

Transition to “Normal”?

The beginning of the rebound of housing, along with the fiscal policy decisions already made and those still to be made, gives the sense that the economy is beginning a transition. However, it is unclear where this transition will lead and what type of economic growth path awaits. Some have questioned whether the country has entered a prolonged period of below-potential GDP growth, which they label “the new normal.” Others ask when housing will return to normal.

We believe the “transition to normal” theme will carry through 2013 with profound implications for a number of longer-term challenges facing the country. We intend to analyze a number of aspects of this theme in our forthcoming 2013 monthly forecasts.

Slow Growth Continues in 2013 and 2014

Our forecast is that 2013 and 2014 will exhibit below-potential economic growth. This is despite the fact that we expect the housing rebound will continue and that the economy will benefit from the gradual increased growth of U.S.-based manufacturing, as well as the expansion of domestic energy production.

The “Year of the Political Economy” (our 2012 theme) ended with a cliffhanger—the partial resolution of a substantial fiscal tightening that would likely have ended the economic expansion if fully implemented. That worst-case scenario came off the table at the eleventh hour, when Congress agreed on a measure to avert the full impact of what became universally known as the fiscal cliff. However, the transition past short-term fiscal imbalance in the economy is not complete, as significant decisions remain in the first quarter of 2013.


The release of fourth quarter gross domestic product (GDP) at the end of this month is expected to confirm continued modest expansion, which is now three and a half years old and has yet to bring employment back to pre-recession levels. Despite unexciting headline growth, notable events that occurred during 2012 included: 1) the unemployment rate falling below 8 percent for the first time since 2009; and 2) home prices likely having shown annual appreciation for the first time in at least half a decade coinciding with residential investment posting a positive annual contribution to the economy.

The economy also encountered several headwinds in 2012. The European sovereign debt crisis flared up again during the spring, contributing to a lull in the U.S. labor market similar to what transpired a year earlier. Mother Nature also played a part, disrupting agricultural production with widespread drought and impacting the Northeast economy with Hurricane Sandy. This followed last year’s devastation resulting from the earthquake and tsunami in Japan in 2011. In addition, the contentious debate surrounding the fiscal cliff has carried over from 2012 into 2013 and resembles the debate around the debt ceiling in the summer of 2011, which proved to have a negative impact on consumer sentiment and consumer attitudes about the economy. In turn, the economy continues to grow, but at a slow pace. This begs the question: has the recovery’s slow growth become the “new normal”?

Fiscal Policy Tightens

The U.S. faces a period of fiscal tightening, although the full extent of this tightening is yet to be known. The eleventh hour measure—the American Taxpayer Relief Act of 2012 (ATRA) signed by the President on January 3, 2013—clarified much of the revenue side of the near-term fiscal tightening. However, it deferred the across-the-board spending cuts (sequestration) by two months until the end of February, which coincides roughly with needed action to raise the debt ceiling. In addition, the continuing resolution to fund government operations (passed prior to the election last November) ends at the end of March.

ATRA is broadly in line with our forecast assumptions and suggests near-term headwinds to growth early this year. The payroll tax rate will revert to its previous 6.2 percent level from 4.2 percent for all working Americans and the legislation extended emergency unemployment compensation for one more year. It permanently extended lower- and middle-income



Bush-era statutory marginal tax rates and provided for an indexation for the Alternate Minimum Tax (AMT) threshold going forward.

However, ATRA raised income tax rates and capital gains and dividend taxes on higher income taxpayers, and reinstated curbs on their personal exemptions and itemized deductions (the so-called Pease limitation). It is yet unclear whether such a limitation will have visibly negative impacts on the housing market and charities.

Relative to current policy, these tax hike measures will raise projected revenue by \$624 billion over a 10-year horizon. Overall, we expect these tax increase measures will act as a drag to economic growth, especially during the first quarter of 2013, and we expect the final implementation of the spending cuts will represent an additional drag to growth this year.

ATRA remains only one part of the equation. With decisions about potential sequestration looming and the Treasury having already reached the debt limit at the end of 2012, the debate about spending will likely be a focal point going into the spring. Decisions on these topics will likely have an impact on the short-term and long-term trajectory of the economy.

