Fed Raises Rates, Introduces Balance Sheet Reduction Plan

MBA Economic and Mortgage Finance Commentary: June 16, 2017

Since our last forecast, economic growth continued at a slow and steady pace, the job market remained strong, and some housing measures such as home sales and housing starts showed signs of slowing, but we did see an encouraging signal in household formation, as new owner households surpassed new renter households formed for the first time in over 10 years. Real GDP growth in the first quarter of 2017 was 1.2 percent, decelerating from 2.1 percent in the fourth quarter, but the first quarter estimate had been revised upwards from a weaker 0.7 percent growth rate. We expect that this is a seasonal, first quarter phenomenon and that growth will accelerate in the second quarter. Monthly job growth slowed to 138,000 jobs in May 2017, but in light of an economy at full employment – with a low unemployment rate and with more plentiful openings than hiring, this slowdown is not surprising. The unemployment rate decreased to the lowest level since 2001 and the U6 measure of underemployment decreased to its lowest level since 2007.

As we had anticipated in our forecast, at their June meeting the Fed proceeded with another 25 basis point rate hike and announced plans to begin to shrink its balance sheet. The Fed will begin to reduce the securities held on its balance sheet later this year (although no exact date was announced yet), with a fixed but growing quantity of securities that are allowed to runoff each month. The cap will be lower for mortgage backed securities compared to treasuries ($4 billion versus $6 billion) and the caps will be allowed to increase each quarter over 12 months to a maximum at $20 billion a month for MBS and $30 billion for treasuries thereafter. The chart below displays the possible path of balance sheet run off if the Fed were to implement this plan.

With lower caps for mortgage backed securities compared to Treasuries, it is possible that there will be less widening in mortgage spreads than previously estimated. We anticipate some volatility in rates as and when the Fed begins to pull back its asset purchases and reinvestments.
The plan emphasizes that the balance sheet will be reduced in a gradual and predictable manner and as Chair Yellen described in the press conference, the process will be “running quietly in the background” if economic growth and inflation continues as expected. The statement also reaffirmed that the target fed funds rate is still the primary means for monetary policy action. Markets viewed the statement as more hawkish than anticipated, with 10 Year Treasury rates rising slightly following the statement.

The Fed’s outlook was slightly upgraded, with increased household spending and business fixed investment, a labor market that has continued to strengthen, and economic activity “rising moderately.” There was acknowledgement of recent declines in inflation, but the committee continues to expect this is temporary and will pick up.

The state of the US labor market has always been important for the housing market, and just as much now as we move into a purchase dominated market. Year to date average monthly employment growth has fallen to just over 160,000 jobs. The unemployment rate decreased to 4.3 percent, the lowest unemployment rate seen since 2001 and the U6 labor underutilization measure (which includes workers marginally attached and working part time for economic reasons) decreased to 8.4 percent, the lowest level since 2007.

Source: FRED, FOMC statement
In a separate report from the BLS, job openings continue to exceed hiring. Job openings are at their highest level since the inception of the survey in 2000, and prior to 2015, openings had only exceeded hiring once, in August 2014. Since March 2016, hiring has fallen below job openings every single month (see chart below). These are signs that the US economy is already at or below full employment, and we expect that the unemployment rate will decrease to 4.1 percent by the end of 2017 and remain close to that level in 2018.

**Difference between Openings and Hiring**

Thousands of jobs

![Chart showing the difference between job openings and hiring from January 2012 to March 2017.](chart)

Source: BLS

Additionally, the NFIB reported that the percent of firms that reported job openings were hard to fill increased to 34.2 percent in May, the highest percentage since November 2000. The historical average for this measure is 21.3 percent, and this has risen steadily since hitting a low of 7.4 percent in 2009. We see this has a positive for wage growth as this will push wages higher as companies have to increase their pay packages to attract and retain workers whose skills they seek, which will eventually help to support consumer spending and housing demand. There are concerns however, as labor force participation remains low and reports of a mismatch in skills between available jobs and job seekers continue to exist. The chart below shows how the NFIB measure has trended since 1986.
According to the Census’ Housing Vacancy Survey, US household formation ticked up in the first quarter of 2017, increasing by 1.2 million households relative to the first quarter of 2016. Although the number of owner-occupied households grew slightly during 2015 and 2016 (measured at the end of the year), they increased significantly in the first quarter of 2017 compared to the first quarter of 2016 by just over 850,000 owner-occupied households. This surge marked the largest year over year increase in owner-occupied households in the post-recession period. Prior to the last two years, household formation has been dominated by growth in the rental sector. This was the first time since 2006 that more owner households were formed relative to renter households.

The homeownership rate came in at 63.6 percent in the first quarter and while the rate has bounced around in recent quarters, it has generally leveled out at this level. We expect the homeownership rate will edge up slightly from here over time. This will support a gradually increasing path of purchase origination volume.
We estimate that total originations will be around $1.6 trillion in 2017, driven by $1.08 trillion in purchase volume, and $528 billion in refinance volume. We increased our estimate of refinance originations up from $515 billion in the May forecast after seeing a period of lower rates and more refinance activity in our Weekly Applications Survey as US political uncertainty, among other reasons, pushed rates lower. 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 we have seen. Housing inventory remains tight, as seen in the inventory data published by the National Association of Realtors and the Census, and we are still not seeing significant growth in housing starts. Both single family and multifamily housing starts in May dropped to their lowest level in nine months. 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.