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Economic & Housing Research **Outlook**

OCTOBER 2016

We've Been Here Before

Economic growth is bouncing back from a weak first half, the labor market is holding steady with low unemployment and modest wage gains. And Fed watchers are coming to the conclusion that a December rate hike is likely and worldwide economic growth is weak and prospects have gotten worse. We've been here before... last year.

As the economy sputters along a little bit faster than stall speed, the U.S. housing market continues to be a bright spot, though there's less room to run than in the prior few years. Mortgage activity, which benefited greatly from low mortgage rates, is starting to see a slowdown in refinance activity that will persist into next year as the mortgage market transitions to a purchase-dominated mix.

Modest economic growth

The economy is making modest gains. After a much-needed boost in nonresidential fixed investment, economic growth is looking up. The final estimate for second quarter real GDP growth was revised up from 1.1 percent to 1.4 percent. Growth in the second quarter was weighed down by inventories, as Real Final Sales (GDP growth minus inventory investment) increased 2.6 percent compared to 1.2 percent in the first quarter. Overall consumer spending remains the strongest component of GDP with growth in consumer expenditures adding 1.11 percent and 2.88 percent to GDP growth in the first and second quarters of 2016

Forecast Snapshot (October 2016)

Summary (annualized)	2015	2016	2017
30-year PMMS (%)	3.9	3.6	3.7
Total home sales (M)	5.75	6.04	6.16
House price growth (%)	6.1	5.6	4.7
Total originations ($B)	1,750	2,000	1,650

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respectively. Continued strength in consumer spending and a reduction in the drag from inventory spending should boost second half growth, resulting in full-year 2016 GDP growth of 1.6 percent. The economy should do modestly better in 2017, posting 1.9 percent year-over-year growth in our forecast.

Inflation under 2 percent

Consumer price inflation remains well below the Federal Reserve's 2 percent target. Headline Consumer Price Index (CPI) increased 1.5 percent on a year-over-year basis in September, while the Federal Reserve's preferred metric of consumer price inflation, the core personal consumptions expenditures (PCE) price index, rose at a 1.7 percent year-over-year rate in August. A rebound in energy prices pushes headline inflation above two percent in 2017 in our forecast.

Labor market at full employment

As the recovery matures, gains in the labor market have leveled off. Total nonfarm payroll month-over-month growth was 156,000 in September, which is under the 170,000 that many were expecting. The latest Job Openings and Labor Turnover Survey (JOLTS) for August showed a decline of 388,000 job openings. Throughout 2016, the pace of hiring and the number of job openings have leveled off. The slowdown in job creation, job openings and hiring is not distressing because the economy is at or near full employment. A mature expansion operating near full employment only needs to generate enough jobs to keep the unemployment rate steady. Since October of last year, the unemployment rate has remained between 4.9 percent and 5.0 percent each month except for May 2016 when the rate dipped to 4.7 percent. We forecast that the unemployment rate will decline slightly over the next year-and-a-half, ending 2017 at 4.7 percent.

Mortgage rates to remain low

After a quiet summer, volatility in financial markets has kicked up in recent weeks. Following the Brexit vote at the end of June, yields on the benchmark 10-year Treasury fell to a record low of 1.37 percent on July 5. Rates bounced back and remained between 1.45 and 1.65 from mid-July through the beginning of September. Over the past month and a half yields have risen, reaching as high as 1.79 percent on October 12.

After the Brexit vote, the implied probability of a FOMC rate hike in 2016 dropped below 50 percent and remained there through mid-August. Since mid-August the market implied probability has risen to 67 percent. We've maintained our assumption that there would be at least one rate hike this year. However, as we saw last year, a Fed rate hike does not mean mortgage rates necessarily rise.

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Whether or not long-term interest rates (including mortgage rates) rise depends more on global growth and worldwide bond yields than FOMC policy. Worldwide government bond yields have risen off their post-Brexit lows, but Japanese and most European bond yields remain below their pre-Brexit levels, with Japanese and Swiss 10-year yields still negative. In what's become a regular semi-annual occurrence the International Monetary Fund lowered their outlook for global growth in October.

Even if worldwide bond yields recover to the pre-Brexit status quo, mortgage interest rates are likely to remain low for an extended period. We've seen the 30-year mortgage tick modestly higher in recent weeks, but as of October 14, it was still below 3.5 percent. Our forecast calls for a gradual rise in rates throughout the remainder of 2016 and into 2017, with the 30-year fixed-rate mortgage averaging 3.9 percent in the fourth quarter of 2017.

