

Step-by-Step

In six steps over the last eight months, the Federal Reserve (Fed) has raised the Federal Funds rate from a 45-year low of 1.0 percent to 2.5 percent (as of February 2nd). The language and the intent of the Fed have been clear: to keep raising rates at a “measured” pace until it is no longer “accommodative.” The objective is to leave no doubt that it plans to keep inflationary pressures and expectations in check. Ironically, perhaps the Fed has done too good a job convincing the markets of its intentions, as evidenced by today’s low long-term rates.

Parsing Fed statements can be an art form, and we are not about to get started on that exercise. Yet, when the Fed keeps saying it wants to be less “accommodative,” what does it really mean? Two things. First, the real Fed Funds rate (that is, factoring in inflation) is still close to zero, which continues to be stimulative. Second, the Fed is indicating concern that there remains a lot of liquidity in the system: Minutes of the December 14, 2004, Federal Open Market Committee meeting state that “a significant degree of liquidity might be contributing to signs of potentially excessive risk-taking in financial markets as evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers and acquisitions activity...” Chairman Greenspan is likely to want a neutral monetary policy by the end of his term next January. Consistent with this we believe that the Fed Funds rate will be at 3.5 percent by the end of the year.

The Fed’s actions to raise short-term interest rates have calmed market fears of inflationary pressures and have had the effect of lowering long-term interest rates and flattening the yield curve. Since the Fed began raising short-term rates last June, 10-year Treasury rates have fallen from a monthly average rate of 4.73 in June 2004 to 4.09 percent (February 4, 2005) while 1-year Treasury rates rose from 2.12 percent to 2.93 percent over the same time period. This flattening of the yield curve will have different effects on various parts of the housing and mortgage markets.

As of early February, the 30-year fixed-rate mortgage rate stood at 5.63 percent, a drop of approximately 0.60 percentage points since the Fed began its tightening. This is likely to put significant pressure on adjustable-rate mortgage (ARM) pricing, with many lenders offering greater initial rate discounts to maintain their current share of production. We see the proportion of ARMs originated staying near 35 percent of origination volume in 2005, with lower shares in the latter part of the year. Because of continued overall low mortgage rates, we expect home sales and housing starts to stay very strong but at slightly lower levels than 2004’s record highs, each down about 3 percent or at 7.66 million and 1.9 million units respectively. The underlying strength of the economy will also keep house prices moving up, with an average increase of 7 to 8 percent for the year.

We have been fortunate that the macroeconomic environment has given the Fed the luxury to be “measured.” While all macroeconomic indicators point to a sanguine outlook for the economy in general, and the housing sector in particular, there are downside risks. The first is that disruptions to oil supplies might cause a rise in oil prices. The second risk is that Federal budget deliberations might produce a larger than expected deficit, and that might unsettle financial markets. The third risk is that the dollar, which has remained relatively stable in the last month relative to our major trading partners, might depreciate again, putting even more upward pressure on inflation.

Details

- Economic growth in the last three months of 2004 fell short of expectations – however, the data are still subject to revision. The correction in Canadian import data should increase fourth quarter GDP by 0.1 to 0.2 percentage points. We decided to stay with our previous forecast of 3.9% growth in the GDP over 2005 and 3.5% after that.
- Inflation seems under control, especially after excluding the volatile food and energy prices. Our forecast factors in a decline in energy prices placing the overall inflation rate at 2.0% in 2005 and then gradually rising to 2.5% in later years.
- Given our GDP growth estimates, the labor market should continue to improve. Often companies wait for a couple of periods of sizable growth before hiring anew. As a result, we expect the unemployment rate to settle in at 5.1% by the end of 2005.
- Long-term mortgage rates have remained remarkably low; most people expected them to rise in conjunction with Fed rate hikes. We envision rates for 30-year fixed-rate mortgages gradually rising to around 6.25% by the end of the year and to somewhere around 6.5% by the end of 2006.
- Rates for ARMs will likely increase more quickly as the Fed raises short-term rates. And as the yield curve flattens, homeowners will have less of an incentive to choose ARMs – given the inherent interest-rate risk associated with these products – unless they receive an initial discount in the interest rate. Nevertheless, we expect the ARM share of mortgage originations will average 35% in 2005 (the same as in 2004) and then decline to 31% in 2006.
- With no dramatic change in our interest-rate forecast or GDP estimates, forecasted housing starts are the same as last month's projections. We show a 3% decline to about 1.90 million units in 2005 and then falling to around 1.80 million units in 2006. Similarly, total home sales are forecasted to fall by 3% to 7.66 million units in 2005 (marking their second best year) and then to around 7.27 million in 2006.
- Gradually rising mortgage rates should help slow home price appreciation from 10.5% in 2004 to around 7.8% in 2005 and to around 6.3% in 2006.
- Given lower home sales, less new construction, fewer refinancing and slower house-price appreciation, overall mortgage originations are expected to decline by about 6 % to \$2.6 trillion in 2005 and to \$2.3 trillion in 2006. The refinance share of new mortgage applications should decline to 41% in 2005 and to 33% in 2006.
- There's enough momentum from last year's strong housing market to maintain strong mortgage debt growth in 2005. We expect mortgage debt growth to average around 12.6 percent in 2005 and then ease to 11.0 % in 2006.

