Economy Back on Track, Housing Continues to Lag

MBA Economic and Mortgage Finance Commentary: September 2014

Broader macroeconomic growth appears to be accelerating, and yet the housing market continues to be disconnected from this broader improvement. Real GDP and other growth indicators such as the ISM manufacturing index and consumer spending outside of housing continue to show strength in the US economy. We believe the broader economy has a much firmer foothold in its recovery and will likely remain on an upward path. International, geopolitical risks remain a concern, and we saw the impact of those holding the 10 Year Treasury yield down around 2.5 percent for much of the third quarter. The job market is also in a much improved state, despite a weak August. The unemployment rate should continue to fall, and payrolls are growing at an average pace of 215,000 jobs per month for the year. There are still concerns about how low labor force participation has fallen but the participation rate has been driven by structural factors such as an aging population and cyclical factors such as a persistently high number of long term unemployed and discouraged workers, as well as workers who are working part time for economic reasons. Inflation was on an upward path earlier in 2014 until moderating in recent months, primarily driven by lower energy prices. However, core inflation remains in the 2 percent range and shelter prices continue to climb.

The FOMC appears to hold a similar view of the economy and we expect that they will end net asset purchases in October, and start to raise short term rates in the second quarter of 2015 as has been broadly implied in recent communication. Barring any significant shocks to the economy, we do not see any near term “noise” in data releases altering the FOMC’s plans, even though there may be changes in how the language is adjusted to create more clarity. Additionally, the Committee shared more details with regards to an exit strategy.

Despite more encouraging signs in most other sectors, housing continues to lag. Home sales are showing mixed results, mortgage applications remain within a narrow range, and homeownership is trending lower. One of the few bright spots is that mortgage performance has improved, as it is tied to broader economic and job growth, as well as higher quality loans being made in recent years. Mortgage credit

© 2014 Mortgage Bankers Association

MBA Mortgage Finance and Economic Commentaries - each month MBA Research provides commentary on the current mortgage finance and economic climates. For more information, please contact Forecasts@mba.org.
availability remains tight even as jumbo lending, which is only a very small portion of the market, is showing an expansion of product offerings. There was a slight increase in the offering of affordability products in the most recent month’s data, but we have not seen enough evidence to suggest a significant and sustained upward trend will be seen in coming months.

Our forecast is similar to last month’s and we expect GDP growth to moderate a little following a 4.2 percent rate of growth in the second quarter, but still at a robust pace of 3.0 percent for the second half of 2014, driven mainly by consumer spending and business fixed investment. Growth in 2015 is expected to be 2.7 percent, still above trend, supported by consumer spending and some growth in housing. The unemployment rate will decrease slowly from an average of 6.2 percent in 2014 to 5.7 percent in 2015. As growth continues and the unemployment rate decreases, rates will increase, with the 10 Year Treasury yield increasing to 3.2 percent from 2.6 percent. We continue to expect that the Federal Reserve will start raising the fed funds rate in the second quarter of 2015.

The BEA reported that second quarter GDP grew at a rate of 4.2 percent, driven largely by PCE, inventory investment, and business fixed investment. We expect that inventory will be a drag in coming quarters since there was significant build up in the second quarter. Consumer spending has been tied to robust stock market wealth recently and much of that spending appears to have been on durable goods. Residential fixed investment returned to positive growth territory after two quarters of contraction, as housing construction and home sales improved. Brokers’ commissions tied to home sales usually accounts for about 70 percent of the residential investment component.

The chart below shows the main drivers of GDP growth, highlighting how significant consumption spending has been, and the extent to which business fixed investment has picked up. Residential fixed investment is no longer a drag to growth, but its contribution remains relatively small given the current weakness in the housing sector. Federal government investment has been less of an impediment to growth of late, and we expect that trend to continue in coming quarters.
Factory goods orders increased in July, but the headline number was somewhat skewed by large aircraft purchases, orders for core capital goods decreased. However, shipments of core capital goods increased in July. Shipments of core capital goods factor into the BEA’s estimates of current quarter business fixed spending, while orders of core capital goods are a proxy for business fixed investment growth in coming quarters. The ISM manufacturing index increased in August, reaching the highest level since 2011 and showing growth for the 11th straight month. The new orders and production components also saw increases, but the employment index saw a slight decrease. Industrial production in August decreased for the first time since January of this year, driven by a drop in manufacturing, while utilities increased after two months of decreases. While some of these indicators were softer in recent months, we still expect a pickup in coming months.

