2017 Mortgage Market Outlook: Executive Economic Report

January 2017

Source	2016 Estimate			2017 Forecast			2017
	Purchase ($B)	Refinance ($B)	Total ($B)	Purchase ($B)	Refinance ($B)	Total ($B)	Purch/Refi Ratio
iEmergent	$947	$903	$1,850	$1,025	$532	$1,557	66%/34%
Fannie Mae	$1,013	$890	$1,903	$1,053	$520	$1,573	67%/33%
MBA	$990	$901	$1,891	$1,092	$479	$1,571	70%/30%
Freddie Mac	$1,060	$940	$2,000	$1,084	$421	$1,505	72%/28%

Note: All forecasts are as of December 2016

For the 2017 housing market, the outlook is generally positive. The long recovery from the elevated delinquency and foreclosure rates of the Housing Bust is nearly complete, and home values nationally have returned to their pre-Boom peak. For the 2017 mortgage industry, a sharply shifting change is in order as refinance volumes fall significantly and purchase becomes a much bigger part of the market.

Forecasters, including Fannie Mae, Freddie Mac, iEmergent and the MBA, anticipate that total mortgage opportunity in 2017 will decrease from 2016, because of a drop in refinance activity, but the purchase market will again see healthy growth.

Comparing the outlooks from these forecasts, we note that they are about as closely aligned as they have been for years. This is largely due to the fact the disruptive forces in the mortgage market for the last decade – elevated delinquency & foreclosure rates, number of households underwater on loans, volume of homes at distressed prices – are dissipating. But there are fundamental differences in forecast methodology here. Most mortgage forecasts are generated at the national level. At iEmergent, we work from the bottom up. Our methodology for forecasting purchase opportunity begins at the census tract level with quantifying the homebuyer pool – or *the number of households that are ready, willing and able to buy a home*. The size of that pool is determined by demographic shifts (i.e. household growth) and by the relationship between the financial health of US households (demand) and housing-market issues (supply). In addition, driving both the demand and supply-sides of the equation are macroeconomic trends, regulatory and legislative actions in lending, and – as always – the individual behaviors of households across the nation.

This market-based approach gives our clients the critical information necessary to make successful tactical and strategic decisions in managing their businesses.

