Office of the Chief Economist

May 2014 U.S. Economic & Housing Market Outlook

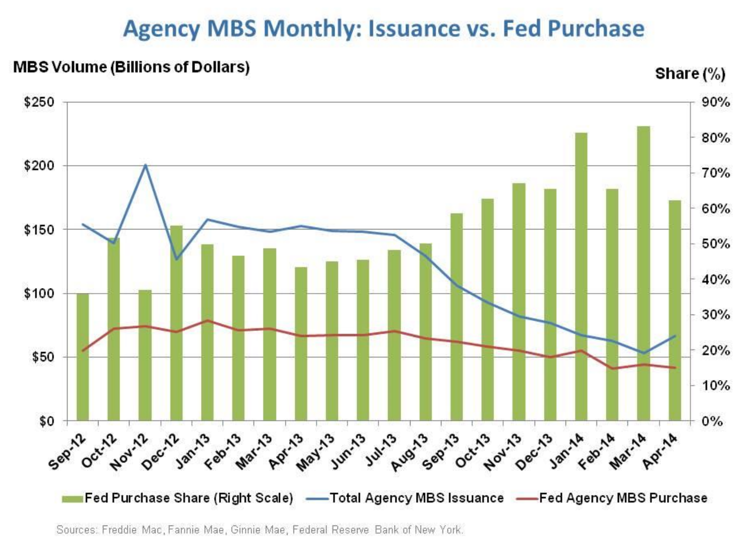
Demand and Supply

Economists use 'demand and supply' diagrams to explain a host of real-world phenomena. To illustrate, let's use this tool to analyze three topics in the housing market that help us understand the current direction we're moving and are critical to keeping the housing recovery not just going but growing – mortgage rates, home sales, and household formations. In each of these fundamental areas, what we expect to be happening isn't.

'Tapering' and Mortgage Rates

"Beginning in May, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $20 billion per month…. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities…"--FOMC Statement, April 30, 2014

The Federal Reserve (Fed) inaugurated its third round of quantitative easing, commonly referred to as 'QE3', on September 13, 2012. For fifteen months thereafter, the Fed grew its holdings of mortgaged-backed securities (MBS) by $40 billion per month and its holding of longer-term Treasury securities by $45 billion per month. Total purchases of MBS were greater than $40 billion each month due to the reinvestment of principal payments reflecting the declining principal balance of its agency debt and MBS portfolio through debt maturity, loan amortization and loan payoff. Over the past five months, the Fed has gradually 'tapered' its growth in MBS holdings. For May 2014, the planned growth in holdings is $20 billion, one-half of what the monthly pace had been from the start of QE3 through the end of 2013.



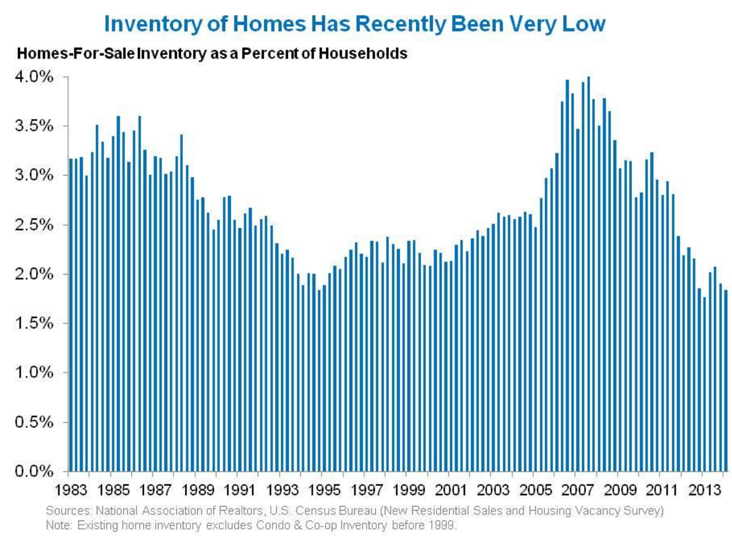
While the Fed has gradually curtailed its MBS acquisitions, mortgage rates have largely held steady, with fixed-rates even dipping in early May to the lowest level since early November, based on Freddie Mac's Primary Mortgage Market Survey® (PMMS). The Fed's 'tapering' has coincided with a sharp reduction in mortgage loan originations and, hence, new MBS issuance. The accompanying exhibit illustrates that even though the Fed's purchases of MBS (the monthly 'net addition' plus the replacement of principal pay downs on existing holdings) are down significantly, so are monthly

MBS issuances. In fact, the Fed's acquisitions, as a ratio to new issuance, are slightly higher than a year ago. In other words, the Fed's 'demand' for new MBS has declined less than has new 'supply', thus keeping the Fed's share of MBS issuance above year-ago levels.

