

### *Striking a Balance*

Two competing trends shape the U.S. economy in the second half of 2006 – slower economic growth and greater inflationary pressures. The economy began the year strong, growing at an annualized rate of 4 percent in the first half of the year, but is expected to slow to only 3 percent in the latter half. Meanwhile, consumer prices increased by 5 percent (seasonally adjusted annual rate) in the second quarter compared to a 2.2 percent rise in the previous quarter, fueling inflation concerns. Whether we see increased pressure in consumer prices depend, to a large extent, on the path of energy prices and labor costs. In mid-July crude oil prices reached a new pinnacle at over \$78 a barrel. Oil prices have retreated since then; however, conflicts in the Middle East, supply constraints, and high global demand point in the direction of sustained elevation in oil prices for some time to come.

Counterbalancing the upside risk of energy prices to inflation is the lower than expected employment numbers released by the Department of Labor for July. The unemployment rate increased by two-tenths to 4.8 percent as the economy produced just 113,000 jobs, below market expectations. The employment cost index, a broad measure of labor costs, was up only 3 percent over the year ending in the second quarter, suggesting that inflation in labor costs remains contained. It is likely that the languid jobs report, coupled with slower growth overall, influenced the Federal Reserve Board to take a much anticipated “pause” in its tightening policy, after 17 consecutive quarter point increases in the federal funds rate.

Slower growth and higher inflation also squeeze the housing sector since family incomes rise more slowly and interest rates move higher. Housing indicators underscore the retreat of the housing sector as the main driver of economic recovery since the 2001 recession. This is not to say that housing activity has petered out; in fact, 2006 should be the third highest level for home sales on record. And though new single-family construction and home sales continue to decline from the record high set in 2005, residential fixed investment and housing consumption continued to contribute solidly to real GDP growth, at about 6 percent and 10 percent, respectively, in the first half of 2006. Nevertheless, a strong but cooling housing market will not be enough to prevent a retraction in economic growth to below trend levels. Additionally, rising interest rates will continue to put upward pressure on mortgage financing costs, which when coupled with high house prices reduce affordability and lower housing demand.

Homeowners seem to have found a short-term remedy to competing risks in the economy by refinancing their mortgages. Motivated by rising short-term interest rates, borrowers consolidated home equity loans into new first-lien mortgages to reduce mortgage payments. Borrowers with adjustable-rate mortgages are also refinancing in response to upcoming interest rate adjustments. We estimate that \$500 billion in first-lien mortgages and \$650 billion in second-liens are scheduled to adjust this year. Even more dramatically, we estimate that \$81 billion was cashed out of home equity through first-lien refinancing during the second quarter, up from \$74 billion in the first. Home equity wealth gains have been key to supporting consumer spending. As house price appreciation continues to slow, this mechanism for sustaining consumer spending will diminish, leaving homeowners with less wiggle room to balance higher interest rates with slower income growth.

## Details

- *Real GDP growth.* Revised figures for historical real GDP growth and the advanced estimate for the second quarter were released at the end of July. The growth rate for the first quarter was unchanged following the revision at 5.6% (seasonally adjusted, annualized rate or SAAR). However, as anticipated, growth slowed significantly in the second quarter to 2.5%. As the effects of higher levels of both energy costs and interest rates filter through the economy, growth should slow in the latter half of this year and next year – our projection for annual growth in 2006 fell to 3.5% and to 3.2% for 2007.
- *Consumer price inflation.* Inflation, as measured by the Consumer Price Index, rose to 5.0% (SAAR) in the second quarter, primarily due to increasing oil prices. Moreover, the Labor Department’s report of slow down in productivity and rising labor costs in the second quarter suggest that inflationary pressure persists into the second half of this year. The Fed assures us that these pressures will moderate over time given the drop off in aggregate demand, contained inflation expectations, and past monetary policy. We left our forecast for inflation unchanged from our July Outlook, at 2.75% for the second half of 2006.
- *Unemployment rate.* The July employment report showed the economy only added 113,000 jobs when more than 145,000 were expected and the unemployment rate jumped to 4.8%. We left our unemployment-rate forecast for the third quarter at 4.7%. We believe slowing economic growth will lead to an increase in the unemployment rate back up to 5% in the second half of 2007.
- *Mortgage rates.* The Federal Reserve maintained its target on the federal funds rate at 5.25% during the August FOMC meeting. Rates on 30-year, fixed rate mortgages should remain below 7% in 2006 and initial rates on 1-year, adjustable-rate mortgages (ARMs) should stay below 6%. At present, initial rate discounts, or “teaser” rates on 1-year ARMs are running 2.25% below the fully indexed rate, meaning they will be more expensive than today’s 30-year, fixed-rate mortgages when they adjust next year.
- *ARM Share.* Our forecast for the ARM share of conventional home-purchase mortgages is unchanged from our July Outlook. ARMs will make up about 23% of such loans in the second half of the year, falling to a forecasted 19% in 2007.
- *Housing starts.* Higher interest rates are dampening housing market activity. Housing Starts came in at 1.88 million units (SAAR) for the second quarter, slightly below our July estimate of 1.91 million units for the quarter. As a result we shaved a little off our forecast for the end of the year – but at 1.90 million housing starts for the year, 50,000 more housing units will be built in 2006 than were built in 2003.
- *Home sales.* Home sales were down a little more than 5% in the first half of the year relative to 2005 and we anticipate further slowing in the second half. We are now estimating 6.90 million single-family house sales (excluding condos) in 2006, which is a 7.5% decline in sales from the record level set in 2005 but 37,000 more houses sold than in 2003. In 2007, single-family house sales should hit near 6.5 million units.
- *Home value appreciation.* Consistent with slowing in the housing market we are forecasting national average home-price appreciation to moderate to 7.1% in 2006, trending down further in 2007 to 6.4%. Market fundamentals suggest that housing markets with strong recent home-price growth (driven by employment growth) should continue to see solid house-price growth, although slower than in years past.
- *Mortgage activity.* Single-family mortgage originations are expected to total \$2.45 trillion in 2006, 13% lower than in 2005. This drop is due primarily to a decline in refinance activity, from 44% of mortgage applications last year down to 38%. Mortgage debt outstanding should grow 12.6% this year, reflecting still strong new-home construction, home sales and equity cash-out activity.

