

Anatomy of a Housing Recovery

The housing market has been central to the economic outlook for the past several years. A buoyant residential sector provided critical support in the recovery from the 2001 recession. More recently, the housing slowdown since mid-2005 has been instrumental in helping realize the Fed's goal of moderating economic growth, in order to nip inflationary pressures in the bud. Over the next several quarters, housing will again be key to the outlook, as a prolonged downturn could threaten more severe consequences for the overall economy, while a housing recovery could engender a broader upturn. Given the importance of housing at the current juncture, two key questions arise: *What will a housing recovery look like;* and, *When will it arrive?*

Previous housing booms help provide a historical context. Residential investment as a share of GDP, a broad indicator of overall housing activity, rose to nearly 6 percent in both 1973 and 1978, compared to a long-run average of 4½ percent. The investment share subsequently slid to approximately 4 percent over the ensuing six to eight quarters, before stabilizing. After reaching a trough, real residential investment rose in the following four quarters. Price appreciation (as measured by the yearly change in repeat-sales indexes) tends to slow after a peak, but did not turn negative on a national basis after these booms. Rather, the boom periods are generally followed by extended sluggish price gains, though economically depressed local and regional markets may register outright declines.

During the recent boom, residential investment rose to a slightly higher share of GDP, reaching 6¼ percent in the second half of 2005. Investment has been declining rapidly since then, however, falling at an 18 percent annual rate (adjusted for inflation) in the third quarter, and is on track to a similar decline in the current period. This trend would reduce residential investment relative to GDP to 4½ percent in the second quarter of 2007, a change in line with declines in previous episodes, and over a similar six- to eight-quarter time frame.

By contrast, forecasts of a more serious and prolonged housing slowdown fall well outside the range of post-war experience. For example, consider an annualized 18 percent decline in residential construction every quarter through end-2008. Under such a scenario, the drop in residential investment relative to GDP would be 50 percent greater than what occurred during the 1973-74 recession, reaching roughly 3 percent, a result worse than during even the most severe post-war recessions.

Many recent indicators run counter to such an outcome. For example, builders responded quickly to the changing market conditions, bringing housing starts to a low level that is more in line with future demand. Inventories of unsold new homes, meanwhile, have begun to drift down from their July peak after having risen nearly 25 percent over the previous year. In addition, the National Association of Homebuilders' survey consumer traffic turned up in October and November amid anecdotes that current conditions—including much lower interest rates and more affordable pricing—are beginning to draw potential buyers back into the market. We expect housing markets to stabilize some time during the first half of 2007.

The recovery, however, will not be a re-run of the white-hot market in 2004-2005. Rather, there will likely be a return to more "normal" conditions next year, with starts and sales picking up only gradually and then growing at a modest pace. Nationally, house prices will likely appreciate around the rate of consumer price inflation, although there is a potential for real declines and some hard-hit areas will need greater improvements in the local economy before experiencing a housing recovery. With smaller price gains and reduced opportunities to extract equity, mortgage debt will grow more slowly. In short, housing markets will move off center stage, but will resume quietly providing homes and opportunities to build a nest egg for millions of American households.

Details

- *Real GDP growth.* The economy grew at an upwardly revised 2.2% annualized rate during the third quarter. We lowered our projection of growth in the 4th quarter from 2.6% to 2.2% based on continued contractions in housing activity and vehicle production through year-end, which puts growth for 2006 at 3.2%. Real GDP growth in the 1st and 2nd quarters of 2007 is predicted to accelerate to 2.8% and 3.0%, respectively.
- *Consumer price inflation.* As energy prices offset increases elsewhere, our outlook is for consumer prices to be flat in the 4th quarter. Headline inflation over the first 10 months of 2006 was 2.4%, a full percentage point lower than for the entire year 2005. However, core inflation – which excludes volatile food and energy prices – has increased 2.8% so far this year, 60 basis points higher than in 2005. Consumer price inflation is predicted to hold steady at 2.5% throughout 2007.
- *Unemployment rate.* The economy added 100,000 jobs in November, bringing our prediction of the unemployment rate for the 4th quarter up to 4.5%. Unemployment is projected to edge upwards next year, but the rate remains below 5% through the first half of 2007.
- *Mortgage rates.* With current long-term yields declining on weak economic reports, we decreased our 4th quarter forecast of the 10-year Treasury yield by 20 basis points to 4.6% and the 1-year Treasury yield by 10 basis points to 5.0%. The slight inversion of the yield curve is predicted to persist in 2007. Our outlook for mortgage rates is lower as well, with 30-year mortgage rates averaging 6.3% in the 4th quarter and little changed in the first quarter of 2007.
- *ARM Share.* We nudged up our forecast of the ARM share of conventional loans in 2007 from 14% to 16% (as a percent of number of loans) to reflect our forecast of lower short-term mortgage rates for the year. Even so, the slightly inverted yield curve will make ARM products less attractive to borrowers than in 2006.
- *Housing starts.* Housing starts are expected to bottoming out at 1.60 million units in the 4th quarter and stabilize in 2007 around that level.
- *Home sales.* We revised upwards the rate of single-family home sales by 10,000 units in the 4th quarter to 6.40 million units, bringing the annual average to 6.74 million units, a 10% decline from 2005's record setting pace. Lower predicted mortgage rates increased our forecast of 2007 home sales by 26,000 units from the November Outlook, leading to an average pace of 6.22 million units for next year.
- *Home value appreciation.* Annualized house price growth in the 4th quarter is expected to slow further to 2% from 5.2% in the 2nd quarter and 4.0% in the 3rd quarter. We expect house prices, like housing starts and sales, to trough in the 4th quarter, with prices appreciating 3.4% in the first half of 2007.
- *Mortgage activity.* Our outlook for the refinance share of applications reaches 48% in the 4th quarter, its highest level in 2006. We expect strong refinance activity through the 1st quarter of 2007, then diminishing to a 36% share by mid-year. The rate of growth of mortgage debt outstanding is projected to slow over the next several years due to lower house price gains and reduced equity extraction. Meanwhile, according to a recent Fed release, delinquency rates on residential mortgages in bank portfolios increased to 1.7%, the highest level since 2003. This rate is only marginally higher than in 2004 and 2005, and remains below rates in the 1990s, indicating only a modest deterioration of credit quality to date.

