

Real Economy Riding High

Housing Markets Continue to Roll with the Good Times

WHILE WALL STREET HAS struggled in recent months with wide market swings brought on by economic turmoil abroad, this country's housing markets are continuing to enjoy record levels of business.

The convergence of several key factors in 1998, against the backdrop of a strong economy overall, largely explains the ongoing prosperity enjoyed by both the homeowning and rental sides of the housing business. Better yet, there is no shortage of the ingredients needed to sustain these conditions at least through the year 2000. Interest rates remain at their lowest levels in 30 years; the federal budget shows a surplus for the first time in a generation; and consumer confidence is high.

An optimistic outlook for the economy—and, by extension, for the housing markets—does fly in the face of imminent recession predictions. According to some analysts, the current economic upswing—now entering a largely unprecedented eighth year—will fall prey to jitters set off by recent financial upheavals abroad and, domestically, to wild stock market swings and an insecure



public. These more pessimistic forecasters, however, fail to consider market fundamentals that include the vibrancy of the country's real economy.

The persistent upward thrust of the real economy, as measured by the increasing output of goods and services nationwide, bodes well for the strength of the country's housing markets. Although it is doubtful that this year's housing-sector accomplishments will top 1998's unparalleled vigor, 1999 is capable of turning in the second best performance ever, and 2000 is well positioned to claim third place. Simply stated, there are plenty of reasons why the country's mortgage lenders, homebuilders, apartment owners and real estate agents should look forward to at least another

two good years. And that's good news for those American families about to buy, sell, refinance or rent a home.

by Michael Marschoun

Rates Fall; Lending Soars

With interest rates on 30-year, fixed-rate mortgages falling as low as 6.5 percent one week in early October 1998—a level last seen three decades ago—mortgage lending continues at a brisk pace. Total single-family outstanding loans topped \$4.3 trillion in October 1998, up a respectable 8 percent from \$4.0 trillion one year earlier. In terms of new additions to the country's housing debt, Freddie Mac expects 1999 single-family originations to miss last year's high mark of nearly \$1.5 trillion but still account for an impressive \$1.1 trillion in new business. In 2000, however, the combined value of **conventional** and government-backed mortgage-loan balances should slip somewhat below \$1 trillion, according to Freddie Mac.

Last year's drop in interest

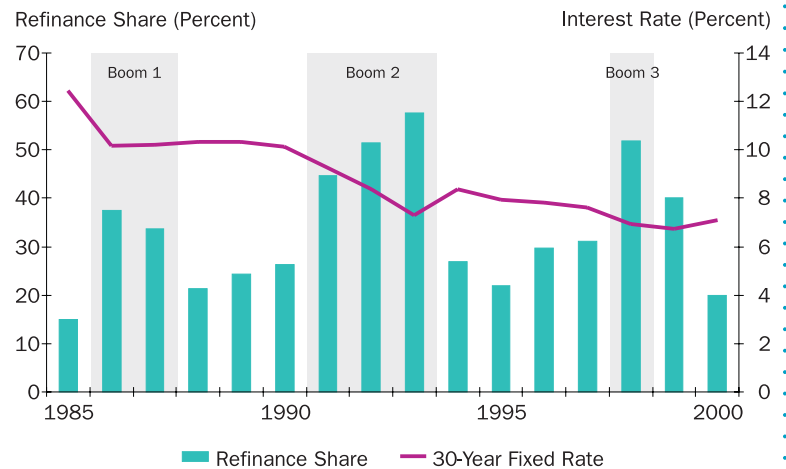
Michael Marschoun is an economist in Freddie Mac's financial research department.

rates represented only the third major downturn in long-term rates in U.S. mortgage-market history. In each instance, a sharp increase in mortgage refinancing followed (*Exhibit 1*). Further distinguishing last year's spasm of loan swapping is that 1998 was one of the few 12-month periods during which mortgage refinancings exceeded purchase-money mortgages. About 52 percent of all mortgages minted in 1998 served to retire existing mortgages (see "Refinancers Crave Cash on Top of Lower Monthly Payments," page 28). Refinancing activity should drop to 40 percent of this year's market and 20 percent in 2000, Freddie Mac forecasts.

Although the refinancing side of the business overshadowed purchase-money mortgages on a market-share basis, the furious pace of home sales last year led to a higher volume of homebuyer financing than in the previous year. By year-end 1998, the amount of mortgages written for the purpose of buying a single-family home had grown to an estimated \$700 billion, up from \$600 billion in 1997.

