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Office of the Chief Economist

May 2006 Economic Outlook

The Natural Rate

Economists refer to the "natural rate of unemployment" as the rate consistent with stable inflation. Policy mavens are trying to determine if the U.S. is at, above or below this rate. The April labor market report contained some mixed news in this regard. The unemployment rate held steady at 4.7 percent, the lowest since July 2001, yet the economy added only 138,000 jobs. Of concern was the rise in average hourly earnings in April, up 6.7 percent for the month, annualized. Yet, the Employment Cost Index, a more inclusive measure of labor costs that includes benefits and other components of labor expense, was up only 2.8 percent in the first quarter relative to a year ago. Further, labor productivity rebounded in the first quarter and grew at a 3.2 percent annualized rate. Strong productivity gains alleviate wage-inflation concerns and enable a lower "natural" rate.

Economic activity bounced back strongly during the first three months of this year to 4.8 percent (annualized). Although some of the growth was expected from the hurricane cleanup from Katrina, Rita and Wilma, strong consumer spending and the best level of business investment since 2000 were the big drivers. Housing also continued to play an important role, as residential fixed investments (RFI) were up 2.6 percent during the quarter.

High levels of new construction and additions and alterations to existing homes drove the contribution flowing through RFI. During the first quarter, single-family housing starts achieved a new record of 1.8 million homes (seasonally adjusted, annual rate) begun during the period. Further, cash-out refinancing, a major source for home improvement funds, remained at a high level: 88 percent of families who refinanced in the first quarter also converted part of their accumulated home equity into cash or consolidated their mortgage debt according to Freddie Mac's Cash-out Refinance Report. The dollars of new equity extracted through the refinance of prime first-lien mortgages sum to $60 billion for the quarter, helping to propel consumer spending and RFI.

Interest rates, including mortgage rates, have inched higher over the past six weeks over concerns that high energy prices and a tightening labor market could fuel inflation. However, an increase in mortgage rates will dampen housing activity. Housing starts and home sales are forecasted to be down about 7 percent in 2006 relative to last year's annual record levels. Higher rates will also discourage refinance and second-mortgage lending, such as home-equity lines of credit, and reduce home-improvement spending in the second half of this year. Thus, housing's contribution to economic growth, while remaining important, will provide less of a spur than it has had over the past few years.

We expect that long-term and short-term rates will gradually rise, perhaps more so for short-term borrowings, continuing the fairly flat yield curve that has been a characteristic of U.S. capital markets this year. In this type of environment, large initial-period interest-rate discounts will continue to be offered in the primary mortgage market, and about 25-30 percent of homebuyers are expected to finance their purchase with an adjustable-rate mortgage (ARM). Those families who opt to refinance – representing close to 40 percent of this year's mortgage origination volume – will do so because of a desire to extract home equity or in order to refinance an ARM that has reached it's payment-adjustment anniversary. We estimate that over $400 billion of first-lien ARM debt will have a payment-adjustment in 2006, and much of this debt will be refinanced.

Overall, as we look to the remaining 7 months of the year, solid but moderating economic growth, still-low but gradually rising interest rates, and healthy productivity growth all point to relatively stable core inflation – meaning we are near the natural rate of unemployment. But uncertainty in energy markets and other events will no doubt cause significant volatility in the numbers for some time to come and may lead to a change in both expectations about inflation and its realization. The vexing question, then, is whether we are un-naturally high or low.

