

Cognitive Dissonance

What explains the mismatch between the data pointing to heightened inflationary concerns and bond market perceptions that have discounted inflationary worries over the last few weeks? In some ways, it's an extension of the "conundrum" theme that Mr. Greenspan raised a few months ago.

Looking at the positive side of the ledger, GDP growth for the first quarter of 2005 came in at 3.5 percent (annualized), consistent with stable or gradually declining unemployment. Added to this was a pickup in labor productivity to an annualized rate of 2.9 percent in the first quarter of 2005 and a gain in consumer confidence from 97.5 in April to 102.2 in May. This increase in consumer confidence presages a rebound in consumption spending in the second quarter. Taken at face value, these indicators point to an economy performing well, and are consistent with stable, low inflation over time.

On the negative side of the ledger, some other data point to a less sanguine view of economic performance. First, despite a decline in the value of the dollar over the past year, there has been no improvement in our net exports, creating a large trade deficit. Further, despite improving labor productivity, labor costs rose at a 3.3 percent annualized rate during the first quarter of 2005, after a jarring 7.7 percent increase during the last quarter of 2004. Additionally, May produced a payroll employment increase of only 78,000 – and manufacturing continued to shed jobs.

Comparing the two sides of the ledger, while GDP growth has been strong, inflationary pressures are percolating and job creation remains less than impressive and volatile. And the US dollar remains weaker than a year ago with no visible impact on exports.

Despite concerns about current mounting inflationary pressures, the bond market remains optimistic about long-term inflationary prospects. In fact, the ten-year, constant-maturity Treasury has fallen from 4.62 percent at the end of March 2005 to less than four percent in early June. The bond market has concluded that long-term inflation is not a cause for concern. Indeed, the Fed's gradual tightening of monetary policy, and statements that it will continue to reduce its accommodative posture, may have convinced the capital market that the Fed remains a vigilant inflation fighter, thus mitigating concerns of a significant rise in inflation later this decade.

Does this signal an economic slowdown or a problem with the data? A strong possibility is that GDP will be revised upward again, and with it, estimates of productivity. This is consistent with the possibility that the bond market is discounting unit-labor-cost numbers. This is also consistent with firms hesitating to hire new workers since their current work force is highly productive.

The stronger-economy-than-the-data-indicate scenario implies strong performance for the housing sector for the remainder of 2005. Housing starts are expected to come in at a strong two million units and home sales at 7.25 million units in the second quarter, both at an annualized rate. With the continuing favorable interest-rate environment, house-price appreciation should stay robust nationally, in the neighborhood of seven to eight percent for the year. However, the continuing strength of the housing sector coupled with innovative financing is allowing investors to highly leverage their positions. These conditions may be creating excess demand in certain areas of the country, perhaps leading to some localized "frothiness." In particular, investor and second-home purchases are up in a number of high-cost and coastal markets.

Details

- *Real GDP growth.* The upward revision to the first quarter's GDP estimate was well anticipated. A 3.5% growth rate is above the past 20-year annualized rate of 3.2%, suggesting the economy remains strong. For the year, we expect annual GDP growth of 3.6%, and 3.5% for 2006.
- *Consumer price inflation.* Given higher oil prices and anecdotal information about firms regaining pricing power, we raised our inflation indicator for the second quarter. However, for the year as a whole, we expect consumer prices to rise 2.5%, below last year's 3.4 % pace.
- *Unemployment rate.* Overall, the labor market has been improving (the May employment report notwithstanding), and with above average GDP growth, we see the unemployment rate at 5.1% at the end of 2005, and further slipping to 5.0% by the end of 2006.
- *Mortgage rates.* Interest rates have fallen since our May Outlook. As a result, our forecast for long-term rates is approximately 10 basis points lower, but still incorporates our expectations of a gradual increase in rates over the next few years. Our forecast for short-term rates was unchanged for 2005. We expect rates on 30-year, fixed-rate mortgages to average 5.9% this year, and 6.2% in 2006.
- *ARM Share.* As the yield curve flattens somewhat, ARMs will likely become less popular among homeowners, even with deep initial discounts; currently, lenders are offering interest-rate discounts of over 1.8 percentage points for 1-year, Treasury-indexed ARMs for the first year of the loan. As a result, we see the ARM share falling to 31% in 2005, and 28% in 2006.
- *Housing starts.* At present, housing starts remain in record territory and are expected to match the pace set in 2004 at 1.96 million units. With mortgage rates gradually increasing, we are forecasting starts of about 1.80 million units in 2006.
- *Home sales.* Both new and existing home sales hit record highs in April, at a pace of 7.59 million units (annualized, excluding condos and coops). However, the inventory of homes for sale has been slowly creeping upward to over 4 months on the market. We see total home sales falling slightly from 2004's record high, to 7.10 million units in 2005, and 6.78 million in 2006.
- *Home value appreciation.* The Conventional Mortgage Home Price Index showed that home prices grew 9.6% (annualized) in the first quarter. We expect home sales to slow, in line with our forecasted rise in mortgage rates, thus moderating the upward pressure on home prices. Our forecast calls for a 7.7% increase in house prices this year, and 6.8% next year.
- *Mortgage activity.* Mortgage origination volume will likely decline in 2005 by 8% to \$2.5 trillion and total \$2.3 trillion in 2006. Less refinancing activity is partly the driving force behind this decline; refinancing will account for 40% of new mortgages in 2005 and 30% in 2006. And with home price appreciation slowing, we expect residential mortgage debt outstanding to slow as well, growing 13.0% in 2005, and 11.2% in 2006.

