

Office of the Chief Economist
July 2004 Economic Outlook

Dot-Dot-Dash Dot-Dash-Dash-Dot!

“Up” in Morse code is dot-dot-dash dot-dash-dash-dot and that is precisely what the Fed communicated for interest rates in its June 30, 2004 Open Market Committee (FOMC) meeting – a message that it had been telegraphing to the market for a while. The market view is that this was the first of as many as twelve consecutive “measured” rate increases of 25 basis points in the Federal Funds rate, with the target rate being 4 percent at the end of 2005. These hikes are intended to move the Fed’s monetary policy from deep in “accommodative” territory into the neutral zone – a Fed Funds rate of about 3 percent – and then on to inflation-fighting mode at higher levels. In the near term these rate hikes will affect the economy very little since the neutral zone is so far away. But by gradually removing the accommodation the Fed will be well poised to apply brakes if the economy grows a little too healthy across a broad set of measures.

Speaking of measures of economic health, consumer confidence in June hit its highest level since June 2002, but the employment report showed just 112,000 non-farm payroll jobs added for the month – about half of the number that was expected. First-quarter growth in real gross domestic product (GDP) was revised significantly downward to a final value of 3.9 percent from the previously revised 4.4 percent rate and expectations for growth in the second quarter have been brought down as well. Yet personal disposable income rose for two consecutive months in April and May, and May showed the biggest increase in consumer spending since October 2001. We conclude the economy still shows some considerable signs of weakness, but positive influences significantly outweigh negative ones for the second half of 2004.

On the housing side of the economy, things couldn’t be better. Higher mortgage interest rates in the second quarter had almost no effect on the housing market: new home sales reached a new all-time high in May at 1.37 million units (annualized), as did sales of existing homes at 6.8 million units (annualized) and also the median price of existing homes sold (\$186,300). Even with the much anticipated Fed hike in interest rates, mortgage rates have remained low by historical standards (rates on 30-year, fixed rate conforming mortgages averaged 6.1 percent in the second quarter) and the yield curve is still steep, meaning mortgage borrowers have many affordable options to consider between shorter-term fixed-rate loans and hybrid, adjustable-rate loans in addition to the standard 30-year, fixed-rate mortgages. These conditions are expected to remain for a while, so the housing market should end the year well into record territory.

Details

- The final measure of real GDP growth was revised down 0.5 percentage points from the preliminary value to 3.9% for the first quarter due to downward revisions to inventory investment and net exports, and these should also have a dampening effect on growth in the second quarter. The latter half of the year is expected to rebound strongly as inventories start to rise again, business investment gets into second gear, and exports make gains.
- Many factors, which we believe are mostly temporary, caused a jump in inflation in the second quarter: record energy costs, corresponding increases in transportation and production costs, increases in import prices due to the decline in the dollar's value and a rebound from unusually low (i.e., sale) prices for a number of commodities. The second half of the year should see inflation moderate to about 3% (annualized) as measured by the consumer price index
- Jobs are coming back at a fast pace: 671,000 non-farm payroll jobs were added in the U.S. economy during the second quarter. The unemployment rate should start to decline soon and is expected to finish the year at 5.4% and remain at that level for all of 2005.
- The market got a little overly excited when the Fed announced a change in May from a policy of being "patient" to being "measured" and interest rates shot upward. They have since moderated a bit and in fact yields on 10-year treasuries came down 16 basis points over the two days following the FOMC meeting. We expect 30-year, fixed mortgage rates to gradually increase to about 6.5% by the 4th quarter and then hold steady in 2005 while short-term interest rates will continue to rise as the FOMC raises the Federal Funds rate over the year.
- Home construction started the year strong and should finish strong. We are forecasting housing starts to total 1.92 million units in 2004, slowing to 2002's level of 1.7 million units in 2005.
- Home sales are shattering records with ease, and should finish the year 2% higher than 2003's record level. The home purchase market should slow next year as the effects of higher interest rates finally take hold and other assets start to compete with housing for investment money.
- The same forces affecting home sales apply to home prices. Home prices are expected to grow 6.7% in 2004, a slightly slower rate of appreciation than we saw in 2003, and then moderate to 5.8% in 2005.
- Refinance activity has already slowed to less than 40% of new mortgage applications and should average 33-34% over the next two quarters and 2005. Fewer refinancings will cause single-family mortgage originations to fall to \$2.3 trillion in 2004 and \$2 trillion in 2005. Mortgage debt growth will be around 12% in 2004 and around 10% next year.
- With a yield curve that still offers a steep discount to shorter-term mortgage products, the ARM share of originations will likely rise to around 39% of the market in the second half of 2004 and then fall back to 33% in 2005 as the short end of the yield curve rises faster than the long end.

