

### *Will the Grinch Stay Home?*

November's labor market report was weaker than had been hoped for: only an 112,000 gain in payroll employment coupled with a cumulative 54,000 downward revision to the two prior months. As usual, nearly all the job gains were in the service sector (104,000 in November), and the construction sector increased hiring for the 21<sup>st</sup> time in 23 months. The unemployment rate nudged downward a tenth to 5.4 percent. The national unemployment rate has remained in a narrow band of 5.4 to 5.6 percent since April and is unlikely to move lower without more substantial job creation.

Still, recent indicators point toward continued steady economic growth averaging 3.9 percent over 2005. The fourth quarter of 2004 should be close to that mark as well. Consumer spending in October rose 0.7 percent and personal income was up 0.6 percent, and factory orders were also up 0.5 percent. The Institute for Supply Management's manufacturing index rose in November to 57.8—the first rise since July and presaging a further pickup in factory activity—and its service sector index was also up. Weakness in the foreign exchange value of the dollar should help to stimulate manufacturing activity in the new-year. The value of the dollar against the Euro has fallen by about 10 percent over the past 3 months.

The housing market continues at a robust pace. Interest rates on 30-year fixed-rate loans have averaged about the same amount during the past two years (5.8 percent), and with an increase of nearly 2 million jobs this has translated into vigorous housing demand. Builders have tried to keep pace by starting single-family homes at a record clip in 2004. Nonetheless, the high level of overall demand has pushed home values up. Over the past year, according to our Conventional Mortgage Home Price Index, the average single-family home gained 12 percent in value. The value gain was not shared equally across communities; those that have experienced job loss generally show the slowest gain, while markets along the coasts, where buildable land is at a premium, have seen the sharpest price gains.

Our forecast includes a further 0.25 percent increase in the federal funds target rate at the December 14 Federal Open Market Committee (FOMC) meeting to 2.25 percent. As the yield curve flattens over the coming year, consumers will shy away from ARM products and away from refinance. Both, as a share of overall originations, will move downward gradually in 2005. HELOCs and closed-end second mortgage loans will continue to remain popular with consumers, perhaps helping to keep the Grinch away at year-end.

## Details

- *Real GDP growth.* The Bureau of Economic Analysis revised the estimate of third quarter GDP growth from 3.7% to 3.9%, with much of the revision coming from stronger consumer spending of 5.1%.(annualized). Due to declining energy costs we raised our fourth quarter forecast for GDP growth to 3.8%, with higher growth of 3.9% expected in 2005.
- *Consumer price inflation.* Consumer price index (CPI) inflation should return to a more moderate pace, averaging 2% in 2005. Since its peak in late October, oil prices declined. However, we expect some effects of the high prices to filter through the economy in the fourth quarter. As a result, we raised our fourth quarter CPI estimate from 2.5% to 3.1%. Oil prices still remain the wild card. Nonetheless, we expect oil prices to gradually drift downward in 2005, helping to keep inflation low.
- *Unemployment rate.* With GDP growth expected to exceed 3.5%, job creation should bring the unemployment rate gradually down, to close to 5% by the end of 2005. The November non-farm payrolls were weaker than expected and inconsistent with other indicators, especially in the manufacturing sector. As a result we believe job growth will strengthen in the coming months.
- *Mortgage rates.* 30-year fixed mortgage rates averaged 5.73% during the month of November; fixed-rate loans are only about 50 basis points above the 46-year low set in June 2003. We expect fixed-rate loans to gradually become more expensive, increasing about one-half of a percentage point between now and the end of 2005, however our average expected rate for 2005 is 10 basis points higher than our previous forecast. ARM rates should increase by more because we expect the FOMC to continue to push the federal funds target higher – we expect another quarter-point increase, to 2.25%, on December 14.
- *Housing starts.* Low mortgage rates continue to fuel new housing demand, either through household formations or desire for second homes. Our expectation for total housing starts in 2004 is at 1.96 million units, unchanged from our November Outlook, and we decreased our housing starts projection to 1.80 million dwellings for 2005.
- *Home sales.* Both previously owned and newly built home sales will easily set records this year, of about 6.6 million and 1.2 million units, respectively. We decreased the total home sales forecast to 7.50 million for 2005 – a 4% decline from the levels of 2004, attributable to slightly higher mortgage rates.
- *Home value appreciation.* Home price growth will moderate over the next year, to about a 7% annual growth rate. Strong homes sales and an improving employment outlook coupled with higher construction costs and very little buildable land in the fastest growing areas continue to push home prices higher. Although we expect this pressure to moderate a bit with higher interest rates, we do not foresee any reason for a correction.
- *Mortgage activity.* The Fed-induced flattening of the yield curve (primarily through rising short-term rates) will bring the ARM share of lending down slightly over the next year. Higher rates will also dampen refinancing volume from a share of 46% in 2004 to about 37% in 2005. After a four-year refinance boom, fewer than 1-in-7 borrowers with a fixed rate mortgage today have an interest rate of 7% or higher – so very few homeowners are “in the money” for a refinance based purely on prevailing mortgage rates. Based on our higher interest rate forecast and lower home sales, we pushed down our origination forecast to \$2.4 trillion for 2005 – most the difference in origination volume is due to lower expected refinance activity. We have 2004 originations at \$2.8 trillion.

