Transition to “Normal”?  

By Doug Duncan  
Senior Vice President and Chief Economist  
Fannie Mae  
January 11, 2013
Disclaimer

Opinions, analyses, estimates, forecasts, and other views of Fannie Mae's Economic & Strategic Research (ESR) group included in these materials should not be construed as indicating Fannie Mae's business prospects or expected results, are based on a number of assumptions, and are subject to change without notice. How this information affects Fannie Mae will depend on many factors. Although the ESR group bases its opinions, analyses, estimates, forecasts, and other views on information it considers reliable, it does not guarantee that the information provided in these materials is accurate, current, or suitable for any particular purpose. Changes in the assumptions or the information underlying these views could produce materially different results. The analyses, opinions, estimates, forecasts, and other views published by the ESR group represent the views of that group as of the date indicated and do not necessarily represent the views of Fannie Mae or its management.
We Expect a Moderate Amount of Fiscal Drag in 2013, but Also a “New Normal” of Slower Trend GDP Growth

ESR Estimated Impact of 2013 Fiscal Consolidation and GDP Forecast

<table>
<thead>
<tr>
<th>Measure</th>
<th>Fiscal Drag (Reduction in Q4/Q4 GDP Growth)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expiration of the Payroll Tax Holiday</td>
<td>0.6%</td>
</tr>
<tr>
<td>Sunset of the Bush-Era Tax Cuts and Cap on Deductions for Upper-Income Earners</td>
<td>0.2%</td>
</tr>
<tr>
<td>Budget Control Act Sequestration (Under Current Assumption)</td>
<td>0.2%</td>
</tr>
<tr>
<td>Affordable Care Act</td>
<td>0.1%</td>
</tr>
<tr>
<td><strong>Total Fiscal Drag</strong></td>
<td><strong>1.1%</strong></td>
</tr>
</tbody>
</table>

ESR Real GDP Forecast (2013Q4/2012Q4 2012 % Change): 2.2%
ESR Real GDP Forecast (2014Q4/2013Q4 % Change): 2.4%

- The passed legislation is broadly in line with our assumptions on the revenue side.
- The final outcome of the sequestration associated with the Budget Control Act (deferred for two months) and the debt ceiling remain uncertain.

Source: Fannie Mae Economic and Strategic Research
Late February/Early March: The U.S. government already reached its $16.394 trillion borrowing limit. Extraordinary measures—including halting investments in government workers’ retiree funds—will be in effect roughly until the end of February when Congress must raise the limit to avoid defaulting.


March 27, 2013: Budget “sequester” is implemented, and the FY13 Continuing Resolution expires. If a new Continuing Resolution is not passed by midnight, March 27, 2013, the federal government shuts down.
The Decline in the Labor Force Participation Rate Accompanies the Drop in the Unemployment Rate to Below Eight Percent
Income Growth has Improved Somewhat Recently, but is Still Below “Normal”

Year-over-year % change

Source: Bureau of Economic Analysis National Income and Product Accounts
Auto Sales Trend Up to Over 15 Million Units

Total Light Vehicle Sales (SAAR, Millions of Units)

Source: Autodata
The Federal Reserve Replaced its Calendar-Based Guidance with Outcome-Based Guidance

By targeting expected rather than actual inflation, the Fed tries to ensure that it will not change policy based on a temporary spike in prices.

November UM 5-10 yr ahead inflation expectations = 2.8%

November 10 yr breakeven rate = 2.5%

September FRB long-term inflation forecast = 2.0%

Sources: Federal Reserve Board, Bloomberg, Fannie Mae Economic and Strategic Research
Current Narrow Spreads are Due in Part to Loose Monetary Policy

Source: Bloomberg
The Federal Reserve Expands its Balance Sheet by $40 Billion of Agency MBS and $45 Billion of U.S. Treasuries Per Month

Federal Reserve Assets

Billions

Source: Federal Reserve Board
Mortgage Defaults and Tighter Lending Standards Drove the Decline in the Homeownership Rate from its Peak

Source: Census Bureau Housing Vacancy Survey
Lean Supply has Put Downward Pressure on Vacancy Rates, Which We Forecast to Return to “Normal” in 2016

Source: Census Bureau Housing Vacancy Survey
U.S. Demographics are Better Than Most People Understand

Population by Age and Sex: 2000 and 2010

(For more information on confidentiality protection, nonsampling error, and definitions, see www.census.gov/prod/cen2010/doc/cf1.pdf)

Note: The lighter shade of blue represents ages 0 to 64 in the 2010 Census. The darker shade of blue represents ages 65 years and over in the 2010 Census.