Frank E. Nothaft
Chief Economist
February 8, 2005

Buchi Ramagopal
Director of Financial Research

Michael Schoenbeck
Economist



We make home possibleSM

Office of the Chief Economist Economic and Housing Market Outlook

February 2005

Indicator	Major Economic Indicators															
	2004				2005				2006		Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006
Real GDP (%)	4.5	3.3	4.0	3.1	3.9	4.0	3.8	3.8	3.5	3.5	0.2	2.3	4.4	3.7	3.9	3.5
Consumer Prices (%) a.	3.6	4.7	1.9	3.4	2.0	2.0	2.0	2.0	2.5	2.5	1.8	2.2	1.9	3.4	2.0	2.5
Unemployment Rate (%) b.	5.6	5.6	5.4	5.4	5.3	5.2	5.2	5.1	5.1	5.1	4.8	5.8	6.0	5.5	5.2	5.1
30-Year Fixed Mtg. Rate (%) b.	5.6	6.1	5.9	5.7	5.8	6.0	6.1	6.2	6.2	6.3	7.0	6.5	5.8	5.8	6.0	6.3
10-Year Const. Mat. Treas. Rate (%) b.	4.0	4.6	4.3	4.2	4.3	4.5	4.6	4.6	4.7	4.8	5.0	4.7	4.0	4.3	4.5	4.8
1-Year Const. Mat. Treas. Rate (%) b.	1.2	1.8	2.1	2.5	3.1	3.3	3.4	3.5	3.6	3.7	3.5	2.0	1.2	1.9	3.3	3.7

Indicator	Housing and Mortgage Markets															
	2004				2005				2006		Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006
Housing Starts c.	1.94	1.92	1.97	1.96	1.95	1.90	1.90	1.85	1.82	1.82	1.60	1.70	1.85	1.95	1.90	1.80
Total Home Sales d.	7.40	7.99	7.83	7.94	7.80	7.69	7.65	7.50	7.27	7.27	6.20	6.54	7.19	7.86	7.66	7.27
House Price Appreciation (%) e.	6.3	9.9	15.9	10.2	9.1	7.6	8.7	5.6	6.6	7.0	7.5	7.3	8.4	10.5	7.8	6.3
1-4 Family Mortgage Originations f.																
Conventional	\$600	\$696	\$659	\$650	\$576	\$661	\$652	\$544	\$480	\$564	\$1,900	\$2,696	\$3,629	\$2,605	\$2,433	\$2,171
FHA & VA	\$39	\$37	\$30	\$39	\$35	\$38	\$37	\$35	\$32	\$39	\$167	\$187	\$231	\$145	\$145	\$141
Total	\$639	\$733	\$689	\$689	\$611	\$699	\$689	\$579	\$512	\$603	\$2,067	\$2,883	\$3,860	\$2,750	\$2,578	\$2,312
ARM Share (%) g.	27	36	38	36	35	36	35	34	33	32	12	17	19	34	35	31
Refinancing Share (%) h.	59	39	39	47	49	40	39	38	37	31	57	59	65	46	41	33
Residential Mortgage Debt (%) i.	11.4	11.1	13.5	14.3	10.8	14.6	13.1	12.1	9.6	12.2	10.0	11.7	12.7	12.5	12.6	11.0

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 averages of monthly 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) 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 (PT 2/7/2005); Send comments and questions to chief_economist@freddiemac.com.

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