

July 16, 2014

Bounce Back in Economic Growth Expected for Remainder of 2014, Housing Outlook Essentially Unchanged

MBA Economic and Mortgage Finance Commentary: July 2014

Key highlights from this month's forecast:

- 1) The BEA's final estimate of GDP growth reported an even steeper contraction in the first quarter of 2014, but we still expect that the economy will rebound in the coming quarters and see above trend growth for the remainder of 2014 and into 2015. However, international events such as unrest in Iraq, Ukraine, and most recently the Gaza Strip provide potential downside risks to the forecast. There is also renewed concern of a financial crisis in the Euro Zone, as the threat of a Portuguese bank collapse caused jitters in financial markets.
- 2) The job market has been robust, providing well over 200,000 jobs per month, and the unemployment rate has declined to 6.1 percent, the lowest in six years. Concerns remain over still-low labor force participation and the ability of the long-term unemployed to find jobs. We expect unemployment to fall below 6 percent by the end of 2014 and continue to decline slowly to around 5.5 percent by the end of 2015.
- 3) Housing had a reprieve from its recent run of poor performance, as home sales, housing starts, and credit availability picked up slightly in the May and June periods. However, we still expect a 42 percent decrease in overall mortgage originations in 2014, with purchase originations decreasing 10 percent and refinance originations decreasing 60 percent.

The biggest economic news in the US over the past month was the final estimate of GDP growth for the first quarter of 2014, which had real GDP contracting by 2.9 percent, a much larger decline than the 1.0 percent rate of contraction previously estimated. This was driven mainly by lower than expected consumer spending and a larger trade deficit. Similar to earlier estimates, residential investment was a drag to real GDP growth for two straight quarters. The last time residential investment contracted was in 2010 and the last time we saw two quarters of negative growth was in 2009.

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While there will not be an FOMC meeting until the end of July, minutes from the June meeting released earlier this month showed that the Committee plans to continue with the current pace of tapering, and complete the asset purchases in October 2014. In Chairwoman Yellen's semi-annual testimony on monetary policy this week, she noted that the economy is still on the road to recovery and that employment and housing are still concerns. However, she did raise the possibility of earlier rate hikes should the job market start to grow more rapidly. Following the last meeting, the FOMC determined that the economy has shown sufficient strength that the tapering of asset purchases will carry on as planned, and announced an additional \$10 billion reduction in purchasing pace following the June meetings. The Committee also lowered their projections for 2014 growth relative to the March meeting, along with expectations for a slightly more rapid decrease in the unemployment rate. The outlook for inflation was for slightly higher inflation in 2014.

In our forecast, we expect real GDP growth to rebound in the second quarter, growing 2.9 percent, and to grow at a pace above 3.0 percent for the rest of 2014. Real GDP growth for 2014 is expected to be 1.5 percent, increasing to 2.7 percent in 2015. Consumer spending is expected to drive a significant part of this growth, increasing by 2.0 percent in the second quarter, and then 3.1 percent for the rest of 2014. The advance report for retail sales for June 2014, while not entirely exceeding expectations, still showed positive growth, and pointed to the possibility of stronger PCE growth in the second quarter. Consumers continue to be buoyed both by stock market and home equity wealth, as household wealth driven by corporate equity holdings reached historical highs in the fourth quarter. Following last year's refinance activity driven by low rates and continued home price improvement, we saw a broader increase in home equity wealth, as lower rate mortgages have allowed households to pay down more of their principal and free up more equity in their homes. Given the recent international events such as political conflict and violence in Iraq, Israel, and Ukraine, investors have sought safer assets and have driven rates down. We expect the 10 Year Treasury rate to remain below 3 percent for 2014, before increasing to 3.3 percent by the end of 2015.

