

A Chilly Start to 2014

The big question in the first quarter of 2014 is how much of an impact the cold weather is having on economic activity. No doubt it has been cold across major parts of the U.S., which would explain a slowdown in construction hiring or consumer shopping for example but not necessarily the drop in internet sales, which also fell. We have expected a weaker first quarter due to a couple of factors: a buildup of inventories that exceeded sales levels and the slowdown in home sales due to the rise in interest rates. However, it appears the slowdown may be greater than our expectation. The follow-on question is whether we will see sufficient pickup later to meet our forecast expectation of 2.9 percent real growth in 2014. We think so.

Economic growth closed 2013 on a strong note, thanks to a pickup in consumer and business spending amid a narrowing trade deficit. Both financial markets and home prices had a stellar year, ensuring continued improving household balance sheets. Combined with expected reduced uncertainty regarding government spending and regulation, we built a case in our January commentary for a broad strengthening of growth in 2014. Since then, some cross currents have appeared not just here in the U.S. but in global economic and financial market conditions (more below), though we stand by our expectation for a modest pickup in growth from 2.7 percent in 2013 to 2.9 percent this year amid strengthening private domestic demand.

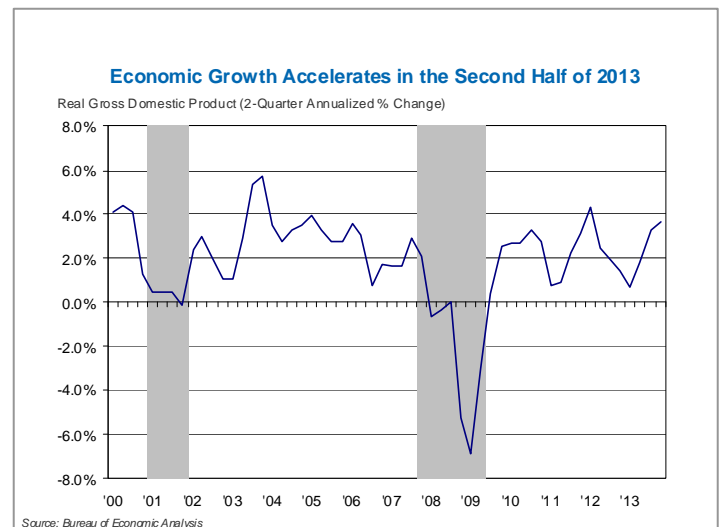
Economic Growth Shifts Higher Late 2013

Economic growth averaged a robust 3.7 percent in the second half of 2013, a figure surpassed only once in the current economic recovery, which is now four and a half years old. Strong two-quarter stretches of growth have occurred previously in this recovery, most notably in 2010 as the heart of the federal fiscal stimulus program was flowing through the economy, and more recently at the outset of 2012, though neither lasted while adding to Federal debt and future tax liabilities. As fiscal stimulus faded in 2011 amid government brinksmanship, so did growth. In 2012, federal tax increases, flagging business investment, and significant declines in government consumption expenditures and investment weighed on the economy, and the strength in growth at the start of the year dissipated.

Real (inflation adjusted) gross domestic product (GDP) advanced at a 3.2 percent annual rate in the fourth quarter according to the first estimate (which we expect to be revised down), after a 4.1 percent surge in the third quarter. A sharp drop in federal government spending (both defense and nondefense), likely a reflection of the October partial federal government shutdown, is believed to have subtracted a full percentage point from growth in the quarter, amid declining real residential investment, which also subtracted from growth for the first time in over three years as a result of the rise in mortgage rates.

On the bright side, growth in real final sales of domestic product—GDP minus inventory accumulation—accelerated during the quarter, driven by the strongest consumer spending growth in three years and the biggest gain in business capital investment in a year. The consumer spending surge was funded by a decline in the saving rate and, since our research shows that real household wealth has yet to have been fully restored, that saving rate is likely to rebound. Also, unless income growth strengthens, the increased saving will be paid for by decreased consumption. Real business investment will reflect the growth rate of consumption most likely.

