

Conundrum?

The word conundrum is a noun, synonymous with mystery or puzzle. The use of the word by Fed Chairman Greenspan in his semi-annual report to Congress has financial market participants trying to discern what he might have been signaling. Was he “jawboning” long rates higher? Or, was he just using the word as part of his “big-think” about financial markets, as he is wont to do on occasion?

Chairman Greenspan’s conundrum was the following: With the federal funds rate up 150 basis points, why had long-term rates fallen about 50 basis points during the same period? Let’s start with the simple answer. First, inflationary expectations declined with the Fed’s stated intention to shift monetary policy to a “neutral” stance, thus putting downward pressure on rates. Second, foreign investors (including central banks) have chosen to buy more US fixed-income assets, bidding up their prices and nudging long-term rates down. There is a more complex answer, and that’s the real reason financial market participants are wondering. That answer deals with the risks to the economy.

The slope of the yield curve has always been seen as a crude indicator of economic health. An upward sloping yield curve signals a robust economy, and one that is getting flat might be signaling that the economy could tip into a recession. Recognizing this interpretation, Chairman Greenspan explicitly stated that the facts did not square with such a pessimistic view. The two reasons he noted were that the stock market was performing well and that spreads on corporate borrowing were low.

Yet, three delicately balanced risks are currently configured to create a benign outcome. Will these risks remain balanced? That is the question that is preoccupying market-watchers. The first risk is inflation. Producer prices jumped 4.2 percent at an annual rate in January. While this is likely a temporary aberration, it raised the specter of higher inflationary trends in the future; after all, crude oil prices (such as West Texas Intermediate) are above \$50 a barrel once again and the probability of disruptions to external suppliers remains elevated. If firms think they can pass on these increases in raw material costs to consumers, they will. So far, the ability to pass on these increases has been kept in check by imports and consumer resistance. However, foreign suppliers have had to bear the brunt of a declining dollar, and their ability to absorb declining margins might be at an end. The implication would be a rise in long-term rates.

The second risk relates to the current account deficit. It was 6 percent of GDP in the last quarter of 2004. Foreign purchases of US Treasury securities and other financial assets (such as Freddie Mac debt and Participation Certificates) are financing this deficit. The concern is that this source of financing might decline, and should this happen, bond prices would fall and rates would rise.

The third risk relates to the budget deficit. Most estimates show sizable deficits through the end of the decade but anticipate a gradual decline. If Congress fails to shrink the deficit appreciably (and credibly), long-term rates may be pushed up further and faster than the market is expecting.

These three risks could increase interest rates and cause an economic slowdown. The current market conundrum is about figuring out what might upset the equilibrium that has these three risks contained.

Details

- *Real GDP growth.* The U.S. Commerce Department revised the Fourth quarter 2004 growth rate upwards to 3.8%, in line with market expectations. We anticipate continued economic growth in 2005 at or above the previous quarter's pace.
- *Consumer price inflation.* Given the recent uncertainty and volatility in oil prices, we pegged our quarterly inflation forecasts at 2% for the year; our expectation is that inflation will remain tame and well managed by the Fed over the year.
- *Unemployment rate.* The labor market is improving (across all sectors) and given our GDP forecast, additional job growth should result in the unemployment rate settling in at 5.1% by the end of the year.
- *Mortgage rates.* Our interest rate model boosted long-term mortgage rates in 2005 by about 10 basis points over the course of 2005 from last month's forecast, but the level of rates will remain relatively low, averaging just 6.0% over the year. As the Fed takes deliberate and "measured" steps to fight off inflation by raising short-term interest rates ARMs will become more expensive at a relatively faster rate than long-term fixed-rate mortgages.
- *ARM Share.* With higher and rising short-term interest rates, mortgage lenders are expected to offer further initial discounts for ARMs. Typically, as the mortgage yield curve flattens, i.e., the rate difference between 30-year fixed-rate mortgages and fully-indexed 1-year ARMs declines, lenders tend to lower their initial offering rates (from the fully-indexed ARM rate). As a result, the ARM share of new loans should remain around one-third of the market in 2005, and gradually decrease after that.
- *Housing starts.* Given an overall upturn in mortgage rates, housing starts are bound to slow (a little). We expect total housing starts to average around 1.90 million units in 2005, buoyed by further multifamily construction.
- *Home sales.* Likewise, home sales should taper off somewhat. Total home sales, which include both new and existing properties, broke sequential records over the past four years. 2005 may offer some long awaited reprieve to the market.
- *Home value appreciation.* As a result of slowing demand, house price appreciation is expected to moderate over the next couple of years to around 6% for the nation as a whole. Overall, we expect the housing sector to settle into a more modest pace, reminiscent of the late 1990s.
- *Mortgage activity.* All of these above factors contribute to a decline in mortgage originations this year. We see originations falling from \$2.7 trillion in 2004 to \$2.4 trillion in 2005 and \$2.2 trillion in 2006. Adding to this drop in origination volumes is that fact that fewer families are refinancing. Given the historically low interest rates of the last few years, most people took advantage (in some cases, multiple times) of the low rates to rebalance and strengthen their household balance sheets – replacing high cost consumer debt with low cost mortgage debt and by making home improvements with home equity loans. We expect refinancing to comprise 41% of new loan activity in 2005 and then fall to around 31% in 2006. Slowing mortgage volumes and slightly slower home price appreciation should cause mortgage debt outstanding to grow at a slower pace than in 2004 – currently we are forecasting mortgage debt outstanding to grow at 11.9%.

