

Orderly and Moderate Cooling

The housing sector crested during the autumn of last year, with a gradual slowing continuing this spring. New construction eased in April to 1.85 million homes (seasonally adjusted, annual rate), the least in nearly a year and a half. House and condominium sales also remain below third-quarter 2005 levels, and the inventory of unsold homes has increased to near a six-month supply in April, about 20 to 25 percent above fall's levels. The softening buyer interest in homes also resulted in a marked slowing in home-value appreciation, from 13.7 percent (annualized) during the third quarter to 8.7 percent during the first quarter – albeit still well above general consumer price inflation. Anecdotal reports from local markets around the U.S. refer to a shift from a “seller’s” market to a “buyer’s.”

A decline from the records set in 2005 – records set for single-family starts, home sales, and real home-value growth (that is, adjusted for general inflation) – was inevitable. High levels of home prices and rising mortgage rates for both adjustable-rate and fixed-rate loans have pinched potential buyers' budgets and reduced the overall affordability of homeownership. Indeed, during the first quarter of 2006 the homeownership rate dipped to 68.6 percent, the lowest in about two years.

In reviewing various measures of housing market performance, Federal Reserve Chairman Bernanke observed at the annual Conference on Bank Structure and Competition last month, that the sector was experiencing “a very orderly and moderate kind of cooling.” We expect that gradually rising interest rates will slacken overall demand further, resulting in construction and home sales off about 7 percent from 2005's record pace. Even with that, the sector will enjoy its third best year ever, surpassed only by the stellar volumes of each of the past two years.

The housing sector is not the only industry that may be experiencing a moderation in activity. May's labor market report revealed lackluster job growth of only 75,000 nationwide; taken with the 37,000 downward revision to March and April's jobs data revealed very modest employment growth over the past two months. Manufacturing lost 14,000 jobs. Construction, which has experienced a housing driven spurt in employment levels over the past few years, added only 1,000 jobs in May, consistent with other measures of moderation in the residential market.

The disappointing labor market report coupled with evidence of a moderating housing sector did have a bright lining: Long-term interest rates eased somewhat in early June, reflecting some cautious optimism in the market that core inflation will remain contained and within the Fed's targeted range. Overall price inflation, as measured by the Consumer or Producer Price Index (CPI or PPI), has accelerated over the past year primarily due to the record levels of energy prices. The core of these indexes (which exclude food and energy prices) has remained relatively low and stable, up only 2.3 percent for the CPI and 1.5 percent for the PPI on an April-over-April basis.

The increase in mortgage rates over the past several months will reduce refinance levels and overall origination volumes. Compared with the third quarter of last year, the coming July-to-September period may see dollar volumes lower by about 25 percent. Lower home sales will be largely offset by home-value gains of about the same proportionate magnitude, resulting in purchase-money volume that is essentially unchanged from the prior year. But a 50 percent drop in refinance originations (in dollars) will translate to lower overall single-family lending during the third quarter, compared with a year earlier. The continuation of a relatively flat yield curve with low long-term rates also means that the ARM share of lending will remain under pressure, with lenders continuing to offer sizable initial-period rate discounts to encourage ARM borrowing.

Details

- *Real GDP growth.* Late last month the Commerce Department revised its first quarter GDP growth estimate from a hefty 4.8 percent annualized rate to a vigorous and unsustainable 5.3 percent annualized rate. In the second quarter, we expect the economy to respond to the cool down in the housing market and rising energy prices by switching from above trend to below trend growth. We forecast that GDP growth will fall to 2.8 annualized rate percent in the second quarter of 2006 and remain at 3 percent for the remainder of the year. The economy stabilizes to an annualized growth rate of 3.3 percent in 2007.
- *Consumer price inflation.* Though we forecast a surge in the growth of consumer prices to 4.7 percent in the second quarter we expect that inflation will peter out somewhat over the remaining half of the year, ending 2006 at 2.5 percent and holding steady at that rate throughout 2007. There is some evidence that rising energy prices have spilled over into other consumer goods as core inflation – CPI less food and energy – has edged upwards over the past couple of months.
- *Unemployment rate.* The economy added 75,000 jobs in May. This weak job growth is tempered by a low national unemployment rate, which we expect will remain at around 4.8 percent in the second half of this year. We also expect the unemployment rate to increase modestly to 4.9 percent in 2007.
- *Mortgage rates.* The bond market's concern about surging inflation in the second quarter continues to put upward pressure on bond yields, increasing interest rates a bit. We forecast a gradual increase to 6.7 percent by year-end on the 30-year fixed rate mortgage. In 2007, the 30-year rate will increase slightly, averaging 6.8 percent, while the introductory rate on the 1-year ARM is expected to rise to 5.7 percent and 5.9 percent by the 4th quarter of 2006 and 2007, respectively.
- *ARM Share.* The ARM share of home-purchase mortgages will drop from 28 percent to 24 percent in the second quarter, according to our forecast. Also we see a decline in the refinance share of applications, which will fall in the 2nd quarter to 28 percent from 44 percent in the 1st quarter. The ARM share and the refinance share will average 25 percent and 31 percent in 2006, respectively.
- *Housing starts.* Unseasonably warm weather and hurricane related rebuilding lead to a higher than expected level of new construction in the first quarter of 2006. We forecast that average number of housing starts per quarter will fall by 16 percent from the 1st quarter to the 4th quarter of 2006 to 1.8 million units. Housing starts stabilize in 2007, averaging close to 1.8 million units throughout that year.
- *Home sales.* There will also be a steady decline in home sales over the next two years. Home sales will reach 7 million units in the second quarter of 2006, experience a moderate decline to 6.7 million units by year-end and average 6.5 million units a quarter in 2007.
- *Home value appreciation.* We estimate that home values will grow at an annualized rate of 6.6 percent in the 2nd quarter. As GDP growth moves to below trend levels, we look for home values to appreciate at an average annualized rate of 7.8 percent in 2006 and 6.8 percent in 2007.
- *Mortgage activity.* We decreased our estimate of one- to four-family conventional mortgage originations by approximately 6 percent from last month to 2.2 trillion and 2.1 trillion dollars in 2006 and 2007, respectively. Above trend house price appreciation will cause residential mortgage debt to grow robustly over the next two years, averaging annualized rates of growth equal to 12.4 percent and 10.2 percent in 2006 and 2007, respectively.

