

### *Where the Jobs Are*

The employment numbers for the first quarter of 2006 are strong. The economy added 211,000 jobs in March, preceded by a revised 225,000 jobs in February and 154,000 jobs in January. In the last four months average hourly earnings have increased by 21 cents. The unemployment rate for the 1<sup>st</sup> quarter is 4.7 percent, the lowest in eighteen quarters. All of this good job news comes with a concern: many of the new jobs are in states where the booming housing market has eroded the affordability of single-family homes.

The inverse relationship between job growth and affordability is most clearly seen in two regions of the country where job creation has been the highest (the West Coast) and the lowest (the Midwest). From February 2005 to February 2006 the West Coast added 610,000 jobs. The Midwest, on the other hand, added about a third of that total or 224,000 jobs. (The two regions have roughly equal populations). Moreover, Michigan and Ohio actually lost jobs this February. Now let's contrast the employment figures with measures of housing affordability. According to the National Association of Realtors the median income household could purchase 164 percent of the median priced house in the Midwest. On the West Coast, the median income household could only afford 81 percent of the median priced house. Furthermore, regional disparities have grown. The difference between the fastest house price growth region in the US and the slowest house price growth region last year was 12 percentage points up from 4 percentage points ten years ago. The challenge for some families is to find a good job and affordable housing in the same location.

One vehicle for managing the affordability problem in the high cost areas has been to finance a home purchase with a nontraditional adjustable-rate mortgage (ARM). Nontraditional ARM products, namely interest-only and negative amortization ARMs, differ from traditional mortgage products because the homeowner avoids making principal payments in the first few years of the loan. As its name suggests for interest-only payments, borrowers pay only the monthly interest cost, with negative amortization loans borrowers repay less than the monthly accumulated interest, which increases the size of the mortgage principal balance. Nontraditional ARMs were primarily designed for borrowers who earned income at variable times of the year, through sales commissions for example. These products are now being marketed to a wider variety of households to help them purchase homes in higher cost markets. Based on data from LoanPerformance, interest-only and negative amortization ARMs climbed from 11 percent of all ARM originations in 2003 to 31 percent in 2005.

The cooling housing market in 2006 will deflate some of the affordability pressures as house price growth moderates to the single digits. Additionally, long-term interest rates will rise modestly; we estimate that the 30-year fixed rate mortgage will end the year at a moderate 6.5 percent. We expect a slight decline in single-family originations by 13 percent to 2.45 trillion dollars. The labor market will continue to be solid in 2006 and beyond; we forecast that unemployment will be below 5 percent for the next two years. The lingering question is whether affordability will increase in the West and job creation will return to the Midwest.

## Details

- *Real GDP growth.* Indicators thus far for the first quarter are pointing to stronger economic growth than we first predicted. We have revised our real GDP growth estimate for the first quarter to 5% but shaved two-tenths off the second quarter growth forecast to put it at 3.8%. On net, these changes bring down our forecast for GDP growth to a very healthy 3.8% for the year.
- *Consumer price inflation.* Oil price volatility still plagues the economy, making any reading of true inflationary pressures difficult to pin down. Nonetheless, we expect average price inflation, as measured by the consumer price index, to be stable at 2.5% throughout the year.
- *Unemployment rate.* The March payroll employment numbers came in a strong 211,000, ahead of expectations, but the January and February numbers were revised downward. The first quarter saw 590,000 jobs added, and an average unemployment rate of 4.7%. With our strong forecast for real GDP growth we are predicting that the economy will add between 2 and 2.5 million new jobs this year with an unemployment rate averaging 4.8%.
- *Mortgage rates.* The Fed has again stated that it remains vigilant in its fight for price stability, and the bond markets have shown that they trust the Fed – which translates into low yields on 10-year Treasury notes and thus low rates for 30-year fixed-rate mortgages (FRMs). We are expecting to see an average rate of 6.5% on 30-year FRMs in the 4<sup>th</sup> quarter, which is just 20 basis points higher than the 1<sup>st</sup> quarter average. We are also expecting the flat or inverted yield curve to be with us for the rest of the year, but low introductory or “teaser” rates on 1-year ARMs will keep their rates below those on 30-year FRMs.
- *ARM Share.* The ARM share is higher today than what it traditionally would be, due, in large part, to interest-only and option-payment hybrid ARMs which create an attractive option to FRMs that would not otherwise be present with the inverted yield curve. We did not change our forecast of the ARM share from the March Outlook, and have it averaging 27% in 2006, down from 31% in 2005.
- *Housing starts.* Last month we were forecasting total housing starts at 2.04 million units at a seasonally adjusted annualized rate (SAAR) for the first quarter, but the starts numbers for the first two months were so strong that we have revised this number to 2.21 million units (SAAR), putting our year-end total estimate at 1.99 million units, representing a 4% decline from 2005’s volume.
- *Home sales.* Unlike starts, combined new and existing single-family home sales slipped during the first two months to 7.07 million units (SAAR). As a result of these numbers we took down our forecast for 2006 across the board, and our new forecast for 2006 shows a 7% decline from 2005’s record high.
- *Home value appreciation.* With slower home sales and modestly higher interest rates we expect a slowing in home price appreciation to below 10% nationally. Our current prediction has house price growth averaging 8.7% for 2006, with stronger growth happening in the first part of the year.
- *Mortgage activity.* Total single-family mortgage originations are expected to hit over \$2.45 trillion in 2006, a 13% decline from 2005 volumes. With slower home sales but still-strong home price growth, purchase-money originations may exceed 2005’s volumes, but the decline in the refinance share of applications (and hence originations) is responsible for the expected decline in total originations. The refi share of applications is forecasted at 36% in 2006, down from 44% in 2005. Total single-family mortgage debt outstanding is expected to grow 12.6% this year, reflecting housing and mortgage markets, that while down from record highs, are still going strong at the national level.

