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Freddie Mac Forecast: Lots of "Ifs" and "Buts"

Freddie Mac's economists say, "The broader economic environment remains favorable for home sales," but they add **a lot of caveats to that statement**. Sales are holding up so far, despite the increase in mortgage rates, but will that continue?

Sales started recovering in 2010, with the aggregate of new and existing sales growing annually except for 2014; largely because rates rose that year. Rates are not necessarily the only driver, however, from 2016 to 2017 home sales rose along with rates.

Of course, sales depend on the interaction between demand- and supply-side factors. Demand factors include demographics, labor market outcomes, and financing conditions including rates and the availability of credit. Among supply factors are the construction of new homes, vacancy rates, and the inventory of existing homes for sale. The last factor is also linked to demand as sellers of existing homes are often buyers as well. That is an important dynamic for understanding the current housing supply.

Looking at demographics, we have the Millennials who will dethrone Baby Boomers as the largest generation next year and have finally started to move the housing market. Boomers, living longer and healthier lives than prior generations, are extending their homeownership years longer as well.

Given population trends, the U.S. should **add over a million households each year** for the next few years. Over time, slower population growth rates should reduce household formation rates. But that reduction is still several years away. There is also substantial pent up demand, although it remains to be seen if the rise of shared living arrangements, multigenerational households, and delayed household formation are generational preferences or reflect the economic situation. Either way, young adults will fuel housing demand over the next decade.

National Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	6.43%	+0.02	0.00
15 Yr. Fixed	5.95%	0.00	0.00
30 Yr. FHA	5.82%	+0.02	0.00
30 Yr. Jumbo	6.62%	0.00	0.00
5/1 ARM	6.28%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.35%	-0.51	0.00
15 Yr. Fixed	5.51%	-0.65	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	6.44%	-0.06	0.54
15 Yr. Fixed	5.88%	-0.16	0.68
30 Yr. FHA	6.36%	-0.06	0.85
30 Yr. Jumbo	6.75%	+0.07	0.39
5/1 ARM	5.98%	-0.27	0.65

Rates as of: 8/30

Recent Housing Data

		Value	Change
Mortgage Apps	Aug 28	226.9	+0.49%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%

		Value	Change
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%
Builder Confidence	Mar	51	+6.25%

The country has added 17.9 million jobs since October 2010. In addition, labor force participation has increased while unemployment remains at the lowest level in 17 years and this has helped fuel demand. Freddie Mac thinks the new tax legislation will boost income, quoting the Congressional Budget Office that total salaries are likely to increase by an average of 0.9 percent due to the new law. Its full effect might not show up until next year as homeowners **begin to pay higher taxes** due to the reduced deductibility of mortgage interest and property taxes. In any case, employment and income increases are likely to have a positive impact on home sales, at least in the short run.

Since 80 to 90 percent of home sales are bought with a mortgage, financing conditions will have a major impact on the demand side. If credit is expensive and tight, housing demand will contract, expanding when credit is cheap and loose. Current conditions are supportive of housing demand.

Mortgage rates are up about half of a percentage point since the beginning of the year. If rates continue to rise, that could slow home sales. However, if rates are rising due to a stronger economy, incomes could offset the increase in rates.

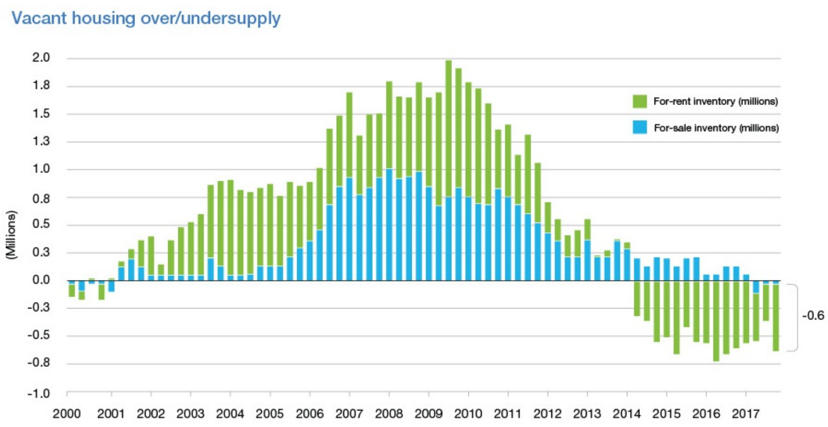
Both published measures of credit availability, the Mortgage Bankers Association's (MBA's) Mortgage Credit Availability Index (MCAI) and the Urban Institute's (UI's) Housing Credit Availability Index (HCAI) show **credit access rising since 2014.** That availability depends on the borrowing capacity and credit worthiness of borrowers in addition to products and terms from lenders. HCAI shows current risk levels well below what UI considers reasonable lending standards in the early 2000s,

While there may be room to safely expand credit in the current environment, credit constraints are not the dominant rein on home sales. Those lay on the supply side of the equation, with construction being among the largest; the economy is not building enough units to meet demand.

