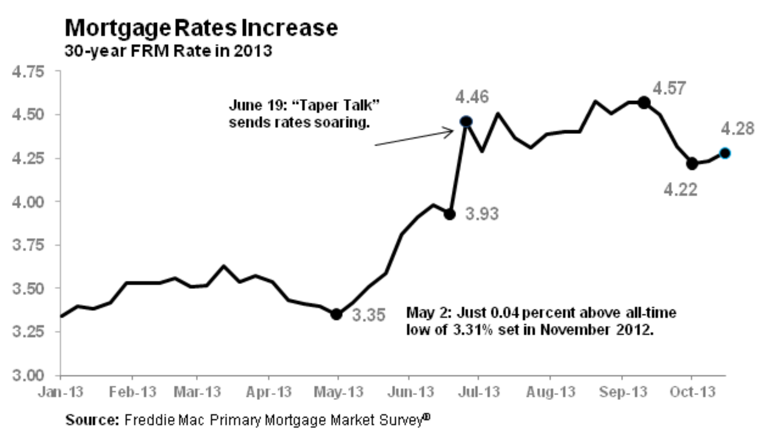
Office of the Chief Economist

October 2013 U.S. Economic & Housing Market Outlook

Will the Economic Recovery Shut Down?

While economic growth in the second quarter of the year was supported by a resurgent housing market, the recovery appears to have slipped a bit heading into the fourth quarter. Rising interest rates from May through September are slowing the economic rebound and weighing on housing markets. With a federal government shutdown at the beginning of October and a debt ceiling default averted at the last minute, the economy still faces ongoing uncertainty since both issues were not resolved for the long term but only delayed until early next year. Will the economic recovery shutdown, or can we expect a pickup in economic activity any time soon?

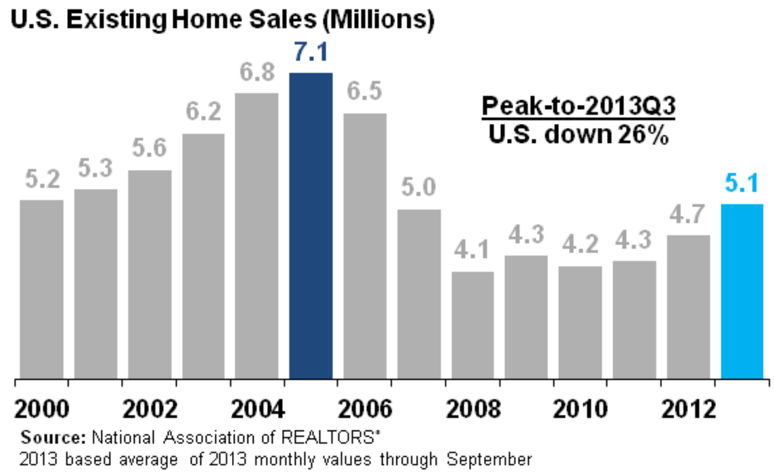
It's been about 18 years since the last federal government shutdown, which also took a toll on the economy. The shutdown during the fourth quarter of 1995 was actually two shutdowns. The first lasted 5 days (November 14-19) and idled about 747,000 federal employees. The second lasted three weeks (December 16 to January 6) and furloughed 284,000 federal employees. At the time, the Bureau of Economic Analysis placed the effect of the lost government output at about a 0.25 of a percentage point reduction in economic growth; the Congressional Budget Office estimated the shutdowns had depressed economic growth by about 0.5 of a percentage point during the fourth quarter of 1995.[i] The October 2013 government shutdown will impair growth during the final quarter of this year. Macroeconomic Advisers has estimated a 0.3 percentage point reduction in economic growth for a shutdown of two weeks.



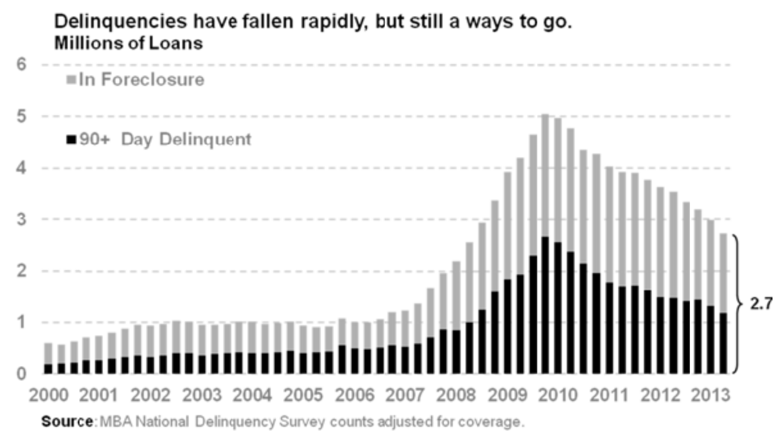
Despite the uncertainty from Washington, the housing market was already beginning to cool off from this spring and summer's strong sales an d rising house prices. Rising mortgage rates dampened some of the momentum in housing markets heading into the fall. From June through early September mortgage rates tracked steadily upwards. Since September 12, mortgage rates have receded about 0.3 percentage points. We expect interest rates to reverse course yet again and gradually trend upwards once the excitement around the government shutdown and the debt ceiling subsides. Over the next couple months expect rates to hover around the 4.3 percent level and then begin heading higher in 2014.

