Freddie Mac May 2016 Insight

May 31, 2016

How to Worry About House Prices

MCLEAN, VA--(Marketwired - May 31, 2016) - Freddie Mac (OTCQB: FMCC) released today its monthly Insight for May with a focus on rising house prices and a two-stage method that can be used to gauge house price risk.

Insight Highlights

- House price growth has been particularly strong in recent years, averaging 5.6 percent annually according to the Federal Housing Finance Agency.
- Price-to-income (PTI) ratio appears to be the clearest indicator of the long-run sustainability of house prices, and is effective when trimming the list of U.S. housing markets down to a tractable watch list.
- However, in some metros, PTI ratios typically are much higher than they are in the U.S. as a whole. For example, San Francisco is a desirable location, and residents historically have been willing to devote a larger-than-average share of their budgets in order to live there. In addition, buildable land in San Francisco is extremely limited, so the supply of housing can't expand to meet the high demand. Both factors help explain the high PTI ratio in San Francisco.
- Ten metros with unusually-high PTI ratios as of the end of 2015 appear in clusters -- Raleigh and Charlotte in North Carolina; Jacksonville, Orlando, and Miami in Florida; Dallas, Austin, and San Antonio in Texas; and Portland and San Jose on the West Coast.
- The PTI ratio doesn't, by itself, identify potential house price bubbles. Three other supporting areas of information are needed, specifically:
    - Are there nonfinancial reasons for the high PTI ratios?
    - Are credit conditions deteriorating?
    - Is leverage increasing?

Quote: Attributed to Sean Becketti, Chief Economist, Freddie Mac.

"House prices have breached the peak levels of 2006, raising concerns about the long-term sustainability of current price levels. The difficulty of forecasting house price appreciation and the conflicting signals of the multitude of house price metrics make it challenging to assess whether -- and where -- house price risk is indeed increasing.

"Our first stage identified ten large metro areas with unusually-high house prices relative to the household incomes in those areas. However, the second stage failed to produce compelling evidence of increasing house price risk. As long as leverage remains low, home owners will remain resilient in the face of economic fluctuations. However, if leverage creeps up, home owners' financial cushion will shrink, leaving them more vulnerable to economic shocks. In sum, our analysis suggests that, aside from isolated areas, we don't need to worry about house prices -- yet."

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