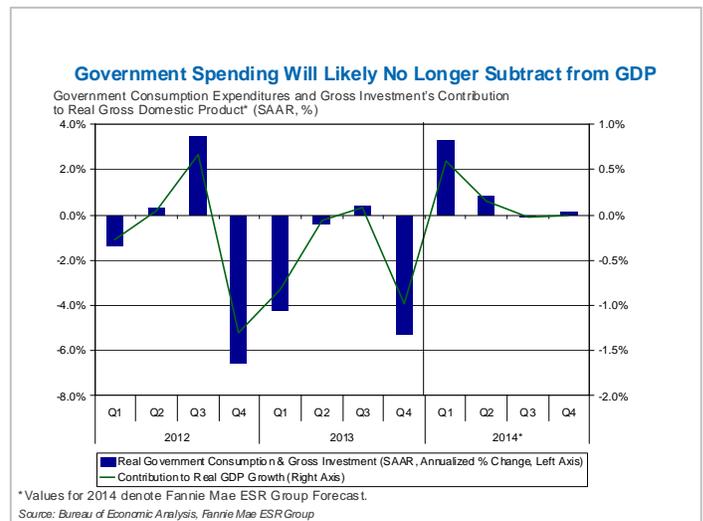
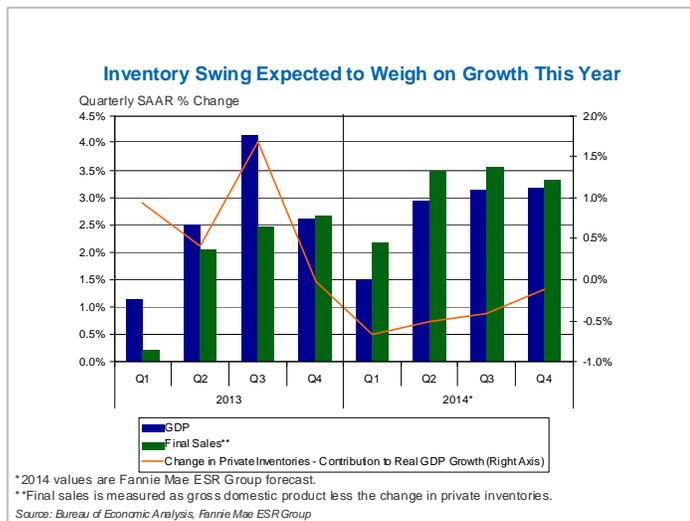


## Inventory Adjustment and Weather Aside, Growth Is Still Slow

The U.S. economy grows in uneven patterns as measured by quarterly annualized real growth rates, but the current underlying trend is still slow growth. Temporary factors such as unusual weather patterns can have an impact, but more frequently the economy’s dynamic aspects make the growth path uneven. Economic activity slowed in the first quarter as we expected, though more than forecasted. There was a sharp decline in inventory investment as consumer spending was less than expected by businesses, who then cut back production. A surprising widening in February net exports also subtracted from growth. Thus, we lowered our estimate of economic growth in the first quarter 0.5 percentage points to 1.5 percent annualized, a decline from 2.6 percent in the fourth quarter of 2013. We continue to expect the economy to grow at 2.7 percent in 2014 after adjusting for inflation, comparable to last year’s pace of 2.6 percent. Our forecast remains more conservative than that of the Federal Reserve’s, which projected a range of 2.8 percent to 3.0 percent in March.

The underlying growth trend, as measured by final sales—gross domestic product (GDP) minus inventories—should be stronger this year, but not by much. Substantial inventory building contributed nearly a percentage point to the robust pace of growth in the second half of 2013. We expect a slower pace of inventory accumulation in 2014 to bring down the inventory-to-sales ratio to more sustainable levels. The timing of when businesses will cut down production to adjust their inventories remains uncertain, but we expect much of it to occur in the first half of this year, exerting a sizable drag on GDP. The orange line in the chart below shows that after adding 1.7 percentage points to GDP in the third quarter of 2013, which helped boost headline economic growth to 4.1 percent (blue bar), the slowing pace of inventory accumulation between then and the first of quarter of this year is expected to substantially reduce growth. Diminishing drag from inventory investment through the remainder of this year should allow the economy to strengthen steadily. For all of 2014, we expect inventory investment to subtract from economic growth after contributing to it in the past two years.



