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Office of the Chief Economist

February 2015 U.S. Economic & Housing Market Outlook

Interest Rate Tension

Summary (page 2)

» Long-term interest rates have fallen since last year. While we expect interest rates to rise, the rise should only be gradual, as there is substantial downward pressure on long-term interest rates. Even if the Federal Reserve begins raising short-term rates later this year, don't expect to see long-term rates—including mortgage rates—increase much. Low mortgage rates should help to support a general improvement in housing market activity**.**

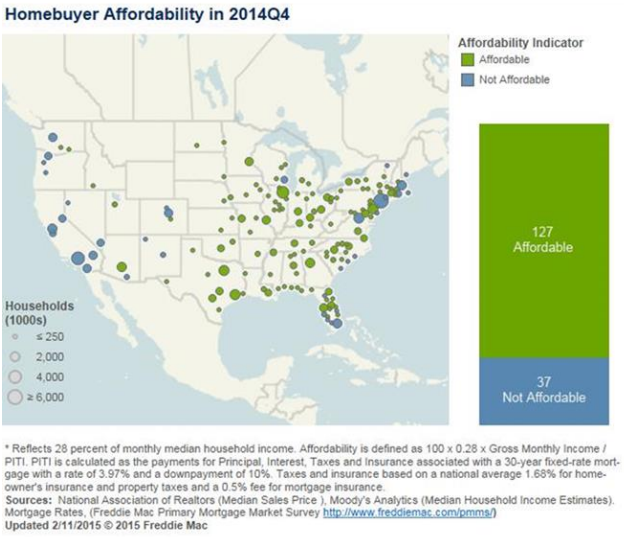
Forecast Update (page 5)

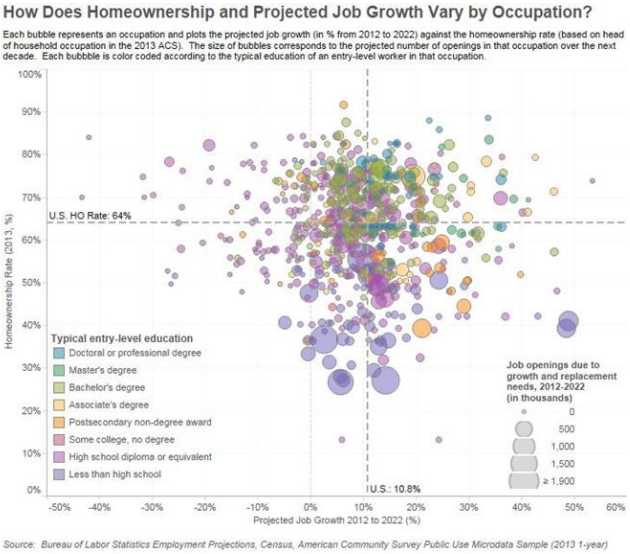
Forecast Summary *(full table on page 9)*	**2015**	**2016**
Real GDP Growth (%)	2.9	2.7
30-Year Fixed Mtg. Rate (%)	3.9	4.8
FMHPI House Price Appreciation (%)	3.9	3.4
1-4 Family Mortgage Originations ($ Billions)	$1,300	$1,275

Interactive Features (page 6)

» Affordability Map

» Homeownership and Job Growth Projections





Interest Rate Tension

Despite strong signals that the Federal Reserve will begin raising its short-term policy rate this year, long-term interest rates, including mortgage rates, have fallen since last year. Since October of 2014, interest rates on 10-year Treasuries have declined by about ½ of a percentage point. The 10-year Treasury reached as low as 1.68 percent on January 30th and February 2nd of this year, the lowest since 2012.

