Office of the Chief Economist

October 2014 U.S. Economic and Housing Market Outlook

L.I.F.T. Off

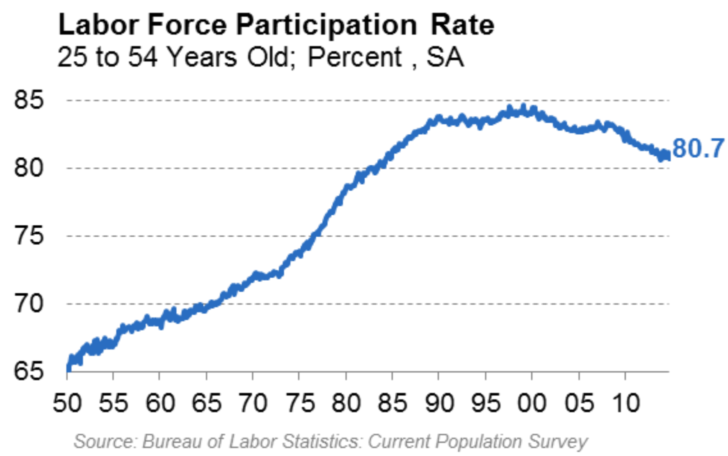
The Great Recession ended in June 2009, and since then the U.S. economy has struggled along at low levels of employment, income growth, and investment spending. What is it going to take to get the economy moving from a trajectory of low-growth to one of robust sustainable growth, with broad-based gains in income, employment, and wealth? In our view, the necessary thrust will need to come from four ingredients: **L**abor, **I**ncome, **F**ixed investment, and **T**rust.

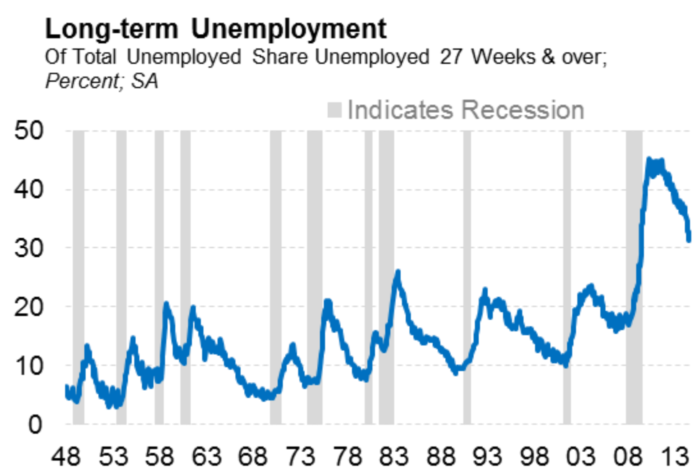
We need the **Labor** market to fully recover, providing solid employment gains and reductions in long-term unemployment. We need broad-based **Income** growth that helps support household formation and business expansion. We need **Fixed investment**, both residential and non-residential, to increase, providing a spark for additional economic growth. Finally, we need increased **Trust**; trust in economic growth, trust in continued improvements in living standards and trust that recent improvements are sustainable, that the economy will not falter, fall off track and erase the gains of the past.

Labor Market Recovery

All eyes are on the labor market. Unless the labor market recovery accelerates, further gains in the housing market, if any, will be gradual. The headline national unemployment rate fell to 5.9 percent in September of 2014, the first time the unemployment rate has been below 6 percent since the recovery began. However, analysts are in broad agreement that the headline unemployment rate does not tell the full story of the labor market.

