

Keeping Them In Their Homes

Economic news early this year has been consistently downbeat. GDP growth stalled in the first quarter, as a widening trade deficit and a sharp inventory correction compounded the housing sector woes. Several indicators, however, point towards a modest turnaround. First, the May jobs report came in strong at 157,000 new jobs created. Second, even as gas prices topped \$3 a gallon, consumer spending has proceeded unabated. Furthermore, gas prices still show little sign of seeping into general inflation rates—the Fed’s preferred measure of core inflation slowed to a 2 percent increase over year-ago, the slowest pace since 2002. Encouragingly, consumers appear optimistic about the future, as captured in the May increase in consumer sentiment.

Continued resilience in the broader economy can provide much-needed support for the housing sector. A return of GDP growth to trend levels (at or above a 3 percent annual rate) later this year should bolster jobs and incomes, ultimately supporting housing demand. The housing outlook remains fragile, though, and the recovery will be an uneven one. Troubles are worst in the subprime market, where 1 in 13 homes are candidates for foreclosure. According to the National Delinquency Survey, in the second half of 2003, approximately 670,000 homes entered foreclosures, 37 percent of which had subprime loans. This year we project that over a million homes will enter foreclosure (a 30 percent increase from 2006) and 60 percent of these homes have subprime loans. These troubles appear to be having little to no direct spillover into the prime mortgage market, however. According to the Fed’s most recent Senior Loan Officer Survey, while a considerable number of institutions tightened their lending standards on nontraditional and subprime mortgages, credit standards for prime mortgages have remained basically unchanged.

A reciprocal relationship exists between house prices and subprime delinquencies. When prices rise rapidly, financially stretched borrowers can easily refinance into mortgages with lower rates, often withdrawing cash from home equity in the process. This helps maintain consumer spending and liquidity for the household. Unfortunately, this works in reverse as well. Lately, with prices weak or falling in many markets, troubled borrowers have fewer opportunities to lower their mortgage rate and access home equity through refinancings. This appears to be contributing to rising subprime foreclosures, inflating the already bloated inventories of unsold homes—and, completing the cycle, further depressing home prices. According to our new Conventional Mortgage Home Price Index-Purchase series, the Midwest states of Illinois, Indiana, Ohio, and Michigan experienced a 4.3 percent decline in home values in the first quarter of this year, the largest decline of any region in the country. Not coincidentally, these states also have the highest rates of subprime delinquencies.

While it is difficult to find good news in the subprime market, one recent development holds out some hope of helping keep people in their homes. Lenders reportedly have stepped up efforts to provide loan modifications and forbearance alternatives that would make mortgage payments more affordable, and Federal bank regulators have encouraged such efforts. One sticking point, however, has been the legal difficulty modifying subprime loans in securitized pools.

Freddie Mac has taken the lead in the prime market in efforts to help keep financially strapped borrowers in their home. Freddie Mac’s subprime initiatives include tougher subprime lending standards, the introduction of new 30-year and adjustable rate subprime mortgages with reduced margins and lower fixed rate periods by midsummer, and consumer education campaigns. While not every subprime mortgage will avoid foreclosure, experience has shown that these efforts can go a long way in helping homeowners keep their homes.

Details

- *Real GDP growth.* First quarter GDP growth was revised down to a 0.6% annual rate as a decline in business inventory investment and a surge of imports each subtracted more from overall GDP growth than initially estimated. The drag from residential construction is showing signs of waning, subtracting 0.9 percentage points from headline growth after two quarters of a negative 1.2 percentage point contribution. We see GDP growth slowly increasing over the next few quarters to average 2.3% for the year and 3.0% for 2008.
- *Consumer price inflation.* Headline consumer prices rose 0.4% in April, boosted by both food and energy prices. Core prices rose 0.2%, in line with recent months. Gasoline prices reached a new high in late May and are likely to continue the upward pressure on headline inflation. Increases in the core personal consumption deflator—the Fed’s preferred measure of core prices—have moderated, with the year-over-year change dropping to 2.0% in April.
- *Unemployment rate.* The unemployment rate was unchanged at 4.5% in May as nonfarm payrolls rose 157,000, the largest increase since March. Employment in residential construction edged down, while real estate and banking firms increased payrolls. Average hourly earnings increased 0.3% in May and are 3.8% above year-ago levels. We see the unemployment rate increasing through the year as GDP stays below its trend growth.
- *Mortgage rates.* Rates on 30-year fixed-rate mortgages (FRMs) rose above 6.50% in early June for the first time this year, and rates on other fixed-rate products posted similar gains. Rates on 30-year FRMs will continue to slowly rise, but average 6.4% in 2007 and 6.6% in 2008.
- *ARM Share.* With rates on adjustable-rate mortgages rising by a smaller amount than those on fixed-rate mortgages, the FRM-ARM spread increased, improving the relative attractiveness of ARMs to borrowers. The ARM share of originations is forecast to remain low by historical standards, but edge up slightly towards the end of 2008.
- *Housing starts.* Housing starts moved up modestly in April but remain significantly below year-ago levels. We expect starts to stay low through the first half of the year due to the supply overhang of new homes, but begin rising modestly into 2008 to 1.60 million units.
- *Home sales.* Demand for housing appears to have sagged a bit more in the first half of this year, and total sales of new and existing homes are not expected to bottom out until sometime around the second half of the year. We expect total home sales to average almost 6.5 million units in 2008.
- *Home value appreciation.* Housing prices decelerated further in the first quarter, rising at a 1.7 % annual rate. Excess inventories and weak demand are expected to continue to weigh on prices, which are likely to rise at or below the rate of consumer price inflation for the next several quarters.
- *Mortgage activity.* Refinancing activity continues to account for over 40% of total mortgage applications, boosted by homeowners facing a rate reset. The monthly Primary Mortgage Market Survey® refinance share has stayed above 40% since April 2005. Freddie Mac’s Refinancing Transition Report shows a large proportion of borrowers with adjustable-rate mortgages turning to a fixed-rate product when they refinance. Cash-out refinancing has helped to boost the amount of residential mortgage debt outstanding. We see mortgage debt rising 6.0% in 2007 and 6.4% in 2008.

