

“In Like a Lion...”

News about the housing market has been like the proverbial March weather, with each warm breeze followed by an icy blast. Most analysts expect a more hospitable environment later this year, with the level of buyer traffic as the spring selling season gets underway an important test for the market. Even the most cheery forecasters, though, warn of two possible storms still on the horizon: the burgeoning overstock of unsold homes, and the shakeout in the subprime mortgage market.

The plunge in home sales since the market peak in mid-2005 left builders and investors with an excess of vacant units. Official government figures report that unsold new homes peaked in July 2006 and have since declined modestly, but actual inventory levels are likely far higher due to cancelled sales contracts, which are not accounted for in sales and inventory numbers. While this statistical distortion may be reversing as these homes are resold, the excess stock of new homes remains substantial. Vacant existing homes for sale represent another source of “hidden inventories”, and rose to record levels as the market softened last year. The impact of homeowner vacancies varies considerably across types of units and geographic regions. Most affected are condos, with vacancy rates in structures with 10 or more units topping 11 percent. Metro areas with greater concentrations of speculative building during the boom are most likely to be saddled with unsold units.

Home prices have sagged under the weight of the oversupply, especially in the markets that were hottest during the boom. For example, the S&P/Case-Shiller® data show prices in Boston down 4.5 percent in the fourth quarter versus a year earlier, and San Diego down 3.3 percent. Not all markets have been hit to the same degree, however, and prices in Miami rose 7.3 percent over the same period. Over a broader regional scale, Freddie Mac’s Conventional Mortgage Home Price Index shows seven states with quarterly price declines in the fourth quarter of last year, including California and Nevada, but still posts a modest 4.9 percent increase nationally. While the optimistic scenario is that still-low mortgage rates and continuing job growth will enable the market to work off these inventories gradually, the process will be slow and prices remain vulnerable to shocks in the meantime.

The deteriorating performance of recent vintages of subprime loans has prompted a reassessment of the risks of such loans. Early payment defaults on subprime loans through mid-2006 have risen to more than triple the rate of early 2005, and some lenders specializing in subprime have closed up shop. Conditions have worsened even outside the subprime arena. Delinquency rates on all mortgages at commercial banks rose in the fourth quarter to 1.91 percent, the highest level in nearly four years, albeit still below the average in the latter half of the 1990s. Bank regulators have stepped up calls for stricter lending standards; not surprisingly, the Fed’s Senior Loan Officer Survey reported last month that 15 percent of banks were tightening standards on mortgage loans, the highest proportion since during the recession of the early 1990s.

Despite the pullback by subprime lenders, there are no signs of a general drying up of liquidity that could develop into a broader “credit crunch” in the prime mortgage market. Mortgage rates moved back down in recent weeks, with the rate on 30-year, fixed-rate mortgages touching 6.18 percent in early March, equaling the lowest rate of the year. GSEs continue to provide liquidity in the prime mortgage market. With ample liquidity available, prime borrowers continue to have access to credit on reasonable terms. While the troubles in subprime may well worsen before they get better, the prime market is OK.

Details

- *Real GDP growth.* Fourth quarter real GDP growth was revised down to a 2.2% annual rate in the preliminary report released on February 28th, due to considerably weaker investment in inventories than initially assumed. As excess inventories (largely in autos and building supplies) are worked off and the drag from residential investment begins to wane, we expect growth to accelerate in the first half of 2007 to 2.6% and average 3% for the year.
- *Consumer price inflation.* Falling energy prices pulled Consumer Price inflation negative in the fourth quarter (a -2.1% annualized rate) but ticked up again by 0.2% (seasonally adjusted) in January as oil prices moved back up a bit. We expect inflation to remain level in 2007 at 2.5%.
- *Unemployment rate.* In 2006, 2.2 million non-farm payroll jobs were added in the U.S., at roughly 180,000 per month. Over 1997-1999, the U.S. averaged a gain of over 260,000 jobs per month, yet the unemployment rate was roughly the same then as it is now; this discrepancy implies that many discouraged workers have left the workforce. With the slowdown in the housing sector, especially new home construction, and an anticipated below trend growth rate in GDP in the first half of the year we expect the unemployment rate to rise gradually over the year, averaging 4.8 percent in 2007.
- *Mortgage rates.* Long-term bond yields have recently come down, and we have lowered our forecast for 30-year fixed mortgage rates in two quarters of 2007 relative to last month's outlook. With flat inflation expectations and assurances from the Fed that it is remaining vigilant against price pressures, long-term bond yields and fixed mortgage rates should not change significantly over the year.
- *ARM Share.* Low fixed mortgage rates and the considerable negative press that nontraditional adjustable-rate mortgage products have received lately should lower demand for adjustable-rate mortgage products overall. Based on the series published by the Federal Housing Finance Board, we expect the ARM share to fall around 13% in 2007, unchanged from last month's forecast.
- *Housing starts.* Homebuilders reacted strongly to softening market, a sign that the housing market is more efficient today than in previous housing market slumps. Last year, housing starts declined 13% relative to 2005, and by the fourth quarter were down to a 1.56 million unit annual rate. We believe we are at the bottom now and that home construction should gradually increase over the year.
- *Home sales.* Home sales were down more than 9% in 2006 relative to 2005 and we expect them to fall another 5% in 2007 (a smaller decrease than we predicted last month). Seller incentives are increasing and mortgage rates have come back down to below 6.25% for 30-year fixed rate mortgages, so we expect sales too to bottom out in the first half of the year.
- *Home value appreciation.* Home prices remain the most difficult of housing-related statistics to forecast due to the nonhomogeneity of homes and the inclusion of unrelated benefits in sales contract prices such as seller-paid closing costs. Based on the Conventional Mortgage Home Price Index, we expect home values to increase in 2007, albeit at just 2.8%, down from the 6.1% rate we saw in 2006 and less than we forecasted in our February Outlook.
- *Mortgage activity.* With fewer home sales, slower home price appreciation, and a smaller refinance share (down to 40% of mortgage applications from 43% in 2006), we anticipate mortgage originations to be about 5% lower this year. Residential mortgage debt outstanding should grow by less than 8%, the slowest rate of increase in a decade.

