

Summer Dreaming

The brightest light in the U.S. economy continues to be the housing sector. In June, new records were achieved in sales of both new and existing houses, and sales through the first half of the year are running nearly six percent higher than over the same period in 2004 – also a record year for home sales. The Federal Reserve System’s (Fed) *Beige Book* (a periodic report on economic conditions across the twelve Fed districts) indicates that the strength of residential real estate markets is widespread, with the exception of the seventh and ninth districts (covering the states of North Dakota, South Dakota, Iowa, Minnesota, Illinois, Wisconsin, Indiana, and Michigan). These two districts had mixed real estate performance by location and market segment due to employment weakness in manufacturing and other local industries.

The strong performance of the housing sector is attracting investors into the market for single-family homes. According to data compiled by LoanPerformance, the share of prime, conforming mortgage loans for home purchase that were taken out by investors hit a new high of 10.3 percent in the first quarter of 2005. Another 7.3 percent of home-purchase mortgages were taken out by buyers of second homes. The combined share of recently purchased investor-owned and second homes (17.6 percent) has nearly doubled in three years – the average share in 2001 was 9.3 percent. These shares are even higher in some metropolitan markets that have experienced much higher than average price appreciation. One concern among market watchers is that speculative investment may be driving prices higher than they should be on the basis of population and income growth. Builders seem to be highly attuned to this, and are now adding in contract provisions to prevent the flipping of homes during construction and through the first year or two after completion.

Higher interest rates will certainly dampen demand for housing eventually, but a stronger labor market will offset some of the interest rate effects. The U.S. has added an average of 188,000 payroll jobs per month in the first six months of this year, just slightly above the 183,000 average new jobs added per month in 2004. Approximately 35 percent of companies recently surveyed by the National Association of Business Economists said they are having trouble finding skilled labor – just 25 percent reported skilled labor shortages last year. In the same survey, 39 percent of respondents indicated wages and salaries were rising, compared with 22 percent for the same period last year.

Looming over this idyllic summer economic picture is threatening clouds. Oil prices once again hit a new record on August 1st, briefly rising over \$62 per barrel, on news of the death of King Fahd of Saudi Arabia. Higher energy costs create a drag on the economy, and, if they should approach \$100 per barrel, could lead to serious discussions of recession. China’s decision in July to de-link the Yuan from the U.S. Dollar and allow it to float against an unspecified currency basket was hailed as a step towards reducing their government’s intervention in markets. The good news is that Chinese goods will likely become relatively more expensive, boosting demand for U.S. produced goods. The bad news is that more expensive goods will hurt U.S. consumers, and China’s demand for U.S. debt instruments like Treasury bonds and mortgage-backed securities may decline. A decline in demand for U.S. Treasury instruments would lead to higher interest rates than we would otherwise expect – thus raining on our sunny housing market.

Details

- *Real GDP growth.* Second quarter real GDP growth dipped to 3.4% from a first quarter average of 3.8% due, in part, to tepid expansion in U.S. service industries. Across the board increases in service activity in the second half of the year drive our prediction that growth in the third and fourth quarters will increase to 3.7%.
- *Consumer price inflation.* Oil prices averaged a record high of just over \$60 a barrel in June, spurring a second quarter increase in the Consumer Price Index of 4.2%. We estimate that the annualized inflation rate will slow to 2.4% in the third quarter and 2.2% in the fourth quarter as oil prices moderate in the coming months.
- *Unemployment rate.* The unemployment rate in July remained at 5.0%. Compared with our previous forecast, we revised our forecast of unemployment in the third quarter down one-tenth to 5.0% as well. We expect the unemployment rate to remain at or near this level for the next five quarters, as economic growth is projected to be sufficient to meet labor force growth.
- *Mortgage rates.* We expect the Fed to continue to reduce its monetary policy accommodation further by hiking the federal funds rate to 3.5% at the August 9 FOMC meeting. We project 30-year, fixed mortgage rates will rise slightly to an average of 6.0% by the fourth quarter of the year. We estimate that mortgage rates will grow slowly in 2006 to 6.3% towards year-end, still well below historical averages.
- *ARM Share.* Discounted initial rates on ARMs continue to make them attractive to borrowers. We expect the ARM share to average slightly over 30%. We increased our forecast for the fourth quarter to 33% of originations. As the effects of tightening monetary policy kick in at the end of the year, the ARM share will decrease steadily in 2006, but remain a significant portion of loan originations.
- *Housing starts.* The second half of 2005 should see moderation in new construction. One- to four-family housing starts reached record highs in the first quarter at 1.75 million housing units (annual rate). We project single-family construction to decline in the second half of the year; reducing total starts (including multifamily) to 1.98 and 1.93 million housing units in the third and fourth quarters, respectively.
- *Home sales.* Likewise, house sales continued their upward momentum in the second quarter, increasing to a record of 7.62 million (annual rate). We forecast that sales will decline by 7% in 2006 (relative to the projected record of 7.3 million sales in 2005) owing to higher mortgage rates.
- *Home value appreciation.* Strength in home sales led us to revise our annualized house price appreciation estimate in the second quarter to 13% nationally, up from an initial estimate of 8.6%. As the housing market cools in response to an increase in mortgage rates, we estimate that house price appreciation will dampen to 10.7% and 7.4% in the in the third and fourth quarters, respectively.
- *Mortgage activity.* The outlook for mortgage originations remains strong in the third and fourth quarters. We project that total originations in 2005 will be over \$2.6 trillion. Refinancing is expected to make up 42% of mortgage originations in 2005 and then fall to 33% of originations in 2006.
- *Mortgage debt.* For 2005, mortgage debt growth is projected to be 13.2%, revised up from last month's forecast because of the strength of new construction, home sales, and home-value appreciation.