Single-family construction is significantly below both historical averages and Freddie Mac's estimate of long term demand. Labor shortages and increases in development costs have held back building and even with its recent ramp-up, it isn't meeting demand. Housing starts picked up in the third quarter of last year so more new homes may be coming on the market in upcoming months and units in process reached new expansion highs of 1.12 million units in March.

The estimated two million-unit excess of vacant homes, both for rent and for sale, that existed early in the recovery has **largely been absorbed.** As homeownership rates dropped and renting surged, that market became very tight. In recent quarters the excess supply of vacant for-sale homes has also turned negative. In the fourth quarter of 2017, there was an undersupply of 600,000 housing units relative to Freddie Mac's estimated demand. Without a greater supply of new or vacant homes, the housing market will have difficulty accommodating increased housing demand.

Exhibit 3



Source: Freddie Mac calculations using U.S. Census Bureau data. Negative values reflect shortage or undersupply relative to the historical benchmark. The over/undersupply of vacant housing was estimated based on the average vacancy rate from 1994Q1 to 2003Q4.

Most home sales involve pre-owned properties, so the existing home sales market is an important source of supply. In recent years, the inventory of those properties has been low and has trended lower. Per estimates by the National Association of Realtors (NAR) the number of single-family homes available for sale in the U.S. in February 2018 was just 1.41 million units, less than half of the peak in 2007.

This presents a **conundrum for the housing market.** As P.T. Barnum said, "Nothing draws a crowd like a crowd." Since most sellers of existing homes are also looking to buy a home, low levels of inventory work to further suppress inventory. Potential sellers may hesitate if they fear selling their existing home and being unable to find another to buy.

Upward trending mortgage rates work on both the supply and demand side; reducing affordability on one hand while fueling the reluctance of homeowners to forgo their current interest rate to buy a home at a higher one. This interest rate lock-in effect may further depress for-sale home inventory.

We all know the laws of supply and demand; when the supply of homes exceeds demand, prices tend to fall or appreciate more slowly. When demand exceeds supply, prices tend to increase. In recent years, demand has outpaced supply and home prices have risen rapidly. As home prices rise, more and more prospective buyers will find that they cannot afford to buy, yet despite several years of home prices outpacing income growth, the demand for homes has remained robust, and modest increases in mortgage rates have not been enough to offset the effects of demographic forces, more jobs and higher incomes.

So, **what should we expect for home sales** over the next two years?

Freddie Mac's baseline economic forecast has the U.S. economy continuing to grow with gradual increases in interest rates, and **home sales should post modest growth** over the next two years. Supply should pick up over the next year, whereas demand, while getting a boost this year from tax reform, will start to cool in response to rising rates. The company expects inflation to pick up by the end of 2019 with the Fed responding with higher rates this year and next; expected to average 4.9 percent and 5.4 percent in the fourth quarter of 2018 and 2019, respectively.

Given these conditions, the company expects total home sales to increase from 6.12 million in 2017 to 6.3 million in 2018, and to 6.44 million in 2019 with new home sales driving the growth. The existing home sales market will likely remain flat as the effect of stronger income growth and other demand-side factors will be roughly balanced by rising rates. New homes sales will drive growth as housing construction keeps grinding higher.

The risks to this forecast lean to the downside. Housing **construction is unlikely to accelerate much**, and existing sales have little room for growth given the inventory. Only modest increases in mortgage rates are expected, and if those rise higher and faster i.e. above 5.5 percent for the 30-year mortgage this year, home sales would likely decline about 10 percent from the estimate.

The economists conclude that the broader economic environment remains favorable for home sales, but without more construction and increased inventories those sales will have a tough time growing from current levels. If incomes grow and mortgage rate increases are gradual, then the housing market should post modest growth this year and next.

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