



July 2015 U.S. Housing Market Insight & Outlook

Insight: It is different this time (p. 2)

Affordability initiatives that allow low down payments—like Freddie Mac’s Home Possible Advantage^(SM)—have raised concerns about the potential return of underwriting practices prevalent prior to the financial crisis. However things *are* different this time.

Pre-crisis underwriting allowed *layered risk*, that is, the combination of multiple features that amplified credit risk. Low down payments often were combined with variable-payment loan structures, property-based underwriting, and questionable appraisals. These risk factors, along with the “irrational exuberance” of some borrowers, led to large losses during the crisis.

Home Possible Advantage controls credit risk by requiring features that reduce risk—fixed payments, borrower-based underwriting, reliable appraisals, and more.

Outlook: Midyear update (p. 4)

The economic engine continues to sputter, alternatively picking up speed then stalling for a bit. For instance, the unemployment rate is declining, but *employment* is tepid and the labor force participation rate is falling. We expect the economy to continue its slow progress, but the journey will be slow with plenty of stops and starts.

How has low-down-payment mortgage lending changed before and after the crisis?

What has changed?	Before the crisis	After the crisis
Payments	<i>Variable</i>	<i>Predictable</i>
Underwriting	<i>Property-based</i>	<i>Borrower-based</i>
Appraisals	<i>Questionable</i>	<i>Improved</i>
Borrower expectations	<i>Overly optimistic</i>	<i>Realistic</i>

Forecast update (p. 6)

Forecast summary	2015	2016
Real GDP Growth (%)	2.2	2.7
30-Year Fixed Mtg. Rate (%)	4.0	4.9
FMHPI House Price Appreciation (%)	4.4	3.9
1-4 Family Mortgage Originations (\$ Billions)	1,350	1,275

Insight: Low down payments: It is different this time

In March, Freddie Mac introduced the Home Possible Advantage^(SM) mortgage, a product designed to make home ownership more affordable for first-time home buyers and low-and-moderate income borrowers. The headline feature of Home Possible Advantage is the reduced down payment. Qualified borrowers can pay as little as 3 percent down. Borrowers can even obtain the down payment as a gift from a family member or employer or as a grant from a government agency.

The availability of low down payment mortgages raises concerns in some quarters that mortgage lending may be returning to the practices that led to the housing crisis. Down payments declined sharply in the overheated housing market of the mid-2000s. These low down payments left home owners with little or no equity cushion during the subsequent housing crisis, especially in those cases where loans had been based on overly optimistic appraisals.¹ And when some of those borrowers eventually defaulted, reduced (or negative) homeowner equity increased losses for lenders and guarantors. In the wake of the housing collapse, lenders and guarantors tightened underwriting standards significantly including requiring much higher down payments on average.

It's undeniable that reduced down payments are one of the risk factors that lenders must consider. When a borrower defaults, a high loan-to-value ratio (that is, a low share of borrower equity in the home) increases the lender's loss.² In addition, borrowers with

negative or negligible equity have less incentive to honor their mortgage obligations. Even borrowers who are willing to continue making payments on an underwater loan, may feel compelled to default if they must move to accept employment in another area.

These concerns overlook important differences between today's carefully crafted low down payment programs and the looser practices of the past. Programs like Home Possible Advantage include features that counterbalance the risk associated with lower down payments.

What went wrong before?

Low down payments were not the only—or even the primary—factor that increased the risk of mortgages in the years leading up to the financial crisis. Many mortgage loans incorporated layered risk, that is, several features that multiplied the total risk of the loans. The following risk factors often were combined with low down payments:

Variable payments: Loans with low initial payments were prevalent. Beyond adjustable rate mortgages (ARMs) with introductory teaser rates, many borrowers took out interest-only (IO) loans. In the initial years of the mortgage, borrowers paid only the accrued interest. At the end of the IO period, the entire principal was amortized over the remaining term of the mortgage, increasing the payment significantly³. There also were negative amortization loans, where borrowers could choose to pay less than the accrued interest initially but were forced to catch up with higher payments in subsequent years. In many cases, the debt-to-income ratios used to qualify borrowers were based

¹ To be sure, in many hard hit areas, a purchase with a 20 percent down payment made at the peak of the market would still have been underwater during the crisis. Low down payments made that outcome more likely.

² Mortgage insurance can limit lender loss when borrowers make low down payments. However during the crisis, private mortgage insurance

companies came under financial pressure that called into question their ability to honor claims.

