January 2004 Economic Outlook

Brisk Housing Activity for 2004

Rising family income coupled with low mortgage rates are two of the critical ingredients for a strong housing market, and we expect both to be at work this year. The income gains are fed by fiscal and monetary policy reinforcing each other to drive real GDP growth to an expected 4.3% real gain in 2004. Economic expansion at that rate is sufficient to gradually draw down the unemployment rate, from 5.9% as of November to an average of 5.5% during the last quarter of 2004. The job gains will drive family income gains.

This year began on a good note with the Institute for Supply Management's release of its manufacturing survey data for December, which showed that the increase in new manufacturing orders was the best in more than 50 years, and the overall index – which combines responses on new orders, employment, production, and other factors – attained its highest reading in 20 years. The battered manufacturing sector should begin to add jobs as a result. The Institute's non-manufacturing index remained above the "expansion" threshold for the ninth consecutive month, reinforcing the conclusion that the economy should expand at a strong pace in the first half of the year.

Inflation in consumer prices should remain low and stable in the coming year: The Consumer Price Index (CPI) is expected to rise only 1.4% during 2004, which would be the least inflation since 1986, reflecting excess capacity at many plants, strong productivity growth, a loose labor market, and weakening energy prices. Indeed, the "core" of the CPI (subtracting the food and energy components) was up only 1.1% in the year ending in November. With inflation low and in-check, the Fed has ample room to maintain the Federal Funds target at 1%. In fact, the Fed has stated that an accommodative monetary policy "can be maintained for a considerable period." We believe the Fed will keep the target at 1% through mid-year and perhaps until the end of the year.

With the two key ingredients in place, 2004 will be another good year for housing. Slightly higher interest rates will choke off some construction and sales activity at the margin, with starts slipping 5% to 1.75 million dwellings and new and existing house sales down 3% to 6.98 million. But that still places construction and sales well above the level of 2002, which was regarded as an exceptional housing year at the time.

Details

- With slightly lower interest rates and accommodative monetary policy by the Federal Reserve, we upped each quarter's economic growth rate in 2004, with the year's average totaling 4.3%, up one-tenth from last month's projection.
- We see inflation easing further in the fourth quarter of 2003 to 1.1 percent. In November, the monthly change in core CPI inflation fell 0.1 percent, the first monthly decline in 21 years. With solid economic growth and a weaker dollar this year, but constrained pricing power among companies, inflation will slowly rise. For the year, CPI inflation will average 1.4%, down from 2.0% last year.
- With real GDP growth forecast to exceed 5% in the latter half of 2003, the employment situation is showing signs of sustainable improvement: We lowered the 2004 average unemployment rate forecast by a tenth, to 5.7%.
- Mortgage rates are hard to forecast in the current environment. Last January, we predicted rates on fixed-rate mortgage would fall nearly a half percentage point in 2003, marking a generational low. This year, mortgage rates will average slightly higher than 2003, somewhere around 6 percent for 30-year fixed-rate mortgages, followed by an additional increase in 2005.
- Unlike mortgage rates, Treasury bond yields rose more quickly in the second half of 2003. With mortgage refinancing slowing, mortgage rate spreads to Treasuries are returning to historical levels. Low inflation and neutral monetary policy will keep Treasury yields at a low level. The 1-year and 10-year Treasury yields will likely average 1.5% and 4.3% in 2004, respectively.
- Housing starts were remarkably strong in October and November, suggesting the fourth quarter will be at a 26-year record. However with rising mortgage rates (ever so slightly), the demand for new homes will lessen. Housing starts will average about 1.75 million units in 2004, representing a 5% decrease from 2003.
- We raised our 2003 mortgage originations estimate after careful examination of market indicators not directly feeding our models; given the relative strength of home sales, housing starts and refinance activity, the year was extraordinary by every means. Our 2004 forecast is 40% below 2003 at $2.2 trillion, owing largely to less mortgage refinancing.
- In terms of product shares, we expect the ARM share to average around 24% in 2004, given the upward trend in fixed-rate mortgage rates. And the refinance share of originations will fall dramatically to around 37% in 2004.
- Nonetheless, residential mortgage debt growth will remain quite strong (up 11%) in 2004, albeit slower than the past two years, for the following reasons: 1) Home values will be up about 6%; 2) Starts and sales, while less than in 2003, are still better than in prior years; 3) Home equity lending will continue to be brisk; 4) And real estate remains attractive as a consumption good and investment vehicle.

