The Fed Stands Pat Again

Following the April FOMC meeting, the Federal Reserve announced that the fed funds rate would be held in the range of 0.25 percent to 0.50 percent. The April statement expressed more caution regarding the pace of growth in the economy, despite acknowledging fairly robust job market growth and what may be an improving global picture. The Fed continued to express concern regarding the low rate of inflation, and highlighted that they will be watching inflation indicators over the next few months very closely. No one had anticipated that the Fed would raise rates at this meeting, rather, expectations were for more of a signal that they would be increasing rates again in June. Odds of a June have slightly, but we expect that is still the most likely outcome.

The US economy is growing slowly. Following 1.4 percent growth in the fourth quarter of 2015, the advance estimate for the first quarter of 2016 showed that the economy grew at a 0.5 percent pace. This was the weakest quarter since the first quarter of 2014 in which the economy actually contracted slightly. The main drivers of growth were consumer spending and residential fixed investment, but exports and business fixed investment, among other factors, were drags to growth. The growth rate of PCE decelerated in the first quarter as spending on durable goods decreased for the first time since 2011, while growth in residential investment continued to accelerate and was the highest since 2012. The contribution to growth from residential investment also picked up. Business fixed investment decreased for the second straight quarter, and the 5.9 percent contract is the weakest single quarter since 2009. The drop in business fixed investment was largely driven by investment in structures, which decreased 10.7 percent and for the sixth time in eight quarters.

We expect that the weakness in growth will only be temporary and that GDP growth will bounce back to above the two percent range for the remainder of the year. Given the strong job market and financial conditions, along with the recovery in home equity wealth, we expect that growth will continue to be driven by consumer spending and residential investment from the housing sector. New household formation is expected to pick up over the next few years and as a result, house demand will likely follow suit.
Job growth has continued into 2016, with the March employment report showing a gain of 215,000 nonfarm jobs across the US. Construction, entertainment, and health care sector job growth continued to lead the way on a year over year basis, while manufacturing sector along with mining and extraction jobs saw the only year over year decreases. The mining and extraction sector, which includes oil related jobs, continues to show the largest contraction for an industry group on a year over year basis. Crude oil prices, which are the main driver of this sector’s weakness, were down over 22 percent from a year ago in March 2016, and have been declining since July 2014. The US has averaged monthly job growth of over 200,000 jobs thus far this year, as well as for 2014 and 2015, the strongest stretch for the job market since the late 1990s.
The unemployment rate increased to 5.0 percent from 4.9 percent and the U6 measure of labor force underutilization increased to 9.8 percent. Part of the reason for the increase in unemployment measures was that more workers entered the work force as employment conditions continue to improve – job openings have increased and wage pressures seem to be trending to the upside. The labor force participation rate increased to 63.0 percent, the highest participation rate since 2013. As more workers come back to the job market and as jobs continue to be added, we expect that the unemployment rate will flatten out in the range of 4.7 to 4.8 percent through 2018.

Source: BLS
Overall CPI inflation slowed in March to 0.9 percent on a year over year basis as oil prices held down headline inflation yet again, but core inflation, which excludes energy and food prices, remained strong at 2.2 percent. Motor fuel prices decreased 21.1 percent compared to a year ago, a trend that has persisted since late 2014. Prices paid by consumers for shelter maintained annual growth of over 3 percent, as vacancy rates remained low and kept upward pressure on rental rates. We expect that oil prices will rise slowly through 2016 but also that core inflation will gradually rise to 2 percent over the next 12 months.

Manufacturing seems to have found its way back up after a few months in the doldrums. The ISM’s gauge of manufacturing activity increased to a value of 51.8, the first time in five months the index has been above 50. The index level of 50 is correlated with economic growth. Component indexes such as the new orders and index production indexes showed improvement in March. The new orders index reached the highest level since 2014 and the production index was the highest since May 2015. The employment index however, slipped in March and remains on a general downward trend. The nonmanufacturing index broke a string of four straight monthly declines in March.
Industrial production decreased overall, but manufacturing production helped prevent a more severe slide in the February data. However, mining and utilities (gas and electric) both decreased, with mining actually falling for the sixth straight month to the lowest level since 2013. Industrial capacity utilization also decreased in the most recent data release, and at 76.7 percent is well below the historical average of around 80 percent. Mining utilization decreased to 77.5 percent, the lowest since the late 1980s and well below the historical average of 87 percent. It was also the seventh straight monthly decrease for the mining sector. Capacity utilization for utilities also fell, to 74.8 percent, the lowest level ever in the data series. Given these results, it is no surprise that investment in the equipment and structures has declined in the overall GDP calculations.

Housing starts slipped in March, as single family starts could not replicate February’s spike and fell to pace of 764,000 units in March from an upwardly revised pace of 841,000 units. Multifamily starts also decreased, going to a pace of 325,000 units from 353,000 units in February. The March multifamily level was the lowest since 2014 after three months of decreases. Single family starts remain well below historical average of around one million units. We continue to forecast an increase in single family housing starts as inventory is still low and household formation picks up. Multifamily starts are expected
to increase as well, but will likely not be too far above the 400,000 unit mark, which is only slightly lower than the historical average for this measure.

**Single and Multi Family Housing Starts**

SAAR, 000s of units

Source: Census

New home sales have remained over a 500,000 unit since November 2015 but have decreased over the past three months. The March total of 511,000 units was still close to early 1990s levels. New homes for sale have been inching up as well, but similarly remain low by historical standards. Existing home sales in March increased to 5.33 million units from 5.08 million units in February. The year over year change in existing home sales was between 5.5 top 7.5 percent from December through February, but slowed to 3.7 percent in March. It is possible that the strong months earlier in the year pulled some transactions forward, but April through June are typically busy months for home sales as well.
In terms of mortgage applications per our Weekly Applications Survey data, purchase applications have been increasing since late February 2016 when looking at the 4-week moving average. We have also seen more broad based increases in purchase applications in terms of the different loan size ranges, with every loan size category showing a year over year increase for the ninth consecutive month. Refinance applications had a small rally in February when rates dropped yet, and this happened again in mid-April, but rates have picked up in recent weeks on better economic news from abroad and on rising oil prices.

We expect $1.6 trillion in total mortgage originations in 2016, with purchase driving most of that number, but with recent rate lows, refinance activity has also been contributing that volume. Purchase originations are expected to increase in 2017 and 2018, as continued economic growth and a strong job market will help support household formation. Household formation in turn is likely to boost housing demand. Additionally, rising rents may also push some households to purchase homes. Refinance originations will continue to decline as rates eventually rise, causing overall industry originations to show a decrease in 2017 and 2018.
Estimated Mortgage Originations: 1990-2018

($billions)

Source: MBA Mortgage Finance Forecast