One sector that should counteract the weather impact and the inventory swing in the first half of this year is the government. After sustained periods of sharp drops and sluggish growth, we expect government spending to rebound sharply in the first quarter from the massive drop in the prior quarter. Government spending is likely to contribute to GDP for the first time in five years through combined federal, state and local consumption, and gross investment. More importantly, the lack of additional broad-based tax increases combined with reduced uncertainty over fiscal policy should allow some progress in private sector strengthening.

As normal seasonal weather returned in March, incoming data showed that pent-up demand helped to boost economic activity after a string of soft data: hiring trends picked up, auto sales jumped to a seven-year high, and the Institute for Supply Management (ISM) surveys of purchasing managers showed improving manufacturing and service activity.

We expect growth to accelerate this quarter amid waning drags from declining inventory and an absence of a drag from government spending. We believe consumer and business spending will continue to contribute to growth this year. While the February trade deficit deteriorated significantly, special factors—including a jump in service imports related to the Sochi Olympics—contributed to the widening gap. We expect a partial reversal in the current quarter and, for the year as a whole, a modest contribution from net exports for the fourth consecutive year.

Housing also is expected to add to growth, but its impact will likely be less than we had thought. We had expected real residential investment to rebound in the first quarter from a sharp drop in the fourth quarter. However, incoming data on home sales suggest continued declines in brokers' commissions amid modest gains in new construction spending and flat home improvement spending. Thus, we expect a slight drop in real residential investment in the first quarter of 2014 with a rebound in the current quarter and strengthening in the second half of the year. Housing is forecast to add to economic growth again this year with a contribution of 0.3 percentage points—similar to 2013.

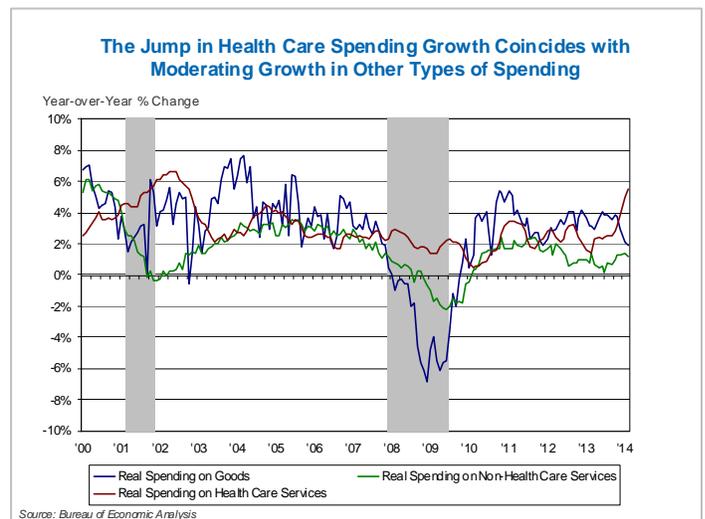
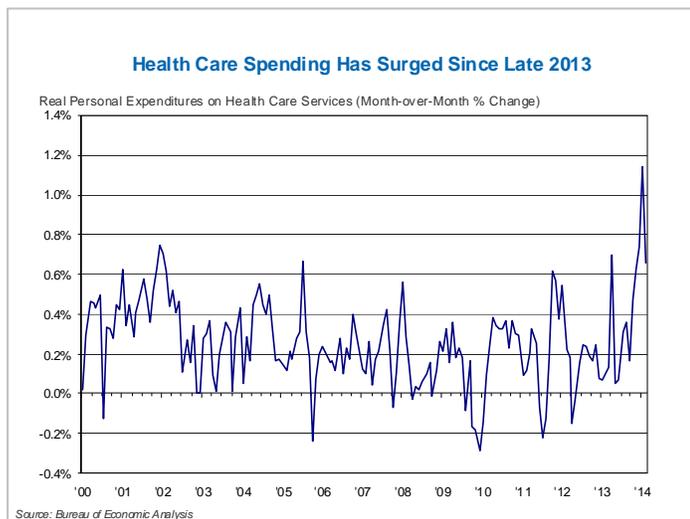
### Monetary Policy: The Fed Modified “Forward Guidance”

