

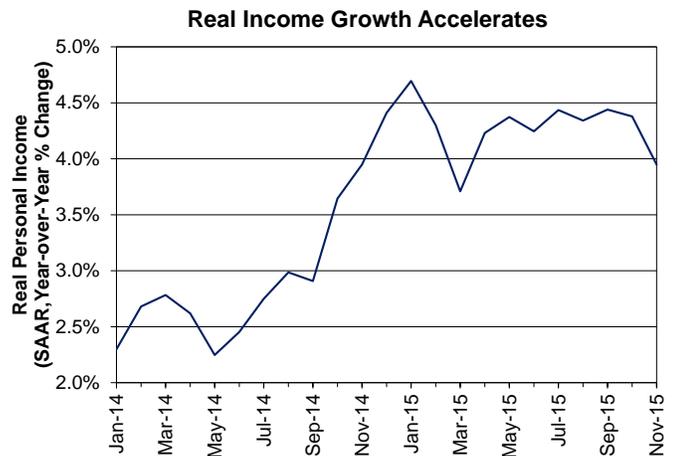
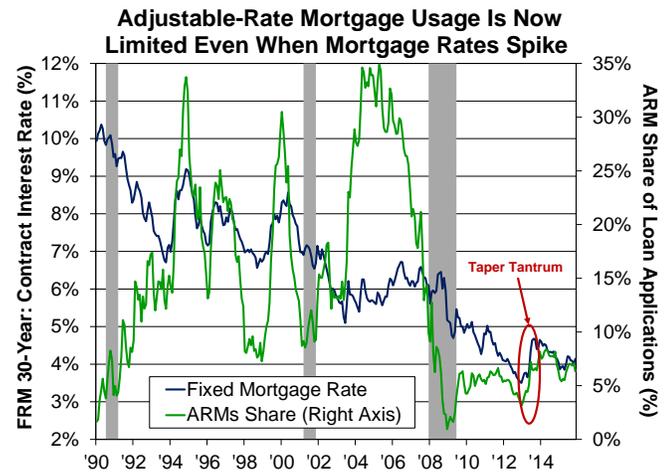
## 2016: Affordability Constrains as the Expansion Matures

In our inaugural Economic Developments commentary for 2016, we present a preview of the key theme that will shape our outlook for the U.S. economy and housing and mortgage markets over the coming year. As the expansion progresses through its seventh year—the fourth longest since World War II—we believe the housing recovery will march on as several factors affecting the ability of households to purchase a home continue to improve. We expect that further labor market tightening will lead to a pickup in compensation and increased job security. In addition, the [fourth quarter 2015 Mortgage Lender Sentiment Survey™](#) shows that lenders expect to continue to ease lending standards and expand consumers’ access to mortgage credit this year. Despite these positives, several opposing factors point to constrained housing affordability, particularly for first-time homebuyers. These factors include continued strong home price appreciation that outpaces income growth, as well as rising mortgage rates. Measures previously available to homebuyers to mitigate the impact of rising interest rates and strong home price gains, such as certain types of adjustable-rate mortgages, are no longer broadly available. In addition to higher interest rates and home prices, elevated rental cost burdens will continue to hurt purchase affordability by inhibiting renters’ abilities to save for down payments.

Because of these affordability challenges, we believe that the home sales market will continue to recover along with the broader economy in 2016, but that the pace of improvement will moderate. By contrast, housing starts should increase this year from the disappointing pace last year, which was partly due to supply constraints. While we expect consumer spending to continue to underpin economic expansion this year, residential investment and government spending should also help drive growth against a continued drag from net exports. Low energy prices are expected to weigh further on nonresidential investment in structures, and business capital investment growth should remain moderate, weighed down by equipment investment in energy and farm sectors. Meanwhile, the worst of the inventory correction appears to have happened during the second half of 2015, bringing inventory investment back to more normal rates. Overall, we expect economic growth to accelerate slightly to 2.2 percent this year from an estimated 2.0 percent in 2015. Further deteriorating economic and financial activity in China, a stronger U.S. dollar, geopolitical turmoil, and monetary policy uncertainty present downside risks to the forecast.

### Economy Drags Housing Upward

Our theme last year posited that the stronger economic backdrop, including improving private domestic demand and hiring, would lead to better income prospects, underpinning a higher rate of household formation and broad-based improvement in housing activity following an uneven recovery in 2014. This pattern of the housing market lagging behind progress in the overall economy contrasts with the typical post-war economic recovery, in which housing has led the expansion.



As it turned out, we were wrong in our economic growth projection. Instead of strengthening, real gross domestic product (GDP) growth is poised to come in about 0.5 percentage points weaker than the 2.5 percent rate in 2014. Despite lackluster output, job creation was strong. The diverging GDP and job numbers imply continued feeble productivity growth. For the housing market, employment and income trends have more weight than GDP. By the end of 2015, the unemployment rate declined five percentage points from its cyclical peak. Reduced labor market slack helped push wages and personal income higher. Combined with low inflation, real average hourly earnings and real personal income picked up in 2015 from 2014, though the trend weakened toward the end of the year. Stronger income growth over the past year helped boost household formation and housing demand. When all of the 2015 housing data come in later this month, we expect to see the best housing market since 2007, as we had projected at the start of the year.

