

Finding Solid Ground

Housing markets have been headline news all summer and into the fall, reflecting their prominent role in the U.S. economy and concerns that a “hard landing” for housing could have more widespread repercussions. The direct contribution of residential investment to GDP growth points to a modest slowing in the economy as housing markets cool. Compounding this effect, however, is the risk that the indirect effects of a housing slump – through lower spending on furniture and consumer durables, the impact on homeowners’ net worth and mortgage equity withdrawal, job and income losses in construction, real estate and mortgage finance sectors, and depressing consumer sentiment more generally – could have broader consequences.

After several years of a soaring housing market, the sector has finally come back to earth. In August, sales of new and existing homes were 12 and 18 percent lower, respectively, than a year earlier, contributing to a bulge in inventories and bringing the months’ supply of new homes to 6.6 months. With houses staying on the market longer, sellers are offering more concessions (some reports indicate automobiles, trips to faraway destinations or plasma TVs are being given, in addition to more traditional offers of free repairs or closing costs), and builders are adding more incentives, such as upgrades to materials, to entice buyers while maintaining the observed transaction prices. Housing starts fell to the lowest level since April 2003, as builders adjust to market conditions. In this buyer’s market, price gains have moderated and the August median sales price of an existing home declined from a year earlier. We expect the overall drag from the housing sector to trim as much as a full percentage point from GDP growth in the second half of this year.

Yet despite the cooling trend in housing, the rest of the economy remains resilient to a steeper downturn. Consumer spending continues to expand at a steady pace. Importantly, consumer demand has not flagged as net mortgage equity extraction in the second quarter slipped 30 percent from a year earlier. Slower home sales most likely contributed to this fall-off due to their role in unlocking home equity. While home equity has been an important source of liquidity for many households, research suggests home values matter more for the “wealth effect”, and that past gains in housing wealth will continue to bolster consumer spending through 2007.

Several positive factors will help sustain the economy going forward. Chief among these are falling energy prices – gasoline prices are 25 percent below their August level – which boost consumers’ real incomes. Housing markets are benefiting from a 50 basis point decline in mortgage rates from their summer highs, with 30-year fixed rate mortgages touching 6.30 percent in early October. Mortgage refinancings have rebounded in recent weeks as homeowners facing upcoming rate adjustments on adjustable-rate mortgages take advantage of the current environment to lock in lower long-term payments. Rising stock prices are contributing to household net worth and reflect a favorable view of economic prospects.

There are early signs that housing markets may be nearing a floor. Mortgage applications for home purchase have stabilized in recent weeks around the level that prevailed in 2003, a period of moderately strong demand for housing. Consumer sentiment remains cautiously optimistic about the future. And there is a silver lining to the slower home price appreciation, as this will help improve affordability, especially for first-time buyers. There will undoubtedly be more bumps on the way, though, and the ride could be rocky in some markets, but the economic fundamentals should help avert a crash landing.

Details

- *Real GDP growth.* We lowered our projection from last month of real GDP growth in the 3rd quarter from an annualized rate of 2.9% to 2.0% to reflect greater-than-expected declines in home construction and sales, smaller inventories, and reduced business spending. We believe that, in total, the slowdown in housing activity will reduce GDP growth in the second half of the year by a full percentage point, leading to a below-trend real GDP growth rate of 2.3%.
- *Consumer price inflation.* We expect consumer price growth to moderate substantially in the latter part of 2006 to 1.5%, as the energy prices that boosted up headline inflation earlier this year continue to fall. Core CPI – inflation minus food and energy prices – has also moderated, reducing the potential for past increases in energy prices to spill over into other consumer goods.
- *Unemployment rate.* The Labor Department reported that the economy added just 51,000 nonfarm payroll jobs in September, holding the unemployment rate at 4.7 for the 3rd quarter. Softer than expected employment numbers last month are mitigated somewhat by an upward revision by 60,000 additional jobs in August. We see the unemployment rate rising slightly to 4.8% for the duration of the year and then drifting up to 5.0% in 2007 and 2008.
- *Mortgage rates.* The 30-year fixed mortgage rate is projected to average of 6.4% in the 4th quarter of 2006. Mortgage rates will be little changed in early 2007 averaging 6.5% and 5.5% for the 30-year fixed-rate and 1-year adjustable-rate mortgages, respectively. To avoid the risk of their mortgages resetting at a potentially higher rate in the future, borrowers with adjustable rate mortgages are beginning to refinance into relatively low-cost fixed-rate products, thereby supporting mortgage originations as rates have risen this year.
- *ARM share.* As the gap between fixed and adjustable mortgage rates has narrowed, borrowers are turning towards fixed products. Thus, the ARM share of the mortgage market is forecasted to drop to 17% in the 4th quarter of 2006 and remain at this level throughout 2007.
- *Housing starts and sales.* The market continues to experience a slowdown in housing starts and home sales. Home construction was down an average of 3.4% in the first half of the year relative to the same period in 2005, but looks to be nearly 20% lower in the second half. Home sales are expected to decline by 9% from 2005 totals to 6.8 million units in 2006 and total 6.4 million units in 2007.
- *Home value appreciation.* Nationally, our forecast for house-price appreciation averages 5.7% for the second half of this year, and 6.2% in the first two quarters of next year. Some local markets will experience flat or declining house prices in the near-term due to regional economic conditions and lower investment demand for housing.
- *Mortgage activity.* We benchmarked last year's single-family mortgage originations volume to the 2005 Home Mortgage Disclosure Act data released this September, revising our estimate up. We increased our estimate from last month of single-family mortgage originations for this year to \$2.7 trillion, an 18% decrease from 2005 and have originations falling by 5% in 2007 to \$2.5 trillion. We forecast that residential mortgage debt will grow by 10.5% and 9.5% in 2006 and 2007, respectively.