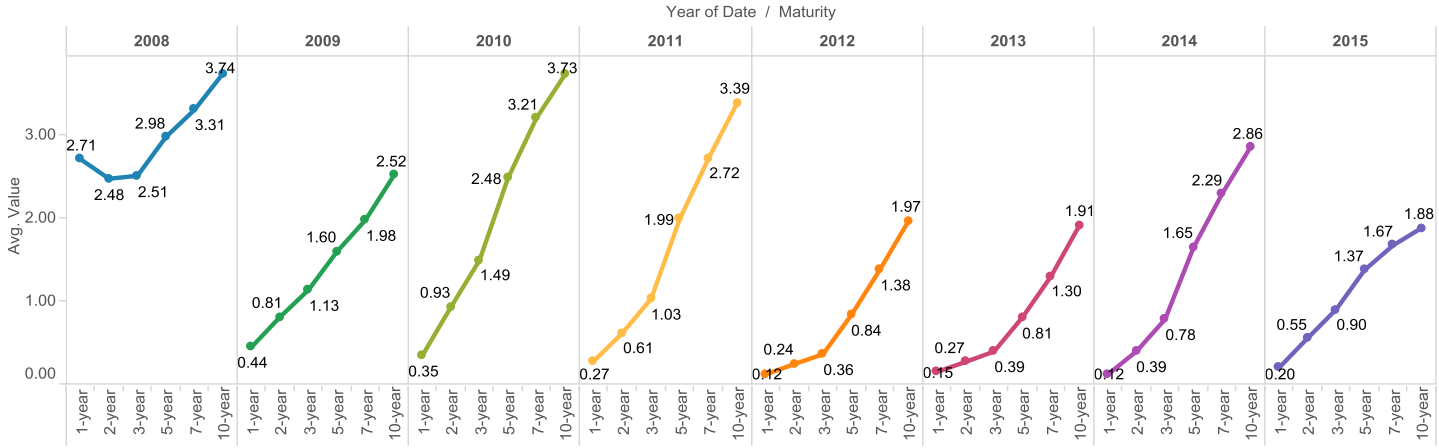
Since then, on the heels of a strong employment report for January 2015, interest rates have bounced back, but are still below the levels they were at the beginning of 2015. Many economists expect that the Federal Reserve will begin to raise its policy rate sometime between mid-year and the third quarter of 2015. But even if the Fed raises short-term rates sooner rather than later, it's unlikely to lead to a dramatic rise in long-term interest rates.

Recently we have seen short-term interest rates rise in anticipation of Fed tightening, while long-term interest rates continue to decline. This has resulted in a "flattening of the yield curve" where the spreads between long-dated and short-dated Treasury securities tighten. Typically, analysts interpret a flattening yield curve as indicative of a weakening economy and a warning sign for a possible recession. Should we be worried?

There are two prevailing theories about why long-term interest rates have been declining recently. Theories of the term structure of interest rates imply that long-term interest rates are based upon expectations for short-term interest rates and a term premium that compensates investors for interest rate risk. This approach would interpret the recent decline in long-term interest rates as a function of 1) lowered expectations for future short term interest rates, and 2) a decline in term premiums. If investors interpret long-term growth prospects for the U.S. economy to be weakening, then expectations for short-term interest rates could decline, particularly expectations for short-term interest rates several years into the future. For example, market participants might expect that sometime over the next five years the likelihood of the U.S. economy entering recession has increased and the therefore expectations for short-term interest rates several years in the future are lower.

