Fed Raises Rates, Data Show Job Market Strength and Rising Inflation

*MBA Economic and Mortgage Finance Commentary: March 17, 2017*

The Federal Reserve raised its short-term rate target at the March FOMC meeting as expected. However, the statement indicated that the Fed is still in no hurry to raise short-term rates as they still see inflation falling somewhat short of their 2 percent target. While they were confident that the economy will keep growing, as monetary policy remains accommodative, there was no indication that they were worried about the economy overheating, even with the quite rapid job growth we have seen thus far this year. There was no change to the language regarding the Fed’s intention to maintain the size of their balance sheet. Given Chair Yellen’s recent testimony and comment by other Fed officials, we expect a change to their balance sheet policy to be announced at some point this year. Markets will likely react to this announcement, and not wait for the actual implementation of a change in balance sheet policy.

There was a single, dovish dissent from Neel Kashkari who preferred keep the fed funds target unchanged. Separate remarks from Kashkari in the days after the meeting indicated that he preferred to have more detailed plans as to how the Fed’s balance sheet will be unwound, along with higher inflation, before another rate hike.

We are holding to our forecast that the Fed will raise rates twice more this year, likely in June and September. These rate moves get us closer to the point where the Fed will start to allow their holdings of longer-term Treasuries and MBS to run-off. Given the size of their holdings and current market conditions, balance sheet runoff could have an even larger impact on mortgage markets than changes in their short-term rate target.

Economic growth continues to advance at a slow but positive pace, increasing 1.9 percent in the fourth quarter of 2016, according to the BEA’s second estimate released at the end of February. Personal consumption expenditures continued to account for a large portion of growth, especially spending on durable goods and on services. Residential investment had a positive contribution to growth in the fourth quarter as well, after two straight quarters of negative contributions. Additionally, businesses seem to have gained confidence in recent months, and indicators of health of the manufacturing sector from the Federal Reserve and ISM pointed to increased activity.
Employment growth started 2017 with a bang, with the economy adding 238,000 jobs in January 2017 and 235,000 jobs in February, the strongest readings in six months. Average hourly wage growth increased 2.8 percent over the year, and maintained a generally increasing trend since late 2015.

Inflation rose sharply in February, with overall CPI inflation increasing faster than core inflation for the second consecutive month as motor fuel prices continued to rebound. In combination, these factors point to rising rates in the US, even though external, international factors continue to exert downward pressure on rates, as well as some near term volatility. Our outlook is for these trends to continue for 2017 and 2018.

In our March 2017 forecast, we estimate that total originations will decrease to $1.6 trillion in 2017 from $1.89 trillion in 2016. This total will increase slightly in 2018 as a growing purchase market is offset by more declines in refinance activity as rates rise. We expect the 30 year mortgage rate will hit 4.7 percent by the end of 2017, reach 5.2 percent by the second half of 2018 and increase further to 5.5 percent by the end of 2019. With a large segment of borrowers having taken advantage of sub-4 percent rates in recent years, refinance volume will decrease even though rates in the 5 percent range are still very low by historical standards. Purchase growth is expected to be driven by the strong job market, rising wage growth, and household formation that is expected to increase more significantly when it comes to owner households, which will in turn create more housing demand.

Mortgage Originations: 1999-2019
GDP growth in the US for the fourth quarter of 2016 was 1.9 percent, based on the second estimate of economic growth from the BEA. Economic growth is forecasted to be around 2.1 percent for 2017, then fall slightly to 1.9 percent in 2018 and 1.9 in 2019. We are still of the view that trend growth for the US economy is in the range of 2 percent. The US economy remains largely driven by consumer spending, which is around 60 to 70 percent of the level of real GDP. As noted earlier, spending on durable goods and services drove much of the fourth quarter growth rate.

Nonfarm payrolls grew by over 230,000 jobs in each of the first two months of 2017. Given the strong start to the year, we now expect that monthly job growth will be slightly higher than 150,000 jobs per month in 2017 even as the economy is essentially at full employment. The average hourly wage paid to workers increased by 2.8 percent on a year over year basis, and is likely to trend upward as job openings still outpace the number of workers actually hired.

The unemployment rate decreased to 4.7 percent in February 2017. Labor force participation moved up slightly to 62.9 percent as well. Labor force participation remains low relative to historical averages, but has increased slightly over the past three months, most recently moving up to 63.0 percent, the highest rate since March 2016. The U6 measure of labor underutilization, which accounts for the unemployed...
workers in the economy along with those marginally attached to the work force and those working part time jobs, decreased to 9.2 percent from 9.4 percent. The U6 measure is well below its historical average of 10.6 percent, and the spread between the U6 and the unemployment rate has narrowed, and it is tighter than the long run average.