We still see upside potential in business fixed investment despite some recent cooling off in the data. Industrial production for June increased, as manufacturing and mining showed increased levels over the month. Utilities however, decreased for the fifth straight month. Capacity utilization was unchanged at 79.1 percent in June, and has been essentially at the same level for the past four months. Mining was the only industry to see an increase in capacity utilization, as utilization for both manufacturing and mining declined over the month. The ISM's manufacturing index decreased slightly in June, but still indicates 13 straight months of expansion in the manufacturing sector. Both shipments and new orders for core capital goods (nondefense capital goods, excluding aircraft) increased in May. Both shipments and new orders increased for the second time in three months. Shipments of core capital goods are used as an input to the BEA's estimates for business fixed investment for the current quarter. New

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orders of core capital goods are an indicator of future business fixed investment. We expect that the coming months' data will improve on strength in manufacturing and industrial production.

Monthly payroll growth has now been over 200,000 for five months straight, averaging almost 250,000 jobs per month in that period. For the first six months of 2014, the average monthly payroll gain was 230,000 jobs, compared to just over 200,000 jobs per month during the first six months of 2013. Total private payrolls added 262,000 jobs in June, with government payrolls adding another 26,000 jobs. Service providing industries drove much of the increase, adding 236,000 jobs over the month, the biggest monthly increase for that sector since January 2012. Gains were broad based and across all the major service providing categories such as retail trade, transportation, education and health services, hospitality and leisure, etc.