The Treasury Yield Curve in January by Year

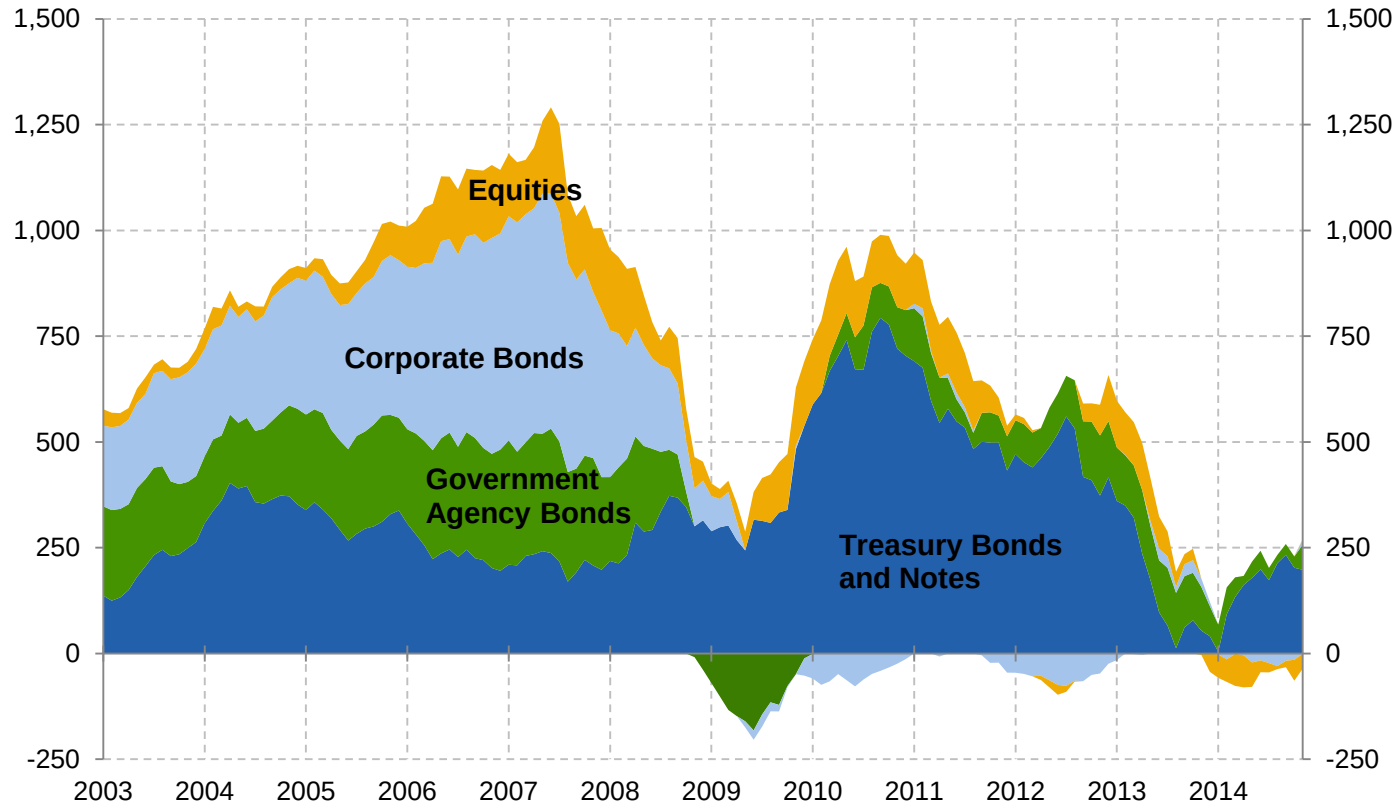
Source: Federal Reserve H.15



A competing theory holds that short-term and long-term securities are not close substitutes and therefore movements in short-term interest rates have limited effects on the path of long-term interest rates. Rather, long-term interest rates are driven primarily by supply and demand dynamics within the market for long-term securities. Thus it is supply (issuance of debt less retired securities and central bank purchases) and demand (domestic saving and foreign capital flows) for long-term bonds that drive long-term interest rate movements. The sharp decline in the budget deficit since 2009 has reduced net Treasury issuance, despite a systematic effort by Treasury to extend the average weighted maturity of its debt portfolio. The result is a reduced incremental supply of long-dated securities.

At the same time, reduced interest rates in Europe and Japan, accompanied by growing concerns of a global growth slowdown, have driven a flight to the relative safety and high returns of U.S. treasuries. Foreign purchases of long-term U.S. securities, including both private and official purchases, have been rebounding. The latest data available (see figure below) from Treasury are only through November, but you can see a recent surge in net foreign buying of long-term U.S. securities, particularly Treasury bonds and notes. Research[i] has shown that net foreign purchases of long-term securities can have a large impact on long-term interest rates, and recent trends seem to support this finding.

Net Foreign buying of long-term U.S. Securities
$ Billions (12-month rolling sum)
Source: U.S. Treasury, Moody's Analytics



Because most signs point to a strengthening domestic economy, we believe that recent declines in long-term interest rates are more a function of reduced incremental supply of long-term Treasuries and increased demand from foreign buyers rather than worse growth prospects here in the U.S. Thus despite the fact the yield curve has flattened, we remain optimistic about the course of the domestic U.S. economy over the next year.

