2012 – Year of the Political Economy

2012 will be replete with policy changes and challenges – both things we are aware of, as well as unexpected events that inevitably will occur. These involve expiring tax provisions faced by individuals, households, and businesses. They also involve program and regulatory changes already under way and scheduled. They involve the global economy, the domestic economy, and the housing sector. The national presidential election also will shape whatever additional actions are taken throughout the year (or are not taken). We expect the net effect will be a year of moderate growth edging away from the 2011 threat of a double dip.

The economy's performance in 2011 was disappointing. Several major headwinds developed during the first half of the year, including surging oil prices related to the "Arab Spring," the supply-chain disruptions stemming from the Japanese tsunami and earthquakes, and the intensified European sovereign debt crisis. Economic growth nearly stalled during that time, and doubts over the durability of the expansion grew, raising the odds of a recession to an uncomfortably high level. As the impacts of the Japanese catastrophe and the run-up in energy prices ebbed, growth picked up in the third quarter, albeit only modestly, in the face of a number of concerns surrounding the U.S. debt ceiling and the resulting sovereign debt rating downgrade by S&P.

However, recent data have shown that the economy appeared to gather momentum as the year drew to a close. Labor market conditions have gradually improved, and consumer confidence has rebounded from its summer plunge. Consumers proved once again to be more resilient than expected, and household spending appeared to have accelerated to a healthy clip during the final quarter of 2011. One negative impetus on consumers was removed: the payroll tax holiday and emergency unemployment benefits were extended for two months, and full year extensions are likely. Economic growth likely came in at slightly over 3 percent in the fourth quarter, sending positive momentum into the current quarter. We've seen a lot of recent forecasts have gone wrong betting against increased spending by the American consumer. While we think they will continue to save, we think they also will continue to spend in 2012.

Housing continued to have a difficult year in 2011, as single-family homebuilding had a setback after rising in 2010 for the first time in five years and new home sales are poised to decline for the sixth straight year to a fresh record low. Existing home sales fared better, tracking to post a modest increase, but from a substantially lower level following a downward revision. Multifamily housing benefited at the expense of single-family housing as more households had to or chose to rent rather than own.

Looking ahead, we expect economic growth to slow in the first half of this year compared to the pace at the end of 2011, and then trend modestly higher in the second half of 2012. Euro zone headwinds, volatile financial markets, and domestic fiscal contractions at all levels of government will combine to restrain growth. For all of 2012, we expect the economy to grow 2.3 percent, compared with an estimated 1.7 percent in 2011. This month's forecast is an upgrade from our December forecast, when we assumed that the payroll tax cut and emergency unemployment benefits would expire as scheduled.

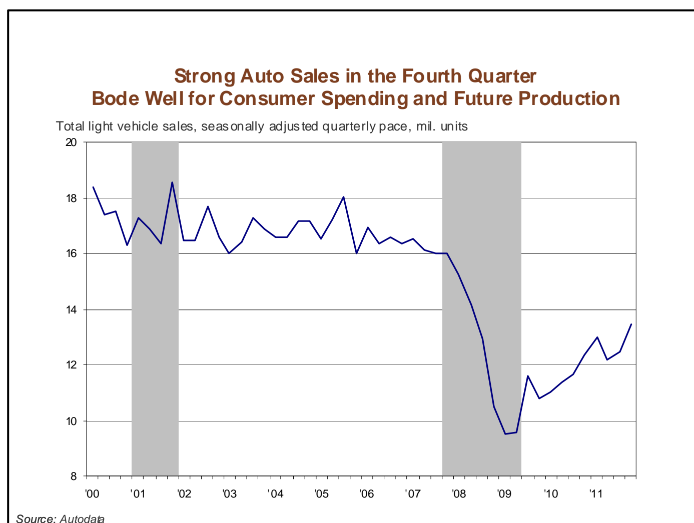
This forecast is subject to both downside and upside risks. As the economy lost momentum in 2011, we estimated that the odds of slipping back into recession in 2012 were a coin toss. Today, we believe that the odds have receded substantially, to about 25 to 30 percent. The contagion effects from the sovereign debt crisis in the euro zone, which appears to be slipping into recession, remains the primary risk to growth in 2012. It is encouraging, however, that the European Central Bank and other key central banks have collaborated to provide low-cost funding to the stressed sovereign bond markets – in an attempt to prevent the governments' costs of financing their debt from spiraling out of control. The biggest challenge is for the peripheral countries to tackle their debt situations by implementing serious austerity measures, but that is unlikely to be resolved in 2012. Europe is not the only region to watch. A potential

renewed surge in oil prices from the current tension in the Middle East remains a major threat to the fragile global economy. Also, a hard landing in China, the world's second largest economy, would have large adverse ripple effects across the globe. On the other hand, our forecast could turn out to be too pessimistic if financial conditions improve by more than we expect, leading to a stronger labor market recovery than anticipated.

