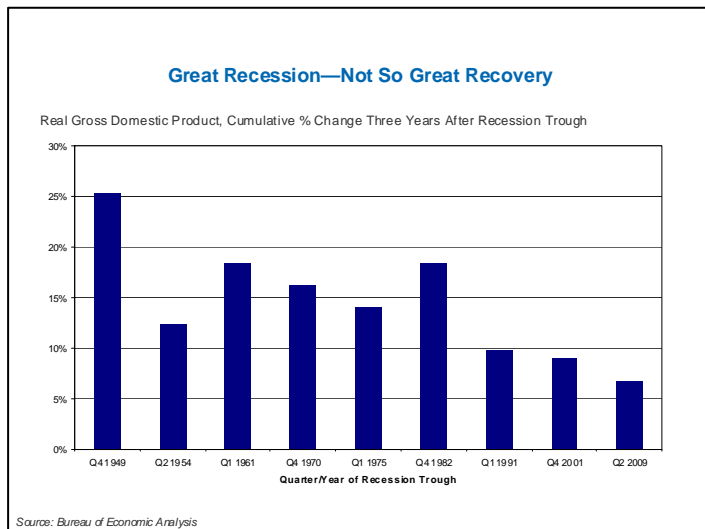


Signs of Improvement Emerge but Outlook Remains Highly Uncertain

Incoming economic reports during the past month point to a pickup of economic growth in the third quarter from the second quarter. However, the improvement is due largely to a downward revision in growth in the second quarter. We see no meaningful improvement in growth in the second half of this year from the subdued pace experienced during the first half, with projected growth remaining below 2 percent. Despite an additional easing by the Federal Reserve, risks remain tilted to the downside. The European debt crisis and looming fiscal cliff and debt ceiling debate continue to present the strongest headwinds to the near-term outlook. With the start of 2013 in sight, there remains extraordinary uncertainty regarding the extent of fiscal contraction, which, if it occurs as mandated under current law, would likely end the economic expansion.

While most analysts, including us, assume a delay or an extension in most of the looming tax and spending changes, no consensus exists regarding how Congress will accomplish such tasks, especially before the election. Following the balloting, current members of Congress, even those who have lost their elections, should return to work by mid-November and serve out their terms until the end of the year. The new Congress will start on January 3, and the next presidential term will begin on January 20. The transitional period before the old and the new Congress, known as the “lame duck session,” makes it extremely challenging for lawmakers to resolve the fiscal cliff issues by year end. We believe that a

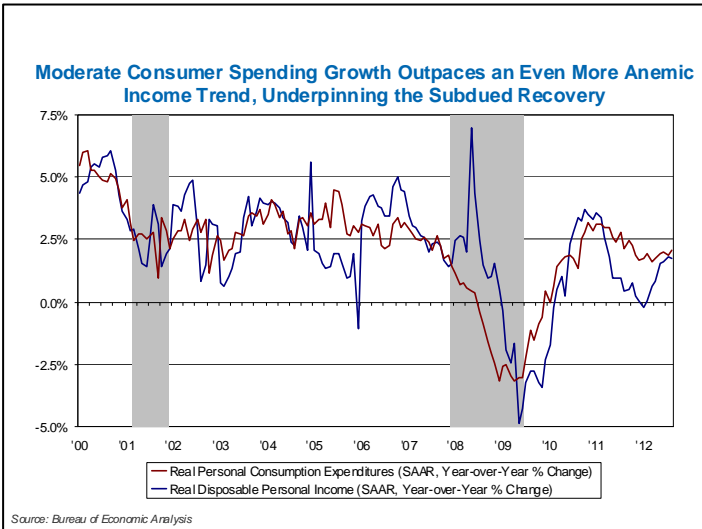


short-term extension is the most likely scenario, but a temporary lapse with retroactive extension next year also is possible. The latter could lead to turmoil in the financial markets and a substantial erosion of business and consumer confidence.

