

### *Deciphering Smoke Signals*

For many months economists have been speculating that the housing market was about to change course – from a seller’s market to a buyer’s market, from a bubble to a bust. Yet the statistics refuse to definitively indicate the direction of the market. The Conventional Mortgage Home Price Index for the fourth quarter of 2005, released March 2<sup>nd</sup>, showed that annual growth in home values hit 13 percent nationally. Housing starts in January hit 2.28 million units, the highest pace since 1973. No signals of a cooling housing market here. But sales of both new and existing homes fell in January and the inventories of existing single-family homes and condominiums for-sale rose to their highest levels since 1999. These contradictory statistics are signs of a slow down.

Some local market evidence is less ambiguous. Phoenix continues to be the hottest housing market with fourth-quarter 2004 to fourth-quarter 2006 appreciation in excess of 41 percent. Its booming economy created 82,000 non-farm payroll jobs in 2005 out of the nearly 2 million added nationwide. In contrast, Las Vegas, which had been the hottest market in 2004, saw home-price appreciation slow quickly to near the national average growth rate. Michigan saw the slowest price growth among states reflecting the weak economy caused by the downturn in the manufacturing sector.

It may be some time before we see definite trends in the national housing market, especially as measured by changes in home prices. Prices tend to be “sticky” on the way down as sellers will leave a home on the market longer or offer non-price concessions to buyers. The prevalence and types of seller concessions are difficult to measure. Nonetheless, we believe the housing market crested during the third quarter of 2005 and that single-digit growth in home values will occur nationally in 2006.

The national economy in the first quarter of 2006 is expected to bounce back strongly from the hurricane-battered, dismal showing in the fourth quarter. Although fourth quarter real GDP growth was revised upwards to 1.6 percent, productivity growth fell for the first time since the first quarter of 2001 while labor costs accelerated to 3.3 percent on an annualized basis, the biggest jump in a year and troubling for those worried about accelerating inflation risks. First quarter GDP growth is looking to come in near 4.8 percent, and the market is already pricing in another one-quarter point increase in the federal funds rate when the Fed Open Market Committee meets again at the end of March, moving the fed funds rate to 4.75 percent and the prime rate to 7.75 percent.

The yield curve has remained inverted, with 2-year Treasury yields exceeding the yields on 10-year notes. The inversion has caused fully indexed interest rates on 1-year adjustable-rate mortgages (ARMs) to exceed those on 30-year fixed-rate mortgages (FRMs) by more than a full percentage point – the fully indexed rate is the rate obtained by adding the margin to the appropriate underlying index rate at today’s levels. With the inverted yield curve, the ARM share of new mortgage applications is high at 32 percent, but initial-rate teaser discounts are attracting borrowers to shorter-term ARMs and interest-only or option-payment features on longer-term ARMs are attracting borrowers with lower initial mortgage payments. Fixed mortgage rates are still historically low and a wide variety of mortgage products are available, which means the capital market is well positioned to support homebuyers. When the smoke clears, we expect to find that the housing market has decelerated to a more normal level of activity, not crashed.

## Details

- *Real GDP growth.* We increased our forecast for economic growth to 4.8% in the first quarter this year, reflecting hurricane rebuilding activity, unexpectedly good weather in January and strong data on consumer and business spending. The remainder of our forecast, however, has not changed, including that of 2007 (3.5% growth for the year).
- *Consumer price inflation.* Stronger growth will lead to a greater threat of inflation, and thus we decided to slightly increase our inflation forecast in the first quarter from 2.3% to 2.5%. Inflation continues to be a salacious beast that financial markets have been closely watching. Nonetheless, we expect it to remain well behaved, holding at a 2.5% annualized rate for the year.
- *Unemployment rate.* Employment growth often follows strong economic conditions, so we lowered our projections of the unemployment rate over the first half of 2006 (averaging 4.8%) and then have it creeping back to 4.9% as economic growth moderates.
- *Mortgage rates.* With inflation demanding greater attention, we are forecasting interest rates to rise a little faster than we predicted last month. The 10-year constant-maturity Treasury note should end the year at a yield of around 4.8%, while interest rates on 30-year fixed-rate mortgages may top 6.5% (compared to 6.3% in our February forecast). Short-term rates, however, are harder to predict (especially with a new Federal Reserve chairman), but we anticipate rates will rise steadily over the next year – the one-year constant maturity Treasury yield is expected to end the year at 5.0%.
- *Housing starts and Home Sales.* These economic conditions predicate a softening in the housing market, with the brunt of the impact hitting new home construction. We anticipate housing starts to wane by over 5% and home sales to ease by about 4%. (Of note, these forecasted levels exceed market records first accomplished three years ago.) Although the housing industry will fail to break any new records in 2006, the housing market maintains an incredible amount of stamina.
- *Home value appreciation.* House prices, on the other hand, have been quite incorrigible, increasing by double digits for the last two years. Our projection calls for home prices to moderate towards more normal levels. Specifically, home prices are expected to climb 8.6% in 2006 and 7.2% in 2007. It takes considerable time for a market to transition from a “seller’s” to a “buyer’s” market, but anecdotal evidence suggests that buyers are now demanding home inspections, and in some cases, home repairs, to be made as a condition of sale.
- *Refinance and ARM Shares.* Higher interest rates will dampen refinance activity, bringing the refinance share of applications down to 36% for the year. The rising prime rate, the rate on which most home-equity lines of credit and second mortgages are based, is a driving force behind cash-out refinancings – according to Freddie Mac’s Cash-out Refinance Report released February 7<sup>th</sup>, 80% of refinance loans in the fourth quarter of 2005 were at least 5% larger than the loan they replaced due to loan consolidation and equity extraction. This trend should continue in ‘06. The inversion of the yield curve along with higher levels of interest rates will dampen demand for ARMs relative to the 2005 share, with a 27% ARM share of applications expected this year.
- *Mortgage activity.* Higher interest rates offset the stronger economic growth and for now we have left our conventional mortgage originations forecast unchanged from last month at \$2.4 trillion. Higher home values and still-strong home sales mean total mortgage debt outstanding is likely to grow by 12% in 2006, which would make it the sixth straight year of double digit growth in mortgage debt.

