

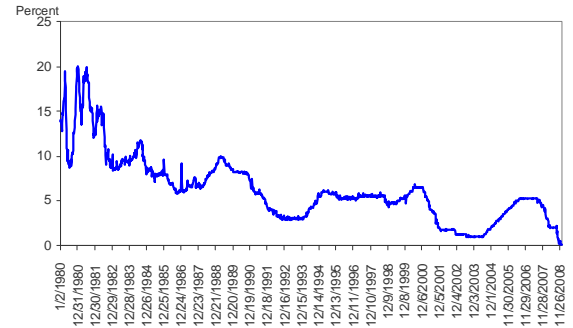
January 16, 2009

“...all available tools...”

–Federal Reserve Board Press Release, December 16, 2008

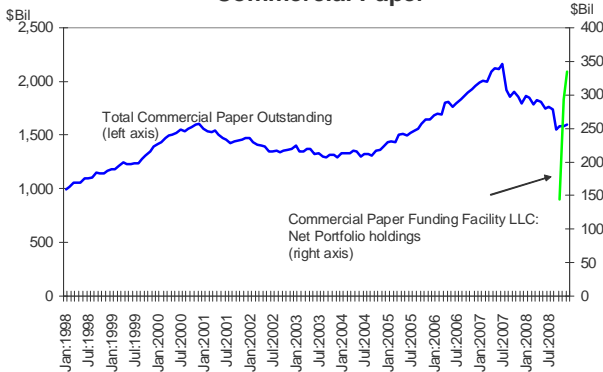
The Federal Reserve made clear it is not stopping innovative monetary policy actions when it used the phrase, “all available tools,” to describe its approach to supporting the resumption of economic growth and the healing of financial markets. There had been concern expressed that the Fed would have run out of ammunition once the Fed Funds Rate target reached zero. The expansion of the balance sheet of the Central Bank from just under \$900 billion at the end of August to \$2.3 trillion in mid-December is evidence of the other tools the Fed can deploy. In this case it is often referred to as “quantitative easing.”

Federal Funds Effective Rate



Part of that expansion was the Fed’s decision to directly purchase Commercial Paper in support of the nonfinancial corporate sector. Commercial paper issuance peaked in August of 2007 when the first major shock from the mortgage market hit. That led to a dramatic decline in the issuance of asset-backed commercial paper where the collateral was mortgages. Then, in September 2008 another shockwave hit the financial market and this time the nonfinancial commercial paper market froze. The Fed stepped up immediately and averted what could well have been the depression scenario that many feared. Had short-term corporate borrowing remained frozen, there would have been the potential for massive job losses as payroll funding would have been unavailable.

Commercial Paper

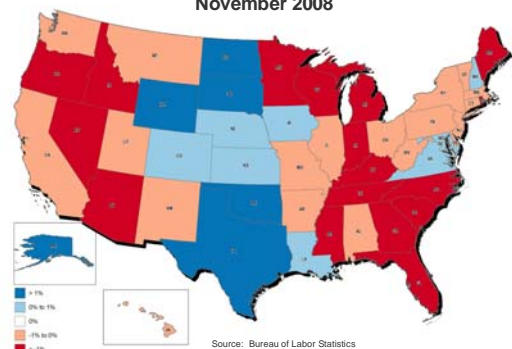


These successive shocks to short-term credit markets finally fed through to the labor markets and very sizeable payroll job losses ensued. In the past five months more than two million jobs have been lost with more expected through the end of 2009. Weekly unemployment claims are averaging around 550,000, the highest level since the early 1980s. The job losses have been widespread, including significant increases in service sector layoffs. The job losses vary widely by region with some areas still adding jobs in the midst of the downturn (state employment data lag by one month).

Initial Unemployment Claims: Four-Week Moving Average



Year/Year Percent Change in Nonfarm Payroll Employment November 2008



Credit restrictions are still very tight with only marginal improvements in risk spreads. This has affected both the supply of and demand for credit. A sign of the extreme conservatism of the commercial banking system, the excess reserves held on the Fed's balance sheet have increased from \$2 billion in August to more than \$800 billion in December, even though the interest earned is only 0.25 percent annually. Banks continue to be very risk averse.