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Details

- *Real GDP growth*. The Advance Report for the first quarter GDP growth came in at 4.8%, very strong and near our expectations. With the immediate boost to economic growth from the 2005 hurricane's now waning, we are expecting real GDP growth to moderate to 3.5% in the second quarter, slowing further to 3.2% for the second half of the year – these values are a bit lower than in our April forecast.
- *Consumer price inflation*. Energy prices declined in the first quarter, putting inflation growth at 2.2% as measured by the Consumer Price Index. But since then, crude oil prices have hit new record highs and this will push up inflation in the second quarter – we are predicting CPI inflation to come in at 4% for the quarter, then trend back to 2.5% unless oil prices continue to rise.
- *Unemployment rate*. The unemployment rate in April was unchanged from that of March at 4.7% and 138,000 non-farm payroll jobs were added in the month. At the pace of jobs growth set in the first 4 months of the year, the economy will add between 1.8 and 2 million jobs in 2006, about the same as were added in 2005. The unemployment rate should remain between 4.7 and 4.8% through year's end.
- *Mortgage rates*. With higher energy prices pushing up current inflation and market worries about future inflation, the bond-market traders have pushed up long-term bond yields in recent weeks. With no immediate end in sight for the energy problem, we increased our forecast for mortgage rates and bond yields from last month's predictions. We now have the 30-year fixed mortgage rate averaging 6.7% in the 4^{th} quarter and the introductory rate on the 1-year ARM rising to 5.8%. The yields on 10-year and 1-year constant maturity Treasury notes should average between 5 and 5.2% for the rest of the year.
- *Housing starts*. Seasonally adjusted housing starts in the first quarter were stronger than in any quarter of 2005, a record year for single-family construction. But we expect construction activity to slow by 7% in 2006 relative to 2005, at 1.93 million units, 60,000 fewer than we predicted last month.
- *Home sales*. Sales of both new and existing homes have declined since the end of 2005, totaling 7.13 million units (seasonally adjusted, annualized rate) in the first quarter. Home sales are also expected to decline 7% in 2006 from 2005's record levels.
- *Home value appreciation*. With higher interest rates and slowing GDP growth expected later this year, home value appreciation should slow from the double-digit growth we saw in the last two years. Our current estimate for home price appreciation in 2006 is 7.5%.
- *ARM and Refinance Shares.* The ARM share of home-purchase mortgages was 28% in the first quarter. As mortgage rates rise, concurrent with the predicted flatness of the yield curve, the ARM share should decline over the year to end at 23%. The refinance share of mortgage applications is also slowing with rising rates, from 44% in the first quarter to an expected average near 30% by the end of the year.
- *Mortgage activity.* Higher mortgage rates are expected to curtail mortgage refinance originations by nearly one-third, while home-purchase originations should be about the same or slightly higher than in 2005. Overall, originations are expected to decline 14% in 2006 to $2.4 trillion. Mortgage debt outstanding is expected to increase 12.5% over the year, reflecting still strong but lower home sales, solid house price appreciation and high cash-out refinance activity. Freddie Mac's quarterly Cash-out Refinance Report showed that 88% of borrowers that refinanced in the first quarter increased their loan balance by 5% or more. That same report forecasts $170 billion in equity will be converted to cash in refinancing of prime conventional first-lien mortgages in 2006.

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Economic and Housing Market Outlook

May 2006

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Major Economic Indicators

Indicator	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	Annual Totals 2002	2003	2004	2005	2006	2007	2008
Real GDP (%)	3.8	3.3	4.1	1.7	4.8	3.5	3.2	3.2	3.3	3.3	3.3	3.3	1.9	4.1	3.8	3.2	3.7	3.3	3.5
Consumer Prices (%) a.	2.5	3.7	5.5	3.2	2.2	4.0	3.0	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.7	2.9	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	6.6	6.7	6.7	6.8	6.8	6.8	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	5.5	5.7	5.8	5.8	5.9	5.9	5.9	4.6	3.8	3.9	4.5	5.6	5.9	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	5.3	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	5.0	5.1	5.1	5.1	5.1	5.2	2.0	1.2	1.9	3.6	4.9	5.1	5.2

Housing and Mortgage Markets

Indicator	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	Annual Totals 2002	2003	2004	2005	2006	2007	2008
Housing Starts c.	2.08	2.04	2.10	2.06	2.13	1.96	1.85	1.79	1.81	1.77	1.75	1.74	1.70	1.85	1.96	2.07	1.93	1.93	1.77
Total Home Sales d.	7.33	7.56	7.56	7.35	7.13	7.05	6.90	6.80	6.70	6.50	6.45	6.35	5.95	6.54	7.17	7.46	6.97	6.50	6.32
House Price Appreciation (%) e.	10.7	15.4	13.4	12.5	8.1	6.4	8.1	7.2	7.7	7.3	7.6	6.3	7.2	8.0	12.1	13.0	7.5	7.5	6.6
1-4 Family Mortgage Originations f.																			
Conventional	$599	$710	$782	$655	$504	$613	$644	$568	$506	$593	$620	$555	$2,696	$3,629	$2,776	$2,746	$2,329	$2,273	$2,299
FHA & VA	$21	$21	$22	$19	$18	$26	$27	$24	$21	$25	$26	$23	$186	$230	$135	$83	$94	$95	$121
Total	$620	$731	$804	$674	$521	$639	$671	$591	$527	$617	$646	$578	$2,883	$3,860	$2,911	$2,828	$2,423	$2,368	$2,420
ARM Share (%) g.	32	33	28	29	28	26	25	23	21	20	19	18	17	19	34	31	26	20	17
Refinancing Share - Applications (%) h.	45	42	44	45	44	31	29	32	32	27	28	31	59	65	46	44	34	30	29
Residential Mortgage Debt (%) i.	10.0	14.8	16.4	14.2	12.0	13.7	13.2	11.0	9.2	12.3	11.9	9.9	11.8	12.7	13.8	13.8	12.5	10.8	10.1

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[SM]; 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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