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### Major Economic Indicators

Indicator	2004				2005				2006		Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006
Real GDP (%)	4.5	3.3	3.9	3.8	3.8	4.0	3.8	3.8	3.5	3.5	0.2	2.3	4.4	3.9	3.9	3.5
Consumer Prices (%) a.	3.6	4.7	1.9	3.1	2.0	2.0	2.0	2.0	2.5	2.5	1.8	2.2	1.9	3.3	2.0	2.5
Unemployment Rate (%) b.	5.6	5.6	5.4	5.4	5.3	5.2	5.2	5.1	5.1	5.1	4.8	5.8	6.0	5.5	5.2	5.1
30-Year Fixed Mtg. Rate (%) b.	5.6	6.1	5.9	5.8	6.0	6.1	6.1	6.2	6.3	6.4	7.0	6.5	5.8	5.9	6.1	6.4
10-Year Const. Mat. Treas. Rate (%) b.	4.0	4.6	4.3	4.2	4.5	4.6	4.7	4.7	4.8	4.9	5.0	4.7	4.0	4.3	4.6	4.9
1-Year Const. Mat. Treas. Rate (%) b.	1.2	1.8	2.1	2.5	2.9	3.1	3.2	3.3	3.4	3.5	3.5	2.0	1.3	1.9	3.1	3.5

### Housing and Mortgage Markets

Indicator	2004				2005				2006		Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006
Housing Starts c.	1.94	1.92	1.97	2.00	1.95	1.79	1.77	1.69	1.70	1.70	1.60	1.70	1.85	1.96	1.80	1.70
Total Home Sales d.	7.40	7.99	7.83	8.00	7.20	7.50	7.90	7.40	6.93	7.00	6.20	6.54	7.19	7.81	7.50	7.00
House Price Appreciation (%) e.	6.5	9.8	15.9	8.3	7.5	6.9	8.4	5.3	6.2	6.7	7.6	7.5	8.6	10.1	7.0	6.0
1-4 Family Mortgage Originations f.																
Conventional	\$600	\$696	\$659	\$650	\$535	\$598	\$617	\$525	\$431	\$515	\$1,900	\$2,696	\$3,629	\$2,605	\$2,275	\$1,995
FHA & VA	\$39	\$37	\$30	\$39	\$35	\$38	\$37	\$35	\$32	\$39	\$167	\$187	\$231	\$145	\$145	\$150
Total	\$639	\$733	\$689	\$689	\$570	\$636	\$654	\$560	\$463	\$554	\$2,067	\$2,883	\$3,860	\$2,750	\$2,420	\$2,145
ARM Share (%) g.	27	36	38	36	37	33	30	28	26	24	12	17	19	34	32	23
Refinancing Share (%) h.	59	39	39	45	43	35	34	34	35	29	57	59	65	46	37	32
Residential Mortgage Debt (%) i.	11.3	12.4	15.4	13.9	11.6	13.2	13.4	11.8	9.4	12.0	10.1	11.8	12.8	13.2	12.5	10.7