As expected, the Federal Open Market Committee (FOMC) announced at its March meeting that it will reduce its asset purchases by \$10 billion, split equally between Treasuries and mortgage-backed securities. The committee also modified the language in its forward guidance for monetary policy by dropping the thresholds of 6.5 percent unemployment rate and 2.5 percent inflation rate as considerations for raising the federal funds target rate. It will now rely on a wide range of information, including indicators of labor market conditions, inflation pressures, and inflation expectations, as well as financial developments. The implication is that Fed actions will be dictated by whatever is its current assessment of the data.

Along with its statement, the FOMC released the Summary of Economic Projections (SEP). Its “dot plot,” which indicates current expectations among FOMC members about future levels of the federal funds rate, seemed to suggest that members expect to raise the rate sooner as it showed an upward drift in the level of the funds rate expected at the end of 2015 and 2016 compared with the previous SEP released in December. The minutes from the meeting showed that some members were concerned that the market could interpret the upward shift as a signal that the Fed would tighten sooner than consensus expectations. The minutes also indicated that some members expressed worry about persistently low inflation. The personal consumption expenditures price index, which is the Fed's favored measure of inflation, was up just 0.9 percent in February from a year ago, well below the Fed's 2.0 percent target. We have not changed our call that the Fed will maintain its near-zero federal funds rate until the third quarter of 2015. Importantly, one member noted that there will need to be communication regarding the appropriate long-term size and composition of the Fed's balance sheet.

### Consumer Spending: Signals of a Pickup?

The third estimate of GDP showed a significant upgrade in real consumer spending from 2.6 percent annualized to 3.3 percent. All of the upward revision came from an upgrade in spending on services, largely on energy and health care. The jump in healthcare spending late last year coincided with the open enrollment period of the Affordable Care Act (ACA). January and February data indicated continued rising spending on healthcare.



The sharp year-over-year rises in healthcare spending coincided with the substantial slowdown in year-over-year spending on goods and non-healthcare services. However, we will need to monitor this going forward to determine whether it will be an ongoing substitution or a temporary adjustment to new rules and increased related costs.

Spending on goods rebounded in February after December and January declines and the surge in March unit auto sales will likely translate to a robust gain in durable goods spending. Data on consumer credit showed signs of consumer caution early this year and perhaps reflected the effect of harsh weather, as revolving credit (largely credit card debt) fell in February for the second consecutive month. For the first quarter, we estimate that real consumer spending slowed markedly to just 2.0 percent, and we expect it to strengthen throughout the year in line with an improving outlook in labor market conditions and income growth. This year, consumers should benefit from no further tax increases, although there could be sticker shock as upper-income households recognize their tax bills.

Consumer confidence will likely trend up, supported by improving financial market conditions and a rising stock market as the stress in emerging markets has subsided. Meanwhile, ongoing home price gains should continue to boost household net worth. Household net worth jumped roughly \$10 trillion (13.8 percent) during the four quarters of 2013 with approximately 65 percent of the increase due to equities, 30 percent tied to home price gains, and the remainder accounted for by other financial assets and increases in the stocks of consumer durables. We expect that rising stock and home prices will further add to the increase in household net worth, which has now regained the losses during the recession even after adjusting for inflation and the number of households. However, our research shows that a disproportionate share of gains have come from financial wealth, the holdings of which are highly skewed toward wealthy households, compared with housing wealth, which is more broadly held. This implies the wealth effect on aggregate consumer spending will be more limited than in the past. We expect real consumer spending to accelerate to 2.8 percent in 2014, a pickup of 0.5 percentage points from 2013.

