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Office of the Chief Economist

January U.S. Economic & Housing Market Outlook

Preparing for 2015 Housing Market Opportunities

As we enter 2015, the U.S. economy and housing markets are prepared for a robust start. Unlike one year ago, when interest rates were rising, growth was sluggish, and disruptive weather from a polar vortex reduced economic growth in the first quarter by about one percent[1], we enter 2015 with a number of positive tailwinds buoying the economy. Economic growth is running at about a 3 percent annual rate. Mortgage rates remain low and have even fallen over the past few months. The labor market continues to heal, posting solid job gains and driving falling unemployment, and falling oil prices have helped push down retail gas prices, effectively giving U.S. consumers upwards of $200 billion extra in aggregate to spend.

On balance there are a lot of positive opportunities in the U.S. economy at the start of the year, and the real question is whether or not households and businesses will be able to seize these opportunities and make the most of them. For, as we shall see, many of these opportunities may be for a limited time only.

First, let's recap the key positive tailwinds for the economy. Mortgage interest rates remained well below expectations last year, with an annual average of 4.17 percent for the 30-year fixed-rate mortgage in the Primary Mortgage Market Survey.

Freddie Mac Primary Mortgage Market Survey®
30-year FRM, U.S. Weekly Average

As we start the new year, mortgage rates have trended even lower, making it possible for refinancing activity to pick up for loans originated over the past year. In January 2015 there is a large pool of mortgages that could be refinanced into mortgages with lower monthly payments.

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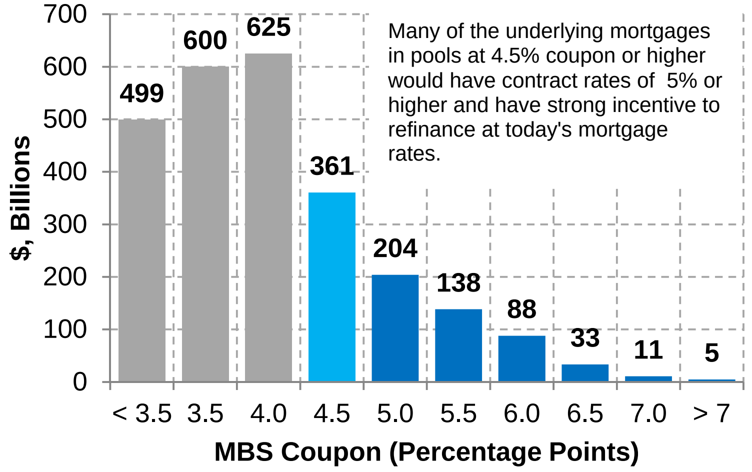
[1] The estimate of the economic impact of weather on GDP growth is from Macroeconomic Advisers (MA). MA estimated that unusually cold temperatures subtracted 1 percentage point off of 2014Q1 GDP growth. Much of this reduction was temporary, as 2014Q2 economic growth was boosted 1.2 percentage points due to recovery from the weather.

Among conventional 30-year fixed mortgage agency MBS, there are $361 billion with a 4.5 percent coupon and an additional $479 billion with a coupon greater than 4.5 percent. Many of the mortgage loans in the pools underlying those MBS would have an interest rate of 5 percent or higher, giving the borrowers a strong incentive to refinance at today's rates. We also expect these low mortgage rates to help the growing purchase market continue to expand and reach the highest levels we've seen since 2007.