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We make home possibleSM

Office of the Chief Economist Economic and Housing Market Outlook June 2005

| Indicator | Major Economic Indicators | | | | | | | | | | | | | | | | |
|---|----------------------------------|-----|------|-----|-----|-----|------|-----|-----|-----|---------------|------|------|------|------|------|------|
| | 2004 | | 2005 | | | | 2006 | | | | Annual Totals | | | | | | |
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| Real GDP (%) | 4.0 | 3.8 | 3.5 | 3.5 | 3.7 | 3.7 | 3.5 | 3.5 | 3.5 | 3.5 | 0.2 | 2.3 | 4.4 | 3.9 | 3.6 | 3.5 | 3.5 |
| Consumer Prices (%) a. | 1.6 | 3.6 | 2.4 | 3.5 | 2.2 | 2.0 | 2.5 | 2.5 | 2.5 | 2.5 | 1.8 | 2.2 | 1.9 | 3.4 | 2.5 | 2.5 | 2.5 |
| Unemployment Rate (%) b. | 5.4 | 5.4 | 5.3 | 5.2 | 5.2 | 5.1 | 5.1 | 5.0 | 5.0 | 5.0 | 4.8 | 5.8 | 6.0 | 5.5 | 5.2 | 5.0 | 5.0 |
| 30-Year Fixed Mtg. Rate (%) b. | 5.9 | 5.7 | 5.8 | 5.8 | 5.9 | 6.0 | 6.1 | 6.2 | 6.3 | 6.4 | 7.0 | 6.5 | 5.8 | 5.8 | 5.9 | 6.2 | 6.6 |
| 10-Year Const. Mat. Treas. Rate (%) b. | 4.3 | 4.2 | 4.3 | 4.2 | 4.3 | 4.4 | 4.5 | 4.6 | 4.7 | 4.7 | 5.0 | 4.6 | 4.0 | 4.3 | 4.3 | 4.6 | 4.9 |
| 1-Year Const. Mat. Treas. Rate (%) b. | 2.1 | 2.5 | 3.1 | 3.4 | 3.6 | 3.7 | 3.8 | 3.9 | 4.0 | 4.0 | 3.5 | 2.0 | 1.2 | 1.9 | 3.4 | 3.9 | 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 | 2007 |
| Housing Starts c. | 1.97 | 1.97 | 2.08 | 2.00 | 1.90 | 1.86 | 1.82 | 1.82 | 1.82 | 1.75 | 1.60 | 1.70 | 1.85 | 1.96 | 1.96 | 1.80 | 1.72 |
| Total Home Sales d. | 7.13 | 7.29 | 7.23 | 7.25 | 7.00 | 6.90 | 6.85 | 6.80 | 6.75 | 6.70 | 5.64 | 5.95 | 6.54 | 7.17 | 7.10 | 6.78 | 6.40 |
| House Price Appreciation (%) e. | 17.6 | 9.7 | 9.6 | 8.0 | 6.6 | 6.4 | 7.0 | 7.3 | 7.2 | 5.7 | 7.5 | 7.3 | 8.3 | 11.0 | 7.7 | 6.8 | 6.2 |
| 1-4 Family Mortgage Originations f. | | | | | | | | | | | | | | | | | |
| Conventional | \$659 | \$650 | \$533 | \$635 | \$664 | \$561 | \$479 | \$557 | \$589 | \$521 | \$1,900 | \$2,696 | \$3,629 | \$2,605 | \$2,393 | \$2,145 | \$2,149 |
| FHA & VA | \$30 | \$23 | \$21 | \$36 | \$37 | \$31 | \$28 | \$33 | \$35 | \$31 | \$167 | \$187 | \$231 | \$129 | \$125 | \$127 | \$149 |
| Total | \$689 | \$673 | \$554 | \$671 | \$701 | \$592 | \$508 | \$590 | \$624 | \$552 | \$2,067 | \$2,883 | \$3,860 | \$2,734 | \$2,518 | \$2,273 | \$2,298 |
| ARM Share (%) g. | 38 | 36 | 32 | 31 | 31 | 31 | 30 | 29 | 27 | 26 | 12 | 17 | 19 | 34 | 31 | 28 | 22 |
| Refinancing Share (%) h. | 39 | 47 | 45 | 40 | 37 | 36 | 35 | 27 | 28 | 29 | 57 | 59 | 65 | 46 | 40 | 30 | 25 |
| Residential Mortgage Debt (%) i. | 16.7 | 11.4 | 11.8 | 14.5 | 13.4 | 12.2 | 10.0 | 12.2 | 12.8 | 9.9 | 10.0 | 11.7 | 12.8 | 13.2 | 13.0 | 11.2 | 10.0 |

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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