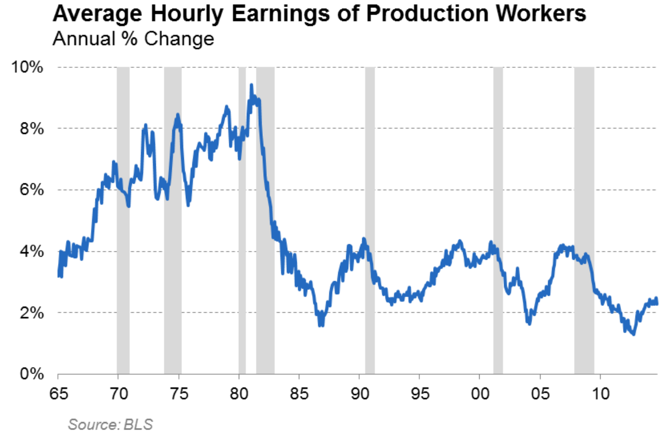
In order for the labor market to be fully recovered, we need three things in addition to a low level of unemployment. First, we need labor force participation to increase for younger age groups, particularly for the critical 25 to 54 year old cohort. Second, we need long-term unemployment, which has been elevated throughout this recovery, to come down closer to historical norms.





Third, we need sustained increases in wages.

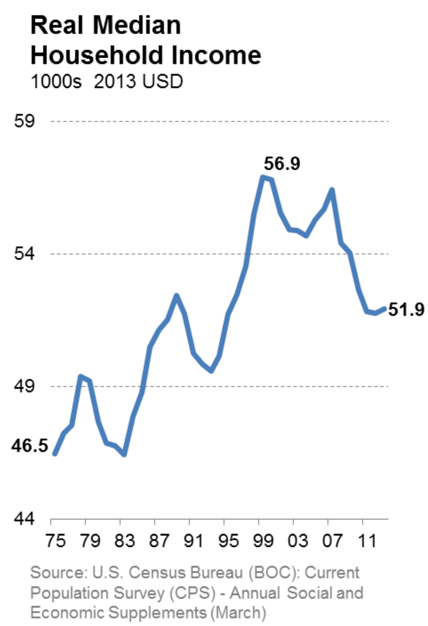
Currently, despite the recent declines in the headline unemployment rate, each of these three indicators tells us the labor market still has room for improvement. Our forecast is for only modest improvements in the headline unemployment rate. For 2015 we expect unemployment to average about 5.7 percent, not much lower than the September reading. This is because as the labor market improves, we expect to see many of the missing 25-54 year olds who have dropped out of the labor market start to return, driving participation rates up.

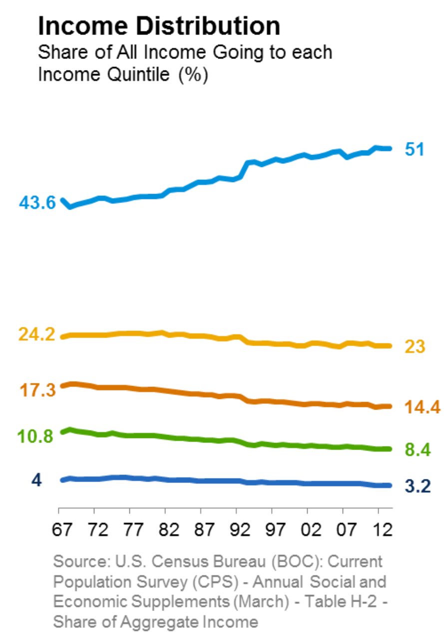


Income Growth

As the labor market improves, incomes will rise. Income growth has been tepid at best throughout this recovery. And while income per capita has improved over the past five years of recovery, the gains have not been widely shared. Recent Census data shows that from 1999 through 2013, real inflation-adjusted median household income has actually fallen in the United States from $56,900 in 1999 to $51,900 in 2013. In order for the economy to perform at its highest level we need to see incomes rise across the income distribution. A faster GDP growth rate is the essential step to getting broad-based income growth.