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Major Economic Indicators																			
Indicator	2005				2006				2007				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2002	2003	2004	2005	2006	2007	2008
Real GDP (%)	3.4	3.3	4.2	1.8	5.6	2.6	2.0	2.6	3.1	3.1	3.2	3.2	1.9	3.7	3.4	3.1	3.2	3.2	3.5
Consumer Prices (%) a.	2.5	3.7	5.5	3.2	2.2	5.0	3.3	1.5	2.5	2.5	2.5	2.5	2.2	1.9	3.3	3.7	3.0	2.5	2.5
Unemployment Rate (%) b.	5.2	5.1	5.0	4.9	4.7	4.6	4.7	4.8	4.9	4.9	5.0	5.0	5.8	6.0	5.5	5.1	4.7	5.0	5.0
30-Year Fixed Mtg. Rate (%) b.	5.8	5.7	5.8	6.2	6.3	6.6	6.6	6.4	6.4	6.5	6.5	6.6	6.5	5.8	5.8	5.9	6.5	6.5	6.7
1-Year Treas. Indexed ARM Rate (%) b.	4.2	4.2	4.5	5.1	5.3	5.7	5.7	5.4	5.4	5.5	5.5	5.5	4.6	3.8	3.9	4.5	5.5	5.5	5.6
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.2	4.5	4.6	5.1	4.9	4.7	4.7	4.8	4.8	4.9	4.6	4.0	4.3	4.3	4.8	4.8	5.0
1-Year Const. Mat. Treas. Rate (%) b.	3.1	3.3	3.8	4.3	4.6	5.0	5.1	4.9	4.9	4.9	4.9	5.0	2.0	1.2	1.9	3.6	4.9	4.9	5.0

Housing and Mortgage Markets																			
Indicator	2005				2006				2007				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2002	2003	2004	2005	2006	2007	2008
Housing Starts c.	2.07	2.06	2.10	2.06	2.12	1.87	1.71	1.68	1.77	1.67	1.68	1.73	1.70	1.85	1.96	2.07	1.84	1.71	1.70
Total Home Sales d.	7.33	7.56	7.56	7.34	7.07	6.96	6.52	6.50	6.42	6.48	6.46	6.35	5.95	6.53	7.16	7.46	6.76	6.43	6.28
House Price Appreciation (%) e.	10.8	15.4	13.9	13.0	9.1	4.9	6.4	4.9	6.3	6.1	7.3	6.0	7.2	8.0	12.0	13.3	6.3	6.4	5.8
1-4 Family Mortgage Originations f.																			
Conventional	\$650	\$815	\$920	\$782	\$600	\$715	\$657	\$604	\$559	\$631	\$653	\$577	\$2,697	\$3,630	\$2,776	\$3,167	\$2,576	\$2,420	\$2,290
FHA & VA	\$21	\$21	\$22	\$19	\$18	\$17	\$27	\$25	\$23	\$26	\$27	\$24	\$186	\$230	\$135	\$83	\$87	\$101	\$121
Total	\$671	\$836	\$942	\$801	\$618	\$732	\$684	\$629	\$582	\$657	\$680	\$601	\$2,883	\$3,860	\$2,911	\$3,250	\$2,663	\$2,521	\$2,411
ARM Share (%) g.	32	33	28	29	28	25	21	17	17	17	17	17	17	19	34	31	23	17	17
Refinancing Share - Applications (%) h.	45	42	44	45	44	42	41	38	36	34	32	30	59	65	46	44	41	33	26
Residential Mortgage Debt (%) i.	10.1	14.8	16.3	13.6	10.0	9.6	10.5	9.5	9.1	11.0	14.1	10.2	11.8	12.7	14.0	13.7	9.9	11.1	11.1

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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