

Driving Home the Point

Housing continues to be a pivotal driver of economic growth. This was clear with the latest revision to the first quarter GDP growth figures, which registered housing consumption and investment at 22 percent of GDP growth over the first three months of this year. The strong support that housing activity has provided to the overall economy is further demonstrated by including consumer spending related to renovations and home buying.

Separate from housing consumption, residential fixed investment (RFI) accounted for 15 percent of first quarter nominal GDP growth. RFI primarily consists of spending on new construction and renovations, but also includes real estate sales commissions. During the spring, new housing starts and home sales continued at a brisk pace, but single-family starts were off slightly from the record pace of the first quarter. However, new and existing home sales were poised to set another quarterly record during the second quarter. Thus, housing will continue to be an important component that sustains economic growth, although its contribution to growth will likely be less than its first-quarter stimulus.

The robust housing activity is directly related to the level of mortgage rates. The dip in 30-year fixed-rate mortgage rates to a 14-month low in June rekindled housing demand and sparked the record pace of sales activity. Adjustable-rate mortgage (ARM) rates have also remained low as lenders have gradually increased the amount of the initial-rate discount offered on these products. For example, during the last week of June, the average fully indexed rate on a 1-year ARM was 6.24 percent compared with an average starting rate of 4.24 percent, or a 200-basis point discount. This is the largest initial-rate discount on a 1-year ARM in more than five years. Larger rate discounts, and a proliferation of ARM products that offer payment flexibility (such as the “interest-only” and “option-payment” products) have kept the ARM share of originations close to one-third of primary market production. The ARM share is likely to hover around that level for much of this year before moving lower next year as the Fed continues to raise short-term interest rates.

Ah yes, the Fed... According to the June 30 FOMC statement, the Fed continues to view monetary policy as accommodative. It maintains the position that it has room to move toward a neutral monetary policy at a “measured” pace. In plain English, we expect the Fed to set the federal funds target at 3.5 percent on August 9 – a quarter-point increase timed with its next FOMC meeting, and consistent with the “measured” steps that it has taken over the past 13 months.

The Fed is concerned with what it sees as near-term inflationary pressures in the economy. Some of these pressures come from record levels of crude oil prices, which have hovered near or slightly above \$60 a barrel over the past month; the tragic bombings in London heighten the degree of economic uncertainty and may increase “risk premia” in futures contracts. Chairman Greenspan has also expressed concern over house-price “froth” in some local markets across the U.S. According to data from LoanPerformance, investor and second-home lending, as a share of single-family purchase-money originations, has crept up over the past year, and accounted for about 20 percent of the number of prime, conventional loans during the first quarter of 2005 – nearly double the level of six years ago. While speculative fervor could contribute to house price gains in some local markets, we expect home-value appreciation to moderate over the coming year as mortgage rates gradually move higher.