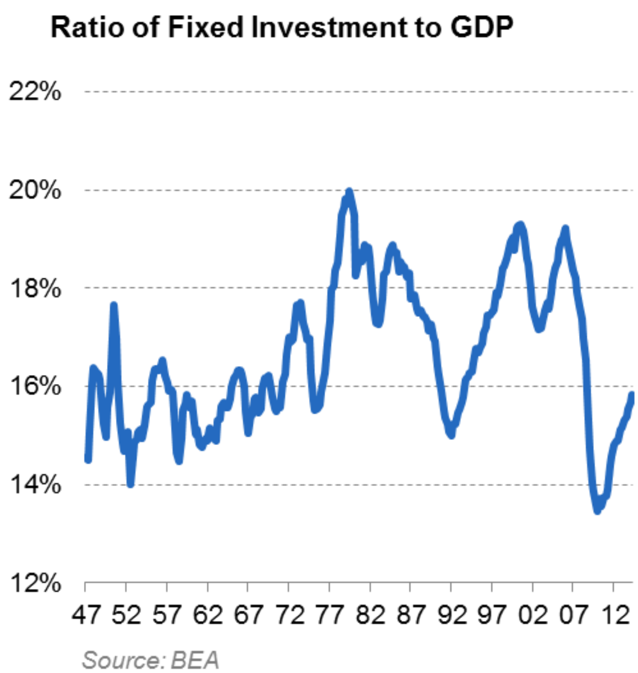
Growth has started to accelerate. In the second quarter, GDP grew at 4.6 percent, and tracking data indicate we are likely to have a robust third quarter as well, growing at a 3 percent-plus annualized growth. For these positive trends to continue we need investment, particularly residential fixed investment, to increase.

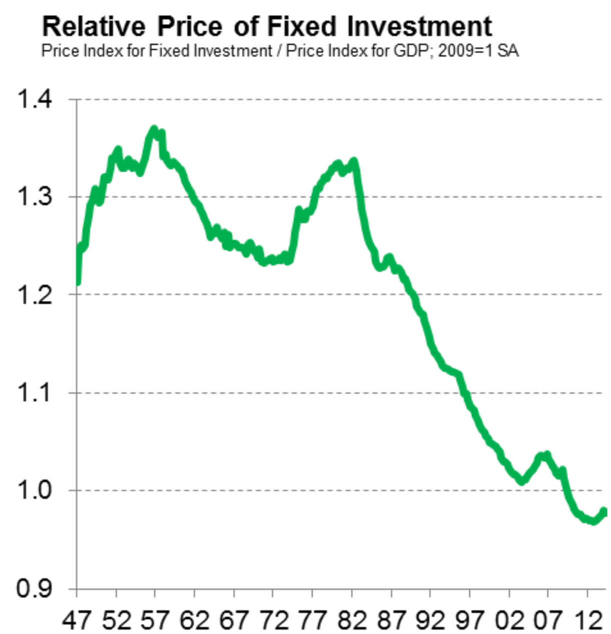




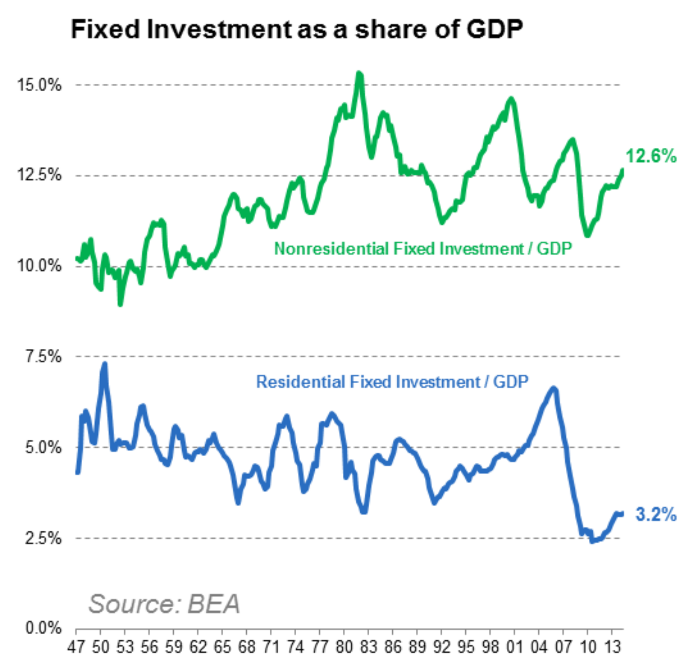
Fixed Investment Normalizes

Fixed investment—investment in residential buildings, non-residential structure, computers, and other equipment—has been slow to recover following the Great Recession. The relative price of fixed investment has been on a 30-year decline, and prior to the Great Recession the share of real GDP going to fixed investment was increasing. Following the end of the Great Recession investment picked up, but as a share of total GDP is still about 2 percentage points below the levels reached prior to the Great Recession.