Besides the ongoing crisis in the euro area and uncertainty about domestic fiscal policy, slowing economic conditions in China also have played a role in restraining U.S. economic activity. Chinese economic fundamentals have clearly deteriorated. Its manufacturing purchasing manager’s index (PMI) remained in contraction territory in September for the second consecutive month. Its nonmanufacturing index, while remaining in expansion territory, fell during the month to the lowest reading in nearly two years.

For the U.S., the view from the rearview mirror has gone from bad to worse. The Bureau of Economic Analysis downgraded real (inflation-adjusted) gross domestic product (GDP) in the third estimate to a 1.3 percent annual rate from the second estimate of 1.7 percent. More than three years have passed after the recession ended and the recovery remains lackluster.

The revisions showed a larger drag from inventories, mostly reflecting the impact of the drought, which lowered farm inventories, as well as a downgrade in consumer spending and exports. Real consumer spending growth slowed by about 1 percentage point from the first quarter to 1.5 percent annualized in the second quarter. Incoming data suggest a slight pickup in the third quarter. Both personal and disposable income grew 0.1 percent in August for the second consecutive month, while consumer spending rose 0.5 percent, the biggest gain since February. As a result, the saving rate fell 0.4 percentage points to 3.7 percent. Nondurable goods spending led nominal spending growth for the second straight month, as consumers spent more on gasoline. Adjusted for inflation, real spending eked out a gain of just 0.1 percent, the same as its average monthly gain throughout the past six months. During the past year, consumer spending has been running ahead of after-tax income. While auto sales posted a robust gain in September, real consumer spending growth likely remained below 2 percent for the second consecutive quarter.



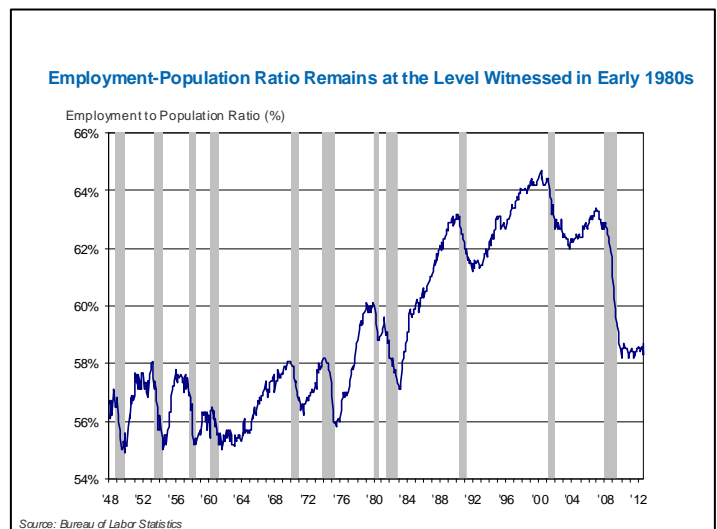
The Fed's preferred inflation measure—the price index tied to consumer spending—rose 0.4 percent in August from the prior month, the fastest pace since March 2011. From a year ago, prices rose 1.5 percent, well within the target of 2 percent. The gain was driven by a surge in gasoline prices in August, which remained elevated through mid-September. Since then, the price of crude oil has slid, improving the outlook for gasoline prices and headline inflation in October, providing more support to consumers.

The outlook for consumer spending depends most importantly on earnings, which improved in September, according to the September jobs report. The report painted a picture of solid improvement in the labor market. While the total nonfarm payroll gain came in at an unspectacular 114,000—a three-month low—revisions added 86,000 jobs

to the prior two months, sending the third quarter average monthly gain to 146,000, a sizable pickup from 67,000 reported in the second quarter. After a long period of layoffs in the government sector, government payrolls rose in September for the third consecutive month, reflecting the upward revisions of payrolls in July and August, which were due solely to hiring in the public sector. The report showed that both average hourly earnings and the average workweek increased 0.3 percent, implying strong income gains at the end of the third quarter. Combined with an earlier report of the preliminary 2012 benchmark revision showing an additional net payroll gain of 386,000 during the 12 months ending in March 2012, the September jobs report provides another sign of an improving picture in the job market.