Outstanding Conventional Agency 30-year FRM MBS in January 2015

Source: Bloomberg



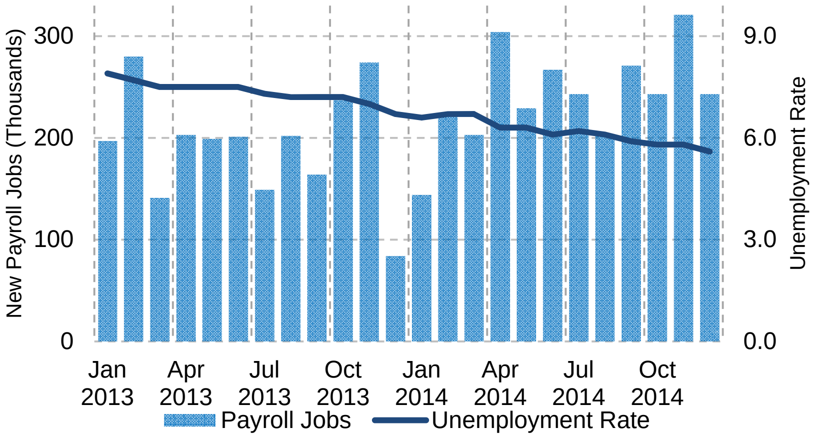
Many of the underlying mortgages in pools at 4.5% coupon or higher would have contract rates of 5% or higher and have strong incentive to refinance at today's mortgage rates.

Despite having a steady and good paying job and good credit history, many potential homebuyers remain sidelined due to high monthly rents which prevent them from saving for a down payment on a home. Recently, the Federal Housing Finance Agency announced that Freddie Mac and Fannie Mae will accept as little as 3 percent down for a home purchase or refinancing under certain guidelines[2], and the Federal Housing Administration announced that it will cut its premiums for new or refinancing borrowers by half a percentage point to help make mortgages more available to first-time homebuyers. These actions will prove to be a positive change, especially as labor markets improve and more Millennials begin to form a larger share of households.

The most important tailwind behind housing coming into the new year is jobs. The economy added an average of 246, 000 jobs per month in 2014, compared to 194,000 in 2013. In addition, the unemployment rate fell from 5.8 to 5.6 percent in December.

New Payroll Jobs (L) and Unemployment Rate (R)

New non-farm payroll jobs added (Thousands), Unemployment Rate in Percentage Points Source: U.S. BLS



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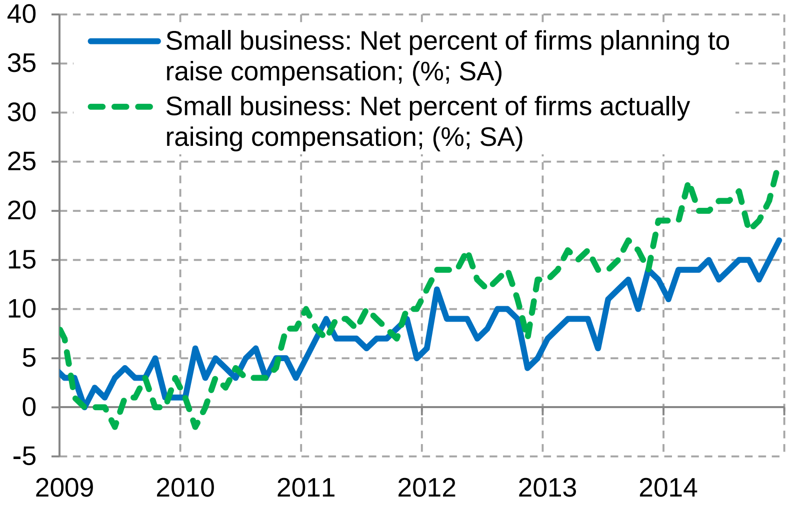
[2] 3% Down: Your Top Questions Answered: http://www.freddiemac.com/blog/homeownership/20141208_three_percent_down_mortgage.html

Over the year, the unemployment rate fell 1.1 percentage points, decreasing the number of unemployed people by 1.7 million. The less stellar aspect of the jobs picture over the year was wage growth, which actually declined 5 cents per hour in December, with the approximately 1.7 percent increase in average hourly earnings for 2014, barely keeping up with the rate of inflation. However, there are signals from consumers and businesses that wages will also improve. For example, The Conference Board Consumer Confidence Index®, improved in December to its highest level since February 2008, showing that consumers are considerably more optimistic about current economic and labor market conditions. Likewise, the National Federation's Independent Business Index was at its highest level since 2006 in December showing most small businesses expect to increase employee compensation this year.