As a result of the phenomenal activity among refinancers and new borrowers in 1998, a remarkable one-third of the country's \$4.3 trillion outstanding mortgage debt—consisting largely of 15-year to 30-year term contracts—is now less than one year old.

EXHIBIT 1
Refinance Share vs. 30-Year Fixed Interest Rates



Note: Data cover conventional mortgages. 1998 figures are estimated; 1999 and 2000 figures are projected.
 Source: Freddie Mac

Refinances have surged every time long-term interest rates have dropped. The refinance share flared for the first time in 1986, when interest rates fell to 9 percent from a peak of 18 percent. In 1993, refinances approached 60 percent as interest rates fell below 7 percent. Refinancing spiked for the third time in 1998, when low inflation and falling budget deficits pushed interest rates to record lows.

Home Sales Flourish

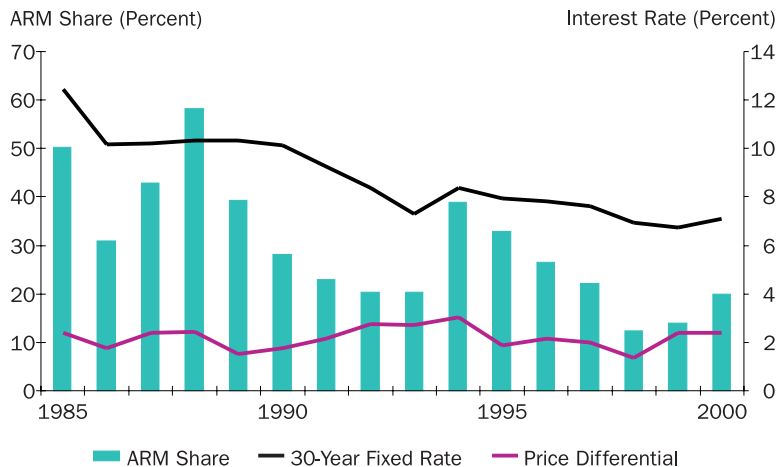
Along with mortgage lenders, builders and real estate agents also have done landmark business in recent months. Sales of new homes cleared 888,000 units in 1998, the highest annual volume ever. At the same time, existing home sales exceeded 4.8 million in 1998, achieving a third consecutive record year. Together, the 5.7-million volume of new and existing unit sales surpassed 1997's 5.0-million total by 13 percent. Including condominium units, total sales topped 6.3 million units. Freddie Mac anticipates that home sales will remain above 1997's volume during the next two years but decline

slightly—to 5.2 million in 1999 and 5.4 million in 2000.

Not surprisingly, the voracious demand for single-family homes has pushed house prices higher. Nationally, house prices rose 4.8 percent in 1998. In particular, house prices performed well when the stock market took a large hit in late summer. With hardly a misstep, house prices grew at an annualized rate of 5.8 percent from July through September. This year and next, however, house-price appreciation should ease slightly to 4.3 percent, Freddie Mac predicts.

Homeowners in the Pacific states currently are enjoying the highest rates of price

EXHIBIT 2 ARM Share and Price Differential vs. Interest Rates



Note: Price differential refers to the spread between 30-year, fixed-rate mortgages and one-year, adjustable-rate mortgages (ARMs). The interest rate and price series are charted against the right-hand axis to highlight the data's variability. Data cover conventional mortgages. 1998 figures are estimated; 1999 and 2000 figures are projected.

Sources: Federal Housing Finance Board, Freddie Mac

A smaller annual ARM share results from both lower prevailing interest rates and from expectations of lower future interest rates, a relationship that is reflected in the price differential—or spread—between fixed-rate and adjustable-rate loans.

appreciation, thanks to robust house-price growth in California and Washington. House-price growth in the Pacific region for 1998 hit 7.1 percent. New England home values, enjoying a similar run of prosperity, increased 6.2 percent for the year.

The sound and fury of 1998 likewise reverberated in the national homeownership rate. A new high of 66.8 percent was set in the third quarter of 1998, surpassing 1978's long-standing record by nearly a full percentage point. The improved market conditions allowed approximately 1.6 million families to become first-time homebuyers. Freddie Mac helped facilitate this growth

by supplying the financing that permitted one in eight of the new owners to purchase their first homes.

Borrowers Bypassing ARMs for Fixed Rates

Of the many borrowers seeking to secure a first mortgage or refinance an existing one, most are choosing fixed-rate products over adjustable-rate mortgages (ARMs).

