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Office of the Chief Economist

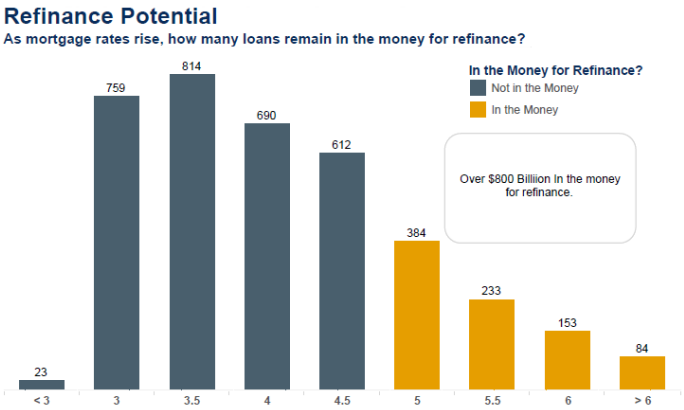
February 2014 U.S. Economic & Housing Market Outlook

Will Housing Take Gold?

Key to another good recovery year for housing is broad-based improvement in employment and family income. We expected housing to come out of the gate at a good clip at the start of 2014 bolstered by an improving economy, but the lackluster labor market report for January has resulted in a slow start for the residential sector. Only 113,000 jobs were created, less than the 194,000 per month the U.S. averaged for 2013. But there were some bright spots: The unemployment rate slipped a tenth to 6.6 percent, the labor force participation nudged up, and 48,000 construction jobs were created, with nearly half of those added in the residential space.

The Federal Reserve's announcement after its January Federal Open Market Committee meeting suggests that as long as growth remains at about 2013's pace or better, it is likely to gradually ratchet down its acquisitions, set at $65 billion in long-term Treasuries and mortgage-backed securities (MBS). Moreover, as long as substantive growth is maintained, the Fed also appears likely to slowly reduce its extra purchases to zero by the end of this year. This will likely put some upward pressure on long-term interest rates, such as fixed-rate mortgage rates.

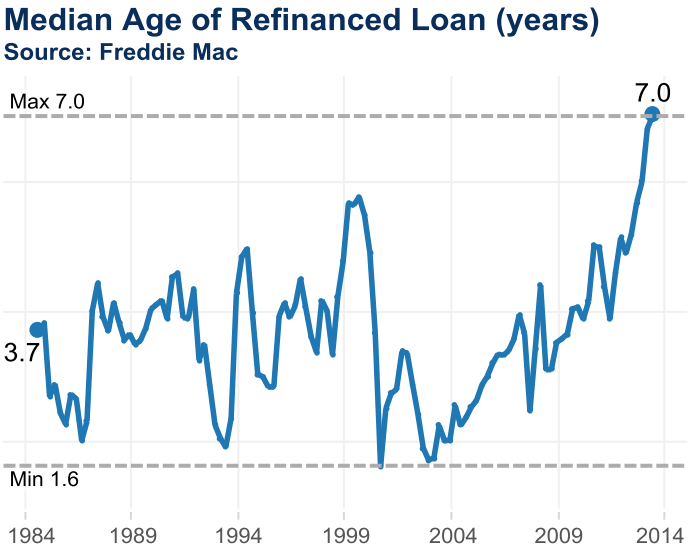
However, in the short-term the effect of the Fed's actions on MBS yields may be somewhat mitigated for a couple of reasons. First, there has been a decline in new MBS issuances over the first part of winter related to the seasonal slowdown in purchase-money originations and drop in refinance activity due to the uptick in fixed rates during the latter half of 2013. Second, global capital market investors have become more concerned about the prognosis for emerging markets' growth and, as a result, have shifted funds into the safety of U.S. Treasury securities and related fixed-income assets. So while the Fed began its tapering activities at the beginning of January, 10-year Treasury yields and fixed mortgage rates generally eased over the month, dipping about 0.3 percentage points between early January and early February – and this appears to be giving refinance activity a second wind.