The Economy: From Year-End's Solid Pace to a First-Half Slowdown

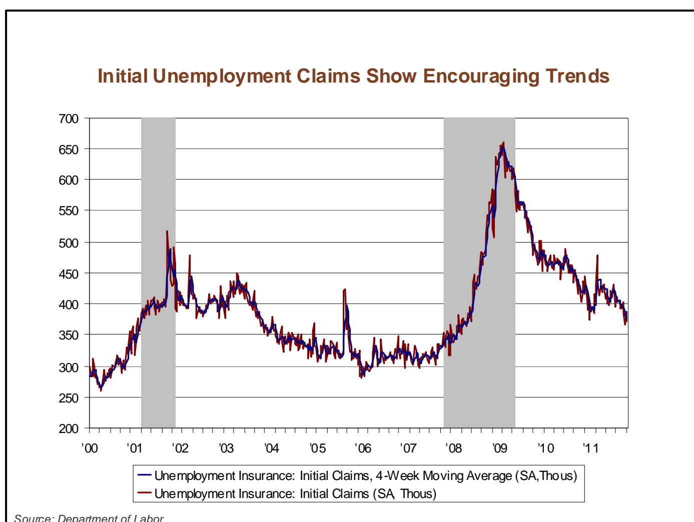
A key reason for the lackluster economic growth during the first three quarters of 2011 was a slowdown in consumer spending activity. Consumers received very little income support during this period, despite the boost to income from the payroll tax holiday and emergency unemployment benefits at the beginning of the year. Real (inflation-adjusted) disposable personal income declined 0.4 percent over the first three quarters of 2011, driven down by the drop in transfer payments reflecting the unwinding of the stimulus as well as the surge in energy prices. The supply-chain disruptions also negatively impacted auto sales, while political gridlock contributed to the erosion of business and consumer confidence. In addition, gains to household net worth in the first quarter of 2011 were more than offset by the combined $2.5 trillion drop in the second and the third quarters, reflecting a massive decline in equity wealth.

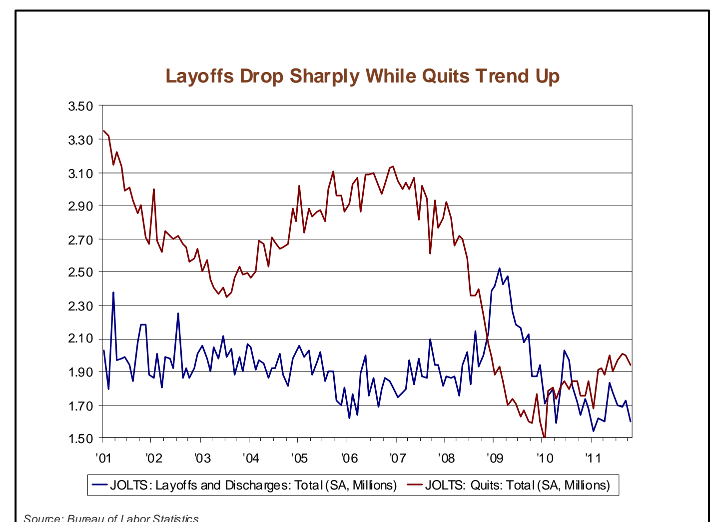
Real consumer spending appears to have picked up its pace in the fourth quarter of 2011, which we estimate to be about one percentage point higher than the 1.7 percent annualized pace in the third quarter. This would be the strongest growth in a year. Some of this strength was expected, as factors that restrained growth earlier in the year subsided or reversed. While auto sales fell slightly in December, they were up considerably from last spring and remain along a solid trend. For the fourth quarter of 2011, auto sales picked up to the strongest pace since the second quarter of 2008.



The strength in auto sales bodes well for consumer spending and auto production in the current quarter, as the industry begins to recover from the decline in auto assemblies stemming from flooding in Thailand late last year.