Monetary Ease Continues

Given the uncertainty surrounding fiscal policy that threatened the economic and labor market recovery, the Federal Open Market Committee (FOMC) took historic action at its December meeting by linking its forward guidance on interest rates to economic outcomes rather than to the calendar. Instead of pledging to keep rates exceptionally low into mid-2015, the Federal Reserve announced that low rates are likely as long as the unemployment rate remains above 6.5 percent, provided that inflation over the next two years is no more than a half percentage point above its 2 percent long-run target.

Our forecast calls for a gradual decline in the unemployment rate over the next several years, reaching 6.5 percent during 2015. Thus, we expect that the Fed will likely maintain its zero interest rate policy through mid-2015, which is unchanged from our expectation prior to the aforementioned switch from calendar-based to outcome-based guidance.

Despite the December FOMC minutes indicating some disagreement about the duration of the current open-ended quantitative easing policy, we expect that the Fed will continue its monthly purchase of \$40 billion of agency mortgage-backed securities and \$45 billion of Treasury securities through the end of 2013. However, the reduction of the central bank balance sheet will likely generate volatility during that transition.

The Real Economy Continues To Grow Slowly

We maintain the view that an expected modest amount of austerity will suppress growth to below 2 percent in the first half of 2013. Once policy makers resolve the short-term fiscal policy problems, growth should accelerate in the second half of 2013 and carry forward into 2014. For all of 2013, we expect that the economy will grow by an inflation-adjusted 2 percent annualized, similar to the estimated pace in 2012, before picking up slightly in 2014.

The seemingly healthy growth of 3.1 percent in the third quarter of 2012 was largely the result of a temporary surge in government spending and inventory investment. The underlying strength of the economy as measured by final sales to private domestic purchasers—the sum of real (inflation-adjusted) consumer and investment spending growth—grew just 1.5 percent, the slowest pace since the end of 2009. We estimate that overall economic growth moderated substantially in the fourth quarter of 2012, due to some payback in the form of a large decline in defense spending and a correction to inventory investment. Some of the slowdown was a result of Hurricane Sandy, which will partially reverse in the current quarter.

However, overall growth during the first quarter of 2013 should remain modest given the front-loaded fiscal drag stemming from the expiration of the payroll tax holiday, which will result in a decline in disposable income and is expected to suppress growth in consumer spending.

Manufacturing Begins To Come Home

Steady gains in manufacturing activity that existed since 2009 subsided in 2012 as the global economic slowdown weighed on U.S. exports. The Institute for Supply Management (ISM) manufacturing index slipped below 50 in June

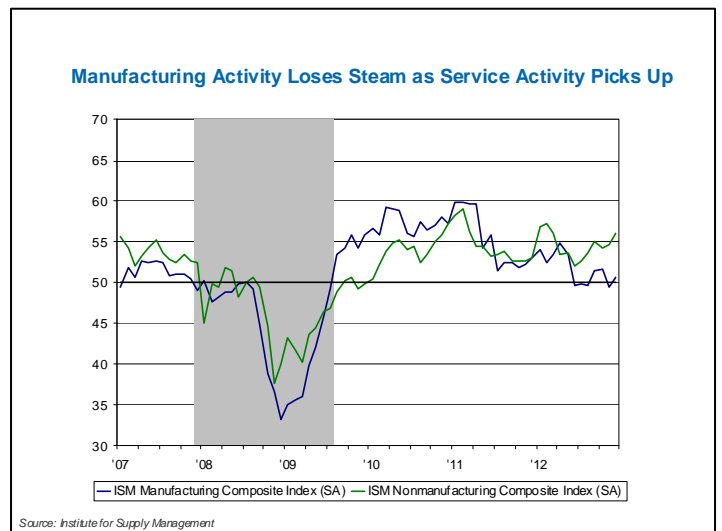
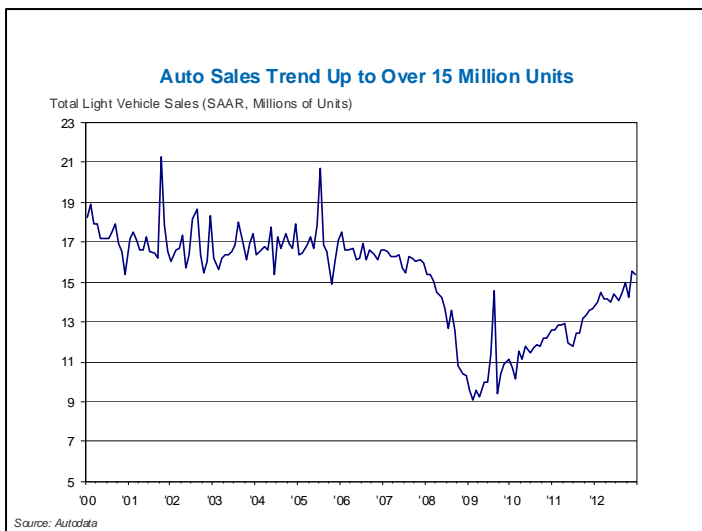
2012—a reading indicating a contraction in the industry—for the first time in the current recovery and stayed in contracting territory for four of the last seven months of the year. While activity ended the year on a positive note, it remained barely in the expansion zone.