Meanwhile, a large jump in exports of goods and services coinciding with a modest gain in imports pushed the real U.S. trade deficit to the lowest level in four and a half years, boosting headline growth by 1.3 percentage points. More recent

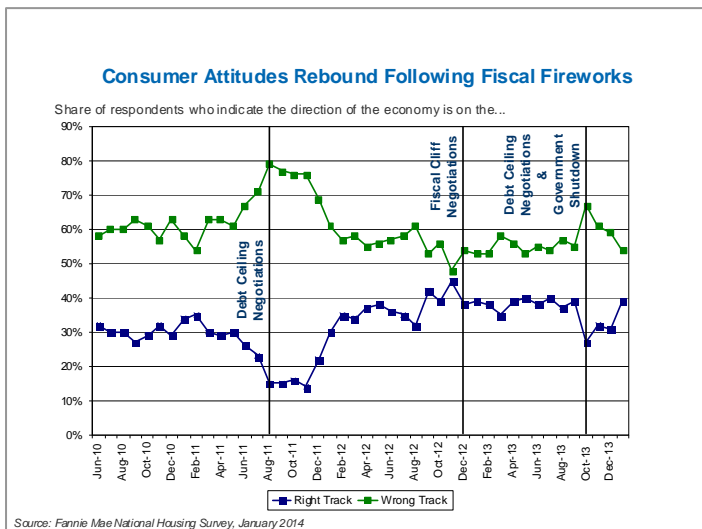


data suggest some downward revision to the boost from net exports during the quarter, however. That said, the growth of domestic energy production will provide trade-related growth benefits though reduced imports of energy products over time. The size of that benefit will depend on how much is absorbed by the import of other goods.

We expect growth in the current quarter to come in at slightly more than 2.0 percent as a correction in the unsustainable pace of inventory accumulation over the second half of last year subtracts roughly 1 percentage point from headline growth. The final first quarter number may be lower if the weather factor is greater than we think. After a tepid start, growth should strengthen toward 3.0 percent for the remainder of 2014, boosted by rising contribution from consumer and business spending as well as housing and a shrinking trade deficit. In addition, for the first time in four years, we project that federal tax increases, government consumption, and investment will no longer weigh on GDP at the margin.

Mixed Consumer Outlook

Despite a partial federal government shutdown and contentious debt-ceiling issues, which took their toll on consumer attitudes in 2013, consumer spending held up remarkably well. Real consumer spending edged up in December despite a host of obstacles, notably a sharp decline in vehicle sales, higher energy prices, disappointing December job growth, and particularly fitful weather during that span. In addition, the recent trend in consumer confidence bodes well for the outlook. Our January 2014 Fannie Mae National Housing Survey showed a broad rebound in consumer attitudes toward the economy during the past few months, and other measures of consumer confidence have shown a similar pattern.

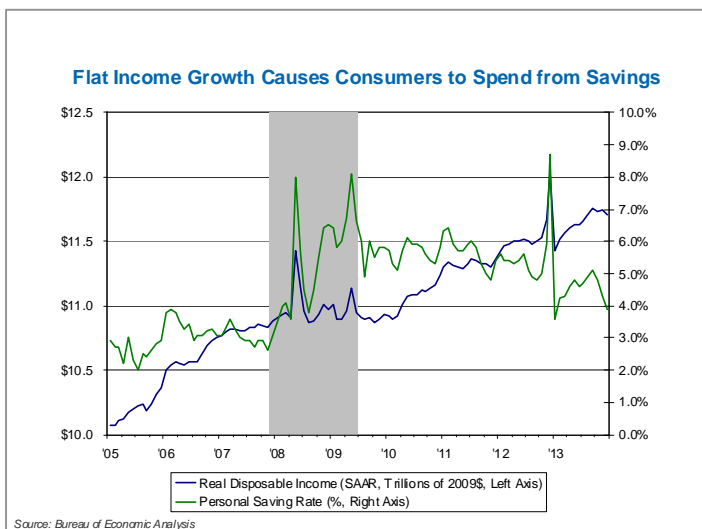


However, incoming data highlighted some downside risks on the consumer side. Strengthening consumer spending during the final quarter of 2013 was accompanied by much weaker income growth. After increasing at a 3.0 percent annual rate in the third quarter, real after-tax personal income increased just 0.8 percent in the fourth quarter. Monthly data showed that the personal saving rate fell to 3.9 percent in December, the only time during the current economic expansion that the rate dipped below 4.0 percent outside of the behavior-distorting change in tax law witnessed at the outset of 2013.

