

Employment Bounces Back

The employment picture brightened considerably with the latest report from the Bureau of Labor Statistics (BLS). The BLS reported a 274,000 gain in non-farm employment for the month of April, and a substantial 93,000 upward revision to February and March. While the large service sector led the increase, the gains were broadly felt across most industries. The construction sector added 47,000 jobs, or 17 percent of the total. Construction employment has been up 24 of the last 25 months, led by the robust pace of housing activity, and stands 8 percent above April 2003's level at a record 7.2 million employed. In stark contrast, manufacturing employment slipped for the 20th time in the past 25 months, and is 2 percent below the two-year ago level.

Construction has been a continuing bright spot for the economy. Consistent with the jobs report, the Census Bureau reported that the value of construction put in place for March set its 14th consecutive record. Within the construction sector, residential building has been the main driver; the jobs report showed a 7 percent gain in employment from a year earlier, and the value of residential construction put in place was up 13 percent year-over-year. On pace with these data are housing starts, which reached a record 1.85-million units (seasonally adjusted, annual rate) for one-to four-family dwellings in February.

A driving force behind the strength of construction, and housing activity more generally, is the continuing low level of mortgage rates. Rates on 30-year fixed-rate loans averaged just 5.8 percent during the first quarter – the same as the annual average for 2003 and 2004 – and remain at about that level in the beginning of May. With interest rates low and more people back at work over the past two years, the result has been a record-setting housing boom.

Mortgage rates are likely to edge up (but remain relatively low) over the balance of the year, as the Fed will continue to push up short-term interest rates. Having won the battle against high levels of inflation, the Fed wants to keep the inflation genie in its bottle. This was quite evident in the statement released by the Federal Open Market Committee (FOMC) at its last meeting (and rate hike) on May 3rd. The FOMC acknowledged the pick-up in inflationary pressures in recent months, while “longer-term inflation expectations remain well contained.” Expect the FOMC to boost the federal funds rate another quarter-point to 3.25 percent by the end of their next meeting, scheduled for June 29-30.

The continuing high level of energy prices has sparked the Fed's inflationary concerns. Gasoline prices hit a record average price of \$2.28 (regular) a gallon at the pumps during the week ending April 11th; higher energy prices increase the cost of production for other goods, increasing pressures to raise prices in the goods-producing sectors. However, higher gas prices have also dampened consumer confidence and are the main culprit in the lackluster consumer spending pace (for non-energy goods) during the first quarter, and with it, the weaker 3.1 percent advance in GDP. Fortunately, labor-cost gains have been modest, thanks in part to continuing improvements in productivity. Over the past year, the BLS' Employment Cost Index is up only 3.4 percent and unit labor costs (which factor in productivity gains) are up only 2.4 percent; after adjusting for general inflation, “real” labor costs are effectively unchanged from a year ago.

Details

- *Real GDP growth.* The first quarter's real GDP growth was reported to be 3.1%, much weaker than the consensus rate of 3.5%. There are indications that this preliminary report will be revised upwards, but, nonetheless, it is indicative of an economy that is not as strong as we had hoped. We revised our GDP growth forecast downward for the next three quarters, to 3.5%, 3.7% and 3.7%, respectively.
- *Consumer price inflation.* Inflation, while still tame, is starting to creep up due to higher energy costs finding their way into the prices of goods and somewhat higher labor costs. We revised our view on inflation for the second quarter upwards to 2.6% (from 2.4%) and for the third quarter upwards to 2.2% (from 2.0%).
- *Unemployment rate.* April's employment report was a bit of welcome news, with 274,000 jobs added and the unemployment rate steady at 5.2%. This report was in line with our forecast for the second quarter, so we did not make any changes to the employment outlook.
- *Mortgage rates.* Despite the Fed's steady beat of increases in the federal funds rate, longer-term bond and mortgage rates have been dancing to their own tune and have actually fallen over the past several weeks. Because of this decline and the weaker than expected economic growth numbers, we brought our forecast for mortgage rates down by about 30 basis points across the board. We now expect 30-year, fixed-rate mortgages to end the year near 6.1%, however the bond markets are volatile enough that these rates could go as high as 6.4% by years end.
- *ARM Share.* Due to our lowered forecast for mortgage rates we expect borrowers to be more attracted to fixed-rate mortgages – thus we lowered our expected adjustable-rate mortgage share to 32% for the rest of the year, down from an average share of 35% that we projected last month.
- *Housing starts.* Low mortgage rates along with improving employment numbers and incomes are sustaining a very healthy housing construction market. We revised our estimate of 2005 housing starts upwards to 1.95 million units from 1.93 million units, just shy of 2004's record level.
- *Home sales.* Home sales too are threatening to outdo 2004's numbers – we revised our outlook for 2005's total single-family house sales upwards to 7.07 million units from the 6.93 million we were forecasting last month. Inventories of homes-for-sale remain low, at about 4.1 months for existing homes and 4.4 months for new homes.
- *Home value appreciation.* With such high demand for homes and low mortgage rates, we are expecting home price growth to remain strong. We are now forecasting house prices to grow 7.9% nationally in 2005, up from our previous forecast of 6.8%. Coastal states will likely see stronger appreciation than the national forecast due to stronger population growth and tight constraints on new construction.
- *Mortgage Activity.* Like the housing market, lower interest rates bode well for the mortgage market. We have increased our forecast for total mortgage originations to \$2.3 trillion for 2005, down about 10% from 2004 originations. Slowing refinance activity is the reason for the decline – purchase money originations should increase over last year. The refi share is expected to average 40% in 2005, down from 46% in 2004.