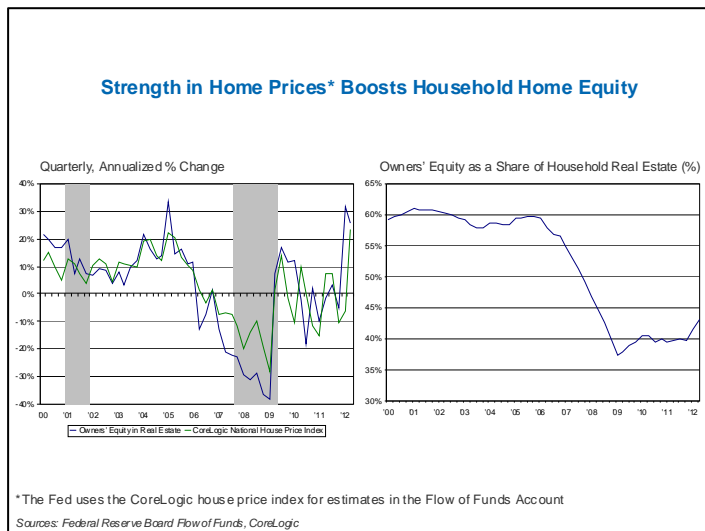
The huge upside surprise for the labor market is the 0.3 percentage point drop in the unemployment rate, calculated from a separate survey of households, to 7.8 percent—the lowest since the start of 2009. Unlike the 0.2 percentage point dip in the unemployment rate in August, which was due entirely to a plunge in the labor force, the September decline occurred amid a gain of 873,000 in household employment that more than doubled the rise in the number of people joining the labor force. The labor force participation rate ticked up to 63.6 percent, boosting the employment-to-population ratio by 0.4 percentage points to 58.7, the highest level in more than two years. Since the start of the last recession, the ratio has plummeted, falling by almost 5 percentage points. Despite the recent uptick, the ratio remains in territory last seen in the late 1970s and early 1980s, when women's labor force participation rates were much lower, a condition that underscores Fed Chairman Ben Bernanke's "grave" concerns.

One not-so-encouraging piece of news from the household survey was a surge in the number of people working part-time for economic reasons. The broadest measure of the unemployment rate, which includes discouraged workers (those who would like to work but are not actively looking for jobs and thus considered out of the labor force) and part-time workers for economic reasons (those who would like to work full-time but cannot find full-time jobs), remained unchanged at 14.7 percent. The household survey has a small sample of about 60,000 households and volatile month-to-month movements are not uncommon. During the past three years, the number of part-time workers for economic reasons jumped during the month of September by at least 400,000. However, in both 2010 and 2011, that number subsequently plunged in October, reversing most of the September gain.

