

Mid-year Roundup

During the second quarter of 2005, total home sales and house price appreciation reached their peak in the 2002 – 2005 Housing Boom. Home values grew at an energetic rate of 15.4 percent annualized and home sales (including condos) hit a record of 8.48 million in the quarter. All economic indicators supported a robust mortgage market: GDP was solid, at a 3.3 percent annualized rate, payroll employment grew by 500,000 that quarter, and 30-year fixed-rate mortgages were at a relatively low 5.7 percent. At that time we knew that the housing market would not continue along this path indefinitely and we predicted a sizable moderation in housing activity in 2006. A year later, the second quarter numbers for 2006 are more moderate as expected. The summer of 2005 signaled a turning point in housing activity from a metaphoric heat wave to a “moderate and orderly cooling.”

Looking forward, the U.S. economy is in a complicated position with mixed economic signals creating uncertainty for financial markets, business, and consumers. Rapid first quarter growth is expected to be replaced by slower GDP growth at a 2.8 percent annualized rate. Consumer prices sprinted upward in the second quarter, as oil prices edged up near \$75 a barrel and the consumer price index, excluding food and energy, grew at a seasonally adjusted annual rate of 3.1 percent in the first five months of 2006, compared to a 2.2 percent increase for all of 2005. Moreover, oil prices seem to be driven not only by supply constraints and global demand but also by geopolitical concerns, which are much harder to predict. Furthermore, the Institute for Supply Management reported tepid growth in June in the manufacturing and service sectors, signaling weakness in economic activity. The Labor Department reported that the economy added a lower than expected 121,000 jobs in June, thus payroll employment grew by 175,000 fewer jobs than the second quarter a year ago. On June 29 the Federal Reserve Board responded to these economic signals by raising the federal funds rate to 5.25 percent. Whether the U.S. will see another elevation in the federal funds rate in August will depend on the Fed’s outlook for inflation and growth.

In the second half of the year the markets, businesses, and consumers will need to adjust to an economy in transition from above trend growth driven in large part by a housing boom to below trend growth exacerbated by higher energy prices and a cooling housing market. As a result we expect some volatility in mortgage rates as they continue to bounce around a gently rising trend, averaging 6.8 percent over the remainder of the year for 30-year fixed-rate mortgages. In addition, investors in the housing market that were once emboldened by the expectation of strong house price appreciation may now contribute to waning housing demand. According to the National Association of Homebuilders lower demand, coupled with affordability concerns and higher interest rates, decreased homebuilder optimism in June to its lowest level since April 1995. Providing another indication of shrinking demand, the National Association of Realtor’s Affordability Index reached its lowest level in over fifteen years. Though the direction of housing activity is unambiguously heading cooler, we remain confident that the climate is still temperate and that 2006 will finish as the third strongest year ever for the national housing market.

Details

- *Real GDP growth.* First quarter growth was revised upwards to 5.6% from 5.3% previously. We expect consumer spending will moderate over the rest of 2006 (owing, in part, to a slowing housing market) and therefore lowered our GDP estimates from May. We expect 2006 GDP growth to be 3.5% and fall to 3.3% in 2007.
- *Consumer price inflation.* We raised our second quarter CPI growth from May's forecast to 4.7% due to higher energy costs. For the rest of the year, we kept our forecast the same. We expect consumer prices will gain by 3.1% in 2006 and ease to 2.5% in 2007. The upside risk to this forecast is continuing acceleration in wage growth.
- *Unemployment rate.* The unemployment rate remained at 4.6% in June and non-farm payrolls averaged an increase of almost 135,000 jobs per month over the first six months of 2006. At this pace, the economy would add between 1.6 and 1.8 million jobs in 2006, below the number of new jobs added in each of the last two years. With slowing GDP growth, we expect the unemployment rate will rise to 4.8% by the fourth quarter of 2006 and continue to increase to 4.9% in 2007.
- *Mortgage rates.* Mortgage rates rose in June, and as a result our forecast is slightly above May's projections. We expect rates on 30-year fixed-rate mortgages to average 6.8% in the second half of 2006 and rates for 1-year Treasury-indexed ARMs to hover around 5.8%. For 2007, we show a moderate upward trend to 6.9% and 5.9%, respectively.
- *ARM and Refi share.* As mortgage rates increase and the yield curve stays relatively flat, both refinancing activity and ARM share are projected to decline in the second half of 2006 and into 2007. We expect the refi share of applications to decline to 35% by the end of 2006 while the ARM share falls to 22%. In 2007, the refi and ARM shares should average about 31% and 19%, respectively.
- *Housing starts.* Increasing house prices and higher rates should dampen new construction in the near future. We see total housing starts falling 7% from 2005 to 1.92 million units in 2006 and a 9% further decline in 2007.
- *Home sales.* Much like housing starts, both new and existing home sales will also slow 7% in 2006 to 6.96 million units (which is stronger than pace set in 2003 and represents the third strongest year on record). Total home sales are projected to decline by an additional 7% in 2007 to 6.49 million units, which is just below the 2003 figures.
- *Home value appreciation.* With GDP slowing even further and higher mortgage rates, we lowered our 2006 forecast by 0.5% to 7.0% from the May projection. We see house price growth slowing to 6.2% in 2007.
- *Mortgage activity.* Single-family originations should fall by 12% to \$2.5 trillion in 2006, largely owing to a 22% decline in refinance loans; originations of home-purchase loans ease by 4 percent. We expect 2007 originations to total \$2.3 trillion in 2007. Mortgage debt outstanding, supported by new construction and house price appreciation, should grow by 13% over 2006 and slow further in 2007.