Even with slightly higher mortgage rates, homebuyer affordability will remain high in most of the country. The key factor driving home prices in many markets is a lack of inventory in the face of rising demand. The National Association of Realtors reported that the supply of homes for sale had fallen to a new post-recession low of 5 months at the end of September. Even though the number of homes offered for sale ("supply") was up 2 percent September-to-September, the number of settlements ("demand") was up 11 percent, driving the inventory-sales ratio to lower levels. Indeed, if we were to look at markets where house price gains have been most impressive, the inventory-to-sales ratio would be much tighter.

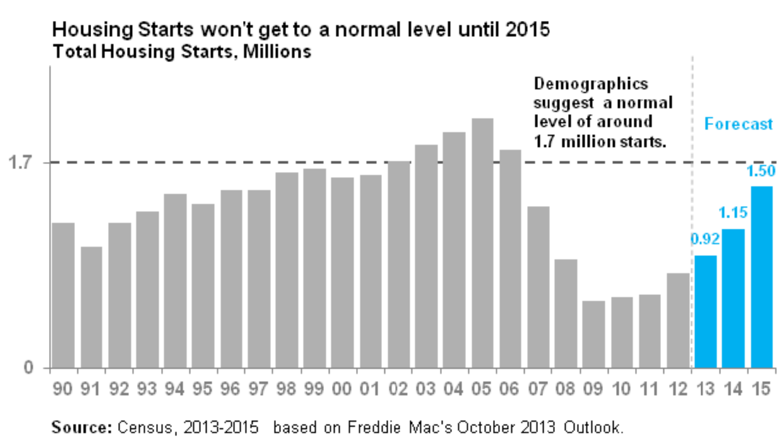
Inventories are tight for three reasons. First, despite recent home price appreciation, most homeowners do not sell when they have negative equity. According to data from CoreLogic as of second quarter 2013, 7.1 million mortgage properties have negative equity, representing 14.5 percent of all mortgage properties in the U.S. Though house price gains helped 2.5 million residences to reach positive equity during the second quarter of 2013, the pace should slow as house price growth moderates. The high level of "underwater" households removes an important source of supply of for-sale homes. Indeed, existing home sales as of the third quarter were still down 26 percent from their peak in the third quarter of 2005.



A second reason inventories are tight is a declining supply of distressed sales. From the peak in 2010, the stock of homes with a seriously delinquent mortgage or in foreclosure was down about 2.4 million, from 5.1 million to 2.7 million as of June 2013. As the supply of distressed sales diminishes and the supply of existing homes for sale remains low, the inventory of for-sale homes will tighten.



The third factor, new home construction remains severely depressed. In a normal economic environment (see our November 2012 Outlook), the U.S. economy should add around 1.7 to 1.8 million housing units per year. According to our latest forecast, the U.S. economy will add less than 1 million housing units in 2013 and around 1.15 million in 2014, significantly below normal levels. This dearth of building is due to weak (but improving) new home sales, and the inability to ramp up production significantly despite rising demand.



Home construction's inability to quickly rebound has kept the U.S. economy from reaching normal levels of economic growth. Construction employment alone is 1 to 2 million below trend levels, which is roughly 1 year of non-farm payroll growth at current levels.

Consequently, the unemployment rate remains elevated and economic growth lackluster. As residential construction gets unstuck, the economy should start to get moving. We are forecasting that the ramping up of residential construction will take a while, and while economic growth will improve over the next year, we won't see an economy operating at full potential until sometime after 2015.

Another key factor for the softening housing market is consumer and business confidence in the economy. Consumer confidence has remained low throughout the recovery, and had begun to show signs of improving earlier this year. The recent federal government shutdown and U.S. debt concerns are likely to weaken confidence further. If we examine the components of consumer confidence, assessments of current conditions have been improving throughout 2013, but expectations of the future had been declining since June. We expect confidence to erode further into the fourth quarter, but should pick back up again in the early part of next year as economic growth accelerates.

While higher long-term interest rates and the government shutdown have slowed the pace of the housing and macroeconomic recovery in the near term, the longer term outlook should brighten as the economy returns to better growth in 2014.