Consumers have established a solid trend line of declining credit demand with credit balances falling for three of the last four months. This has been evident as the end-of-year retail sales data were the worst since 1970 (using chain store sales). If this shift is a sign that consumers really are transitioning from a mindset of consumption based on access to credit to a mindset of savings and consumption balance, then the recovery of the economy is likely to be slow irrespective of any stimulus.

It is perhaps telling that even the burst of the bubble in commodities prices and the attendant stimulus to household budgets has not led to a consumer rebound. Retail gasoline prices fell by 42 percent from their peak in July to November. Had energy goods and services prices remained at their July peaks on an annualized basis, the additional bill to consumers would have been \$223 billion higher. The collapse of these costs has been a big help to households.

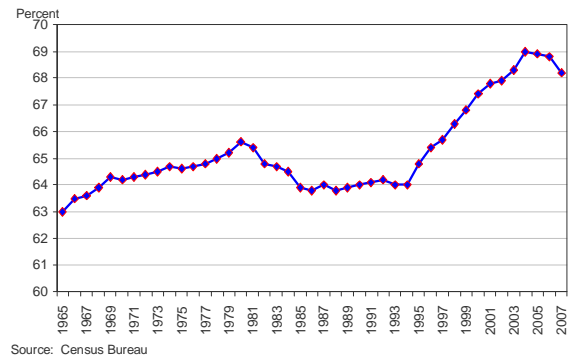
Still, our forecast calls for declines in economic growth in both the first and second quarters of 2009 with very modest second half growth. Full-year real economic growth is expected to be slightly negative. That means companies will continue to shed employees as they attempt to restore profit margins. That, in turn, will mean continued slack in consumer spending. Who can blame the consumer for being shell shocked? Household wealth is down significantly with home price declines, stock price declines, credit restrictions, and rising future tax liability.

The centerpiece of interest continues to be housing. The Fed's decision to buy Mortgage Backed Securities has definitely shown an impact as headline mortgage rates have been coming down. The homeownership rate has also been coming down and there has been some argument that by lowering mortgage rates to 4.5 percent enough new borrowers can be brought into the market to return the homeownership rate back to its peak of over 69 percent. However, that assumes that the credit and house price bubbles did not artificially inflate the homeownership rate. In fact, our internal calculations indicate that the actual number of new homeowners created by the rate decline will be very small.

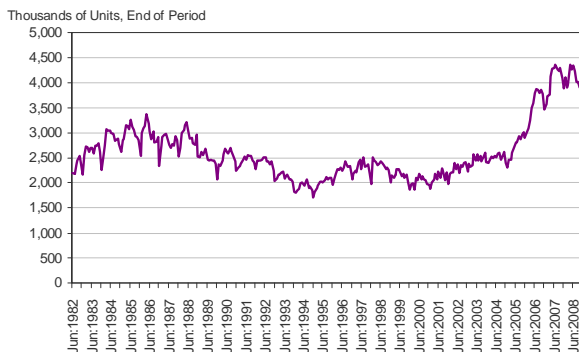
Adjusted Reserves of Depository Institutions



U.S. Homeownership Rate



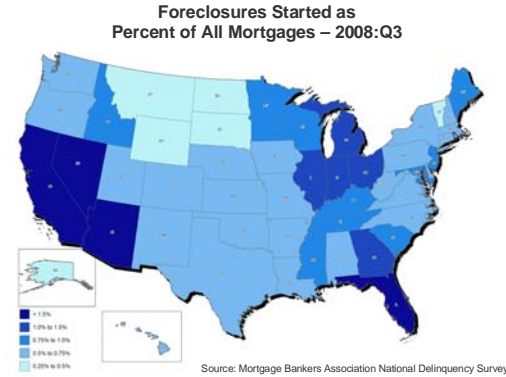
Inventory of New and Existing Single-Family Homes on the Market



The big problem continues to be inventory, and the inventory of total homes on the market is still near the peak as foreclosures come close to replacing sales. That said, the inventory is down from its absolute peak and to the extent that the lower expected mortgage rates occur and remain there, the incremental addition of owners will help. Likewise, the ability of homeowners to refinance their existing mortgages and shore up the household balance sheets will help as well.