Labor Market Shows Weakness in Hiring

The pace of job growth has slowed in recent months, which bodes ill for the outlook for income growth. After stumbling at year-end with a sub-100,000 increase in total nonfarm payrolls, January's hiring picture remained weak, showing a gain of just 113,000. The lack of a meaningful upward revision for December was disappointing, indicating that the labor market has softened substantially over the last two months. Government employment was a large drag, falling by 29,000. The trend for the private sector was a bit more encouraging, as gains in private payrolls rose to 142,000 from 84,000 in December, though they remained below the robust pace witnessed in prior months. The separate survey of households was more upbeat, showing continued improvement in the unemployment rate, which fell one tick to 6.6 percent amid rising labor force participation.

Over the past several years, the labor market showed this pattern of volatility without dramatically altering the underlying steady pace of job growth. We expect monthly job growth to pick up, averaging above 200,000 over the next year, coincident with improvement in private sector activity.



Global Risk-Off Accompanies Fed Tapering

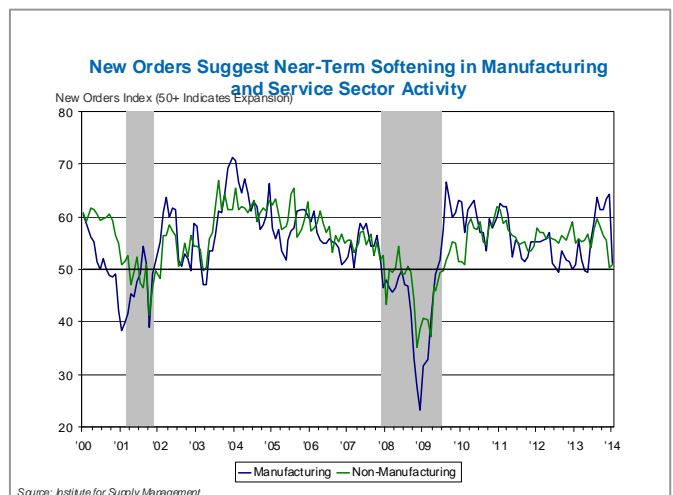
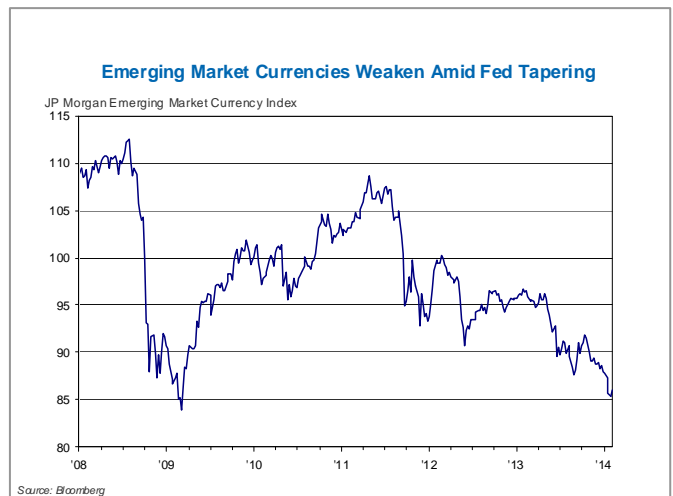
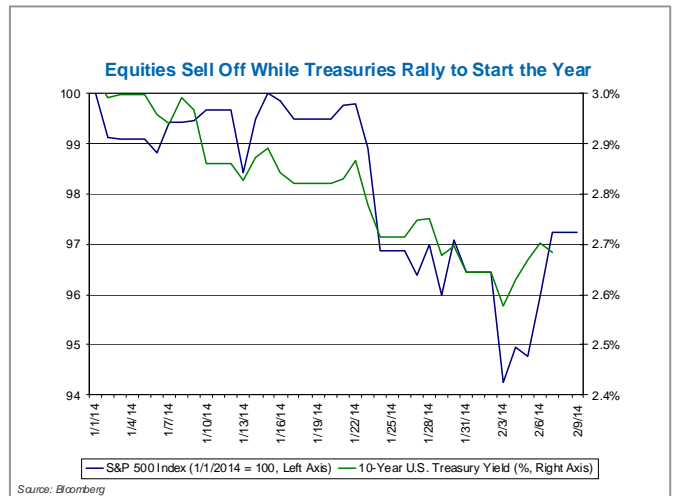
Underscoring the extremely difficult position new Fed Chair Janet Yellen will face as the central bank attempts to withdraw monetary stimulus from the economy was the rocky start to the year in financial markets. The Fed first began tapering at the outset of this year, and this month, the Fed again reduced its monthly purchases by an additional \$10 billion, split evenly between purchases of Treasury notes and mortgage-backed securities (MBS) to \$35 billion and \$30 billion, respectively. Financial markets responded with a broad risk-off—a decrease in risk appetite—with the S&P 500 losing nearly 3.0 percent year to date at the time of this writing, while a rally in U.S. Treasury debt pushed the 10-year Treasury yield from above 3.0 percent at the start of the year to below 2.7 percent. Note: Our corporate forecast process imposes the forward yield curve from the last business day of the prior month on the outlook, which, given the January market response to Fed activity, results in the February forecast reporting a reduction of year end forecast of mortgage rates to 4.7 percent from last month's 5.0 percent.

