

A Question of Supply

Last month's data calendar contained a mixed bag of news on the housing market and the economy overall. There were signs of a recovery in housing demand, as sales of existing single-family homes rose 4 percent in February and sales of existing condos and co-ops increased 5 percent. Offsetting this, though, new home sales dropped 4 percent. Consumer confidence took a hit as well, falling half of a percentage point from the 5-year high posted in March, as higher gasoline prices and subprime-driven volatility in the financial markets fanned fears about the economic outlook. More recently, the robust 180,000 rise in nonfarm payrolls in March, on the heels of a solid gain in personal income and consumer spending in February, bolstered the view that the overall economy is stabilizing and poised to return to near-trend growth later this year.

The housing market was largely responsible for pulling the economy through the recession in 2001 and back to a vigorous pace of growth. It remains to be seen whether the macro economy will return the favor, with overall GDP growth helping housing out of its downturn. The next month or so will be a critical period, as spring home sales provide a key test of housing demand.

Spring is a popular time to shop for homes. Better weather makes house hunting more pleasant, and a purchase in April or May allows families to settle in before school starts in the fall. With rates on 30-year fixed-rate mortgages steady at just above 6 percent and job growth more solidly on track, conditions are ripe for a firming in housing demand. Of course, this is only half of the equation, and housing supply presents several challenges to the recovery.

The burgeoning inventories of new homes cloud the supply picture. Inventories as reported in the Census Department statistics remain high relative to the sales pace, with months' supply in February jumping to a 16-year high of 8.1 months. The official statistics, though, do not reflect the impact of the cancellation of new home contracts, which last year rose as high as 30 percent at several major builders. These cancellations imply that actual new home sales last fall were far lower than reported, while inventories were higher. This distortion has likely begun to reverse in recent months, however, as cancellations have slowed and builders are selling homes whose contracts had been cancelled previously. With these sales neither added to reported new home sales nor deducted from inventories, the official statistics may understate any recent improvements in new home sales and months' supply. In fact, a simple exercise to calibrate the impact of the re-sale of homes with previously cancelled contracts suggests such sales may account for most of the recent reported downturn in sales, which bodes well for a gradual recovery in coming months.

It is far too early, though, to declare that housing is out of the woods. The turmoil in the subprime mortgage market may curtail housing demand, as some potential buyers find they no longer qualify for financing. With subprime loans providing a significant share of home purchase money last year, this effect could be significant, though its impact is likely to be strongest in those neighborhoods with high concentrations of subprime borrowers; the potential effects on demand more generally remain to be seen. Rising foreclosures may also dump new supply onto already-depressed local markets, intensifying the downward price pressures in these areas. Furthermore, the jump in homeowner vacancies last year suggests a "hidden supply" that may come on the market during the spring sales season. Indeed, ZipRealty Inc. reported a 6.5 percent rise in homes listed for sale in 18 major metropolitan areas in March, well above the normal seasonal increase. Even if the expected upturn in housing demand does materialize, these sources of excess supply will continue to weigh on price appreciation nationally and may lead to continued price declines in the hardest-hit local markets.

