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Office of the Chief Economist

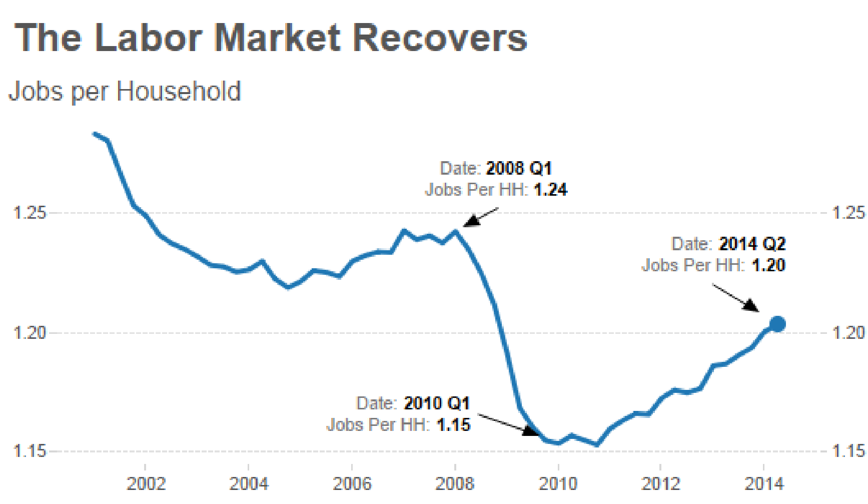
August 2014 U.S. Economic & Housing Market Outlook

Housing: The Path Forward

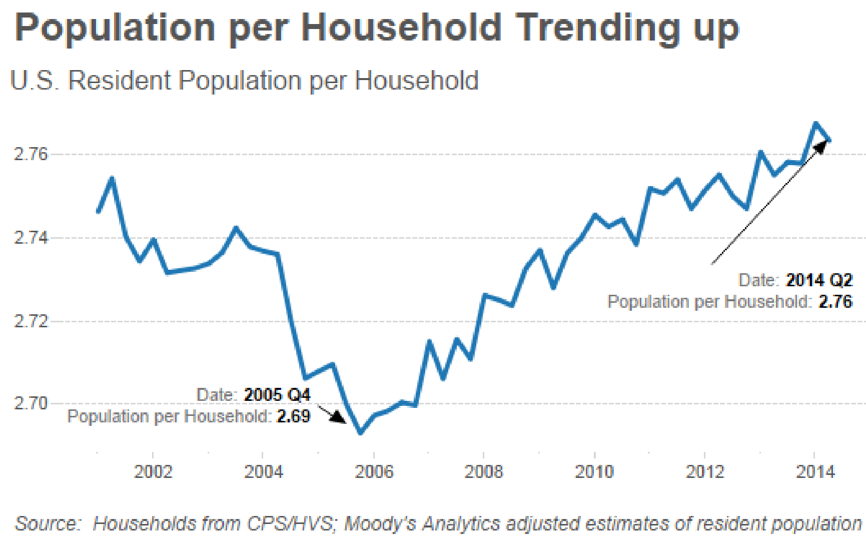
According to the advance report from the BEA, economic growth picked up in the second quarter, with GDP growth accelerating to 4.0 percent from a revised estimate of -2.1 percent in the first quarter. The pickup in national income growth is good news for the housing market. Our latest forecast for the U.S. economy and housing market shows continued improvement in economic growth averaging 3.3 percent in 2015 and the unemployment rate continuing to gradually decline. In this scenario, household formations should pick up and housing starts are projected to increase 28 percent over 2014's pace to 1.3 million starts in 2015. If so, long-term interest rates will likely creep up, with 30-year fixed-rate mortgages reaching about 5 percent at the end of 2015.

When describing our forecast, one immediate concern is that single-family housing markets have underperformed for several years. Following the sharp increase in mortgage rates during the spring and summer of 2013, single-family housing markets slowed toward the end of last year and into the beginning of 2014. While single-family starts and sales moved higher in the second quarter, doesn't this show that at best we have a very fragile housing market? In this month's outlook, we'll outline the path forward for housing.

We are getting closer to a more normalized economy, and now we are expecting to see housing driven by fundamentals. Single-family housing markets have been recovering from a very deep recession and have been operating far away from normal. After several years of weakness, we are starting to see the labor market pick up steam, having added 230,000 net new jobs on average for the first seven months of this year. We mentioned jobs as being a fundamental driver in recent past outlooks and that is something we've been tracking with our new housing index. It's no surprise more and better jobs lead to greater housing demand. The top ranked metros and states in our index all have strong and steady job growth in common. As the steadily improving labor market expands, this will stimulate housing activity by driving household formations and housing demand in more markets.



Source: BLS, Current Employment Statistics Total Nonfarm Payrolls; CPS/HVS Households



However, despite the recent improvements in the labor market, household formation still remains very slow: the Census Bureau reported that over the past four quarters, net household formations totaled only 458,000, compared with long-term projections by the Joint Center for Housing Studies of 1.2 to 1.3 million per year. Slow household formation has resulted in increased "doubling up" and a rise in the number of persons per household. For example, the number of persons per household has increased by 2.6 percent since 2005, going from 2.69 to 2.76 persons per household. If the persons per household had held steady over that period, there would be an additional 3 million households today.