## Labor Market: Improving Trends Should Continue

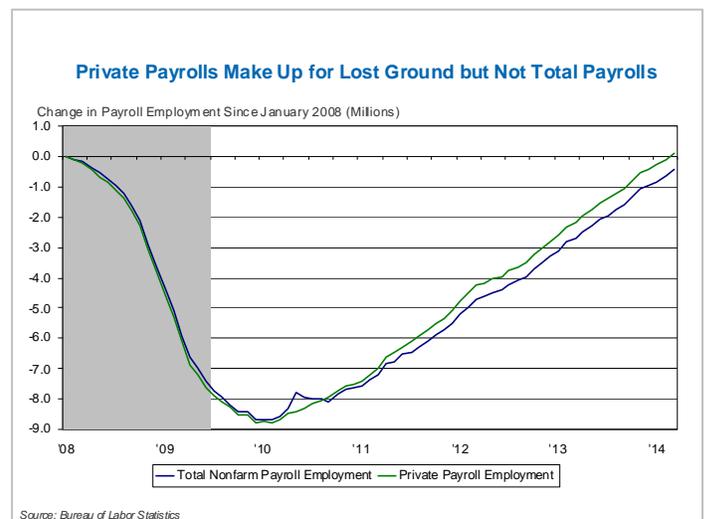
The March jobs report showed an encouraging sign of a pickup in hiring following a string of weak monthly job gains. Nonfarm payrolls rose 192,000, while upward revisions of 37,000 jobs for the prior two months pushed the average monthly gain in the first quarter to nearly 180,000. Other details were mixed, perhaps reflecting the weather impact. Hours worked rebounded to a recovery high after a three-month lull, while earnings growth was flat following significant gains early in the year. The details of the household survey were more upbeat than the headline. While the unemployment rate held steady at 6.7 percent, it reflected the combination of sizable increases in household employment and number of people joining the labor force, which pushed the labor force participation rate up to a six-month high of 63.2 percent.

The March jobs gain put private payrolls at a record 116.1 million, surpassing the previous peak set in January 2008. Five years into the current economic expansion, the private sector finally added enough jobs to replace the 8.8 million jobs lost during the recession—an indication of a tepid jobs recovery. However, when including jobs from the government sector, total nonfarm payrolls have not yet regained all the lost jobs.

Construction payrolls advanced at a steady clip, rising 19,000 during the month and averaging nearly 30,000 per month during the first quarter and 20,000 over the last six months. During the past year, the economy has added 151,000 construction jobs. Residential construction employment, which includes construction workers and specialty trade contractors in the residential sector and comprises approximately 38 percent of total construction employment, edged up 9,000, in line with its 3-month and 12-month averages.

## Nonresidential Investment: Contribution to the Economy Expected to Grow

Spending growth on business equipment and intellectual property products appeared to moderate substantially in the first quarter following the robust pace in the fourth quarter as the bonus expensing provisions expired at the end of the

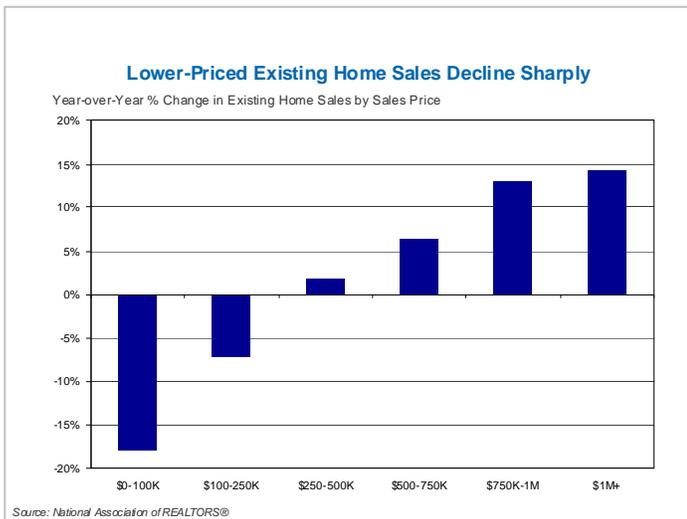


year. We expect it to firm through the rest of the year in response to a pickup in consumer demand, reduced policy uncertainty, and improving financial conditions, which help narrow risk spreads and reduce the cost of capital. Commercial real estate market conditions, including commercial vacancy rates, both office and industrial, also are improving gradually, and structures investment is poised to pick up. In addition, as hydraulic fracturing or “fracking” continues to grow, so does spending on mining, exploration, and extraction.