We also do not foresee a major turnaround in the global growth picture and therefore recent trends in foreign buying activity should continue. That means continued downward pressure on long-term interest rates here in the U.S. Even if the Federal Reserve begins raising short-term rates later this year, don't expect to see long-term rates—including mortgage rates—increase much. Over the course of the year long-term interest rates should rise from their current levels, but the overall increase should not be substantial. However, once the Fed does begin to raise rates, there could be substantial volatility in the weeks leading up to and after the Fed moves. But at the end of the year, we expect that 30-year fixed mortgage rates to be about 4.2 percent and average 3.9 percent for the year.

This is great news for housing markets, especially headed into the spring homebuying season. Lower rates help to offset some of the recent increases in house prices and keep homebuyer affordability high. See below for a link to an interactive chart where you can explore homebuyer affordability across the country. Lower mortgage rates and a stronger jobs market should help to drive the best year for home sales since 2007.

Forecast Update

Major Economic Indicators

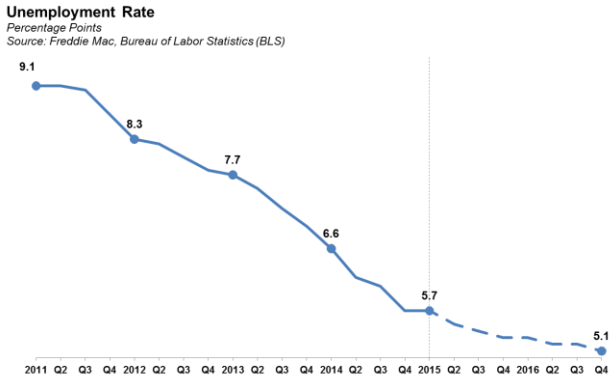
Compared to last month, we have revised down our forecast for economic growth. Data for the fourth quarter of 2014 and the first quarter of 2015 indicate that overall economic growth may have slowed from the torrid pace in the third quarter of 2014. We've lowered our overall projection of first quarter growth to 2.5 percent (from 3.0 percent last month) and lowered 2015 annual growth by 0.1 percentage points to 2.9 percent for the year.

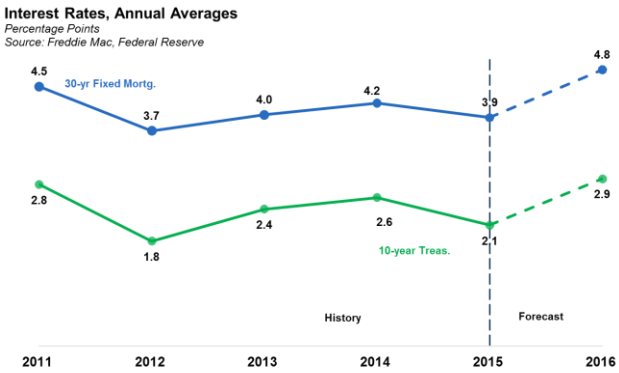
Due to declining interest rates in January (see above for detailed analysis) we have lowered the projected path for most interest rates. We still expect that the Federal Reserve will begin to raise the Fed Funds target and short-term rates will rise accordingly. However, long-term interest rates will only rise slowly. We've revised the average 30-year fixed-rate mortgage rate forecast for 2015 down to 3.9 percent for the year (compared to 4.2 percent last month).