Details

- *Real GDP growth.* The final value for the first quarter real GDP growth stands at 3.8% – exactly where we said it would be in our December 2004 Outlook. We also correctly predicted the upward revisions in the advance and the preliminary GDP growth measurements in our May and June 2005 Outlooks. Hoping to continue our streak of spot-on forecasting, we are now predicting real GDP growth in the second, third and fourth quarters of 3.5%, 3.7%, and 3.7%, respectively.
- *Consumer price inflation.* Record high oil prices have once again appeared, pushing inflation up in the second quarter. Our prediction is a 4.2% increase in the Consumer Price Index, annualized, in the second quarter, slowing to an annualized inflation rate of 2.5% or lower over the next six quarters.
- *Unemployment rate.* The national unemployment rate fell to 5.1% in May, its lowest level since September 2001. As a result, we lowered our forecast for the unemployment rate by one-tenth of a percent for the second quarter, to 5.1%, and in each of the next three quarters. An unemployment rate of 5.0% is now expected in the fourth quarter of this year rather than the second quarter of 2006.
- *Mortgage rates.* Long-term mortgage rates are steadfastly refusing to go higher, and, in fact, retreated throughout the second quarter. Low inflation expectations, low 10-year Treasury bond rates and Fed assurances that price stability is their number-one concern lead us to think that 30-year fixed mortgage rates will average 5.8% again this year – the same average rate we have enjoyed for the past two years.
- *ARM Share.* ARMs are getting more expensive with each Fed rate hike, but teaser rates are prevalent on typical 1-year ARMs. The wide availability now of both regular interest-only hybrid ARMs as well as option-payment hybrid ARMs (where the borrower can choose between a minimum payment (usually with negative amortization), an interest only payment, or a 30-year or 15-year amortization payment), have also pushed the ARM share higher than it otherwise would be. We boosted our annual average ARM share for 2005 to 32% from last month's forecasted level of 31%.
- *Housing starts.* Home construction is still a shining star in the economy. We have given in after five months of record and near record levels of housing starts, and are now expecting a new record for total housing starts in 2005 of 1.99 million units, falling to 1.83 million units in 2006.
- *Home sales.* Like housing starts, the home sales numbers for the first five months of the year lead us to declare that 2005 will be a record year for new and existing single-family house sales at 7.21 million transactions. Slightly higher mortgage rates are expected to slow sales in 2006 to 6.73 million.
- *Home value appreciation.* Record house sales and very low inventories of homes-for-sale will continue to put pressure on home prices. We increased our forecast for home price growth slightly to 7.9% for 2005, up from our June forecast of 7.7% for the year. We are expecting further moderation in home price growth in 2006 to just under 7%.
- *Mortgage activity.* Our expectation that mortgage rates will be lower than we were predicting last month moves our forecast of 2005 mortgage originations upward to \$2.62 trillion, about \$100 billion more than we previously forecasted. We also increased our originations prediction for 2006 to \$2.35 trillion. Refis are expected to make up 42% of mortgage applications in 2005, falling to 30% in 2006.

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Major Economic Indicators																	
Indicator	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	3.8	3.5	3.7	3.7	3.5	3.5	3.5	3.5	0.2	2.3	4.4	3.9	3.7	3.5	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	2.2	2.0	2.5	2.5	2.5	2.5	1.8	2.2	1.9	3.4	2.7	2.5	2.5
Unemployment Rate (%) b.	5.4	5.4	5.3	5.1	5.1	5.0	5.0	5.0	5.0	5.0	4.8	5.8	6.0	5.5	5.1	5.0	5.0
30-Year Fixed Mtg. Rate (%) b.	5.9	5.7	5.8	5.7	5.8	5.9	6.0	6.1	6.2	6.3	7.0	6.5	5.8	5.8	5.8	6.2	6.5
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	4.3	4.4	4.5	4.6	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	3.3	3.7	3.8	3.9	4.0	4.1	4.1	3.5	2.0	1.2	1.9	3.5	4.0	4.3

Housing and Mortgage Markets																	
Indicator	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	2.01	1.98	1.89	1.85	1.81	1.83	1.81	1.60	1.70	1.85	1.96	1.99	1.83	1.79
Total Home Sales d.	7.13	7.29	7.22	7.53	7.10	7.00	6.80	6.75	6.70	6.65	5.64	5.95	6.54	7.17	7.21	6.73	6.39
House Price Appreciation (%) e.	17.6	9.7	9.6	8.6	6.9	6.5	7.0	7.2	7.2	5.6	7.5	7.3	8.3	11.0	7.9	6.8	6.2
1-4 Family Mortgage Originations f.																	
Conventional	\$659	\$650	\$568	\$647	\$689	\$589	\$503	\$577	\$606	\$536	\$1,900	\$2,696	\$3,629	\$2,605	\$2,494	\$2,222	\$2,191
FHA & VA	\$30	\$23	\$21	\$36	\$37	\$31	\$28	\$33	\$35	\$31	\$167	\$187	\$231	\$129	\$125	\$127	\$149
Total	\$689	\$673	\$589	\$683	\$726	\$620	\$531	\$610	\$641	\$567	\$2,067	\$2,883	\$3,860	\$2,734	\$2,619	\$2,349	\$2,340
ARM Share (%) g.	38	36	32	33	32	32	31	29	28	26	12	17	19	34	32	29	22
Refinancing Share (%) h.	39	47	45	42	41	38	36	28	28	29	57	59	65	46	42	30	28
Residential Mortgage Debt (%) i.	16.7	11.6	9.2	16.3	14.6	11.4	10.4	13.0	12.6	9.8	10.0	11.7	12.8	13.4	12.9	11.5	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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