As *Exhibit 2* demonstrates, the most recent decline in borrower preference for ARMs was quite faithful to historical experience. In 1998, as in previous years, the demand for ARMs was influenced by two key variables:

the prevailing level of interest rates on fixed-rate mortgages and the spread between the rates on fixed-rate and adjustable-rate mortgages.

Mortgage rates averaged 6.9 percent for 1998, a sharp drop from the 8.4-percent average five years earlier. Simultaneously, a flatter yield curve pulled ARM rates to within 1.4 percentage points of 30-year fixed rates compared to an average 2.3 percentage points in recent years. As a result, ARM demand, which stood at nearly 40 percent in 1994, collapsed to an estimated 12 percent in 1998.

Last year's lackluster 12-percent ARM volume set a record in its own right by becoming the loan product's worst showing since the federal government began tracking ARM origination data in 1981. Even borrowers who have selected ARMs recently are demonstrating a preference for those that act more like fixed-rate loans (see "ARM Borrowers Match Loans to Their Uncertainty Tolerances," page 26). New research shows that a tightening between adjustable and fixed interest rates—despite the mixed messages loan shoppers can read into a steeper yield curve—could help ARMs regain some future ground (see "Steepening Yield Curve Inspires More ARM Borrowers to Act Than Flee" page 22).

Steepening Yield Curve Inspires More ARM Borrowers to Act Than Flee

A steepening in the market's interest-rate **yield curve** sends a mixed message to mortgage shoppers trying to decide between an adjustable-rate mortgage (ARM) or a fixed-rate mortgage.

On the one hand, a steeper Treasury yield curve might signal green to nail down an ARM, presumably because the cost of a fixed-rate mortgage is now more expensive relative to an ARM. On the other hand, the same yield curve could trip a red light to avoid ARMs. After all, the floating interest rate on a newly obtained ARM is now more than likely headed upward, along with that borrower's future mortgage payments.

A statistical model developed by Freddie Mac sorts out the opposing impacts on the market share of adjustable-rate mortgages (ARMs) created whenever the difference between long-term and short-term interest rates increases.

Mortgage shoppers who value the price advantage of ARMs are more likely to read a "buy now" message into the steeper gradient of a yield curve. That's because the interest-rate differential between fixed-rate mortgages and ARMs is related to the degree by which the yield curve slopes: the steeper the yield curve, the cheaper ARMs tend to become relative to fixed-rate loans.

Then again, a Treasury yield curve that changes to a steeper slope reflects expectations that short-term interest rates—including ARM rates—will rise in the future. A sophisticated borrower choosing between a

fixed-rate mortgage and an ARM, then, will take into account that the current interest-rate differential between the two credit instruments likely will narrow in the future. Thus, the steepening of the yield curve sends a less appealing "rising index" warning to a borrower considering an ARM, who then would expect to pay more on the same loan in the future.

Freddie Mac's model shows that the effect of the "buy now" signal is approximately three times stronger than the "rising index" warning. Suppose ARMs hold a 20-percent market share, short-term interest rates fall by 1 percentage point, long-term interest rates remain unchanged and the interest-rate spread between fixed-rate mortgages and ARMs increases by the same amount. The model predicts that the ARM share will drop by 3 percent, as the prospect of rising interest rates induces some ARM holders and new borrowers to opt for the predictability of fixed-rate loans. Concurrently, though, the product's attractive pricing will increase its market share by 8 percent, resulting in a net ARM-share gain of 5 percent.

The Freddie Mac model also can be used to forecast future ARM shares. Because interest rates are expected to remain low and the yield curve is expected to remain fairly flat, the model predicts that the ARM share of **conventional** originations—which slipped to a historically low 12 percent in 1998—should remain below 15 percent through 1999.—**Silvia Garcia, research assistant and Frank Nothaft, deputy chief economist**

Apartment Business Going Gangbusters; Future Less Certain

The rental-housing industry enjoyed an auspicious year in 1998, with indications that the annual rate of multifamily lending reached a decade high. Continued prosperity within the apartment business is certainly plausible, but—unlike the single-

family homeownership sector—its future is clouded by more uncertainties.

One sign of the industry's health is found in the rapid expansion of total multifamily debt outstanding in 1998. Although no reliable multifamily loan-origination data are kept for the industry—in contrast to

data-collection practices followed on the single-family side—the 8-percent increase in debt suggests heavy trafficking in purchase-loan originations. Moreover, when total multifamily debt hit \$332 billion at the end of third quarter 1998, the \$24.5-billion jump marked the largest annual hike in 10 years, dwarfing

1997's 5-percent debt increase of \$14 billion.