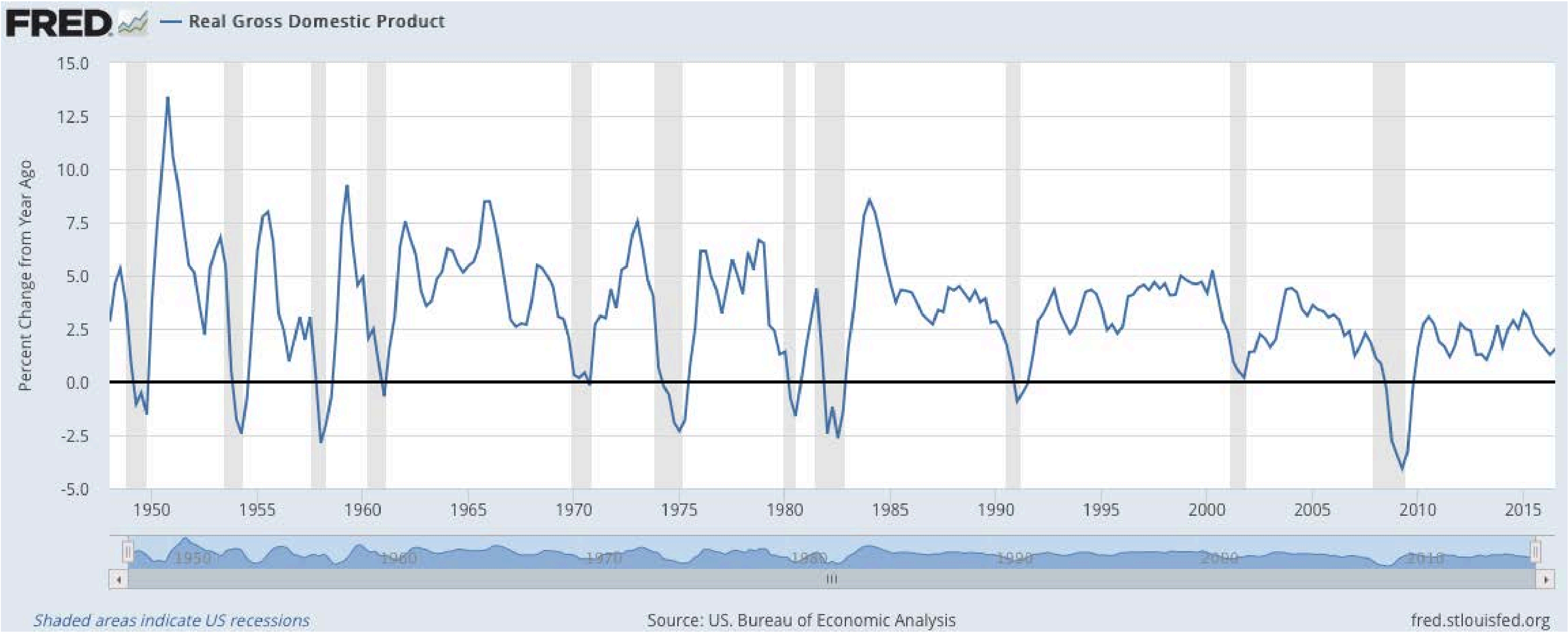
ECONOMIC CONDITIONS OVERVIEW

- Current economic situation is good & outlook generally positive. Recent employment, income & consumer spending trends have been pretty good lately. Equity markets have reached all-time highs.
    - GDP – Latest estimate for Q3/16 was +3.5%, but consumer spending portion slowed.
    - Employment – Best readings yet in a long, but slow expansion period.
    - Consumer Income – Troublesome real income trend.
    - Inflation – Very stable.
    - Interest rates – The era of low rates might be over.

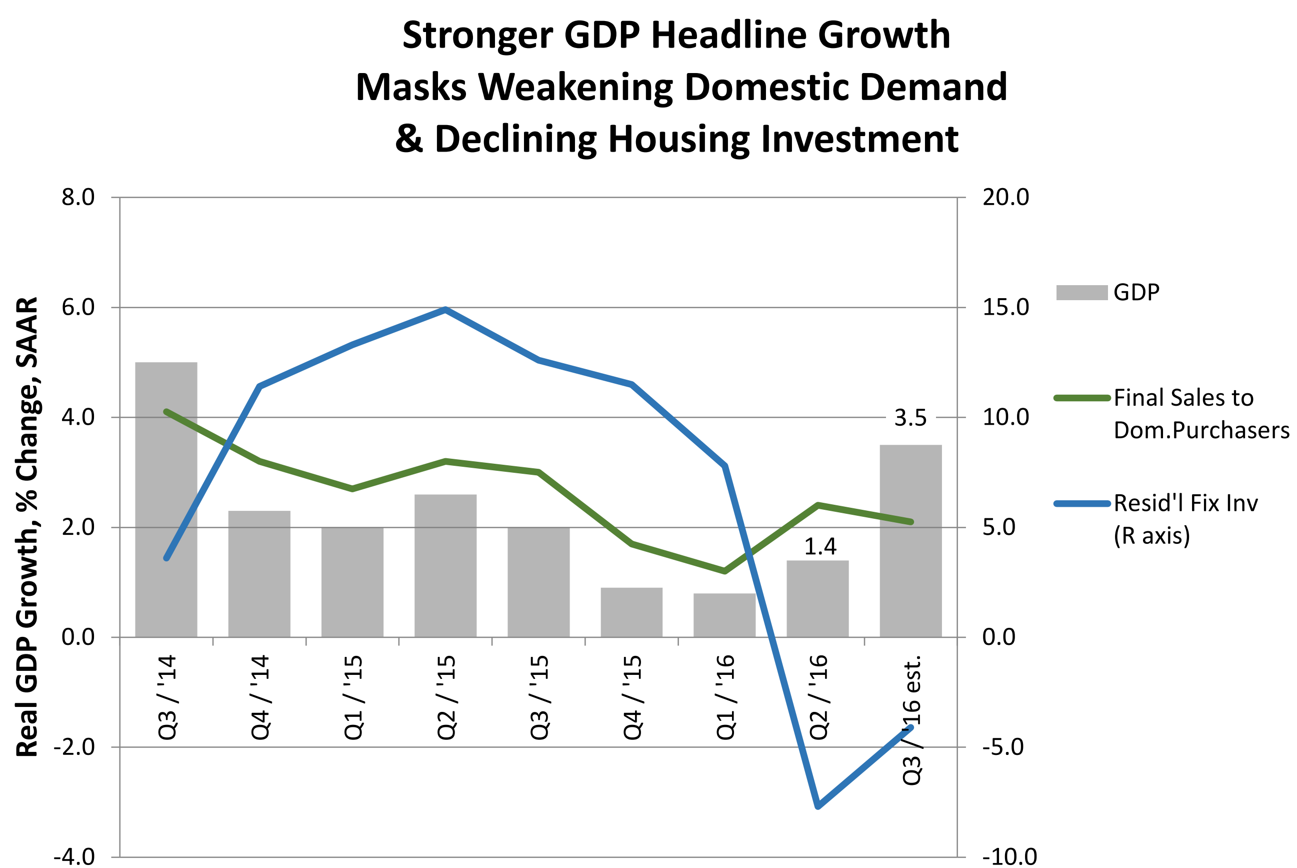
- Trump's new administration promises sweeping political changes, raising uncertainty in financial markets. Uncertainty is rarely good for the economy: although government spending will likely increase, businesses and consumers will become more cautious. Hiring and investment growth are likely to slow. Consumer spending, particularly for big-ticket items like housing, is also likely to slow.

