

June 2004 Economic Outlook

Fear of Flying

With all major economic indicators pointing upward, the recovery is gaining altitude. The latest labor market report is the latest sign of increasingly strong economic activity. Payroll employment was up an additional 248,000 during May, bringing the gain over the March-to-May interval to 947,000 jobs. Spurred by a brisk housing market, construction employment was up 37,000, and is up by 118,000 over the past 3 months. Even manufacturing employment was up by 32,000, the most since August 1998.

However, some of the indicators on the “instrument panel” are showing disturbing signals. In particular, the Consumer Price Index has accelerated, up 4.4 percent (at an annual rate) over the first four months of this year. Much of this rise has been due to the run-up in crude oil prices, which averaged \$40 in May, the highest on record. In turn, retail gasoline prices hit an all-time high of \$2.10 in late May. While the pickup in energy costs will add to inflation in the near-term and offset some of the economic growth that would have occurred, the level of energy prices is still only about one-half the record, after adjusting for inflation. Consequently, gasoline takes a much smaller bite out of the consumer’s pocketbook than a quarter century ago, mitigating the effect of the price rise on consumer spending.

The signs of a sustainable expansion with some upward pressure on consumer prices nearly guarantees that the Federal Open Market Committee will vote to increase the federal funds target to 1.25 percent at the end of June. Chairman Greenspan and his Board colleagues have indicated that they prefer a series of small hikes (we expect 0.25 percent at a time) to gradually raise the target over time.

Fixed-rate mortgage rates currently stand about 1 percent above the 2004 low that occurred in March. Yet, at about 6.3 percent for 30-year product, rates remain low. With employment and family income gains boosting consumer confidence, home sales and construction will remain vibrant through summer. Refinance will continue to fall-off: Less than 1-in-6 conforming fixed-rate mortgages have a coupon of 7 percent or higher, thus the pool of borrowers with a large financial incentive to refinance is relatively small. A combination of higher fixed-rates and a flatter yield curve will likely keep the ARM share close to its current level; ARMs are expected to account for 3-of-8 purchase-money originations over the coming year.

Details

- Second quarter real GDP growth will likely be about 4.5 percent, followed by 4.2 percent in both the third and fourth quarters. For the year as a whole, the economy should grow 4.3 percent in 2004 and 4.0 percent in 2005.
- We will see a higher rate of inflation in 2004 of about 2.7 percent, largely because of higher energy costs. However, inflationary pressures should moderate in 2005 to around 2.3 percent.
- Stronger economic growth should lead the unemployment rate downwards to somewhere around 5.4 percent by year-end. We expect the unemployment rate to average 5.4 percent throughout 2005.
- Mortgage rates rose in the second quarter in anticipation that the Federal Reserve Board will begin raising rates. We see the interest rate for 30-year fixed-rate mortgage rising up to average 6.7 percent by the end of the fourth quarter of 2004. For the year, the 30-year mortgage rate will average 6.3 percent in 2004 and 6.7 percent in 2005.
- 2004 will be another strong year for home construction. We see housing starts just barely surpassing last year's pace at about 1.86 million units in 2004. Starts should level off to 1.70 million in 2005.
- With the rebound in the economy, total home sales will likely reach a new record of 7.25 million homes in 2004. Higher mortgage rates will dampen sales to around 6.67 million units in 2005.
- House price appreciation will begin to moderate in 2004 to around 6.6 percent and slow to 5.7 percent in 2005.
- Single-family mortgage originations will fall to \$2.2 trillion in 2004 as refinancing activity recedes. We expect mortgage originations to total about \$1.8 trillion in 2005.
- With rising long-term rates, the ARM share of originations will likely rise to around 38 percent of the market in 2004 and 2005. Further, refinancing will represent only about 40 percent of new loans in 2004 and about 31 percent in 2005.
- Mortgage debt growth will be around 10 percent in 2004 and then ease slightly to around 9 percent in 2005.

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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	4.4	4.5	4.2	4.2	4.0	4.0	0.0	2.8	4.3	4.3	4.0	3.5
Consumer Prices (%) a.	3.9	0.6	2.3	0.7	3.6	3.0	2.0	2.0	2.0	2.2	1.8	2.2	1.9	2.7	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 (%) c.	5.8	5.5	6.0	5.9	5.6	6.2	6.6	6.7	6.7	6.7	7.0	6.5	5.8	6.3	6.7	6.8
10-Year Const. Mat. Treas. Rate (%) b.	3.9	3.6	4.2	4.3	4.0	4.7	5.0	5.1	5.1	5.1	5.0	4.7	4.0	4.7	5.1	5.2
1-Year Const. Mat. Treas. Rate (%) b.	1.3	1.2	1.2	1.3	1.2	1.7	2.1	2.2	2.3	2.5	3.5	2.0	1.3	1.8	2.5	2.9

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 d.	1.74	1.74	1.88	2.03	1.95	1.92	1.80	1.76	1.70	1.70	1.60	1.70	1.85	1.86	1.70	1.72
Total Home Sales e.	6.80	6.96	7.58	7.41	7.38	7.35	7.20	7.10	6.90	6.80	6.20	6.54	7.19	7.25	6.67	6.33
House Price Appreciation (%) f.	5.5	5.1	6.0	17.9	5.6	6.5	7.4	6.8	6.0	5.9	7.6	7.6	8.5	6.6	5.7	5.0
1-4 Family Mortgage Originations g.																
Conventional	\$787	\$1,000	\$1,140	\$553	\$517	\$596	\$508	\$406	\$353	\$434	\$1,900	\$2,558	\$3,480	\$2,027	\$1,664	\$1,700
FHA & VA	\$54	\$59	\$64	\$54	\$51	\$59	\$50	\$40	\$39	\$48	\$167	\$187	\$231	\$200	\$185	\$189
Total	\$841	\$1,059	\$1,204	\$607	\$568	\$655	\$558	\$446	\$392	\$482	\$2,067	\$2,745	\$3,711	\$2,227	\$1,849	\$1,889
ARM Share (%) h.	16	15	18	27	27	37	44	42	41	39	12	17	19	38	38	31
Refinancing Share (%) i.	77	75	57	50	59	39	30	32	33	28	57	59	65	40	31	31
Residential Mortgage Debt (%) j.	11.1	15.5	12.7	10.7	6.9	11.0	11.5	10.6	7.5	11.2	10.3	12.4	12.5	10.0	9.2	7.4

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; based on the seasonally-adjusted, all-urban consumer price index.

b. Quarterly averages of monthly rates; not seasonally-adjusted.

c. Quarterly averages of monthly rates; not seasonally-adjusted. Conventional, conforming, prime mortgages only.

d. Millions of housing units; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).

e. 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).

f. Annualized growth rate of Freddie Mac's Conventional Home Mortgage Price Index (CHMPI). Not seasonally adjusted.

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.

j. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages; not seasonally-adjusted.