“Unusually Uncertain”

In his recent testimony before the Congress, Fed Chairman Bernanke described the economic outlook as “unusually uncertain.” Economists differentiate between risk and uncertainty so the choice of words is particularly interesting. Risk is a condition where the likelihood of an event has some known or estimable probability of occurrence and can be managed, shared, sold, hedged, or treated in some manner. Uncertainty is a condition where such probabilities are unknown. The latter is clearly weighing on the markets today.

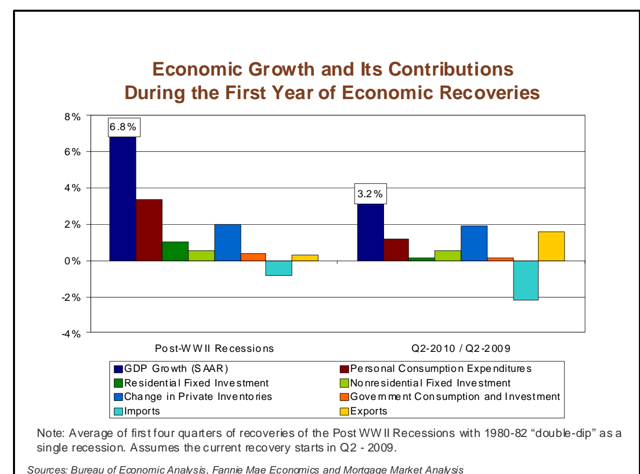
Economic releases during the past month have confirmed expectations that economic growth has downshifted. The latest gross domestic product (GDP) report showed that the U.S. economy lost momentum in the second quarter of this year, growing by 2.4 percent from an upwardly revised pace of 3.7 percent in the first quarter. As expected, the boost to growth from the inventory cycle has about run its course, and the impact of the fiscal stimulus is waning. However, it appears that private demand is unlikely to pick up and replace those weakening drivers of growth, and economic growth is poised to moderate in the second half of the year.

The equity markets remain volatile as investors have become more risk-averse and continue to seek safe haven assets, bringing down Treasury yields. Consumers are more cautious and still are raising savings. And the housing give back, post-tax credit, appears to be worse than most market participants had expected. Businesses are reluctant to hire, especially small businesses, given the uncertainty of demand. They are sitting on their cash, although some large businesses are taking advantage of the low rates in the bond market.

During the last two months, we have downgraded our projected economic growth for this year and next year. Incoming data have confirmed the slowdown projected earlier. We largely maintain the outlook projected in the July forecast, although we have delayed our expectation for the Fed’s next rate hike to the final quarter of 2011. We expect growth in the second half of the year to continue at about the same pace seen in the second quarter, producing modest economic growth of 2.7 percent for all of 2010. We expect growth to remain close to that pace in 2011.

Deeper recession, shallower recovery

The GDP report, which included annual benchmark revisions back to 2006 data, indicated that the recession was more severe than initially reported. Real (inflation-adjusted) GDP peaked in the fourth quarter of 2007 and troughed in the second quarter of 2009, marking a peak-to-trough decline of 4.1 percent, compared with a 3.7-percent drop reported earlier.



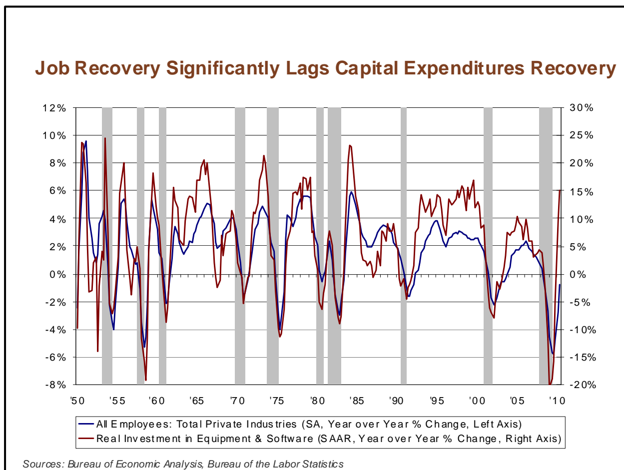
Note: Average of first four quarters of recoveries of the Post WW II Recessions with 1980-82 “double-dip” as a single recession. Assumes the current recovery starts in Q2 - 2009.