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Economic and Housing Market Outlook

July 2004

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Major Economic Indicators

Indicator	2003		2004				2005				Annual Totals					
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2001	2002	2003	2004	2005	2006
Real GDP (%)	8.2	4.1	3.9	3.7	5.0	4.4	4.2	3.8	3.9	3.9	0.0	2.8	4.3	4.3	4.0	3.5
Consumer Prices (%) a.	2.3	0.7	3.6	4.7	3.3	2.5	2.0	2.0	2.0	2.0	1.8	2.2	1.9	3.5	2.0	2.5
Unemployment Rate (%) b.	6.1	5.9	5.6	5.6	5.5	5.4	5.4	5.4	5.4	5.4	4.8	5.8	6.0	5.5	5.4	5.4
30-Year Fixed Mtg. Rate (%) c.	6.0	5.9	5.6	6.1	6.4	6.5	6.5	6.5	6.6	6.6	7.0	6.5	5.8	6.1	6.5	6.7
10-Year Const. Mat. Treas. Rate (%) b.	4.2	4.3	4.0	4.6	4.9	4.9	5.0	5.0	5.0	5.1	5.0	4.7	4.0	4.6	5.0	5.2
1-Year Const. Mat. Treas. Rate (%) b.	1.2	1.3	1.2	1.8	2.3	2.4	2.5	2.6	2.7	2.8	3.5	2.0	1.3	1.9	2.7	3.1

Housing and Mortgage Markets

Indicator	2003		2004				2005				Annual Totals					
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2001	2002	2003	2004	2005	2006
Housing Starts d.	1.88	2.03	1.94	1.97	1.90	1.85	1.77	1.70	1.68	1.65	1.60	1.70	1.85	1.92	1.70	1.72
Total Home Sales e.	7.58	7.41	7.41	7.45	7.29	7.19	6.90	6.80	6.77	6.70	6.20	6.54	7.19	7.33	6.79	6.43
House Price Appreciation (%) f.	6.0	17.9	5.6	6.7	7.6	6.9	6.0	6.0	6.8	4.5	7.6	7.6	8.5	6.7	5.8	5.0
1-4 Family Mortgage Originations g.																
Conventional	\$1,140	\$553	\$517	\$611	\$554	\$445	\$396	\$476	\$499	\$439	\$1,900	\$2,558	\$3,480	\$2,128	\$1,810	\$1,861
FHA & VA	\$64	\$54	\$39	\$60	\$55	\$44	\$44	\$53	\$55	\$49	\$167	\$187	\$231	\$198	\$201	\$207
Total	\$1,204	\$607	\$556	\$672	\$609	\$490	\$440	\$529	\$554	\$488	\$2,067	\$2,745	\$3,711	\$2,326	\$2,011	\$2,068
ARM Share (%) h.	18	27	27	36	39	38	36	33	31	30	12	17	19	35	33	26
Refinancing Share (%) i.	57	50	59	40	33	33	36	31	32	35	57	59	65	41	34	33
Residential Mortgage Debt Growth (%) j.	13.2	10.3	11.4	11.5	13.2	12.1	7.4	10.0	12.6	8.4	10.2	12.0	12.8	12.0	9.6	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. 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.

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