Likewise, the number of newly constructed rental units ballooned by 17 percent last year, an event that undoubtedly helped drive much of 1998's rental loan activity. The Department of Housing and Urban Development reported that builders erected multifamily units at an annual rate of 280,000 in the first nine months of last year.

Rising property prices in recent years have helped fuel the building frenzy. The National Real Estate Index recorded a 7.4-percent annual expansion in apartment building values in third quarter 1998. Although last year's rental property performance trails the 9.0-percent and 10.8-percent gains of the previous two years, it easily bests the 4.5-percent appreciation achieved for single-family homes in 1998.

The influx of new rental stock may cause problems, however, if the supply should overwhelm renter demand. One sign that apartment supply is not overbuilt stems from the willingness of the market to absorb rent increases of 3.4 percent in 1998 and 3.1 percent in 1997, while overall consumer prices went up only 1.6 percent and 1.7 percent, respectively. Given that rents increased at a slower pace than the general price level earlier in the 1990s, this would suggest that demand currently is growing even faster than supply.

Forgotten in all the handwringing over the stock-market volatility and foreign economic crises is the simple fact that this country's real economy is doing quite well.

Then again, rising vacancy rates point to marketplace imbalances in the making. The vacancy rate for apartments with five or more units crept up to 9.4 percent in 1998 from 9.1 percent the previous year, according to the Census Bureau. That development could point to a weakening in renter demand in the face of an abundant apartment supply.

A final unknown is whether the country's rising homeownership rate, which, by necessity, depletes some of the renter household ranks, will lead to any ill effects for the multifamily sector. At the same time that the number of

homeowners was growing by 1.6 million families in 1998, the total number of occupied rental units was decreasing by 500,000 units. Undoubtedly, the decrease would have been much larger if not for a large number of new household formations sparked by the strong economy and inflows of immigrants, who tend to live in rental units. Possibly, these two factors could prove strong enough to expand the rental market, thereby mitigating renter losses to homeownership.

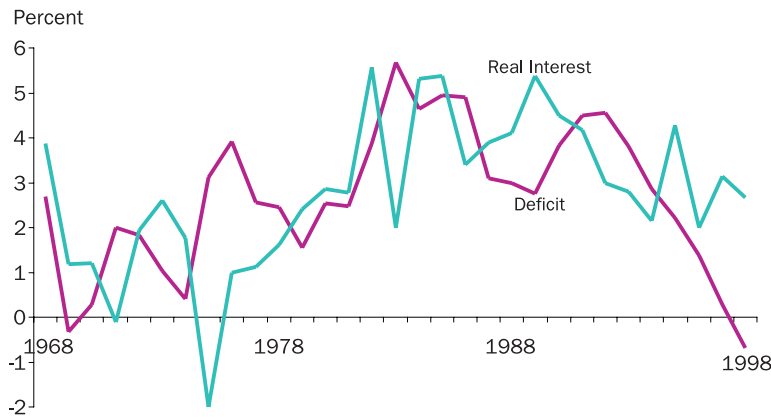
In Light of the Boom, Why the Gloom?

How do the rosy mortgage-performance numbers square with gloomy newspaper headlines chronicling a troubled U.S. stock market, fluctuating consumer confidence and the persistent economic crisis in Southeast Asia?

Suffice it to say that the media's reports of recession at this point are greatly exaggerated. Forgotten in all the handwringing over stock-market volatility and foreign economic crises is the simple fact that this country's real economy is doing quite well. Far from sputtering, the economy is as strong now as it has been in recent years. Economic growth and productivity are high nationally, while unemployment is low throughout the country.

At the same time, the nation's housing markets have benefited from the stabilizing influence of

EXHIBIT 3 Federal Budget Deficit vs. Long-Term Real Interest Rates



Note: Real interest rates are measured as long-term market rates minus expected inflation. Federal budget deficit is measured relative to U.S. gross domestic product (GDP).

Sources: Federal Reserve Board of St. Louis, Freddie Mac

When annual federal budget deficits exceeded 4 percent of gross domestic product (GDP) in the early 1980s, real interest rates hit uncharacteristically high levels of more than 5 percent. The recent federal budget surplus has reduced the demand for funds. As a consequence, the price of funds—the real interest rate—has fallen to around 3 percent.

the secondary mortgage market. While other credit-granting sectors of the economy teetered to a halt early in the fall of 1998, the residential mortgage market continued to do record-breaking business without missing a beat.