- 2017 areas of concern:
    - Interest rates are rising – long-term rates spiked after the election with the anticipation of higher deficits due to tax cuts and higher government spending.
    - Inflation expectations are rising – expansionary fiscal policy with the economy is near full employment will lead to income gains as businesses compete in a tighter labor market, but will also increase inflationary pressure.

Well, it hasn't been the flashiest economic expansion in the last 70 years. In terms of average year-over-year real GDP growth, it has actually been the worst at only 1.8% annualized per quarter. However, at 30 quarters (7 ½ years), it is already the fourth *longest* expansion the U.S. has experienced (out of 12 in this period), and early this year it'll move up to number three. It follows the Great Recession, the longest and deepest recession we've had since the Great Depression of the 30s. To many households and businesses, gains have come at a frustratingly slow pace.



The latest estimate for Q3 GDP shows the largest growth for real GDP in eight quarters. At 3.5%, Q3 growth was two and a half times the growth of the previous quarter. But underlying that robust gain was a downward tic in domestic demand, as well as a second consecutive decline in housing investment.



Source: BEA

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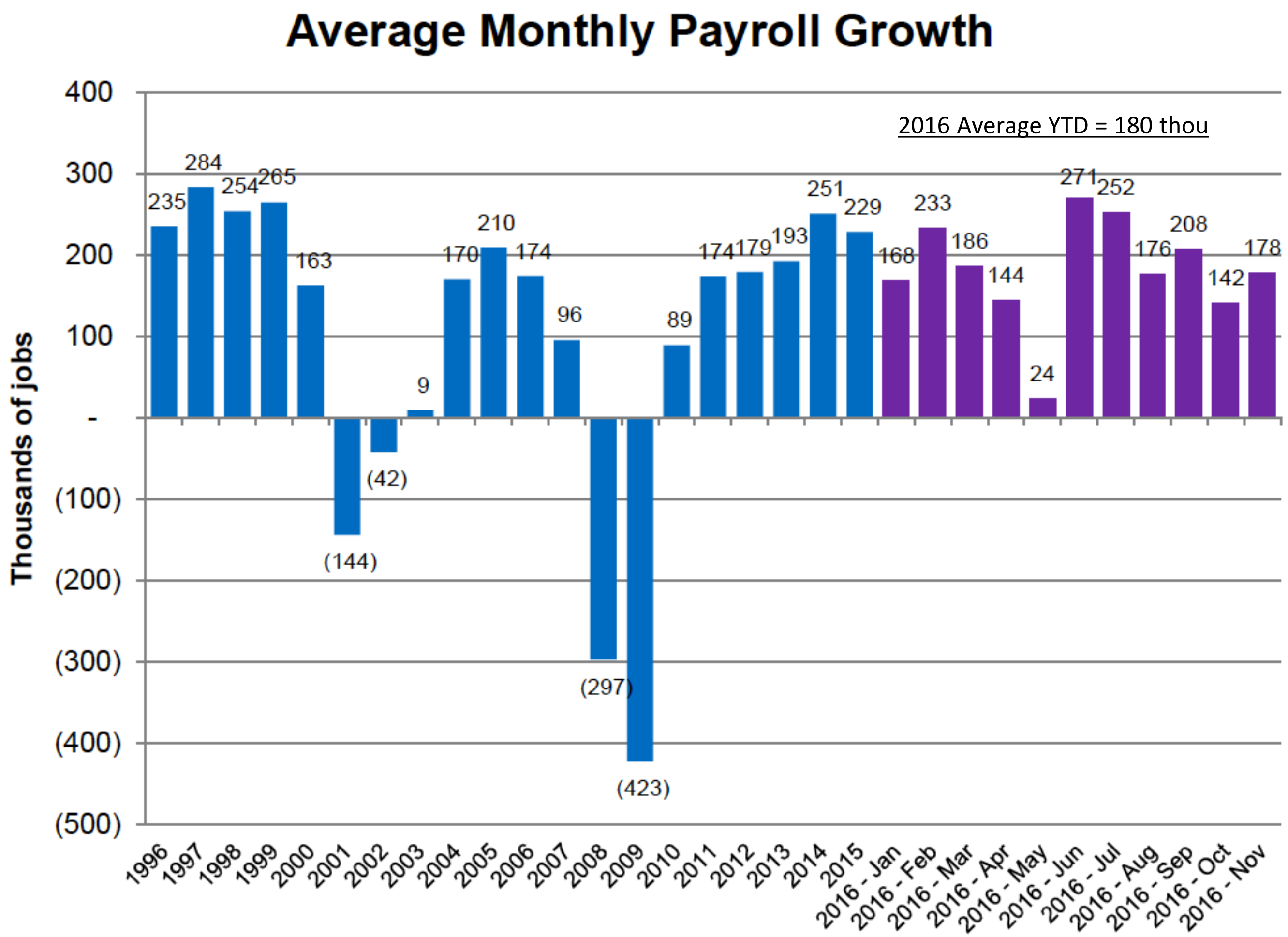
For the first few years of this expansion, many referred to it as a “job-less” recovery. Unemployment stayed stubbornly high and extended periods of unemployment were common. The employment-to-population ratio and the labor force participation rate lagged far behind levels of the last two expansions. However, they were above the levels experienced during the 70s and 80s.

