

### *Let the Good Times Roll*

The labor market improved in December, with the addition of 157,000 payroll jobs. Coupled with the upward revision of 34,000 jobs for the prior two months, 2.2 million jobs were created during 2004—the most in a single year since 1999. The manufacturing sector also added jobs in December, consistent with late 2004 reports of a pickup in factory orders during the fourth quarter. The decline in the foreign exchange value of the dollar is likely to support additional manufacturing gains in coming months.

The minutes of the Federal Open Market Committee's (FOMC) December meeting confirm that the Fed views monetary policy as accommodative and this accommodation could be removed at a "measured" pace. In plain English, this means that the Fed is very likely to continue the course it started on last June—that is, quarter-percentage point increases in the Federal Funds target, announced at FOMC meetings, but not necessarily at every FOMC meeting. The FOMC is likely to nudge the Federal Funds target up to 2.5% at its next meeting (February 1-2), with further increases later in the year. We anticipate that the Federal Funds target will be set at 3.0% by midyear and at 3.5% by year-end. With inflation remaining tame (between 2% and 2.25% in 2005), the outlook for long-term interest rates, such as on fixed-rate mortgages, also remains very good, with fixed-rate mortgages up only about one-half of a percentage point over the year. Thus, the yield curve should continue to flatten over 2005, as it did over the second half of last year.

Higher, but still modest, mortgage rates means that the housing market should have another splendid year in 2005. Housing starts and home sales should fall short of the record pace of last year, but only by 1% to 2%. House price appreciation should also moderate, but come in at a brisk 7% appreciation pace for the average single-family house.

The flatter yield curve will likely entice lenders to increase the size of interest-rate discounts that they offer on ARM products in order to maintain ARM volume. Initial-rate discounts increased from 0.4 percentage points at the beginning of 2004 to 1.3 percentage points at the beginning of this year for the 1-year, Treasury-indexed product. The flatter yield curve will likely increase consumer interest in hybrid ARMs; the 5/1 hybrid is already the most popular ARM product, accounting for two-in-five ARM loans made last year. Higher mortgage rates will further reduce refinance originations as the year unfolds. Homeowners are likely to resort to HELOCs and other second-lien products to convert home equity into cash; over the year ended September 30, 2004, HELOCs and seconds accounted for almost 20% of single-family debt growth, and should contribute significantly to debt growth in 2005.

## Details

- *Real GDP growth.* The upward revision in the final estimate of third quarter 2004 GDP growth affirmed our expectations for above trend growth in the economy over this year. We anticipate 2005 will match 2004's annual growth rate of 3.9 percent.
- *Consumer price inflation.* Oil prices remain relatively high owing to geo-political risks and OPEC's announced production cuts. As a result, we raised our inflation forecast, as measured by the Consumer Price Index, for fourth quarter 2004 and first quarter 2005. However, these effects should be temporary and we see little pricing power among other industries. For the year as a whole, consumer prices will likely rise 2.1 percent in 2005, less than its 3.4 percent increase in 2004.
- *Unemployment rate.* Above trend economic growth should spur further job growth. We expect the unemployment rate to steadily decline to 5.1 percent by the end of 2005 and hold steady after that.
- *Mortgage rates.* With inflation expected to be contained, long-term interest rates will rise moderately. We see rates on 30-year fixed-rate mortgages averaging around 6 percent in 2005 and 6.3 percent in 2006. Short-term interest rates, however, should increase more dramatically as the Federal Reserve continues its measured rate hikes.
- *Housing starts.* November's housing starts showed a large decline, which likely was weather-related, given the high level of permits for the month. With slightly higher mortgage rates in 2005, annual housing starts are expected to decline 1.6 percent to 1.90 million units for the year.
- *Home sales.* Total home sales will likely remain strong in 2005 owing to healthy economic growth and a better labor market. New and existing home sales may total 7.75 million units in 2005.
- *Home value appreciation.* House price appreciation has been strong over the past few years, but should moderate somewhat in upcoming years. We expect house prices will increase by 7.2 percent in 2005 and 6.3 percent in 2006.
- *Mortgage activity.* Single-family originations will slow to \$2.6 trillion in 2005 and \$2.3 trillion in 2006. The entire decline stems from slowing refinance activity (falling to 39 percent of the market in 2005 and to 32 percent in 2006). Home-purchase originations should rise in 2005 given strong home sales and house price growth.
- Finally, the ARM share should account for around one-third of mortgage originations in 2005 and 2006. Residential mortgage debt growth should slow down, in line with a slowing in house price appreciation, to around 12 percent in 2005 and less than 11 percent in 2006. (Double-digit growth also reflects an increase in first-time homebuyers as well as improvements, additions, and replacement of the existing housing stock.)

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We make home possible<sup>SM</sup>

# Office of the Chief Economist Economic and Housing Market Outlook

January 2005

Indicator	Major Economic Indicators															
	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	4.0	3.8	3.9	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	3.5	2.4	2.0	2.0	2.0	2.5	2.5	1.8	2.2	1.9	3.4	2.1	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	5.7	5.9	6.0	6.1	6.1	6.2	6.3	7.0	6.5	5.8	5.8	6.0	6.3
10-Year Const. Mat. Treas. Rate (%) b.	4.0	4.6	4.3	4.2	4.4	4.5	4.5	4.6	4.7	4.8	5.0	4.7	4.0	4.3	4.5	4.8
1-Year Const. Mat. Treas. Rate (%) b.	1.2	1.8	2.1	2.5	2.9	3.1	3.3	3.5	3.6	3.7	3.5	2.0	1.2	1.9	3.2	3.7

Indicator	Housing and Mortgage Markets															
	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	1.91	1.95	1.90	1.90	1.85	1.82	1.82	1.60	1.70	1.85	1.93	1.90	1.80
Total Home Sales d.	7.40	7.99	7.84	8.05	7.90	7.80	7.70	7.60	7.30	7.30	6.20	6.54	7.19	7.82	7.75	7.30
House Price Appreciation (%) e.	6.3	9.9	15.9	8.3	7.8	7.1	8.4	5.4	6.5	7.0	7.5	7.3	8.4	10.1	7.2	6.3
1-4 Family Mortgage Originations f.																
Conventional	\$600	\$696	\$659	\$650	\$581	\$636	\$645	\$545	\$479	\$557	\$1,900	\$2,696	\$3,629	\$2,605	\$2,407	\$2,159
FHA & VA	\$39	\$37	\$30	\$39	\$35	\$38	\$37	\$35	\$32	\$39	\$167	\$187	\$231	\$145	\$145	\$141
Total	\$639	\$733	\$689	\$689	\$616	\$674	\$682	\$580	\$511	\$596	\$2,067	\$2,883	\$3,860	\$2,750	\$2,552	\$2,300
ARM Share (%) g.	27	36	38	37	37	36	34	33	33	33	12	17	19	35	35	32
Refinancing Share (%) h.	59	39	39	47	46	37	36	36	36	30	57	59	65	46	39	32
Residential Mortgage Debt (%) i.	11.4	11.1	13.5	14.1	10.1	12.7	13.3	11.5	9.1	11.9	10.0	11.7	12.7	13.2	11.9	10.6

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.

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

Prepared by Office of the Chief Economist (PT 1/10/2005); Send comments and questions to [chief\\_economist@freddiemac.com](mailto:chief_economist@freddiemac.com).

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