³ The impact of a reduced amortization period on the monthly payment is so strong that the payment at the end of the IO period is likely to increase *even* if the interest rate resets lower.

on the temporarily low initial payment. When payments reset higher, the borrowers' debt-to-income ratios often exceeded prudent limits.

Property-based underwriting: In the mid-2000s, some lenders assumed ever-increasing house prices would limit their risk in the event of default. As a consequence, these lenders placed less emphasis on the ability of the borrower to pay under the terms of the mortgage. Borrowers with lower credit scores found it easier than usual to obtain loans. Some borrowers were allowed to state, without verification, their income and assets in order to qualify for a loan. In addition, a larger than usual share of loans went to investors⁴ who did not intend to occupy the homes. During the crisis, investors were quicker to walk away from a loan as property values sank.

Questionable appraisals: During the pre-crisis period, when house prices were increasing rapidly, it became difficult for appraisers to assess the value of a home. In addition, business practices at the time allowed real estate agents and lenders to influence the choice of appraiser, putting pressure on some appraisers to confirm values that turned out to be inflated.

Borrower "irrational exuberance": In the mid-2000s, the housing boom increased consumer willingness to stretch financially when purchasing a home. Some borrowers consciously increased their leverage in the belief that investment in housing was a sure bet. In other cases, consumers who were not financially ready to take on mortgage debt or who didn't fully understand the terms they were accepting entered the housing market. As a result, the home ownership rate hit historic highs.

⁴ Bhutta, Neil. "The ins and outs of mortgage debt during the housing boom and bust." *Journal of Monetary Economics* (2015).

What's different this time?

Today's higher underwriting standards guard against these types of risks:

Payment predictability: Today the market is dominated by fully-amortizing, fixed-rate loans. Not only do these loans avoid the payment shock that got so many borrowers into trouble, over time they pay down the principal balance of the loan and increase the borrower's equity. Only fixed-rate mortgages are available through the Home Possible Advantage program.

Borrower-based underwriting: Current underwriting standards focus on the borrower's ability and willingness to make the mortgage payments rather than on the value of the property. Lenders are cautious about extending credit to borrowers with low credit scores or histories of difficulty handling debt. Full documentation of income and assets typically are required. Debt-to-income ratios are capped to insure borrowers are able to make their payments. And cash-out refinances—which led to some borrowers treating their home as a check book—are more tightly controlled. Home Possible Advantage mortgages require full documentation. In addition, first-time home buyers must complete pre-purchase housing counseling, like Freddie Mac's CreditSmart®. Research has shown that this type of counseling can reduce default risk⁵. Home Possible Advantage loans are available only for the borrower's principal residence, further reducing default risk. And no cash out refinances are allowed through the program.

Improved appraisal practices: An important post-crisis reform has been the emphasis on independent appraisal, uninfluenced by lenders, real estate agents, or anyone else who has a financial interest in the outcome.

⁵Hirad, Abdighani, and Peter M. Zorn. *A little knowledge is a good thing: Empirical evidence of the effectiveness of pre-purchase homeownership counseling*. Joint Center for Housing Studies of Harvard University, 2001.

The use of appraisal management companies (AMCs) to assign appraisers has helped guarantee that independence.

Realistic borrower expectations: Just as the Great Depression spawned a generation of risk-averse savers, the recent financial crisis has had a sobering effect on borrower attitudes toward the risks of investing in housing. Some consumers who could qualify for a mortgage are choosing nonetheless to rent, at least for a while longer. And those who are purchasing or refinancing a home predominantly are choosing plain vanilla fixed rate loans to limit their exposure to future mortgage rate fluctuations.

Conclusion

By lowering down payments, programs like Home Possible Advantage extend the opportunity for home ownership to qualified borrowers who might otherwise be locked out. Previous research⁶ has found that reduced down payments can increase the relative probability of homeownership among some groups by over 25 percent. As long as the underwriting process bars the return of the layered risks prevalent in the pre-crisis era, lower down payments are not a cause for concern. Home Possible Advantage strikes the right balance—increasing affordability while incorporating the best practices of post-crisis underwriting.

⁶ Quercia, Roberto G., George W. McCarthy, and Susan M. Wachter. "The impacts of affordable lending efforts on homeownership rates." *Journal of Housing Economics* 12, no. 1 (2003): 29-59.

Outlook: Midyear Update

Lately the economy reminds me of a Volkswagen Beetle I borrowed when I was a college freshman. My girlfriend was stranded overnight in a bus station an hour away (long story), and I had to borrow a car to rescue her. The owner of the car warned me that not all the cylinders fired reliably, but this car was the best I could find under the circumstances.