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<i>Revised 8/09/2006</i>	<b>Major Economic Indicators</b>																		
Indicator	2005				2006				2007				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2002	2003	2004	2005	2006	2007	2008
Real GDP (%)	3.4	3.3	4.2	1.8	5.6	2.5	2.9	3.0	3.1	3.1	3.2	3.2	1.9	4.1	3.8	3.2	3.5	3.2	3.5
Consumer Prices (%) a.	2.5	3.7	5.5	3.2	2.2	5.0	3.0	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.7	3.2	2.5	2.5
Unemployment Rate (%) b.	5.2	5.1	5.0	4.9	4.7	4.6	4.7	4.8	4.9	4.9	5.0	5.0	5.8	6.0	5.5	5.1	4.7	5.0	5.0
30-Year Fixed Mtg. Rate (%) b.	5.8	5.7	5.8	6.2	6.3	6.6	6.8	6.8	6.8	6.9	6.9	7.0	6.5	5.8	5.8	5.9	6.6	6.9	7.0
1-Year Treas. Indexed ARM Rate (%) b.	4.2	4.2	4.5	5.1	5.3	5.7	5.8	5.8	5.8	5.9	5.9	6.0	4.6	3.8	3.9	4.5	5.7	5.9	6.0
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.2	4.5	4.6	5.1	5.0	5.1	5.1	5.1	5.2	5.2	4.6	4.0	4.3	4.3	4.9	5.2	5.3
1-Year Const. Mat. Treas. Rate (%) b.	3.1	3.3	3.8	4.3	4.6	5.0	5.1	5.1	5.1	5.1	5.1	5.2	2.0	1.2	1.9	3.6	5.0	5.1	5.2

<i>Revised 8/09/2006</i>	<b>Housing and Mortgage Markets</b>																		
Indicator	2005				2006				2007				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2002	2003	2004	2005	2006	2007	2008
Housing Starts c.	2.07	2.06	2.10	2.06	2.12	1.88	1.83	1.76	1.80	1.71	1.71	1.71	1.70	1.85	1.96	2.07	1.90	1.73	1.68
Total Home Sales d.	7.33	7.56	7.56	7.34	7.07	7.01	6.87	6.67	6.60	6.52	6.42	6.30	5.95	6.53	7.16	7.46	6.90	6.46	6.28
House Price Appreciation (%) e.	10.8	15.4	13.7	13.0	8.7	5.6	8.1	6.0	6.7	6.2	7.1	5.6	7.2	8.0	12.0	13.2	7.1	6.4	5.9
1-4 Family Mortgage Originations f.																			
Conventional	\$599	\$710	\$782	\$655	\$607	\$625	\$609	\$525	\$485	\$573	\$607	\$546	\$2,697	\$3,630	\$2,776	\$2,746	\$2,366	\$2,211	\$2,252
FHA & VA	\$21	\$21	\$22	\$19	\$18	\$17	\$25	\$22	\$20	\$24	\$25	\$23	\$186	\$230	\$135	\$83	\$82	\$92	\$119
Total	\$620	\$731	\$804	\$674	\$625	\$642	\$634	\$547	\$505	\$597	\$632	\$569	\$2,883	\$3,860	\$2,911	\$2,828	\$2,448	\$2,303	\$2,371
ARM Share (%) g.	32	33	28	29	28	25	24	22	21	20	19	18	17	19	34	31	25	19	17
Refinancing Share - Applications (%) h.	45	42	44	45	44	42	33	34	33	27	27	29	59	65	46	44	38	29	26
Residential Mortgage Debt (%) i.	10.3	15.0	16.5	14.3	12.5	13.6	13.9	10.6	8.9	12.7	11.9	10.0	11.8	12.7	14.0	14.0	12.6	10.9	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 (CMHPI); 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<sup>SM</sup>; quarterly averages of monthly shares of all single-family 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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