



March 2014 U.S. Economic & Housing Market Outlook

Will Job Growth Propel an Emerging Purchase Market?

The bounce back in home sales over the past three years has laid the foundation for the housing recovery. Sales of new and existing homes in 2013 totaled 5.5 million, a 20 percent jump from 2011's volume. And with the sales gain, mortgage originations for home purchase have also turned the corner, up more than 20 percent in 2013 from a 15-year low in 2011. After being driven by refinances for more than a decade, the mortgage market in 2014 should experience its first purchase-money dominated year since 2000. We expect home sales to be up about 3 percent in 2014, new home construction to increase by almost 20 percent, and house-price appreciation to moderate but continue last year's positive momentum with annual growth of 5 percent in 2014. With a strengthening economy, we expect long term interest rates to rise, including mortgage rates: the 30-year fixed-rate mortgage is expected to average about 4.9 percent in the fourth quarter, up about one-half of a percentage point from the first quarter.

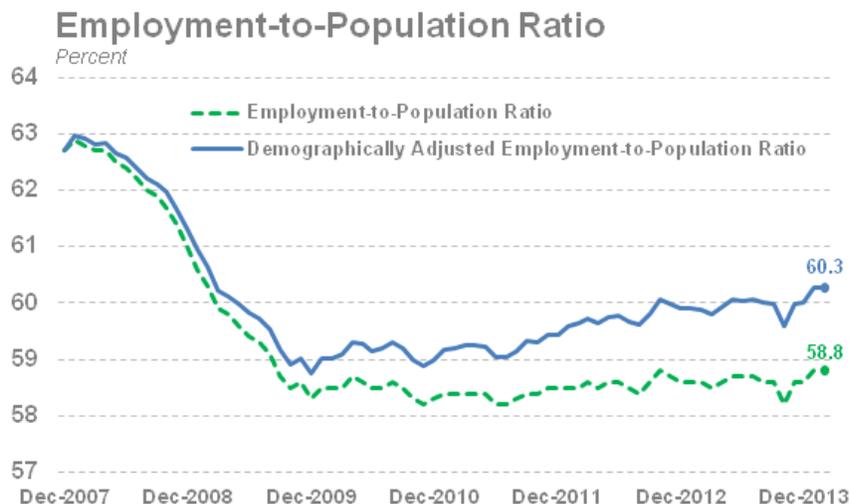
But how does a forecast of rising home sales reconcile with higher mortgage rates and house prices? As we noted in previous economic outlooks, the incredibly high homebuyer affordability that we saw over the past few years has begun to wane. Homebuyer affordability in many high-cost metro areas has declined to the point where the median priced single-family house is unaffordable to a family earning the median income, given traditional housing payment-to-income guidelines. With rates set to go higher and house prices continuing their upward trend, affordability may erode further. To sustain the rally in housing we need another component of affordability—family income—to increase.

However, broad-based income growth requires continued improvement in the labor market. Despite substantial progress, the labor market remains below its potential with unemployment stubbornly high and total nonfarm payrolls below peak levels. What will it take to get the labor market moving again? Let us consider the labor market and its challenges.

When considering the labor market, there are two key statistics most often used to summarize the current situation: the unemployment rate and nonfarm payroll employment. Today, both measures indicate slack in the labor market. The unemployment rate in February 2014 stood at 6.7 percent, well above what economists consider the 'natural' rate of unemployment (the unemployment rate with stable inflation is generally considered to be between 5 and 6 percent). Because the unemployment rate is the ratio of two numbers—unemployed divided by labor force—the unemployment rate doesn't always move with the overall labor market. To help make sense of the unemployment rate, it's often helpful to consider total employment. Today, total nonfarm payrolls remain below the peak level reached prior to the Great Recession.

If total employment remains below its cyclic peak, why has the unemployment rate fallen so much? The answer is declining labor force participation (the percent of the population aged 16 or older that is in the labor force). As unemployed workers exit the labor force the unemployment rate falls. Demographic factors drive down the labor force participation rate, but not all of the current declining participation is due to the aging of the baby boomers. In December 2007 the employment-to-population ratio was 62.7 percent. In February 2014, that ratio had declined to 58.8 percent.

At the start of the Great Recession the employment-to-population ratio fell across all but the oldest age group (at least 55 years old). The fall was particularly sharp for the youngest cohort 16-24 years old). Recently this ratio has increased for most age groups. However, the increases by age group have not been enough to offset the demographic shift. Despite the fact that the eldest age group increased its employment-to-population ratio, this group includes many retirees and thus has a much lower employment-to-population ratio than younger cohorts. The net effect is that employment-to-population ratios remain low relative to pre-Great Recession levels.