The trend in durable goods orders was similar to the ISM index, with year-over-year growth weakening substantially in 2012. After trending down sharply since March, partly because of heightened concerns over the European debt crisis and worries surrounding domestic fiscal issues, core capital goods orders (non-defense capital goods orders excluding aircraft)—a leading indicator of business capital investment—rebounded strongly in November for the second consecutive month.

This encouraging trend suggests that, given more clarity around fiscal policy, businesses may gain more confidence and may be willing ramp up capital investment this year after the lackluster performance in the second half of 2012. This could be even more likely now that ATRA has extended for one more year the ability of businesses to immediately deduct 50 percent of depreciation allowance.

Within manufacturing, the auto industry continued to rebuild with annualized sales passing 15 million units as households moved to replace the oldest rolling stock ever on the roads. This sales pace was last seen in 2008.

By contrast, The ISM non-manufacturing index indicates that the service industry was well into expansion territory during 2012. While activity softened during the spring and summer months, it strengthened in the second half of 2012 and ended the year with the fastest pace of expansion since February 2012.



We expect that foreign demand for U.S. goods will strengthen this year and that the trend in net exports also should improve. While non-residential investment in structures is notably above its level during the recession, activity likely will remain weak in the near term and we expect only modest growth in the sector during 2013.

The bright spot this year will be the housing market, which should provide a rising contribution to overall growth. The housing recovery finally gained traction in 2012 as housing affordability continued to rise for the sixth consecutive year to another annual record high.

Despite ongoing fiscal austerity, improving trends in consumer spending, net exports, and non-residential investment, combined with accelerated residential investment, should help transition sub-par growth onto a stronger growth path in the second half of this year and beyond.