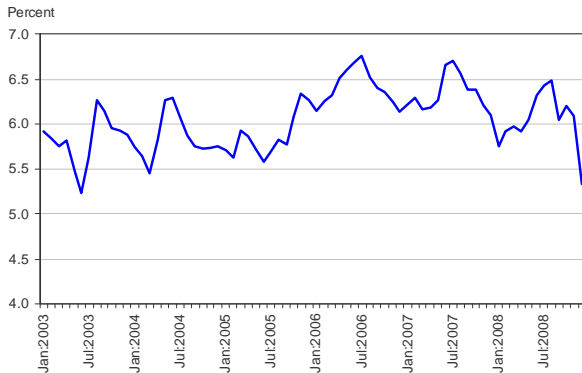
The foreclosures continue to be focused in three primary areas: the Pacific Southwest, the Upper Midwest, and Florida. There was some evidence in the third-quarter data from the Mortgage Bankers Association that a peak might be near. However, with the rapid deterioration in employment that now looks unlikely.

We expect total mortgage originations to increase in 2009, but there are really two stories here. With the continued decline in the housing market, and our expectation that housing starts, sales, and prices will decrease in 2009, we expect purchase originations to decline by about 15 percent for all of 2009 to about \$800 billion.



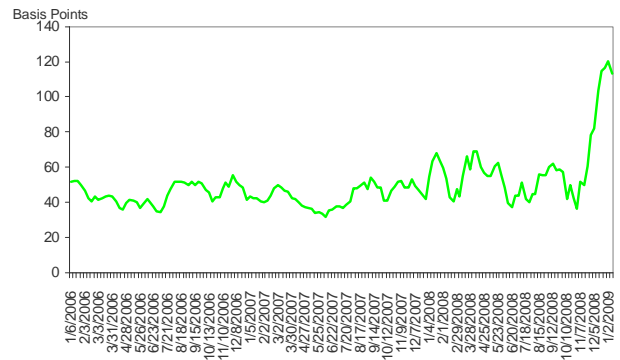
The large drop in long-term mortgage rates and its potential impact on refinance originations completes the mortgage originations story. Each weekly update of mortgage rates brings the news of record lows in the 30-year mortgage rate. At the time of writing this commentary, the 30-year mortgage rate was 4.96 percent, with the potential to go even lower. One frustration, however, has been the stubborn spread between the 30-year fixed-rate market interest rate and the conventional conforming secondary market yield on Fannie Mae securities. This spread traditionally reflected the servicing fee and guaranty fee averaging 40 to 50 basis points over time. It remains in the range of 100 basis points currently. Thus, while market rates have come down, a return to historical averages for the secondary market spread would bring them down another significant amount.

30-Year FRM Rate



Source: Federal Reserve Board

30-Year FRM/Fannie Mae 30-Year CC MBS Yield Spread
Four-Week Moving Average



Sources: Bloomberg, Federal Reserve Board

At the rates provided in our forecast, a large majority of total mortgage debt outstanding is in-the-money to refinance, meaning that borrowers have a rate incentive to refinance. While at first glance this information would lead one to believe that we will see the largest refinance boom ever recorded, declining home prices, tighter credit conditions, and a bifurcation of the mortgage market into conforming and jumbo loans should dampen demand for refinancing.

Applying haircuts for these potential eligibility requirements to the in-the-money share of mortgage debt outstanding (MDO) greatly reduces the share of mortgage debt that could potentially be refinanced, so while we saw more than 40 percent of total MDO refinanced in 2003, we might only see about 20 percent of total MDO refinanced in 2009.

Doug Duncan and Molly R. Boesel
Economics and Mortgage Market Analysis
January 16, 2009

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