

## *A Soft Landing*

Every year for five years America's housing market has soared to higher and higher record heights. In 2005, single-family housing starts and home sales rose to an estimated 1.73 million homes built and 7.48 million units sold, respectively. House price growth accelerated to breathtaking double-digit rates of growth, reaching a peak of 14 percent year-over-year in the second quarter of 2005 and putting the national median purchase price of a home at \$215,000. A proliferation of innovative adjustable-rate mortgage (ARM) products made home ownership slightly more affordable to those in high-cost areas. Homeowners took advantage of the increases in house values and historically-low interest rates to refinance into lower-cost mortgages while at the same time cashing out an estimated \$2.0 billion in equity from their homes to fund home improvements, investments and consumer spending, leading residential mortgage debt outstanding to increase by 62 percent over the last 5 years.

Anecdotal evidence of a decline in housing market activity has led some to speculate that a crash in home prices is inevitable. The crash scenario is fueled by the conjecture that home-value appreciation has accelerated to an unsustainable and speculatively driven level; therefore a large market correction is required to return home values back to "normal." A more optimistic view is that the increase in house-price appreciation is driven by economic fundamentals. Income, employment and population growth, particularly along the coasts where price appreciation has been the greatest, as well as limited land supply, low interest rates and construction cost increases attributable to hurricanes have driven home-value gains. In this fundamental scenario the housing market will experience an overall deceleration, with perhaps fundamental-driven declines in some local markets or market segments like condos or high-end homes, with minimal overall impact on economic growth in 2006. Recent research by Macroeconomic Advisors, LLC indicates that even a gloomy view of a downturn in the housing sector will clip GDP growth by only 0.2 percentage points.

But there is turbulence on the horizon in the shape of an inverted yield curve wherein short-term rates are higher than long-term rates. The bond market takes an inverted curve as a harbinger of an economic recession, but the Federal Reserve Board has cautioned using such a reading in this recent slight inversion. Other signals of the strength of the economy are positive – low unemployment rate at 4.9 percent, robust GDP growth in 2006 at 3.6 percent and tame inflation expectations of 2.5 percent.

Higher short-term rates may lead to a bumpy descent for those homeowners who relied on ARMs to purchase their homes. The interest rate savings on ARMs are now smaller, even with the initial rate discounts that are offered by lenders. According to Freddie Mac's Annual ARM Survey, the one-year adjustable rate loan carried a rate that was 1.6 percentage points below that of a 30-year fixed-rate loan at the end of 2004, but only 0.9 percentage points lower at year's end 2005. This reduction in spread will likely slow ARM lending activity in 2006 and may further impact affordability in very high cost markets. Long-term rates are still low compared to historical levels and provide a viable alternative to ARM products, but higher home prices will continue affordability pressures.

Without question America's joy ride in the housing market is coming to an end. However, a slowdown from record highs does not necessarily lead to a crash. Conditions are favorable for a soft landing, perhaps with a little turbulence on the approach.

## Details

- *Real GDP growth.* The final estimate for third quarter economic growth came in below the preliminary one, putting real GDP growth at 4.1% for the quarter, still a very healthy number. Our outlook for the fourth quarter at 3.5% and the first half of 2006 at 3.8% is down from our forecast last month, but is still very strong historically and at those levels should keep employment growth healthy in 2006.
- *Consumer price inflation.* Oil prices have been moderating recently, although there is still a sizeable risk that oil prices could shoot up again and stay high. But absent any unforeseen problems we are expecting overall price inflation, as measured by the Consumer Price Index, to be low at 2.5% throughout 2006.
- *Unemployment rate.* There was a lot of good news in the December employment report: the unemployment rate dipped lower again to 4.9%, 108,000 new non-farm payroll jobs were added, and as an extra bit of good news, the already high November payroll numbers were revised upward by nearly 50% to 305,000 jobs. The unemployment rate should stay between 4.9 and 5% in 2006.
- *Mortgage rates.* The decline in expected inflation and signaling by the Fed that it will likely slow the rate of increases in the Fed Funds rate in 2006 has moderated pressure on long-term Treasury rates, and hence, on long-term, fixed mortgage rates. Our rates forecasts are 10 basis points lower than last month's levels, so we now expect 30-year fixed-rate mortgages (FRMs) to average 6.4% over the year. The inverting of the yield curve will put short- and long-term Treasury rates very close together, but mortgage lenders will likely continue their deep discount teaser rates on 1-year adjustable-rate mortgages (ARMs) so that they will remain about 1 percentage point lower than the rate on 30-year FRMs. The average teaser discount was 1.95% in December putting the average rate on 1-year ARMs at 5.17% with 0.7 points while the average 30-year FRM had a rate of 6.27% with 0.5 points according to the Primary Mortgage Market Survey<sup>SM</sup>.
- *ARM Share.* Even with deep discounts, ARMs will lose some of their appeal in 2006, falling from the 31% share of applications they enjoyed in 2005 to around 27% in 2006. According to data from LoanPerformance, 30.6% of ARMs used for home purchase and 18.4% of ARM refi loans held in private-label mortgage-backed securities as of September 2005 have an interest-only feature. These loans will likely continue to be popular in high-cost markets where affordability is a growing problem.
- *Housing starts.* Increasing interest rates will start to slow the housing market from its record pace of 2005. We are expecting housing starts to fall as much as 9% to 1.90 million units in 2006. If this projection is accurate, 2006 will be the third best year for single-family housing construction ever.
- *Home sales.* Home sales will again set a new record in 2005, running at a pace of 7.48 million units through November. Sales should slow in 2006 by about 5%, to 7.10 million units, which would be the third best sales level ever, just behind 2004's level of 7.17 million homes sold.
- *Home value appreciation.* Modestly higher interest rates will dampen enthusiasm in the housing market and lead to slower, but still positive, appreciation at the national level. For 2005 we are anticipating the year-over-year home price growth rate to be near 10.9% when the 4<sup>th</sup> quarter release of the Conventional Mortgage Home Price Index arrives in March, and then slow to around 7.0% in 2006.
- *Mortgage activity.* Refi activity is expected to be higher in 2006 than would normally be anticipated with rising interest rates due to the large volume of ARMs up for a rate reset next year. We raised our forecast of refi share of applications to 32% in 2006 and that brings our estimated mortgage originations volume to \$2.47 trillion and the increase in mortgage debt outstanding to 11.6%. The total originations volume in 2005 is estimated at \$2.86 trillion with a refi share of mortgage applications at 44%.