The labor market recovery appears to have picked up speed toward the end of 2011, which is positive for labor income. During the last two months of the year, weekly initial unemployment claims trended down, staying below the 400,000 mark for all but one week, an encouraging sign of a sustained improvement in layoffs.



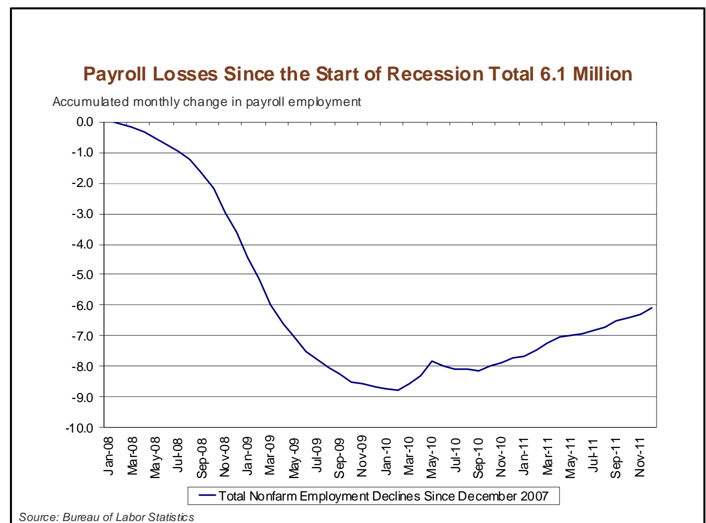


Furthermore, announced layoffs stabilized during the final quarter of 2011, according to data from Challenger, Gray & Christmas. The Job Openings and Labor Turnover (JOLT) survey continues to be encouraging, showing a gradual uptrend in job openings and hiring. At the same time, separations have declined sharply, with substantially more quits than layoffs, indicating more confidence in the labor market among existing workers.

The National Federation of Independent Business (NFIB) December economic survey showed that the number of small business owners cutting jobs was at the lowest level since the start of the recession. At the same time, the share of owners adding workers continued to trend up. This trend bodes well for small business job creation in the coming months.

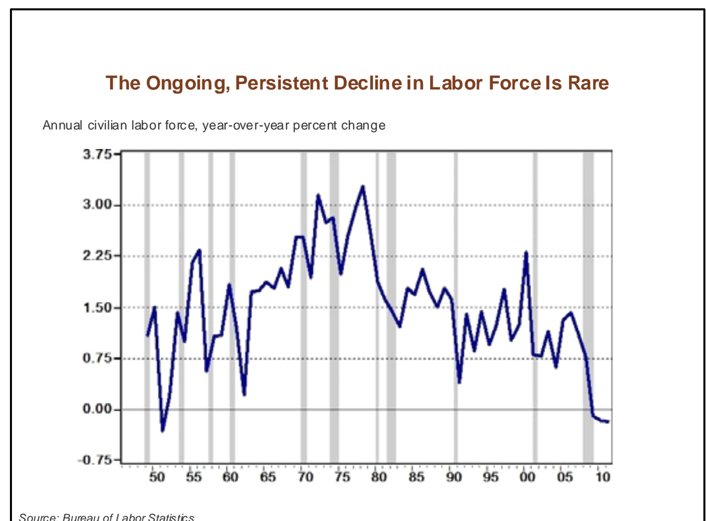
The December employment report added to the growing list of indications that the labor market built up momentum in recent months. The survey of establishments showed that total nonfarm payrolls rose 200,000, up from an average gain of 141,000 over the prior three months. Gains were broad-based across a wide range of industries.

Part of the gains may be due to special factors, however. The weather was unseasonably warm in much of the country, marking December 2011 as the warmest winter month in five years, which helped boost construction employment. In addition, seasonal adjustments for some holiday hiring, such as couriers and messengers, may be improperly applied and are likely to be reversed in January. Couriers and messengers payrolls jumped by 42,000 during the month compared with a trend of only 1,000 per month. Similar gains in the previous two Decembers were reversed in January as seasonal hires were laid off.



For 2011 as a whole, the performance in the labor market was a marked improvement from the prior year, as a total of 1.67 million jobs were created versus a gain of 872,000 jobs in 2010. Private sector employment was up by 1.93 million, compared with 1.13 million in 2010. This improvement is a step in the right direction, but it was nowhere near enough to repair the damage suffered during the recession. At the end of 2011, businesses employed 6.1 million fewer workers than they did in January 2008.