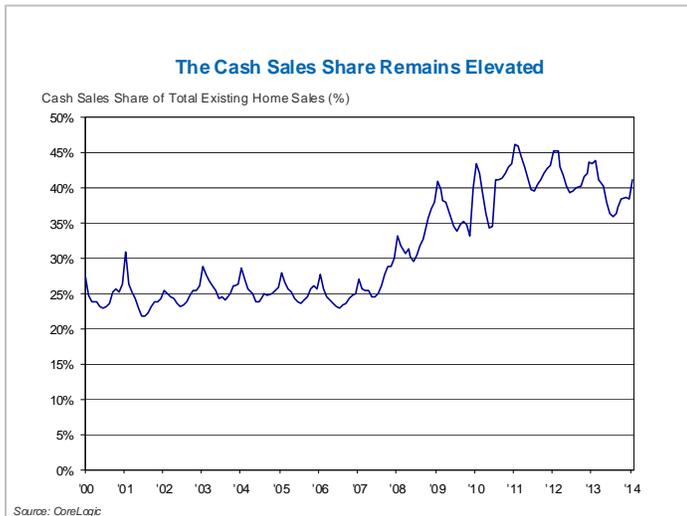
## Housing: Broad-Based Loss of Momentum is Likely Temporary

Housing activity weakened during the first two months of 2014 relative to the same period last year, with single-family starts and existing home sales posting year-over-year declines and new home sales staying flat. Some but not all of the weakness is likely related to the abnormally severe winter weather and should rebound in coming months. However, a significant share of the weakness appears to be related to the sharp decline in housing affordability and could persist for some time.

In February, existing home sales fell slightly from January, posting the sixth drop during the last seven months, sending sales to the slowest pace since July 2012. Sales were roughly 7.0 percent below their level at the same time last year. Details of the distribution of existing home sales by price ranges showed that sales of lower-priced homes—\$250,000 and below, and comprising more than 60 percent of home sales—were responsible for the decline. Meanwhile, existing home sales of higher-priced homes rose across the board, suggesting that declining affordability conditions and lean inventory of bargain-priced homes—consistent with a shrinking pipeline of foreclosure properties—contributed largely to the dismal performance of existing home sales.



Homebuyers at the lower-end price range, including first-time homebuyers, are more sensitive to a rise in mortgage rates and tightened lending standards than those at the higher-end price range. Data from CoreLogic showed that, during the early stages of the housing recovery, distressed sales accounted for a sizable share of total existing home sales, averaging over 25.0 percent between 2009 and 2011. The number of distressed sales has declined sharply since then, with the share of distressed sales averaging about 15.0 percent in the second half of 2013.



For a stronger recovery in the existing home market, we believe more first-time homebuyers will need to enter the market, helping to spur transactions among existing homebuyers and replace diminishing investor demand. One positive trend in the housing market is sales of second homes or vacation homes, which have been on the rise. (For more details on the second home market’s recent trend, its outlook, and demographics of typical buyers, see David Kopita, “[Second Homes: Recovery Post Financial Crisis](#),” FM Commentary, April 7, 2014.) Since nearly 40 percent of second-home buyers purchased their homes using cash, according to the National Association of REALTORS®, the upward trend in second-home sales helps explain continued elevated cash-sales share in the face of a declining share of distressed sales. CoreLogic data showed that cash sales accounted for 41.2 percent of total home sales in January, down slightly from a year ago but up from the prior month.

