

Hiccough?

The discouraging economic data released the first week of August was enough to begin speculation that the economy might be on the verge of losing momentum. The data showed that real GDP growth slowed to just 3% and consumer spending grew just 1% (both annualized numbers) in the second quarter. Next, the employment report for July showed an increase of just 32,000 jobs (208,000 short of expectations). Then nominal oil prices hit several new highs and those led to an annual rate of increase of 27% for the first half of the year in consumer energy prices. That was enough bad news for the bond market: yields on the 10-year Treasury notes sank from a relative high of 4.60 on July 29th to 4.17 on August 6th. Despite the hand wringing, it's difficult to believe that it's anything more than a temporary hiccough as the sectors of the economy settle into different roles in the next phase of the recovery.

Getting better perspective requires an accounting for the data pointing in a positive direction. Last quarter, exports rose 13.2%, spending by businesses ratcheted up 10% at an annual rate and this was accompanied by a 5% increase in construction spending on offices and warehouses. Now, throw in the news that businesses are beginning to add to their inventories. Inventory accumulation rose in first quarter by \$40 billion and was followed last quarter by nearly \$50 billion. Moreover, inventory levels are currently low. Just getting inventories to a level where firms feel comfortable will provide a significant boost to the economy.

Yet, the most significant boost to the economy during the second half of the year will come from the accumulation of unfilled orders. Data released by the Commerce Department for June of this year shows that, excluding aircraft orders, the backlog of orders for manufacturers rose by 14%. What this means is a large part of the production for the second half of the year is already locked in.

The housing sector of the economy is likely to be influenced, if at all, by the volatility of interest rates. Yet, with 30-year fixed-rate mortgage rates expected to average 6.1% for the quarter and GDP growth staying strong, housing starts and home sales are expected stay on track to hit record levels of 1.90 million units and 7.54 million units, respectively. As Fed actions contribute to the flattening of the yield curve, the allure of ARMS might begin to fade. This will quite likely bring a dose of reality to prospective homebuyers. However, rising incomes and improving job prospects are apt to dominate in their calculations despite the current mixed signals in the news as the economy moves to a more sustainable pace of activity.

Details

- Real growth in Gross Domestic Product (GDP) came in at 3.0% for the second quarter. This was lower than expected, and led us to lower our expectations for growth in the third quarter to 4.0% and to 4.1% for the fourth. Continued increases in crude oil prices and weakness in labor markets could further dampen expectations for growth – risk is to the downside.
- Inflation has started to become a troubling prospect. Higher energy prices have begun to trickle through into other commodity prices, so that the core rate of inflation, which takes out the effects of volatile energy and food components, has started to rise even though wages and retail prices have remained flat. Higher energy costs have a big impact on household balance sheets, and consumer spending decreased in June as a result. We expect overall inflation as measured by the Consumer Price Index to run at 4% (annualized) in the third quarter, and at 3.7% for the year, nearly double 2003's rate of inflation (1.9%).
- The July jobs report came in well below market expectations of 240,000 new jobs for the month at just 32,000 jobs added, and the May and June job counts were revised lower by 61,000. We still anticipate a slow decline in the unemployment rate by year's end to 5.4%.
- The bond market responded to the July jobs report by dropping the yield on 10-year Treasury notes by 23 basis points before making a slight recovery on the day of the release. We believe interest rates are at about the right level given economic conditions and expect 30-year fixed mortgage rates to average 6.1% in the 3rd quarter, easing up to 6.3% in the 4th. The yield curve should continue to flatten gradually as the Fed increases short-term interest rates at a "measured" pace.
- The home construction industry has remained strong, June's housing starts data notwithstanding. We left our forecast for residential housing starts unchanged at 1.90 million units (annualized) for the 3rd quarter, 1.85 million units in the 4th, and 1.70 million units over 2005.
- Home sales are shattering records with ease – the 2nd quarter total came in at 8.08 million units (annualized), buoyed by March's near-record-low interest rates. Although higher, interest rates at between 6% and 6.5% for 30-year fixed rate mortgages are still very supportive of a vibrant housing market. We expect 2004 sales to top 2003's total by nearly 5% at 7.54 million units.
- The same forces affecting home sales apply to home prices. Our lowered interest-rate forecast suggests slightly stronger home price appreciation (around 7.1% for 2004) than we predicted last month but still quite a bit slower than what we saw in 2003.
- Refinance activity has already slowed to less than 40% of new mortgage applications and should average 33-35% over the next two quarters and into 2005. Fewer refinancings will cause single-family mortgage originations to fall to \$2.4 trillion in 2004 and \$2.1 trillion in 2005. Mortgage debt growth will be around 12% in 2004 and just under 10% next year.
- Rising short-term interest rates with falling or level long-term rates are likely to make adjustable rate mortgages (ARMs) relatively less attractive over time, but the deep discounts available today have put the ARM share up to 36% in the 2nd quarter where it is expected to stay through the end of the year. In 2005 the ARM share should fall to 30%.

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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 (%)	7.4	4.2	4.5	3.0	4.0	4.1	4.2	3.8	3.9	3.9	0.2	2.3	4.4	3.9	4.0	3.5
Consumer Prices (%) a.	2.3	0.7	3.6	4.7	4.0	2.5	2.0	2.0	2.0	2.0	1.8	2.2	1.9	3.7	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	6.1	6.3	6.3	6.4	6.4	6.5	7.0	6.5	5.8	6.0	6.4	6.6
10-Year Const. Mat. Treas. Rate (%) b.	4.2	4.3	4.0	4.6	4.6	4.8	4.8	4.9	4.9	5.0	5.0	4.7	4.0	4.5	4.9	5.1
1-Year Const. Mat. Treas. Rate (%) b.	1.2	1.3	1.2	1.8	2.2	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	1.91	1.90	1.85	1.77	1.70	1.68	1.65	1.60	1.70	1.85	1.90	1.70	1.72
Total Home Sales e.	7.57	7.42	7.40	8.08	7.49	7.19	6.90	7.10	7.05	6.95	6.20	6.54	7.19	7.54	7.00	6.54
House Price Appreciation (%) f.	6.0	17.9	5.6	6.7	8.0	8.2	6.4	5.6	6.2	4.3	7.6	7.6	8.5	7.1	5.6	4.9
1-4 Family Mortgage Originations g.																
Conventional	\$1,140	\$553	\$517	\$640	\$570	\$499	\$413	\$499	\$518	\$448	\$1,900	\$2,558	\$3,480	\$2,226	\$1,878	\$1,839
FHA & VA	\$64	\$54	\$39	\$63	\$56	\$49	\$46	\$55	\$58	\$50	\$167	\$187	\$231	\$207	\$209	\$204
Total	\$1,204	\$607	\$556	\$703	\$626	\$548	\$459	\$554	\$576	\$498	\$2,067	\$2,745	\$3,711	\$2,433	\$2,087	\$2,043
ARM Share (%) h.	18	27	27	36	37	36	33	31	29	28	12	17	19	34	30	24
Refinancing Share (%) i.	57	50	59	39	36	32	32	32	33	35	57	59	65	42	33	32
Residential Mortgage Debt Growth (%) j.	13.2	10.3	11.4	9.7	14.7	12.4	8.8	11.0	10.8	7.7	10.2	12.0	12.8	12.0	9.5	7.9

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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