

Quarter Back

The start of a new quarter is always a time to think about perspective – summarizing what just happened and what the year-end numbers are likely to be, looking forward to the up-coming quarter or next year. The first quarter of 2005 has turned out to be jolly good for housing – new home sales rose 9.4 percent in February to an annualized 1.23 million units, up from a revised January sales rate of 1.12 million units, and existing home sales and sales of condos and co-ops are also running at a brisk pace. The median sales prices of all three types of homes are up strongly too, and single-family housing starts hit a new record (seasonally-adjusted, annual rate) in February. While we don't think this pace of activity can be maintained with our projection of higher interest rates – and we are expecting 2005 totals to fall short of last year's – housing should mark a very good year when the year-end tally is in.

Mortgage markets also had an active first quarter, with refinance activity just below 50 percent of new mortgage applications, and new mortgage applications running at levels last seen in April 2004, according to the Mortgage Bankers Association Applications Survey. Adjustable-rate mortgages (ARMs) retained a one-third share of loans closed over the first two months of the quarter even with rapid increases in short-term interest rates. A re-emergence of teaser rates on 1-year ARMs and the growth of interest-only mortgages for hybrid ARMs have kept ARM initial monthly payments low enough to entice borrowers away from fixed-rate mortgages for now.

The rest of the economy has not fared as well as the housing and mortgage markets over the first quarter of the year. Oil prices have zoomed back up to record levels, but, unlike the situation a few months ago, no reprieve is expected in the near term. In fact a new report by Goldman Sachs suggested that crude oil prices might be entering a “superspike” region with \$100 a barrel possible at the higher end of the trading range. Contributing factors are extremely high worldwide demand for crude oil products and no excess supply capacity or reserves to help sate it. This time, though, the full brunt of the increase in crude oil prices has been passed on directly to consumers at the gas pumps, making March the most expensive month ever in which to fill the tank on the family car. Moreover, the Dollar remained stubbornly weak against the Euro and the Japanese Yen, keeping pressure on prices of imported consumer goods, and helped push the Consumer Price Index up 3 percent (annualized) in the first two months of the year.

Economic growth boosted employment in the first quarter, but by less than expected given projections of real Gross Domestic Product (GDP) growth of 4.4 percent. In total, 477,000 jobs were added, and the strong construction market absorbed 61,000 of them. Manufacturing, though, lost another 20,000 jobs after attempting a feeble recovery at the end of 2004. In the coming months, the economy (as measured by real GDP) is expected to continue growing at a healthy pace of 3.8 to 4.0 percent, which *should* be strong enough to push the employment numbers up near an average of 200,000 jobs added each month. Of course, we have witnessed time and again over the past four years that we can also achieve strong economic growth through productivity gains rather than with additional workers, so it is by no means a certainty that the jobs will come. If the jobs do come, increases in household incomes should partially offset the effects of higher interest rates on the housing sector and provide a nice long summer of brisk (but not record) home sales.

