Tax Reform in Focus

*MBA Economic and Mortgage Finance Commentary: December 20, 2017*

Given the near certainty of the tax bill being signed into law, we expect that GDP growth will be higher by 0.25 percentage points over the next couple of years as a result of the bill, and this month’s forecast reflects that boost. The unemployment rate will be 0.1 percent lower across the path, bottoming out at 3.7 percent this cycle. Rates will edge somewhat higher, and we expect that refinance volume will continue to decrease. However, we have adjusted purchase mortgage volume a touch higher as a result.

There may be the headwind of slightly less borrowing at the margin from the proposed change in mortgage interest deduction (MID). We also expect less cash-out and home equity borrowing as a result of the loss of home equity deduction. Home price growth is expected to decelerate but this is unchanged from our most recent forecasts. However, the tax impacts may vary by geography and price point; geographies with higher prices and higher borrower incomes may be hit harder since these areas will tend to have a greater number and share of higher income households who tend to itemize their deductions. In other places, an increase in the standard deduction could leave households better off. The housing supply response has been very slow despite rising prices with little sign of acceleration, and we do not expect our starts path to change much given the factors above, or even the given the recent months’ strength which was likely due to temporary factors.

The Fed raised rates at their December meeting, which was not a surprise, however, they did markedly increase their forecasts for economic growth in 2018. They also expect the unemployment rate to average 3.9 percent in the next two years, well below the long-run sustainable level of about 4.6 percent. With this optimistic outlook, driven in part by an expectation of increased demand from the tax cuts, it is surprising that the Fed still expects just three rate hikes next year. It is our view that they will revise up this guidance early next year to show four rate hikes in 2018.

The stronger job market is likely to lead to faster wage growth, but inflation to date remains below the Fed’s target of 2 percent. For this reason, there were two dissenting votes at the last meeting. These members preferred to keep rates unchanged at this point. However, it is important to note that voting members of the FOMC will change come January 2018, with a more hawkish set of members casting votes in 2018.
Mortgage rates have remained in a narrow range in 2017, ranging from around 3.8 percent to 4.2 percent. The Fed’s expected path of increasing short-term rates and continuing to shrink its balance sheet over the next few years will put upward pressure on mortgage rates in 2018, but we expect that short rates will continue to increase faster than long rates, leading to a flatter yield curve. We also think that mortgage rates may also become somewhat more volatile in the year ahead, particularly as the Fed allows its MBS portfolio to run off at a faster rate through the course of the year.

Our forecast for real GDP growth is 2.2 percent for 2018 and 2019, slowing slightly to 2.0 percent in 2020, reflecting a slight positive impact from the tax impacts. There will be some business and consumer spending pulled forward into 2018, and a slowdown after. The unemployment rate is expected to average 3.8 percent in 2018, with the low point being a 3.7 average in the fourth quarter of 2018 through early 2019. The unemployment rate will remain around 3.8 percent in 2019 before increasing slightly to 4.0 percent in 2020, still well below the 4.5 percent that the Fed regards as a long term average.

As far as rates are concerned, 10 year Treasury yields are forecast to increase in 2018, increasing to 2.7 percent from a 2.3 percent average in 2017, and then climbing to 3.0 percent and 3.4 percent in 2019 and 2020. Mortgage rates will follow a similar path, increasing to 4.5 percent in 2018 from 4.0 percent in 2017. We estimate that mortgage rates will reach the 5.0 percent level by the middle of 2018, but rising only slightly beyond that to average 5.3 percent in 2020.

**History and Forecast Mortgage Originations ($B)**

![Image showing mortgage originations history and forecast with data points for total, refi, and purchase categories.](image-url)

Source: MBA Forecast
Our forecast for 2018 is that we will see continued growth in purchase originations, as we expect around 7 percent growth for the year, followed by 5 percent in each of 2019 and 2020, as purchase originations continue to exceed the $1T mark in each of these years. Sustained strength in the economy, a tight job market, and a high likelihood of growth in household formation continue to support this forecast.

Refinance activity will continue to decrease as rates increase, decreasing 29 percent in 2018 and another 7 percent in 2019. The chart below above shows the history and forecast for mortgage originations.

From MBA’s Research team, Happy Holidays!