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[i] Survey of Current Business, June 1996, p. 6; Congressional Budget Office, The Economic and Budget Outlook: An Update, August 1996, p. 1; Congressional Research Service, Federal Funding Gaps: A Brief Overview, September 23, 2013, p. 3.

October 2013 Economic and Housing Market Outlook

Revised 10/17/2013

Indicator	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2009	2010	2011	2012	2013	2014
											Annual Totals					
Real GDP (%)	2.8	0.1	1.1	2.5	**2.0**	**2.1**	**2.8**	**3.0**	**3.0**	**3.2**	-0.2	2.8	2.0	2.0	**1.9**	**3.0**
Consumer Prices (%) a.	2.1	2.2	1.4	0.0	**2.5**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	1.5	1.4	3.0	1.8	**1.5**	**2.0**
Unemployment Rate (%) b.	8.0	7.8	7.7	7.6	**7.4**	**7.3**	**7.2**	**7.1**	**6.9**	**6.8**	9.3	9.6	8.9	8.1	**7.5**	**7.0**
30-Year Fixed Mtg. Rate (%) b.	3.6	3.4	3.5	3.7	4.4	**4.3**	**4.4**	**4.7**	**4.9**	**5.1**	5.0	4.7	4.5	3.7	**4.0**	**4.8**
1-Year Treas. Indexed ARM Rate (%) b.	2.7	2.6	2.6	2.6	2.7	**2.7**	**2.7**	**2.8**	**2.8**	**2.9**	4.7	3.8	3.0	2.7	**2.7**	**2.8**
10-Year Const. Mat. Treas. Rate (%) b.	1.6	1.7	2.0	2.0	2.7	**2.6**	**2.8**	**3.0**	**3.3**	**3.5**	3.3	3.2	2.8	1.8	**2.3**	**3.2**
1-Year Const. Mat. Treas. Rate (%) b.	0.2	0.2	0.2	0.1	0.1	**0.1**	**0.1**	**0.2**	**0.2**	**0.3**	0.5	0.3	0.2	0.2	**0.1**	**0.2**

Indicator	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2009	2010	2011	2012	2013	2014
											Annual Totals					
Housing Starts c.	0.78	0.90	0.96	0.87	**0.90**	**0.95**	**1.05**	**1.10**	**1.20**	**1.25**	0.55	0.59	0.61	0.78	**0.92**	**1.15**
Total Home Sales d.	5.12	5.28	5.39	5.50	**5.80**	**5.65**	**5.70**	**5.80**	**5.90**	**6.00**	4.72	4.51	4.57	5.03	**5.59**	**5.85**
FMHPI House Price Appreciation (%) e.	1.1	0.1	2.7	5.2	**0.9**	**0.0**	**1.0**	**2.5**	**2.0**	**0.4**	-2.3	-5.0	-3.3	5.9	**9.0**	**6.0**
S&P/Case-Shiller® Home Price Index (%) f.	2.1	-0.4	1.1	7.1	**1.5**	**0.0**	**1.1**	**3.1**	**1.5**	**0.2**	-2.5	-3.8	-3.7	7.2	**9.9**	**6.0**
1-4 Family Mortgage Originations g.																
Conventional	$471	$495	**$440**	**$461**	**$315**	**$275**	**$306**	**$362**	**$258**	**$194**	$1,549	$1,300	$1,206	$1,750	**$1,491**	**$1,120**
FHA & VA	$97	$105	$100	$99	**$85**	**$75**	**$77**	**$91**	**$64**	**$48**	$451	$377	$294	$380	**$359**	**$280**
Total	$568	$600	**$540**	**$560**	**$400**	**$350**	**$383**	**$453**	**$322**	**$242**	$2,000	$1,677	$1,500	$2,130	**$1,850**	**$1,400**
ARM Share (%) h.	8	7	8	9	**10**	**11**	**12**	**13**	**14**	**15**	3	5	11	10	**10**	**14**
Refinancing Share - Applications (%) i.	82	83	79	73	**64**	**45**	**45**	**40**	**40**	**35**	70	76	75	81	**68**	**41**
Refinancing Share - Originations (%) j.	69	73	**75**	**70**	**55**	**40**	**45**	**40**	**40**	**35**	68	67	64	70	**63**	**41**
Residential Mortgage Debt (%) k.	-3.0	-0.1	-1.8	-1.2	**1.5**	**0.5**	**1.0**	**2.0**	**3.0**	**4.0**	-1.6	-4.2	-2.2	-2.1	**-0.3**	**2.5**

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. Primary Mortgage Market Survey®; quarterly averages of monthly shares of all single-family mortgage applications (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 10/17/2013 (MAS); Send comments and questions to chief_economist@freddiemac.com.