Details

- *Real GDP growth.* Gains in business inventories (especially non-automotive) in January and healthy figures for February's retail sales, housing starts, and durable goods orders have led us to revise up first quarter GDP growth to 4.4%. Thereafter, we expect GDP growth to moderate to a rate of 4% for the second quarter and slightly lower for the second half of the year.
- *Consumer price inflation.* With crude oil prices now in record territory, and unit labor costs rising, we expect consumer prices to rise 2.5% (annualized) in the first quarter and moderate to an average of 2% for the second half of the year. The moderation in consumer prices will be a result of firms finding it difficult to make price increases stick.
- *Unemployment rate.* The hesitancy of employers to commit to hiring during this expansion stands in stark contrast to previous experience. However, there have been job gains, albeit at a more sluggish pace. The unemployment rate is expected to decline from 5.3% in the first quarter to about 5.1% by the end of the year.
- *Mortgage rates.* The first quarter of 2005 might be the last quarter to record thirty-year fixed-rate mortgages below 6% for a while. From the second quarter onward we see this mortgage rate staying above this level. We expect to see inflationary expectations feeding into the thirty-year fixed-rate mortgage and as a result push this rate to about 6.4% by the fourth quarter.
- *ARM share.* As the mortgage yield curve has continued to flatten, originators have been continuing to offer further initial discounts on ARMs. If the yield curve flattens any further, ARM originations may come under pressure. For now, however, we expect ARM originations to come in just a bit above a third of the market.
- *Housing starts.* The housing start numbers for the first two months were a surprise to the upside, coming in at 2.14 million units at an annual rate. However, gradually rising rates this year will have an effect on starts and we expect the pace of starts to moderate to an annual rate of about 1.85 million units for the second half, pulling total starts down 2% from last year's pace.
- *Home sales.* Home sales in 2004 hit a record of 7.16 million units. Home sales in 2005 will not be far behind, and are expected to come in at approximately 6.93 million units.
- *Home value appreciation.* As mortgage rates continue to rise in 2005, the demand for housing will slow. This will have the effect of slowing the rate house prices have been rising nationally from 10.7% in 2004 to a forecasted 6.8% in 2005.
- *Mortgage activity.* Given the sensitivity of housing market activity to interest rates, the impact of our forecasted rates will be to dampen mortgage originations in 2005. As rates rise, we expect that originations will begin to decline from more than \$600 billion in the first quarter to approximately \$439 billion by the end of the year. In response to the rising rates, the refinance share of originations will decline from 48% of volume in the first quarter and drop to 32% of volume in the fourth quarter. For 2005, refinance volume is expected to comprise 35% of origination volume. Finally, in response to slightly lower rates of home price appreciation we forecast residential mortgage debt outstanding to grow at 12.5% in 2005.

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Office of the Chief Economist Economic and Housing Market Outlook

April 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	4.4	4.0	3.8	3.8	3.5	3.5	3.5	3.5	0.2	2.3	4.4	3.9	4.0	3.5
Consumer Prices (%) a.	1.6	3.6	2.5	2.4	2.0	2.0	2.5	2.5	2.5	2.5	1.8	2.2	1.9	3.4	2.2	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	5.8	6.2	6.4	6.4	6.5	6.5	6.6	6.6	7.0	6.5	5.8	5.8	6.2	6.6
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.8	4.9	5.0	5.1	5.1	5.2	5.2	5.0	4.7	4.0	4.3	4.8	5.2
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.8	3.9	4.0	4.1	4.1	4.2	4.3	3.5	2.0	1.2	1.9	3.7	4.2

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	2.15	1.90	1.86	1.82	1.82	1.82	1.82	1.75	1.60	1.70	1.85	1.96	1.93	1.80
Total Home Sales d.	7.13	7.27	7.15	7.18	6.86	6.52	6.51	6.48	6.47	6.46	5.64	5.95	6.54	7.16	6.93	6.48
House Price Appreciation (%) e.	17.5	9.0	8.3	6.6	7.1	5.3	5.9	6.4	6.0	4.3	7.5	7.3	8.4	10.7	6.8	5.7
1-4 Family Mortgage Originations f.																
Conventional	\$659	\$650	\$597	\$598	\$578	\$439	\$470	\$546	\$579	\$518	\$1,900	\$2,696	\$3,629	\$2,605	\$2,212	\$2,114
FHA & VA	\$30	\$23	\$35	\$35	\$34	\$26	\$32	\$38	\$38	\$32	\$167	\$187	\$231	\$129	\$131	\$140
Total	\$689	\$673	\$632	\$633	\$612	\$465	\$502	\$584	\$617	\$550	\$2,067	\$2,883	\$3,860	\$2,734	\$2,343	\$2,254
ARM Share (%) g.	38	36	33	35	36	34	33	32	30	29	12	17	19	34	35	31
Refinancing Share (%) h.	39	47	48	33	31	32	32	27	28	30	57	59	65	46	36	29
Residential Mortgage Debt (%) i.	16.7	11.4	12.0	13.7	13.6	10.8	9.2	11.7	11.5	9.2	10.0	11.7	12.7	13.2	12.5	10.4

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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