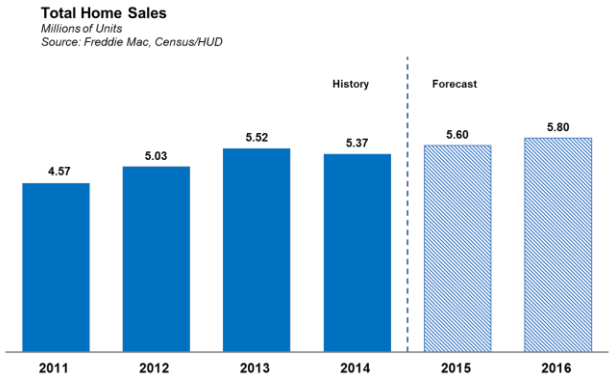
Housing and Mortgage Markets

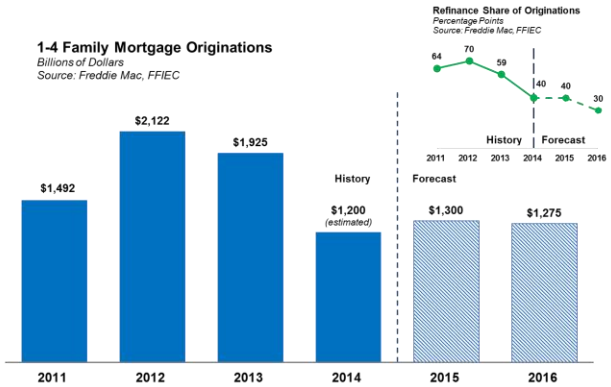
Lower mortgage rates and an improving jobs picture should support increased housing activity relative to last year. Our forecasts for home sales (5.6 million in 2015) and housing starts (1.18 million in 2015) are unchanged from last month. Due to continued strong growth in house prices and relatively low inventories, we are expecting house prices to increase 3.9 percent in 2015 (up from our forecast of 3.5 percent last month).

With lower mortgage rates and stronger house price growth we expect more mortgage origination activity in 2015 compared to last month's forecast. We have raised our 2015 originations forecast to $1.3 trillion (from $1.2 Trillion last month). We also revised up our forecast of the refinance share of originations in 2015 from 35 percent to 40 percent.









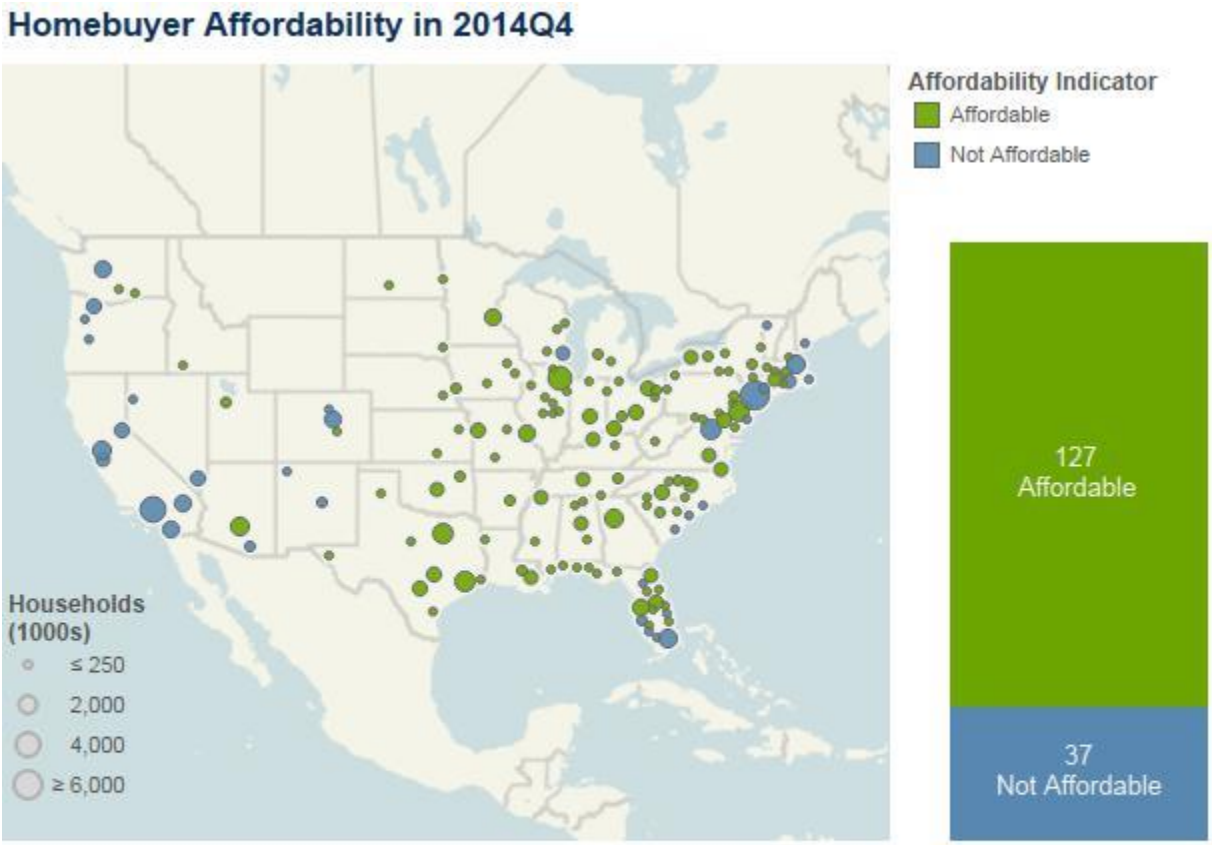
Interactive Features

We regularly provide innovative interactive charts on Freddiemac.com to support our analysis of housing and mortgage markets. Here are some of the highlights from last month.