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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	1.7	5.0	3.8	3.4	3.0	3.5	3.5	1.9	4.1	3.8	3.2	3.8	3.5	3.5
Consumer Prices (%) a.	2.1	3.5	2.5	3.7	5.5	3.2	2.5	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.7	2.5	2.5	2.5	
Unemployment Rate (%) b.	5.4	5.4	5.2	5.1	5.0	4.9	4.7	4.8	4.8	4.8	4.9	4.9	5.8	6.0	5.5	5.1	4.8	4.9	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	5.5	5.6	5.7	5.7	5.7	4.6	3.8	3.9	4.5	5.5	5.7	5.8	
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	4.5	4.6	4.7	4.7	4.8	4.8	4.9	4.6	4.0	4.3	4.3	4.7	5.0	5.2	
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.3	3.8	4.3	4.6	4.9	4.9	5.0	5.0	5.0	2.0	1.2	1.9	3.6	4.9	5.0	5.1	

### 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	2.06	2.21	1.98	1.89	1.86	1.87	1.86	1.70	1.85	1.96	2.07	1.99	1.85	1.78
Total Home Sales d.	7.08	7.29	7.33	7.56	7.57	7.36	7.07	6.95	6.90	6.80	6.75	6.70	5.95	6.54	7.17	7.46	6.93	6.65	6.44	
House Price Appreciation (%) e.	19.5	10.7	10.7	15.4	13.4	12.5	9.2	8.9	9.0	7.6	7.6	7.3	7.2	8.0	12.1	13.0	8.7	7.0	6.3	
1-4 Family Mortgage Originations f.																				
Conventional	\$649	\$693	\$599	\$710	\$782	\$655	\$496	\$619	\$652	\$592	\$515	\$581	\$2,696	\$3,629	\$2,776	\$2,746	\$2,359	\$2,283	\$2,258	
FHA & VA	\$30	\$23	\$21	\$21	\$22	\$19	\$21	\$26	\$27	\$25	\$21	\$24	\$187	\$231	\$129	\$83	\$98	\$95	\$119	
Total	\$679	\$717	\$620	\$731	\$804	\$674	\$517	\$645	\$679	\$616	\$537	\$605	\$2,883	\$3,860	\$2,905	\$2,828	\$2,457	\$2,378	\$2,376	
ARM Share (%) g.	38	36	32	33	28	29	29	28	26	24	22	21	17	19	34	31	27	21	18	
Refinancing Share (%) h.	39	47	45	42	44	45	43	33	32	34	35	28	59	65	46	44	36	31	28	
Residential Mortgage Debt (%) i.	16.6	13.1	10.0	14.8	16.4	14.2	11.7	13.3	14.2	11.3	9.7	12.6	11.8	12.7	13.8	13.8	12.6	11.1	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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