Employment and Income Show a Bit of Progress

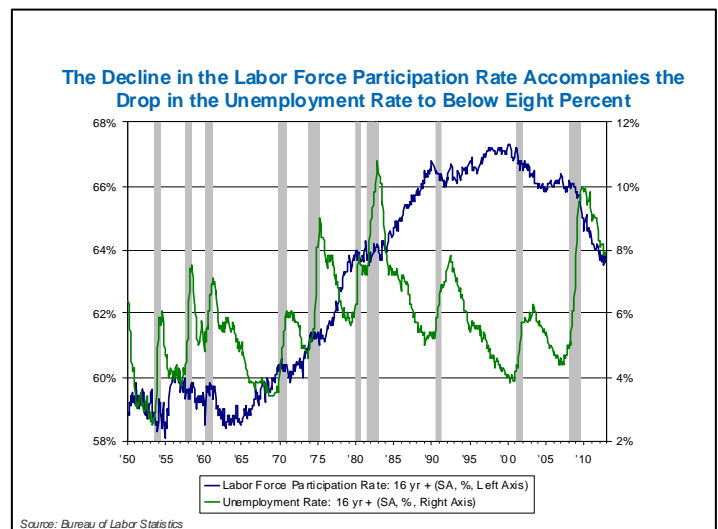
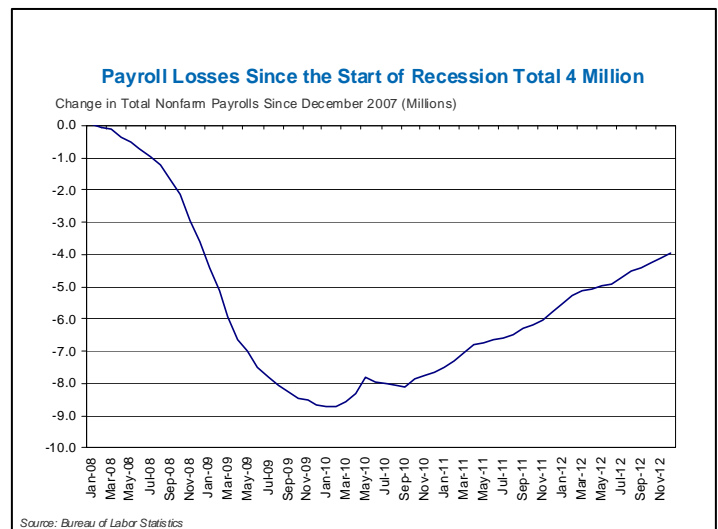
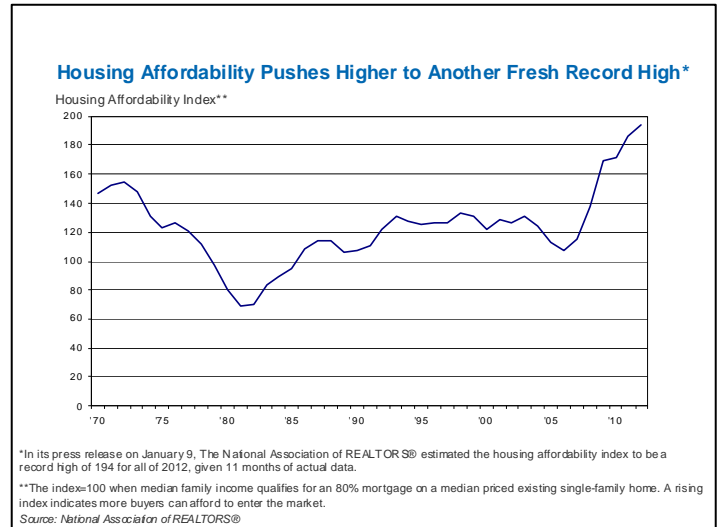
December hiring painted a picture of a resilient job market amid fiscal uncertainty, as businesses closed out 2012 by adding a net total of 155,000 new employees—about the same as the average over the last three- and six-month periods. For all of 2012, the U.S. economy created 1.86 million new jobs after adding 1.78 million jobs in 2011, indicating a gradual improvement in the labor market that is consistent with the modest economic growth witnessed during the year. The loss of 59,000 government jobs in 2012 marked the fourth year of job cuts in the public sector. The slow healing in the jobs market was nowhere near enough to make up for the massive job losses that occurred during the recession. At the end of 2012, businesses employed 4 million fewer workers than they did at the start of the recession.

There was little good news in the household survey, as the unemployment rate was unchanged at an elevated 7.8 percent amid a flat labor force participation rate and a decline in the employment-to-population ratio, which has continued to trend sideways after plunging during the recession.