Sources: Bureau of Economic Analysis, Fannie Mae Economics and Mortgage Market Analysis

Meanwhile, growth in the early stages of recovery, which most analysts believe to have begun at the end of the second quarter of 2009, was slower than initially estimated. In the past recoveries since the end of World War II, real GDP averaged 6.3 percent in the first year. Assuming that the current recovery started in the second quarter of 2009, the growth rate during the first year of this economic recovery stood at only 3.2 percent.

More boost from business investment, less from consumer spending

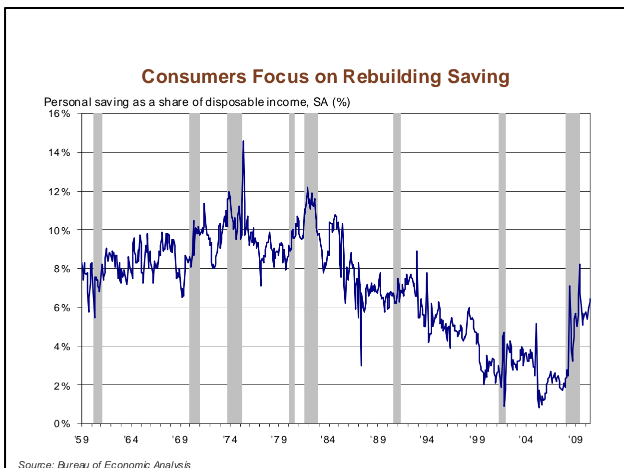
The composition of growth also has changed, with gains coming more from business investment and less from consumer spending than originally thought. With historically strong profits, businesses have ramped up investment in equipment and software at a faster pace than previously estimated. Businesses have been willing to make an ample investment in capital—perhaps to the detriment of labor. Historically, capital expenditures and hiring tend to move together through business cycles. The relationship has weakened in more recent business cycles. For the current recovery, capital expenditures rebounded sharply after a severe decline during the recession while the recovery in private employment has been muted.

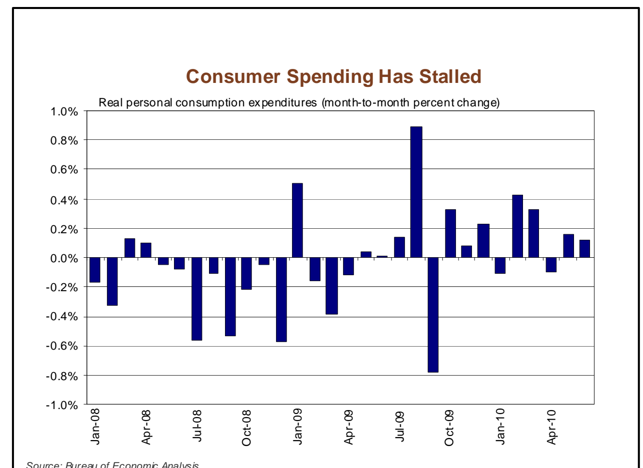


Increased capital expenditures may help prolong the period of rapid productivity growth, allowing businesses to limit hiring, especially in manufacturing. Manufacturing productivity, or output per hour, rose at an annualized pace of 4.5 percent in the second quarter, accelerating from 1.5 percent in the first quarter. This was due to a large increase in output which outweighed a smaller increase in hours worked. Real business investment in equipment and software increased strongly in the second quarter, posting a back-to-back surge of more than 20 percent. A solid gain in core capital goods orders in May and June, a proxy for future equipment and software spending, suggested continued strong growth, albeit slowing, into the second half of the year. Time will tell how the uncertainty regarding the cost and regulatory burden of the recent health care legislation may be driving this near-term shift in the balance of labor and capital.

The recovery has received less of a boost from consumer spending than initially believed. The benchmark revisions boosted personal income levels for each of the past three years while lowering consumer spending, with the biggest downward revision in 2009. As a result, the revisions showed a much higher path of the saving rate than previously reported, suggesting households are further along the process of repairing their balance sheet than was anticipated. However, with the high degree of uncertainty regarding future disposable income, as well as the slow pace of pickup in private sector hiring, the level of saving consumers will aspire to and achieve remains to be seen.

The saving rate has trended up in recent months, reaching 6.4 percent in June—the highest rate in a year. With consumers focusing more on raising the proportion of their disposable incomes that goes toward reducing their debt and accumulating assets, consumer spending growth clearly moderated in the second quarter of this year from the first quarter.





With little momentum going into the second half, we expect spending to remain sluggish for the rest of the year before gradually strengthening in 2011, as household balance sheets will likely have improved materially by then.