Other details of the report were positive. The average workweek increased from 34.3 hours to 34.4 hours, and average hourly earnings rose 0.2 percent. The gain in employment and earnings points to a sizable increase in personal income in December. The payroll proxy for private sector labor income—aggregate hours worked times hourly earnings—rose a strong 0.7 percent, which bodes well for consumer spending in the final month of the year.



The unemployment rate, calculated from the survey of households, fell from 8.7 percent in November to 8.5 percent, the lowest level since February 2009. The decline in the unemployment rate was mostly good news, with the labor force falling only modestly and household employment up strongly. The broader unemployment rate, which included discouraged workers and part-time workers who want full-time work, fell 0.4 percentage points to 15.2 percent, also the lowest since February 2009. The share of the labor force working part time for economic reasons fell to 5.3 percent, to a new low for the recovery.

Over the past two years, the unemployment rate has declined 1.4 percentage points even though job growth has been moderate. Some of the decline in the unemployment rate was attributable to the drop in the labor force participation rate, which has fallen by two percentage points since the start of the recession. The participation rate was unchanged in December, holding at a cycle low of 64.0 percent. While some of the drop in participation during the past few years may be due to the aging of the workforce, the participation rate for prime-age workers (ages 25-54) has dropped by about 1.5 percentage points since the recession began and remains only 0.2 percentage points above its cycle low. The ongoing, persistent decline in the labor force seen during this recovery is very rare, and thus the drop in the unemployment rate during the past two years should not be viewed as an indication of a strong recovery in the labor market.

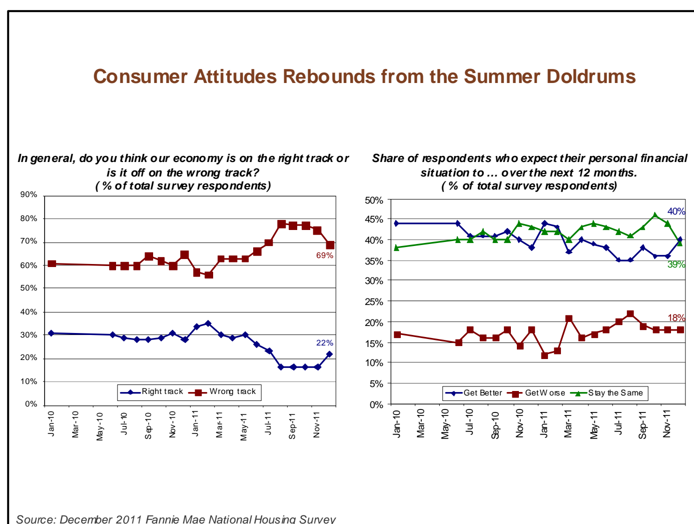
Consumers have gotten out of their summer rut. Measures of consumer attitudes continued to rise in December, consistent with other indicators signaling improvement in the economy. The Conference Board consumer confidence index rose 9.3 points to 64.5 in December after a gain of14.3 points reported for the prior month. The assessment of the labor market has made substantial improvement in recent months, which is consistent with recent developments in the labor market. The gap between the share of consumers reporting jobs hard-to-get and those reporting jobs plentiful posted the best showing since January 2009.

The Reuters/University of Michigan consumer sentiment index also continued to rise in December, up 5.8 points to 69.9. The index has increased almost 15 points since August.

Fannie Mae's December National Housing Survey also showed a rebound in consumer attitudes from the lows seen this past summer. There is marked improvement in consumer sentiment regarding the direction of the economy and personal finances. However, consumer attitudes remain depressed, with more than two-thirds saying that the economy is on the wrong track.

We expect that consumer spending growth will moderate in the first half of this year from the fourth quarter 2011 pace. December job growth and labor income growth should slow in January as the boost from temporary factors fades. Continued problems in the euro zone, and the resulting market volatility, will continue to restrain demand.

As mentioned earlier, one negative factor confronting consumers in early 2012 was removed. Just prior to the Christmas holiday, Congress approved a two-month extension of expiring payroll tax and unemployment benefits. The cost of extending these programs will be offset over the next decade by higher mortgage fees charged by Fannie Mae and Freddie Mac. Our forecast assumes a full year extension of both unemployment benefits and the payroll tax holiday. We do not yet include additional offsets for the remaining ten-month extension in this forecast as we assume that the cost will be deferred to the out-years of the ten-year budget planning horizon.