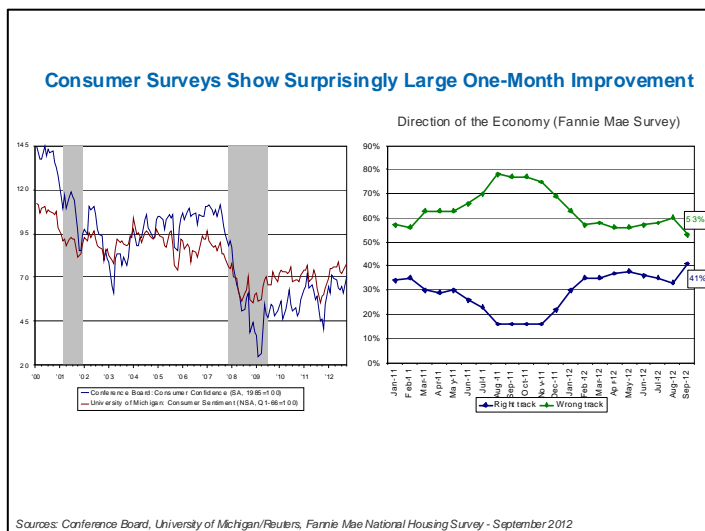


Until households are sufficiently satisfied with the condition of their balance sheets to increase their debt usage once again, consumer spending growth will remain restrained by developments in the labor market and the income trend. The Fed's Flow of Funds showed that households have made some progress in repairing their balance sheets during the current recovery. During the second quarter, household net worth slipped after large gains in the prior two quarters, dragged down by declining financial assets. For real estate assets, single-family mortgage debt outstanding declined for the 17th consecutive quarter, which also reflected non-voluntary deleveraging from charge-offs and, to a smaller extent, short sales and loan modifications. Meanwhile, homeowners' equity posted a strong gain in the second quarter for a second consecutive quarter, thanks to improving home prices.

The increase in the CoreLogic house price index (the series used in the Flow of Funds) in the first quarter, and to a greater extent in the second quarter, resulted in an increase of \$863 billion in homeowners' equity during the first half of this year. Consequently, owners' equity as a share of total real estate assets rose more than 3 percentage points to 43.1 percent between the end of 2011 and June 2012. While the share remains well below the peak of more than 60 percent in early 2001, it has trended up from a record low of 37.2 percent in early 2009.



Because residential investment as a share of GDP has declined to just slightly more than 2 percent, the contribution of housing to the economy has greatly diminished. However, rising home prices and home equity also can help boost consumer confidence. Measures of consumer confidence have recently shown substantial improvement. The Conference Board consumer confidence index surged to the highest level since February, boosted in part by more optimistic assessments of current and future labor market conditions. Similarly, the Reuters/University of Michigan consumer sentiment index rose to the highest reading since May, due to more favorable prospects for the economy and for jobs in the coming year. Consumers also reported a modest improvement in their financial situation, resulting from a reduction in their debt levels and an increase in the value of their assets stemming from rising stock prices and home values.



The Fannie Mae National Housing Survey also showed that consumers were much more upbeat about the general direction of the economy in September, with 41 percent saying the economy is on the right track, up 8 percentage points from August. Meanwhile, 53 percent believe the economy is on the wrong track, down by 7 percentage points from the prior month. As a result, the right track/wrong track gap narrowed significantly to just 12 percentage points. Both the right track and wrong track figures mark the highest and the lowest readings, respectively, since the survey began in June 2010.

Besides a marked improvement witnessed in several surveys of consumers, surveys of manufacturing and service sectors also indicated strengthening activity in

September. The Institute for Supply Management (ISM) manufacturing survey rose to expansion territory for the first time in four months, while the nonmanufacturing survey rose for the third consecutive month.