Source: Census Bureau
New Census Bureau Population Projections Imply a Substantially Smaller U.S. Labor Force in 2050

2012 vintage population projections suggest a 2050 labor force that is 15 million workers, or 7%, smaller than suggested by 2008 projections.

Projected Labor Force in 2050 by Age

Projections assume that age-specific labor force participation rates remain constant at 2011 levels. Labor force participation rates used in the projections are based on civilian noninstitutional population, whereas population projections reflect the entire resident population. As a result, the labor force projections are greater than would be the case had population projections been available for the civilian noninstitutional population.

Source: Census Bureau
We Forecast that Homebuilding Activity will Reach “Normal” Levels in 2016

<table>
<thead>
<tr>
<th>2015-2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Demand (thousands):</strong></td>
</tr>
<tr>
<td>Change in Households</td>
</tr>
<tr>
<td>Change in Vacancies</td>
</tr>
<tr>
<td>Net Removals</td>
</tr>
<tr>
<td>Total Demand</td>
</tr>
<tr>
<td><strong>Supply (thousands):</strong></td>
</tr>
<tr>
<td>Single-Family</td>
</tr>
<tr>
<td>Multifamily</td>
</tr>
<tr>
<td>Manufactured</td>
</tr>
<tr>
<td>Total Supply</td>
</tr>
</tbody>
</table>

**Source:** Fannie Mae Economic and Strategic Research
Purchase Originations Will Accelerate as a Share of Total Mortgage Production as Refinance Burnout Hits

*Mortgage Originations (Billions of $, 1-4 units)

*Fannie Mae Forecast

Source: Fannie Mae

January 2013
Factors Affecting the Transition to “Normal”

**Macro Economy:** We expect fiscal and regulatory drag will continue to weigh on economic and income growth. At the same time, there are three potential bright spots that could lead to higher growth: energy development; the return of manufacturing; and housing’s rebound (which will level off after 2015). The new normal may be real annual GDP growth of slightly greater than 2% coupled with a second round effect of a somewhat slower rebound in housing.

**Fiscal Policy:** We expect fiscal policy will continue to be growth restrictive, with additional burdens due to continued near-term policy uncertainty like the Budget Control Act Sequestration, the debt ceiling, and the larger long-term issue of entitlement insolvency further out. We expect that slower growth will move entitlement solvency issues forward in time.

**Monetary Policy:** We expect the Fed will continue its expansive monetary regime and will now make policy determinations based on outcomes rather than timing. We expect exit strategy execution plans will probably contribute to greater market volatility during the transition and affect the appetite for different forms of risk. Continued rate suppression policy could distort a more efficient allocation of capital.

**Housing Market:** We expect the housing recovery will continue in 2013, but we do not expect to return to normal levels of activity until 2016. After 2016, we expect activity to level off driven by demographic factors (slow population and workforce growth) and household income growth. We expect refinancing activity will drop off as the policy drivers wane and interest rates rise.

**Housing Policy:** There is significant uncertainty going forward in U.S. housing policy. Recent policy has had a mixed impact in relation to its stated objective and some policies may have countervailing effects (e.g., the extension of the Mortgage Debt Forgiveness Act may be countered by the cap placed on the mortgage interest deduction for high-income earners).
Contact Information
fanniemae.com/portal/research-and-analysis/

Doug Duncan, Senior Vice President & Chief Economist
Fannie Mae
3900 Wisconsin Avenue, NW
Mail Stop 1H-2N/01
Washington, DC  20016

(o) 202-752-0160
(c) 202-409-5913
(fax) 202-752-4441

douglas_g_duncan@fanniemae.com