NFIB Small Business Optimism Index

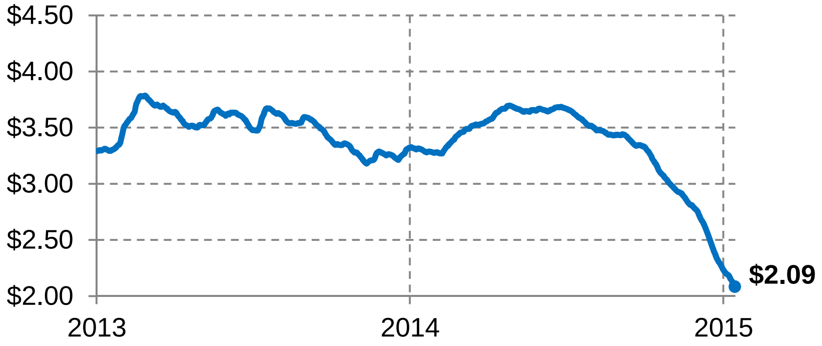
Source: National Federation of Independent Business



The big surprise so far this year has been gas prices. While many American's aren't seeing their paychecks grow as fast as they would like, they are realizing the benefit of lower prices at the gas pump. The average price at the pump was hovering around $2.13 a gallon as of the second week of January. Crude oil's price decline has the potential to push the national average U.S. price for gasoline below $2 a gallon for the first time since early 2009. Currently, nearly half of the U.S. now averages sub-$2 gasoline, which according to some economists amounts to anywhere from a $125 to $200 billion stimulus for consumers. However, falling gas prices could also start having adverse effects on housing markets that have so far benefitted from strong energy economies. In fact, many of the best recovering housing markets have been in the energy states according to Freddie Mac's Multi-Indicator Market Index (MiMi). As of October, metro areas like San Antonio, Austin and Houston and Dallas continue to improve and Texas is showing an overall increase of 4.88 percent from the same time last year in the stability of its housing market as measured by MiMi.

Daily National Average Gasoline Prices

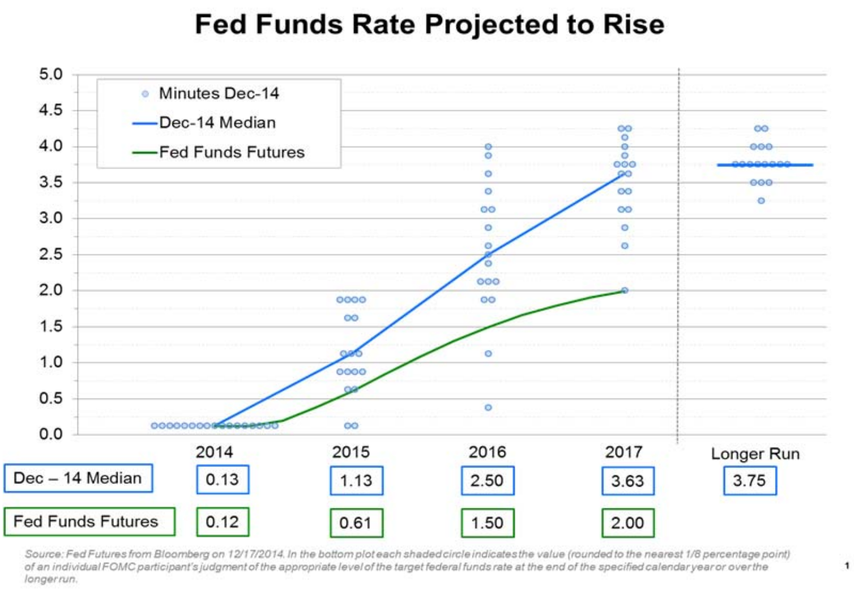
Source: Bloomberg, American Automobile Association
Data through January 14, 2015



For a Limited Time Only

While there are substantial opportunities in the domestic housing market, many could be for a limited time only. Unexpected weakness in the global economy and a flight to the relative safety of U.S. Treasuries has put downward pressure on interest rates, inflation, and gas prices. Over time the global economy should stabilize and many of these trends may reverse themselves. In addition, domestic economic policy, particularly by the Federal Reserve, has the potential to affect interest rates. We expect to see the relatively low interest rates of the past few weeks persist for the first two quarters of the year, but then start to move higher in the second half.

