

### *Rita*

Hurricane Rita battered the Gulf coast just three short weeks after Katrina, and while no where as severe nor as close to major population centers, it wreaked a fair amount of destruction and undid some of the reconstruction in the New Orleans area. The double whammy of two substantial storms hitting nearly the same coastline has severe repercussions for economic growth and the labor market. The clearest sign of their effect was in the Department of Labor's report for the month of September. Payroll employment outside of farms fell for the first time since May 2003, down by 35,000. Over the prior year, the average monthly job gain had been 194,000, thus the storms had wiped out a net of about 200,000 jobs last month. The biggest losses were in retail, which dropped 88,000, and leisure and hospitality, down 80,000 as hotel and casino jobs were washed away. Manufacturing continued to shed jobs, losing another 27,000 in September. On the positive side, construction jobs were up once again, as single-family construction remains on a record-setting pace in 2005.

Shuttered businesses, lost jobs, import-export delays through the New Orleans area (the fifth busiest port in the U.S.), and higher energy costs will reduce GDP growth by about one-half of a percentage point (annualized rate) in the final months of 2005, to an estimated 3.5% growth rate. The federal monies that will go to reconstruction will have a significant stimulative effect by early next year, adding about 0.5% (annual rate) to economic growth over the first half of 2006. While crude oil prices may gradually moderate in coming months, there are reports of natural gas shortages looming as the nation approaches the winter heating season, raising the specter of higher heating bills for many northern households.

With the employment report not as bad as some had feared, economic growth likely to accelerate in 2006, and the specter of higher energy costs adding to inflationary concerns, it is likely that the Federal Reserve will continue to boost the federal funds target at quarter-point increments, timed with Federal Open Market Committee (FOMC) meetings. Thus, barring any further shocks that may derail economic activity, the Federal Reserve may well boost the target at both its November 1 and December 13 meetings, placing the federal funds rate at 4.25% by year-end.

Acceleration in U.S. growth and rising energy costs will likely translate into higher long-term rates as well. Thus, mortgage rates, from 1-year ARMs to hybrids to 15-year and 30-year fixed-rate loans, are projected to rise gradually over the next year. For example, 30-year fixed-rate loans are projected to rise from an average of 5.8% in September 2005 to 6.4% by December 2006.

Home sales will hit a record in 2005, but higher mortgage rates will ease overall demand next year, resulting in less sales and a significant slowdown in home-value appreciation. The reconstruction efforts will place additional upward pressure on construction material costs. Since construction materials account for about one-third of the cost of a new home, increases in costs for lumber, cement, gypsum board and other materials of only 5% to 10% could add 2% to 3% to new home costs over the next year. Refinance will slow further and account for only about one-third of new loan production in 2006, the lowest share since 2000. Single-family originations will be off by about 5% in 2006 from this year's volume as a result; purchase-money lending should remain robust, as a dip in home sales will be largely offset by higher home values, thereby maintaining home-purchase originations.

## Details

- *Real GDP growth.* Despite major challenges to the economy from Hurricanes Katrina and Rita in conjunction with high energy prices, our forecast of GDP remains at 3.5% (annualized rate) for the last two quarters of 2005. We expect GDP growth in the first half of 2006 to receive a boost from additional government spending in the Gulf region; federal approval is now at \$62 billion and may increase. Our estimate of first quarter growth in 2006 stands at 4.3% at an annualized rate.
- *Consumer price inflation.* We increased our estimate of CPI inflation in the third quarter from 3.2% to 5.5% due to the short-term disarray in oil production and refining caused by the hurricanes. We expect CPI inflation to moderate back towards a manageable 2.5% in 2006 as energy costs moderate. Tight labor markets and growth in hourly labor compensation may put upward pressure on the CPI in 2006.
- *Unemployment rate.* The unemployment rate rose to 5.1% for the month of September from 4.9% in August. In some sense this was good news because many economists expected job losses to be four times greater than the reported 35,000. However, these numbers should be interpreted with caution, as the full extent of Katrina and especially Rita is not accounted for in the September statistics.
- *Mortgage rates.* The Federal Reserve Board's determination to reign in inflationary pressure is exhibited by their steadfast strategy of increasing the funds rate by a quarter of a percent over the last 11 FOMC meetings. Short-term rates may increase in the last quarter of 2005 as the Board seeks to achieve a neutral monetary policy. Despite this flattening of the yield curve we forecast that 30-year fixed interest rate will end 2005 near 6% and end 2006 near 6.4%.
- *ARM Share.* The ARM share of originations will continue to decline as the mortgage yield curve flattens. However they will remain a significant component of originations at about one third of the total in the latter part of this year and averaging 26% of purchase-money originations during 2006.
- *Housing starts.* We predict that housing starts will be strong at 2.04 million units in 2005 and at 1.9 million units in 2006. New single-family construction, already setting records due to historically low interests rates, will be amplified in 2006 by the rebuilding efforts in the Gulf region.
- *Home sales.* Our forecasts of home sales holds steady at 7.31 million units and 7.07 million units in 2005 and 2006 respectively.
- *Home value appreciation.* Slower GDP growth in the latter half of this year coupled with slightly higher mortgage rates will dampen the demand for housing slightly in 2005 and we have decreased our estimate of third quarter house price appreciation forecast by a percentage point to 10.5%. We expect that home-value growth to slow to 7.1% in the fourth quarter as the market cools in response to increased mortgage rates.
- *Mortgage activity.* Even in the presence of increased mortgage rates and slowed income growth mortgage activity remains strong in 2005 and the first half of 2006. Refinance activity will continue to decline, averaging one-third of lending volume in 2006. We have elevated our projection of total mortgage originations to approximately \$2.75 trillion in 2005 and \$2.6 trillion in 2006.
- *Mortgage Debt.* Moreover, increased mortgage rates and slowed house price appreciation has led us to revise our estimate of growth in residential mortgage debt downward to 12.6% and 11.5% in 2005 and 2006 respectively.