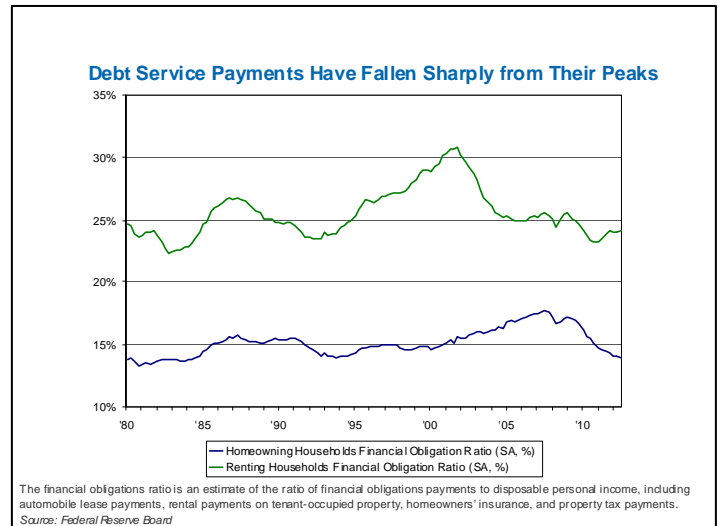
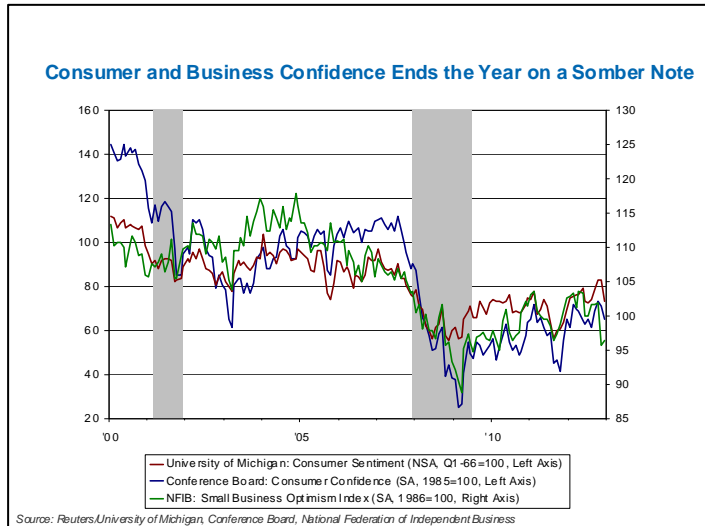
Fortunately, the income picture improved at the end of 2012 with real disposable income increasing 0.8 percent in November, the biggest monthly rise since mid-2009. In addition, the December employment report showed that average hourly earnings were up 0.3 percent for the second consecutive month, the biggest back-to-back increase since the economic recovery began. Combined with a rise in the average work week, average weekly earnings jumped, posting the largest two-month gain since early 2007, before the onset of the recession.

Post Fiscal Cliff, Consumer and Business Sentiment Improve a Bit

The debates on fiscal policy pushed consumer and business sentiment lower during the final month of 2012. The Conference Board's consumer confidence index fell more than six points in December. The drop was still smaller than the Reuters/University of Michigan consumer sentiment index, which fell nearly 10 points during the month. The National Federation of Independent Business (NFIB) showed that small business confidence edged up in December.



However, the small gain followed a plunge in November to a two-year low and the survey's employment indicators deteriorated as the share of firms with job openings ticked down and the share of firms planning to increase employment fell to a nine-month low.



A key driver of the transition to higher growth later this year is consumer spending. We expect consumer spending growth to pick up gradually throughout the year. Several factors contribute to the expected improvement trend, including a more favorable picture of household balance sheets stemming from rising equity and home prices. Household debt burden continued to trend down for both owner and renter households. As a share of disposable personal income, household payments to service various types of debt and to pay for housing-related expenses have dropped sharply since the end of the recession. While some of the decline in debt service reflects charge-offs or some other form of debt forgiveness, the rest is a result of voluntary debt pay-down, record low interest rates, and rising income.

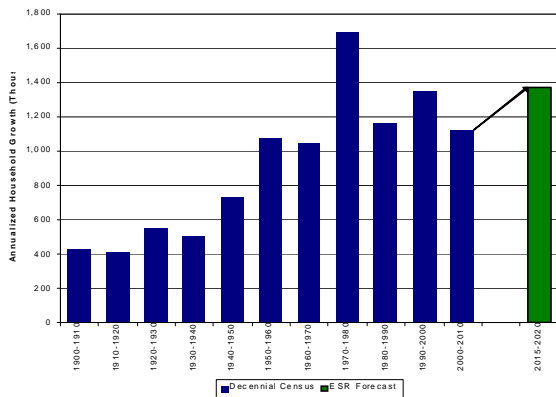
Furthermore, banks have become increasingly willing to extend credit for various types of borrowing, including consumer installment loans and credit cards. The continued healing of the household balance sheet, the declining debt burden, and more favorable lending conditions should combine to reduce households' need to pare down their debt usage and help support consumer spending growth going forward.