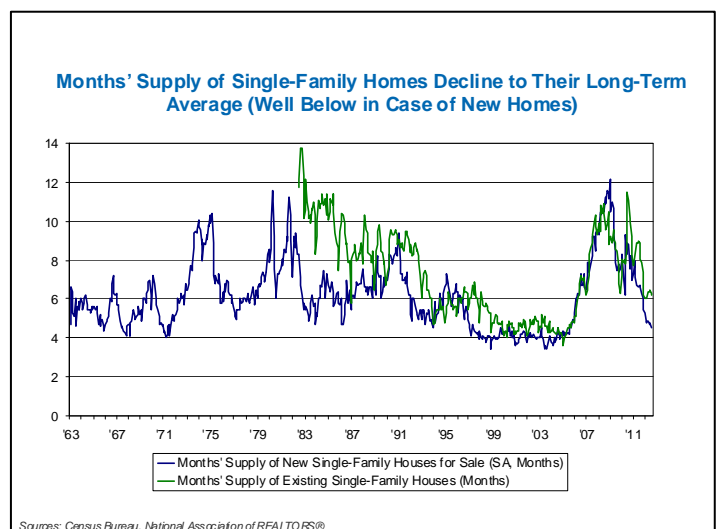
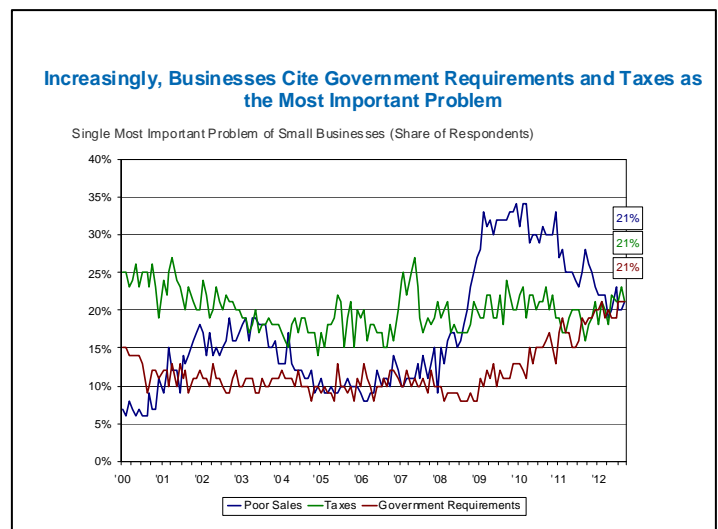
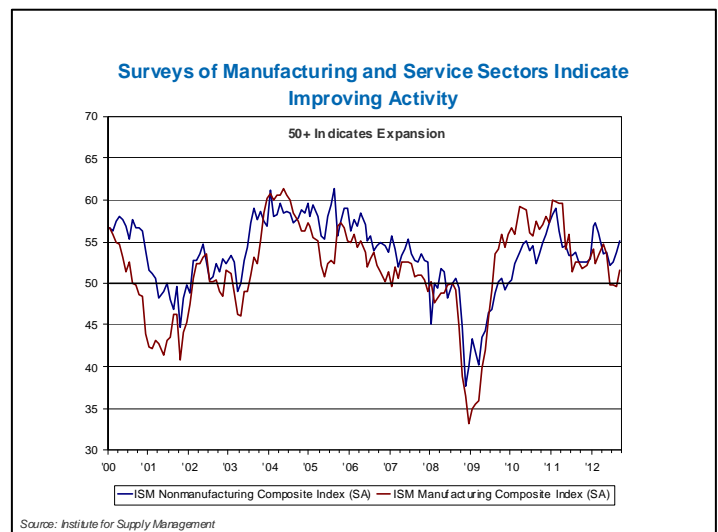
However, while some aspects of the economy improved, others deteriorated. The Business Roundtable's CEO Confidence Index tumbled in the third quarter from the second quarter. From the small business side, confidence was essentially unchanged in September, according to the National Federation of Independent Business (NFIB) Small Business Optimism Index. Survey details were mixed, with businesses reporting lagging sales and profits. The net percentage of small firms planning to hire in the next six months fell considerably from August, and the net share planning to make capital expenditures also slipped. However, small companies are slightly more optimistic about the future. The net share saying the economy will improve during the next six months climbed into positive territory for the first time since February 2011. As sales concerns have eased during the past several months, small businesses have increasingly cited government requirements and taxes as their most important problem.

The anecdotal improvement in September's survey data come on the heels of a softening trend in August. All major components of industrial production posted declines, with factory production plunging 0.7 percent. Durable goods orders also plummeted in August, and details on core capital goods orders—a leading indicator of business investment in equipment and software—signaled a further retreat in business spending, which was one of the components of strength at the early stages of the recovery. The slowdown in capital expenditures occurs at the same time that nonfinancial businesses are cash-rich and in well capitalized positions.

Overall, during the second half of the year, consumer spending growth, while hardly robust, will remain the biggest driver of GDP as it was during the first half of this year and in 2011. Residential investment, nonresidential investment (both in structures and equipment and software), and net exports will provide modest support to growth—similar to their contribution in the first half of this year—while government and inventory investment will continue to be a drag. For all of 2012, we expect economic growth to come in at 1.7 percent, moderating from 2.0 percent in 2011.