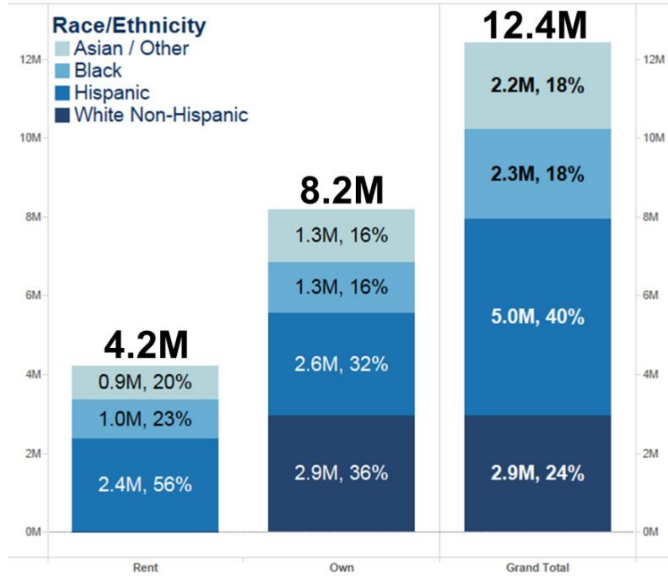


Of the major components of fixed investment, residential spending is particularly lagging. Prior to the Great Recession residential fixed investment—primarily the construction of new single-family homes, condominiums, and apartment buildings, and residential additions and alterations—averaged about 5 percent of GDP. During the recovery from June 2009 to June 2014, residential investment has only constituted about 3 percent of GDP. To place in context, there have been about 1.0 million housing starts over the past twelve months, whereas the nation will need to add as much as 1.7 million additional housing units each year to keep pace with long-run demand. Long-run demand is comprised of net household growth, replacement of existing housing stock (about 300,000 to 400,000 dwellings per year) and second-homes (about 100,000 to 150,000 per year).



Projections from the Joint Center for Housing Studies put household growth from 2015 to 2025 at 12.4 million, 8.2 million of which are expected to be homeowners. There is not enough vacant housing stock to absorb those additional households. The significant gap between the level of residential investment today and potential long-run demand implies residential fixed investment could add significantly to GDP growth.

Household Growth from 2015 to 2025



Source: Joint Center for Housing Studies; http://www.jchs.harvard.edu/research/publications/baseline-household-projections-next-decade-and-beyond ; Middle Projection

Trust and Confidence Restored

The final ingredient we need for liftoff is arguably the most fragile today. In order for robust growth to kick in, households and businesses need to feel better about the overall economy. Confidence and trust in the economy and one's financial security are needed to engage and propel economic growth.

In the aftermath of the Great Recession, confidence was at historic lows (since standardized measurement began in the 1960s) and uncertainty about the future remained elevated. Consumer confidence dropped precipitously during the recession and has only gradually recovered. Business owners' concerns about uncertain demand for their products resulted in a haphazard, gradual improvement in their outlook surrounding market conditions.