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Major Economic Indicators																			
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 (%)	3.8	3.3	4.1	1.7	5.3	2.8	3.0	3.0	3.3	3.3	3.3	3.3	1.9	4.1	3.8	3.2	3.5	3.3	3.5
Consumer Prices (%) a.	2.5	3.7	5.5	3.2	2.2	4.7	3.0	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.7	3.1	2.5	2.5
Unemployment Rate (%) b.	5.2	5.1	5.0	4.9	4.7	4.7	4.8	4.8	4.9	4.9	4.9	4.9	5.8	6.0	5.5	5.1	4.8	4.9	5.0
30-Year Fixed Mtg. Rate (%) b.	5.8	5.7	5.8	6.2	6.3	6.6	6.7	6.7	6.7	6.8	6.8	6.9	6.5	5.8	5.8	5.9	6.5	6.8	6.9
1-Year Treas. Indexed ARM Rate (%) b.	4.2	4.2	4.5	5.1	5.3	5.6	5.7	5.7	5.7	5.8	5.8	5.9	4.6	3.8	3.9	4.5	5.6	5.8	5.9
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.2	4.5	4.6	5.1	5.1	5.2	5.2	5.2	5.3	5.3	4.6	4.0	4.3	4.3	5.0	5.3	5.4
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	5.2	5.2	2.0	1.2	1.9	3.6	4.9	5.1	5.2

Housing and Mortgage Markets																			
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	2.13	1.91	1.88	1.80	1.84	1.76	1.76	1.76	1.70	1.85	1.96	2.07	1.93	1.78	1.74
Total Home Sales d.	7.33	7.56	7.56	7.34	7.07	7.00	6.90	6.70	6.70	6.55	6.40	6.30	5.95	6.54	7.16	7.46	6.92	6.49	6.32
House Price Appreciation (%) e.	10.8	15.4	13.7	13.0	8.7	6.6	8.5	7.2	7.2	6.8	7.2	6.0	7.2	8.0	12.0	13.2	7.8	6.8	5.7
1-4 Family Mortgage Originations f.																			
Conventional	\$599	\$710	\$782	\$655	\$504	\$607	\$579	\$517	\$467	\$547	\$581	\$535	\$2,696	\$3,629	\$2,776	\$2,746	\$2,207	\$2,129	\$2,211
FHA & VA	\$21	\$21	\$22	\$19	\$18	\$25	\$24	\$22	\$19	\$23	\$24	\$22	\$186	\$230	\$135	\$83	\$89	\$89	\$116
Total	\$620	\$731	\$804	\$674	\$521	\$632	\$603	\$539	\$487	\$569	\$605	\$557	\$2,883	\$3,860	\$2,911	\$2,828	\$2,296	\$2,218	\$2,327
ARM Share (%) g.	32	33	28	29	28	24	24	22	21	20	19	19	17	19	34	31	25	20	17
Refinancing Share - Applications (%) h.	45	42	44	45	44	28	24	26	27	22	23	25	59	65	46	44	31	24	24
Residential Mortgage Debt (%) i.	10.3	15.0	16.5	14.3	12.5	11.9	13.6	11.4	8.3	11.9	11.3	9.3	11.8	12.6	14.0	14.0	12.4	10.2	9.0

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 (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 SurveySM; 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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