

Refinancings: Down But Not (Cashed) Out

The housing market impacts the macro economy through many channels, most directly through construction jobs and homebuilding activity, and spending on furniture and appliances by families moving into new or existing homes. No channel has been more important of late—or more controversial—than housing wealth. According to many prominent economists, including former Fed chairman Alan Greenspan, the extraction of home equity wealth in recent years has propped up consumer spending. A sudden swoon in housing prices, they warn, could shut off this spigot, prompting a sharp cutback in spending and elevating recession risks.

Growth of house prices has indisputably stalled, and even reversed in some parts of the country. According to Freddie Mac's Conventional Mortgage Home Price Index, price appreciation on a year-ago change basis slowed from rates exceeding 13 percent in 2005, to 6 percent by the fourth quarter of 2006. More recent monthly data through February from the S&P/Case-Shiller® Index show prices flat or falling in many major cities. Such weakness has fueled fears that an abrupt halt to growth of housing wealth may limit households' ability to withdraw home equity. Such a decline in cash-out refinancings could, in turn, undermine consumer spending.

Freddie Mac's reports on mortgage applications and cash-out refinancings provide important and perhaps surprising news. The refi share of mortgage applications averaged 46 percent in the first quarter of 2007, unchanged from the prior period, according to the Primary Mortgage Market Survey®. Moreover, as shown in Freddie Mac's Cash-Out Refinance Report, homeowners continued to extract home equity in the first quarter at close to the pace of late last year, despite diminished price appreciation. In particular, 82 percent of loans refinanced during the first quarter resulted in a new loan balance at least 5 percent greater than the unpaid balance of the original loan, with an estimated \$70.5 billion cashed out, only slightly below the \$77.0 billion cashed out in the fourth quarter of 2006.

There are several reasons why cash-outs have defied reports of their demise. Most importantly, the current rate of housing price appreciation is not what determines if a cash-out is feasible, but rather the cumulative gain since the existing loan was originated. The median age of Freddie Mac-owned loans that were refinanced last quarter was 3.3 years, and thus homeowners have benefited from robust price gains during 2004 and 2005. As a result, the median appreciation on refinanced properties was 24 percent, providing ample margin for taking out cash without running down home equity. The low level of long-term interest rates provides another incentive for cash-out refinancings. Rates on 30-year fixed-rate mortgages averaged 6.2 percent in the first quarter, allowing many homeowners to use the proceeds to pay off higher-cost credit card debts or home equity lines. With mortgage rates stable in our economic forecast, we anticipate that refinancing activity will wane only gradually.

There are still legitimate concerns that a high level of cash-outs may deplete homeowners' equity in their properties. Federal Reserve data show, however, that homeowners' equity had grown to nearly \$11 trillion at the end of 2006, an increase of 30 percent over the past three years, even after cash-out activity. Concerns that owners are using their homes "like an ATM" and the consumer sector may soon find the account overdrawn are belied by such strong trends in homeowner wealth.

The housing market recovery still faces significant risks, to be sure, in particular the danger that problems in the subprime space spill over to mortgage markets in general, inflicting damage on the macro economy. Nevertheless, the refinancing data underscore that prime mortgage markets—supported by Freddie Mac's backstop liquidity in the secondary market—functioned well through what was the most challenging quarter in many years. Continued smooth performance of the mortgage markets will be a critical factor supporting the housing recovery in the months ahead.