Beginning in 2014, the employment-to-population ratio finally started trending upward. The unemployment rate continued to decline steadily and has now reached very healthy levels – toward what many economists would say is the “full-employment” unemployment rate.

In terms of job creation, 2016 has slipped a bit as the expansion has matured, but we are still at robust levels. Although conditions could always be better, from most perspectives, the employment situation is fairly good.



Source: BLS, chart from MBA Forecast Commentary.

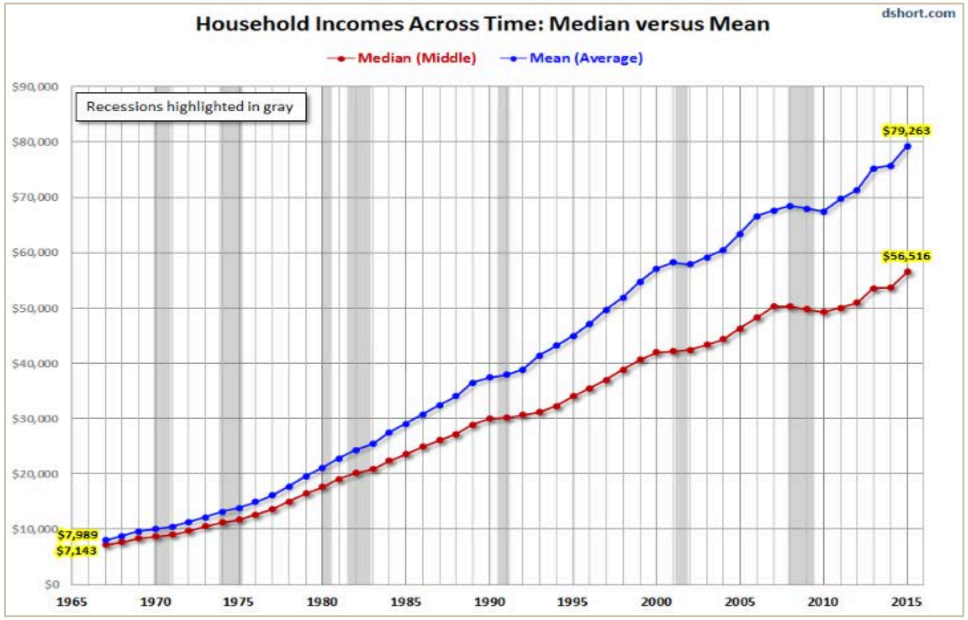
Income gains have been less positive than job gains in the current expansion, and for that matter, since the turn of the century.

