

Growth Continues

The advance report estimate of third quarter real GDP growth came in above market expectations at 3.8 percent, annualized. The U.S. economy appears to be fundamentally strong despite the substantial damage wrought by Katrina and Rita. Of course then Wilma came along on October 24th and gave South Florida a piece of her mind, and more than 300,000 customers of Florida Power and Lighting were still without power about two weeks after the storm. Wilma's greatest impact on the U.S. economy will be through higher food prices and even more pressure on already high building material prices as demand for home repairs jumps, but fortunately she did not rifle through the Gulf oil and gas infrastructure the way her two siblings did.

The October jobs report again showed a big impact from Katrina and Rita now that hurricane-devastated businesses are assessing their needs and capacity to support workers. Prior to the hurricanes the U.S. economy was adding a little more than 190,000 non-farm payroll jobs per month. In September a net 8,000 jobs were lost and in October just 56,000 new jobs were gained. In the absence of the storms we would have expected the economy to have added another 310,000 to 330,000 jobs in those two months. As the rebuilding effort gets underway these jobs should return.

The combination of strong economic growth and rising inflationary pressures from the energy sectors led the Federal Reserve's Federal Open Market Committee (FOMC) to once again raise the benchmark federal funds rate by one-quarter of a percentage point, to 4 percent. The FOMC's action translates into a direct effect on certain mortgage rates by increasing the prime rate – the index used for most home equity lines of credit – to 7 percent and pushing up other short-term interest rates used as the basis for adjustable-rate mortgages (ARMs).

In the Primary Mortgage Market SurveySM from Freddie Mac, for the week ended November 3, 2005, contract rates on 1-year ARMs rose above 5 percent for the first time since March of 2002. The Fed's actions have an indirect effect on longer-term interest rates through influencing expectations of future inflation and monetary policy – 30-year fixed mortgage rates rose to 6.3% in reaction to the strong third-quarter GDP figures and the possibility of higher inflation. However, as noted in the FOMC's November 1st statement, "core inflation has been relatively low in recent months and longer-term inflation expectations remain contained." We expect 30-year FRM rates to average 6.2 percent in the fourth quarter, rising to 6.5 percent by the end of 2006; start rates on one-year ARMs will likely rise to 5.3 percent by the fourth quarter of 2006.

Mortgage borrowers continue to extract home equity through refinancing. Freddie Mac's Cash-out Refinance Report, released November 1, shows that homeowners cashed out \$60.4 billion in home equity when refinancing a mortgage during the third quarter – homeowners are expected to extract \$204 billion in home equity in 2005. Borrowers that refinanced during the third quarter lowered their 30-year fixed mortgage rates an average 0.57 percentage points, or \$55 per month on a \$150,000 loan. Both the cash extraction and the lower mortgage payments help fuel consumer spending and economic growth.

Details

- *Real GDP growth.* Resilience and momentum characterize the U.S. economy in the second half of this year. Three successive hurricanes, though devastating to the impacted areas, did not thwart above trend growth nationally. The preliminary estimate of annualized GDP growth in the third quarter is 3.8% and we're forecasting 3.5% growth in the fourth quarter. Robust growth will continue into 2006 stimulated in part by the rebuilding effort in the Gulf region.
- *Consumer price inflation.* Overall the surge in oil prices appears to be receding. Though natural gas prices will be a thorn in the side of households this coming winter, energy price surges are not expected to have a large impact on non-energy prices. We have revised our 4th quarter estimate of CPI upwards to 4% to reflect the short-term impact of the hurricanes. However, we expect CPI inflation to slow to a moderate pace of 2.5% in 2006.
- *Unemployment rate.* The October jobs report indicates that the economy added 56,000 non-farm payroll jobs, substantially less than many economists had expected. Regions outside those directly affected by the hurricanes experienced below trend job growth in October, possibly as a result of hurricane related spikes in energy prices. Nevertheless, strong economic growth leads us to decrease our unemployment forecast in the 4th quarter to 5.0% from 5.1% last month.
- *Mortgage rates.* We increased our forecast of the 30-year fixed rate by 20 basis points to 6.2% in the fourth quarter, and expect it to average 5.9% and 6.4% for 2005 and 2006, respectively. The 1-year ARM is also on the rise, reaching an average of 5.0% in the 4th quarter and averaging 4.5% for the year.
- *ARM Share.* Flattening of the yield curve (primarily through increasing short-term rates) will cause the adjustable-rate share of mortgage lending to drift down gradually over the next year; our estimate is at 31% and 28% for 2005 and 2006, respectively.
- *Housing starts.* Solid income growth continues to foster demand for new housing despite increases in home building costs. Our expectation for total housing starts in 2005 is at 2.05 million units, up slightly from our October Outlook. Housing starts are expected to decrease 7.3% in 2006 to 1.9 million units as a consequence of higher mortgage rates.
- *Home sales.* Total home sales will easily set a record level in 2005 at around 7.5 million units. We increased our 2006 forecast to 7.0 million— a 7% dip from the expected 2005 level set; this is a lower projection than last month's estimate and it ties to our higher interest rate forecast for 2006.
- *Home value appreciation.* Because of higher mortgage rates and seasonal effects we decreased our forecast of 4th quarter house price appreciation to 5.4%, annualized. Still, even with higher mortgage rates, we expect house price growth to average 7.5% in 2006 due to continued strong economic growth and high home building costs.
- *Mortgage activity.* Even with higher mortgage rates, refinancing activity was strong in the 3rd quarter, with 44 percent of new mortgage applications being submitted for refis. As interest rates continue to increase the refi share will drop to one-third of total originations in 2006.
- *Mortgage Debt.* We decreased slightly our estimate of growth in residential mortgage debt to 12.5% in 2005 and 11% in 2006 to reflect the higher mortgage rates and lower house price growth identified in this month's forecast.