Even if the labor market improves, how do we know the single-family housing market will rebound? After all, the Census Bureau also reported that over the past four quarters, the number of home owners was essentially unchanged, while the number of renter households increased by 458,000. Maybe the new households all want to become renters.

Those three million "missing" households are likely to show up over the next couple of years, especially if recent labor market trends persist. Those new households will require a place to live (new households generally begin with an apartment in the rental market) and will add to housing markets that are already seeing a tightening of available inventory. For example, rental market vacancy rates are at the lowest levels in over 14 years. And while aggregate vacancy rates for single-family properties remain elevated, many parts of the country are already experiencing a dearth of available for-sale inventory. Over time, the majority of those additional renter households will likely transition to homeownership. Millennials as a whole have formed households and married at older ages than prior cohorts, and will likely transition to homeownership at an older age as well.

Long-run projections of homeownership from Harvard's Joint Center for Housing Studies put the long-run homeownership rate between 64 and 65 percent, just where the U.S. rate was during the second quarter (64.7 percent) of this year. One very real concern is that even if households desire to become homeowners, will they be able to attain their dream? How will they afford it?

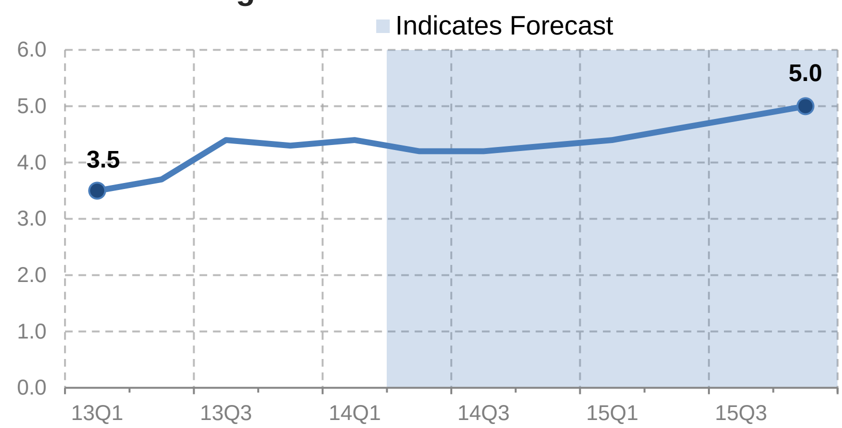
The good news is homebuyer affordability remains strong in most parts of the country as of the second quarter of this year. The last six months of 2013 saw the 30-year fixed-rate mortgage averaged 4.37 percent in our weekly survey, compared to the first six months of this year which averaged 4.30, and the second quarter averaged 4.23 percent, just 13 basis point below the first quarter. Moreover, stronger economic growth and job creation will also boost family incomes. For example, a 5 percent increase in income will increase homebuyer affordability by 12 percent. The June JOLTS report shows modest improvement: in job openings and hirings, rising 0.1 percent each from their May levels to 3.3 percent and 3.5 percent, respectively. Meanwhile, the quits rate remained at 1.8 percent, and layoffs and separations remained steady at 1.2 percent.

Improved labor market conditions, more household formations, and increased rental demand in the face of low vacancy rates are going to put upward pressure on single-family house prices and residential rents across the country. Won't rising house prices and interest rates drive down homebuyer affordability, stifling single-family housing markets?

Currently, the monthly mortgage payment-to-rent ratio for the U.S. is near the lowest it has been in more than 35 years. Thus, even with some increase in house prices and interest rates, the ratio will remain relatively low. One challenge for households seeking to transition from tenancy to ownership is amassing the funds for the down payment and closing costs. A stronger economy should provide a growing number of households the savings necessary for ownership in the future.

Affordability is also quite sensitive to interest rates. We expect 30-year fixed mortgage rates to rise gradually, only increasing 0.8 percentage points by the end of next year. The Federal Reserve has indicated that they will continue accommodative policy until the labor market fully recovers. As they note, a fully recovered labor market is not just a lower level of unemployment, but also requires improvement in a broader set of indicators.

30-Year Fixed Mtg. Rate



Source: Freddie Mac Office of the Chief Economist, August Outlook

The economic growth and labor market gains we saw in the second quarter of this year are projected to continue, strengthening household formations and the housing sector. A recovering housing sector will sustain the rally in homebuilding despite likely increases in long-term interest rates. Increased construction activity will further accelerate the improvement in labor markets and fuel even more household formations and more housing demand. The result is an economy that gradually recovers back towards its potential.