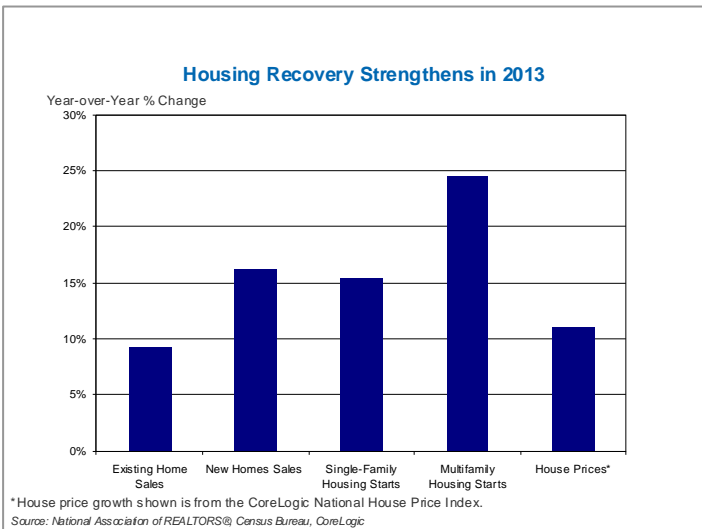
The damage was not contained within the U.S. as capital flight from emerging markets caused broad declines in their relative exchange rates, prompting interest rate hikes in India, South Africa, and in particular, Turkey by 550 basis points to 10 percent. Argentina devalued their currency. Despite some stabilization, emerging market currencies stood only modestly above their trough attained in 2009 during the height of the global financial crisis.

Other factors likely contributed to the sell-off in financial markets, including recent manufacturing surveys of purchasing managers both domestic and abroad. The HSBC China survey of purchasing managers fell into contraction territory in January, underscoring concerns of weak global growth. Meanwhile, the Institute for Supply Management survey of U.S. manufacturing activity showed a sharp slowdown in growth to start the year, particularly in its forward-looking new orders component, which dropped at the fastest rate in more than three decades. While the ISM nonmanufacturing survey showed a faster rate of expansion in the service industry in January, its new orders index has trended lower in recent months. Some of the recent weakness, in the manufacturing sector particularly, may have been a result of the harsh winter weather witnessed across the U.S. However, this could reverse in coming months.

Fading Negative Impact from Fiscal Policy

One of the key assumptions that underlies both our 2014 theme "Private Forces Move to the Fore" and our expectation for strengthening growth this year is waning negative impacts from fiscal policy, including spending cuts, tax hikes, and new regulations. We also anticipated reduced uncertainty from the fiscal front. The Treasury enacted "extraordinary measures" on February 7, which it estimated to run out by February 27, when the U.S. will breach the debt ceiling absent action from Congress. However, Congress and the President reached an agreement with little if any market disruption.