The labor market slips off-track

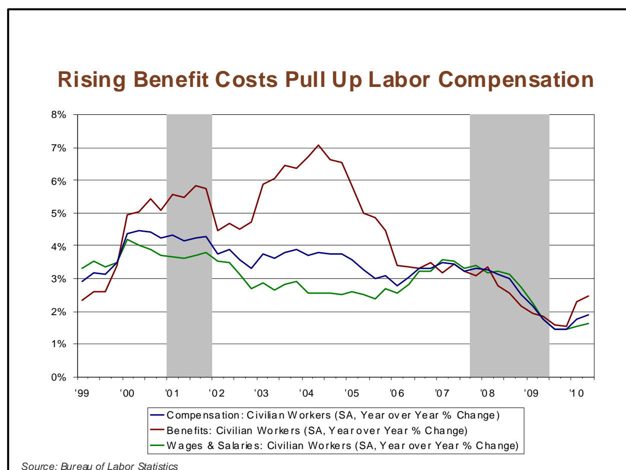
The July employment report was again lackluster. Total nonfarm payrolls fell by 131,000, as the private sector payroll gain of 71,000 was not enough to make up for the government jobs lost, including 154,000 federal government workers (mostly temporary census workers) and 48,000 state and local government workers. Previous months' employment was revised substantially lower. Taking into account revisions to prior months, since the start of the year, state and local governments have shed 169,000 jobs. Given the challenges facing government entities that cannot run budget deficits, further layoffs are in the cards despite the expected aid from the federal government.

The private sector added an average of 51,000 jobs a month during the past three months, compared with a monthly average of 154,000 in the prior three months, indicating a significant loss of momentum in the labor market. It appeared that businesses have been more cautious in their hiring decisions since the start of the European debt crisis. One discouraging sign from the report was that temporary help services, a leading indicator of the labor market, fell for the first time in ten months. Historically, a string of increases in temporary workers was followed by sustained, solid gains in full-time workers. The current conditions of the labor market indicated that businesses are more reluctant to increase hiring to expand their production, and a turnaround in the near term is unlikely.

The July employment report contained some positives. The average work week, another leading indicator of the labor market, resumed its upward trend after sliding in June, and the average weekly earnings rose during the month after staying flat in the prior month. While more hours worked and higher average hourly earnings should help produce a solid gain in July labor income, nominal income for the third quarter will likely be weaker than witnessed in the first half of the year, as the income support from the fiscal stimulus fades.

The unemployment rate, calculated from a separate Household Survey, remained unchanged at 9.5 percent, as both employment and the labor force fell for the third consecutive month. Usually, such weak job creation is not enough to absorb the flow of new entrants into the labor force, pushing up the unemployment rate. However, during this recovery, many unemployed workers have been out of work for so long, they have become discouraged and have dropped out of the labor force. Between May and July, about 1.2 million people have left the labor force. The 0.75 percent drop in the labor force during the three-month period was the biggest since the late 1960s.

With great slack in the job market, employment costs have been subdued. The employment cost index rose 1.9 percent in the second quarter from a year ago. Cost of benefits, which accounts for about 30 percent of the index, picked up 2.5 percent from a year ago, much faster than the 1.6 percent increase in wages and salaries.



Source: Bureau of Labor Statistics

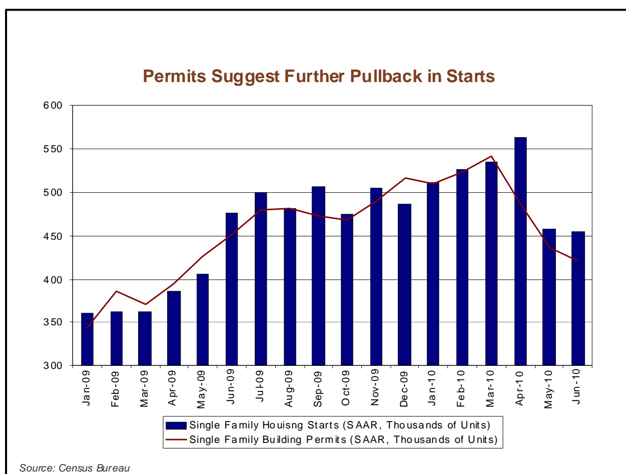
While businesses have cut some benefits to workers, such as 401k matching, they generally continue to subsidize healthcare costs to retain employees. Rising healthcare costs, and perhaps the uncertainty of future liabilities, likely have caused some businesses to be reluctant to add full-time workers. While the year-over-year gain in the overall employment cost index was the largest since the second quarter of 2009, it has been on a decelerating trend since the start of the recession, indicating no inflationary pressure in the labor market. Growth in compensation costs appears to have stabilized and is showing no signs of slipping into negative territory, indicating no imminent deflationary threat.