Details

- *Real GDP growth.* GDP growth in the fourth quarter of 2006 was revised upward to a 2.5% annual rate, bolstering our view that economic growth is firming. Our forecast calls for growth to average 3.0% this year, and for trend-like growth of 3.5% in 2008 and beyond. With interest rates low and consistent job growth, consumer spending will likely continue to be solid.
- *Consumer price inflation.* Headline CPI inflation has picked up due to higher gasoline prices, as several major refineries were closed for maintenance; the impact of energy prices should unwind in coming months. Core inflation is expected to edge down due to below-trend economic growth. We see headline inflation, as measured by the consumer price index, averaging out to 2.5% through 2007 and onwards.
- *Unemployment rate.* March's strong 180,000 increase in nonfarm payrolls reflected a rebound from the weather-induced decline in construction employment in February, as well as solid job gains in most areas outside of manufacturing. With the economy growing below its potential, we expect the unemployment rate will creep up to 4.7% by the end of 2007.
- *Mortgage rates.* We've shaved 10 basis points of our forecast for interest rates on 30-year fixed rate mortgages, averaging 6.2% in 2007 and 6.4% in 2008. Rates have been stable as inflation remains contained and there is ample liquidity at the long end of the yield curve. Interest rates on 1-year adjustable-rate mortgages (ARMs) will likely stay where they are currently.
- *ARM Share.* With interest rates on fixed-rate mortgages still low and house prices still at high levels, we decreased our forecast for the ARM share of mortgage applications. The ARM share is projected at 11% in 2007 and 13% in 2008, below its historical average since 1985 of 29%.
- *Housing starts.* Builders reacted quickly to the weakening in housing demand, and single-family housing starts have fallen more than 30% from a year earlier. As the reduction in new supply helps work off excess inventories of unsold homes, we anticipate housing starts to show gradual improvement, averaging 1.56 million units in 2007 and 1.70 million in 2008.
- *Home sales.* Homes sales appear to have stemmed their decline and are expected to turn up later this year, as continuing growth of jobs and incomes and low interest rates support demand. Total home sales are projected to average 6.44 million units in 2007 and rise to 6.49 million in 2008.
- *Home value appreciation.* With softer demand and excess inventories of unsold homes weighing on the housing market, prices are expected to post their smallest gain in several years. We see home prices, as measured by the conventional mortgage house price index, increasing in line with general consumer prices, averaging 2.5% in 2007 and then picking up to 3.2% in 2008.
- *Mortgage activity.* Refinancing activity will likely remain strong this year and next, as many mortgages enter their initial rate-adjustments. However, with families locking into low fixed-rate mortgages, refinancing is expected to slow in future years. We expect \$2.8 trillion in mortgage originations for 2007 and \$2.7 trillion in 2008 (as house price appreciation slows). This will boost the amount of residential mortgage debt outstanding by about \$1.5 trillion come the end of 2008.
- *Comment.* Many careful readers noted last month's revision to mortgage originations in 2006. These changes resulted from benchmarking based on year-end totals as reported by lenders.

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Office of the Chief Economist

Economic and Housing Market Outlook

April 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	2.4	2.8	3.2	3.4	3.5	3.5	3.5	3.5	3.7	3.4	3.1	3.1	3.0	3.5	3.5
Consumer Prices (%) a.	1.9	5.0	3.2	-2.1	3.7	1.5	2.3	2.5	2.5	2.5	2.5	2.5	1.9	3.4	3.7	1.9	2.5	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	6.2	6.2	6.3	6.3	6.4	6.4	6.5	5.8	5.8	5.9	6.4	6.2	6.4	6.6
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	4.6	4.7	4.7	4.8	4.8	4.9	4.9	4.0	4.3	4.3	4.8	4.7	4.8	5.0
1-Year Const. Mat. Treas. Rate (%) b.	4.6	5.0	5.1	5.0	5.0	4.8	4.8	4.9	4.9	4.9	4.9	4.9	1.2	1.9	3.6	4.9	4.9	4.9	5.0

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.	2.12	1.87	1.71	1.56	1.50	1.55	1.60	1.60	1.68	1.69	1.71	1.72	1.85	1.96	2.07	1.80	1.56	1.70	1.72
Total Home Sales d.	7.13	6.90	6.51	6.50	6.55	6.40	6.40	6.40	6.45	6.50	6.50	6.50	6.53	7.16	7.46	6.73	6.44	6.49	6.63
House Price Appreciation (%) e.	9.7	5.4	4.4	4.9	2.7	2.7	2.3	2.3	2.4	3.6	4.1	2.7	7.8	11.9	13.4	6.1	2.5	3.2	4.0
1-4 Family Mortgage Originations f.																			
Conventional	\$687	\$802	\$746	\$685	\$642	\$746	\$763	\$598	\$615	\$674	\$671	\$604	\$3,631	\$2,776	\$3,167	\$2,920	\$2,749	\$2,565	\$2,423
FHA & VA	\$19	\$20	\$22	\$19	\$16	\$21	\$24	\$19	\$26	\$28	\$28	\$25	\$220	\$130	\$90	\$80	\$80	\$107	\$128
Total	\$706	\$822	\$768	\$704	\$659	\$767	\$787	\$617	\$641	\$702	\$699	\$629	\$3,851	\$2,906	\$3,257	\$3,000	\$2,829	\$2,672	\$2,550
ARM Share (%) g.	28	25	19	14	11	11	11	12	12	13	14	14	19	34	31	21	11	13	15
Refinancing Share - Applications (%) h.	44	42	41	46	46	42	36	35	33	31	29	27	65	46	44	43	40	30	20
Refinancing Share - Originations (%) h.	50	48	47	52	52	49	43	42	41	40	38	34	70	52	50	49	46	38	28
Residential Mortgage Debt (%) i.	10.1	10.2	8.1	6.8	5.5	7.6	8.5	6.0	5.3	8.7	9.1	6.5	12.7	14.5	13.6	8.8	6.9	7.4	7.2

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).

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