Fed Holds Rates Steady; Balance Sheet Reduction “Relatively Soon”

MBA Economic and Mortgage Finance Commentary: July 26, 2017

The Fed is embarking on a new course. Having given the market plenty of notice that they would begin shrinking their balance sheet holdings of Treasuries and MBS this year, following their July meeting, they have now indicated their intention to slow reinvestments in their securities portfolio ‘relatively soon’. Read that as a signal that they will likely announce at their September meeting that they will begin tapering reinvestments in October. Chair Yellen and other Fed officials have reiterated at different times that once initiated the process will be passive and running quietly in the background so long as economic growth and inflation continues as expected.

The job market is tight. Many employers are finding it increasingly challenging to fill open positions. And yet wage growth and price inflation remain low. We agree with the Fed’s expectation that inflation will increase later this year and into next, and this will prompt further increases in the Fed’s short-term target, with the next hike most likely coming in December.

Real GDP growth in the US was estimated to 1.4 percent in the first quarter, a slight upward revision from the BEA’s second estimate. We, along with most other forecasters, expect that this is a seasonal, first quarter phenomenon and that growth will accelerate in the second and third quarter of 2017. Monthly job growth topped 200,000 jobs in June for the fourth time in six months this year even as the unemployment rate ticked up slightly to 4.4 percent. We are well below the 5 percent mark for unemployment and adding more than 150,000 jobs per month. Historically, job growth of around 100,000 per month has been sufficient to keep the unemployment rate steady.

The relatively strong data will reinforce the Fed’s decision to begin winding down its balance sheet at a later point in 2017 and continue raising rates. However, inflation continues to remain weak, which casts some uncertainty on the timing and pace of the Fed’s actions. The CPI measure of inflation (on a year over year percent change basis) fell for fourth straight month in June, driven heavily by oil and fuel prices that have begun to slide again. The core CPI measure, which excludes food and energy, has also been declining and its 1.7 percent year over year growth rate was its lowest growth rate since May 2015. The moderation of price increases for new vehicles, shelter, and medical services have contributed to the deceleration in the core CPI.
Our forecast is for the unemployment rate to continue to decline through 2017, reaching a low of 4.1 percent, before slowly inching back up. Job growth should continue in the 150,000 jobs per month range for the next few months before declining to 100,000 in 2018. We still expect wages rates to accelerate, as companies have reported that jobs have been harder to fill.

We estimate that total originations will be around $1.6 trillion in 2017, driven by $1.1 trillion in purchase volume, and $538 billion in refinance volume. We increased our estimate of refinance originations slightly as rates have not increased as rapidly as expected. We continue to expect that growth in the purchase market will be driven by increasing household formation and housing demand, given the economic and job market strength. Existing home sales in June were down and new home sales were up slightly relative to the previous month as tight inventories of homes for sale continued to constrain purchase activity. However, both new and existing home sales were higher than the same month in 2016. Additionally, home prices continue to appreciate at an almost 7 percent rate on a YOY basis, based on May data from the FHFA. MBA’s purchase applications index has showed some leveling out for the year in terms of purchase activity, but the index for every month in 2017 was higher than the corresponding month in 2016.

Housing inventory remains tight, as seen in the inventory data and the pace of home price appreciation, but we have not seen a sustained increase in housing starts. However, if the appetite for housing continues to grow along with home prices, we expect that more homes will be put up for sale or built as home prices rise. Domestic economic fundamentals will continue to push rates higher, but there will be volatility and downward pressure from global and domestic geopolitical uncertainty, along with a Fed that will start to phase itself out as the largest purchaser of MBS. Our forecast is for mortgage rates to average 4.2 percent in 2017 before increasing to 4.9 percent in 2018, these rates are still very low by historical standards and will not be a significant impediment to home buying activity.