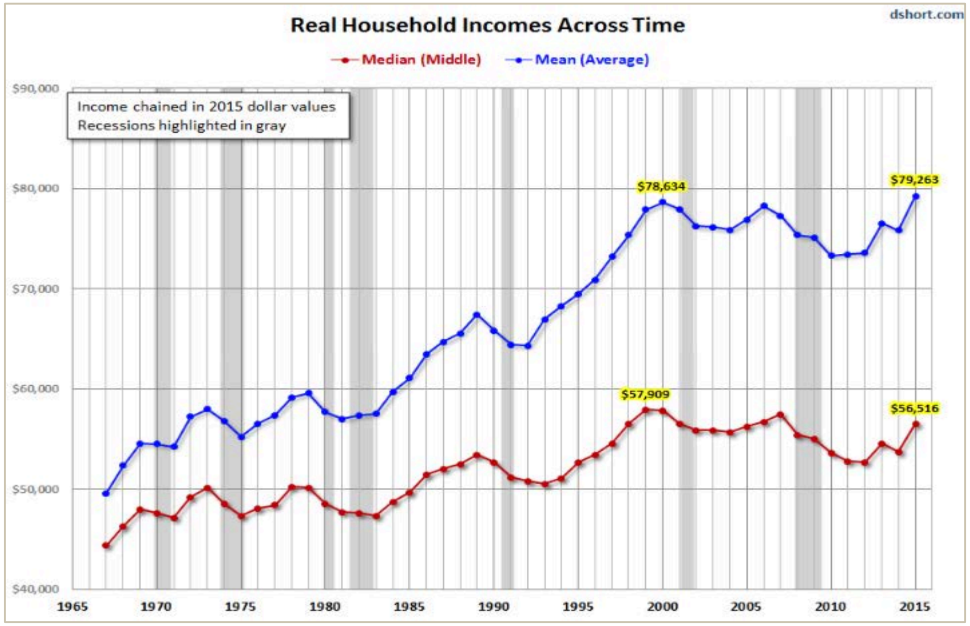
The top chart shows mean and median household income in nominal dollars. "Median," by definition, is the exact middle, so it is representative of the middle class. "Mean" is the average of all households, so the fact that it is above than the median indicates that households with higher-than-median incomes have experienced greater income growth over the time period. It is one indication of increasing income inequality, one of the two major problems shown in the household income statistics.

The second problem becomes apparent when inflation is removed and the income data is viewed to real terms. For most of the years since the late 90's, real household income has fallen. By 2015, real *mean* household income had only just passed its peak level in 2000. But real *median* household income still hasn't reached its 1999 peak.

Stagnant real incomes were augmented in the early 2000s by tapping into accumulated home equity, but that solution was curtailed by the Housing Bust.

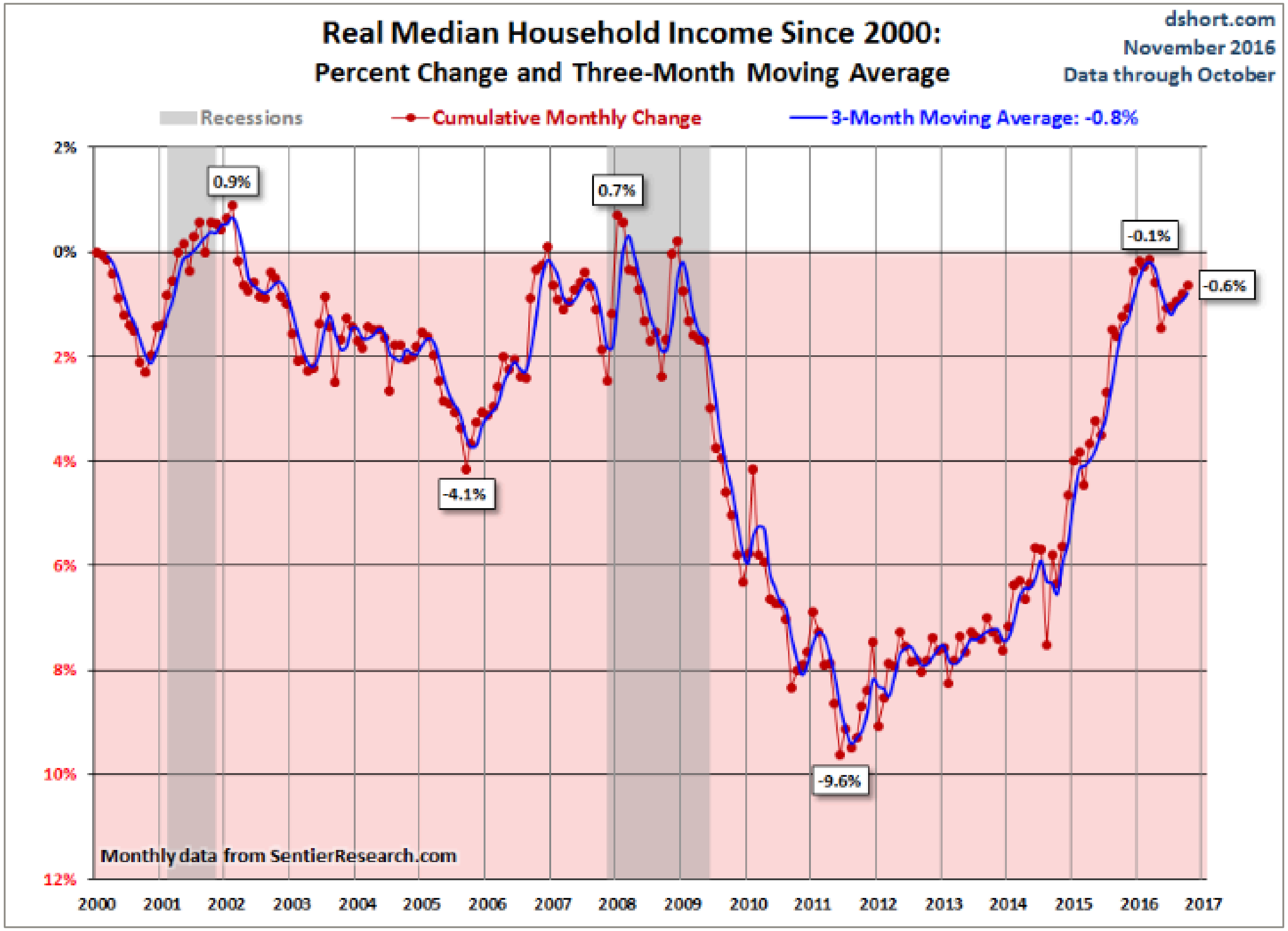
(Income analysis charts from Doug Short Advisor Perspectives, https://www.advisorperspectives.com/dshort/updates)





