

Changing of the Guard

Ben Bernanke was sworn in as the new Chairman of the Federal Reserve Board on February 1. One of many challenges he will face is how to steer monetary policy in order to achieve economic growth while keeping inflation low and in check. Unforeseen events – Hurricanes Katrina, Rita, and Wilma, for example – show how challenging this can be. As a result of hurricane-related disruptions, energy prices spiked and inflation, as measured by the Consumer Price Index, was up 3.4 percent in 2005, the fastest pace since 2000. Higher energy costs and business disruption also weakened GDP growth in the final quarter of the year: real GDP grew only 1.1 percent, well below market expectations and the slowest in four years.

Economic growth should snap back strongly in the first half of 2006 and reveal growth above 4 percent, at an annual rate. Some factors contributing to the growth rebound are the following: government spending, especially for national defense and hurricane reconstruction; strong near-term capital spending (new factory orders for nondefense capital goods were up 17 percent in the fourth quarter compared to the third quarter); a pickup in net exports (in part, due to lower oil imports as domestic production ramps up along the Gulf coast); and a rebound in consumption spending.

Monetary policy will also be providing an additional nudge to economic growth during the first half of this year. Monetary policy effects economic growth with a lag that can vary, but usually in the range of two to four quarters. Because monetary policy was still “accommodative” during the latter part of 2005, economic growth should be supported through the first half of this year. Because of the inertia in the labor market – in December and January, non-farm payroll employment rose over the two months by 333,000 and the unemployment rate dipped by 0.3 percentage points to 4.7 percent – and the rise in overall CPI inflation, most market analysts are expecting that the Federal Open Market Committee will boost the federal funds target by 0.25 percent to 4.75 percent on March 28. This meeting, the first headed by Chairman Bernanke, will be closely watched to see whether the new chairman appears to follow the policies of his predecessor.

A higher federal funds rate will translate into increases in other short-term rates, including those on consumer credit, home-equity lines-of-credit, and adjustable-rate mortgages (ARMs). A relatively flat Treasury yield curve, perhaps with slight inversion, is likely to be with us for most of 2006, and the mortgage “yield curve” in the primary market will likely flatten a bit further. As of February 2, the average interest rate on a 30-year fixed-rate mortgage was 6.23 percent, while the initial rate on a 1-year ARM was 5.33 percent, a scant 0.9 percentage point difference. Over the course of 2006, this difference is likely to decline further, as short-term rates rise relative to long-term rates.

A flatter mortgage-pricing environment will likely push the ARM share of new lending lower, and higher overall mortgage rates will further reduce refinance volume. Those borrowers who do refinance will do so to avoid a payment hike on an existing ARM, or to “cash-out” some home equity. During the final quarter of 2005, 4-of-5 borrowers who refinanced also cashed-out a bit of home equity, the largest share since the third quarter of 2000, and homeowners converted \$243 billion of their home equity into cash through the refinancing of prime first-lien mortgages during the year.