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Major Economic Indicators

Indicator	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	Annual Totals 2001	2002	2003	2004	2005
Real GDP (Growth) a.	2.0	3.1	8.2	4.4	4.5	4.3	4.2	4.2	4.0	4.0	0.0	2.9	4.4	4.3	4.0
Consumer Prices (Growth) a.	3.9	0.6	2.3	1.1	1.3	1.3	1.4	1.5	2.0	2.2	1.8	2.2	2.0	1.4	2.3
Unemployment Rate (Avg.)	5.8	6.2	6.1	5.9	5.8	5.7	5.6	5.5	5.5	5.4	4.8	5.8	6.0	5.7	5.4
30-Year Fixed Mtg. Rate (Avg.)	5.8	5.5	6.0	5.9	5.8	5.8	5.9	6.0	6.1	6.2	7.0	6.5	5.8	5.9	6.1
10-Year Const. Mat. Treas. Rate (Avg.)	3.9	3.6	4.2	4.3	4.2	4.2	4.3	4.4	4.4	4.5	5.0	4.7	4.0	4.3	4.5
1-Year Const. Mat. Treas. Rate (Avg.)	1.3	1.2	1.2	1.3	1.3	1.4	1.5	1.6	1.7	1.8	3.5	2.0	1.3	1.5	1.9

Note: Quarterly and annual forecasts are shown in shaded areas.
a. Quarterly percent changes at annualized rates. Yearly data reflect Q4/Q4.

Housing and Mortgage Markets

Indicator	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	Annual Totals 2001	2002	2003	2004	2005
Housing Starts a.	1.74	1.74	1.88	2.03	1.80	1.75	1.75	1.70	1.67	1.67	1.60	1.71	1.85	1.75	1.65
Total Home Sales a.	6.85	6.92	7.58	7.35	7.15	7.00	7.00	6.75	6.90	7.00	6.20	6.54	7.18	6.98	7.06
House Prices b.	5.3	4.9	4.8	3.4	4.3	7.3	7.1	5.5	6.9	6.1	7.6	7.7	4.6	6.1	6.0
1-4 Family Mortgage Originations c.															
Conventional	$787	$1,000	$1,140	$553	$457	$571	$577	$407	$396	$515	$1,900	$2,558	$3,480	$2,012	$1,949
FHA/VA	$54	$59	$60	$47	$45	$56	$57	$40	$44	$57	$167	$187	$220	$199	$217
Total	$841	$1,059	$1,200	$600	$502	$627	$634	$447	$440	$572	$2,067	$2,745	$3,700	$2,211	$2,166
ARM Share (%) d.	16	15	18	26	24	24	24	25	25	25	12	17	19	24	25
Refinancing Share (%)	77	75	57	51	47	35	32	34	35	30	57	59	65	37	32
Residential Mortgage Debt Growth (%) e.	11.2	15.4	14.9	7.5	6.2	14.7	13.0	10.4	9.4	12.2	10.3	12.4	12.3	11.0	10.6

Note: Quarterly and annual forecasts are shown in shaded areas. Totals may not add due to rounding.
a. Millions of units. Quarterly data at seasonally-adjusted annual rates.
b. Freddie Mac-Fannie Mae Conventional Mortgage Home Price Index. Quarterly data at annual rates. Yearly data reflect Q4/Q4.
c. Billions of dollars, not seasonally-adjusted.
d. Percent of the number of mortgage loans closed for purchase.
e. Includes single-family and multifamily debt; Stated at an annual rate.

Prepared by the Office of the Chief Economist (MAS 1/7/2004); Contact chief_economist@freddiemac.com if you have comments or questions.