

### *And the Beat Goes On*

Another month has gone by in 2004 and sure enough, another record high in oil prices was achieved. The Fed raised short-term interest rates again. A hurricane hit Florida. Another hurricane hit Florida. For the moment, things seem to be humming along at a steady beat, albeit, not necessarily on a positive track for the U.S. economy.

The near-term impacts of the five tropical storms and hurricanes that have caused significant damage in the southern U.S. thus far in 2004 – Charley, Gaston, Francis, Ivan and Jeanne – will be negative in national economic statistics. This is due to lost corporate profits on insured losses and lost rents due to uninsured losses to residential property and higher prices for agricultural crops from the region – these losses are on the order of \$21 billion. The longer-term impacts will be large and positive – rebuilding all the homes and businesses destroyed by the storms will add to GDP and add jobs. Florida already has one of the strongest housing markets in the economy and booming home construction activity. The rebuilding effort will make the construction market even tighter, with fierce competition for construction workers and materials.

The Federal Reserve has said it will continue with its measured increases in the federal funds rate. We believe this means another quarter-percentage point increase in short-term interest rates when the Fed's Open Market Committee next convenes on November 10th. Low inflationary pressures excluding energy and food prices continue to allow the Fed room to be accommodative and it is still about one-percentage point shy of neutral monetary policy. With low inflation there is no reason for longer-term interest rates to rise, and this means bargain mortgage rates for several more months.

The major risk to our economic outlook is oil. The record high prices for petroleum and related products are expected to be temporary, although they have already lingered longer than initially anticipated. Consumers are starting to react to higher prices at the gas pump by cutting back on other spending, which significantly affects GDP growth (about 70 percent of GDP is made up of consumption spending). Furthermore, energy costs are starting to feed into retail prices as producers try to pass on higher transportation and material costs to consumers, and the already weak airline industry is buckling under the higher fuel costs. If high energy prices continue or rise even further this will put the brakes on the economy and could turn a soft patch into something much worse. The Fed has bought itself some wiggle room with the recent interest rate increases, which it can undo if necessary to help bolster the economy. Our worry is that they may have to.

## Details

- *Real GDP growth.* Gains in payroll employment, industrial production, housing starts and net exports point toward a second half bounce back, and GDP growth should hit 4% (annualized) over the next two quarters, and 3.9% overall for 2005.
- *Consumer price inflation.* After a second quarter, energy-cost induced spike in the consumer price index (CPI), CPI inflation should return to a more moderate pace, averaging at about a 2% inflation rate in 2005, unchanged from our previous outlook. Oil prices remain the wild card and biggest downside risk to our forecast: a barrel of oil closed above \$50 a barrel last week for the first time. Nonetheless, we expect oil prices to gradually drift downward in 2005, helping to keep inflation low.
- *Unemployment rate.* Our unemployment rate forecast is unchanged from last month. With GDP growth expected to exceed 3.5%, job creation should bring the unemployment rate gradually down, to close to 5% by the end of 2005.
- *Mortgage rates.* With 30-year fixed mortgage rates averaging 5.72% as of September 30, fixed-rate loans are only about 50 basis points above the 46-year low of June 2003. We expect fixed-rate loans to gradually become more expensive, increasing about one-half of a percentage point between now and the end of 2005. ARM rates will increase by more because we expect the Fed to continue to push the federal funds target higher – we expect another quarter-point increase, to 2%, on November 10.
- *Housing starts.* Low mortgage rates continue to foster new housing demand, either through household formations or desire for second homes. We bumped up our housing starts projection to 1.80 million dwellings for 2005.
- *Home sales.* Both previously owned and newly built home sales will easily set records this year, of about 6.5 million and 1.2 million, respectively. We increased the total home sales forecast to 7.15 million for 2005 – a 7% dip from the level set in 2004 attributable to slightly higher mortgage rates.
- *Home value appreciation.* Home price growth will moderate over the next year, with appreciation averaging between 4% and 7% per year over the next few years.
- *Mortgage activity.* The Fed-induced flattening of the yield curve (primarily through raising short-term rates) will bring the ARM share of lending down over the next year. Higher rates will also choke off refinancing volume, and those who do choose to refinance will more likely do so in order to tap into home equity. We pushed up our origination forecast to \$2.6 trillion for 2004 and \$2.2 trillion for 2005, based on the lower mortgage rates of the past month.

Frank E. Nothhaft  
Chief Economist  
October 6, 2004

Amy Crews Cutts  
Deputy Chief Economist

Michael Schoenbeck  
Economist



We make home possible<sup>SM</sup>

# Office of the Chief Economist Economic and Housing Market Outlook

October 2004

Revised 10/6/2004

## 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	3.3	3.5	4.0	4.0	3.8	3.8	3.8	0.2	2.3	4.4	3.8	3.9	3.5
Consumer Prices (%) a.	2.3	0.7	3.6	4.7	1.6	2.5	2.0	2.0	2.0	2.0	1.8	2.2	1.9	3.1	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	5.8	5.9	6.0	6.1	6.2	7.0	6.5	5.8	5.9	6.1	6.4
10-Year Const. Mat. Treas. Rate (%) b.	4.2	4.3	4.0	4.6	4.3	4.2	4.3	4.4	4.4	4.5	5.0	4.7	4.0	4.3	4.4	4.7
1-Year Const. Mat. Treas. Rate (%) b.	1.2	1.3	1.2	1.8	2.1	2.3	2.4	2.5	2.7	2.8	3.5	2.0	1.3	1.8	2.6	3.0

## 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	1.92	1.99	1.90	1.85	1.80	1.80	1.75	1.60	1.70	1.85	1.94	1.80	1.72
Total Home Sales e.	7.57	7.42	7.40	7.98	7.76	7.50	7.30	7.20	7.10	7.00	6.20	6.54	7.19	7.66	7.15	6.79
House Price Appreciation (%) f.	6.2	17.9	6.5	9.8	9.0	8.8	7.2	5.9	6.6	4.5	7.6	7.5	8.6	8.5	6.1	5.1
1-4 Family Mortgage Originations g.																
Conventional	\$1,115	\$607	\$600	\$700	\$627	\$523	\$465	\$539	\$547	\$475	\$1,900	\$2,696	\$3,629	\$2,450	\$2,025	\$2,004
FHA & VA	\$64	\$54	\$39	\$37	\$55	\$45	\$40	\$47	\$48	\$41	\$167	\$187	\$231	\$176	\$176	\$174
Total	\$1,179	\$661	\$639	\$737	\$682	\$568	\$505	\$586	\$594	\$516	\$2,067	\$2,883	\$3,860	\$2,627	\$2,201	\$2,178
ARM Share (%) h.	18	27	27	36	37	34	33	31	29	28	12	17	19	34	30	25
Refinancing Share (%) i.	57	50	59	39	37	43	42	35	33	34	57	59	65	45	36	30
Residential Mortgage Debt Growth (%) j.	13.3	10.4	11.3	12.4	14.7	13.4	9.7	11.7	10.5	8.2	10.1	11.8	12.8	13.0	10.0	8.2

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.

Prepared by Office of the Chief Economist (MAS 10/6/2004); Send comments and questions to [chief\\_economist@freddiemac.com](mailto:chief_economist@freddiemac.com).