

February 2004 Economic Outlook

Confidently Patient

Consumer confidence is back – at least back to where it was in July 2002. Consumer confidence rose to 96.8 in January from a revised 91.7 in December. The expectations index rose to 108.1, the highest since May 2002, from December's level of 103.3. The index measuring confidence about the current economy rose to 80.0 in January from 74.3 in December. These indicators are important measures because they tell us that the consumer segment is still in the game and may be looking to add even more economic pull, for example, by buying homes. Consumption spending by households is one of the three key components in GDP growth – the other two being private investment and government spending.

With all the discussion of deficits and the new federal budget negotiations, it is clear that government spending is doing its part to support economic growth. On the investment side, capacity utilization remains weak although orders for high tech equipment and computers have been strong and small businesses are responding to the new investment tax incentives. In December, manufacturing activity grew at its fastest rate in 20 years and marked 8 months of expansion as measured by the Institute for Supply Management's (ISM) Manufacturing Index. The ISM index for non-manufacturing sectors hit its highest level since the start of the index in July 1997. Overall corporate profits have been up in the latest rounds of earnings announcements, supporting the notion that business (investment) is picking up.

Between consumer confidence, strong business indicators and low inflation, we believe economic growth in 2004 will be strong. We also believe that jobs will come back, but are less optimistic about the timing of their return. Higher than expected productivity growth in recent quarters indicates that businesses are increasing output by extending the hours worked by current employees rather than hiring. In last week's Fed Open Market Committee Meeting, the Committee left short-term interest rates unchanged as was expected. However, their policy statement indicated "...the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal...[and thus] the Committee believes that it can be patient in removing its policy accommodation." Noticeably absent, at least to skittish investment markets, was the statement "for a considerable period." Until there are very strong indicators that the economy is generating jobs and that workers and businesses have the ability to increase wages and prices, it is our belief that the Fed will stand pat on rates, meaning mortgage rates will stay low and the housing market will remain robust in 2004.

Details

- Although GDP growth fell short of market expectations in the fourth quarter of 2003, it may have upward revisions. We expect economic growth of about 4.4% in the first half of 2003, followed by 4.2% in the second, all above our assumption for sustainable growth of about 3.5%. 2005 will be a little slower at 4.0%, but still above trend.
- Many industries currently face either declining or little pricing power. The core consumer price index was up 1.1% for the year ending December 2003, the lowest level of growth in nearly 37 years, which leads us to believe that 2004 will experience a mild 1.4 percent increase in consumer prices and a 2.3% rise in 2005.
- Above trend growth in the economy should encourage greater rounds of jobs hiring (eventually). The unemployment rate will likely continue its decline to around 5.5% by the end of 2004, averaging about 5.7% for the year. In 2005, it may decline to 5.4%.
- Given the Federal Reserve Board's reassurances (although the language keeps changing), notable imbalances between varying sectors of the economy and slow improvement in the labor market there's little reason to expect dramatic increases in interest rates any time soon. Interest rates on 30-year fixed-rate mortgages will average near 5.7% in 2004 and 6.0% in 2005. Similarly, Treasury bond yields will have minor increases in 2004 and gain more upward momentum in 2005.
- Our models predict another record year of total home sales, on the order of 7.28 million units in 2004. We expect families will take advantage of extremely low mortgage rates and focus on their current living arrangements from both a consumption and investment perspective. By 2005, total sales will ease to 7.24 million units. Similarly, housing starts will be very robust in 2004, coming in near the 2003 level of 1.85 million units.
- House price appreciation should fair well in 2004, averaging about 6.5%, well above the general rate of inflation. In addition, we increased the third quarter 2003 growth estimate by over two percentage points to 7%, owing to the strength in home sales and refinance volume during the quarter.
- Total single-family mortgage originations should decline by 35% in 2004 to \$2.4 trillion, owing to a decline in mortgage refinancing. In 2005, originations will fall a little further to \$2.2 trillion.
- ARM shares of originations will remain fairly strong, averaging around 26% in 2004, as fixed-rate mortgage rates remain above the lows of last summer. Meanwhile, the refinance share of new mortgage loans will taper off to average 41% for the year. Similarly, the ARM share will rise to 28% and refinance share decline to 35% in 2005.
- Residential mortgage debt growth should exceed double digits over the next year, rising by around 12% in 2004 .