Details

- *Real GDP growth.* The “Advance Report” estimate for real economic growth in the fourth quarter of 2005 came in at a disappointing 1.1% annualized rate. Consensus estimates had put the growth rate at 2.8%. This is the first measured impact of Hurricanes Katrina, Rita and Wilma on economic growth, and could be revised higher in the February “Preliminary Report”. We boosted our forecast for growth in the first half of the year to 4.25%, fueled by the rebuilding effort in the areas affected by the storms.
- *Consumer price inflation.* The market got a little inflation spook with the January employment numbers. Average wages in January grew faster than expected and productivity growth was the slowest in four years. With the expectation that energy prices will moderate, we took our forecast of inflation (as measured by the Consumer Price Index) down to 2.2% for the first quarter, rising to 2.5% for the rest of the year.
- *Unemployment rate.* The January employment report also indicated solid growth in labor markets. The unemployment rate dipped sharply to 4.7% and 193,000 nonfarm payroll jobs were added in January while the December payroll employment numbers were adjusted upward by 32,000. For now, we’ve left our forecast of the unemployment rate at 4.9% until we see validation of a lower trend in the February report.
- *Mortgage rates.* Although long-term bond yields have come up in recent weeks, long-term fixed mortgage rates have been slower to rise. We lowered our forecast for 30-year fixed mortgage rates and now expect them to rise from the 6.23% reported in the February 2nd Primary Mortgage Market SurveySM to an average of 6.3% in the fourth quarter. Initial rates on fully amortizing, one-year Treasury-indexed adjustable-rate mortgages (ARMs) are also forecasted to rise at a slower rate than we predicted last month, now ending the year with an average of 5.3%.
- *ARM Share.* Teaser discounts are currently averaging 2.1 percentage points on one-year ARMs and lenders are offering more types of products to attract borrowers to ARMs. Even with these lures, the share of home purchases funded with ARMs is expected to shrink with the inversion of the yield curve which makes fully indexed ARMs (the underlying index plus the margin) more expensive than fixed-rate mortgages. The 2006 ARM share should be near 25%, down from the 31% share in 2005.
- *Housing starts.* Construction continues to be the strongest industry, adding 345,000 payroll jobs in 2005. Slightly higher interest rates will slow the rate of housing starts by about 7% relative to 2005’s record pace of 2.06 million units, 310,000 of which were multifamily rental and condominium apartments.
- *Home sales.* The housing market seems to be showing signs of cooling off a bit, but the winter weather could be the driver of these blahs. Total home sales dipped in December to the lowest level since February of 2004, but 2005 bested the record set in 2004 by nearly 4%.
- *Home value appreciation.* Low mortgage rates could push home sales to the second best year on record, but nonetheless, we are forecasting national average home price growth at 7.9% for 2006, down from the sizzling averages of 2004 and 2005, which both topped 12%. Eroding affordability will take more homebuyers out of the market, especially in high cost areas.
- *Mortgage activity.* Mortgage originations in 2005 came in at \$2.83 trillion (preliminary until the Home Mortgage Disclosure Act data become available next September), making it the 4th best year for mortgage lenders. The higher trend in mortgage rates and slower predicted home price appreciation this year should cause a decline in mortgage volumes by about 12%, nearly all of it coming out of refinance activity. The refinance share of mortgage applications is predicted to fall to 37% from 44% in 2005. Strong cash-out refinance activity and home sales should help total mortgage debt outstanding grow by nearly 12% in 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	1.1	4.5	4.0	3.4	3.2	3.5	3.5	1.9	4.1	3.8	3.1	3.8	3.5	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	5.1	3.2	2.2	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.7	2.4	2.5	2.5	
Unemployment Rate (%) b.	5.4	5.4	5.3	5.1	5.0	4.9	4.9	4.9	4.9	4.9	5.0	5.0	5.8	6.0	5.5	5.1	4.9	5.0	5.0	
30-Year Fixed Mtg. Rate (%) b.	5.9	5.7	5.8	5.7	5.8	6.2	6.2	6.2	6.3	6.3	6.4	6.4	6.5	5.8	5.8	5.9	6.2	6.5	6.7	
1-Year Treas. Indexed ARM Rate (%) b.	4.1	4.1	4.2	4.2	4.5	5.1	5.2	5.2	5.3	5.3	5.4	5.4	4.6	3.8	3.9	4.5	5.2	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	4.6	4.7	4.7	4.8	4.6	4.0	4.3	4.3	4.6	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	4.7	4.7	4.7	4.8	4.8	2.0	1.2	1.9	3.6	4.7	4.8	5.0	

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	2.04	1.97	1.92	1.89	1.87	1.85	1.83	1.71	1.85	1.95	2.06	1.91	1.82	1.76
Total Home Sales d.	7.13	7.29	7.23	7.58	7.62	7.32	7.49	7.29	7.09	6.89	6.85	6.80	5.97	6.53	7.17	7.44	7.19	6.79	6.52	
House Price Appreciation (%) e.	20.0	10.4	10.5	15.3	12.3	10.6	8.0	8.1	8.4	7.1	7.2	7.0	7.2	8.1	12.3	12.2	7.9	6.7	6.2	
1-4 Family Mortgage Originations f.																				
Conventional	\$649	\$693	\$599	\$710	\$782	\$654	\$519	\$630	\$665	\$581	\$517	\$617	\$2,696	\$3,629	\$2,776	\$2,745	\$2,395	\$2,200	\$2,200	
FHA & VA	\$30	\$23	\$21	\$21	\$22	\$19	\$22	\$26	\$28	\$24	\$22	\$26	\$187	\$231	\$129	\$83	\$100	\$98	\$98	
Total	\$679	\$717	\$620	\$731	\$804	\$673	\$541	\$656	\$693	\$605	\$539	\$643	\$2,883	\$3,860	\$2,905	\$2,828	\$2,495	\$2,298	\$2,298	
ARM Share (%) g.	38	36	32	33	28	29	26	25	24	23	23	22	17	19	34	31	25	22	19	
Refinancing Share (%) h.	39	47	45	42	44	45	45	36	32	34	35	28	59	65	46	44	37	30	28	
Residential Mortgage Debt (%) i.	16.6	13.1	9.9	14.6	15.2	12.5	11.3	12.6	12.8	10.7	9.2	11.8	11.8	12.7	13.7	13.0	11.9	10.5	9.5	

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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