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Office of the Chief Economist Economic and Housing Market Outlook

March 2005

Indicator	Major Economic Indicators															
	2004		2005				2006				Annual Totals					
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	2001	2002	2003	2004	2005	2006
Real GDP (%)	4.0	3.8	3.9	4.0	3.8	3.8	3.5	3.5	3.5	3.5	0.2	2.3	4.4	3.9	3.9	3.5
Consumer Prices (%) a.	1.6	3.6	2.0	2.0	2.0	2.0	2.5	2.5	2.5	2.5	1.8	2.2	1.9	3.4	2.0	2.5
Unemployment Rate (%) b.	5.4	5.4	5.3	5.2	5.2	5.1	5.1	5.1	5.1	5.1	4.8	5.8	6.0	5.5	5.2	5.1
30-Year Fixed Mtg. Rate (%) b.	5.9	5.7	5.7	6.0	6.0	6.1	6.2	6.3	6.3	6.4	7.0	6.5	5.8	5.8	6.0	6.3
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.6	4.7	4.8	4.8	4.9	5.0	5.0	5.0	4.7	4.0	4.3	4.6	4.9
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.5	3.6	3.7	3.8	3.9	4.0	4.1	3.5	2.0	1.2	1.9	3.5	3.9

Indicator	Housing and Mortgage Markets															
	2004		2005				2006				Annual Totals					
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2001	2002	2003	2004	2005	2006
Housing Starts c.	1.97	1.98	1.95	1.90	1.90	1.85	1.82	1.82	1.82	1.75	1.60	1.70	1.85	1.96	1.90	1.80
Total Home Sales d.	7.13	7.27	7.24	7.18	6.86	6.52	6.51	6.48	6.47	6.46	5.64	5.95	6.54	7.16	6.95	6.48
House Price Appreciation (%) e.	17.5	9.0	9.5	8.2	8.3	6.0	5.8	6.3	6.0	4.7	7.5	7.3	8.4	10.7	8.0	5.7
1-4 Family Mortgage Originations f.																
Conventional	\$659	\$650	\$550	\$605	\$602	\$495	\$480	\$558	\$578	\$490	\$1,900	\$2,696	\$3,629	\$2,605	\$2,252	\$2,106
FHA & VA	\$30	\$23	\$33	\$36	\$34	\$32	\$32	\$38	\$38	\$32	\$167	\$187	\$231	\$129	\$135	\$140
Total	\$689	\$673	\$583	\$641	\$636	\$527	\$512	\$596	\$616	\$522	\$2,067	\$2,883	\$3,860	\$2,734	\$2,387	\$2,246
ARM Share (%) g.	38	36	36	36	35	33	31	30	29	27	12	17	19	34	35	29
Refinancing Share (%) h.	39	47	47	40	37	37	36	29	29	31	57	59	65	46	41	31
Residential Mortgage Debt (%) i.	13.5	13.2	10.6	13.2	12.5	11.3	9.9	12.3	12.1	9.7	10.0	11.7	12.7	12.3	11.9	11.0

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 single-family 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).

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