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Indicator	Major Economic Indicators																		
	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	3.8	3.5	4.3	3.9	3.5	3.3	3.5	3.5	0.2	1.9	4.0	3.8	3.6	3.8	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	5.1	4.0	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	6.2	6.3	6.3	6.4	6.5	6.5	6.6	7.0	6.5	5.8	5.8	5.9	6.4	6.6
1-Year Treas. Indexed ARM Rate (%) b.	4.1	4.1	4.2	4.2	4.5	5.0	5.1	5.1	5.2	5.3	5.4	5.4	5.8	4.6	3.8	3.9	4.5	5.2	5.4
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	4.5	4.7	4.7	4.8	4.8	4.9	4.9	5.0	4.6	4.0	4.3	4.3	4.8	5.0
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.3	3.8	4.3	4.5	4.6	4.7	4.7	4.8	4.8	3.5	2.0	1.2	1.9	3.6	4.6	4.9

Indicator	Housing and Mortgage Markets																		
	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	2.07	2.00	1.95	1.88	1.90	1.85	1.80	1.74	1.60	1.70	1.85	1.96	2.05	1.90	1.74
Total Home Sales d.	7.13	7.29	7.23	7.58	7.57	7.57	7.25	7.05	6.85	6.80	6.70	6.60	5.64	5.95	6.54	7.17	7.49	6.99	6.54
House Price Appreciation (%) e.	17.5	9.8	10.5	15.0	10.5	5.4	6.5	7.8	8.5	7.1	7.3	7.3	7.5	7.3	8.3	11.1	10.4	7.5	6.8
1-4 Family Mortgage Originations f.																			
Conventional	\$649	\$693	\$599	\$710	\$782	\$656	\$535	\$638	\$664	\$582	\$527	\$632	\$1,900	\$2,696	\$3,629	\$2,776	\$2,747	\$2,418	\$2,409
FHA & VA	\$30	\$23	\$21	\$21	\$22	\$27	\$22	\$27	\$28	\$24	\$22	\$26	\$167	\$187	\$231	\$129	\$91	\$101	\$100
Total	\$679	\$717	\$620	\$731	\$804	\$684	\$557	\$664	\$691	\$606	\$549	\$658	\$2,067	\$2,883	\$3,860	\$2,905	\$2,838	\$2,519	\$2,509
ARM Share (%) g.	38	36	32	33	28	29	29	28	27	26	25	24	12	17	19	34	31	28	24
Refinancing Share (%) h.	39	47	45	42	44	37	35	28	27	31	33	28	57	59	65	46	42	30	31
Residential Mortgage Debt (%) i.	16.5	11.8	9.8	12.4	16.0	11.7	9.5	11.9	12.6	9.9	8.3	11.3	10.0	11.9	12.8	13.2	12.5	11.0	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 average of monthly unemployment rates (seasonally-adjusted); Quarterly averages of monthly interest 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 detached 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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