Inflation remains subdued, at least at the headline level and also for core inflation. Energy prices have driven overall inflation lower in recent months, but the shelter component has continued its upward
path. Given recent reports of low rental vacancy rates, this supports the fact that the rental market continues to be tight. The chat below shows the degree to which shelter costs have risen relative to the aggregate CPI measure and core CPI measure.

![Inflation Trends from the CPI](image)

Source: BLS

Both housing starts and permits fell in August for both single family and multifamily units. The drop in multifamily starts to 313,000 units from 458,000 units was somewhat expected and a reversion from a 44 percent surge in July. However, the August pace of starts was the lowest in almost a year. The single family market has been frail of late and this report showed no different, as starts decreased to 643,000 units from 659,000 units. The July revisions were generally better than expected, but there definitely is cause for concern after seeing the August numbers.

Existing home sales decreased to an annual pace of just over 5 million units in August, and also saw downward revisions to the July numbers. On a non-seasonally adjusted basis, this was 7.5 percent below the pace a year ago. The inventory of homes for sale decreased to 2.3 million units but was still higher.

© 2014 Mortgage Bankers Association

MBA Mortgage Finance and Economic Commentaries - each month MBA Research provides commentary on the current mortgage finance and economic climates. For more information, please contact Forecasts@mba.org.
than 2.2 million units a year ago. The Census Bureau’s report on new home sales on the other hand, saw an 18 percent increase in August, and hit the highest annual pace since 2008 at 504,000 units. There was also an upward revision to the July sales pace figure. The MBA’s estimate of new home sales for August showed a different picture, with a decrease to 424,000 units from 433,000 units in July.

Mortgage applications continue to show declines, as both purchase and refinance applications fell in August. Even as mortgage rates have generally held in the 4.25 percent range for most of the year, this was still higher than the 3.5 percent average for 2013. Most eligible borrowers have already refinanced into lower rates and it has been estimated that about 80 percent of loans outstanding have a mortgage rate of 4.5 percent and lower. Within the remaining 20 percent, it is likely that many are still underwater, owing more than their homes are worth, or do not have the income or credit to refinance. On the purchase side of the market, tighter credit has either shut many potential borrowers out of the market, or simply discouraged them for applying for a loan. Combine this with declining household mobility, stagnant income growth, and increasing student loan debt, and this would likely account for a sizable portion of the decline in purchase applications over the year.

Taken together, all these factors affecting homeownership and housing have led us to maintain our view that mortgage originations will not increase meaningfully until 2015. The shift to a purchase market has not materialized as expect and refinances are now a fifth of where they were during the 2012-2013 when mortgage rates were at historical lows.

We maintain our forecast for mortgage originations to total $1 trillion in 2014, increasing to $1.1 trillion in 2015 as refinances continue to wane and as more purchase growth is seen over the year. Purchase activity in 2014 will likely remain weak, ending the year at $569 billion, a 13 percent decrease from $652 billion in 2013. With continued economic and job growth, along with declining unemployment, we expect purchase originations to increase to $729 billion in 2015. Mortgage rates are expected to average 4.3 percent in 2014, and increase to 5.0 percent in 2015. As a result, refinance originations will be $438 billion in 2014, a 60 percent decrease from $1.1 trillion in 2013. As rates increase over 5 percent in 2015, we expect refinance originations will drop further to $400 billion. The remaining volume will likely come from borrowers who might finally be able to refinance given improved home equity positions or a more secure employment or credit situations.

© 2014 Mortgage Bankers Association

MBA Mortgage Finance and Economic Commentaries - each month MBA Research provides commentary on the current mortgage finance and economic climates. For more information, please contact Forecasts@mba.org.