Freddie Mac
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Office of the Chief Economist

December 2005 Economic Outlook

'Tis the Season

'Tis the season to be jolly…and, there is plenty to be jolly about where the economy is concerned. The Bureau of Economic Analysis revised its third quarter estimate of GDP growth upwards from 3.8 percent to 4.3 percent. The Labor Department released a report of a hardy 215,000 gain in payroll employment during November, more than offsetting the downward revision in October jobs to only a 44,000 pickup. Furthermore, in response to a sizable retreat in gasoline prices and an improving job market, consumer confidence rose last month to its highest level since last August. Confident consumers translate to enthusiastic shoppers, just in time for the holiday season. Retailers enjoyed sales of $27.8 billion during the kickoff weekend to the holiday shopping season, November 25-27, the second best season-starting volume in six years.

November's job growth was widespread throughout the economy, however construction did particularly well, posting 37,000 new jobs. Some of the new jobs in construction are related to the hurricane clean up and rebuilding efforts in the US Gulf Region. Estimates of the total dollar volume of construction work done in October set a record for the fourth straight month at $1.13 trillion (seasonally adjusted annual rate). Construction numbers underscore the importance of housing in the U.S. economy. New construction will continue to put upward pressure on home building costs, increasing new-house prices and supporting the value of existing homes in most areas.

All this good news has some on Wall Street betting that the Federal Reserve will up the federal funds rate at the next FOMC meeting on December 13 for the 13th straight time to offset the inflationary pressure caused by strong economic growth. The prices on futures contracts indicate traders have already anticipated a quarter percentage increase in the federal funds rate to 4.25 percent. However, robust increases in worker productivity (the amount a worker produces per hour of work) and falling labor costs may ease inflationary concerns. The Department of Labor announced this week that worker productivity more than doubled in the third quarter from second quarter estimates to an annual rate of 4.7 percent, while labor costs have decreased by 1 percent (annual rate). Labor productivity in the fourth quarter is expected to have a similar moderating effect on wage increases, further reducing inflationary pressure.

The encouraging reports about enduring productivity gains are one reason that long-term inflationary expectations have remained well contained. For four straight years, the Livingston Survey (conducted by the Philadelphia Federal Reserve Bank) has reported that financial economists expect the 10-year inflation rate of the Consumer Price Index to be 2.5 percent per year. A continuing benign inflation outlook over a long horizon helps to keep long-term interest rates low. We expect 30-year fixed-rate mortgages to carry interest rates next year that average about three-fifths of a percentage point higher than in 2005…still modest relative to the 9.5 percent average of the past 30 years.

There is a little naughty in all this niceness as natural gas prices have yet to abate, more than doubling since last year. As colder weather chills the Northeast and Midwest, residents may feel a bit of the chill in their pocketbooks. Furthermore, home equity cash-out (via conventional refinance) is expected to drop by 40 to 50 percent in 2006, further moderating consumer spending aspirations and tempering a bit of the jolliness that strong economic growth can bring.

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Details

- *Real GDP growth*. We revised our fourth quarter estimate upwards from 3.5% to 3.8%, which puts growth for 2005 at 3.8%. Our estimate for 2006 of 3.7% is slightly below the November forecast reflecting the higher interest rates over the year.
- *Consumer price inflation*. We lowered our fourth quarter estimate of consumer price growth to 3.8%, owing in part to lower gasoline prices, pegging 2005 growth at 3.9%. Over the first ten months, the core inflation rate (which excludes energy and food prices) has been at a 2.1% annual pace. We expect a decline in some of the energy prices next year causing the 2006 general inflation rate to fall to 2.5%.
- *Unemployment rate*. We are holding the unemployment rate at 5.0% for the rest of 2005, and lowered the first half of 2006 to 4.9%. We expect the strong growth in the economy over the upcoming quarters should lead to further job creation.
- *Mortgage rates*. Our interest rate forecasts for fixed-rate mortgages and ARMs are slightly higher than the previous month. We expect the 30-year fixed-rate mortgage to average 6.5% in 2006; rates for 1-year ARMs will likely average 5.5% in 2006, due to the market's expectations of federal funds hikes by the Federal Reserve. We expect these rate hikes will flatten the Treasury yield curve further, placing the interest difference between the 10-year and 1-year Treasury yields near 10 basis points in 2006.
- *ARM Share.* With ARM rates increasing, we expect the ARM share of mortgage originations to decline slightly, averaging 28% in 2006. Given the flatness of the yield curve, hybrid ARMs with longer initial adjustment periods (7/1 and 10/1) will likely become less popular among homeowners.
- *Housing starts*. We expect housing starts will taper down from their record levels set in 2005. Total starts should reach 2.05 million units in 2005 and then fall to around 1.90 million in 2006.
- *Home sales*. Similarly, total home sales will also ease over the coming new year. Homes sales should reach 7.5 million units in 2005, marking a third consecutive annual record, and then slow to 7.1 million in 2006.
- *Home value appreciation*. We see house price appreciation returning closer to its historical average over the next number of years. We predict home price growth nationally will average 11.1% in 2005 (tying 2004's growth rate), and then will grow by 8.3% in 2006 and slow to 7.6% in 2007.
- *Mortgage activity.* Single-family mortgage originations should total almost $2.9 trillion in 2005, just below the level seen in 2004. In 2006, we see originations 14% lower at $2.5 trillion due to a 40% drop in the dollar volume of refinancing activity; the refinance share of applications should fall from 41% in 2005 to 28% in 2006. Our forecast for the dollar volume of home-purchase originations increases by about 5% from 2005 to 2006. Finally, with a slowing of new construction and home sales activity, we expect the growth in residential mortgage debt outstanding will slow from 12.4% in 2005 to 10.9% in 2006.