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## Office of the Chief Economist Economic and Housing Market Outlook January 2006

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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	2002	2003	2004	2005	2006	2007	2008	
	Real GDP (%)	4.0	3.3	3.8	3.3	4.1	3.5	4.0	3.6	3.4	3.2	3.5	3.5	1.9	4.1	3.8	3.7	3.6	3.5	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	5.1	3.6	2.5	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.4	2.5	2.5	2.5	
Unemployment Rate (%) b.	5.4	5.4	5.3	5.1	5.0	4.9	4.9	4.9	5.0	5.0	5.0	5.0	5.8	6.0	5.5	5.1	5.0	5.0	5.0	
30-Year Fixed Mtg. Rate (%) b.	5.9	5.7	5.8	5.7	5.8	6.2	6.3	6.4	6.4	6.5	6.5	6.6	6.5	5.8	5.8	5.9	6.4	6.6	6.8	
1-Year Treas. Indexed ARM Rate (%) b.	4.1	4.1	4.2	4.2	4.5	5.1	5.3	5.4	5.4	5.5	5.5	5.6	4.6	3.8	3.9	4.5	5.4	5.6	5.8	
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	4.5	4.4	4.5	4.6	4.6	4.7	4.7	4.6	4.0	4.3	4.3	4.5	4.8	5.0	
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.3	3.8	4.3	4.4	4.5	4.5	4.6	4.7	4.7	2.0	1.2	1.9	3.6	4.5	4.7	4.9	

### Housing and Mortgage Markets

Indicator	2004		2005				2006				2007		Annual Totals							
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2002	2003	2004	2005	2006	2007	2008	
	Housing Starts c.	1.97	1.97	2.08	2.04	2.10	2.10	1.95	1.90	1.88	1.85	1.80	1.74	1.71	1.85	1.95	2.08	1.90	1.74	1.70
Total Home Sales d.	7.13	7.29	7.23	7.58	7.61	7.50	7.40	7.20	7.00	6.80	6.80	6.75	5.97	6.53	7.17	7.48	7.10	6.69	6.47	
House Price Appreciation (%) e.	20.0	10.4	10.5	15.3	12.3	5.6	6.4	7.0	8.0	6.5	7.0	6.9	7.2	8.1	12.3	10.9	7.0	6.8	6.3	
1-4 Family Mortgage Originations f.																				
Conventional	\$649	\$693	\$599	\$710	\$782	\$677	\$533	\$628	\$649	\$559	\$496	\$589	\$2,696	\$3,629	\$2,776	\$2,768	\$2,369	\$2,251	\$2,257	
FHA & VA	\$30	\$23	\$21	\$21	\$22	\$28	\$22	\$26	\$27	\$23	\$21	\$25	\$187	\$231	\$129	\$92	\$99	\$94	\$94	
Total	\$679	\$717	\$620	\$731	\$804	\$705	\$555	\$654	\$676	\$582	\$517	\$613	\$2,883	\$3,860	\$2,905	\$2,860	\$2,468	\$2,345	\$2,351	
ARM Share (%) g.	38	36	32	33	28	29	29	27	26	25	24	23	17	19	34	31	27	22	20	
Refinancing Share (%) h.	39	47	45	42	44	44	39	31	28	30	31	26	59	65	46	44	32	28	27	
Residential Mortgage Debt (%) i.	16.6	13.1	9.9	14.6	15.2	12.5	10.0	12.6	12.7	10.9	9.0	12.1	11.8	12.7	13.7	13.1	11.6	10.8	10.3	

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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