A slowly improving picture, risks and opportunities remain

MBA Economic and Mortgage Finance Commentary: January 2012

Economic growth in the US was, overall, stronger at the end of 2011 than previously anticipated, due to some temporary factors such as inventory investment, but growth will likely slow somewhat in 2012. Data from the end of the year started to show a little softening, with a wider trade deficit, lower vehicle production estimates, and lower than expected retail sales over the holidays. With the uncertainties regarding Europe and the Persian Gulf, global growth will likely slow in 2012 as well. US growth continues to be supported by consumer spending on durables, largely pent-up demand, and will also be impacted by policy issues such the Congress' decision (or indecision) on the temporary payroll tax cuts and extended unemployment benefits.

This month's outlook assumes that Europe is in or will soon be in a recession. The depth of that recession will depend on whether it is caused mainly by fiscal contraction due to new required austerity, in which case it will likely be a short but mild recession, or whether it is caused by large losses and a financial sector panic, in which case the recession will be much more severe than the aforementioned. In the case of the mild recession, the US will export less, reducing earnings of US corporations doing business in Europe, and in the case of the more severe scenario, there will be a threat to money market funds and the earnings and capital of US banks due to exposure to European counterparties. In this worst case scenario, there is significant risk that the European situation continues to fester, harms the global financial system, and as a result, throws the US economy into recession in the first half of 2012.

There are some upside possibilities however. The tone of recent housing market data has improved and unlike 2011, there is the potential for an upside surprise in this spring buying market. Homebuilder sentiment has returned to pre-recession levels, even though construction activity remains near 50-year lows. A more robust housing market recovery would spur faster overall growth. The employment picture has seemed to brighten as well, but it is still difficult to say whether the growth in payrolls and decline in the unemployment rate is sustainable in the coming months.

Based on our outlook and assumptions, we anticipate that GDP growth will average 1.8 percent in 2012 before increasing to 2.3 percent growth in 2013. The unemployment rate will stay close to 8.5 percent for much of 2012, and should decrease to below 8 percent by the end of 2013 as economic growth picks up.

We expect that the Fed, as it has communicated, will keep its fed funds rate target near the zero bound for the next two years, and that mortgage-Treasury spreads will remain wide, in the 200 basis point range, as there is an imbalance in supply and demand and originators continue to deal with capacity constraints. Any sort of recession will keeps rates lower for a longer period of time, while a more robust economic or housing recovery would provide upward pressure on rates.

In terms of mortgage originations, we expect that purchase origination volume will increase marginally as home sales increase in 2012 and as we see some home price growth by the

end of 2012, or earlier in some major markets that may already be on the upswing. As mortgage rates increase, refinance volume should slowly start to decline, and also as the number of potential borrowers decreases as a result of the increased refinance activity we have seen in recent months. The first half of 2012 will benefit from spillover of applicants from end of 2011, as rates have been and continue to be at record lows. The HARP 2.0 program will have a measurable, but limited, effect on refinance volume, but it is still too early to tell if the program will meet the Administration's projections. A recession in the US would lead to lower purchase volume in the first half of 2012, as well as some but not complete offset in refinance volume, since many eligible borrowers have already refinanced or are in the process of doing so. Based on our current forecast, total mortgage originations for 2012 will be $992 billion, down from $1.26 trillion in 2011, driven by a 32 percent drop in refinance originations as purchase originations remain essentially unchanged. Refinance activity will decrease another 39 percent in 2013, but we should see some recovery in the purchase market, resulting in total originations of a little over $1 trillion in 2013. The 30-year fixed mortgage rate will increase slightly over the course of 2012 to 4.3 percent, and increase through 2013 to end the year at almost 5 percent.

Q3 GDP revised lower

GDP grew at an annual rate of 1.8 percent in the third quarter of 2011, up from the first and second quarter of this year which reached 0.4 percent and 1.3 percent respectively. This third estimate of GDP released by the Commerce Department is a downward revision from the second estimate of a seasonally adjusted 2.0 percent and advance estimate of 2.5 percent. While positive, GDP growth this year has been significantly lower, averaging 1.2 percent for the first three quarters, versus 3.4 percent in 2010.