The unemployment rate decreased to 6.1 percent in June from 6.3 percent in May, and was at the lowest level since August 2008, but the participation rate, unchanged at 63.8 percent, was the lowest since 1978. A piece of potentially good news here is that the participation rate seems to have hit a floor, reaching the 62.8 percent level five times in the last nine months, however, an increase would probably be better news. The number of long-term unemployed decreased for the fourth straight month and by the largest margin for a single month since 2011, and at just over 3.1 million is the lowest total since 2009. There still remains a concern over the mismatch of available workers to skills that employers are seeking, along with the difficulty for long-term unemployed workers to find jobs. The number of workers who took part time jobs for economic reasons, i.e. because they could not find full time positions, increased sharply in June by 275,000, the largest single month increase in a year. The U6 measure of labor underutilization inched lower to 12.1 percent, which was the lowest level since 2008, but this is still above the long run average of 10.7 percent.

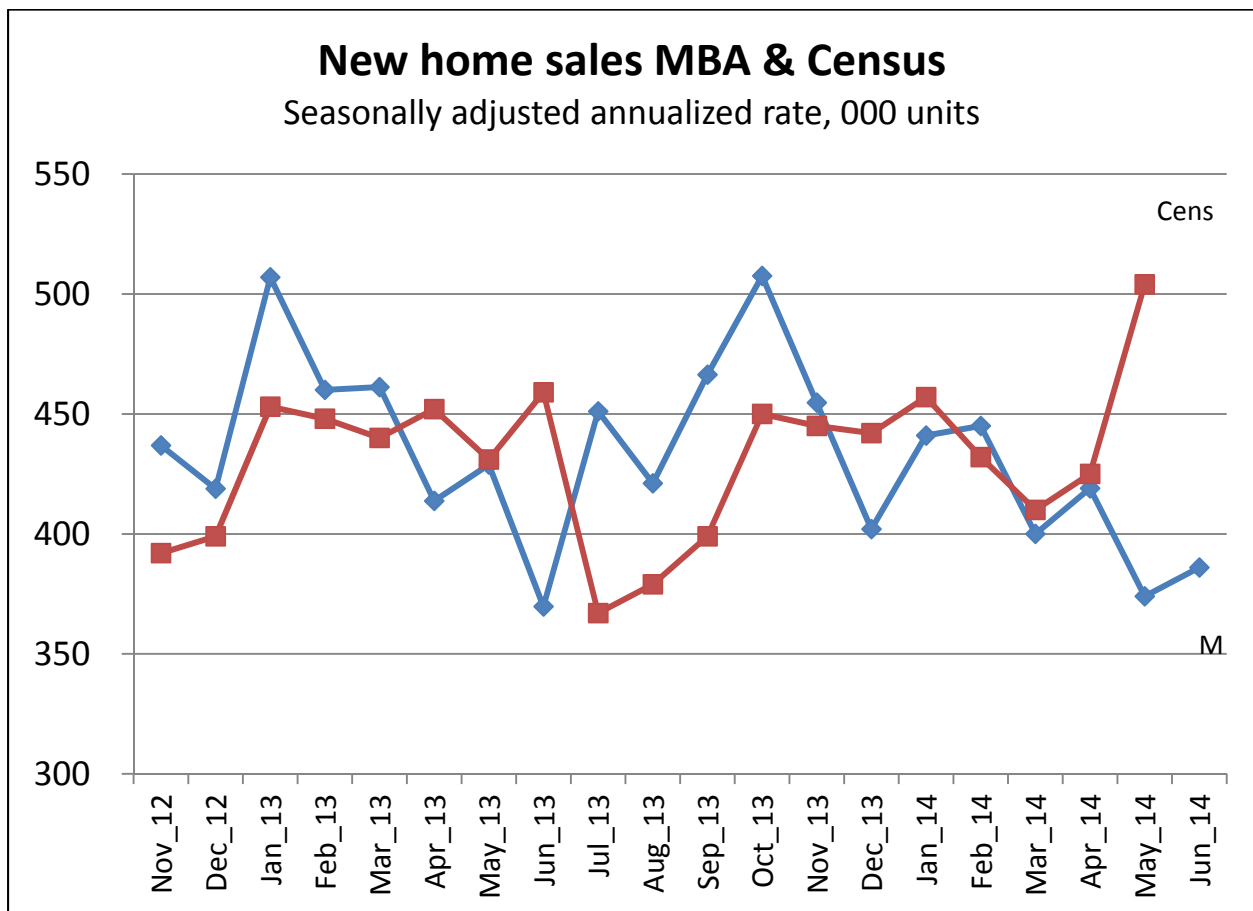
The labor market seems to be back on track, gaining over 200,000 jobs per month, and we expect this pace of growth through 2015. We expect the unemployment rate to decline slowly though through 2014 and 2015, averaging 6.2 percent for 2014 and 5.7 percent in 2015.