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

Major Economic Indicators																	
Indicator	2004		2005				2006				Annual Totals						
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2001	2002	2003	2004	2005	2006	2007
Real GDP (%)	4.0	3.3	3.8	3.4	3.7	3.7	3.5	3.5	3.5	3.5	0.2	1.9	4.0	3.8	3.7	3.5	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	2.4	2.2	2.5	2.5	2.5	2.5	1.8	2.2	1.9	3.4	2.8	2.5	2.5
Unemployment Rate (%) b.	5.4	5.4	5.3	5.1	5.0	5.0	5.0	5.0	5.0	5.0	4.8	5.8	6.0	5.5	5.1	5.0	5.0
30-Year Fixed Mtg. Rate (%) b.	5.9	5.7	5.8	5.7	5.8	6.0	6.1	6.2	6.3	6.3	7.0	6.5	5.8	5.8	5.8	6.2	6.5
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.3	4.5	4.6	4.7	4.7	4.8	5.0	4.6	4.0	4.3	4.3	4.7	5.0
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.3	3.8	4.0	4.1	4.1	4.2	4.3	3.5	2.0	1.2	1.9	3.6	4.2	4.4

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	1.97	2.08	2.01	1.98	1.93	1.87	1.83	1.85	1.83	1.60	1.70	1.85	1.96	2.00	1.85	1.77
Total Home Sales d.	7.13	7.29	7.23	7.62	7.23	7.11	6.87	6.82	6.77	6.72	5.64	5.95	6.54	7.17	7.30	6.80	6.58
House Price Appreciation (%) e.	17.6	9.7	9.6	13.0	10.7	7.4	7.4	7.8	7.8	6.1	7.5	7.3	8.3	11.0	10.2	7.3	6.3
1-4 Family Mortgage Originations f.																	
Conventional	\$659	\$650	\$568	\$674	\$702	\$589	\$510	\$598	\$626	\$543	\$1,900	\$2,696	\$3,629	\$2,605	\$2,533	\$2,277	\$2,295
FHA & VA	\$30	\$23	\$21	\$21	\$30	\$21	\$21	\$25	\$26	\$23	\$167	\$187	\$231	\$129	\$93	\$95	\$96
Total	\$689	\$673	\$589	\$695	\$732	\$610	\$531	\$623	\$652	\$566	\$2,067	\$2,883	\$3,860	\$2,734	\$2,626	\$2,372	\$2,391
ARM Share (%) g.	38	36	32	33	32	33	32	30	28	27	12	17	19	34	32	29	22
Refinancing Share (%) h.	39	47	45	42	42	40	39	31	30	31	57	59	65	46	42	33	29
Residential Mortgage Debt (%) i.	16.7	11.6	9.2	15.9	15.7	12.1	10.8	13.7	13.3	10.5	10.0	11.7	12.8	13.4	13.2	12.1	10.4

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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