Housing starts stall on lack of labor

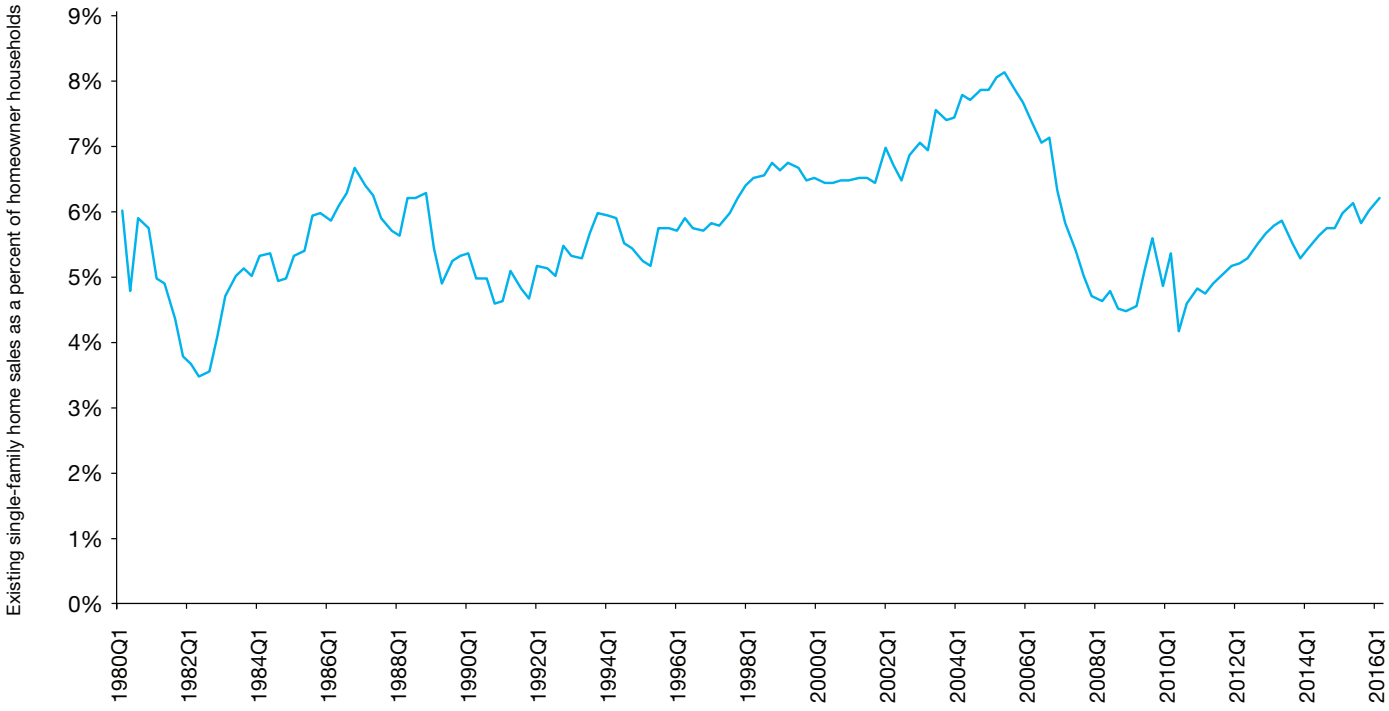
Low rates by themselves are not enough to drive housing starts significantly higher. We maintain our forecast for an increase in housing starts, but the rate of increase will be gradual. Home builders face constraints in available land and labor. The JOLTS data show that while construction job openings are up significantly over the past few years, construction hiring has been flat. The slow recovery of housing construction, particularly new single-family homes, continues to restrain housing markets and is reflected in our housing starts forecast. We're forecasting a 7 percent year-over-year increase in housing starts for 2016 and a 14 percent increase in 2017. However, even with these increases total housing starts will remain below long-run housing demand throughout the forecast period.[1]

Home sales near normal

Yet despite the slow recovery in new home sales, total home sales are on track for their best year in a decade. Unlike new home sales, existing home sales have nearly recovered back to pre-recession norms. The ratio of existing home sales to owner households has historically averaged about 6 percent per year. The current level of existing home sales is right in that range.

1 We estimate that long-run housing demand, due to population growth, second home demand, and replacement of existing stock to be around 1.6 or 1.7 million housing units per year. We only forecast 1.19 million and 1.36 million housing starts in 2016 and 2017 respectively.

Existing home sales have nearly recovered back to pre-recession norms



Source: National Association of Realtors, U.S. Census Bureau: Housing Vacancies & Homeownership, Moody's Analytics Forecasted. Note: Forecasted data used for Q1 and Q2 2016 U.S. Census Bureau Total Households

With mobility on the decline, existing home sales might not have that much more room to improve. A recent report by the National Association of Realtors showed repeat homebuyers expect to live in their current home for 15 years (first-timers expect to remain in their home 10 year), up from 9 years (6 years) in 2006. According to a report from the Urban Institute this declining mobility is affecting the mortgage market. As Americans age and labor market mobility declines, turnover of the existing housing stock should decline. In terms of existing home sales, we are probably close to an equilibrium level.[2]

2 First American produces a report on "potential home sales" that tracks the level of existing home sales consistent with economic fundamentals as measured by a statistical model. According to a recent report, potential home sales, as measured by First American are about 5.6% below potential.