Source: December 2011 Fannie Mae National Housing Survey

We expect that a significant fiscal tightening is in the cards for next year, as the expiration of these two programs as well as the expiration of the Bush-era tax cuts will turn into a drag on income. We continue to assume that the automatic budget cuts set for January 2013 (because the Joint Select Committee failed to reach agreement on a plan to cut the deficit) will be avoided and a new agreement will be reached. We also continue to assume a path for federal spending consistent with the Budget Control Act of 2011. Risks that the U.S. sovereign debt rating could face a downgrade in 2013 will remain if no credible plans to tackle the deficit are on the table before then.

While consumer spending is expected to be the biggest contribution to growth in the fourth quarter of 2011 and in 2012, contributions from other components of the economy are mixed. We expect the government sector to remain a drag on economic growth this year and for the next several years.

We also expect state and local governments will continue to reduce spending this year in light of falling property tax collections and fewer resources from the federal and state governments.

The trade sector is expected to have contributed to economic growth in the fourth quarter, as a gain in exports outpaced import growth. However, net exports should remain relatively flat this year as growth in exports decelerates in response to the slowing in global growth induced by the recession in the euro zone.

Business fixed investment likely slowed sharply in the fourth quarter of last year. We expect it to recover early this year and to remain a support to growth throughout 2012. The main driver of business investment during the past year—investment in equipment and software—should remain healthy, but will slow from the double-digit gains witnessed in 2011, which were induced by the 100 percent depreciation allowance that was reduced to 50 percent this year. Business fixed investment in structures is expected to stabilize as the commercial real estate market gradually improves.

Inventory investment—the change in private inventories—is expected to swing from a modest decline in the third quarter to an increase, boosting growth in the fourth quarter. However, it is not expected to be a driver of growth in the first half of 2012, reflecting business caution in the face of uncertainty amid slowing demand.

We expect the fourth-quarter growth spurt to slow in the first half of 2012, averaging only about 2 percent, before accelerating to about 2.5 percent in the second half once financial conditions improve and the labor market strengthens.

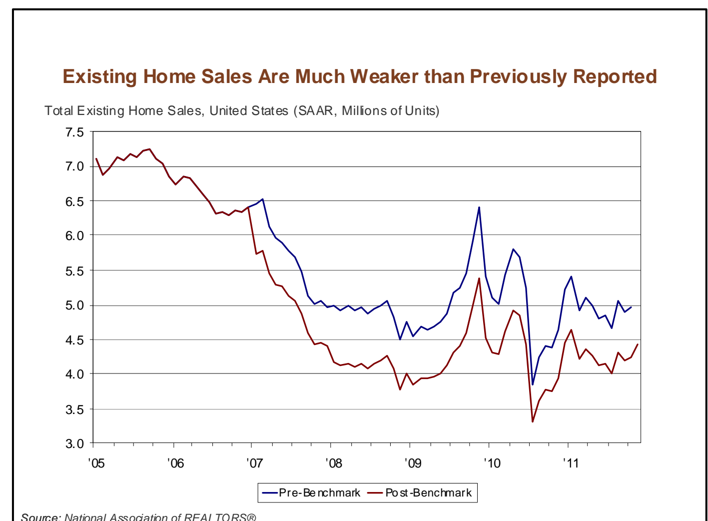
Housing: Swinging from a Drag to Growth to a Modest Driver

Recent housing indicators also have shown some improvement. Construction momentum appears to be building. Single-family and multifamily housing starts as well as permits—a gauge of future construction—rose in November. New home sales rose in November for the third consecutive month. The number of new homes for sale declined slightly and continues to be at a historical low. The last time inventories posted a monthly gain was in April 2007. The increase in sales and the decline in inventories pushed the months' supply down to 6.0 months, the lowest ratio of inventory to current sales since early 2006.

Builders' sentiment continued to climb in December for the third straight month, the first such streak since mid-2009. While confidence has remained at a historically low level, it is the best showing since May 2010.