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August 13, 2014

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August 2014 Economic and Housing Market Outlook

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Indicator	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2009	2010	2011	2012	2013	2014	2015
											Annual Totals						
Real GDP (%)	4.5	3.5	-2.1	4.0	**3.0**	**3.2**	**3.3**	**3.3**	**3.3**	**3.3**	-0.2	2.7	1.7	1.6	3.1	**2.0**	**3.3**
Consumer Prices (%) a.	2.2	1.1	1.9	3.0	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	1.5	1.2	3.3	1.9	1.2	**2.2**	**2.0**
Unemployment Rate (%) b.	7.2	7.0	6.7	6.2	**6.2**	**6.0**	**6.0**	**5.9**	**5.8**	**5.7**	9.3	9.6	8.9	8.1	7.4	**6.3**	**5.9**
30-Year Fixed Mtg. Rate (%) b.	4.4	4.3	4.4	4.2	**4.2**	**4.3**	**4.4**	**4.6**	**4.8**	**5.0**	5.0	4.7	4.5	3.7	4.0	**4.3**	**4.7**
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	3.2	3.0	3.1	3.0	**3.2**	**3.4**	**3.7**	**3.9**	**4.2**	**4.4**	4.8	3.8	3.3	2.8	2.9	**3.2**	**4.1**
1-Year Treas. Indexed ARM Rate (%) b.	2.7	2.6	2.5	2.4	**2.4**	**2.5**	**2.5**	**2.6**	**2.7**	**2.7**	4.7	3.8	3.0	2.7	2.6	**2.5**	**2.6**
10-Year Const. Mat. Treas. Rate (%) b.	2.7	2.7	2.8	2.6	**2.6**	**2.6**	**2.7**	**2.9**	**3.1**	**3.3**	3.3	3.2	2.8	1.8	2.4	**2.7**	**3.0**
1-Year Const. Mat. Treas. Rate (%) b.	0.1	0.1	0.1	0.1	**0.1**	**0.1**	**0.2**	**0.3**	**0.3**	**0.4**	0.5	0.3	0.2	0.2	0.1	**0.1**	**0.3**

Indicator	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2009	2010	2011	2012	2013	2014	2015
											Annual Totals						
Housing Starts c.	0.88	1.03	0.93	0.98	**1.05**	**1.10**	**1.20**	**1.30**	**1.30**	**1.40**	0.55	0.59	0.61	0.78	0.92	**1.02**	**1.30**
Total Home Sales d.	5.71	5.39	5.03	5.29	**5.40**	**5.50**	**5.55**	**5.55**	**5.60**	**5.70**	4.72	4.51	4.57	5.03	5.51	**5.31**	**5.60**
FMHPI House Price Appreciation (%) e.	1.6	-0.7	1.6	3.60	**0.8**	**-1.0**	**0.0**	**2.0**	**1.0**	**0.0**	-3.1	-4.9	-3.3	6.1	9.3	**5.0**	**3.0**
S&P/Case-Shiller® Home Price Index (%) f.	3.1	-0.3	0.2	**4.4**	**1.0**	**-0.6**	**0.0**	**2.0**	**1.0**	**0.0**	-2.5	-3.8	-3.7	7.2	11.4	**5.0**	**3.0**
1-4 Family Mortgage Originations g.																	
Conventional	**$363**	**$291**	**$198**	**$255**	**$256**	**$208**	**$212**	**$272**	**$208**	**$148**	$1,549	$1,300	$1,206	$1,752	**$1,570**	**$917**	**$840**
FHA & VA	$87	$59	$52	$65	**$64**	**$52**	**$53**	**$68**	**$52**	**$37**	$451	$367	$286	$370	$355	**$233**	**$210**
Total	**$450**	**$350**	**$250**	**$320**	**$320**	**$260**	**$265**	**$340**	**$260**	**$185**	$2,000	$1,667	$1,492	$2,122	**$1,925**	**$1,150**	**$1,050**
ARM Share (%) h.	9	10	11	10	**12**	**13**	**14**	**15**	**15**	**15**	3	5	11	10	9	**12**	**15**
Refinancing Share - Applications (%) i.	54	59	52	45	**35**	**34**	**32**	**22**	**18**	**17**	68	73	71	77	63	**41**	**23**
Refinancing Share - Originations (%) j.	**52**	**51**	**48**	**41**	**31**	**30**	**30**	**22**	**18**	**17**	68	67	64	70	**61**	**37**	**22**
Residential Mortgage Debt (%) k.	0.8	-0.7	-1.0	**0.0**	**1.0**	**2.0**	**2.5**	**3.0**	**3.0**	**3.5**	-1.7	-4.2	-2.1	-1.7	-0.5	**0.5**	**3.0**

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 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 (FMHPI); not seasonally-adjusted; Dec.to-Dec. for yearly data.
f. National composite index (quarterly growth rate); not seasonally-adjusted; Q4-to-Q4 for yearly data.
g. Billions of dollars (not seasonally-adjusted).
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.
k. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages (not seasonally-adjusted, annual rate).

Prepared by Office of the Chief Economist and reflects views as of 8/12/2014 (GTW); Send comments and questions to chief_economist@freddiemac.com.