We do not anticipate much increase in total home sales going forward. We forecast a slight decline in seasonally-adjusted sales in the fourth quarter. Next year, rising new home sales driven by increases in new single-family housing construction will push total home sales slightly higher, to 6.16 million in 2017 compared to 6.04 million in 2016 in our forecast.

House prices push higher

With limited inventory of for-sale homes and strong buyer demand, house price growth remains robust across the country averaging about 6 percent on a year-over-year basis through June. Low mortgage interest rates are helping to somewhat offset the impact of higher house prices on homebuyer affordability and the labor market is starting to show signs of wage growth. House prices display considerable momentum as supply constraints gradually loosen. We forecast that house prices will grow at a 5.6 percent annual rate in 2016, moderating to 4.7 percent in 2017.

Mortgage originations to decline

As we enter the fourth quarter, housing market activity cools considerably and home sales and home purchase mortgage activity should enter their seasonal lull. Mortgage application data indicate that mortgage refinance activity is slowing from the highs reached this summer, but on a year-over-year basis refinance applications are still up about 30 percent. Much refinance activity is rate sensitive (as we analyzed before in our August 2016 outlook The Return of the $2 Trillion Mortgage Market) so any slight upward movement in rates will likely cool mortgage refinance activity.

We expect $1 trillion in refinance mortgage originations in 2016, but 2017 volume will fall about 41 percent to just under $600 billion. Home purchase and home improvement mortgage activity will somewhat offset this, rising from $1 trillion in 2016 to $1.15 trillion in 2017. Total mortgage originations will fall about 18 percent from 2016 to 2017 in our forecast.

October 2016 Economic & Housing Market Forecast

Forecasted Figures

Historical Data

As of 10/18/2016

INDICATOR	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2017 Q4	Annual Totals 2015	Annual Totals 2016	Annual Totals 2017
Real GDP (%)	0.8	1.1	2.0	2.1	1.9	1.9	1.9	1.9	1.9	1.6	1.9
Consumer Prices (%) a.	-0.3	2.5	1.6	2.0	1.9	2.1	2.3	2.5	0.4	1.5	2.2
Unemployment Rate (%) b.	4.9	4.9	4.9	4.8	4.8	4.8	4.7	4.7	5.3	4.9	4.8
30-Year Fixed Mtg. Rate (%) b.	3.7	3.6	3.5	3.6	3.6	3.6	3.7	3.9	3.9	3.6	3.7
5/1 Hybrid Treas. Indexed ARM Rate (%) b.	2.9	2.8	2.8	3.2	3.2	3.3	3.4	3.6	2.9	2.9	3.4
10-Year Const. Mat. Treas. Rate (%) b.	1.9	1.8	1.6	1.8	1.8	2.0	2.1	2.3	2.2	1.8	2.1
1-Year Const. Mat. Treas. Rate (%) b.	0.6	0.6	0.6	0.6	0.7	0.9	1.1	1.3	0.3	0.6	1.0
Housing Starts c.	1.15	1.16	1.18	1.25	1.29	1.34	1.38	1.43	1.11	1.19	1.36
Total Home Sales d.	5.83	6.08	6.15	6.10	6.11	6.16	6.16	6.21	5.75	6.04	6.16
FMHPI House Price Appreciation (%) e.	1.6	1.4	1.3	1.2	1.2	1.2	1.1	1.0	6.1	5.6	4.7
1-4 Family Mortgage Originations f.											
- Conventional	$290	$410	$492	$391	$245	$359	$381	$296	$1,344	$1,583	$1,281
- FHA & VA	$95	$125	$103	$94	$95	$101	$89	$84	$406	$417	$369
- Total	$385	$535	$595	$485	$340	$460	$470	$380	$1,750	$2,000	$1,650
Refinancing Share - Originations (%) g.	55	49	50	47	43	39	33	30	45	50	36
Residential Mortgage Debt (%) h.	0.8	2.4	3.7	4.0	4.0	4.0	4.0	4.0	1.5	2.7	4.0

Note: Quarterly and annual forecasts are shown in shaded areas; totals may not add due to rounding; quarterly data expressed as annual rates.
Annual forecast data are averages of quarterly values; annual historical data are reported as Q4 over Q4.

a. Calculations based on quarterly average of monthly index levels; index levels based on the seasonally-adjusted, all-urban consumer price index.

b. Quarterly average of monthly unemployment rates (seasonally-adjusted); Quarterly average of monthly interest rates (not seasonally-adjusted).

c. Millions of housing units; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).

d. Millions of housing units; total sales are the sum of new and existing single-family homes; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).

e. Quarterly growth rate of Freddie Mac's House Price Index; seasonally-adjusted; annual rates for yearly data.

f. Billions of dollars (not seasonally-adjusted); conventional for 2014 are Freddie Mac estimates.

g. Home Mortgage Disclosure Act for all single-family mortgages (not seasonally-adjusted); annual share is dollar-weighted average of quarterly shares (2014 estimated).

h. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages (not seasonally-adjusted, annual rate).

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