Turning to the housing market, the most recent data points for home sales and housing starts provided some good news finally. Existing home sales in May increased to a 4.9 million unit annual pace, breaking a run of four months of being mired in the 4.6 million unit range, as reported by the NAR. The sales pace was the highest since October 2013, although, on a year over year basis, existing home sales have shown declines for seven consecutive months. The Census Bureau reported that in May, new home sales surged to a 504,000 unit pace from 425,000 units in April, the highest pace of new home sales since May 2008. The May data point also provided the first year over year gain after three months of declines.

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The Census data however, differed from the MBA's Builder Application Survey, which also has a measure of new home sales. The MBA data showed that new home sales actually decreased in May, but increased slightly in June. It should be noted that the MBA uses a different sample than Census, containing primarily mortgage affiliates of large builders, whereas Census samples across the industry. The MBA sample is estimated to cover 30 percent of the market in terms of new home sales, which is a larger sample than what Census uses, although the MBA survey is based on broad market coverage, while the Census survey is based on a smaller, statistically constructed sample. Despite the sample and methodology differences, the MBA's new home sales series has tracked closely with Census' data for most of the survey's history but due to these sample differences, there may be months where the data points are different. At a similar point last year, the two series also saw a divergence in trends, as shown in the chart below.

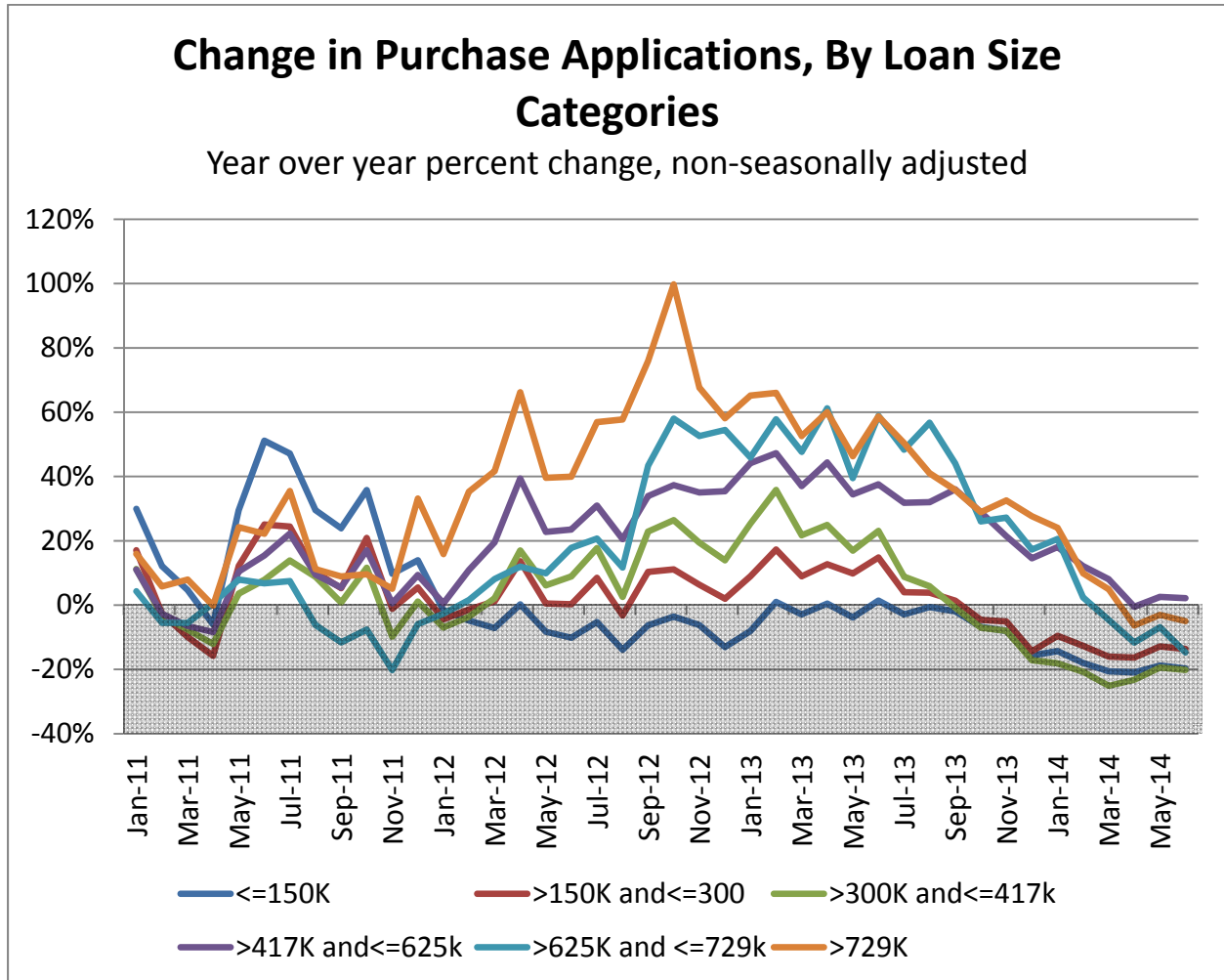


Source: MBA, Census

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The divergence in the mix of mortgage applications for home purchase, based on loan amounts continues, but every loan size category except one is showing a decline. The chart below shows how that trend has evolved and most recently, even the larger loan size bands are starting to show declines over the year. Only the band for purchase applications between \$417,000 and \$625,000 is showing year over year growth. Overall purchase applications were down almost 16 percent in June from a year earlier, and we have now seen nine consecutive months of weakness on a year over year basis.



