MBA Forecast Commentary
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All Eyes on the Fed

MBA Economic and Mortgage Finance Commentary: March 2015

Highlights from this month’s outlook:

1. US economic growth has been weak in the first quarter, but the job market remains strong.
2. Market participants will be paying even closer attention to monthly job and inflation reports now that the Fed has become “data dependent” in making a decision for the first rate increase.
3. Housing measures started 2015 slowly, with credit still tight and severe disruption from winter weather.

The rate of US economic growth slowed in fourth quarter of 2014 and is expected to slow further to start 2015. We expect that the first quarter slowdown is temporary and a bounce back will occur in the second quarter. Despite lower oil prices leading to lower fuel prices for households, providing more disposable income, a quickly appreciating US dollar and winter weather related disruptions have led to less first quarter growth than expected. Ongoing labor issues at ports on the West coast also continue to affect the volume of international trade and business activities. Business investment slowed toward the end of 2014 and has seen a relatively slow start to the year as well. Employment growth once again provided positive news for the US economy, with healthy payroll gains in the first two months of 2015 and a declining unemployment rate. Concerns over global economic weakness and political unrest remain, and these have had the impact of imparting downward pressure on interest rates.

A strong economy, job growth, and increasing wages should provide the push for more household formation, and consequently, a lift for housing overall. We saw refinance activity pick up for several weeks at the beginning of the year as mortgage rates declined to their lowest levels in a year and a half, but most of that “boomlet” has since subsided, even though mortgage rates dipped below 4 percent again in the most recent week’s data. We now look to the purchase market to help lift mortgage originations for the next two years, as new households form and entry-level buyers return to the market.

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Following the FOMC’s March 2015 meeting statement, the door is open to an increase in the fed funds target at the June meeting. However, the balance of the Fed’s statement, and even in Chairwoman Yellen’s press conference following the release, iterated that the June date was not a lock for the first rate increase. There is a reasonable chance that the committee will wait until September or later for the first hike. The term “data dependent” was used several times with respect to their first move, and this likely means that particular attention will be paid to the job market and inflation reports over the next two months. Job growth at the current pace coupled with a leveling out of energy prices might provide the impetus for a move in June. Based on the committee’s forecast, 15 of the FOMC members expect the first hike in 2015, and only 2 expect it to fall into next year.

The committee did not announce a change in their expectations with respect to the Fed’s holdings of MBS and longer-term Treasuries. We do anticipate that later this year plans will be announced to slow the reinvestment in MBS and the results of that would be wider spreads of mortgage rates over Treasury rates.

Markets appeared to view this announcement as relatively dovish, meaning that the Fed could move more slowly to raise rates than had been anticipated, with longer-term Treasury rates dropping in response. One supporting item for this view is that the statement received unanimous support from the Committee, as opposed to the regular dissents Chairman Yellen has received in recent meetings.

Real GDP growth in the fourth quarter of 2014 was revised downwards to a rate of 2.2 percent (previously reported as 2.6 percent), following a 5.0 percent growth rate in the third quarter. Growth in PCE was 4.2 percent and that accounted for 2.8 percent of the growth rate. The level of consumer spending typically accounts for about 70 percent of GDP, and we expect that overall economic growth in the next two years will be driven largely by consumer spending. Nonresidential fixed investment saw positive growth, but was the weakest in three quarter. We expect the fixed investment component to pick up as businesses work to keep pace with consumer spending over the next few quarters. Federal government spending decreased significantly for the quarter, which was mostly payback for exceptionally strong third quarter defense spending. Import growth surged more than 10 percent in the fourth quarter, and this was a negative for overall growth. This was partially due to the impact of the stronger dollar effectively reducing import prices and increasing export prices, as well as weaker growth abroad reducing consumption of US exports.

Overall inflation continues to be held down by fuel prices, but we expect these prices to stabilize over the next year and edge back up to the 2 percent mark. Core inflation, which excludes food and energy, increased 1.6 percent from a year ago, signaling that prices are not quite as weak as the headline number suggests. The shelter component has leveled off a little in recent months, but is still generally high in terms of its year over year growth.
The US labor market picked up where it left off in 2014, chugging along at a good pace, averaging 270,000 jobs added for the first two months of 2015, compared to an average of 260,000 jobs per month in 2014. Weekly unemployment claims have trended up in recent weeks (based on a 4-week moving average), but remains close to the 300,000 claims level, which is still below the historical average of around 380,000 claims per week. Compared to 2014, where the average number of weekly unemployment claims was 309,000 claims, the first 11 weeks of 2015 have yielded an average of 298,000 claims thus far. Other measures of labor market health, such as data on job openings and voluntary quits have also shown positive signs. The number of job openings continues to increase, as does the quit rate. An increasing quit rate is seen as a positive development because it implies that works are feeling secure enough in their job prospects that they are willing to quit their current jobs to find a new job, presumably one that is better paying or with better conditions in general. Conversely, quit rates tend to drop during recessions or times of deteriorating job market conditions because employed workers tend to stay in their secured positions longer.