The Affordability Stretch Got a Little Easier

Declining interest rates help to support homebuyer affordability. Each quarter, with the release of metro area median house price data from the National Association of Realtors, we produce an interactive affordability map that lets you see trends in homebuyer affordability across over 100 metro areas in the U.S. With declining rates, affordability has increased. Our data is only through the 4th quarter, but interest rates fell by about one quarter of a percentage point since the end of 2014. By adjusting the interest rate assumption of the affordability map, you can see how homebuyer affordability changes.

Click to see the full analysis



* Reflects 28 percent of monthly median household income. Affordability is defined as 100 x 0.28 x Gross Monthly Income / PITI. PITI is calculated as the payments for Principal, Interest, Taxes and Insurance associated with a 30-year fixed-rate mortgage with a rate of 3.97% and a downpayment of 10%. Taxes and insurance based on a national average 1.68% for homeowner's insurance and property taxes and a 0.5% fee for mortgage insurance.
Sources: National Association of Realtors (Median Sales Price), Moody's Analytics (Median Household Income Estimates). Mortgage Rates, (Freddie Mac Primary Mortgage Market Survey http://www.freddiemac.com/pmms/)
Updated 2/11/2015 © 2015 Freddie Mac

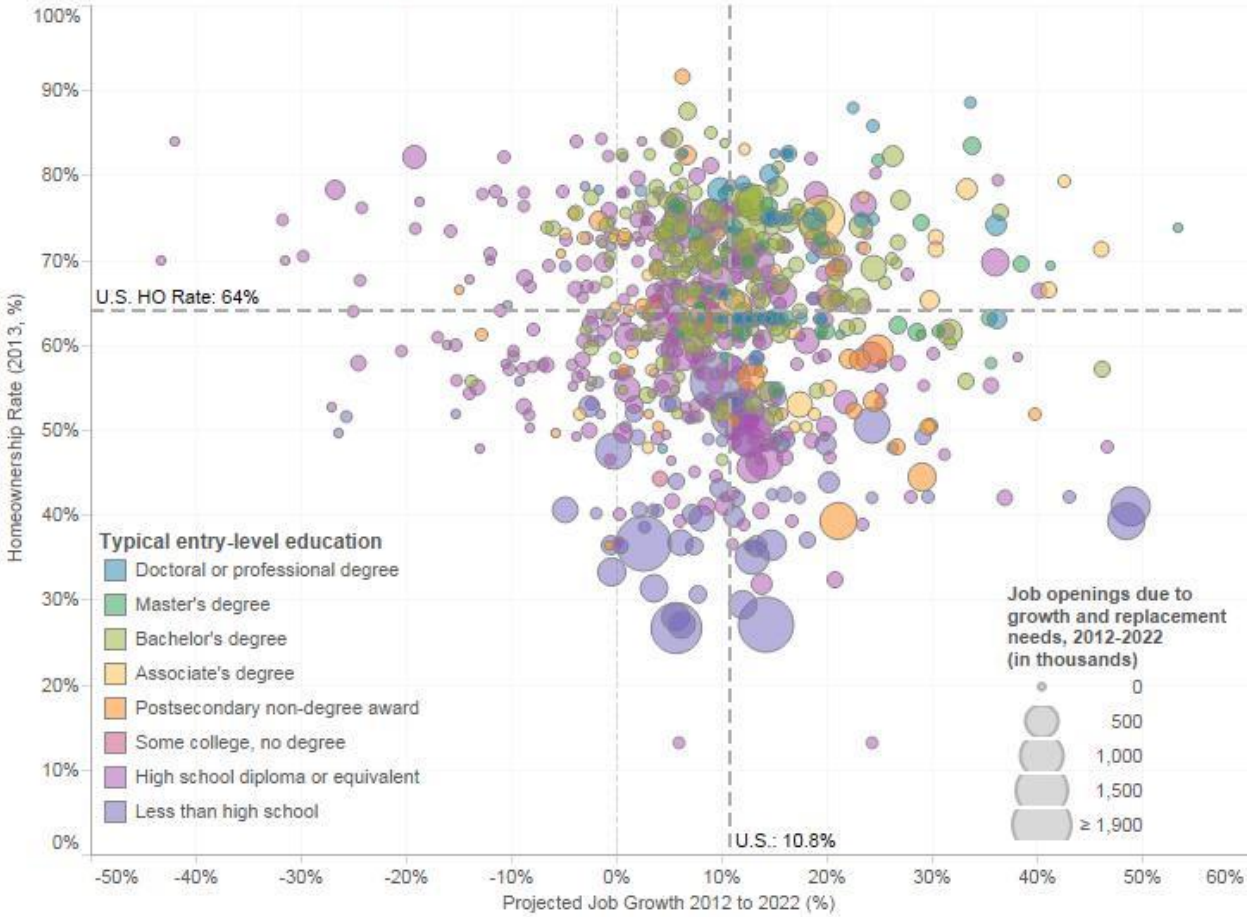
Job Outlook Casts Shadow on Homeownership Rate