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Economic and Housing Market Outlook

December 2005

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Major Economic Indicators

	2004		2005				2006				2007		Annual Totals						
Indicator	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	4.3	**3.8**	**4.2**	**3.8**	**3.4**	**3.2**	**3.5**	**3.5**	0.2	1.9	4.0	3.8	**3.8**	**3.7**	**3.5**
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	5.1	**3.8**	**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**	**4.9**	**4.9**	**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	**6.3**	**6.4**	**6.5**	**6.5**	**6.6**	**6.7**	**6.7**	7.0	6.5	5.8	5.8	**5.9**	**6.5**	**6.7**
1-Year Treas. Indexed ARM Rate (%) b.	4.1	4.1	4.2	4.2	4.5	**5.1**	**5.4**	**5.5**	**5.5**	**5.6**	**5.7**	**5.7**	5.8	4.6	3.8	3.9	**4.5**	**5.5**	**5.7**
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	**4.5**	**4.5**	**4.6**	**4.7**	**4.7**	**4.8**	**4.8**	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	3.8	**4.3**	**4.4**	**4.5**	**4.6**	**4.6**	**4.7**	**4.7**	3.5	2.0	1.2	1.9	**3.6**	**4.5**	**4.8**

Housing and Mortgage Markets

	2004		2005				2006				2007		Annual Totals						
Indicator	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	2.09	**2.00**	**1.95**	**1.90**	**1.88**	**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	7.61	**7.64**	**7.40**	**7.20**	**7.00**	**6.80**	**6.70**	**6.60**	5.64	5.95	6.54	7.17	**7.52**	**7.10**	**6.64**
House Price Appreciation (%) e.	20.0	10.4	10.5	15.3	12.3	**6.3**	**7.6**	**8.4**	**9.4**	**7.7**	**8.0**	**7.9**	7.5	7.2	8.1	12.3	**11.1**	**8.3**	**7.6**
1-4 Family Mortgage Originations f.																			
Conventional	$649	$693	**$599**	**$710**	**$782**	**$677**	**$525**	**$629**	**$648**	**$558**	**$495**	**$589**	$1,900	$2,696	$3,629	$2,776	**$2,768**	**$2,359**	**$2,253**
FHA & VA	$30	$23	$21	$21	$22	**$28**	**$22**	**$26**	**$27**	**$23**	**$21**	**$25**	$167	$187	$231	$129	**$92**	**$98**	**$94**
Total	$679	$717	**$620**	**$731**	**$804**	**$705**	**$547**	**$655**	**$674**	**$581**	**$516**	**$614**	$2,067	$2,883	$3,860	$2,905	**$2,859**	**$2,457**	**$2,347**
ARM Share (%) g.	38	36	32	33	28	**30**	**30**	**29**	**28**	**26**	**25**	**24**	12	17	19	34	**31**	**28**	**23**
Refinancing Share (%) h.	39	47	45	42	44	**34**	**32**	**26**	**25**	**28**	**31**	**25**	57	59	65	46	**41**	**28**	**28**
Residential Mortgage Debt (%) i.	16.5	11.8	9.8	12.4	**15.6**	**11.7**	**9.1**	**12.2**	**12.3**	**10.1**	**8.3**	**11.5**	10.0	11.9	12.8	13.2	**12.4**	**10.9**	**10.1**

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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