The strongest growth came from exports which advanced 4.7 percent in the third quarter. Personal consumption expenditures (PCE) rose a seasonally adjusted 1.7 percent, more than double 0.7 percent rise seen in the second quarter. Consumer spending on durable goods contributed heavily to that, increasing 5.7 percent in the quarter after a 5.3 percent drop in the second quarter. Services maintained the same level of growth as second quarter at 1.8 percent, still the highest level in a year. Imports, which subtract from GDP, rose by 1.2 percent in the third quarter from 1.4 percent in the second quarter. Government spending declined for the fourth quarter in a row.

In a separate release, personal Income increased by a seasonally adjusted annual rate of 0.1 percent in November by 8.5 billion. Disposable personal income fell by 5.0 billion after increasing 27.2 billion in October. Personal consumption expenditures increased by 0.1 percent, or 13.1 billion, due to a large increase in services of 10.6 billion in November, more than quadruple the gain in October of 2.4 billion. Wages and salary fell for the first time in three months by 0.1 percent with salary drops in both the goods and services providing industries of 0.6 percent and 0.01 percent; government salaries rose by 0.01 percent or 1.0 million.

Housing activity on the rise

Advancing by highest level in seven months, new homes sales rose 1.6 percent in November with a seasonally adjusted annual rate of 315,000 units, up from 310,000 sales

pace in October. Compared with November last year, new home sales are up 9.8 percent. Sales of existing homes increased for third consecutive month in November to a seasonally adjusted annual rate of 4.42 million units which is 4.0 percent higher than the 4.25 million pace last month. Compared to November last year, the pace of existing home sales is 11.5 percent higher. The impact of the revision was to lower existing home sales by roughly 15 percent over the past 5 years, on the order of a total of 3 million fewer sales than had been previously reported. The revision will increase the depth of the decline in existing home sales in 2007 from -12.8 percent to -22.5 percent relative to the year before and steepen the decline in 2008 from -13.1 percent to -17.8 percent. According to NAR, the main reasons for the downward revision was an over-estimate of the FSBO share of the market and MLS databases used in the calculations had been seeing an increased occurrence of multiple counting of the same property as market conditions deteriorated and sellers listed the property in multiple MLS systems within the surrounding geography.. Although the size of this revision is unsettling, the revised NAR data tracks closer to purchase mortgage application data from the MBA's Weekly Applications Survey. With respect to our originations forecast, the revisions do not alter our outlook for mortgage originations, as we had already assumed that the prior sales data was an overestimate of actual activity.

Total housing starts in December decreased to a seasonally adjusted annual pace of 627,000 units from 685,000 units in November, a 4.1 percent decrease over the month. The decrease was driven by a 20.4 percent decrease in the multi-family starts component, which was reduced to a SAAR of 187,000 units from 235,000 units in November. Single family starts saw a healthy 20,000 unit increase in December to reach a pace of 470,000 units, which is the highest since April 2010. On a non-seasonally adjusted, year over year basis, single family starts increased 10.2 percent, while multifamily starts are 73.6 percent higher than a year ago. Overall permits are essentially unchanged from the previous month, but single family permits are up 1.8 percent to 444,000 permits, the highest annual rate in a year. Despite a decrease this month, multifamily permits are still close to levels last seen in the fall of 2008. Housing completions increased 9.2 percent to 605,000 units, driven by multifamily completions, with single family completions falling slightly to 448,000 units. This was the first time since March 2011 that single family starts has exceeded completions, a sign that perhaps builders are doing more than just working through current inventory, but are instead seeing potential demand in the near term. This is supported somewhat by the uptick in the NAHB/Wells Fargo Housing Market Index, which measures builders' sentiment. That index has risen for four months straight and is at its highest since June 2007, even though the overall index is still below 50 at 25, which implies that more homebuilders view the housing market as "poor" rather than "good". A reading greater than 50 would mean sentiment is more heavily weighted towards a "good" housing market.

Housing prices continue to slip as reflected by all major indicators. Declining for the fourth consecutive month, the Core Logic Home Price Index for single family detached homes fell by a non-seasonally adjusted 1.5 percent in November after dropping by 1.3 percent in October. Also showing signs of decline, the FHFA home price purchase index fell a non-seasonally adjusted 0.4 percent in October while the S&P/Case-Shiller 20 city index fell by 1.2 percent. The FHFA index indicated that major decreases were seen in the South Atlantic (-1.2 percent) and East North Central (-1.2 percent) region. The S&P Case-Shiller home price index reflected greater than 2.5 percent declines in Atlanta, Detroit and Minneapolis.

