

## April 2004 Economic Outlook

### *More Is Less and Less Is More*

The March employment report came out with a pleasantly and unexpectedly large jump in nonfarm, payroll employment. In total, 308,000 jobs were added in the U.S. economy in March, the largest gain since April of 2000. The January and February employment numbers were also revised upwards by a total of nearly 90,000 jobs. The job gains came primarily in the construction sector, which added 71,000 jobs reflecting strong demand for new housing, and the retail service sectors. March marked the first month since August of 2000 that there were no job losses in the manufacturing sector. Yet, amid all of this decidedly good news, there is an undercurrent of weakness. The unemployment rate edged back up to 5.7 percent, as workers entering the labor market in March were unable to find work. Average weekly earnings fell in March despite a slight rise in average hourly wages. Other worrisome indicators are that consumer confidence is waning, energy prices are spiking up and U.S. civilian and military casualties in Iraq are rising fast.

The stock and bond markets reacted to the positive news in the March employment report by pushing up yields on 10-year Treasury Notes by 27 basis points on the day of the jobs announcement. However, the signs of lingering economic weakness should soon moderate the euphoria and bring yields back down. One reason is that one month's worth of good news does not resolve all macroeconomic uncertainties, especially with the high degree of revision in these numbers over time. Thus, it is our view that there will be no near-term change in the Fed's stance with regard to its patient plan of accommodative monetary policy, meaning the Federal Funds target will remain at 1 percent until at least the Summer and perhaps through the end of 2004. Long-term interest rates and mortgage rates will also remain low, with 30-year, fixed mortgage rates averaging 5.6% for the year.

Low interest rates are helping the housing market continue its strong performance in the first two months of the year, with total home sales running close to record levels and housing starts running ahead of 2003's blistering pace. Home prices should grow at slightly higher rates in 2004 than in 2003 due to increasing demand for homes – as the economy improves and interest rates stay low – and tight supplies of homes for sale. Mortgage originations are staying brisk as homeowners take advantage of low rates to refinance. Total single-family mortgage originations in 2004 are now expected to be near \$2.8 trillion.

## *Details*

- All signs indicate that economic growth in 2004 will be robust. The question is how strong and when. Due to higher energy prices and weaker orders for non-defense capital goods than anticipated in the first quarter, we revised our forecast for real GDP growth down to 4.3%. The realization of higher tax refunds should bolster consumer spending in the second quarter and we revised our second quarter forecast up to 4.7 percent, leaving our annual growth rate for 2004 unchanged.
- Three forces are in play affecting consumer prices. The first, energy costs – especially record crude oil prices – is placing upward pressure on inflation. The second, productivity gains, and third, a lack of pricing power by producers and labor, are keeping consumer prices low. In the first quarter, energy costs rule, pushing inflation as measured by the Consumer Price Index to 3.3% (annualized), but the latter two forces will dominate later, bringing inflation down to 2.0% for the year.
- The GDP growth machine seems to have finally meshed gears with job creation. The 513,000 jobs gained in the first quarter is the strongest gain since the second quarter of 2000. Strong GDP growth should bring the unemployment rate down from its current level of 5.7% to 5.4% by year's end.
- Despite the volatile reaction of the 10-year Treasury rates to the March employment report, we see mortgage rates remaining low and stable throughout the year. Rates on 30-year, fixed rate mortgages came in at 5.6% in the first quarter; we expect rates to dip 10 basis point in the second quarter before gently rising up to 5.7% in the fourth quarter. In 2005, 30-year FRM rates should average 5.9%.
- Housing starts hit a 25-year peak of 1.85 million units in 2003 and we should see about the same level in 2004. However, the annualized starts in the first two months of this year exceeded last year's total, and low interest rates could keep construction activity pounding way past 2003 levels.
- With relatively very-low mortgage rates, total home sales will likely set a new record again this year. We forecast total home sales to come in at 7.27 million units in 2004, 1% higher than 2003 sales.
- We expect house price growth, as measured by the Conventional Mortgage Home Price Index, to come in at 8.9% for the year. Strong demand for housing, aided by low mortgage rates, and low inventories of homes for sale (currently at a little over 4 months supply) will help keep house prices growing robustly and boost housing equity in the American homeowners' balance sheet
- Lowering our forecast for mortgage rates by 10 basis points for 2004 also leads us to an increase in our forecast for total single-family mortgage originations to \$2.8 trillion, just over 2002's total, and to an increase in the refi share of applications to 52%. In 2005, originations should return to 2001's level as rising interest rates bring the refi share down below 40%.
- All indicators point to a relatively steep yield curve for the remainder of 2004. That will provide consumers with attractive financing opportunities provided by many of the hybrid ARM products available. We forecast the ARM share to average 23% in 2004 and again in 2005.
- Residential mortgage debt outstanding is expected to grow at 12.6%. Since we expect the pace of activity in the housing market to pick up during the second and third quarter, we also expect the bulk of the residential mortgage debt growth to take place during this period.