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December 8, 2006

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Office of the Chief Economist

Economic and Housing Market Outlook

December 2006

Revised 12/08/2006

Major Economic Indicators

Indicator	2005		2006				2007				2008		Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2002	2003	2004	2005	2006	2007	2008
Real GDP (%)	4.2	1.8	5.6	2.6	2.2	2.2	2.8	3.0	3.2	3.4	3.2	3.4	1.9	3.7	3.4	3.1	3.2	3.1	3.5
Consumer Prices (%) a.	5.5	3.2	2.2	5.0	2.9	0.0	2.5	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.3	3.7	2.5	2.5	2.5
Unemployment Rate (%) b.	5.0	4.9	4.7	4.6	4.7	4.5	4.7	4.9	5.0	5.0	5.0	5.0	5.8	6.0	5.5	5.1	4.6	4.9	5.0
30-Year Fixed Mtg. Rate (%) b.	5.8	6.2	6.3	6.6	6.6	6.3	6.2	6.3	6.3	6.4	6.4	6.5	6.5	5.8	5.8	5.9	6.4	6.3	6.5
1-Year Treas. Indexed ARM Rate (%) b.	4.5	5.1	5.3	5.7	5.7	5.5	5.5	5.5	5.5	5.5	5.5	5.5	4.6	3.8	3.9	4.5	5.5	5.5	5.5
10-Year Const. Mat. Treas. Rate (%) b.	4.2	4.5	4.6	5.1	4.9	4.6	4.6	4.6	4.7	4.7	4.8	4.8	4.6	4.0	4.3	4.3	4.8	4.7	4.9
1-Year Const. Mat. Treas. Rate (%) b.	3.8	4.3	4.6	5.0	5.1	5.0	4.9	5.0	5.0	5.0	5.0	5.0	2.0	1.2	1.9	3.6	4.9	5.0	5.0

Housing and Mortgage Markets

Indicator	2005		2006				2007				2008		Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2002	2003	2004	2005	2006	2007	2008
Housing Starts c.	2.10	2.06	2.12	1.87	1.72	1.60	1.60	1.63	1.64	1.62	1.78	1.73	1.70	1.85	1.96	2.07	1.83	1.62	1.75
Total Home Sales d.	7.56	7.34	7.11	6.96	6.49	6.40	6.25	6.20	6.20	6.22	6.10	6.20	5.95	6.53	7.16	7.46	6.74	6.22	6.32
House Price Appreciation (%) e.	14.2	13.1	9.6	5.2	4.0	2.0	3.5	3.3	3.5	3.0	3.2	3.9	7.2	7.8	11.8	13.4	5.2	3.3	3.5
1-4 Family Mortgage Originations f.																			
Conventional	\$920	\$782	\$600	\$715	\$659	\$597	\$561	\$635	\$631	\$568	\$517	\$589	\$2,697	\$3,630	\$2,776	\$3,167	\$2,571	\$2,395	\$2,275
FHA & VA	\$22	\$19	\$17	\$21	\$21	\$21	\$23	\$26	\$26	\$24	\$22	\$25	\$186	\$230	\$135	\$83	\$81	\$100	\$120
Total	\$942	\$801	\$617	\$736	\$680	\$618	\$584	\$661	\$657	\$592	\$539	\$614	\$2,883	\$3,860	\$2,911	\$3,250	\$2,651	\$2,495	\$2,395
ARM Share (%) g.	28	29	28	25	19	14	15	15	16	16	17	17	17	19	34	31	21	16	17
Refinancing Share - Applications (%) h.	44	45	44	42	41	48	48	36	33	33	30	23	59	65	46	44	44	38	25
Residential Mortgage Debt (%) i.	16.3	13.4	10.2	9.8	7.6	6.4	4.6	8.4	8.4	6.6	5.3	8.3	12.7	12.7	14.5	13.6	8.5	7.0	7.1

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 averages 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 averages of monthly interest rates (not seasonally-adjusted).
- 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 detached single-family homes; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
- e. Annualized growth rate of Freddie Mac's Conventional Mortgage Home Price Index (CMHPI); not seasonally-adjusted.
- f. Billions of dollars (not seasonally-adjusted).
- g. Federal Housing Finance Board (FHFB); quarterly averages of monthly shares of conventional, home-purchase mortgage closings (not seasonally-adjusted).
- h. Primary Mortgage Market Survey[®]; quarterly averages of monthly shares of all single-family mortgage applications (not seasonally-adjusted).
- i. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages (not seasonally-adjusted, annualized rate).

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