The chances are slim over this next year that the country's economic fundamentals will deteriorate much at all, let alone provoke a decline in the housing market. Current conditions favor a continuation of low long-term interest rates and positive growth in the economy overall, both of which are critical to the performance of the housing market. For starters, the country's newly recovered ability to manage its budget deficit has

freed up cash that can help satisfy the demand for funds by real estate and other economic sectors without exerting upward pressure on real interest rates. This, along with low inflation, is an important factor in keeping long-term rates low.

Interest rates in 1998 averaged 6.9 percent. For 1999, Freddie Mac foresees a slight decline in the average 30-year, fixed interest rate to 6.7 percent. For 2000, the company forecasts an increase to 7.1 percent.

Real interest rates largely are determined by the supply of and the demand for long-term debt, namely 10-year Treasury securities and other long-term bonds. The rates tend to wax and

wane with the budget deficit (Exhibit 3). As the deficit declines, the government supply of long-term securities withers.

With the 1998 federal budget surplus, then, the supply of government Treasuries evaporated. That forced investors to seek out other sources of long-term, fixed-income securities, including Reference NotesSM issued by Freddie Mac and similar debt instruments issued by Fannie Mae and Ginnie Mae. As a result, the price paid for these securities rose, while yields and interest rates fell accordingly.

Actions on the part of the Federal Reserve Board have kept inflation—and, thus, long-term interest rates—in check. The consistent anti-inflationary monetary policy first implemented by the Fed to curb runaway inflation in the late 1970s has, over the years, brought down not only inflation but also expectations of inflation. Not since 1968 has the inflation rate slowed to a subdued 2 percent.

The mortgage market, though, does not respond so much to the Fed's power to alter short-term interest rates as it does to the Fed's ability to control inflation and expectations of inflation. The Fed may throw around the weight of an 800-pound gorilla when it comes to the prices of short-term securities that shape short-term interest rates, but it performs more like a barking sentry dog when it comes to the cost of long-term securities to

which mortgage rates are tied. The Fed brings pressure to bear on long-term interest rates mostly indirectly by changing inflation expectations or by influencing economic output and growth. If, for instance, the Federal Reserve Board, in an attempt to stimulate the economy, were to cut short-term interest rates too much, then inflation would accelerate. This, in turn, would cause long-term interest rates to rise.

Like long-term interest rates, economic growth is expected to remain steady, albeit at a somewhat lower level than in recent months. Economic activity in 1998 was brisk, as fourth-quarter **gross domestic product** (GDP) grew at an astounding 5.6 percent annual rate. Freddie Mac predicts that this marker of economic output will trail off a bit in 1999 and again in 2000. However, the company expects GDP to exert enough force to continue the current economic expansion. That would result in the longest uninterrupted period of economic growth in the country's history.

The odds, then, of the economy plunging into a recession—often defined as two consecutive quarters of negative growth in real GDP—remain low. This contention is borne out by looking at the **leading economic indicators**, a family of measures that brings together market-mood and real-economy information. Downward

Like long-term interest rates, economic growth is expected to remain steady, albeit at a somewhat lower level than in recent months.

movements of these indicators are better harbingers of future recessions than any individual measure, such as the state of the stock market or the shape of the yield curve. The most recently available leading economic indicators bring reassuring news. After falling in May and June of 1998, the leading indicators remained steady through October and then increased in November and December, the most recent months for which data are available. The current behavior of these leading indicators is widely interpreted as a forecast of continued economic expansion and little likelihood of recession, at least through 1999.

Greenspan's Midas Touch

The U.S. economy is not, of course, immune to future downturns. Intensifying banking problems in Japan or a bear market on Wall Street could curtail consumer demand enough to tip the economy into recession. A large-scale failure somewhere in the world to cope with Year 2000 technology glitches also could pose a threat to U.S. prosperity.

In the final analysis, however, whether the U.S. economy's current record expansion will end depends not on doomsday headlines or public sentiment but on whether the Federal Reserve Board has struck the right monetary policy over the past six months. If the Fed got the magnitude of its interest-rate cuts right—powerful enough to prevent an economic slowdown but not so strong as to trigger inflation—then the current high growth rates and low unemployment rates should accompany the country into the next century.

Proof of whether the recent Fed moves achieved this goal is still a few months in the offing. Yet, reason makes a strong case to expect good results. The evidence so far suggests that Alan Greenspan is favored with a Midas touch. SMM