Frank E. Nothaft  
Chief Economist  
March 8, 2006

Amy Crews Cutts  
Deputy Chief Economist

and Michael Schoenbeck  
Business Economist

[www.freddiemac.com/news/finance](http://www.freddiemac.com/news/finance)

[chief\\_economist@freddiemac.com](mailto:chief_economist@freddiemac.com)

*Opinions, estimates, forecasts and other views contained in this document are those of Freddie Mac's Office of the Chief Economist, do not necessarily represent the views of Freddie Mac or its management, should not be construed as indicating Freddie Mac's business prospects or expected results, and are subject to change without notice. Although the Office of the Chief Economist attempts to provide reliable, useful information, it does not guarantee that the information is accurate, current or suitable for any particular purpose. © 2006 by Freddie Mac. Information from this document may be used with proper attribution. Alteration of this document is strictly prohibited.*

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

Revised 3/08/2006

### 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	1.6	4.8	4.0	3.4	3.2	3.5	3.5	1.9	4.1	3.8	3.2	3.9	3.5	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	5.1	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	5.3	5.1	5.0	4.9	4.8	4.8	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	6.4	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	5.5	5.6	5.6	5.7	4.6	3.8	3.9	4.5	5.5	5.7	5.9	
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	4.5	4.5	4.7	4.7	4.8	4.8	4.9	4.6	4.0	4.3	4.3	4.7	4.9	5.1	
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	2.04	1.98	1.89	1.86	1.87	1.86	1.71	1.85	1.95	2.06	1.95	1.85	1.78
Total Home Sales d.	7.08	7.29	7.33	7.56	7.56	7.36	7.50	7.30	7.10	6.90	6.85	6.81	5.97	6.53	7.11	7.45	7.20	6.81	6.45	
House Price Appreciation (%) e.	19.5	10.7	10.7	15.4	13.4	12.5	9.0	8.8	8.8	7.7	7.8	7.6	7.2	8.1	12.2	13.0	8.6	7.2	6.6	
1-4 Family Mortgage Originations f.																				
Conventional	\$649	\$693	\$599	\$710	\$782	\$655	\$521	\$632	\$665	\$579	\$480	\$580	\$2,696	\$3,629	\$2,776	\$2,746	\$2,396	\$2,200	\$2,200	
FHA & VA	\$30	\$23	\$21	\$21	\$22	\$19	\$19	\$23	\$24	\$21	\$17	\$21	\$187	\$231	\$129	\$83	\$87	\$80	\$80	
Total	\$679	\$717	\$620	\$731	\$804	\$674	\$539	\$655	\$689	\$600	\$497	\$601	\$2,883	\$3,860	\$2,905	\$2,828	\$2,483	\$2,280	\$2,280	
ARM Share (%) g.	38	36	32	33	28	29	29	28	26	24	23	22	17	19	34	31	27	21	18	
Refinancing Share (%) h.	39	47	45	42	44	45	44	34	32	34	35	28	59	65	46	44	36	31	29	
Residential Mortgage Debt (%) i.	16.6	13.1	9.9	14.6	15.2	12.5	11.6	12.6	12.9	10.8	9.3	12.0	11.8	12.7	13.7	13.0	12.0	10.7	9.9	

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).

Prepared by Office of the Chief Economist (YC 3/8/2006); Send comments and questions to chief\_economist@freddiemac.com.

Opinions, estimates, forecasts and other views contained in this document are those of Freddie Mac's Office of the Chief Economist, do not necessarily represent the views of Freddie Mac or its management, should not be construed as indicating Freddie Mac's business prospects or expected results, and are subject to change without notice. Although the Office of the Chief Economist attempts to provide reliable, useful information, it does not guarantee that the information is accurate, current or suitable for any particular purpose.

© 2006 by Freddie Mac. Information from this document may be used with proper attribution. Alteration of this document is strictly prohibited