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Economic and Housing Market Outlook

July 2006

Revised 7/10/2006																			
Major Economic Indicators																			
Indicator	2005				2006				2007				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2002	2003	2004	2005	2006	2007	2008
Real GDP (%)	3.8	3.3	4.1	1.7	5.6	2.8	3.0	3.0	3.3	3.3	3.3	3.3	1.9	4.1	3.8	3.2	3.6	3.3	3.5
Consumer Prices (%) a.	2.5	3.7	5.5	3.2	2.2	5.0	3.0	2.5	2.5	2.5	2.5	2.5	2.2	1.9	3.4	3.7	3.2	2.5	2.5
Unemployment Rate (%) b.	5.2	5.1	5.0	4.9	4.7	4.6	4.7	4.8	4.8	4.8	4.9	4.9	5.8	6.0	5.5	5.1	4.7	4.9	5.0
30-Year Fixed Mtg. Rate (%) b.	5.8	5.7	5.8	6.2	6.3	6.6	6.7	6.8	6.8	6.9	6.9	6.9	6.5	5.8	5.8	5.9	6.6	6.9	7.0
1-Year Treas. Indexed ARM Rate (%) b.	4.2	4.2	4.5	5.1	5.3	5.7	5.8	5.8	5.8	5.9	5.9	5.9	4.6	3.8	3.9	4.5	5.7	5.9	6.0
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.2	4.5	4.6	5.1	5.3	5.3	5.3	5.4	5.4	5.4	4.6	4.0	4.3	4.3	5.1	5.4	5.5
1-Year Const. Mat. Treas. Rate (%) b.	3.1	3.3	3.8	4.3	4.6	5.0	5.4	5.5	5.5	5.5	5.5	5.5	2.0	1.2	1.9	3.6	5.1	5.5	5.5

Housing and Mortgage Markets																			
Indicator	2005				2006				2007				Annual Totals						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2002	2003	2004	2005	2006	2007	2008
Housing Starts c.	2.07	2.06	2.10	2.06	2.12	1.91	1.85	1.78	1.82	1.73	1.73	1.73	1.70	1.85	1.96	2.07	1.92	1.75	1.70
Total Home Sales d.	7.33	7.56	7.56	7.34	7.07	7.13	6.93	6.72	6.65	6.55	6.45	6.31	5.95	6.53	7.16	7.46	6.96	6.49	6.29
House Price Appreciation (%) e.	10.8	15.4	13.7	13.0	8.7	5.6	7.4	6.3	6.6	6.2	6.6	5.4	7.2	8.0	12.0	13.2	7.0	6.2	5.5
1-4 Family Mortgage Originations f.																			
Conventional	\$599	\$710	\$782	\$655	\$607	\$629	\$613	\$543	\$495	\$583	\$617	\$556	\$2,696	\$3,629	\$2,776	\$2,746	\$2,392	\$2,251	\$2,292
FHA & VA	\$21	\$21	\$22	\$19	\$18	\$26	\$26	\$23	\$21	\$24	\$26	\$23	\$186	\$230	\$135	\$83	\$92	\$94	\$121
Total	\$620	\$731	\$804	\$674	\$625	\$655	\$639	\$566	\$516	\$608	\$643	\$579	\$2,883	\$3,860	\$2,911	\$2,828	\$2,484	\$2,345	\$2,412
ARM Share (%) g.	32	33	28	29	28	25	24	22	21	20	19	18	17	19	34	31	25	19	17
Refinancing Share - Applications (%) h.	45	42	44	45	44	42	34	35	34	28	29	31	59	65	46	44	39	31	28
Residential Mortgage Debt (%) i.	10.2	15.0	16.5	14.3	12.5	13.8	14.1	11.5	9.0	12.6	12.0	9.9	11.8	12.7	14.0	14.0	13.0	10.9	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 SurveySM; 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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