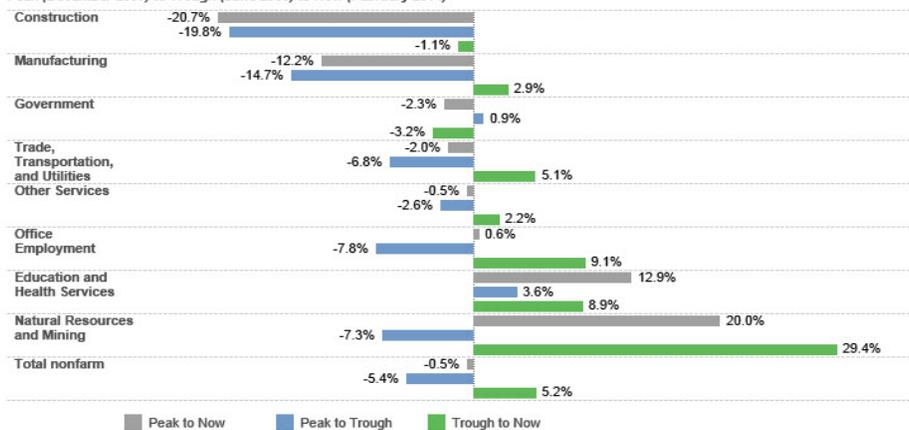
Source: Bureau of Labor Statistics, Current Population Survey
Demographically Adjusted Employment-to-Population Ratio calculated by keeping population weights for age groups fixed at December 2007 Levels.

By our demographic analysis of the 3.9 percent decline in the employment-to-population ratio, about 40 percent was driven by retiring baby boomers between December 2007 and February 2014. The remaining portion is due to other factors.

What other factors? Employment growth has been sluggish largely due to the slow housing recovery. As we mentioned last year ([Where's the Juice?](#)), we believe the major problem facing the U.S. labor market is structures, not structural. Construction spending and housing starts are low relative to historic benchmarks. In February, construction employment was 5.9 million, 1.5 million less than the in December 2007. With housing starts at a 907,000 annual rate in February, there is considerable room for expansion in construction without over-heating the market. Adding 1.5 million more construction workers would increase the employment-to-population ratio by 0.6 percent.

Employment Changes by Industry

Peak (December 2007) to Trough (June 2009) to Now (February 2014)



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Of the 3.9 percentage point decline in the employment-to-population ratio since the end of 2007, 1.5 percentage points were due to demographics and 0.6 percent due to the slow recovery in construction. The remaining 1.8 percentage points were related to the generally weak economic environment. Indeed, as the bar charts shows, construction and manufacturing are still considerably below peak employment: 20.7 percent and 12.2 percent, respectively. Like

construction, manufacturing is highly procyclical. As growth renews, we should expect to see increased manufacturing employment.

In fact, we are already starting to see some signs of a resurgent labor market. The extreme weather in many parts of the country make parsing the January and February employment reports more challenging than usual, but we don't have to dig too deep to see some signs of hope. Wage growth has turned around. Following the end of the Great Recession—when the labor market was weakest—wage growth fell sharply. But recently, with continued steady improvement in labor markets, wage growth has begun to pick up. In the February report, annual growth in wages was at 2.5 percent, well above consumer price inflation. These real increases in earnings should do a lot to help improve households' confidence and ultimately increase consumer spending.

In order to have solid home sales in 2014, we need to see continued improvement in the labor market. Demographic headwinds have accounted for about 40 percent of the decline in the employment-to-population ratio. The remaining 60 percent is due largely to cyclical factors. Manufacturing and construction are the two sectors that have been slowest to recover. With increased economic growth, these two sectors should start to improve. With more jobs, wage growth should continue to accelerate, giving American households much needed income to help sustain the emerging purchase market.