While data on wage growth have been relatively disappointing until now, alternative measures of labor costs, such as the BLS Employment Cost Index (ECI) have shown an increase in compensation for civilian
workers. While the year over year increases in the ECI are not back to historical averages, the 2.3 percent increases in the third and fourth quarters of 2014 were the biggest increases since 2008 and the recent trend has been in an upward direction.

Source: BLS, NFIB

There has also been a significant improvement of job availability. As noted earlier, we have been seeing a decline in the unemployment rate, and an increase in job openings. Considering the ratio of unemployed workers to job openings, we see that this measure has exhibited a decreasing trend, which implies there has been more competition for jobs. This in turn should help put some upward pressure on wages. While this is a useful, supplemental gauge of labor market health, it does not account for any skill or occupational mismatches or geographic market differences. The gap between the unemployment rate and the underutilization rate (or the BLS U6 measure) remains wider than seen in years past, so there are still a number of works who are discouraged or working below their potential, either in part time and/or lower paying jobs.
We forecast monthly job growth will average 220,000 per month in 2015, and that the unemployment rate will decrease to 5.3 percent by the end of 2015 and 5.0 percent by yearend 2016. We expect the unemployment rate to bottom out at around 5 percent because labor force participation is expected to increase once wages rise and hiring becomes more competitive. Increasing labor force participation generally exerts some upward pressure on the unemployment rate.

Our projection for overall US economic growth is 2.7 percent in 2015 and 2.5 in 2016, which will be driven mainly by strong consumer spending and steady business fixed investment. This is despite anticipation of a weaker than expected first quarter of 2015, as the trade deficit widened on a stronger dollar, and winter weather appears to be pushing back economic activity, which we think will recover in the second quarter and beyond. As shown in the chart below, consumer spending is still a very important component of growth and will continue to account for most of US economic growth in the next two years.
Interest rates trended down throughout 2014 and have started out low in 2015 as well. Continuing their flight to quality, global investors have put downward pressure on longer-term Treasury yields. Our forecast for the 10 Year Treasury yield is 2.4 percent for 2015 and 3.1 percent for 2015, and our forecast for the 30 Year Fixed mortgage rate is for 4.2 percent in 2015 and 5.0 percent in 2016.

Despite lower than expected rates and a growing economy, mortgage credit remains tight. While we have seen credit availability improve over the past year, much of that has been driven by the non-conforming jumbo market as shown in the chart below. This has included lenders offering more jumbo products to borrowers, which has been in line with increased purchase mortgage application activity for mortgages of higher loan balances, especially those exceeding $625,000. Mortgage products in the agency conforming space have been approximately flat for most of 2014, and these levels are well below pre-recession levels. Fannie Mae has added a 97 percent LTV product, but that has not moved the dial very much just yet. Freddie Mac will be releasing a similar product later this month. In our most recent release, jumbo products continue to be added to the market, while we saw a modest pull back in conforming products.
Home sales and housing starts both started the year on a low note in January, which could be attributed to weather related factors, but we saw some signs of life in household formation in the fourth quarter of 2014, and if that continues into 2015, we expect that housing activity will gradually increase as predicted. Multifamily housing starts have already been at or close to longer run averages and we expect that with a tight rental market, that trend will continue in the near term. Single family building continues to run below historical averages, but is expected to soon increase.
In 2014, the higher price tiers of the housing market saw more growth than the lower end. However, based on MBA’s purchase applications data, the lower price tiers of the market, specifically loan amounts of $417,000 and below account for 85 percent of all applications. This segment is also more sensitive to entry level home buyers to fuel “move up” activity, and looking at the data, these transactions have not taken place much at all, which explains why the lower end of the market remains slow. A similar pattern can be seen when comparing the purchase applications data to existing home sales data, which account for almost 90 percent of home sales.

In February’s purchase applications data there were signs of year over year increases in some of the lower loan amount categories, which is a good sign. We remain cautiously optimistic however, as these were based off data from February 2014, which was another particularly slow month for purchase activity. As noted above, the increase in household formation and wage growth should soon provide more of a boost to home sales and purchase applications.
In closing, we estimate a total of $1.2 trillion in mortgage originations for 2015, compared to $1.12 trillion in 2014. Purchase originations will drive the increase, increasing to $730 billion in 2015 from $638 billion in 2014. Refinances are expected to be to $501 billion in 2015, an upward adjustment from $491 billion previously reported, as lower rates in the early part of 2015 provided a small boost to refinance activity. For 2016, we expect $791 billion in purchase originations. However, rates will likely continue to rise and cause refinance to decline to $379 billion for a total of $1.17 trillion in origination volume in 2016. The chart below shows historical mortgage originations estimates as well as our forecast, and also visually shows 2014 as the first purchase dominated market since the mid 2000s, with that trend likely to continue into 2015 and 2016.
Source: MBA March 2015 Forecast