Frank Nothaft
Chief Economist
March 8, 2007

Amy Crews Cutts
Deputy Chief Economist

Calvin Schnure
Economic Analysis Director

Nela Richardson
Senior Economist

www.freddiemac.com/news/finance

chief_economist@freddiemac.com

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Office of the Chief Economist

Economic and Housing Market Outlook

March 2007

Revised 3/8/2007

Major Economic Indicators																				
Indicator	2005		2006				2007				2008		Annual Totals							
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2002	2003	2004	2005	2006	2007	2008	
Real GDP (%)	4.2	1.8	5.6	2.6	2.0	2.2	2.4	2.8	3.2	3.4	3.5	3.5	1.9	3.7	3.4	3.1	3.1	3.0	3.5	
Consumer Prices (%) a.	5.6	3.4	1.9	5.0	3.2	-2.1	2.5	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.7	1.9	2.5	2.5	
Unemployment Rate (%) b.	5.0	4.9	4.7	4.6	4.7	4.5	4.6	4.8	4.9	5.0	5.0	5.0	5.8	6.0	5.5	5.1	4.6	4.8	5.0	
30-Year Fixed Mtg. Rate (%) b.	5.8	6.2	6.3	6.6	6.6	6.2	6.2	6.3	6.3	6.4	6.4	6.5	6.5	5.8	5.8	5.9	6.4	6.3	6.5	
1-Year Treas. Indexed ARM Rate (%) b.	4.5	5.1	5.3	5.7	5.7	5.5	5.5	5.5	5.5	5.5	5.5	5.5	4.6	3.8	3.9	4.5	5.5	5.5	5.5	
10-Year Const. Mat. Treas. Rate (%) b.	4.2	4.5	4.6	5.1	4.9	4.6	4.7	4.7	4.7	4.8	4.8	4.9	4.6	4.0	4.3	4.3	4.8	4.7	4.9	
1-Year Const. Mat. Treas. Rate (%) b.	3.8	4.3	4.6	5.0	5.1	5.0	5.0	5.0	5.0	5.0	5.0	5.0	2.0	1.2	1.9	3.6	4.9	5.0	5.0	

Housing and Mortgage Markets																				
Indicator	2005		2006				2007				2008		Annual Totals							
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2002	2003	2004	2005	2006	2007	2008	
Housing Starts c.	2.10	2.06	2.12	1.87	1.71	1.56	1.50	1.55	1.60	1.60	1.68	1.69	1.70	1.85	1.96	2.07	1.80	1.56	1.70	
Total Home Sales d.	7.56	7.34	7.13	6.90	6.51	6.54	6.45	6.40	6.40	6.45	6.45	6.50	5.95	6.53	7.16	7.46	6.74	6.43	6.53	
House Price Appreciation (%) e.	14.2	12.9	9.7	5.4	4.4	4.9	3.2	3.4	2.9	1.8	1.4	2.6	7.2	7.8	11.9	13.4	6.1	2.8	3.2	
1-4 Family Mortgage Originations f.																				
Conventional	\$920	\$782	\$687	\$802	\$746	\$685	\$707	\$705	\$680	\$679	\$610	\$673	\$2,697	\$3,631	\$2,776	\$3,167	\$2,920	\$2,771	\$2,456	
FHA & VA	\$22	\$19	\$19	\$20	\$22	\$19	\$18	\$20	\$21	\$22	\$25	\$28	\$176	\$220	\$130	\$90	\$80	\$80	\$129	
Total	\$942	\$801	\$706	\$822	\$768	\$704	\$725	\$725	\$701	\$701	\$635	\$701	\$2,873	\$3,851	\$2,906	\$3,257	\$3,000	\$2,851	\$2,585	
ARM Share (%) g.	28	29	28	25	19	14	13	13	14	14	15	15	17	19	34	31	21	13	15	
Refinancing Share - Applications (%) h.	44	45	44	42	41	46	45	40	38	37	35	28	59	65	46	44	43	40	29	
Refinancing Share - Originations (%) h.	50	51	50	48	47	52	51	46	45	44	42	36	66	70	52	50	49	46	37	
Residential Mortgage Debt (%) i.	16.2	13.4	10.2	10.2	8.1	6.4	6.6	7.9	8.9	6.0	4.6	7.5	12.7	12.7	14.5	13.6	8.7	7.4	6.4	

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 3/08/2007); Send comments and questions to chief_economist@freddiemac.com.

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