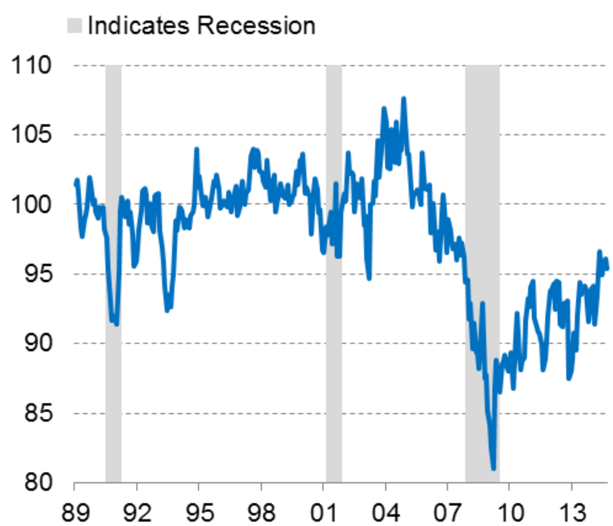
Households Feeling More Confident …

Consumer Confidence Index

Source: Conference Board

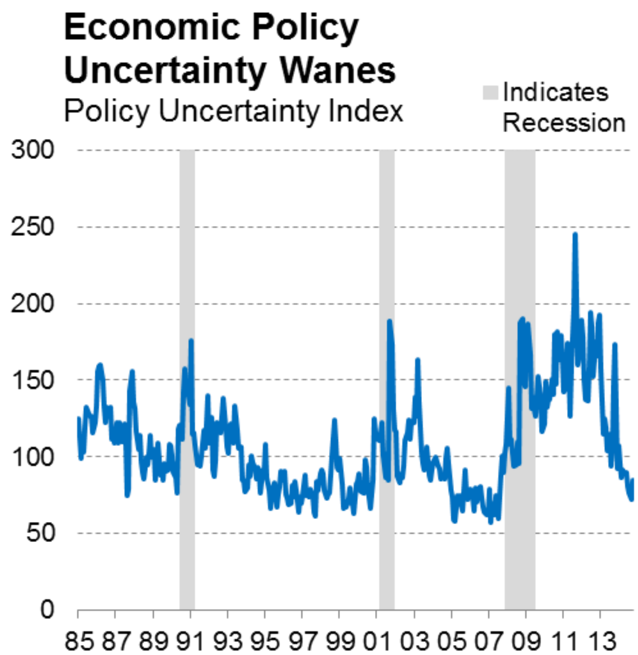
…Businesses too

Small Business Optimism Index



Source: National Federation of Independent Business (NFIB)

Throughout the past few years debates over fiscal and monetary policy actions, new legislation, lawsuits (and the fear of them) and extended deliberations over new regulations have increased uncertainty about economic policy. Recently, confidence has been bolstered by a recovering economy, particularly for higher-income households. Headlines about fiscal and monetary policy have ebbed and total economic policy uncertainty is near the lowest level since the end of the Great Recession.



Source: "Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

Renewed confidence and declining uncertainty are starting to unfold. However, fears of a slowdown in Europe and a multitude of crises overseas have struck a blow to confidence in recent weeks. While the recent news on the domestic economy has been positive, we are keeping a wary eye on the economy to see if confidence falters.

Given the fundamentals for U.S. growth, we remain optimistic for growth here at home even if the rest of the world slows. An improving labor market, robust GDP growth, resilient U.S. consumers and a decline in the price of oil should help to bolster the economy in the short term. Longer-term, strong pent-up demand for housing and low interest rates should support continued improvements in the housing sector.

As the labor market heals, incomes rise, and fixed investment increases, trust and confidence should start to build throughout the economy. These forces can provide the necessary lift for economic growth to be stronger in 2015.

Frank E. Nothaft — Chief Economist

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October 20, 2014

Data Note: Our refinance share of originations and quarterly origination estimates for 2013 have been revised to reflect our benchmarking to 2013 Home Mortgage Disclosure Act data.