Source: MBA Weekly Applications Survey

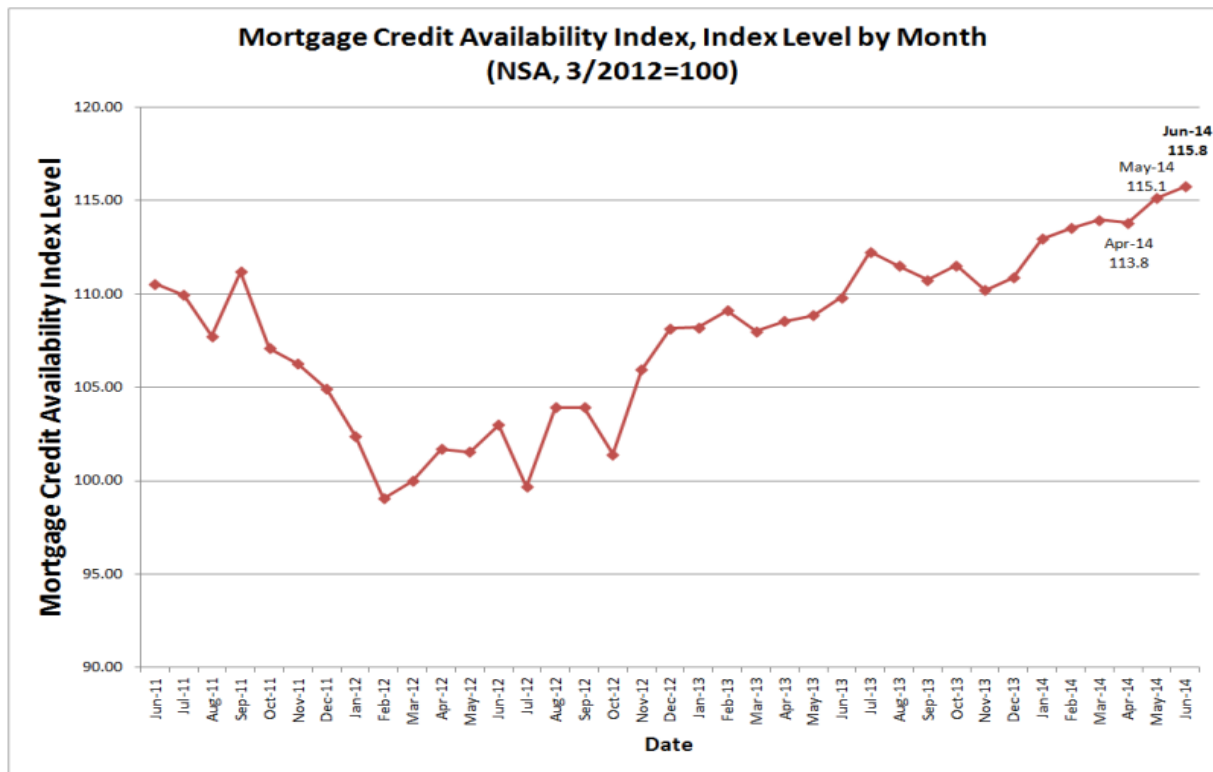
Housing starts in May were down 6.5 percent after a 12.7 percent increase in April. Single family starts decreased 5.9 percent to a pace of 625,000 units after two months of healthy increases, while

