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Office of the Chief Economist

September 2004 Economic Outlook

Will they or Won't They?

Personal consumption expenditures comprise about 70 percent of GDP. It's no wonder that economic growth slows when consumption spending is weak, and expands when it strengthens. One question that the Fed will be wrestling with at its next monetary policy meeting (September 21) is whether consumption spending will accelerate from the moribund one-percent annualized growth rate of the second quarter. The August employment report showed 144,000 jobs were created (and an additional 41,000 upward revision to July), presaging better income gains and spending in the current quarter.

The unexpectedly weak spending pattern during the April-to-June quarter reflected the rise to record levels in crude oil prices (which kept gas prices high, further taking a bite out of family disposable income), a lackluster stock market and the rise in interest rates from March's lows. It appears that oil prices may have peaked; world oil prices are down about 10 percent from the record, but still have a large "risk premium" reflecting the uncertainty in the Middle East and potential disruptions from the Yukos scandal in Russia. While oil prices remain high in nominal terms, they remain well below the record real prices of the early 1980s: West Texas Intermediate peaked in nominal value in August, but that was still 50 percent below the April 1980 record in real value. Common stocks have continued to under-perform, but this has been offset by the continued strength in home-equity wealth creation through home-value gains. Interest rates have also trended down over the third quarter, helping to bolster consumer finances.

The August employment report also contained a hint of good news regarding earnings: average hourly earnings of non-supervisory workers had accelerated to an annualized 4.3 percent rate during July and August, suggesting real (inflation-adjusted) wage gains during the third quarter, compared with the 1.8 percent annualized decline in real earnings during the second quarter. This news may be sufficient to sway the price-stability hawks at the Fed to raise the federal funds target an additional one-quarter percent on the 21st. Thus the question is, will they or won't they – the Fed that is – raise interest rates? Traders appear to think so: contracts for federal funds futures imply that traders assign a nearly 100 percent likelihood to the increase.

Whatever the outcome of the Fed's deliberations, fixed-rate mortgage rates are likely to remain low. Coupled with income growth, the housing market should remain robust for the balance of 2004, setting new annual records for home sales and single-family starts. Purchase-money originations will set a new annual record, too, but with refinances drifting down, total originations will end up 30 percent below the 2003 pace. Refinance will slip, in part, because there remains a relatively small pool of borrowers who have not yet taken advantage of refinancing; only about 1-in-8 fixed rate mortgages today have a coupon of 7 percent or higher, which would be prime candidates for refinance.

Details

- In August, the growth rate in real Gross Domestic Product (GDP) was revised down from the initial estimate of 3.0% to 2.8% for the second quarter. This was further evidence of a so-called "soft patch" in economic growth in the second quarter. Continued high crude oil prices and weakness in labor markets could further dampen expectations for growth – risk remains to the downside.
- High oil prices continue, however in recent weeks we have seen a small decline from record highs. Wages have also started to show signs of real growth, which is a strong sign of turnaround in the labor market. With these trends in mind, we lowered our forecast for overall inflation as measured by the Consumer Price Index to 3% (annualized) in the third quarter, and to 2.5% in the fourth.
- The August employment report was a mixture of good news and bad. For the month, payroll employment rose by an estimated 144,000 jobs (near the consensus total of 150,000) and the July report was revised upwards by 41,000 (still 165,000 jobs shy of the originally expected July total). We remain optimistic that the economy will continue to add jobs at a pace of 100,000 jobs-or-more per month and that the unemployment rate will end the year at 5.4%.
- Since our previous outlook release (August 9), yields on 10-year Treasury Notes stayed relatively flat, within the range of 4.21% to 4.29%, before falling sharply over the days prior to the August jobs report. In contrast, mortgage rates have trended down since the end of July, and 30-year, fixed mortgage rates averaged just 5.77% for the week ended September 2. We expect 30-year, fixed mortgage rates to remain low, averaging 5.9% for the second half, and, in response to increases in short-term interest rates, adjustable mortgage rates should gradually rise through year's end.
- July's housing starts numbers came in at the blistering pace of 1.978 million units (annualized). Over the first seven months of the year, housing starts have been on a pace of 1.94 million units, the highest level in over 25 years. We are predicting total starts in 2004 to hit 1.91 million units, with a new record in single-family construction for the year.
- Home sales continue to push past record volumes. July's total home sales came in at 7.85 million units (annualized) and as a result we increased our total forecast for the year to 7.65 million units from August's predicted total of 7.54 million.
- The same forces affecting home sales apply to home prices. Our lowered interest-rate forecast suggests stronger home price appreciation than we predicted last month and we now are estimating growth in home values at 8.6% for 2004, equal to the appreciation rate we saw in 2003.
- Refinance activity rebounded a bit with August's lower mortgage rates to just over 40% of new applications. The refi share should average 36-37% over the second half. Fewer refinancings will cause single-family mortgage originations to fall to \$2.6 trillion in 2004 and \$2.3 trillion in 2005. Based on the newly released Home Mortgage Disclosure Act data, we revised our estimate for originations in 2003 upwards to \$3.9 trillion. Mortgage debt growth is expected at 12 to 13% in both 2004 and 2005.
- The adjustable rate mortgage (ARM) share of new mortgage applications has risen markedly in 2004 as fixed mortgage rates came up from 45-year lows. However, in coming quarters, short-term interest rates should rise faster than long-term rates, making ARMs relatively less attractive as the fixed-rate-versus-ARM spread narrows. In the 3rd and 4th quarters of 2004, the ARM share should average 34%.

