced between upside and downside risks.

Housing: Finally a Tailwind to Growth

The housing market has turned the corner and a sustained recovery is under way. Residential investment has been a positive, albeit small, contributor to economic growth during the past several quarters and will add to growth on an annual basis this year for the first time since 2005. While the current contribution of housing to the economy is small, it is growing.

Home prices have weakened as we entered the seasonally weak fall and winter months; however, year-over-year home price gains have strengthened, helping the healing process in the balance sheets of households and financial intermediaries. For the first time in six years, we expect home prices to end the year on a positive note, with an improving outlook in coming years.



Single-family new home sales were little changed in October amid near-record low levels of new home inventories. The months' supply of new homes was 4.8 months, well below its long-term average of around six months. With a pickup in the rate of household formation from a substantial below-trend pace during the last five years, lean supply conditions create opportunities for new construction, especially in the single-family market, which posted record low housing starts in 2011. Total housing starts rose in October to the highest level since July 2008 on the strength of multifamily construction, which has grown substantially during the past two years in response to rising demand that has pushed vacancy rates lower and rents higher. (For more information on multifamily market conditions, read the [December 2012 Multifamily Market Commentary](#)).

While single-family housing starts were essentially flat following

two back-to-back strong gains, single-family permits, a leading indicator of construction activity, continued to trend up. Single-family permits have not posted a decline since March. Boosted by improving assessments of current sales and expected sales throughout the next six months, home builders' confidence rose in November for the seventh consecutive month, jumping 5 points to a six-year high.

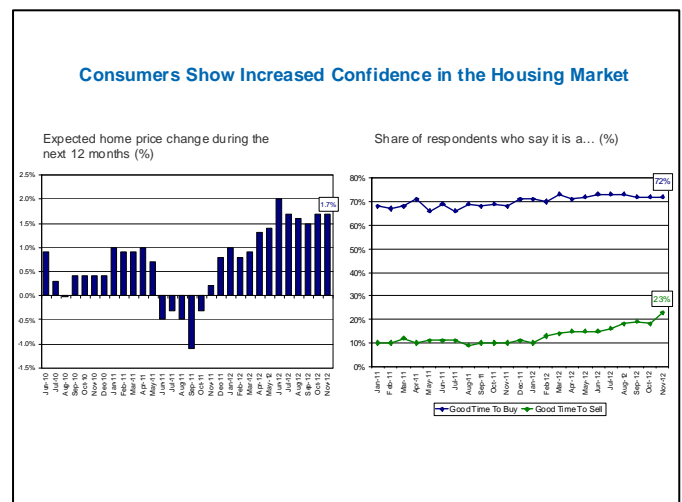
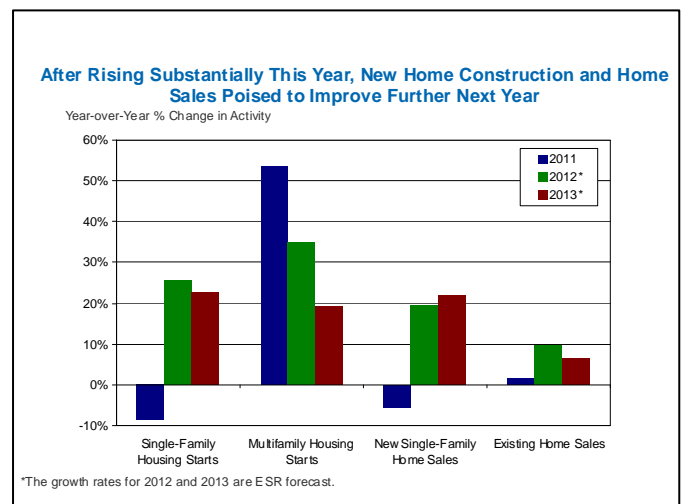
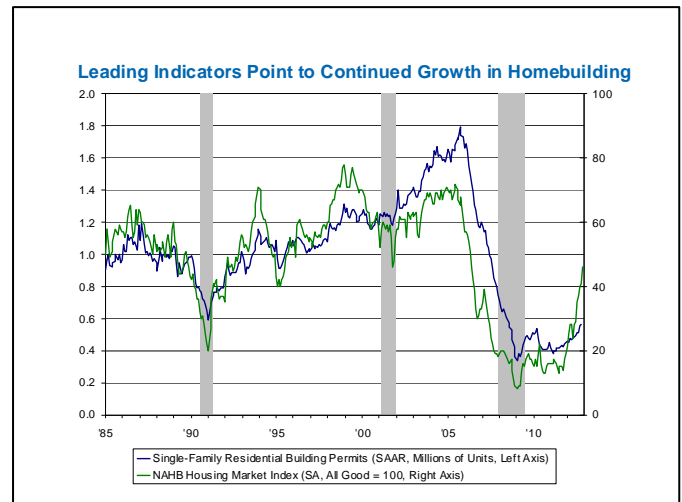
Existing home sales rose in October for the third time in four months, while the months' supply ticked down to 5.4 months – the lowest reading since February 2006. Leading indicators of home sales suggest improving activity in coming months, with pending home sales (contract signings of existing homes) jumping in October to the highest level since early 2010 when the home purchase tax credits were in effect. In addition, purchase mortgage applications have trended up during the past three months, reaching the highest level this year.

