that IT investment has stabilized after months of sharp declines. The downturn of the past 18 months has essentially erased the run-up of stock prices in the 1990s. Since the recession of 1991, if stocks had simply averaged 7 percent above inflation per year, then the stock prices would be close to current levels.

Over the next year we expect to see market returns more closely related to expected growth in corporate profits and the growth in the economy in general. Once the recovery is under way we are likely to see economic growth in the 2 to 3 percent range, inflation of 1 to 2 percent and corporate profit growth in the 5 to 6 percent range. Price/earnings ratios will shrink somewhat, but remain above their historical average. Overall, expectations of stock market returns are more likely to be in the high single-digits than the double-digit rates of the mid-1990s. We appear to be gradually returning to more “normal” times.

Short-term government rates are currently about 2 percent, and should remain at these low levels over the near term. Since the start of the year, the Federal Funds rate has been cut by 450 basis points and short-term Treasury Bills have shown a similar decline in yields. Despite the lowest short-term rates in 40 years, the yield on 3-month T-bills is lower than the Federal Funds rate, suggesting that additional interest rate cuts are forthcoming. Overall, short-term rates will remain in the 2 percent range until there is clear evidence that recovery is underway. The bank prime rate is expected to continue a slight decline and be around 5 percent until loan demand increases with an increase in economic activity.

Long-term Treasury rates have also declined, although much less than the short-term rates. The 10-year Treasury rate is about 4.25 percent, a reduction of 85 basis points since the start of the year. Since short-term rates have fallen by more than long-term rates, the yield curve has become steeper. This development is a favorable indicator for the economy because a steepening of the yield curve is associated with higher growth in the future. As growth picks up, short-term rates will rise as the Federal Funds rate reverts to a more balanced target.

The Outlook for Housing

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Activity in the nation’s home building industry is expected to hold up fairly well against a general decline in economic growth during the final two business quarters of 2001. While the terrorist attack on America on September 11th has had a negative impact on consumer confidence, it appears that a healthy number of prospective homebuyers remain in the marketplace, and that low mortgage interest rates are helping to moderate the housing slowdown that is now occurring.

For the past year, the role of housing has been anything but typical, as it remained strong as the economy weakened, preventing growth of the Gross Domestic Product from turning negative. New residential construction alone accounts for 5 percent of the GDP on average and 14 percent when related financial and other activities are included.

The drop in mortgage rates from a peak of 8.7 percent in May of 2000 is helping to support the industry by making home buying more affordable. Interest rates are around 6.5 percent for fixed-rate mortgages and close to 5 percent for adjustable-rate mortgages. According to Freddie Mac, the national average commitment rate for a 30-year, conventional, fixed-rate mortgage was 6.82 percent in September, down from 6.95 percent in August; it was 7.91 percent in September 2000. Rates for fixed-rate mortgages had increased slightly at the time of this writing, but remain near historic lows, which allows homebuyers and people refinancing their homes probably the best mortgage financing terms since the 1960s.

There are some reasons to believe that the next significant move in long-term mortgage rates will be up from current levels. For one, the rate on the 10-year Treasury Note, a bellwether bond used to help price mortgages, has kicked up recently. It stands now at 4.57 percent—not that much higher than its recent low of 4.48 percent on October 3rd, but it is not falling, either.

Second, the housing market may be holding up better than most had expected following September

11th. The number of mortgage applications to finance a home purchase has been rising, and is down only modestly from its pre-terrorist attack levels. And housing starts did not swoon during September, as had been widely expected. (While the reported September pace was actually stronger than August's rate, the two numbers are, statistically speaking, indistinguishable.) All of this activity means that demand is holding up better than expected, which adds upward pressure to mortgage rates.

The third reason mortgage rates are likely to go up is inflation. While there is hardly any inflation at the moment, the forward-looking nature of the financial markets means that future inflation is always much more important than current inflation. Mortgage rates (as well as other long-term interest rates) will incorporate the rising expectation that higher inflation will result in a couple of years from this year's significant Federal Reserve easing and the likelihood of a sharp economic rebound by early 2002. Because the rates on adjustable-rate mortgages, such as the 1-year ARM are less susceptible to inflation, these rates are less likely to reverse course as quickly as the rates on 15-year and 30-year fixed mortgages.

From 1992-2001, existing home sales increased from an annual rate of 3.3 million to 5.5 million and the median sales price of an existing home zoomed from $98,200 to $150,000. Sales traffic was down by about 10 percent immediately following September 11th, but it is now off by only about 5 percent.

Table 1
Housing and Interest Rate Forecast

	1999	2000	2001	2002	2003
Total Starts (000)	1,647	1,575	1,554	1,574	1,684
Single-Family (000)	1,306	1,233	1,227	1,240	1,324
Multifamily (000)	341	342	327	334	360
New Home Sales (000)	879	881	890	889	957
Existing-Home Sales (000)	5,194	5,123	5,218	5,238	5,562
Interest Rates (Freddie Mac Commitment)					
Fixed Rate	7.4%	8.1%	6.9%	6.9%	7.8%
ARMs	6.0%	7.0%	5.7%	5.3%	6.4%
Prime Rate	8.0%	9.2%	7.0%	6.1%	7.4%

Source: NAHB Economics Department
Annual data are averages of seasonally adjusted quarterly data and may not match annual data published elsewhere. Updated September 28th, 2001.

