

The Remodeled Housing Market

Market trends tend to be short-lived. In the housing market once pervasive trends – brisk house price growth, low homes-for-sale inventory, and record breaking single-family home sales and starts – have faded as the market adapts to weakened housing demand. In the current housing slowdown, the slightly inverted yield curve has made once popular adjustable-rate mortgages (ARMs) much less attractive. Also, with an 11 percent November-to-November drop in home sales last year, mortgage applications for purchase are at their lowest level since mid-2003. In short, the seller's market has evaporated into a buyer's market with 7 months supply of inventory, about double the amount in 2005, and though house prices have burgeoned to high levels, the pace of house-price growth has decreased considerably and prices have fallen in a number of metro areas.

Employment figures provide more evidence of change. Last year, housing-related industries lost 64,000 jobs (October-to-October), a sharp contrast to the 352,000 jobs in housing construction, sales and finance industries gained in 2005. In the past, housing slowdowns have dragged the economy into recession, however, a rash of good employment news is leading the transitioning economy into the new year. The Labor Department reported 167,000 jobs created in December and 1.8 million jobs in 2006. Furthermore, wages increased by 4.2% last year, the largest increase since 2000.

Yes, trends come and go; nevertheless, in the last five years three trends have remodeled housing finance and become fixtures of the market. The first trend is a higher baseline in refinance activity. The housing boom has made homeowners more savvy in using their refinance options, while advances in technology and reduction in the costs of originating mortgages has reduced barriers to refinance. In the last 15 years there have been three refinance booms (periods when the refinance share of applications was over 50 percent). In the fourth quarter of 1993 the refinance share of applications peaked at 64 percent but five quarters later had declined to 11 percent. The next refinance boom occurred in 1998, when the refinance share reached 59 percent and then decreased to 15 percent a year and a half later. In the latest boom, the refinance share topped out at 77 percent in the 1st quarter of 2003. Approximately five quarters after the peak, the refinance share settled to 39 percent, a much higher level than the last two refinance drops. Moreover, even as mortgage rates continued to inch up over 2006, the refinance share stayed between 40 and 45 percent of all mortgage applications.

The second ongoing trend in the housing market is greater product variety. According to Freddie Mac's Annual ARM Survey of prime lending, hybrid ARMs are more popular relative to one-year ARMs. In recent years other innovative products have made homeownership more accessible. Subprime mortgages are predominantly found among borrowers with low credit ratings, while nontraditional products attract homebuyers in high-cost areas due to their low introductory rates. Industry analysts estimate that about \$500 billion in first-lien adjustable-rate mortgages are scheduled to have a payment reset this year, and an even larger volume including junior liens (such as HELOCs). Some homeowners may find it difficult to meet their payments if payments increase substantially. Mounting delinquencies and the failure of several subprime lenders will heighten the public scrutiny of nontraditional and subprime mortgage products in 2007.

The third enduring trend is the lack of affordable housing. Double-digit house price gains are over, but left in their wake are high price levels that bar many potential buyers from homeownership. Incomes have not kept pace with house price growth causing affordability to be at its lowest level since the late 1980's when 30-year mortgage rates topped 10 percent. New construction provides few answers as only 18 percent of new construction was priced at \$150,000 and under in 2005.

The housing boom and slowdown will leave a lasting impression on the nation's housing market, retooling the way people finance their homes.