Unlike manufacturing productivity, which continued to post a solid gain, total nonfarm productivity fell at an annualized rate of 0.9

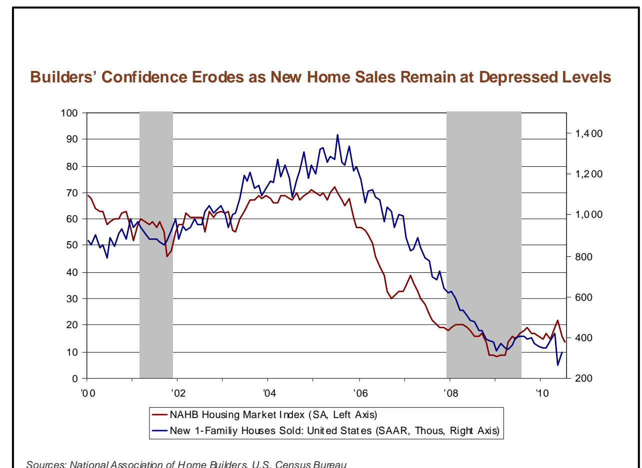
percent in the second quarter, compared with a gain of 3.9 percent in the first quarter. If demand continues to increase going forward, weaker productivity growth will prompt businesses to boost hiring, especially as unit labor costs remain low. For the second quarter, unit labor costs were up only 0.2 percent from the first quarter—the first increase in a year.

Rough road to a self-sustained housing recovery

The expiry of the homebuyer tax credit has triggered renewed declines in housing activity. Single-family starts fell 19 percent in May and were little changed in June. The volatile multifamily starts fell sharply in June after three consecutive gains. Despite recent weakening performance, homebuilding activity has remained above its trough reached in 2009. Single-family starts have remained 26 percent above their record low in January 2009, while multifamily starts have been 76 percent above their record low reached in November 2009. While single-family starts appeared to be stabilizing, their near-term outlook has remained shaky, foreshadowed by their leading indicator, single-family permits, which fell in June for the third consecutive month.

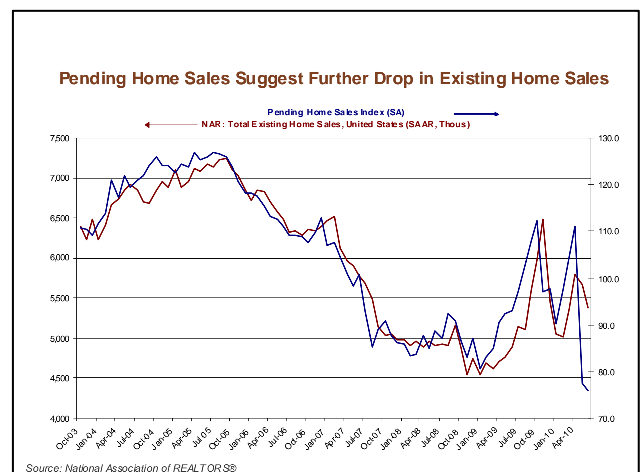


One housing indicator experiencing a double-dip is new home sales. Sales appeared to have troughed in January 2009, gradually recovered, and surged in March and April of this year, thanks to the homebuyer tax credit. By April, new home sales stood about 24 percent above their record low. After plunging 37 percent in May, new home sales set a fresh record low, reaching 21 percent below their previous record low. Sales rebounded in June but have remained below the level in January 2009.