From a separate BLS data source, private sector openings are the highest since July 2016, hiring level is the highest since December 2015, and the number of quits is the highest since April 2001. A high or increasing quit rate typically means that workers are more optimistic concerning their job prospects in the market and voluntarily leave their jobs, which is a positive signal for the economy. Openings still exceed hiring for the 11th straight month, a sign that employers are still having some difficulty filling open positions, but the gap has been closing in each of the past 4 months.

**Private Job Openings, Hires, and Quits**
* (Seasonally adjusted, thousands)

Source: BLS

Overall CPI growth in February 2017 grew at a pace of 2.7 percent on a year over year basis, the fastest pace since 2012, as energy prices surged. Headline CPI exceeded core CPI, which excludes the food and energy components, for the second straight month. Core inflation decreased slightly to 2.2 percent on a year over year basis. Motor fuel prices increased 30.6 percent over the year, the largest annual increase since 2011. Oil prices started to slide in late 2014 and have only recently begun to recover. Shelter
prices, which are dominated heavily by rental costs, increased 3.5 percent in February compared to the year before. Shelter costs have been growing in the range of 3 to 3.5 percent since mid-2015. Sustained increases in rental costs have burdened renters since 2007 and are often blamed for preventing future homeowners from being able to save for a down payment on a home.

These results are particularly significant because accelerating inflation is often tied to an economy that is picking up, along with upward wage pressures. Additionally, with the recent discussion and speculation surrounding how quickly the Federal Reserve might next raise rates, more rapidly rising inflation provides more impetus for a rate hike, especially since the job market continues to show monthly payroll growth and low unemployment.

Turning to housing and mortgage markets, and focusing on some recently released data, the Census Bureau reported that one-to-four family housing starts increased in February 2017 to their highest rate since October 2007, staying above 800,000 units for the fifth month in a row. While that is a recent high, single family starts still remain quite low relative to the historic average of more than a million

Source: BLS
units a year. Multifamily starts were essentially flat from January, coming in at 391,000 starts at a seasonally adjusted rate for February and above the long run average of 361,000 units.

**Chart of the Week - March 17, 2017**

**Housing Starts in 1-4 Unit and 5+ Unit Structures**

**12-Month Rolling Average**

Source: Census

An alternative metric, units under construction, suggests that more resources have been flowing to multifamily housing compared to one-to-four family housing since 2013. In February, nearly 1.1 million total units were under construction in the US, comprised of 626,000 multifamily units (highest point since 1974) and 465,000 one-to-four family units (below average). Together, these statistics show that new construction of one-to-four family houses is still early in its cycle, whereas the multifamily cycle is at a more mature stage.

Related to new single family construction, MBA’s Builder Application Index posted a modest annual gain in February 2017, increasing 2.2 percent. The bar was high as February 2016 was a particularly strong month for applications, as was March 2016. The strong employment numbers for the beginning of 2017 suggested that demand for new homes should continue to grow this year. Additionally, the estimated annual pace of new single-family home sales were running at a seasonally adjusted annual rate of 586,000 units in February 2017, based on data from the BAS, which collects data from a sample of mortgage lending affiliates of home builders. The new home sales estimate is derived using mortgage
application information from the BAS, as well as assumptions regarding market coverage and other factors.

Credit availability loosened slightly in February, due to the net result of two countervailing movements. The supply of credit increased as more investors offered affordable low down payment mortgages and streamlined documentation loans guaranteed by the Federal Housing Administration and the Veterans Administration. However, the impact of that increase on the overall index was partially offset by the first downturn in the availability of jumbo credit in a year due to the consolidation of some jumbo programs. Mortgage credit availability increased 0.4 percent in February 2017 and reached its highest level since 2007, according to data from the Mortgage Credit Availability Index (MCAI). Acknowledging that the unsustainable lending of the 2006 period should not be emulated, the MCAI provides a sense of just how different credit availability is today. The index reached a high of 869 in mid-2006, while today it stands at 177. Of the four component indices, the Government MCAI saw the greatest increase in availability over the month (up 2.3 percent), followed by the Conforming MCAI (up 0.1 percent). The Conventional MCAI decreased 2.2 percent while the Jumbo MCAI decreased 4.4 percent.

![Mortgage Credit Availability Index (NSA, 3/2012 = 100)](image)

Source: MBA’s Mortgage Credit Availability Index Powered by Ellie Mae’s AllRegs Market Clarity