Lower Rates Following Brexit and Global Growth Worries

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The Brexit vote stunned markets. Treasury rates plummeted to record lows following the UK’s vote to leave the EU. Although the likely impact on the US economy is minimal, it has lowered the expected path for interest rates, as investors around the world seek safety in US Treasury securities. We now expect that the Fed will raise the Fed Funds rate only once this year, most likely in December. In the two weeks following the Brexit vote, Treasury rates decreased as much as 40 basis points compared to the day before the voting results were released.

Rates have begun to rebound this week as the political system in the UK appears to be stabilizing. Most equity markets have since recovered, with the Dow Jones Industrial Index well above the 18,000 mark and Treasury rates are around 10 basis points higher at the time of this writing. However, news with respect to the terms and conditions of the UK’s exit will continue to destabilize markets.

Given the potential for broader financial market volatility, we expect that rates will be lower for a longer period of time, and this will support more refinance activity. Mortgage rates have been low for years by historical standards, but the impact of Brexit has brought us close to record lows again, and for many borrowers who may not have been able to refinance previously or who are looking for even lower rates, this could be the necessary impetus to act. Additionally, jumbo rates are at record lows (since we started collecting data in 2011), giving more borrowers with large loan balances great financial benefit by refinancing. We have raised our refinance originations forecast for 2016 to $760 billion from $690 billion in our June forecast. The increased refinance volume will result in an increase in refinance activity for 2016 relative to 2015, whereas we had previously expected a decrease.

In addition to the increase in refinance activity, lower rates also seem to be helping potential homebuyers jump into the market. Even though financial market volatility may be causing some anxiety, the combination of low rates and a still strong job market in the US outweighs those fears for these homebuyers. Overall origination volume for 2016 is expected to be $1.74 trillion compared to $1.63 trillion in 2015.
We noted in a Chart of the Week recently that a Brexit vote by Britain to “leave” Europe would be highly disruptive, given the likely flight to quality into safe assets like US and German bonds. The 10-year German bond has been negative for the past month, and we believe that is another factor in a lower rate path for the US. The analysis examined the factors that have typically been drivers of the spread between 10-year US and German bonds, and the chart is show below for reference.
From our June 17 note:

Historically, US and German yields were quite comparable, with US rates lower than German rates as recently as 2009. Typically, the spread appears to have been driven by changes in “fundamentals,” if the US economy grew relatively more quickly or had higher inflation, the spread widened, if the reverse, it narrowed. However, from 2009 on, the spread has consistently widened, and the widening does not appear to be driven by “fundamentals,” rather the “trend” component has been driving the spread widening. That means the spread has widened not due to economic fundamentals, but due to policy, demographic factors and expectations about future growth that were not explicitly captured in the model. The European Central Bank’s move to negative rates, the cycle of sovereign debt concerns, and a more fraught political environment may all be factors. Whatever the cause, it suggests that US yields may not be as responsive to a change in German yields as in the past.

Despite the volatility that we have seen, the economic forecast for the US is largely unchanged. We still expect slightly over 2 percent GDP growth for rest of 2016 and about 125,000 jobs added to the economy per month. The third estimate of real GDP growth for the first quarter of 2016 was 1.1 percent.
on an annualized basis, which was higher than the previous estimate of 0.8 percent. Consumer spending continued to be a main driver of growth, but there were drags from business fixed investment, inventory investment, and government spending. We expect that business fixed investment will turn around in the quarters ahead, but also that consumer spending will grow at a slower rate. However, if we realize the increases in wage growth that are expected, that may help spur an upside surprise in consumer spending.

Job growth in June totaled 287,000 jobs, but the payroll count for May was revised down to 11,000 jobs from an already paltry 38,000 jobs. The June increase was the strongest month since October 2015. The unemployment rate rose slightly to 4.9 percent, but labor force participation increased as well, edging up to 62.7 percent, but still well below the long run average of 63.4 percent.

Average Monthly Payroll Growth
Seasonally adjusted, 000s of jobs

Source: BLS

Average hourly earnings by private industry workers increased 2.6 percent compared to the same month a year ago, which was a slight increase from 2.5 percent in May. We had seen wage growth in this region a few months ago, only for it to dip, but three months of 2.5+ percent hourly wage growth is a step in the right direction. Rising wages will likely help to bring workers back into the labor force and
push up the participation rate. We also believe that the strength in the labor market will help support household formation in the coming months.

**Average Hourly Earnings**

*Year over year percent change*

Source: BLS

We have seen home purchase application activity in the range of 10 to 15 percent above last year’s levels, and these increases have been across all loan size categories. In 2014 and for most of 2015, most of the growth in the purchase market was only in the higher end of the market, which has a much smaller share of transactions. Slow growth in the lower end of the purchase market means there were fewer first time and entry level buyers, and also fewer opportunities for “move up” buying. When rates dipped after Brexit, there was a small increase in purchase applications as potential homebuyers who were on the fenced were likely incentivized by lower rates to act on their purchases.

The refinance share of applications hit the highest level since February this year and the refinance index was at its highest level since early 2015 the week after Brexit (and with the most recent week’s data, is now the highest in three years). As noted in previous commentaries, there has been a stronger relationship between refinance loan balances and rate movements in 2016 – refinancing of larger loan balances tends to occur for a given drop in rates. We have seen the average loan size increase whenever rates fall, implying that borrowers with larger loans stand to gain more by refinancing and may not need as large of a rate incentive than borrowers with lower loan balances. Many borrowers also continue to
recover in their home equity positions as home prices increase, and this home price recovery has been uneven across states and cities. There may also be additional cash out refinancing occurring as rates remain low and home equity holdings increase.

As addressed at the beginning of the commentary, our estimates for mortgage originations have increased compared to last month’s forecast. We expect $1.74 trillion in total mortgage originations in 2016, with around $980 billion coming from purchase and $760 billion from refinances. The overall originations total for 2016 now exceeds the 2015 estimated total of $1.63 trillion, as does the refinance total. Purchase originations are expected to increase gradually in 2017 and 2018, as continued economic growth and a strong job market will 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 is expected to stick around a little longer with lower rates, but will still be sensitive to rate movements as the pool of potential borrowers who can refinance is relatively small.

**Mortgage Originations History and Forecast**

Source: MBA Mortgage Finance Forecast