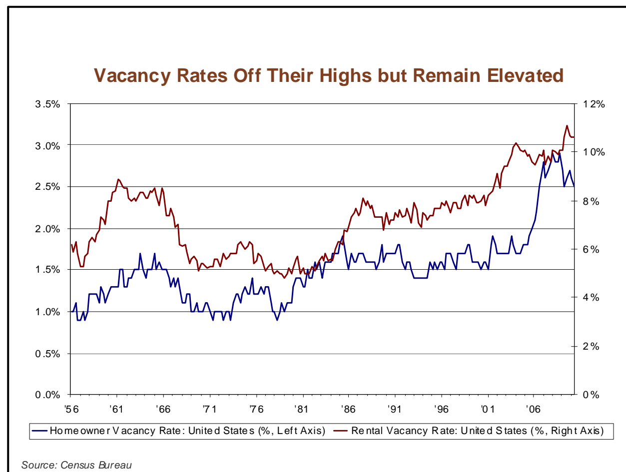


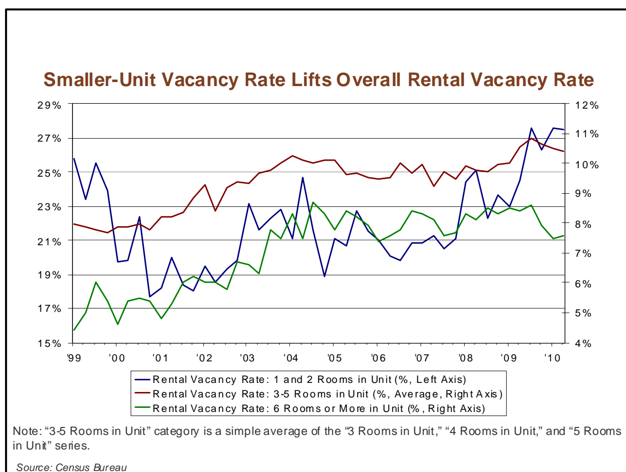
Sluggish homebuying activity, sales, and traffic of prospective buyers since the expiration of the homebuyer tax credit have made builders more wary of the housing market recovery. Builders' confidence fell for a second straight month in July to its lowest reading since April of 2009, according to the National Association of Home Builders/Wells Fargo Housing Market Index (HMI). In addition to soft demand for new homes, obtaining financing for new projects has remained a challenge.

In a beauty contest of two not-so-pretty contestants, existing home sales came out a winner over new home sales. Total existing home sales (including condos) fell in May against expectations of a robust increase, given a jump in April pending home sales (i.e., contract signings). Total existing home sales fell again in June, but the five-percent drop was much better than expected given the thirty-percent plunge in May pending home sales. Usually, pending home sales are a reliable leading indicator of existing home sales, as closings customarily lag contract signings for one to two months. However, with homebuyers rushing to close before the original deadline of the tax credit at the end of June, it could create a backlog, blurring the usually tight relationship between pending home sales and



existing home sales. Existing home sales are expected to decline further in the near term, indicated by the second consecutive drop in June pending home sales.





The excess supply of housing has shown little improvement, according to the Housing Vacancy Survey. During the second quarter of this year, the homeowner vacancy rate continued to edge down from its record high, while the rental vacancy rate held steady at an historically high level.

The details of the rental vacancy rate showed the rates for larger-unit properties have improved substantially during the past several quarters. However, the rate for the 1- to 2-unit properties has deteriorated substantially during the past year.

The rising trend in the smaller-unit vacancy rate sends a cautionary signal. When market conditions show signs of improvement, these smaller units may be put up for sale and compete with owner-occupied units, as some of these units may belong to reluctant landlords. Furthermore, the number of vacant units that are held off market (for reasons other than that they are occasionally used or temporarily occupied by persons whose usual residence is elsewhere) continued to increase sharply for the third consecutive quarter, indicating a greater amount of shadow inventory.

Recent weaknesses in housing activity confirm our projected declines in activity in the third quarter. We continue to expect a modest rebound in activity in the fourth quarter, assuming continued gradual healing of the labor market. For 2010, housing starts are projected to increase by 17 percent to 650,000 units from an annual record low in 2009. Total home sales are projected to be little changed in 2010 from 2009.

Mortgage originations get some boost from refi

Our forecast of mortgage rates in the second half of this year was slightly lower than in the July forecast, with the 30-year fixed mortgage rate yield projected to average about 4.5 percent for the rest of year. This projected level will boost refinance activity for borrowers who are in a position to refinance, have a good credit history, and ample home equity, but the rate is still not low enough to trigger a big refinance boom. With no appreciable changes in projected housing activity and mortgage rates, our forecast of mortgage originations has remained close to the July forecast. For all of 2010, total mortgage originations are projected to decline to $1.45 trillion from an estimated $1.92 trillion in 2009, with a refinance share of 61 percent. Total single-family mortgage debt outstanding is projected to decline by 3.7 percent, accelerating from a 1.9 percent decline in 2009.