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 data are averages of quarterly values.

a. Calculations based on quarterly averages of monthly index levels; index levels based on the seasonally-adjusted, all-urban consumer price index (seasonally-adjusted).

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

e. Freddie Mac/Fannie Mae conventional home price index (CMHPI); not seasonally-adjusted.

f. Annualized growth rate of Freddie Mac's Conventional Home Mortgage Price Index (CHMPI).

g. Billions of dollars (not seasonally-adjusted).

h. Federal Housing Finance Board (FHFB); quarterly averages of monthly shares of conventional, home-purchase mortgage closings (not seasonally-adjusted).

i. Primary Mortgage Market Survey; quarterly averages of monthly shares of mortgage applications (not seasonally-adjusted).

j. 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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## December 2004 Economic Outlook Comparison Table

	2004		2005				2006		2004	2005	2006
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
<b>GDP</b>											
Fannie	3.9	3.5	3.6	3.9	4.1	3.9	3.5	3.6	3.7	3.9	3.6
MBA	3.9	3.8	3.1	3.1	3.1	n.a.	n.a.	n.a.	4.4	3.3	n.a.
Economy.Com	3.9	4.5	3.4	2.9	2.9	2.9	3.1	3.4	4.5	3.5	3.2
Macroeconomic Advisers	3.9	3.7	3.8	3.8	3.9	4.0	4.2	4.0	3.9	3.9	3.9
Freddie Mac	3.9	3.8	3.8	4.0	3.8	3.8	3.5	3.5	3.9	3.9	3.5
<b>CPI</b>											
Fannie	1.9	3.1	1.4	1.7	1.9	2.1	2.1	2.0	3.3	1.8	2.1
MBA	1.9	3.1	1.5	1.3	1.5	n.a.	n.a.	n.a.	2.7	2.0	n.a.
Economy.Com	1.9	2.9	1.7	2.1	1.8	1.7	2.3	2.2	2.7	2.2	2.2
Macroeconomic Advisers	1.9	3.7	2.0	2.1	2.2	2.0	1.7	1.9	3.5	2.1	2.0
Freddie Mac	1.9	3.1	2.0	2.0	2.0	2.0	2.5	2.5	3.3	2.0	2.5
<b>Unemployment</b>											
Fannie	5.4	5.4	5.3	5.2	5.2	5.2	5.1	5.1	5.5	5.2	5.1
MBA	5.4	5.4	5.3	5.3	5.4	n.a.	n.a.	n.a.	5.5	5.3	n.a.
Economy.Com	5.4	5.5	5.5	5.5	5.4	5.3	5.4	5.3	5.5	5.4	5.3
Macroeconomic Advisers	5.4	5.4	5.3	5.3	5.2	5.2	5.2	5.1	5.5	5.3	5.1
Freddie Mac	5.4	5.4	5.3	5.2	5.2	5.1	5.1	5.1	5.5	5.2	5.1
<b>30-Year FRM</b>											
Fannie	5.9	5.8	5.8	6.0	6.1	6.2	6.2	6.3	5.9	6.0	6.3
MBA	5.9	5.7	5.9	6.1	6.2	6.3	6.4	n.a.	5.8	6.1	n.a.
Economy.Com	5.9	6.0	6.4	6.6	6.7	6.8	6.9	7.0	5.9	6.6	7.2