Existing home sales rose in November, marking the third increase during the last four months, sending sales to the strongest pace since January 2011. The number of homes listed for sale (not seasonally adjusted) has trended down since April to the lowest level since May 2005 and has posted year-over-year declines for nine straight months. The strong sales pace and the decline in inventory pushed the months' supply down to 7.0 months, the lowest reading in two years. In the November report, the National Association of REALTORS® included substantial downward revisions of sales data from 2007 through October 2011. The overstatement was due to many factors, including individual properties being listed by a number of local Multiple Listing Services (MLSs). The revisions showed that sales were about 14 percent lower than originally reported and thus indicated that the housing downturn was more severe than previously believed. The revisions also implied that there will be fewer units of housing demand to absorb the excess supply and shadow supply than originally believed.

Despite recent improvements in home sales and construction of new homes, the level of activity continues to hold close to recession lows. For all of 2011, the existing home market is poised to post a modest gain from a pace that was much weaker than previously reported last year.

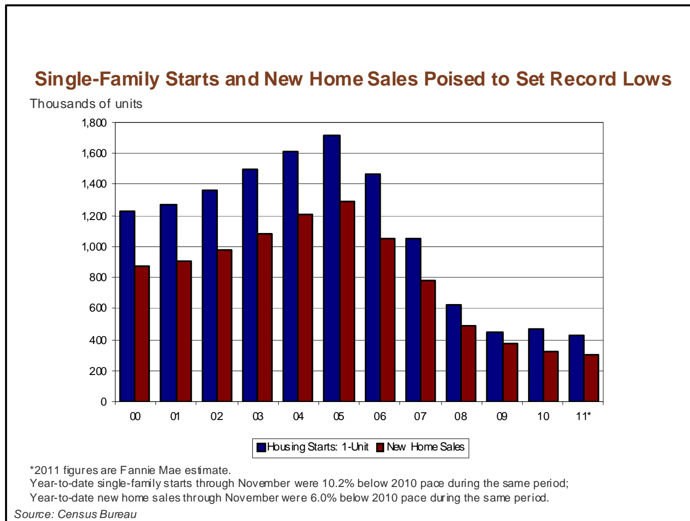


Existing Home Sales Are Much Weaker than Previously Reported

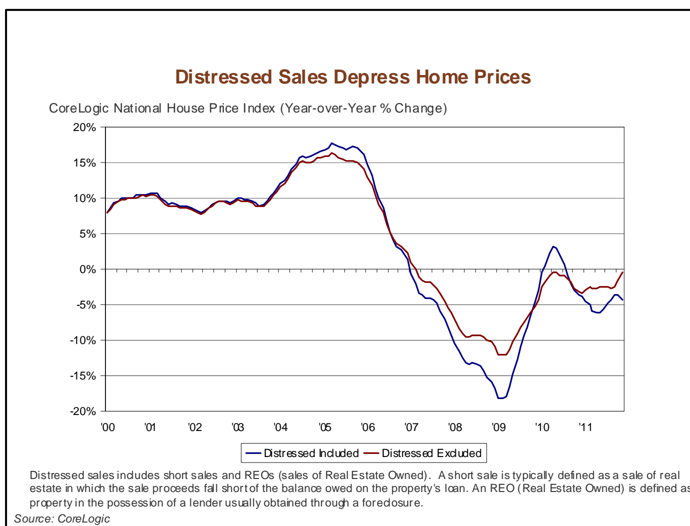
Source: National Association of REALTORS®

Single-family homebuilding and new home sales fared much worse than the existing home markets as they showed little signs of life after the contract signing deadline to qualify for the homebuyer tax credit that expired in the spring of 2010. Single-family starts are poised to decline from 2010 to a record low, while new home sales are poised to fall for the sixth consecutive year to a new low.

Meanwhile, multifamily remains the shining segment of this lackluster sector, with starts likely rising by more than 50 percent in 2011 from the level in 2010, as builders attempted to meet increased demand, which has pushed rents up and vacancy rates down considerably during the past year. (For more information on multifamily market conditions, read the *January 2012 Multifamily Market Commentary*).