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Revised 10/15/2014

	2013		2014				2015				Annual Totals						
Indicator	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012	2013	2014	2015	2016
Real GDP (%)	4.5	3.5	-2.1	4.6	**3.0**	**3.2**	**3.3**	**3.3**	**3.3**	**3.3**	2.7	1.7	1.6	3.1	**2.2**	**3.3**	**3.0**
Consumer Prices (%) a.	2.2	1.1	1.9	3.0	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	1.2	3.3	1.9	1.2	**2.2**	**2.0**	**2.0**
Unemployment Rate (%) b.	7.2	7.0	6.7	6.2	6.1	**5.9**	**5.8**	**5.7**	**5.6**	**5.5**	9.6	8.9	8.1	7.4	**6.2**	**5.7**	**5.3**
30-Year Fixed Mtg. Rate (%) b.	4.4	4.3	4.4	4.2	4.1	**4.1**	**4.3**	**4.5**	**4.8**	**5.1**	4.7	4.5	3.7	4.0	**4.2**	**4.7**	**5.5**
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	3.2	3.0	3.1	3.0	3.0	**3.1**	**3.3**	**3.6**	**3.9**	**4.2**	3.8	3.3	2.8	2.9	**3.1**	**3.8**	**4.8**
1-Year Treas. Indexed ARM Rate (%) b.	2.7	2.6	2.5	2.4	2.4	**2.5**	**2.5**	**2.6**	**2.7**	**2.8**	3.8	3.0	2.7	2.6	**2.5**	**2.7**	**3.1**
10-Year Const. Mat. Treas. Rate (%) b.	2.7	2.7	2.8	2.6	2.5	**2.4**	**2.6**	**2.8**	**3.1**	**3.4**	3.2	2.8	1.8	2.4	**2.6**	**3.0**	**3.8**
1-Year Const. Mat. Treas. Rate (%) b.	0.1	0.1	0.1	0.1	0.1	**0.1**	**0.2**	**0.3**	**0.6**	**1.0**	0.3	0.2	0.2	0.1	**0.1**	**0.5**	**2.5**

	2013		2014				2015				Annual Totals						
Indicator	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012	2013	2014	2015	2016
Housing Starts c.	0.88	1.03	0.93	0.99	1.02	**1.06**	**1.15**	**1.15**	**1.25**	**1.25**	0.59	0.61	0.78	0.92	**1.00**	**1.20**	**1.40**
Total Home Sales d.	5.71	5.39	5.03	5.30	**5.40**	**5.50**	**5.55**	**5.55**	**5.60**	**5.70**	4.51	4.57	5.03	5.51	**5.31**	**5.60**	**5.80**
FMHPI House Price Appreciation (%) e.	1.6	-0.7	1.6	3.60	**0.8**	**-1.0**	**0.0**	**2.0**	**1.0**	**0.0**	-4.9	-3.3	6.1	9.3	**5.0**	**3.0**	**3.0**
S&P/Case-Shiller® Home Price Index (%) f.	2.1	-0.2	1.2	3.1	**1.1**	**-0.5**	**0.0**	**2.0**	**1.0**	**0.0**	-4.1	-3.9	6.5	10.8	**5.0**	**3.0**	**3.0**
1-4 Family Mortgage Originations g.																	
Conventional	$380	$260	**$198**	**$255**	**$280**	**$224**	**$224**	**$280**	**$216**	**$160**	$1,300	$1,206	$1,752	$1,570	**$957**	**$880**	**$928**
FHA & VA	$87	$59	$52	$65	**$70**	**$56**	**$56**	**$70**	**$54**	**$40**	$367	$286	$370	$355	**$243**	**$220**	**$247**
Total	$450	$350	**$250**	**$320**	**$350**	**$280**	**$280**	**$350**	**$270**	**$200**	$1,667	$1,492	$2,122	$1,925	**$1,200**	**$1,100**	**$1,175**
ARM Share (%) h.	9	10	11	11	**10**	**11**	**12**	**13**	**15**	**17**	5	11	10	9	**11**	**14**	**20**
Refinancing Share - Applications (%) i.	54	59	52	45	50	**45**	**40**	**25**	**18**	**15**	73	71	77	63	**48**	**25**	**15**
Refinancing Share - Originations (%) j.	49	43	**48**	**41**	**45**	**40**	**35**	**22**	**16**	**15**	67	64	70	59	**43**	**23**	**15**
Residential Mortgage Debt (%) k.	0.9	-0.5	-0.8	0.3	**1.0**	**2.0**	**2.5**	**3.0**	**3.0**	**3.5**	-4.2	-2.1	-1.7	-0.5	**0.6**	**3.0**	**5.0**

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 10/17/2014 (TGW); Send comments and questions to chief_economist@freddiemac.com.