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Economic and Housing Market Outlook  
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Major Economic Indicators																			
Indicator	2004		2005				2006				2007		Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006	2007
Real GDP (%)	4.0	3.3	3.8	3.3	3.5	3.5	4.3	3.9	3.5	3.3	3.5	3.5	0.2	1.9	4.0	3.8	3.5	3.8	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	5.5	3.3	2.5	2.5	2.5	2.5	2.5	2.5	1.8	2.2	1.9	3.4	3.9	2.5	2.5
Unemployment Rate (%) b.	5.4	5.4	5.3	5.1	5.0	5.0	5.0	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	6.0	6.1	6.2	6.3	6.4	6.4	6.5	7.0	6.5	5.8	5.8	5.8	6.2	6.5
1-Year Treas. Indexed ARM Rate (%) b.	4.1	4.1	4.2	4.2	4.5	5.0	5.2	5.3	5.5	5.6	5.8	5.9	5.8	4.6	3.8	3.9	4.5	5.4	6.0
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	4.4	4.6	4.6	4.7	4.8	4.9	5.0	5.0	4.6	4.0	4.3	4.3	4.7	5.0
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.3	3.8	4.1	4.2	4.3	4.4	4.4	4.5	4.5	3.5	2.0	1.2	1.9	3.6	4.3	4.5

Housing and Mortgage Markets																			
Indicator	2004		2005				2006				2007		Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006	2007
Housing Starts c.	1.97	1.97	2.08	2.04	2.04	2.00	1.92	1.88	1.90	1.88	1.80	1.74	1.60	1.70	1.85	1.96	2.04	1.90	1.74
Total Home Sales d.	7.13	7.29	7.23	7.59	7.28	7.15	7.14	7.09	7.04	6.99	6.81	6.75	5.64	5.95	6.54	7.17	7.31	7.07	6.71
House Price Appreciation (%) e.	17.5	9.8	10.5	15.0	10.5	7.1	7.5	8.3	8.2	6.8	6.7	6.9	7.5	7.3	8.4	11.2	10.8	7.7	6.3
1-4 Family Mortgage Originations f.																			
Conventional	\$649	\$693	\$599	\$710	\$725	\$615	\$552	\$667	\$685	\$592	\$536	\$642	\$1,900	\$2,696	\$3,629	\$2,776	\$2,648	\$2,496	\$2,455
FHA & VA	\$30	\$23	\$21	\$21	\$30	\$26	\$23	\$28	\$29	\$25	\$22	\$27	\$167	\$187	\$231	\$129	\$97	\$104	\$102
Total	\$679	\$717	\$620	\$731	\$755	\$641	\$575	\$695	\$714	\$616	\$559	\$669	\$2,067	\$2,883	\$3,860	\$2,905	\$2,746	\$2,600	\$2,558
ARM Share (%) g.	38	36	32	33	29	30	29	27	26	24	22	20	12	17	19	34	31	26	20
Refinancing Share (%) h.	39	47	45	42	44	41	39	30	30	31	33	27	57	59	65	46	43	33	30
Residential Mortgage Debt (%) i.	16.5	11.8	9.8	12.4	16.0	12.3	9.9	12.2	13.5	10.1	8.6	11.2	10.0	11.9	12.8	13.2	12.6	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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