Frank E. Nohaft
Chief Economist
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Amy Crews Cutts
Deputy Chief Economist

Michael Schoenbeck
Senior Financial Analyst

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Indicator	Major Economic Indicators										Annual Totals				
	2003				2004				2005		2001	2002	2003	2004	2005
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2					
Real GDP (%)	2.0	3.1	8.2	4.0	4.5	4.3	4.2	4.2	4.0	4.0	0.0	2.8	4.3	4.3	4.0
Consumer Prices (%) a.	3.9	0.6	2.3	0.9	1.3	1.3	1.4	1.5	2.0	2.2	1.8	2.2	1.9	1.4	2.3
Unemployment Rate (%) b.	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 (%) b.	5.8	5.5	6.0	5.9	5.7	5.6	5.7	5.8	5.8	5.9	7.0	6.5	5.8	5.7	6.0
10-Year Const. Mat. Treas. Rate (%) b.	3.9	3.6	4.2	4.3	4.1	4.0	4.1	4.2	4.3	4.3	5.0	4.7	4.0	4.1	4.4
1-Year Const. Mat. Treas. Rate (%) b.	1.3	1.2	1.2	1.3	1.2	1.2	1.4	1.5	1.6	1.7	3.5	2.0	1.3	1.3	1.8

Indicator	Housing and Mortgage Markets										Annual Totals				
	2003				2004				2005		2001	2002	2003	2004	2005
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2					
Housing Starts c.	1.74	1.74	1.88	2.04	1.90	1.85	1.80	1.80	1.67	1.67	1.60	1.70	1.85	1.84	1.65
Total Home Sales d.	6.85	6.92	7.58	7.40	7.20	7.40	7.30	7.20	7.20	7.20	6.20	6.54	7.19	7.28	7.24
House Price Appreciation (%) e.	5.3	4.9	7.0	8.8	4.7	7.9	7.6	5.8	8.1	7.2	7.6	7.7	6.5	6.5	7.2
1-4 Family Mortgage Originations f.															
Conventional	\$787	\$1,000	\$1,140	\$553	\$500	\$600	\$600	\$500	\$418	\$508	\$1,900	\$2,558	\$3,480	\$2,200	\$1,955
FHA/VA	\$54	\$59	\$64	\$47	\$49	\$59	\$59	\$49	\$46	\$56	\$167	\$187	\$224	\$218	\$217
Total	\$841	\$1,059	\$1,204	\$600	\$549	\$659	\$659	\$549	\$465	\$565	\$2,067	\$2,745	\$3,704	\$2,418	\$2,172
ARM Share (%) g.	16	15	18	27	27	25	26	27	28	28	12	17	19	26	28
Refinancing Share (%) h.	77	75	57	50	51	43	35	35	39	32	57	59	65	41	35
Residential Mortgage Debt (%) i.	11.2	15.4	14.9	8.8	7.5	15.3	13.4	10.7	11.0	13.5	10.3	12.4	12.5	11.7	12.0

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; 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) home sales; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).

e. Freddie Mac/Fannie Mae conventional home price index (CMHPI); not seasonally-adjusted.

f. Includes single-family and multifamily debt; Stated at an annual rate.

g. Billions of dollars; not seasonally-adjusted.

h. Federal Housing Finance Board (FHFB); quarterly averages of monthly shares of conventional, home-purchase mortgage closings; not seasonally-adjusted.

i. Primary Mortgage Market Survey; quarterly averages of monthly shares of mortgage applications; not seasonally-adjusted.

l. Federal Reserve Board; residential mortgage debt is the sum of single-family and multifamily mortgages; not seasonally-adjusted.