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Office of the Chief Economist

Economic and Housing Market Outlook

June 2007

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Major Economic Indicators

Indicator	2006				2007				2008				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2003	2004	2005	2006	2007	2008	2009
Real GDP (%)	5.6	2.6	2.0	2.5	0.6	2.6	2.9	3.2	3.0	3.0	3.0	3.0	3.7	3.4	3.1	3.1	2.3	3.0	3.5
Consumer Prices (%) a.	1.9	5.0	3.2	-2.1	3.8	5.9	2.5	2.5	2.5	2.5	2.5	2.5	1.9	3.4	3.7	1.9	3.7	2.5	2.5
Unemployment Rate (%) b.	4.7	4.6	4.7	4.5	4.5	4.5	4.6	4.7	4.8	4.8	4.8	4.8	6.0	5.5	5.1	4.6	4.6	4.8	4.8
30-Year Fixed Mtg. Rate (%) b.	6.3	6.6	6.6	6.2	6.2	6.3	6.5	6.5	6.6	6.6	6.6	6.7	5.8	5.8	5.9	6.4	6.4	6.6	6.8
1-Year Treas. Indexed ARM Rate (%) b.	5.3	5.7	5.7	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	3.8	3.9	4.5	5.5	5.5	5.5	5.5
10-Year Const. Mat. Treas. Rate (%) b.	4.6	5.1	4.9	4.6	4.7	4.8	4.9	5.0	5.0	5.0	5.1	5.1	4.0	4.3	4.3	4.8	4.8	5.1	5.2
1-Year Const. Mat. Treas. Rate (%) b.	4.6	5.0	5.1	5.0	5.0	4.9	5.0	5.0	5.0	5.1	5.1	5.1	1.2	1.9	3.6	4.9	5.0	5.1	5.1

Housing and Mortgage Markets

Indicator	2006				2007				2008				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2003	2004	2005	2006	2007	2008	2009
Housing Starts c.	2.13	1.86	1.70	1.56	1.46	1.45	1.49	1.53	1.55	1.58	1.62	1.65	1.85	1.96	2.07	1.81	1.48	1.60	1.70
Total Home Sales d.	7.16	6.59	6.49	6.49	6.50	6.35	6.37	6.40	6.45	6.50	6.50	6.50	6.53	6.98	7.46	6.73	6.41	6.49	6.63
House Price Appreciation (%) e.	9.5	5.5	4.9	5.4	1.7	1.0	1.5	1.9	2.0	3.0	3.0	2.0	7.7	11.7	13.1	6.3	1.5	2.5	3.6
1-4 Family Mortgage Originations f.																			
Conventional	\$687	\$802	\$746	\$685	\$662	\$729	\$712	\$604	\$539	\$604	\$601	\$541	\$3,631	\$2,776	\$3,167	\$2,920	\$2,707	\$2,285	\$2,142
FHA & VA	\$19	\$20	\$22	\$19	\$18	\$20	\$22	\$19	\$22	\$25	\$25	\$23	\$220	\$130	\$90	\$80	\$80	\$95	\$113
Total	\$706	\$822	\$768	\$704	\$680	\$749	\$734	\$623	\$561	\$629	\$626	\$564	\$3,851	\$2,906	\$3,257	\$3,000	\$2,786	\$2,380	\$2,254
ARM Share (%) g.	28	25	19	14	11	11	13	13	13	13	14	14	19	34	31	21	12	14	15
Refinancing Share - Applications (%) h.	44	42	41	46	46	35	30	28	26	20	19	20	65	46	44	43	35	21	18
Refinancing Share - Originations (%) h.	50	48	47	52	52	42	38	36	33	29	28	29	70	52	50	49	42	30	27
Residential Mortgage Debt (%) i.	10.2	10.5	9.5	7.5	5.6	6.5	6.8	5.1	5.6	7.0	7.4	5.5	12.7	14.6	13.5	9.4	6.0	6.4	6.3

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 6/8/2007); Send comments and questions to chief_economist@freddiemac.com.

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