Since their peak in July, existing home sales have fallen a cumulative 14.0 percent. Meanwhile, inventory (not seasonally adjusted) posted a year-over-year increase in February for the fourth consecutive month, pushing the months’ supply higher to 5.2 months, the highest reading since last April. Despite the increases, both inventories and

monthly supplies have remained low by historical standards, which help support home price gains despite faltering demand. The CoreLogic home price index, which is used by the Fed to estimate the value of housing units and housing wealth in the Financial Accounts of the U.S., posted a year-over-year gain of more than 12.0 percent in February.

However, we expect inventories to continue to trend up against a backdrop of sluggish demand this year, which should moderate the pace of home price appreciation.

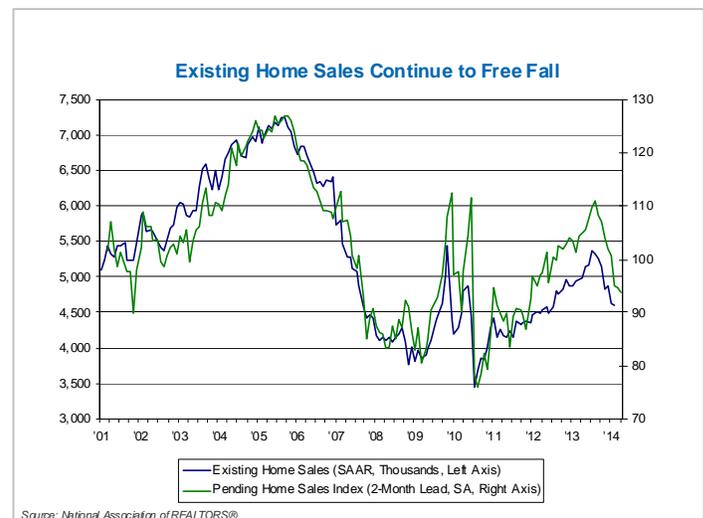
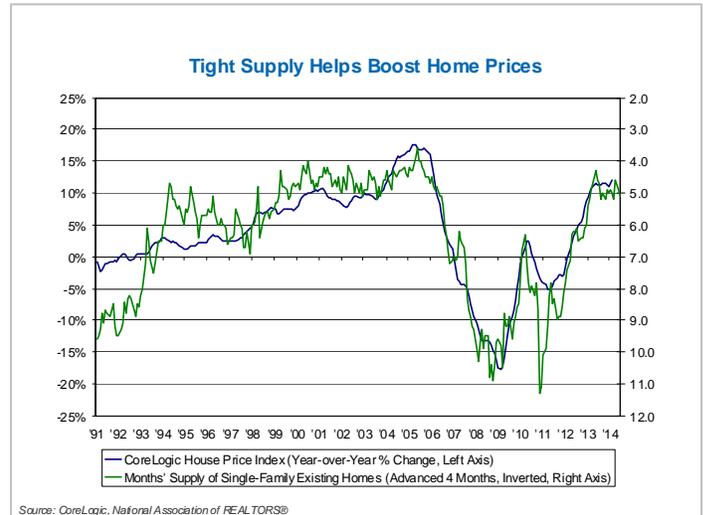
A pickup in existing home sales by early spring is unlikely, as pending home sales, which generally lead existing home sales by one to two months, fell in February for the eighth consecutive month.