Given that most of us will need a job to buy a home, we married homeownership data from the U.S. Census Bureau's American Community Survey with the Bureau of Labor Statistics' (BLS) projections for job growth between 2012 and 2022. By organizing available data on homeownership rates by profession from Census and BLS, we can see 1) which jobs are projected to be available for Millennials and other new arrivals to the labor scene (recent immigrants) and 2) whether they're the sorts of jobs that homeowners tend to have. What we find is that many of America's fastest growing careers (in terms of numbers of workers) have average or below average homeownership rates. At the same time, the professions with higher homeownership rates are generally headed for average or subpar growth.

Click to see the full analysis.

How Does Homeownership and Projected Job Growth Vary by Occupation?

Each bubble represents an occupation and plots the projected job growth (in % from 2012 to 2022) against the homeownership rate (based on head of household occupation in the 2013 ACS). The size of bubbles corresponds to the projected number of openings in that occupation over the next decade. Each bubbble is color coded according to the typical education of an entry-level worker in that occupation.



Source: Bureau of Labor Statistics Employment Projections, Census, American Community Survey Public Use Microdata Sample (2013 1-year)

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February 18, 2015

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NOTES

[i]See for example:

Warnock, F. E., & Warnock, V. C. (2009). International capital flows and US interest rates. *Journal of International Money and Finance*, *28*(6), 903-919.

Beltran, D. O., Kretchmer, M., Marquez, J., & Thomas, C. P. (2013). Foreign holdings of US Treasuries and US Treasury yields. *Journal of International Money and Finance*, *32*, 1120-1143.

February 2015 Economic and Housing Market Outlook

Revised 2/17/2015

Indicator	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4	Annual Totals 2011	2012	2013	2014	2015	2016
Real GDP (%)	-2.1	4.6	5.0	2.6	**2.5**	**3.0**	**3.0**	**3.0**	**2.7**	**2.7**	**2.7**	**2.7**	1.7	1.6	3.1	2.5	**2.9**	**2.7**
Consumer Prices (%) a.	1.9	3.0	1.1	-1.2	**-1.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	3.3	1.9	1.2	1.2	**1.3**	**2.0**
Unemployment Rate (%) b.	6.7	6.2	6.1	5.7	**5.7**	**5.5**	**5.4**	**5.3**	**5.3**	**5.2**	**5.2**	**5.1**	8.9	8.1	7.4	6.2	**5.5**	**5.2**
30-Year Fixed Mtg. Rate (%) b.	4.4	4.2	4.1	4.0	**3.7**	**3.8**	**4.0**	**4.2**	**4.4**	**4.6**	**4.9**	**5.1**	4.5	3.7	4.0	4.2	**3.9**	**4.8**
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	3.1	3.0	3.0	3.0	**2.8**	**2.9**	**3.2**	**3.4**	**3.7**	**4.0**	**4.3**	**4.6**	3.3	2.8	2.9	3.0	**3.1**	**4.2**
1-Year Treas. Indexed ARM Rate (%) b.	2.5	2.4	2.4	2.4	**2.5**	**2.4**	**2.5**	**2.6**	**2.7**	**2.8**	**3.0**	**3.2**	3.0	2.7	2.6	2.4	**2.5**	**2.9**
10-Year Const. Mat. Treas. Rate (%) b.	2.8	2.6	2.5	2.3	**1.9**	**2.0**	**2.1**	**2.3**	**2.5**	**2.8**	**3.0**	**3.2**	2.8	1.8	2.4	2.6	**2.1**	**2.9**
1-Year Const. Mat. Treas. Rate (%) b.	0.1	0.1	0.1	0.2	**0.2**	**0.3**	**0.5**	**0.8**	**1.0**	**1.5**	**2.0**	**2.5**	0.2	0.2	0.1	0.1	**0.5**	**1.8**