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Office of the Chief Economist Economic and Housing Market Outlook May 2005

Major Economic Indicators																	
Indicator	2004		2005				2006				Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	2001	2002	2003	2004	2005	2006	2007
Real GDP (%)	4.0	3.8	3.1	3.5	3.7	3.7	3.5	3.5	3.5	3.5	0.2	2.3	4.4	3.9	3.5	3.5	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	2.6	2.2	2.0	2.5	2.5	2.5	2.5	1.8	2.2	1.9	3.4	2.3	2.5	2.5
Unemployment Rate (%) b.	5.4	5.4	5.3	5.2	5.2	5.1	5.1	5.1	5.1	5.1	4.8	5.8	6.0	5.5	5.2	5.1	5.1
30-Year Fixed Mtg. Rate (%) b.	5.9	5.7	5.8	5.9	6.0	6.1	6.2	6.3	6.4	6.4	7.0	6.5	5.8	5.8	6.0	6.3	6.6
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.3	4.4	4.5	4.6	4.7	4.8	4.9	5.0	4.6	4.0	4.3	4.4	4.8	5.0
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.4	3.6	3.7	3.8	3.9	3.9	4.0	3.5	2.0	1.2	1.9	3.5	3.9	4.2

Housing and Mortgage Markets																	
Indicator	2004		2005				2006				Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2001	2002	2003	2004	2005	2006	2007
Housing Starts c.	1.97	1.98	2.09	1.95	1.90	1.86	1.82	1.82	1.82	1.75	1.60	1.70	1.85	1.96	1.95	1.80	1.72
Total Home Sales d.	7.12	7.29	7.28	7.10	7.00	6.90	6.51	6.48	6.47	6.46	5.64	5.95	6.54	7.17	7.07	6.48	6.18
House Price Appreciation (%) e.	17.5	9.0	9.0	8.0	8.2	6.4	6.4	7.1	6.7	5.5	7.5	7.3	8.4	10.7	7.9	6.5	6.0
1-4 Family Mortgage Originations f.																	
Conventional	\$659	\$650	\$538	\$620	\$642	\$544	\$482	\$570	\$604	\$536	\$1,900	\$2,696	\$3,629	\$2,605	\$2,344	\$2,192	\$2,135
FHA & VA	\$30	\$23	\$32	\$36	\$37	\$31	\$29	\$34	\$36	\$32	\$167	\$187	\$231	\$129	\$136	\$131	\$148
Total	\$689	\$673	\$570	\$656	\$679	\$575	\$511	\$604	\$640	\$568	\$2,067	\$2,883	\$3,860	\$2,734	\$2,480	\$2,323	\$2,283
ARM Share (%) g.	38	36	32	32	32	32	32	31	31	30	12	17	19	34	32	31	28
Refinancing Share (%) h.	39	47	45	39	37	37	36	29	29	31	57	59	65	46	40	31	29
Residential Mortgage Debt (%) i.	16.7	11.4	11.9	14.3	14.6	11.6	10.0	12.3	12.8	9.7	10.0	11.7	12.8	13.2	13.1	11.2	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 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 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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