Employment grows while consumer sentiment reaches eight month high

The Bureau of Labor and Statistics reported that nonfarm payroll employment grew by 200,000 jobs in December, on a seasonally adjusted basis, double the downwardly revised gain during November of 100,000 jobs (previously reported as 112,000 jobs). While it is not the largest employment growth seen this year, it is the highest level of growth compared to other Decembers during the past decade. Private companies continue to lead the employment growth by adding 212,000 jobs after expanding by 120,000 jobs in November while the government sector saw the fourteenth straight month of jobs loss with a decline of 12,000 jobs in December. For the private sector, most of the employment growth was from the services industry which gained 164,000 jobs, following a gain of 126,000 jobs in November. The main contributor was courier and messenger employment which had the largest gain of the year of 42,200 positions. The permanence of these positions is unclear given the consistent trend in recent years of increases in courier and messenger positions in December followed by a decline in January. Education and health services have continued to contribute to positive job growth for more than two and a half years by gaining 29,000 positions in December. The private goods producing industry rose by 48,000 jobs with the largest growth originating in manufacturing, which had an increase of 23,000 jobs (compared to increase of 1,000 in November).

The unemployment rate fell to its lowest level since 2009, decreasing to 8.5 percent in December from 8.7 percent in November. While the labor force participation rate remained unchanged from last month at 64.0 percent, this level of participation is the lowest since 1984. The broadest measure of unemployment, the U-6, which captures discouraged workers, those working part-time for economic reasons and others marginally attached to the labor force fell from 15.6 percent to a low in 2011 of 15.2 percent in December. The average work week increased slightly from 34.3 hours in November to 34.4 hours in December. The December data brings the fourth quarter unemployment rate to 8.7 percent, slightly lower than our forecast of 8.8 percent.

Positive news comes from consumer confidence which increased to a seasonally adjusted 64.5 in December, the highest level since April 2011, from 55.2 in November. The data released by the Conference Board indicates that 2011 ended with the strongest monthly gains in over two and a half years. On an annual basis, consumer confidence averaged 58.1, the highest level since 2007. Consumers' view of the present situation increased to the highest level in over three years of 46.7 from 38.3 in November and longer term expectations rose to a seven month high of 76.4 in December from 66.4.

Manufacturing remains strong

The PMI index released by the Institute of Supply Management increased to a seasonally adjusted six month high of 53.9 in December from the previous month's level of 52.7. Given that a PMI level greater than 42.5 reflects an expansion in the overall economy, growth has been consistent the past 2 years. While supplier deliveries maintained its same level of 49.9, new orders, production and employment indices all increased in December. New orders increased from 56.7 in November to 57.6. A threshold of 52.1 generally reflects an increase in Census Bureau manufacturing orders; the new orders index has been above

that level for the past 3 months.   Production index rose to an 8 month high of 59.9 from 56.6 in November, both levels consistent with increases in Federal Reserve Production figures. Employment index rose with largest monthly increase this year of 6.4 percent by rising from 51.8 in November to 55.1 in December. Employment index has been above 50.1 percent for more than the past 2 years, consistent with growth in Bureau of Labor and Statistic manufacturing employment. While remaining unchanged from last month, the supplier deliveries index is at its lowest level in over 2 years. Inventories index declined from 48.3 to 47.1 in December which is still consistent with expansion in the Bureau of Economic Analysis' figures on overall manufacturing inventories.

Mortgage applications finished year at record lows, dominated by refinances

Mortgage applications increased 0.1 percent from November to December as the Weekly Application Survey market index grew to an average of 655.9 to 656.5. Even with historically low interest rates, purchase applications fell by 1.0 percent in December to an index value of 185.2 while refinance applications increased by 1.8 percent to index value of 3468.5. The refinance share peaked to highest monthly average of the year at 79.82.

Interest rates fell to the lowest level since the beginning of each series in 1990 for the 30 year fixed rate mortgage which averaged at 4.11, 15 year fixed mortgage at 3.42, and FHA rate at 3.95.

Aggregated yearly, the market index in 2011 finished at the lowest level since 2000. Similarly, the purchase index which had been declining for the past 4 years averaged 182.6, the lowest since 1995, while the refinance index fell 14.6 percent to its lowest level in 3 years.

© 2012 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@mortgagebankers.org.