Housing is on a Firm Footing Heading Toward Normal

Incoming housing indicators confirmed that the housing recovery is on a faster upward track, with home prices beginning to rebound from their low point in the first quarter of 2012. Continued healing of the labor market and low mortgage rates are key factors driving this recovery. In turn, housing's contribution to economic growth should grow this year and in coming years. New and existing home sales have trended higher and the inventory of homes available for sale has trended lower. Months' supply measures of both new and existing home sales dipped well below their long-term averages, indicating a balanced home sales market. Declining housing inventories amid rising demand has created opportunity for home building activity: both housing starts and permits are on the upswing, with improvement seen in both multifamily and single-family structures. (For more information on multifamily market conditions, read the [January 2013 Multifamily Market Commentary](#).)

Household formation continues to rebound, helping to reduce the homeowner and rental vacancy rates. Lenders have increased efforts to implement short sales and other foreclosure alternatives, helping to support better home price trends. Serious delinquency rates, though still high by historic standards, have gradually declined from their peaks in most areas. Home prices have reflected a more balanced housing market and declining shadow inventory, with annual gains accelerating substantially in the second half of 2012. Improving market conditions have accompanied a corresponding rise

Annual Household Growth Should Bounce Back to More Than 1.3 Million in Second Half of the Decade



Source: Census Bureau, Decennial Census, and Fannie Mae Economic and Strategic Research

in homebuilder confidence. Overall, building activity, home sales, and home prices as well as homebuilder confidence, have risen to multi-year highs.

We expect housing starts to rise by approximately 23 percent in 2013 to 950,000 units following a similar rise in 2012. While this level of activity will remain far below the peak of more than 2 million units in 2005, it will be more than 60 percent above the annual record low in 2010. Last month, the Census Bureau released new population projections consistent with the Decennial 2010 population levels. Using our forecast of the headship rates—the rates that population in various age cohorts will form into households—we project annual household growth of 1.37 million in the second half of the decade.

Demographic Factors Suggest Annual Average of Nearly 1.8 Million New Housing Units in the Second Half of the Decade

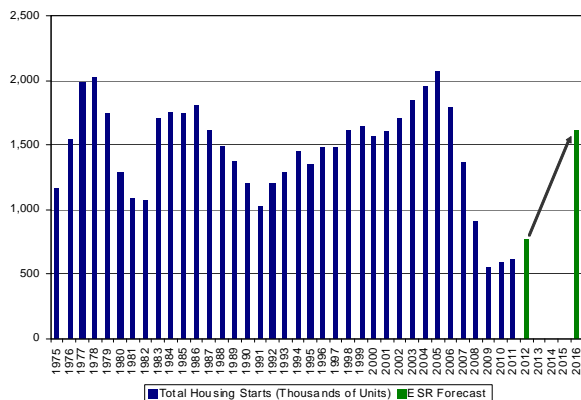
2015-2020	
Demand (thousands):	
Change in Households	1,370
Change in Vacancies	160
Net Removals	230
Total Demand	1,760
Supply (thousands):	
Single-Family	1,260
Multifamily	400
Manufactured	100
Total Supply	1,760

Source: Fannie Mae Economic and Strategic Research

During the same period, we expect an annual increase in vacancy units of 160,000. This component of housing demand includes demand for second homes and vacant homes for sale and for rent required to facilitate the liquid operation of a healthy housing market. Vacancy rates have trended close to their long-term averages.