Housing: The Budding Recovery Poised to Firm

Housing indicators continue to show positive signs. Existing home sales jumped in August, while new home sales held relatively steady at the highest level in more than two years. During the first eight months of this year, sales of existing homes were up 9 percent from the same period last year,



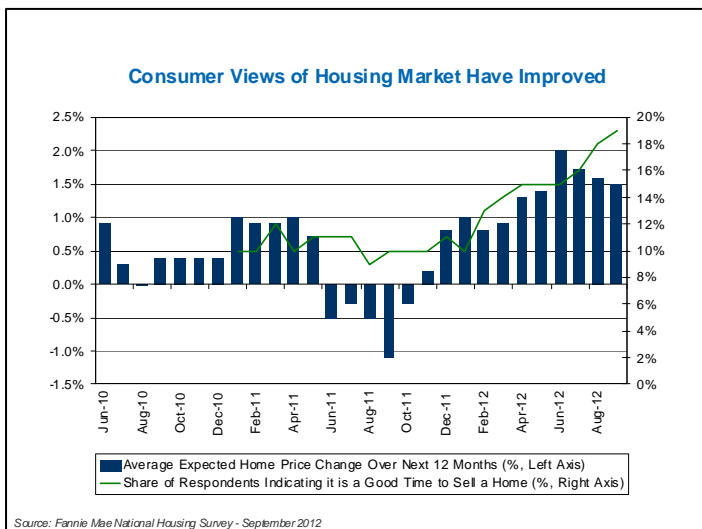
compared with a 22 percent gain for sales of new homes. The months' supply of existing homes (not seasonally adjusted) dipped to 6.1 months, its approximate long-term average, while for the months' supply of new homes fell to 4.5 months, the lowest reading seen since 2005 and well below its long-term average of 6.2 months.

The low level of inventories of new homes bodes well for home building activity, allowing a sizable year-to-date gain from last year, with multifamily performing substantially better. (For more information on multifamily market conditions, read the [October 2012 Multifamily Market Commentary](#)). Total housing starts moved higher in August, solely because of a healthy gain in the single-family segment, while home builders' confidence continued to improve in September to a six-year high.

As housing inventory continued to grind lower amid increased sales, home prices posted strong increases in the second quarter and continued to rise going into the third quarter, albeit at a slower pace. The strength in the recent home price trend reflects both improving fundamentals as well as seasonality, which causes the share of distressed sales to decline in the spring and summer months. We expect to see some deterioration in home prices as we move into the winter months, but we continue to believe that prices reached bottom in the first of quarter of this year. Given better than expected performance in actual home prices in the first half of this year, our current home price forecast is slightly more optimistic than in the prior forecast, especially for this year and next.

The pace of liquidations of distressed properties is expected to moderate during the next year, thanks to aggressive modifications, the 50-state Attorneys General settlement, and rising short sales activity. This should help bring the level of shadow inventory down, reducing downward pressure on home prices. The improvement will likely be uneven across regions and price ranges. Home prices in non-judicial states, such as Arizona and California, should recover more quickly than those in judicial states, as it takes a much shorter time period to clear the distressed inventory. Similarly, homes in the lower-end price range, which are attractive to investors, should continue to perform better than those in the higher-end range. The high-end housing market relies largely on organic demand, which has improved only gradually, as reflected in the relatively flat trend in purchase mortgage applications.

The September Fannie Mae National Housing Survey showed continued modest improvement for housing. Consumer expectations indicate a firmer conviction that house prices have bottomed, in line with our expectations. Consumers' home price change expectations have remained positive for nearly a year. In addition, the share expecting home price declines has stabilized at a survey low of 11 percent during the past three months.