This is one reason the primary market is currently enjoying lower than expected mortgage rates. New MBS supply will continue to run below last year's pace because of the sharp decline in refinance originations. Refinance is down from about 80 percent of the dollar volume of applications in January 2013 to only 43 percent in April 2014 and is expected to decline further. The refinance drop reflects two important factors: First, fixed mortgage rates are up about a percentage point from a year ago (sharply reducing the incentive to refinance), and second, more than 30 million borrowers have either refinanced or taken a new home-purchase loan since the beginning of 2009 and already enjoy a very low mortgage rate. We expect to see the 30-year fixed-rate mortgage rate gradually rise to around 4.6 percent by the end of the year as the Fed continues to 'taper' and ultimately reduces its share of new MBS issuance.

Home Sales Down, Yet Prices Up

Many real estate agents are reporting a relatively low inventory of homes available for sale, so that even with the decline in existing home sales over the past six months the current months' supply of existing homes on the market (or, inventory-to-sales ratio) remains low, at 5.2 months in March. Including newly built homes in the inventory count, the total number of homes offered for sale relative to the number of households in the U.S. has been running at the lowest level in more than 30 years, as shown in the second exhibit. The relatively low for-sale inventory reflects several features of today's market.



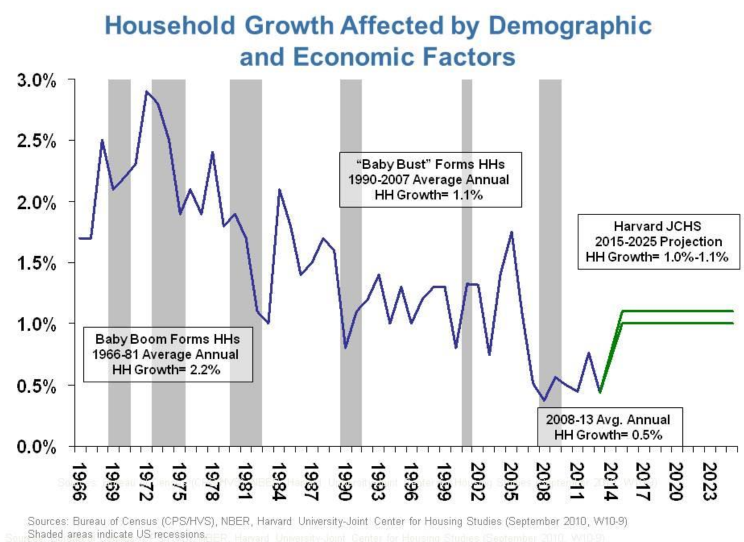
First, many homeowners remain 'underwater' and are reluctant to short-sell given the expiration of the Mortgage Forgiveness Debt Relief Act on December 31, 2013. CoreLogic has estimated that about 6.5 million homeowners remained underwater as of year-end 2013; the firm also reported a sharp decline in short sales at the beginning of 2014, from 5.2 percent of sales in December to 2.2 percent of sales in February, based on preliminary data for the latter month.

Second, the majority of today's homeowners with a mortgage either purchased their home during the last few years, refinanced into a low-rate mortgage, have an adjustable-rate mortgage that has adjusted down to a very low rate, or have had their interest rate reduced through a loan modification (for example, homeowners with a modification through the U.S Treasury's Home Affordable Modification Program may have an interest rate as low as 2 percent). In fact, the Bureau of Economic Analysis has estimated that the average interest rate on single-family mortgages outstanding was 3.9 percent during the first quarter of 2014, well below the average 30-year fixed-rate average rate of 4.4 percent for new loans during the quarter, as recorded in our mortgage survey. Homeowners with mortgage rates well below current market rates may be reluctant to sell their current home and forego the low-rate mortgage loan they currently have.

Third, while real-estate owned (REO) sales remain strong in some markets, in aggregate, REO sales have slowed considerably over the past couple of years. A decline in the number of homes offered for sale at each price point over the past year is consistent with the trend in the number of sales and in house prices: A supply-constrained market (holding other factors constant) will result in a decline in the volume of sales and an increase in real transaction prices (that is, house prices rising faster than inflation for all other goods). Thus, even though existing home sales are down 6.3 percent during the first quarter of 2014 compared with a year ago, house prices are up 8 percent in the Freddie Mac House Price Index (and even more in some other price measures).

Household Formations and Housing Starts

Housing starts have increased substantially from their trough in 2009, but still remain at depressed levels. While several forces have conspired to restrain new construction, a key factor has been the lackluster rate of household formations. Net formations (gross formations less household dissolutions) have averaged barely better than 500,000 per year since the Great Recession, compared with an average of more than one million per year in the decade before. Harvard's Joint Center for Housing Studies is projecting an average of 1.2 to 1.3 million per year over the 2015 to 2025 decade. Household formations are traditionally the largest driver of the demand for new housing; thus, when demand is weak, net new supply will be reduced as well.