Increased policy uncertainties ahead

The Fed chair's characterization of the outlook as "unusually uncertain" suggests that it has shifted from focusing on an exit policy from zero interest rates to searching for options to prevent the recovery from derailing. In his question-and-answer session following his semiannual testimony, Bernanke noted that the Fed was "prepared to take further policy actions" if the economy slows enough to materially push up the unemployment rate. Those actions include being more explicit in its pledge to keep interest rates low, lowering the interest rate on excess reserves from its current 25-basis-point level to encourage bank lending, and expanding its balance sheet by purchasing more Treasuries and/or agency mortgage-backed securities (MBS). Bernanke also suggested that, instead of expanding, the Fed could opt to keep the

balance sheet constant by reinvesting proceeds from maturing MBS into Treasuries instead of letting debt holdings shrink over time as the securities mature, which amounts to a gradual tightening of monetary policy.

Adding to the market's concern about a double-dip recession is a risk of deflation. The deflation debate has intensified as the Consumer Price Index (CPI) fell in June for the third consecutive month, with the core CPI showing a decelerating trend, staying just 0.9 percent above its year-ago level. Other core prices, such as the core personal consumption expenditures (PCE) price index also experienced a decelerating trend. However, the index has shown signs of stabilization, especially in the rental components. The GDP annual benchmark revisions also showed that the core PCE inflation rate path was 0.2 percentage points higher than previously believed. In June, the core PCE increased 1.4 percent from a year ago, remaining close to the Fed's comfort zone of 1.5 percent core PCE inflation.

In his recently released paper, St. Louis Fed President James Bullard indicated that he is now more concerned about deflation and suggested that the Fed's additional purchase of government debt would be more effective than communicating its intention to keep policy accommodative. With a barrage of disappointing economic news, including the July employment report, as well as the deflation debate that is taking place, the financial market has increasingly expected the Fed to do more to support the fragile recovery.

At the Federal Open Market Committee (FOMC) meeting on August 10th, the Fed opted for tweaking its policy stance rather than implementing more stimulative policy measures. The Fed announced that it would reinvest the proceeds of maturing MBS into longer-dated maturity Treasuries. The action is a signal that the Fed acknowledges concerns about the recent slowdown in economic activity; however, it also implies that it expects the economy to gather steam in coming quarters without further monetary stimulus. This will leave the Fed with other tools in its toolkit to employ if the economy fails to revive on its own.

Some market participants also are expecting additional fiscal policy stimulus. However, public support for more spending has declined in favor of a support for fiscal restraint. In the months ahead, Congress has to make decisions regarding the tax burden imposed on businesses and individuals. These decisions include the income tax rates established in 2001 and 2003 that are scheduled to expire at the end of the year and return to higher rates, unless they are extended, as well as the expiration of a number of other business and personal tax provisions. The latter involves the Making Work Pay credit embodied in the 2009 stimulus bill as well as numerous other tax provisions, such as the partial expensing of business equipment, the deferral of business income arising from business debt re-acquisition, and the tax credit for research and experimentation. Uncertainty about the future of monetary and fiscal policy is adding to the many factors weighing negatively on the economy. Despite our recent downward projections to economic growth, the downside risks to the forecast remain dominant.

Global economies contribute to risks

During the last month, the heightened risks associated with the European debt crisis have eased off their peaks, but remain elevated. With nearly $1 trillion in its European Stabilization Fund, distressed sovereign borrowers have a backstop should private markets not wish to finance new borrowings at affordable rates. However, the underlying problems of competitiveness within the European Union have yet to be on a clear path of improvement. In addition, a series of European bank stress tests were released to considerable skepticism about the severity of the exercise. The pullback in hiring on the part of U.S. firms appeared to coincide with the rise in risk associated with this crisis, as companies likely re-evaluated the opportunity for demand overseas and domestic consumers were hit by rising risk premia in the equity market. The European economies themselves have yet to experience a major retreat as a result of the debt crisis and, in fact, business sentiment has improved recently, likely in response to the twenty-percent drop in the euro during the past year, although the single currency has rebounded in recent weeks as the U.S. economy shows increasing signs of a slowdown.

The other major story overseas is China. Concerns about a housing bubble and overheating have led to credit restrictions and GDP growth eased from 11.9 percent year-over-year in the first quarter to 10.3 percent in the second quarter. While still robust, concerns remain of a sharper downward decline in response to policy measures in coming months.

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