Details

- *Real GDP growth.* The final reading on real GDP growth in the third quarter came in at 2.0%, between the two previous government estimates. We are continuing to forecast below-trend growth in the first quarter due to a lingering, but diminishing, drag from the housing sector. With supportive financial conditions and lower energy prices, we expect growth to accelerate in the second half of 2007.
- *Consumer price inflation.* Falling energy prices put general inflation, as measured by the Consumer Price Index, into negative territory in the fourth quarter. Inflationary pressures are expected to stay mild throughout 2007, running at a 2.5% rate each quarter, absent any energy-price shocks.
- *Labor markets.* Non-farm payrolls rose a robust 167,000 in December, bringing the net job gain to 1.8 million for the year, while the unemployment rate was unchanged in December at 4.5%. The manufacturing sector lost 72,000 jobs during 2006, while construction, even with the slowdown in the residential sector, gained 39,000 jobs as commercial construction boomed. A stronger job market is expected to have the effect of raising the unemployment rate over 2007 as it attracts previously discouraged workers back into the labor market.
- *Mortgage rates.* Low inflation is likely to keep long-term Treasury yields low, and in turn, keep 30-year fixed mortgage rates below 6.5% in 2007. Indeed, they ended 2006 where they began, averaging 6.2% in the fourth quarter. The yield curve is predicted to remain inverted throughout 2007, absent any moves by the Fed to lower short-term interest rates. Initial coupon rates on 1-year Constant Maturity Treasury adjustable rate mortgages (ARMs) are forecast to average 5.5% each quarter of 2007.
- *ARM Share.* The ARM share for home-purchase loans is expected to fall in 2007 to 14%, the lowest share since 2001, as the inverted yield curve makes ARMs less attractive relative to fixed-rate mortgages, and regulatory pressure makes lenders more conservative in underwriting loans with nontraditional features.
- *Housing starts.* The housing market is expected to stabilize in 2007 as activity has come more in line with trend growth and 30-year fixed mortgage rates have fallen back below 6.25%. Housing starts are likely to reach their low point in the first quarter of 2007 before rising slowly over the rest of the year. In total, 2007 starts are expected to be 11% below the 2006 level.
- *Home sales.* Like housing starts, home sales are also expected to bottom out in the first half of the year as lower mortgage rates help entice homebuyers back into the market and stop the decline in sales. Relative to 2006, single-family home sales should be about 6% lower in 2007.
- *Home value appreciation.* Home prices are expected to soften further in 2007, though considerable uncertainty remains as to how far and in what ways. For example, sellers are reluctant to lower prices, and thus sales incentives such as seller-paid closing costs are counted in the price if they are part of the purchase contract, masking what might otherwise be counted as a price decline. Overall we anticipate home prices to grow modestly at 2.9% in 2007, but also expect the numbers to be volatile and vary widely across states.
- *Mortgage activity.* Single-family mortgage originations are forecast to decline roughly 6% in 2007 due to a drop in refinancing activity and lower home sales. About \$500 billion in first-lien ARMs are scheduled for a payment reset in 2007, and many borrowers will likely refinance to avoid an increase. With fixed mortgage rates once again quite low, refinance borrowers have attractive options. Mortgage debt will likely grow at about 7%, its slowest rate since 1997, due to the slow down in the housing market and the lower volumes of equity extraction, as forecast in our November Cash-out Refinance Report.

Frank Nothaft
Chief Economist
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Amy Crews Cutts
Deputy Chief Economist

Calvin Schnure
Economic Analysis Director

Nela Richardson
Senior Economist

www.freddiemac.com/news/finance

chief_economist@freddiemac.com

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Economic and Housing Market Outlook
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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	2.0	2.2	2.5	3.0	3.2	3.4	3.5	3.5	1.9	3.7	3.4	3.1	3.1	3.0	3.5	
Consumer Prices (%) a.	5.5	3.2	2.2	5.0	2.9	-2.0	2.5	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.3	3.7	2.0	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	6.2	6.2	6.2	6.3	6.3	6.4	6.4	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	4.7	4.7	4.8	4.8	4.9	4.9	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	5.0	5.0	5.0	5.0	5.0	5.1	2.0	1.2	1.9	3.6	4.9	5.0	5.1	

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	1.71	1.59	1.57	1.59	1.64	1.67	1.70	1.70	1.70	1.85	1.96	2.07	1.82	1.62	1.70	
Total Home Sales d.	7.56	7.34	7.07	6.96	6.50	6.55	6.35	6.30	6.35	6.40	6.40	6.40	5.95	6.53	7.16	7.46	6.77	6.35	6.45	
House Price Appreciation (%) e.	14.2	13.1	9.6	5.2	4.0	2.0	2.0	2.0	4.3	3.3	2.9	3.9	7.2	7.8	11.9	13.4	5.2	2.9	3.6	
1-4 Family Mortgage Originations f.																				
Conventional	\$920	\$782	\$600	\$715	\$659	\$605	\$561	\$635	\$631	\$568	\$536	\$612	\$2,697	\$3,630	\$2,776	\$3,167	\$2,578	\$2,395	\$2,343	
FHA & VA	\$22	\$19	\$17	\$21	\$21	\$21	\$23	\$26	\$26	\$24	\$22	\$25	\$186	\$230	\$135	\$83	\$81	\$100	\$123	
Total	\$942	\$801	\$617	\$736	\$680	\$626	\$584	\$661	\$657	\$592	\$559	\$637	\$2,883	\$3,860	\$2,911	\$3,250	\$2,659	\$2,495	\$2,466	
ARM Share (%) g.	28	29	28	25	19	14	13	14	14	14	15	15	17	19	34	31	21	14	15	
Refinancing Share - Applications (%) h.	44	45	44	42	41	46	46	35	32	31	29	23	59	65	46	44	43	36	30	
Refinancing Share - Originations (%) h.	50	51	50	48	47	52	52	42	39	39	37	31	66	70	52	50	49	44	38	
Residential Mortgage Debt (%) i.	16.3	13.5	10.0	9.8	7.6	7.5	5.2	7.2	8.6	6.9	5.6	8.7	12.7	12.7	14.5	13.6	8.7	7.0	7.4	

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 application; (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).

Prepared by Office of the Chief Economist (MS 1/11/2007); Send comments and questions to chief_economist@freddiemac.com.

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