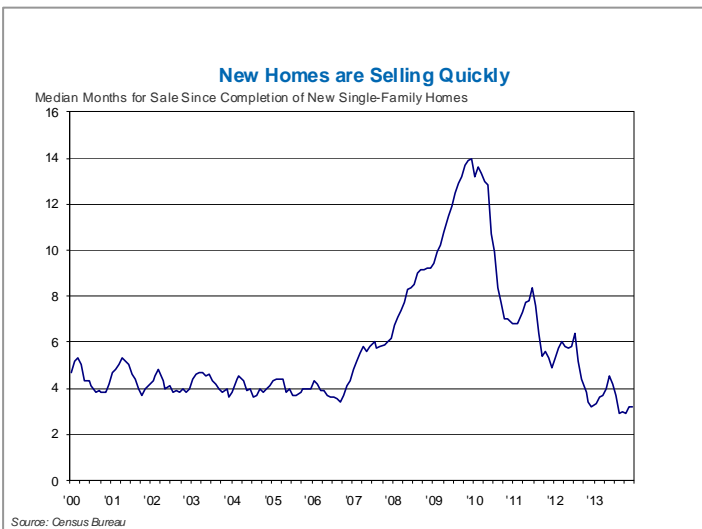




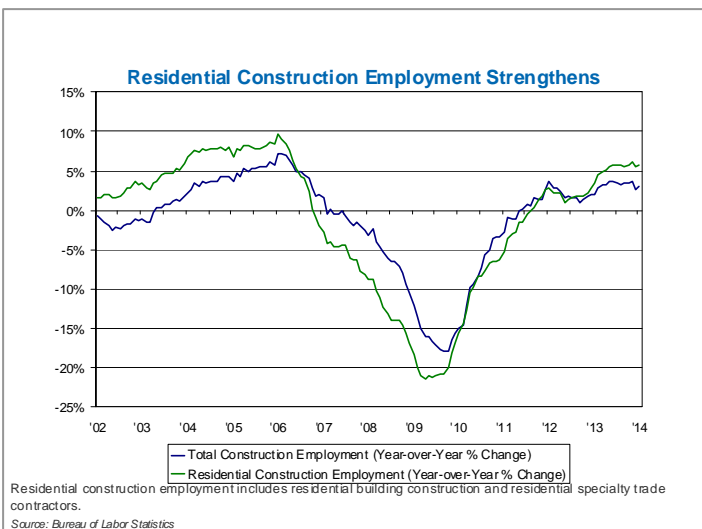
Housing Recovery Continues

While some housing activities weakened substantially from the impact of rising rates—more than 100 basis points over the course of the year—all of them posted sizable gains from 2012.

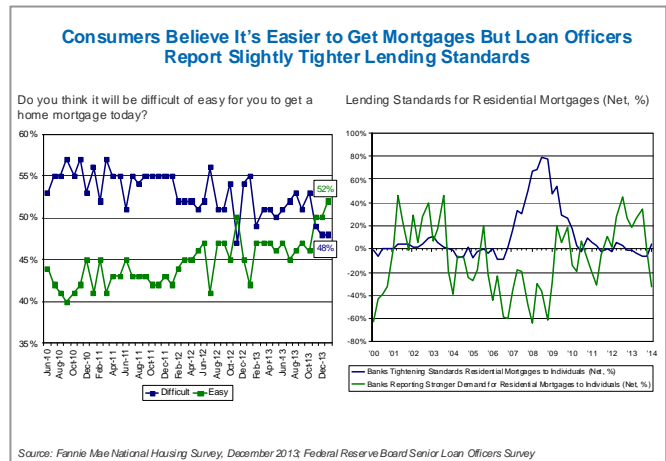
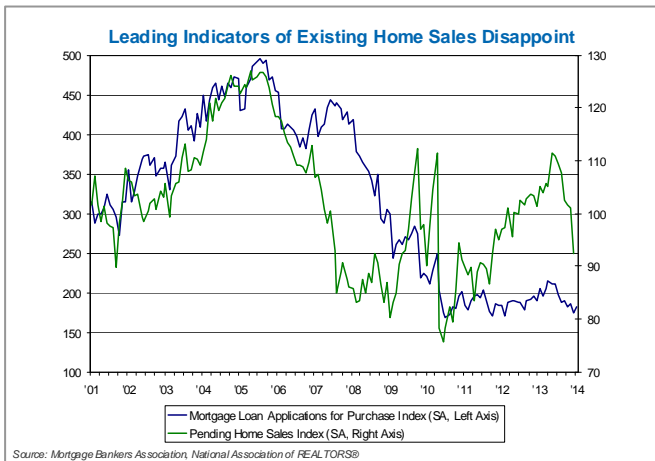
As we mentioned earlier, real residential fixed investment, which consists primarily of residential construction, improvements, and broker commissions, declined in the fourth quarter, and while we expect it to reverse in the current quarter and strengthen through this year, boosted by a pickup in home building activity, the weather may be a factor to the downside. Housing starts were quite volatile over the course of 2013 as steadily improving homebuilder confidence was countered by the mid-year surge in mortgage rates. Though both single-family and multifamily starts edged down in December, the decline followed a remarkable gain in the prior month. (For more information on multifamily market conditions, read the [February 2014 Multifamily Market Commentary](#).) For all of 2013, total housing starts came in at 923,000 units and a healthy increase of 18.3 percent over 2012. Though builder confidence took a small step back in January, supply in the new homes market remains remarkably tight, underscoring our expectation for another double-digit annual gain in housing starts in 2014 to approximately 1.1 million units, with a commensurate increase in new home sales.