The warnings were on target. The Volkswagen accelerated nicely on each downhill stretch of the hilly highway I had to travel, but there was serious doubt whether the car would make it to the top of each uphill segment. Similarly this long-running economic recovery remains weak and continues to sputter. Economic releases indicating growing economic strength (home sales and house prices for instance) alternate with mixed or disappointing signals (weak first-quarter GDP growth and stagnant wage growth).

First half performance

At the start of the year, we predicted acceleration in real growth, tightening labor markets, and an uptick in inflation that would finally convince the Fed to begin increasing interest rates. Instead, another severe winter in the Northeast along with a strike in the ports of Los Angeles and Long Beach generated negative real growth in the first quarter. These events, combined with deterioration in global growth prospects, helped push down long-term interest rates in the U.S.

The national unemployment rate ticked up in January to 5.7 percent, then resumed its steady improvement to its current mark of 5.3 percent, the lowest rate since early 2008. However growth in *employment* remained weak-to-moderate, a reflection of the continuing decline in the labor force participation rate. Nonfarm payroll employment growth averaged only 195,000 jobs per month in the first quarter of this year, dropping from an average of 324,000 in the last quarter of 2014. The pace picked up

a bit in the second quarter of this year, to an average of 221,000 per month, however the data on wage growth has been mixed.

The housing market posted convincing gains despite the winter weather. Home sales are on [track](#) for the best year since 2007. Pending home sales data in May recorded the highest volume in over nine years. However, it's important to remember that, despite these gains, housing market activity has not yet fully recovered.

Outlook for the remainder of 2015

We expect the economy to post a stronger second half, especially in the housing sector. Real growth should average a bit over three percent, and the unemployment rate will decline a little bit more in the next six months. Wage gains, which have disappointed so far, should accelerate.

The recovery from a weak first quarter accounts for some of the expected strength in the second half of the year. A second factor is the Federal Reserve's decision to defer any tightening of monetary policy until compelling evidence accumulates for a stronger labor market and inflation near the Fed's two percent target rate. By delaying to September—or possibly later—the interest rate increase that had been expected in June, the Fed is giving the economic engine more time to quit sputtering and to start hitting on all cylinders.

The housing sector will benefit from the delay in monetary tightening. For the year as a whole, we expect housing starts to increase 14 percent and single-family mortgage originations to increase 8 percent. Strong housing demand combined with continued tight supply should boost house prices by over 4 percent this year. The improvement in house prices should support an eventual increase in the supply of homes for sale as the number of homeowners with negative or negligible equity continues to shrink. Nonetheless, supply is expected to remain on the tight side.

Risks to the outlook

Overseas events—the Greek debt crisis, financial volatility in China, etc.—may put a damper on the U.S. economy in the second half. The recent depreciation of the euro and some Asian currencies poses a more-concrete risk to the U.S. economic outlook. Our forecast already incorporates an expectation that declining net U.S. exports will dampen real growth by 0.3 percent this year, but increasing headwinds overseas could reduce export demand even further.

Beyond 2015 where are things likely to head?

My experience with the not-entirely-reliable borrowed Volkswagen had a happy ending. Several times I was convinced I was facing a grade that would bring the car to a complete and final stop, but each time the car painfully chugged its way over the top of the hill. I did feel guilty about the frustrated drivers stuck behind me as the car slowed to a crawl. But, after a nerve-racking journey, I successfully retrieved my stranded girlfriend—and she eventually married me.

Similarly, we expect the U.S. economy eventually to reach its destination—full employment, steady growth, a fully-recovered housing market—but not without continuing frustration with the stops and starts and unevenness of its progress. In the absence of some unexpected significant disruption, the sputtering progress of this recovery should slowly get us there.

Forecast update

Major economic indicators

Real GDP decreased at an annual rate of 0.2 percent in the first quarter of the year based on the final estimate released by the BEA. The upward revision of the first quarter GDP brings our Real GDP projections for 2015 to 2.2 percent, up from 2.0 percent in our June's Outlook. The 2016 projection is unchanged at 2.7 percent. First quarter CPI increased at strong 3.0 percent, reflecting an increase in gasoline prices. We revised our CPI projections for 2015 and 2016 to 0.9 percent and 2.2 percent respectively, up from June's projections of 1.0 percent and 2.3 percent respectively."

Our unemployment rate projections for 2015 and 2016 were unchanged from the prior month at 5.4 percent and 5.1 percent respectively. Our annual interest rate projections for 2015 and 2016 were also unchanged from our June Outlook.