The previous chart was a 50-year look at annual data. Here we look at the underlying monthly series which includes 2016 data. Real median household income rose sharply in 2014, and even more sharply in 2015. But in 2016, real income gains stopped at a level still below the January 2000 level.

Stagnation in household incomes is one of several long-term challenges for the economy, for consumers, and for the housing market.

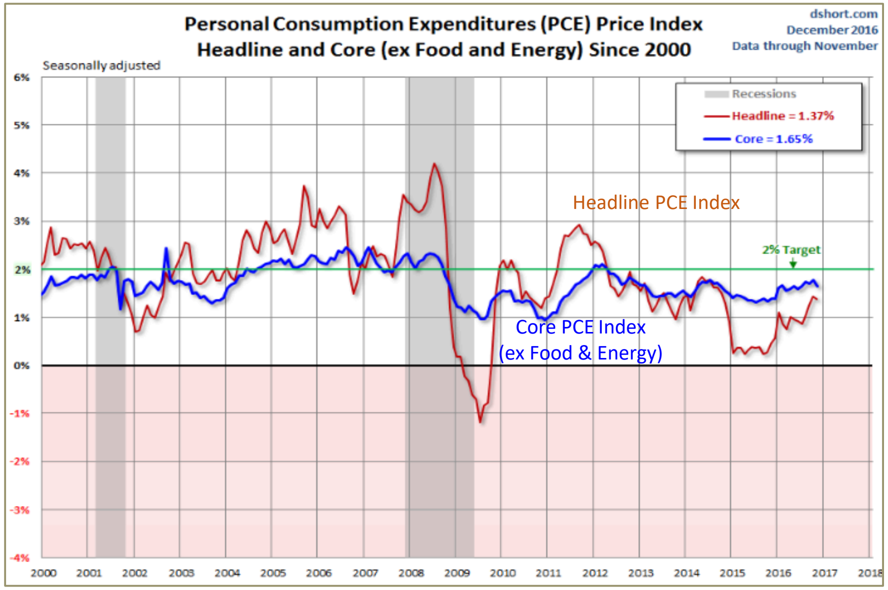


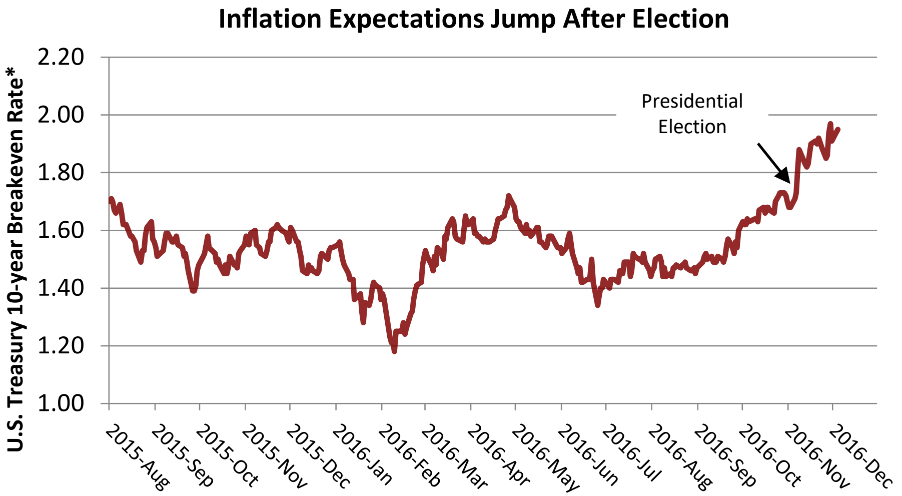
Inflation has been well under control since the late 90s. The Federal Reserve monitors the Personal Consumption Expenditure (PCE) price index, and more particularly, the Core PCE index which excludes food and energy.