*2011 figures are Fannie Mae estimate.
Year-to-date single-family starts through November were 10.2% below 2010 pace during the same period;
Year-to-date new home sales through November were 6.0% below 2010 pace during the same period.
Source: Census Bureau



Distressed sales includes short sales and REOs (sales of Real Estate Owned). A short sale is typically defined as a sale of real estate in which the sale proceeds fall short of the balance owed on the property's loan. An REO (Real Estate Owned) is defined as property in the possession of a lender usually obtained through a foreclosure.
Source: CoreLogic

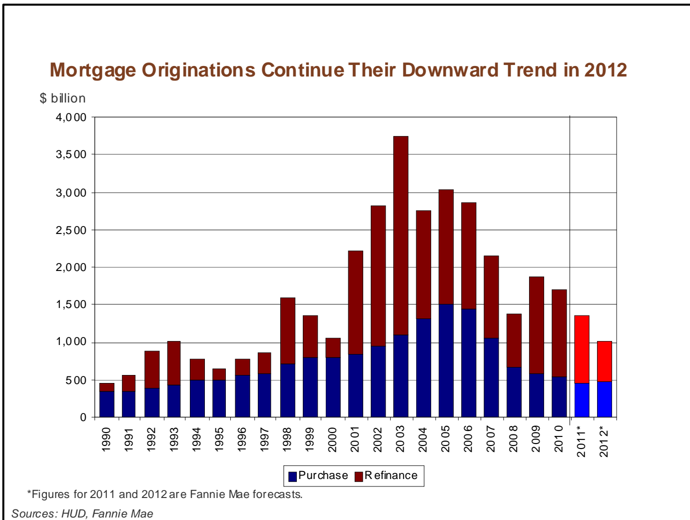
While other housing indicators have improved during the past few months, home prices were an exception. After firming in the second quarter, prices have resumed their decline. Main measures of home prices—the S&P/Case-Shiller, the FHFA purchase-only, and the CoreLogic house price index—declined further in October. Though the rate of new foreclosures started is down considerably from its peak, it has remained elevated. Homes in or near foreclosure, REO properties, and a still considerable number of excess vacant homes on the market will continue to put downward pressure on home prices, which will likely decline further this year. The pace at which homes in the foreclosure process are transformed into homes on the market will be critical to home price trends during the next several years.

One measure of home prices, the CoreLogic house price index, can shed light on the extent that distressed sales negatively impact home prices. The index fell in November for the fourth consecutive month and 4.3 percent from a year ago. However, the index excluding distressed sales was only slightly below the level in November 2010.

Mortgage rates should remain a support to the housing market. Given an expected modest economic growth path through most of the year and continued concerns over the European debt crisis that encourage a flight to safety, long-term Treasury yields should be little changed in the first half of 2012 and rise only modestly during the rest of the year. Despite the scheduled increase in mortgage fees, which essentially will widen mortgage spreads, mortgage rates are expected to remain near their record lows, rising to just slightly more than four percent by the end of 2012.

We continue to expect the Federal Reserve to hold the target fed funds rate steady through mid-2014. However, the financial markets should get more information regarding how the Fed implements monetary policy starting at the next Federal Open Market Committee (FOMC) meeting on January 24-25. The minutes of the FOMC December 13 meeting showed that the Fed will attempt to improve the transparency of its policy-making by incorporating in its quarterly Summary of Economic Projections (SEP) three pieces of information: participants' projections of the appropriate level of the fed funds rate; participants' projections for the date of the first rate hike; and "qualitative" balance sheet guidance, which could involve what participants believe to be the direction they expect the Fed's balance sheet to take.

The improved housing activity in the fourth quarter of 2011 suggests that residential investment likely added to economic growth during the quarter. After acting as a drag to growth since 2006, the contribution of residential investment to economic growth should be essentially zero in 2011. With an expected improvement in housing activity in 2012, residential investment should start contributing to growth, albeit only modestly initially. Housing starts are projected to rise by about 16 percent, as multifamily starts continue their uptrend and single-family starts rebound from their record low. New and existing home sales are expected to increase a modest 3.5 percent in the face of several challenges, including the considerable imbalance in the market, still-tight lending standards for mortgages, expected further declines in home prices, and only gradual improvement in the labor market.



*Figures for 2011 and 2012 are Fannie Mae forecasts.
Sources: HUD, Fannie Mae

For all of 2012, total mortgage originations are projected to decline to $1.01 trillion from an estimated $1.36 trillion in 2011, as purchase originations are expected to rise only modestly while refinance originations should decline sharply.

The refinance share is expected to drop sizably from an estimated 66 percent in 2011 to 53 percent in 2012. Total single-family mortgage debt outstanding should post a fifth consecutive annual drop, falling by 1.3 percent in 2012, moderating from an estimated 2.4 percent decrease in 2011.

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Economics & Mortgage Markets Analysis

January 9, 2012

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