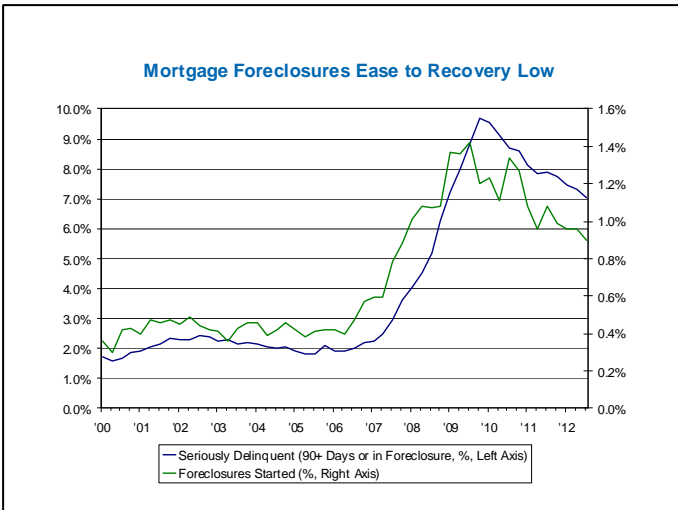
Overall, housing construction activity and home sales are on pace to grow substantially over last year's levels, and we expect further improvement in 2013.

The [November Fannie Mae National Housing Survey](#) showed that consumer attitudes toward both the economy and the housing market continue to gain momentum, with many of the survey's key indicators at or near their record highs since its inception in June 2010.

Another improvement in the housing market is declining shadow inventory, as measured by the serious delinquency rate (includes loans that are 90 days or more past due or are in the foreclosure process), which continued to trend down in the third quarter, according to the Mortgage Bankers Association National Delinquency Survey. We expect the current trend of declining shadow inventory to continue, thanks in part to increased modification efforts and increasing levels of short sales. Furthermore, incremental additions to shadow inventory from newly delinquent loans have been declining, with the new foreclosure rate declining in the third quarter to the lowest level since the end of 2007.

Low mortgage rates will continue to support the housing and mortgage markets in 2013. We expect the Fed to continue to purchase \$40 billion a month in Agency mortgage-backed securities during 2013. In addition, we expect Operation Twist to expire at the end of 2012 as scheduled. In its place, we expect the Fed to continue with a similar-sized program of outright purchases of long-term Treasuries, essentially expanding the Fed's balance sheet with a combined purchase of MBS and Treasuries of approximately \$85 billion a month. Consequently, we expect that the 10-year Treasury yield will rise only modestly from its current level of slightly more than 1.6 percent to about 1.8 percent by the end of 2013, with 30-year fixed mortgage rates gradually trending up to 3.5 percent.





Given our expectations of continued improvement in housing starts, home sales, and home prices in 2013, we project that purchase mortgage originations will rise to \$595 billion from a forecast of \$518 billion in 2012. However, refinance originations should decline to \$956 billion from a projected \$1.3 trillion in 2012, resulting in a refinance share of 62 percent – a drop of 10 percentage points from the projected share in 2012. The Federal Reserve Board’s Flow of Funds showed continued deleveraging in total single-family mortgage debt outstanding, which fell at a 3.4 percent annualized rate in the third quarter of this year. We expect that mortgage debt outstanding will decline an additional 1.0 percent in 2013, following a projected 2.4 percent decline in 2012.

While we believe that the housing recovery will gain momentum in 2013, the housing market will continue to face

challenges. Ongoing tight lending conditions that emerged during the housing downturn have held back home sales despite record high housing affordability. In his speech in Atlanta, Fed Chairman Ben Bernanke expressed concerns that the pendulum has swung too far the other way, preventing creditworthy borrowers from purchasing a home and thereby impeding the economic recovery.

Significant policy uncertainty around the mortgage origination business remains, including the Qualified Mortgage (QM) and Qualified Residential Mortgage (QRM) rules, as well as Basel III rules around capital requirements for Mortgage Servicing Rights (MSRs). The ongoing fiscal cliff debate could potentially change the tax code to limit the mortgage interest deduction and other housing tax incentives. In addition, the Mortgage Debt Relief Act of 2007 will expire at the end of the year if Congress takes no action. Currently, mortgage debt forgiven after a foreclosure or short sale, or through a loan modification, is an exclusion from a taxpayer’s taxable income. We believe a failure to extend the exclusion would negatively affect the housing recovery as it would deter short sales, which have less detrimental effects on home prices than foreclosures, and hamper the Attorneys General settlement efforts in providing loan modification relief to homeowners nationwide.

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