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September 8, 2004		

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Economic and Housing Market Outlook

September 2004

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Major Economic Indicators

Indicator	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	Annual Totals 2001	2002	2003	2004	2005	2006
Real GDP (%)	7.4	4.2	4.5	2.8	**3.5**	**4.0**	**4.0**	**3.8**	**3.8**	**3.8**	0.2	2.3	4.4	**3.7**	**3.9**	**3.5**
Consumer Prices (%) a.	2.3	0.7	3.6	4.7	**3.0**	**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**	**5.3**	**5.2**	**5.2**	**5.1**	4.8	5.8	6.0	**5.5**	**5.2**	**5.2**
30-Year Fixed Mtg. Rate (%) c.	6.0	5.9	5.6	6.1	**5.9**	**5.9**	**5.9**	**6.0**	**6.1**	**6.2**	7.0	6.5	5.8	**5.9**	**6.1**	**6.3**
10-Year Const. Mat. Treas. Rate (%) b.	4.2	4.3	4.0	4.6	**4.3**	**4.3**	**4.3**	**4.4**	**4.5**	**4.6**	5.0	4.7	4.0	**4.3**	**4.5**	**4.7**
1-Year Const. Mat. Treas. Rate (%) b.	1.2	1.3	1.2	1.8	**2.0**	**2.1**	**2.2**	**2.3**	**2.4**	**2.6**	3.5	2.0	1.3	**1.8**	**2.4**	**2.8**

Housing and Mortgage Markets

Indicator	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	Annual Totals 2001	2002	2003	2004	2005	2006
Housing Starts d.	1.88	2.03	1.94	1.92	**1.92**	**1.85**	**1.77**	**1.70**	**1.68**	**1.65**	1.60	1.70	1.85	**1.91**	**1.70**	**1.72**
Total Home Sales e.	7.57	7.42	7.40	8.01	**7.70**	**7.50**	**7.00**	**7.20**	**7.15**	**7.05**	6.20	6.54	7.19	**7.65**	**7.10**	**6.60**
House Price Appreciation (%) f.	6.2	17.9	6.5	9.8	**9.5**	**8.7**	**7.6**	**6.5**	**6.3**	**4.5**	7.6	7.5	8.6	**8.6**	**6.2**	**5.0**
1-4 Family Mortgage Originations g.																
Conventional	**$1,115**	**$607**	**$600**	**$700**	**$600**	**$500**	**$445**	**$561**	**$540**	**$490**	**$1,900**	**$2,696**	**$3,629**	**$2,400**	**$2,036**	**$1,950**
FHA & VA	$64	$54	$39	$37	**$50**	**$44**	**$49**	**$62**	**$60**	**$54**	$167	$187	$231	**$170**	**$226**	**$217**
Total	**$1,179**	**$661**	**$639**	**$737**	**$650**	**$544**	**$494**	**$623**	**$600**	**$544**	**$2,067**	**$2,883**	**$3,860**	**$2,570**	**$2,262**	**$2,167**
ARM Share (%) h.	18	27	27	36	**36**	**32**	**31**	**29**	**28**	**27**	12	17	19	**33**	**29**	**25**
Refinancing Share (%) i.	57	50	59	39	**38**	**35**	**32**	**32**	**33**	**35**	57	59	65	**43**	**33**	**32**
Residential Mortgage Debt Growth (%) j.	13.2	10.3	11.4	**13.9**	**14.6**	**10.3**	**13.6**	**14.2**	**12.5**	**11.0**	10.2	12.0	12.8	**12.6**	**12.8**	**10.3**

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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