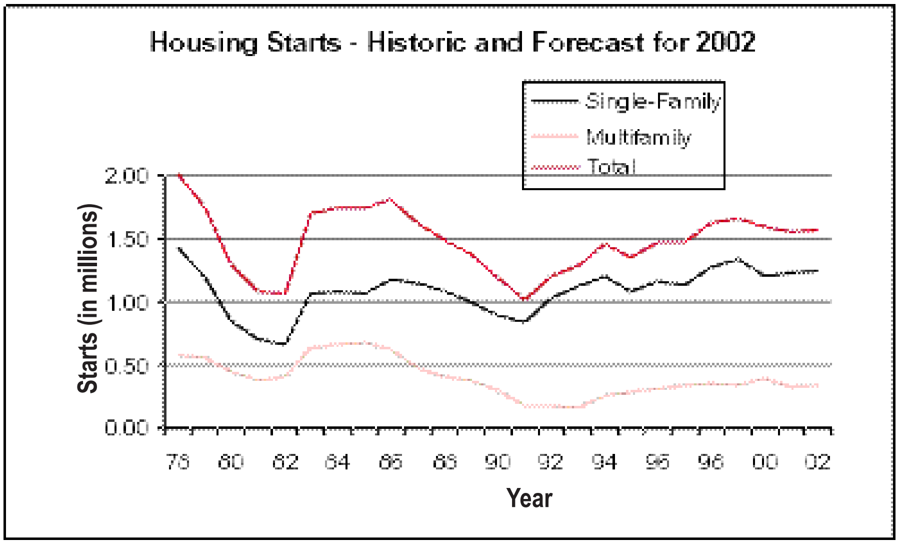
The market for existing single-family home sales fell in September as the nation reacted to the attack on America. Existing-home sales dropped 11.7 percent to a seasonally adjusted annual rate of 4.89 million units in September from an upwardly revised pace of 5.54 million units in August, which was an all-time record. Last month's sales activity was 5.2 percent below the 5.16 million unit pace in September 2000. The National Association of Realtors (NAR) projects total sales for this year at 5.19 million, an increase of 1.3 percent from 2000, which will be the second highest total for existing-home sales on record.

In a surprisingly strong showing, starts of new housing units rose 1.7 percent in September to a seasonally adjusted annual rate of 1.574 million according to the Census Bureau. The housing numbers for September were better than expected, although permits for new construction, which can be an indicator of future activity, decreased by 3 percent, including a 4 percent setback for single-family units. Permit issuance weakened in September (establishing downward pressure on housing starts for October), mortgage applications for home buying were down in the first half of October, and the National Association of Home Builders (NAHB) Housing Market Index dropped in October to the lowest level since mid-1995.

September starts and permit figures reflect builder behavior, not consumer actions. The starts numbers show that builders were still in gear in September, but the permits suggest that they were seeing demand drop off as the month progressed. Most of the increase in housing starts in September was in the multifamily sector. Multifamily rebounded from the previous month with a 6.3 percent increase. Single-family housing starts increased by only 0.6 percent.

The NAHB is forecasting 1.45 million housing starts for the fourth quarter, down 9 percent from the revised third quarter pace, despite maintenance of low interest rates in the mortgage market (see **Table 1**). The NAHB's forecast continues to show improvement in housing market activity and resumption of positive economic growth in the first quarter of 2002, followed by even stronger activity during the year. The NAHB forecasts housing starts to be about 1.57 million for 2002, up slightly from 1.55 million expected for 2001. This may be a little optimistic, however, and our forecast is for housing starts to be flat for 2001. This would still be a very respectable number by historical standards (see **Figure 1**).

Figure 1



The national median existing-home price was $148,100 in September, up 4.6 percent from September 2000 when the median price was $141,600. The median is the midpoint, which is a typical market price where half of the homes sold for more and half sold for less.

Regionally, existing homes in the Midwest were selling at an annual rate of 1.08 million units in September, down 9.2 percent from August; the pace was 3.6 percent below September 2000. The median price in the Midwest was $131,000, up 2.6 percent from September 2000.

Growth in home values increased by an annualized rate of 6.9 percent nationwide in the second quarter of 2001, down from a revised annualized rate of 9.2 percent for the first quarter of 2001, according to the Conventional Mortgage Home Price Index released recently by Freddie Mac. The index showed that annual house-price appreciation also increased 8.5 percent from the second quarter of 2000 through the second quarter of 2001.

Housing has remained a strong sector throughout the first half of 2001, due in part to the low mortgage interest rates that prevailed throughout that period. Nationally, home values have appreciated at more than twice the rate of consumer price inflation, which means housing remains a good investment for families.

Freddie Mac expects annual growth in home prices to slow to more normal levels, in the 4 to 5 percent range, over the rest of the year. The Federal Reserve Bank's efforts to boost the economy through lower interest rates should help the housing sector remain vibrant and healthy.

Indiana

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Indiana was hit hard by the recession in the early 1980s. From peak employment in mid-1979 to the low point in first quarter 1983, the number of jobs in Indiana fell by 14 percent. The state unemployment rate reached 12.7 percent by Christmas 1982 (see **Figure 1**), well above the national peak of 10.8 percent.

It was three years—1986—before employment in the state climbed back to 1979 levels. The state's unemployment rate stayed above the national average until 1986, too.

As Hoosiers now battle the recession of '01-'02, the situation for Indiana does not look as bad as it did in 1982. Interest rates today are at historical lows instead of at historical highs as they were in the early 1980s, and oil prices are relatively low and stable .

Ironically, one factor that appears to be working in the state's favor is the relatively slow population growth rate of the last decade. The rate of people moving into Indiana slowed markedly in the last few years. The result was a population increase from 1990 to 2000 of only 9.7 percent. Since the average in the nation was 13.2 percent, our relative decline cost Hoosiers a seat in the U.S. Congress.