A net benefit of improving residential construction will be stronger employment growth. Residential construction employment, which includes residential specialty contractors, increased 17,000 in January and grew in every month last year. Though we don't expect a return to the bubble years when residential construction employment approached 2.5 million, we look for this sector to supplement private sector job growth going forward.



We are much more cautious in the existing homes market, however. Total existing home sales stabilized in December, rising 1.0 percent after three straight monthly declines and hovering near the lowest since October 2012. For all of 2013, existing home sales totaled 5.1 million—a 9.2 percent gain from 2012. Leading indicators give little reason for optimism in the near term. Pending home sales, or contract signings of existing homes, plunged 8.7 percent in December, marking the seventh consecutive drop. A survey of mortgage applications for purchase was not quite as bleak, showing a modest increase through January, though they remained nearly 20 percent below the recent peak in last May prior to the upward shift in mortgage rates. Given recent developments, we expect existing home sales to increase just 1.0 percent this year.



An important foundation underpinning our view on housing is an increase in organic housing demand that is helping to offset the reduced investor footprint in the market. This transition could be rocky, as evidenced by the most recent Federal Reserve survey of senior loan officers who reported deterioration in mortgage demand along with modest tightening of lending standards in early 2014. Though we attribute much of the decline in mortgage demand to recent refi burnout amid a higher interest rate environment, the reversal of the recent trend of modest easing of lending standards will be a cause for concern if maintained. This may reflect the implementation of the new Qualified Mortgage rule and reflect lender caution as they ponder the real impact of the regulation.

For now, a majority of consumers believe that it is getting easier to get a mortgage, according to the [January Fannie Mae National Housing Survey](#), which shows the share of consumers believing it would be easy to obtain a mortgage at a survey-high of 52 percent, building on momentum through the second half of 2013. This is the first time in the survey's three-and-a-half-year history that more consumers believe it will be easier to get a mortgage compared to those who believe it will be harder. We continue to expect no substantial changes in lending standards this year.

Home prices remain a bright spot continuing to support the rebuilding of household wealth. For example, the December CoreLogic house price index continued to increase upwards of 11.0 percent on a year-over-year basis—the 10th consecutive month of double-digit annual gains albeit moderating from prior months. The monthly change turned negative in the fourth quarter—due in part to seasonal factors. We expect home price gains to moderate this year, consistent with our tepid outlook in existing home sales and a reduced investor footprint. Given the tight supply conditions in the housing market, negative price growth in the near-term outlook is highly unlikely.

Long-term interest rates have come down since the start of the year amid two consecutive disappointing jobs reports, the second Fed tapering announcement, and trouble bubbling up in emerging markets. The 30 basis point decline on the 10-year Treasury yield year-to-date has led to a commensurate decline in the yield on 30-year fixed mortgage rates from 4.53 percent at the outset of the year to 4.23 percent at the time of this writing. We continue to expect mortgage rates to edge up at a moderate pace this year amid a strengthening economy and housing market, and slowly normalizing Fed policy. For all of 2014, we expect total mortgage originations to decline approximately 30.0 percent to \$1.28 trillion as a near 15.0 percent rise in purchase originations is outmatched by a sharp decline in refinances. We project the refinance share to fall to 38.0 percent in 2014 from 62.0 percent in 2013. Mortgage debt outstanding should post a modest increase in 2014, breaking a streak of six consecutive annual declines through last year.

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Economic and Strategic Research
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