The pace of household formations is affected by two principle forces: demographics and the business cycle. Currently, the demographic component is favorable for household formations; the number of live births in the U.S. increased significantly around 1990 and gradually rose until peaking in 2007, laying the groundwork for a rising number of young households arriving in the housing market at about this time. However, the protracted period of a weak labor market—with high unemployment, workers taking lower-wage or part-time jobs, or even being too discouraged to seek work—has meant that many adults in their 20s have continued to live with relatives (often parents) and have had to wait an extended period to save funds and generate an earnings cash-flow sufficient to set up their own household. At the same time, many have turned to college or graduate school to enhance their human capital, but have also built considerable student debt in the process.

A pickup in household formations—an increase in demand for additional housing, in economists' parlance—will require stronger job growth. We understand that we might sound like a broken record here, along with many other economists, but the need to have a job before buying a house is a simple fact of life. The labor market report for April was an encouraging sign, with 288,000 jobs added to the economy. We anticipate economic growth accelerating to about a 3.0 percent annualized rate in the final three quarters of 2014. If we reach that level it should generate between 200,000 and 250,000 jobs per month, and with that an increase in net household formations and new housing starts—or in other words, additional housing supply. If we get that, we'll be able to address the underlying 'supply' problem because we know the 'demand' for housing is there.

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Freddie Mac® Office of the Chief Economist

May 2014 Economic and Housing Market Outlook

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	2013		2014				2015				Annual Totals						
Indicator	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Real GDP (%)	4.1	2.6	0.1	**2.8**	**3.0**	**3.2**	**3.3**	**3.3**	**3.3**	**3.3**	-0.2	2.8	2.0	2.0	2.6	**2.3**	**3.3**
Consumer Prices (%) a.	2.2	1.1	1.9	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	1.5	1.2	3.3	1.9	1.2	**2.0**	**2.0**
Unemployment Rate (%) b.	7.2	7.0	6.7	**6.3**	**6.3**	**6.2**	**6.1**	**6.0**	**5.9**	**5.8**	9.3	9.6	8.9	8.1	7.4	**6.4**	**6.0**
30-Year Fixed Mtg. Rate (%) b.	4.4	4.3	4.4	**4.3**	**4.4**	**4.6**	**4.8**	**5.0**	**5.2**	**5.4**	5.0	4.7	4.5	3.7	4.0	**4.4**	**5.1**
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	3.2	3.0	3.1	**3.2**	**3.3**	**3.5**	**3.8**	**4.0**	**4.2**	**4.4**	4.8	3.8	3.3	2.8	2.9	**3.3**	**4.1**
1-Year Treas. Indexed ARM Rate (%) b.	2.7	2.6	2.5	**2.4**	**2.5**	**2.5**	**2.6**	**2.6**	**2.7**	**2.8**	4.7	3.8	3.0	2.7	2.6	**2.5**	**2.7**
10-Year Const. Mat. Treas. Rate (%) b.	2.7	2.7	2.8	**2.7**	**2.8**	**3.0**	**3.2**	**3.4**	**3.6**	**3.8**	3.3	3.2	2.8	1.8	2.4	**2.8**	**3.5**
1-Year Const. Mat. Treas. Rate (%) b.	0.1	0.1	0.1	**0.1**	**0.1**	**0.1**	**0.2**	**0.3**	**0.3**	**0.4**	0.5	0.3	0.2	0.2	0.1	**0.1**	**0.3**

	2013		2014				2015				Annual Totals						
Indicator	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Housing Starts c.	0.88	1.01	0.92	**1.05**	**1.15**	**1.25**	**1.30**	**1.40**	**1.40**	**1.50**	0.55	0.59	0.61	0.78	0.93	**1.09**	**1.40**
Total Home Sales d.	5.71	5.39	5.04	**5.44**	**5.70**	**5.80**	**5.90**	**5.90**	**6.00**	**6.05**	4.72	4.51	4.57	5.03	5.50	**5.50**	**5.96**
FMHPI House Price Appreciation (%) e.	1.6	-0.7	1.2	**2.5**	**1.5**	**-0.3**	**0.0**	**2.0**	**1.0**	**0.0**	-3.1	-4.9	-3.3	6.1	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**	**$291**	**$240**	**$312**	**$256**	**$192**	**$228**	**$288**	**$224**	**$160**	$1,549	$1,300	$1,206	$1,750	**$1,570**	**$1,000**	**$900**
FHA & VA	$87	$59	**$60**	**$78**	**$64**	**$48**	**$57**	**$72**	**$56**	**$40**	$451	$367	$286	$372	$357	**$250**	**$225**
Total	**$450**	**$350**	**$300**	**$390**	**$320**	**$240**	**$285**	**$360**	**$280**	**$200**	$2,000	$1,667	$1,492	$2,122	**$1,925**	**$1,250**	**$1,125**
ARM Share (%) h.	9	10	11	**11**	**12**	**13**	**14**	**15**	**15**	**15**	3	5	11	10	9	**12**	**15**
Refinancing Share - Applications (%) i.	54	59	52	**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).

Prepared by Office of the Chief Economist and reflects views as of 5/15/2014 (PTT); Send comments and questions to chief_economist@freddiemac.com.