Core PCE inflation has been under the Fed's 2% target for the duration of the expansion, and total PCE inflation has been even lower, courtesy of depressed energy and food prices for the last two years.

However, following the election, the breakeven rate on 10-year Treasury bonds rose sharply. The breakeven rate is the difference between the nominal Treasury bond yield and the yield on Treasury Inflation-Protected securities (TIPs), and thus, an indicator of inflation expectations.

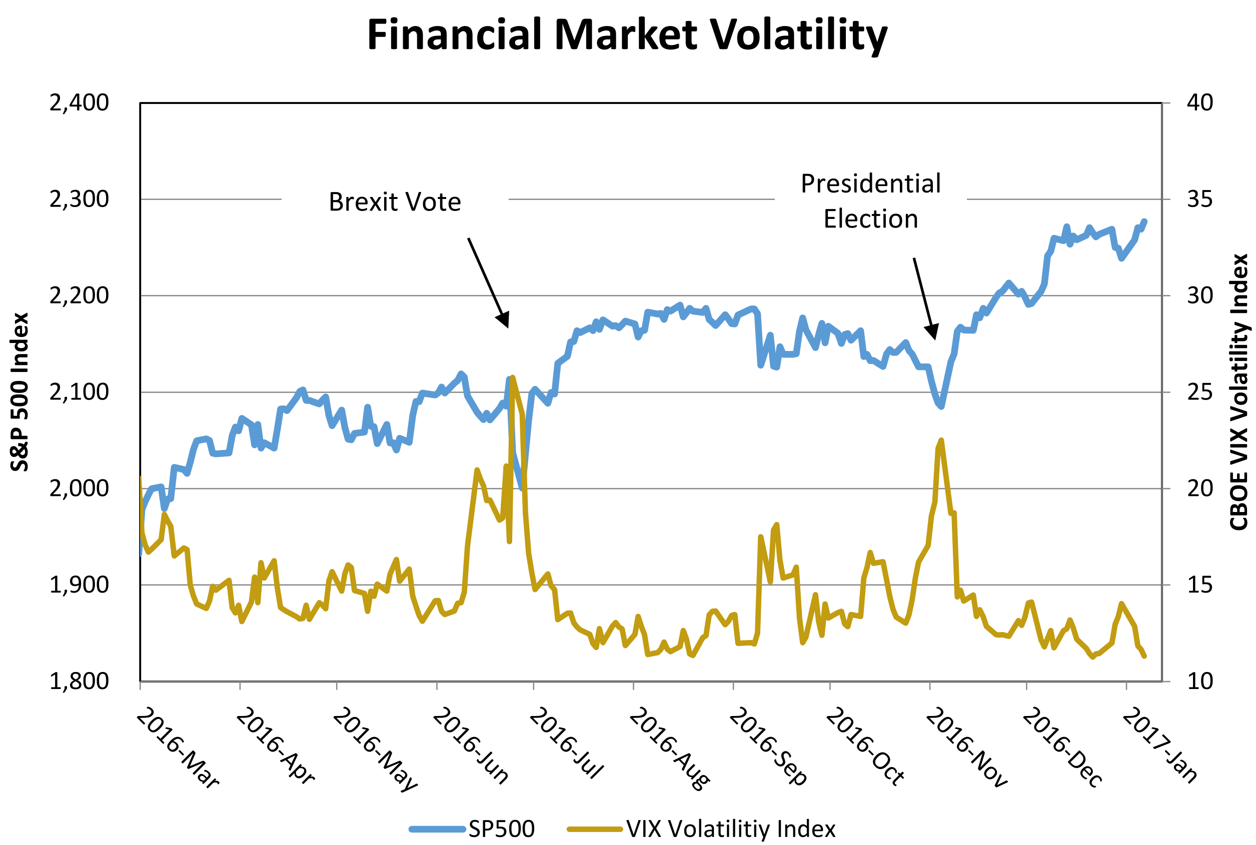
The tax breaks and the infrastructure and defense spending increases suggested by Candidate Trump represent expansionary fiscal policy stimuli. Such expansionary stimuli make sense in a recessionary environment, but with the economy operating at close to full employment, such policies will lead to higher inflation, hence the jump in inflation expectations.