The key consideration for interest rates is Federal Reserve policy. In particular, when will the Fed change its policy so we see lift-off and they start to raise short term interest rates. Many economists and analysts are expecting the Fed to start raising interest rates sometime this year. When it does, it is likely to continue raising rates repeatedly, and short term interest rates in the U.S. should rise fairly quickly. In fact, we are forecasting that the 1-year constant maturity treasury yield will rise by nearly one percentage point by the end of the year, and most of that increase to come following lift off.



Fed Funds Rate Projected to Rise

Source: Fed Futures from Bloomberg on 12/17/2014. In the bottom plot each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual FOMC participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run.

Even if the Fed beings to tighten its monetary policy and long-term rates follow short rates higher, we don't expect to see interest rates spike dramatically. There is always the potential for large short-term movements in bond markets, like with the Taper Talk of June 2013, but the longer-term trend should be for only a gradual increase in rates. With rates down about 0.75 percentage points from last year, there is still a lot of room for rates to rise before they start to weigh against growth and housing markets.

But a Fed policy shift isn't the only downside risk to the economy. Weakness in global growth could translate into slower growth at home. In the immediate short-

Global Growth Forecasts

Consensus Forecast of Real GDP Growth

Source: Bloomberg Jan 12, 2015

	2014	2015
U.S.	2.3%	2.9%
Canada	2.4%	2.5%
Eurozone	0.8%	1.1%
Germany	1.5%	1.2%
France	0.4%	0.8%
Italy	-0.4%	0.4%
Spain	1.3%	1.8%
United Kingdom	3.0%	2.6%
Japan	0.2%	1.0%
China	7.4%	7.0%

term, it appears the primary effects of the global slowdown, lower oil prices and lower long-term interest rates are a net positive for U.S. growth. But if the slowdown in the world economy persists, then declining exports and profitability of U.S. corporations could lower growth here in the U.S. The consensus forecast for the world's leading economies is for growth to pick up in much of the world, but remain soft in Europe in particular.

The economy has a great opportunity to expand in 2015. The reprieve in interest rates and drop in gas prices should help to spur economic growth. Until rates start to rise later in the year, housing markets should respond positively and we anticipate increases in home sales and continued improvement in construction activity. With rates lower at the beginning of the year, we'll see higher than expected refinance volume, but expect refinance volume to drop quickly as rates rise.

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January 20, 2015

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January 2015 Economic and Housing Market Outlook

Revised 1/14/2015

	2014				2015				2016				Annual Totals					
Indicator	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013	2014	2015	2016
Real GDP (%)	-2.1	4.6	5.0	2.5	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	1.7	1.6	3.1	2.5	3.0	3.0
Consumer Prices (%) a.	1.9	3.0	1.1	-1.2	1.5	2.0	2.0	2.0	2.0	2.0	2.0	2.0	3.3	1.9	1.2	1.2	1.9	2.0
Unemployment Rate (%) b.	6.7	6.2	6.1	5.7	5.7	5.6	5.5	5.4	5.4	5.3	5.3	5.2	8.9	8.1	7.4	6.2	5.6	5.3
30-Year Fixed Mtg. Rate (%) b.	4.4	4.2	4.1	4.0	3.9	4.1	4.3	4.5	4.7	4.9	5.1	5.3	4.5	3.7	4.0	4.2	4.2	5.0
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	3.1	3.0	3.0	3.0	3.0	3.2	3.5	3.7	4.0	4.3	4.5	4.8	3.3	2.8	2.9	3.0	3.4	4.4
1-Year Treas. Indexed ARM Rate (%) b.	2.5	2.4	2.4	2.4	2.3	2.4	2.5	2.6	2.7	2.8	3.0	3.2	3.0	2.7	2.6	2.4	2.5	2.9
10-Year Const. Mat. Treas. Rate (%) b.	2.8	2.6	2.5	2.3	2.3	2.5	2.7	2.9	3.1	3.3	3.5	3.7	2.8	1.8	2.4	2.6	2.6	3.4
1-Year Const. Mat. Treas. Rate (%) b.	0.1	0.1	0.1	0.2	0.1	0.3	0.5	0.8	1.0	1.5	2.0	2.5	0.2	0.2	0.1	0.1	0.4	1.8