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Housing and mortgage markets

Our forecasts for home sales (5.6 million in 2015) and housing starts (1.14 million in 2015) are unchanged from last month. We nudged down our house price forecast to 4.4 percent in 2015, but we expect solid house growth to persist longer so we increased our forecast for 2016 to 3.9 percent up from 3.5 percent in last month's forecast.

The mortgage originations forecast is unchanged from last month. We expect to see \$1.35 trillion in single-family mortgage originations in 2015 and about the same refinance share as in 2014. As mortgage rates rise, we forecast refinance share to decline to 30 percent in 2016.

July 2015 Economic and Housing Market Outlook

Revised 7/22/2015

Indicator	2014				2015				2016				Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013	2014	2015	2016
Real GDP (%)	-2.1	4.6	5.0	2.2	-0.2	2.5	3.3	3.0	2.7	2.7	2.7	2.7	1.7	1.6	3.1	2.4	2.2	2.7
Consumer Prices (%) a.	2.1	2.4	1.2	-0.9	-3.1	3.0	2.3	1.3	2.2	2.2	2.2	2.2	3.3	1.9	1.2	1.2	0.9	2.2
Unemployment Rate (%) b.	6.6	6.2	6.1	5.7	5.6	5.4	5.3	5.2	5.2	5.1	5.1	5.0	8.9	8.1	7.4	6.2	5.4	5.1
30-Year Fixed Mtg. Rate (%) b.	4.4	4.2	4.1	4.0	3.7	3.8	4.1	4.3	4.5	4.7	5.0	5.2	4.5	3.7	4.0	4.2	4.0	4.9
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	3.1	3.0	3.0	3.0	2.9	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	2.4	2.5	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	2.0	2.2	2.3	2.5	2.6	2.9	3.1	3.3	2.8	1.8	2.4	2.6	2.3	3.0
1-Year Const. Mat. Treas. Rate (%) b.	0.1	0.1	0.1	0.2	0.2	0.3	0.6	0.9	1.1	1.6	2.1	2.6	0.2	0.2	0.1	0.1	0.5	1.9

Indicator	2014				2015				2016				Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013	2014	2015	2016
Housing Starts c.	0.93	0.98	1.03	1.06	0.97	1.15	1.20	1.25	1.30	1.35	1.45	1.50	0.61	0.78	0.92	1.00	1.14	1.40
Total Home Sales d.	5.10	5.31	5.50	5.53	5.49	5.65	5.65	5.65	5.70	5.80	5.80	5.90	4.57	5.03	5.52	5.38	5.61	5.80
FMHPI House Price Appreciation (%) e.	1.6	0.8	1.0	1.5	1.6	0.7	1.0	1.0	1.0	1.0	0.9	0.9	-3.2	6.2	9.6	5.0	4.4	3.9
S&P/Case-Shiller® Home Price Index (%) f.	1.4	-0.2	1.2	2.2	1.0	0.7	1.0	1.0	1.0	1.0	0.9	0.9	-3.7	6.6	10.8	4.6	3.8	3.9
1-4 Family Mortgage Originations g.																		
Conventional	\$198	\$257	\$278	\$255	\$274	\$320	\$264	\$216	\$200	\$312	\$308	\$200	\$1,206	\$1,750	\$1,570	\$988	\$1,074	\$1,020
FHA & VA	\$52	\$63	\$71	\$75	\$76	\$80	\$66	\$54	\$50	\$78	\$77	\$50	\$286	\$372	\$355	\$259	\$276	\$255
Total	\$250	\$320	\$350	\$330	\$350	\$400	\$330	\$270	\$250	\$390	\$385	\$250	\$1,492	\$2,122	\$1,925	\$1,250	\$1,350	\$1,275
ARM Share (%) h.	11	11	10	11	6	8	9	9	13	14	15	16	11	10	9	11	8	15
Refinancing Share - Applications (%) i.	52	45	50	60	63	47	40	40	39	38	36	33	71	77	63	52	48	37
Refinancing Share - Originations (%) j.	44	38	42	50	57	45	35	34	32	32	29	25	64	70	59	43	43	30
Residential Mortgage Debt (%) k.	-0.8	0.4	1.4	1.8	-0.4	2.0	2.0	2.5	2.5	3.0	3.0	3.5	-2.1	-1.7	-0.5	0.7	1.5	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 7/22/2015 (PTT); Send comments and questions to chief_economist@freddiemac.com.

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