Macroeconomic Advisers	5.9	5.8	6.1	6.1	6.3	6.5	6.8	7.0	5.9	6.2	7.0
Freddie Mac	5.9	5.8	6.0	6.1	6.1	6.2	6.3	6.4	5.9	6.1	6.4
<b>1-Year CMT</b>											
Fannie	2.1	2.3	2.4	2.6	2.8	2.9	3.1	3.3	1.9	2.7	3.3
MBA	2.3	2.5	2.5	2.5	2.8	2.9	3.2	n.a.	1.8	2.7	n.a.
Economy.Com	2.1	2.4	3.2	3.6	3.7	3.9	4.2	4.5	1.9	3.6	4.8
Freddie Mac	2.1	2.5	2.9	3.1	3.2	3.3	3.4	3.5	1.9	3.1	3.5
<b>Housing Starts</b>											
Fannie	1.97	1.84	1.83	1.83	1.82	1.82	1.82	1.81	1.92	1.82	1.81
MBA	1.97	1.93	1.90	1.86	1.84	1.80	1.74	n.a.	1.94	1.85	n.a.
Economy.Com	1.97	1.97	1.89	1.79	1.70	1.59	1.55	1.51	1.95	1.74	1.52
Macroeconomic Advisers	1.97	1.99	1.91	1.90	1.88	1.83	1.78	1.74	1.96	1.88	1.72
NAHB									1.93	1.85	1.80
Freddie Mac	1.97	2.00	1.95	1.79	1.77	1.69	1.70	1.70	1.96	1.80	1.70
<b>Home Sales</b>											
Fannie	7.83	7.55	7.16	7.14	7.12	7.12	7.05	6.99	7.69	7.13	6.94
MBA	7.83	7.51	7.19	7.03	7.02	6.90	6.73	n.a.	7.68	7.04	n.a.
Economy.Com	7.83	7.90	7.17	6.76	6.29	6.06	6.00	6.01	7.78	6.57	6.01
NAHB									7.72	7.34	7.15
NAR									7.72	7.38	
Freddie Mac	7.83	8.00	7.20	7.50	7.90	7.40	6.93	7.00	7.81	7.50	7.00
<b>House Prices</b>											
Fannie	9.2	8.0	6.5	4.0	3.6	3.0	3.2	3.0	8.0	3.0	3.1
Economy.Com	4.8	14.8	1.3	0.8	1.1	1.4	2.3	2.8	9.3	1.2	2.1
Freddie Mac	15.9	8.3	7.5	6.9	8.4	5.3	6.2	6.7	10.1	7.0	6.0
<b>SF Originations</b>											
Fannie	629	640	529	591	547	444	367	487	2,718	2,111	1759
MBA	685	612	503	659	644	492	434	n.a.	2,810	2,298	n.a.
Economy.Com	469	401	374	356	346	343	346	349	2,096	1,419	1,403
Freddie Mac	689	689	570	636	654	560	463	554	2,750	2,420	2,145
<b>ARM Share</b>											
Fannie	38	34	32	32	31	30	29	28	34	31	27
MBA	38	39	37	37	37	37	36	n.a.	35	37	n.a.
Economy.Com	38	21	18	16	17	19	21	22	31	17	23
Freddie Mac	38	36	37	33	30	28	26	24	34	32	23
<b>Refi Share</b>											
Fannie	39	52	55	37	31	33	36	23	51	39	26
MBA	33	42	39	35	33	30	30	n.a.	44	34	n.a.
Economy.Com	35	19	17	15	13	12	12	11	38	14	11
Freddie Mac	39	45	43	35	34	34	35	29	46	37	32

Sources: Freddie Mac (12/7/2004), Fannie Mae (11/16/2004), MBA (11/18/2004), Economy.Com (12/03/2004), Macroeconomic Advisers (12/2/2004), National Association of Home Builders (11/9/2004), and National Association of Realtors (November 2004).

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