The third and final component of housing demand is net removals, which include houses lost to intentional demolition and to disasters, such as storms or fires, as well as the net conversion of structures between residential and non-residential use. We conservatively project net removals of 230,000 units per year—approximately 0.2 percent of the current estimate of housing stock. Thus, summing up all the units of housing required for new households, vacant units, and net removals, we expect a “normal” or sustainable housing supply of 1.76 million units of single-family, multifamily, and manufactured homes. (For details on our assumptions for demand projections, please see the [Appendix.](#))

Housing Starts Should Surpass 1.6 Million Units in 2016



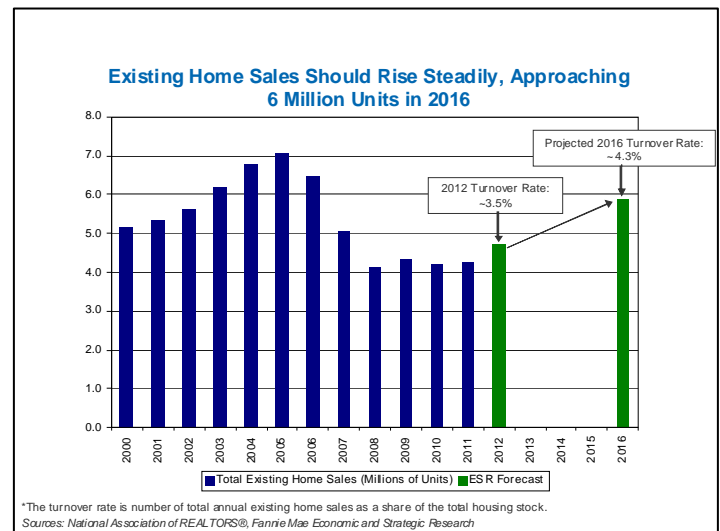
Source: Census Bureau, Fannie Mae Economic and Strategic Research

Our forecast indicates continued rising homebuilding activity, with housing starts activity reaching sustainable levels in 2016. This will mark a 10-year process of transition from the downturn back to normal activity.

We also expect existing home sales to trend up steadily, reaching nearly 6 million units in 2016. That pace of sales implies a 4.3 percent increase in the housing stock, which we believe to be the normal rate of turnover, based on historical trends.

Mortgage Finance Begins a Transition

As mentioned earlier, we expect that the first interest rate hike by the Federal Reserve will not occur until the second half of 2015. As a result, long-term interest rates should increase on a very gradual upward path over the next few years. We expect the yield on the 10-year Treasury note to rise from the current rate of 1.86 percent to 2 percent at the end of 2013 and 2.3 percent at the end of 2014. Mortgage rates also should rise steadily going forward, ending 2013 and 2014 at around 3.8 percent and 4.2 percent, respectively.




The Federal Reserve Board's Senior Loan Officer Opinion Survey shows that a majority of lenders loosened lending standards slightly on mortgages from the tough stance they adopted in 2007. However, standards have been little changed since 2010 and serve to explain part of the only moderate increase in home sales over the past several years, despite record high housing affordability.

We expect that additional rises in guaranty fees in the conventional conforming space and rising mortgage insurance premiums in the FHA space will raise the cost of obtaining mortgages going forward. At the time of this writing, the Consumer Finance Protection Bureau (CFBP) released the ruling on Qualified Mortgage (QM). We will analyze its impact on the mortgage origination business in the next forecast commentary.

One note from ATRA that should have a positive impact on the housing market is an extension of the Mortgage Forgiveness Debt Relief Act of 2007. This provision allows homeowners who experience debt reduction through mortgage principal forgiveness or a short sale to exclude the forgiven amount from taxation. ATRA also extends a law that allowed for the deductibility of mortgage insurance premiums for taxpayers (subject to income).

Policy encouraging refinance activity is likely to wane after 2013. Significant numbers of borrowers are still "in the money"—in a position to benefit financially from refinancing—given their current mortgage terms and will hold the level of refinance activity relatively high across the year. However, the current HARP refinance program terminates at year's end and the Federal Reserve will likely be giving additional guidance on its plans to end quantitative easing, which will start to put upward pressure on interest rates. Thus, we expect 2012 to be seen as the high watermark for refinances and 2013 as the first of several transition years as the housing finance market transitions back to a more normal balance between purchase and refinance activity.

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 \$642 billion from a forecast of \$518 billion in 2012. However, refinance originations should decline to \$961 billion from a projected \$1.4 trillion in 2012, resulting in a refinance share of 60 percent—a marked drop-off from the projected 73 percent share in 2012. We expect that mortgage debt outstanding will decline an additional 0.8 percent in 2013, following an estimated 2.2 percent decline in 2012.



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