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Indicator	2013		2014				2015				Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011	2012	2013	2014	2015
Real GDP (%)	4.1	2.4	2.0	2.8	3.0	3.2	3.3	3.3	3.3	3.3	-0.2	2.8	2.0	2.0	2.5	2.8	3.3
Consumer Prices (%) a.	2.6	0.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.5	1.4	3.0	1.8	1.2	2.0	2.0
Unemployment Rate (%) b.	7.2	7.0	6.6	6.6	6.5	6.4	6.3	6.2	6.2	6.1	9.3	9.6	8.9	8.1	7.4	6.5	6.2
30-Year Fixed Mtg. Rate (%) b.	4.4	4.3	4.4	4.5	4.7	4.9	5.1	5.3	5.5	5.7	5.0	4.7	4.5	3.7	4.0	4.6	5.4
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	3.2	3.0	3.1	3.2	3.3	3.5	3.7	3.9	4.1	4.3	4.8	3.8	3.3	2.8	2.9	3.3	4.0
1-Year Treas. Indexed ARM Rate (%) b.	2.7	2.6	2.6	2.6	2.6	2.7	2.7	2.8	2.9	3.0	4.7	3.8	3.0	2.7	2.6	2.6	2.9
10-Year Const. Mat. Treas. Rate (%) b.	2.7	2.7	2.8	2.8	3.0	3.2	3.4	3.6	3.8	4.0	3.3	3.2	2.8	1.8	2.4	3.0	3.7
1-Year Const. Mat. Treas. Rate (%) b.	0.1	0.1	0.1	0.1	0.2	0.2	0.3	0.3	0.4	0.5	0.5	0.3	0.2	0.2	0.1	0.2	0.4

Indicator	2013		2014				2015				Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011	2012	2013	2014	2015
Housing Starts c.	0.88	1.01	0.95	1.05	1.15	1.25	1.30	1.40	1.40	1.50	0.55	0.59	0.61	0.78	0.93	1.10	1.40
Total Home Sales d.	5.71	5.38	5.30	5.50	5.70	5.90	5.95	6.00	6.00	6.05	4.72	4.51	4.57	5.03	5.50	5.60	6.00
FMHPI House Price Appreciation (%) e.	1.5	-0.4	1.0	2.5	1.5	-0.1	0.0	2.0	1.0	0.0	-2.3	-4.9	-3.2	5.9	9.3	5.0	3.0
S&P/Case-Shiller® Home Price Index (%) f.	3.1	-0.3	1.1	3.5	1.0	-0.6	0.0	2.0	1.0	0.0	-2.5	-3.8	-3.7	7.2	11.3	5.0	3.0
1-4 Family Mortgage Originations g.																	
Conventional	\$363	\$289	\$280	\$340	\$266	\$194	\$237	\$296	\$233	\$166	\$1,549	\$1,300	\$1,206	\$1,750	\$1,543	\$1,080	\$932
FHA & VA	\$87	\$61	\$70	\$85	\$67	\$48	\$63	\$79	\$62	\$44	\$451	\$367	\$286	\$372	\$357	\$270	\$248
Total	\$450	\$350	\$350	\$425	\$333	\$242	\$300	\$375	\$295	\$210	\$2,000	\$1,667	\$1,492	\$2,122	\$1,900	\$1,350	\$1,180
ARM Share (%) h.	9	10	10	11	12	13	14	15	15	15	3	5	11	10	9	12	15
Refinancing Share - Applications (%) i.	54	59	51	41	34	33	30	20	15	15	68	73	71	77	63	40	20
Refinancing Share - Originations (%) j.	52	51	48	40	33	33	30	20	15	15	68	67	64	70	61	39	20
Residential Mortgage Debt (%) k.	1.3	0.1	0.0	1.0	2.0	3.0	3.0	4.0	4.0	5.0	-1.6	-4.3	-2.2	-2.1	-0.2	1.5	4.0

Note: Quarterly and annual forecasts (or estimates) are shown in shaded areas; totals may not add due to rounding; quarterly data expressed as annual rates.
 Annual forecast data are averages of quarterly values; annual historical data are reported as Q4 over Q4.

a. Calculations based on quarterly average of monthly index levels; index levels based on the seasonally-adjusted, all-urban consumer price index.
 b. Quarterly average of monthly unemployment rates (seasonally-adjusted); Quarterly average of monthly interest rates.
 c. Millions of housing units; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
 d. Millions of housing units; total sales are the sum of new and existing single-family homes; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
 e. Quarterly growth rate of Freddie Mac's House Price Index (FMHPI); not seasonally-adjusted; Dec.to-Dec. for yearly data.
 f. National composite index (quarterly growth rate); not seasonally-adjusted; Q4-to-Q4 for yearly data.

g. Billions of dollars (not seasonally-adjusted).
 h. Federal Housing Finance Agency (FHFA); quarterly averages of monthly shares of number of loans of conventional, home-purchase mortgage closings (not seasonally-adjusted).
 i. MBA Applications Survey; activity by dollars, total market refi share percent for United States (not seasonally-adjusted).
 j. Home Mortgage Disclosure Act for all single-family mortgages (not seasonally-adjusted); Annual share is dollar-weighted average of quarterly shares.
 k. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages (not seasonally-adjusted, annual rate).

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