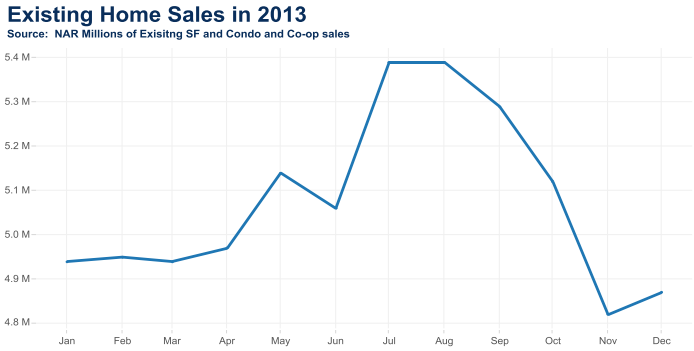
This dip in long term mortgage rates has resulted in a seasonally adjusted mortgage application volume increase by more than 20 percent since the end of 2013 (28 percent for refinance), as reported by the Mortgage Bankers Association. Despite high levels of refinance volume over the past few years, this application increase underscores that a significant amount of potential refinance remains. For example, if we look at 30-year MBS outstanding for Fannie Mae, Freddie Mac, and Ginnie Mae in January 2014, we find more than $800 billion in securities with a coupon of at least 5.0 percent. Typically, servicing and other fees account for at least a one-half percentage point gap between MBS coupon and the note rate on the underlying mortgage. With 30-year mortgage

rates at about 4.25 to 4.50 percent, many of the loans underlying a 5.0 percent (and higher) coupon security would have incentive to lower their payments by refinancing[1].

Even with the uptick in mortgage rates last summer, many borrowers continued to refinance through the end of 2013. Borrowers who refinanced during the final three months of last year cut their contract mortgage rate about 25 percent, and they will save an average of about $3,000 in mortgage interest over the first year of their new loan. And about half of the borrowers who refinanced held their previous loan for seven years or longer.[2] Thus, there are many borrowers today, with loans originally taken out in 2006 or earlier, that can substantially reduce their mortgage interest expense by refinancing. If these borrowers have limited equity (or are underwater) but have loans owned by Freddie Mac or Fannie Mae, they may qualify for a HARP refinance.[3]



On the home purchase front, rising mortgage rates in the second half of 2013 stunted the housing recovery. Sales of new homes fell by 7 percent in December from the previous month. After existing home sales reached their 2013 peak of 5.4 million in August, sales have declined nearly 10 percent (seasonally adjusted). While some of the decline is attributable to the harsh December weather in parts of the U.S., a good portion of the decline occurred before winter began.



As we indicated in our January Outlook, total home sales are closing in on the "normal" range when considering historical rates of turnover. But it's the new versus existing composition of home sales activity that is outside the normal range. We expect overall home sales to rise about 5 percent in 2014 relative to last year, with about a 3 percent rise in existing home sales coupled with a 30 percent jump in new home sales. Further, over the past few years the share of all cash

[1] For example, a $200,000 30-year fixed-rate mortgage (FRM) at 5.5% interest has monthly principal and interest payments of $1,135. Refinancing into a new 30-year FRM with a 4.5% interest rate reduces monthly payments to $1,013 a month, a savings of $122 per month.

[2] See Freddie Mac's 2013 Fourth Quarter and Full Year Refinance Report at http://www.freddiemac.com/finance/refinance_report.html

[3] HARP eligibility requirements can be found at http://www.freddiemac.com/mortgage_help/harp.html

sales has remained elevated at about 30 percent. We expect to see more new home sales and a larger share of home sales financed with a mortgage in 2014.

Of course, if rates rise it will be difficult for many families to purchase a home without some income growth. Rising home prices and interest rates along with little to no income growth has resulted in a substantial erosion of homebuyer affordability over the past year (see updated affordability map). Therefore, jobs and income growth are necessary for 2014 to turn in another gold-medal performance for the housing recovery.

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