Frank Nothaft  
Chief Economist  
April 7, 2004

Amy Crews Cutts  
Deputy Chief Economist

Buchi Ramagopal  
Director of Financial Research

April 2004

Major Economic Indicators																
Indicator	2003				2004				2005		Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006
Real GDP (%)	2.0	3.1	8.2	4.1	4.3	4.7	4.2	4.2	4.0	4.0	0.0	2.8	4.3	4.4	4.0	3.5
Consumer Prices (%) a.	3.9	0.6	2.3	0.7	3.3	2.0	1.4	1.4	2.0	2.2	1.8	2.2	1.9	2.0	2.3	2.5
Unemployment Rate (%) b.	5.8	6.2	6.1	5.9	5.6	5.6	5.5	5.4	5.4	5.4	4.8	5.8	6.0	5.5	5.4	5.4
30-Year Fixed Mtg. Rate (%) b.	5.8	5.5	6.0	5.9	5.6	5.5	5.6	5.7	5.8	5.8	7.0	6.5	5.8	5.6	5.9	6.2
10-Year Const. Mat. Treas. Rate (%) b.	3.9	3.6	4.2	4.3	4.0	3.8	3.9	4.0	4.1	4.2	5.0	4.7	4.0	3.9	4.2	4.5
1-Year Const. Mat. Treas. Rate (%) b.	1.3	1.2	1.2	1.3	1.2	1.2	1.3	1.5	1.6	1.7	3.5	2.0	1.3	1.3	1.8	2.3

Housing and Mortgage Markets																
Indicator	2003				2004				2005		Annual Totals					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2001	2002	2003	2004	2005	2006
Housing Starts c.	1.74	1.74	1.88	2.03	1.90	1.89	1.80	1.80	1.65	1.63	1.60	1.70	1.85	1.85	1.65	1.63
Total Home Sales d.	6.80	6.95	7.57	7.41	7.19	7.40	7.30	7.20	7.20	7.20	6.20	6.54	7.19	7.27	7.24	7.14
House Price Appreciation (%) e.	5.4	5.0	5.9	17.8	9.8	9.5	8.5	7.7	7.6	6.3	7.6	7.6	8.4	8.9	6.4	5.6
1-4 Family Mortgage Originations f.																
Conventional	\$787	\$1,000	\$1,140	\$553	\$522	\$697	\$729	\$611	\$482	\$561	\$1,900	\$2,558	\$3,480	\$2,559	\$2,126	\$1,954
FHA/VA	\$54	\$59	\$64	\$54	\$52	\$69	\$72	\$60	\$54	\$62	\$167	\$187	\$231	\$253	\$236	\$217
Total	\$841	\$1,059	\$1,204	\$607	\$574	\$766	\$801	\$672	\$536	\$623	\$2,067	\$2,745	\$3,711	\$2,812	\$2,362	\$2,171
ARM Share (%) g.	16	15	18	27	24	21	22	23	23	23	12	17	19	23	23	23
Refinancing Share (%) h.	77	75	57	50	58	55	49	46	44	40	57	59	65	52	39	32
Residential Mortgage Debt (%) i.	11.1	15.5	12.7	10.7	10.8	15.5	12.8	11.3	9.0	11.2	10.3	12.4	12.5	12.6	9.8	8.0

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. Annualized growth rate of Freddie Mac's Conventional Home Mortgage 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; residential mortgage debt is the sum of single-family and multifamily mortgages; not seasonally-adjusted.