Details

- *Real GDP growth.* The US economy grew at an annualized rate of 1.3% in the first quarter of the year, the slowest pace in four years, due to the slowdown in housing and a bigger trade deficit. As home construction begins to level out later this year, economic growth is predicted to accelerate a bit, to around 3% in the third and fourth quarters. The after shocks of the housing slowdown will still be felt in 2008, but will likely be milder than previously experienced allowing GDP to grow at a steady 3%.
- *Consumer price inflation.* A 16% jump (annual rate) in energy prices pushed consumer price inflation to a 3.8% rate in the first quarter, as temporary interruptions at refineries caused a spike in gasoline prices. Productivity growth in the non-farm business sector posted a stronger-than-expected gain of 1.7% (annual rate) in the first quarter and unit labor costs rose just 0.6%, muting somewhat concerns that labor costs may drive inflation higher.
- *Unemployment rate.* The unemployment rate edged up one-tenth to 4.5% in April. With the economy expanding at a sub-par pace, a modest 88,000 jobs were created in April, the smallest monthly increase in more than two years. Hiring was weak across most sectors, and both construction and manufacturing employment declined. We forecast the unemployment rate to rise slowly but remain below 5% for 2007 and 2008.
- *Mortgage rates.* The bright spot in the current mortgage market is the still-low level of the 30-year fixed rate mortgage. The 30-year fixed rate is expected to average between 6.2 % and 6.3% this year and then edge up to 6.5% next year. We also predict that the one-year adjustable rate mortgage will hold steady at 5.5% over the next several quarters. The yield curve inversion between the 10-year and the 1-year Constant Maturity Treasury rate is expected to continue for the remainder of the year.
- *ARM Share.* There has been a steep decline in the share of new mortgage applications that are adjustable rate mortgages (ARMs), from 28% a year ago to 11% in the first quarter. We expect the ARM share to remain low over the next two years as the inverted yield curve enhances the attractiveness of fixed-rate mortgages.
- *Housing starts.* The supply overhang of new homes will continue to weigh on housing starts throughout 2007. We expect a modest pick-up in new home construction beginning in the second half of this year, followed by a 7% increase in starts in 2008.
- *Home sales.* Our outlook shows home sales reaching a trough in the second quarter at an annualized pace of 6.4 million unit. We expect this pace to inch up in 2008 to 6.5 million units.
- *Home value appreciation.* House prices are likely to average growth in the low single digits this year. Prices could come under greater downward pressures, however, should there be a surge in homes for sale in the coming months.
- *Mortgage activity.* Refinance activity is still strong at over 40% of the total number of applications. In addition to cash-out activity, there is a sizeable number of mortgages scheduled to reset this year and next, which will likely sustain refinance activity. Our forecast is for the refinance share to drop 35% in the latter half of the year and average 26% in 2008. Mortgage debt growth will likely slow to 6.1% for the year, from rates in the low-teens in 2005 and 2006, and 8.8% last year.

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Office of the Chief Economist

Economic and Housing Market Outlook

May 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	1.3	2.6	2.9	3.2	3.0	3.0	3.0	3.0	3.7	3.4	3.1	3.1	2.5	3.0	3.5
Consumer Prices (%) a.	1.9	5.0	3.2	-2.1	3.8	3.5	2.5	2.5	2.5	2.5	2.5	2.5	1.9	3.4	3.7	1.9	3.1	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	4.7	4.7	4.8	4.8	4.9	4.9	5.0	4.0	4.3	4.3	4.8	4.7	4.9	5.1
1-Year Const. Mat. Treas. Rate (%) b.	4.6	5.0	5.1	5.0	5.0	4.9	4.9	4.9	4.9	5.0	5.0	5.0	1.2	1.9	3.6	4.9	4.9	5.0	5.1

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	1.47	1.45	1.49	1.53	1.55	1.58	1.62	1.65	1.85	1.96	2.07	1.80	1.49	1.60	1.70
Total Home Sales d.	7.13	6.90	6.51	6.50	6.47	6.35	6.37	6.40	6.45	6.50	6.50	6.50	6.53	7.16	7.46	6.73	6.40	6.49	6.63
House Price Appreciation (%) e.	9.7	5.4	4.4	4.9	1.7	1.6	3.7	1.9	3.3	2.4	3.5	3.3	7.2	11.8	13.3	6.1	2.2	3.1	3.7
1-4 Family Mortgage Originations f.																			
Conventional	\$687	\$802	\$746	\$685	\$642	\$746	\$736	\$598	\$615	\$674	\$644	\$604	\$3,631	\$2,776	\$3,167	\$2,920	\$2,722	\$2,538	\$2,396
FHA & VA	\$17	\$21	\$21	\$19	\$18	\$21	\$23	\$19	\$26	\$28	\$27	\$25	\$231	\$129	\$82	\$78	\$81	\$106	\$126
Total	\$704	\$823	\$767	\$704	\$660	\$767	\$759	\$617	\$641	\$702	\$671	\$629	\$3,862	\$2,905	\$3,249	\$2,998	\$2,803	\$2,644	\$2,522
ARM Share (%) g.	28	25	19	14	11	11	12	12	12	12	12	12	19	34	31	21	12	12	13
Refinancing Share - Applications (%) h.	44	42	41	46	46	40	35	34	32	24	23	24	65	46	44	43	39	26	20
Refinancing Share - Originations (%) h.	50	48	47	52	52	47	42	33	39	32	32	32	70	52	50	49	43	34	29
Residential Mortgage Debt (%) i.	10.1	10.2	8.1	6.8	5.0	6.9	7.3	5.3	5.6	7.7	7.8	6.8	12.7	14.5	13.6	8.8	6.1	7.0	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 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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