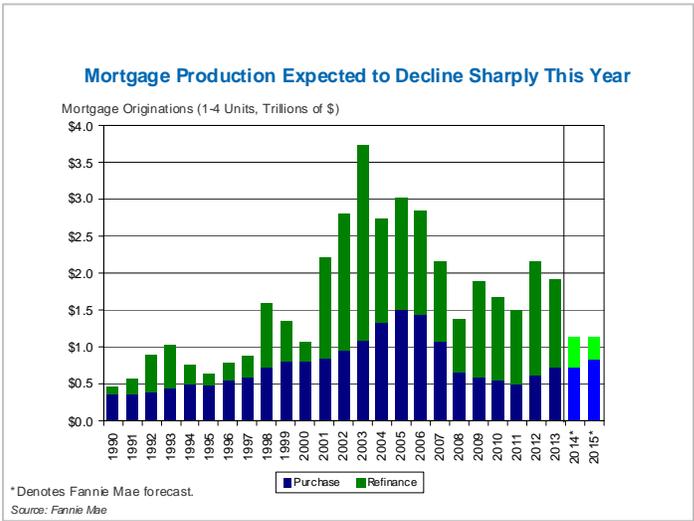
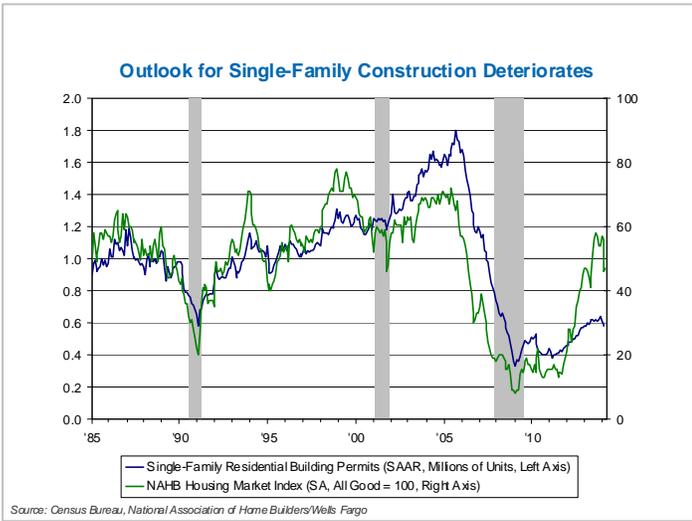
While purchase mortgage applications rose 3.5 percent over the past four weeks, they remain more than 15.0 percent below last year's levels, echoing the trend in pending home sales.

New home sales also fell in February from a level in January that was revised significantly lower. The months' supply of new homes rose to a five-month high of 5.2 months. Despite the weakening trend this year, new home sales have still performed significantly better than existing home sales. Since their recent peak in June, new home sales have posted a modest drop of approximately 2.0 percent. During the past year, new home sales have faced less competition from deep-discount distressed homes. In addition, a typical new homebuyer has higher income than a typical existing homebuyer, which makes them more immune to rising mortgage rates and home prices.

Homebuilding activity also pulled back in February. Multifamily starts fell for the third consecutive month, although permits—a leading indicator—jumped. (For information on multifamily market conditions, read the [April 2014 Multifamily Market Commentary](#).) Single-family starts were flat in February following large drops in the prior two months. In addition, single-family housing permits fell for the third consecutive month. The weakening outlook in the single-family segment helps explain continued soft builder confidence, which edged up just one point to 47 in March following a 10-point drop in February—its largest monthly decline on record (a reading of less than 50 indicates that more builders view the market as poor than good).

We believe mortgage rates have stabilized, with the yield on 30-year fixed-rate mortgages moving within a narrow range of 3.30 to 3.40 percent for most of this year so far. We expect rates to rise only modestly, ending the year around 4.6 percent. Given cooling housing activity in recent months and a somewhat deteriorating near-term outlook, we revised lower our forecasts of single-family starts, new home sales, and existing home sales, and thus our projected purchase mortgage originations. Recent developments in refinancing also led us to downgrade our projected refinance originations. However, we revised higher our 2013 estimate of total mortgage originations by approximately \$90 billion to \$1.91 trillion, given incoming data suggesting higher-than-expected originations held on bank portfolios. As a result, we project that total mortgage originations will decline by about 40.0 percent from 2013 to \$1.14 trillion. The expected large drop stems from a sharp pullback expected in refinance originations, pushing the refinance share down from an estimated 62.0 percent in 2013 to our forecast of 37.0 percent in 2014. After declining for six straight years, we expect single-family mortgage debt outstanding to rise slightly in 2014.





Doug Duncan, Orwin T. Velz, and Brian Hughes-Cromwick  
Economic and Strategic Research  
April 10, 2014

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