* Breakeven Rate is the difference between the nominal yield on Treasury bonds and the yield on Treasury Inflation-Protected securities (TIPS) of the same term.
Source: Federal Reserve

The presidential election results surprised financial markets, causing a spike in the VIX Volatility Index and a sharp dip in the stock market, which was quickly reversed. Since then, the stock market has rallied to new, all-time highs in anticipation of fiscal stimulus and a more pro-business regulatory environment.



Source: S&P, CBOE

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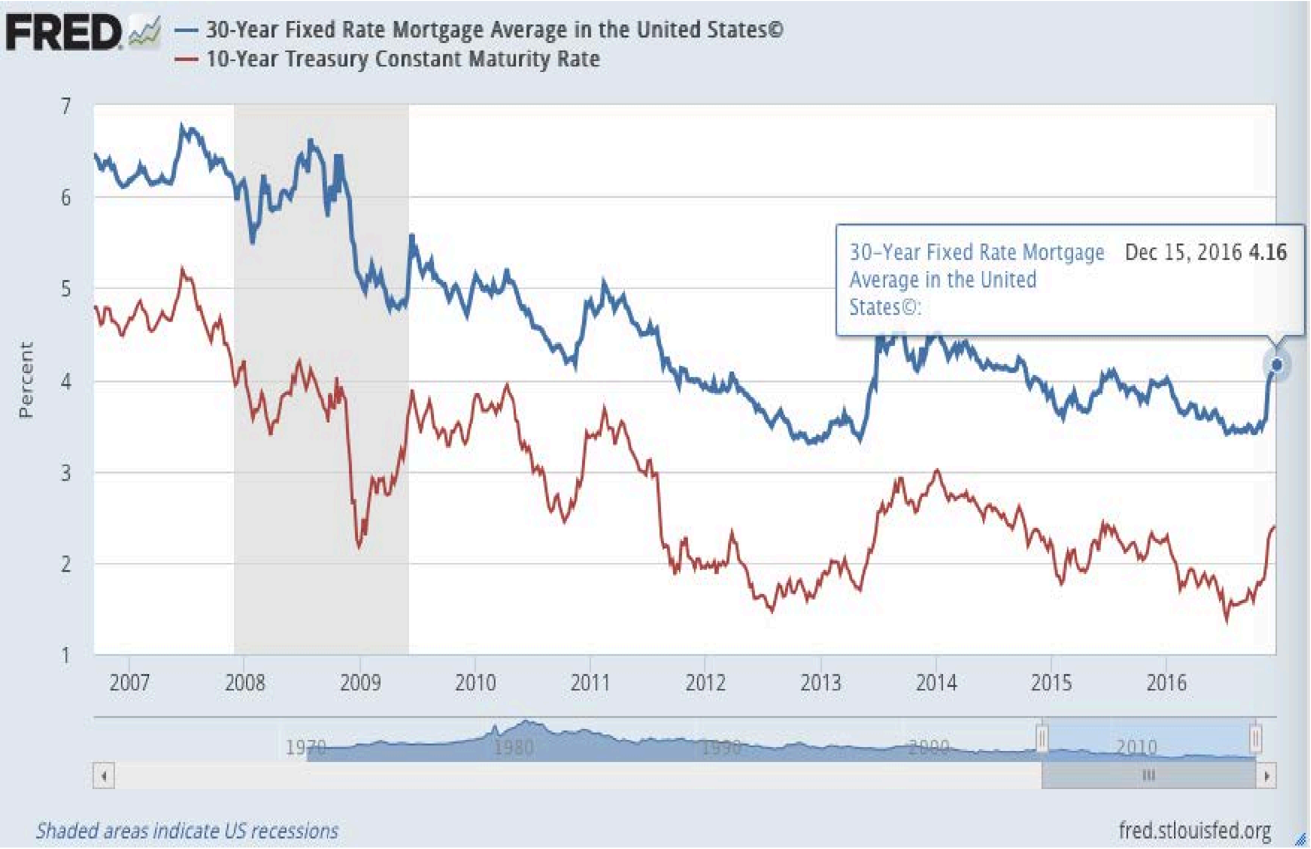
In the wake of the election, Treasury bond rates rose sharply, pulling 30-year fixed mortgage rates up above 4% for the first time in 2016. Bond rates rose because the Trump administration's expected tax cuts and increased government spending will most likely not be "revenue-neutral." They will raise the federal deficit and increase government borrowing needs.



An assessment of the economic outlook under the Donald Trump administration by the forecasting group Moody's Analytics suggests that initially real growth will exceed earlier expectations due to the fiscal stimulus efforts proposed by the President-elect. However, in the longer term, economic output will be hurt by those efforts due to higher inflation and higher interest rates. Moreover, Trump's aggressive attitude toward foreign relations may also hurt international trade.