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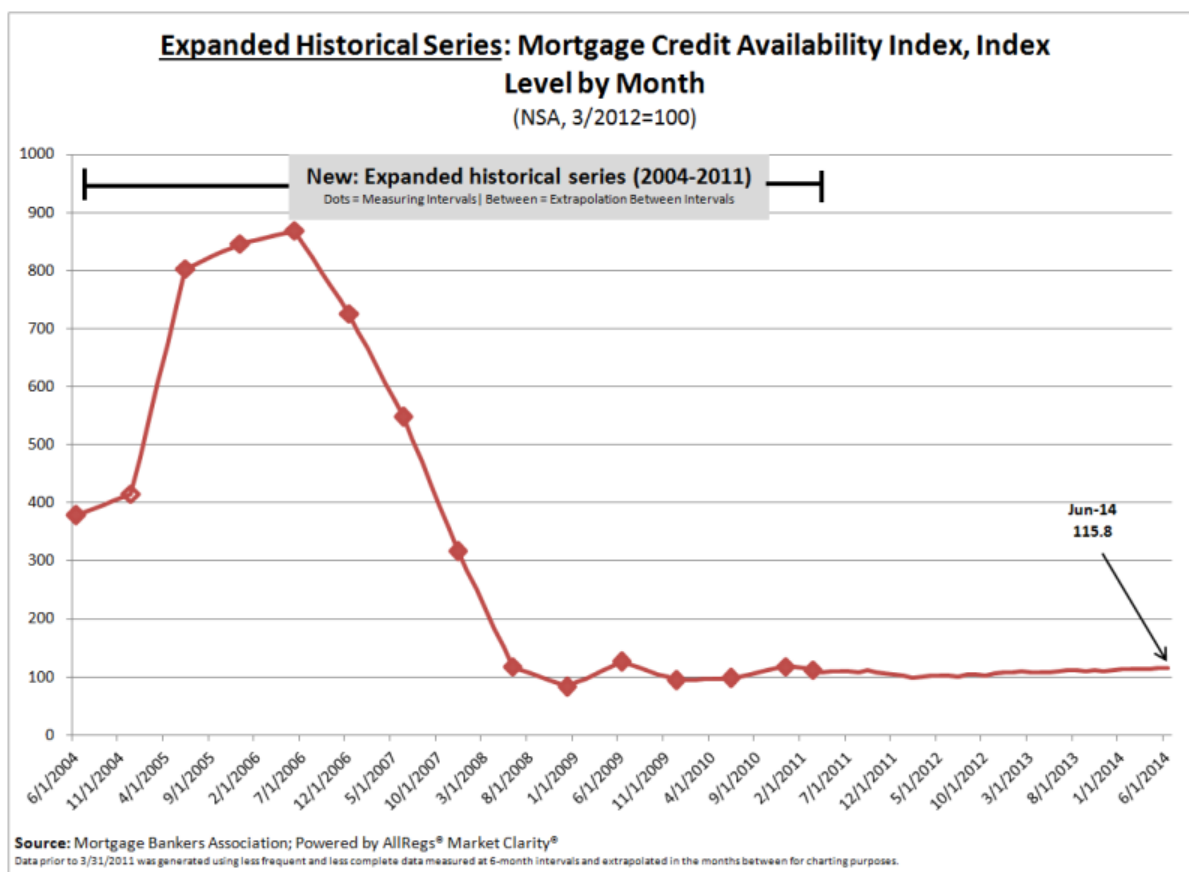
multifamily starts were down 7.6 percent to a pace of 376,000 units following a 29.2 percent increase in April. Single family permits averaged about 620,000 permits in 2013, but in 2014, that average has dropped to 600,000 in the first five months of the year. We expect single family housing starts to increase slowly in 2014, but at an even flatter trajectory than in previous forecasts. On the multi-family side, permits averaged 370,000 per month in 2013, and the monthly average is for 2014 to date is up to just over 400,000 permits. We have raised our forecast for multi-family starts in 2014 with higher expectations for rental household growth.

Mortgage credit availability increased in June according to MBA’s MCAI. Mortgage credit loosened somewhat in as a result of a slight net loosening in lender criteria regarding Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) loans with respect to minimum credit scores and maximum loan-to-value (LTV) ratios. The MCAI increased to 115.8 in June to 115.1 in May. A decline in the MCAI indicates that lending standards are tightening, while increases in the index are indicative of a loosening of credit. The index was benchmarked to 100 in March 2012. However, to provide historical context, credit availability was eight times as high in 2006 and about four times as high in 2004. Given the current regulatory environment and changing preferences of borrowers, it is unlikely that we will reach those levels in the near term. The following two charts illustrate the most recent data from the credit index.



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Source: MBA Mortgage Credit Availability Index, Powered by AllRegs Market Clarity

As outlined at the beginning of this commentary, even as the macroeconomic environment improves, mortgage application activity for home purchase remains in decline and home sales have generally underperformed as well. We expect purchase originations to decrease 10.6 percent in 2014 relative to 2013, totaling \$583 billion in purchase volume. Refinance originations, despite a very brief revival in the third quarter of 2014 as rates ticked down, are still expected to fall 60.9 percent to \$431 billion in 2014 relative to 2013's level of \$1.1 trillion. For 2015, purchase originations are expected to increase to \$729 billion, an increase of 25.2 percent as home sales grow more rapidly and with fewer cash transactions. Refinance originations will decrease slightly in 2015, dropping to \$401 billion, as rates continue to increase and fewer borrowers remain "in the money" and have incentive to refinance. Even with lower than expected mortgage rates thus far in 2014, we have not seen much refinance activity. We expect that mortgage rates will remain below the 5 percent mark for 2014, averaging 4.5 percent for the year, before increasing to 5.1 percent for 2014.

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