Indicator	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4	Annual Totals 2011	2012	2013	2014	2015	2016
Housing Starts c.	0.93	0.99	1.03	1.07	**1.10**	**1.15**	**1.20**	**1.25**	**1.30**	**1.35**	**1.45**	**1.50**	0.61	0.78	0.92	1.01	**1.18**	**1.40**
Total Home Sales d.	5.03	5.29	5.56	5.53	**5.55**	**5.60**	**5.60**	**5.65**	**5.70**	**5.80**	**5.80**	**5.90**	4.57	5.03	5.52	5.37	**5.60**	**5.80**
FMHPI House Price Appreciation (%) e.	1.5	0.9	1.2	**1.3**	**1.1**	**1.0**	**0.9**	**0.9**	**0.9**	**0.9**	**0.8**	**0.8**	-3.2	6.1	9.3	**5.0**	**3.9**	**3.4**
S&P/Case-Shiller® Home Price Index (%) f.	1.4	-0.2	1.2	**2.0**	**1.1**	**1.0**	**0.9**	**0.9**	**0.9**	**0.9**	**0.8**	**0.8**	-3.7	6.6	10.8	**4.5**	**3.9**	**3.4**
1-4 Family Mortgage Originations g.																		
Conventional	**$198**	**$257**	**$278**	**$208**	**$276**	**$300**	**$260**	**$204**	**$200**	**$312**	**$308**	**$200**	$1,206	$1,750	$1,570	**$941**	**$1,040**	**$1,020**
FHA & VA	$52	$63	$72	$72	**$69**	**$75**	**$65**	**$51**	**$50**	**$78**	**$77**	**$50**	$286	$372	$355	$259	**$260**	**$255**
Total	**$250**	**$320**	**$350**	**$280**	**$345**	**$375**	**$325**	**$255**	**$250**	**$390**	**$385**	**$250**	$1,492	$2,122	$1,925	**$1,200**	**$1,300**	**$1,275**
ARM Share (%) h.	11	11	10	11	**10**	**10**	**11**	**11**	**13**	**14**	**15**	**16**	11	10	9	11	**11**	**15**
Refinancing Share - Applications (%) i.	52	45	50	60	**55**	**50**	**40**	**40**	**39**	**38**	**36**	**33**	71	77	63	52	**47**	**37**
Refinancing Share - Originations (%) j.	**44**	**38**	**42**	**38**	**48**	**38**	**37**	**37**	**35**	**32**	**29**	**25**	64	70	59	**40**	**40**	**30**
Residential Mortgage Debt (%) k.	-0.8	-0.1	1.2	**1.5**	**1.5**	**2.0**	**2.0**	**2.5**	**2.5**	**3.0**	**3.0**	**3.5**	-2.1	-1.7	-0.5	**0.5**	**2.0**	**3.0**

Note: Quarterly and annual forecasts 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; seasonally-adjusted; annual rates for yearly data.
f. National composite index (quarterly growth rate), seasonally-adjusted; annual rates for yearly data.
g. Billions of dollars (not seasonally-adjusted); conventional for 2014 are Freddie Mac estimates.
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 (2014 estimated).
k. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages

Prepared by Office of the Chief Economist and reflects views as of 2/17/2015 (PTT); Send comments and questions to chief_economist@freddiemac.com.

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