	2014				2015				2016				Annual Totals					
Indicator	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013	2014	2015	2016
Housing Starts c.	0.93	0.99	1.03	1.06	1.15	1.15	1.25	1.25	1.30	1.35	1.45	1.50	0.61	0.78	0.92	1.00	1.20	1.40
Total Home Sales d.	5.03	5.29	5.56	5.60	5.55	5.60	5.60	5.65	5.70	5.80	5.80	5.90	4.57	5.03	5.52	5.37	5.60	5.80
FMHPI House Price Appreciation (%) e.	1.5	0.9	1.2	0.8	1.0	0.9	0.9	0.8	0.8	0.8	0.8	0.8	-3.2	6.1	9.3	4.5	3.5	3.0
S&P/Case-Shiller® Home Price Index (%) f.	1.4	-0.2	1.2	1.0	1.0	0.9	0.9	0.8	0.8	0.8	0.8	0.8	-3.7	6.6	10.8	3.4	3.5	3.0
1-4 Family Mortgage Originations g.																		
Conventional	$198	$257	$282	$224	$256	$280	$240	$184	$200	$312	$308	$200	$1,206	$1,750	$1,570	$961	$960	$1,020
FHA & VA	$52	$63	$68	$56	$64	$70	$60	$46	$50	$78	$77	$50	$286	$372	$355	$239	$240	$255
Total	$250	$320	$350	$280	$320	$350	$300	$230	$250	$390	$385	$250	$1,492	$2,122	$1,925	$1,200	$1,200	$1,275
ARM Share (%) h.	11	11	10	11	11	11	12	12	13	14	15	16	13	11	8	10	12	15
Refinancing Share - Applications (%) i.	52	45	50	60	50	40	35	35	34	33	32	31	71	77	63	52	40	33
Refinancing Share - Originations (%) j.	44	38	42	38	45	35	30	30	28	25	23	20	64	70	59	40	35	24
Residential Mortgage Debt (%) k.	-0.8	-0.1	1.2	1.5	2.5	3.0	3.0	3.5	3.5	4.0	4.0	4.5	-2.1	-1.7	-0.5	0.5	3.0	4.0

Note: Quarterly and annual forecasts 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 average 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 average of monthly interest rates.

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 single-family homes;quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).

e. Quarterly growth rate of Freddie Mac's House Price Index; seasonally-adjusted; annual rates for yearly data.

f. National composite index (quarterly growth rate), seasonally-adjusted; annual rates for yearly data.

g. Billions of dollars (not seasonally-adjusted); conventional for 2014 are Freddie Mac estimates.

h. Federal Housing Finance Agency (FHFA); quarterly averages of monthly shares of number of loans of conventional, home-purchase mortgage closings (not seasonally-adjusted).

i. MBA Applications Survey: activity by dollars, total market refi share percent for United States (not seasonally-adjusted).

j. Home Mortgage Disclosure Act for all single-family mortgages (not seasonally-adjusted); annual share is dollar-weighted average of quarterly shares (2014 estimated).

k. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages

Prepared by Office of the Chief Economist and reflects views as of 1/16/2015 (LCK); Send comments and questions to chief_economist@freddiemac.com.

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