The survey also showed a sharp drop in mortgage rate expectations among survey respondents, with 33 percent expecting mortgage rates to go up during the next year, a decrease of 7 percentage points from the prior month. The huge one-month decline was not surprising following the Fed's actions at the Federal Open Market Committee (FOMC) meeting on September 12-13. The Fed announced another round of quantitative easing (QE3)—open-ended purchases of \$40 billion a month of agency mortgage-backed securities (MBS) until the economic conditions, especially the labor market, improve substantially—as well as a delay in the expected interest rate hike through mid-2015.

Given our forecast of a gradual healing of the housing market, it implies that the Fed will likely continue to expand its balance sheet through all of 2013 and perhaps well into 2014, adding approximately a trillion dollars to its portfolio through new purchases (excluding reinvestment of MBS pay-downs and maturing MBS). This should create a massive demand in MBS, drive up their prices, reduce their yields, narrow the secondary mortgage spreads significantly, and effectively drive primary or retail mortgage rates lower. Following the Fed's announcement, yields on 10-year Treasuries rose to a four-month high of 1.88 percent but have

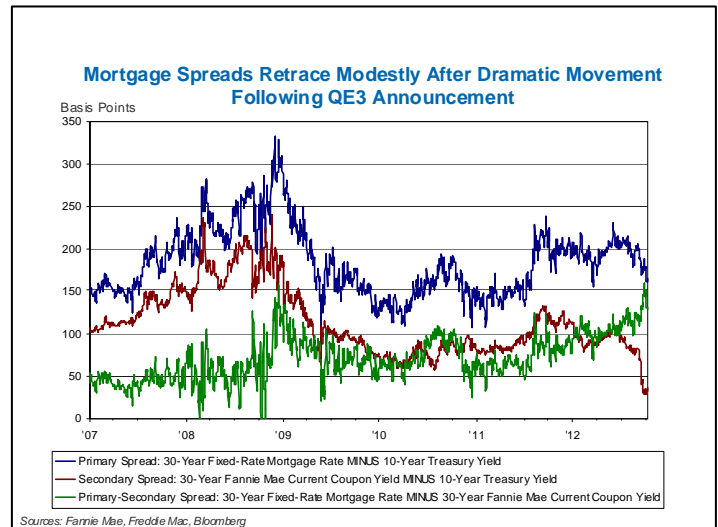
retraced since and hovered around 1.7 percent at the time of this writing. Mortgage spreads also narrowed dramatically. While they have widened somewhat recently, they have remained extremely tight.

We keep our forecast of the 10-year Treasury yield the same as the prior forecast but lower our projected mortgage rates, with the 30-year fixed mortgage rate gradually rising to 3.5 percent by the end of 2013, about 20 basis points lower than the prior forecast. Capacity constraints in the industry and future increases in g-fees will play an important role in influencing mortgage rate trends.

While we do not expect QE3 to result in a meaningful improvement in the labor market, we expect generationally low mortgage rates to provide strong support for refinance activity. Increased refinance activity would free up discretionary income for households, allowing them to spend more, save more, or pay down their debt. While using the extra cash flow to increase saving or to pay down the debt does not lead to increased demand for goods and services in the short run, it allows households to strengthen their balance sheets, positioning them for spending more in the future. Given continued tight lending standards and a slowly improving job market, lower mortgage rates will benefit the purchase mortgage market to a much lesser extent. We expect home sales to rise approximately 9 percent this year—little changed from the prior forecast.

As a result of an annual benchmark to recently released data from the 2011 Home Mortgage Disclosure Act (HMDA), we revise higher our estimate of total mortgage originations in 2011 by about \$135 billion to \$1.5 trillion. In addition, given the renewed decline in mortgage rates, we also revise higher originations for 2012 and 2013. For all of 2012, we project that total single-family mortgage originations will rise by about 20 percent to \$1.8 trillion—more than \$200 billion more than the prior forecast, largely because of an upward revision in refinance originations. The refinance share should rise to 71 percent from 66 percent in 2011. Total single-family mortgage debt outstanding should decline by an additional 1.7 percent following a 2.4 percent decline in 2011.

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