## Second Half Growth Disappoints

The final estimate of third quarter economic growth came in at 2.0 percent annualized following a robust 3.9 percent rate in the prior quarter. The unwinding of an unsustainable pace of inventory investment during the first half of the year was the biggest drag on GDP. However, real inventory investment remained elevated in the third quarter, and recent data suggest that the painful but necessary inventory correction continued late last year, thereby also suppressing GDP growth in the final quarter of 2015. The strong dollar and soft overseas growth also weighed on net exports. However, domestic consumer and business demand, as measured by real final sales to private domestic purchasers, grew a solid 3.2 percent annualized in the third quarter.

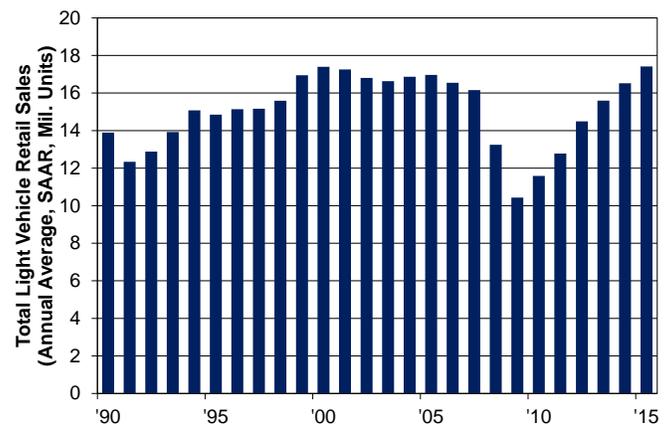
Incoming data point to anemic headline and underlying economic growth for the fourth quarter, with consumer spending the biggest source of disappointment. So far, consumers have saved rather than spent the windfall from the decline in gasoline prices. Oil prices tumbled further in early January, with West Texas Intermediate oil declining to around \$31 per barrel at the time of this writing. While this presents good news for consumers, it presages more pain for the energy sector. Real consumer spending rebounded 0.3 percent in November following a flat reading in October. Spending likely ended 2015 on a weaker note, as chain store sales data for the holiday shopping season fell short of retailers' expectations, and auto sales declined 4.7 percent in December, the biggest drop in 2015 following three consecutive strong monthly gains. Despite the decline in December, auto sales posted a record high average pace of 17.4 million in 2015, thanks to easy access to credit and low gasoline prices. We estimate that real consumer spending came in at 2.2 percent annualized in the fourth quarter, at odds with declining gasoline prices and strong labor market conditions during the quarter. On the plus side, the buildup in savings late last year should help support spending in the near term.

The December jobs report provided a much-needed strong finish for 2015. With nonfarm payrolls rising 292,000 in December and positive revisions to prior months, the three-month average monthly gain of 284,000 marks the strongest pace of job growth since January 2015. Notably, construction payrolls rose 45,000 following a 48,000 gain in November. The 1.4 percent jump in construction employment between October and December was the second biggest two-month gain in the past decade.

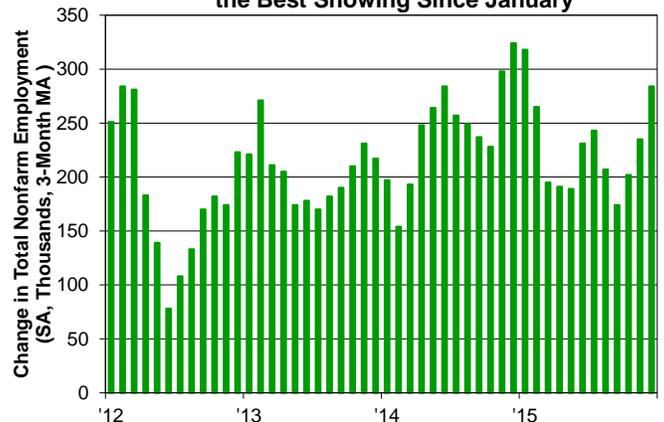
However, the strong increase was partly due to unseasonably warm weather, which delayed construction layoffs that typically occur in the winter months and boosted the seasonally adjusted employment figure. The payback may come this month as the weather has returned to more normal winter patterns.

The one weak link in the December jobs report was the absence of a monthly increase in average hourly earnings (not adjusted for inflation); however, the year-over-year gain of 2.5 percent was at the upper end of the range witnessed during

**2015 Marks Best Year Ever for Auto Sales**



**3-Month Average Job Gains End the Year with the Best Showing Since January**



the recovery, and, as noted previously, real earnings growth was relatively strong during 2015. The December unemployment rate was unchanged at 5.0 percent, but the lack of improvement was for the right reason as the labor force participation rate ticked up to 62.6 percent. However, the participation rate is little changed from a year ago and remains well below the rate of 65.7 percent registered at the start of the expansion. The employment-to-population ratio edged up to 59.5 percent in December, an expansion high but still well below the rate prior to the recession.

The upbeat December jobs report should allay worries generated by other incoming data, which have been weak and have sparked concerns that the troubles in China and other emerging markets could derail the U.S. economic expansion. Both the Dow Jones Industrial Average and the S&P 500 plunged more than 6 percent during the first week of 2016, each marking the worst first five-day start of any year. Manufacturing data continued to show malaise for the sector. Factory orders fell in November for the third time in four months. Core capital goods orders—non-defense capital goods excluding aircraft—also fell during the month following a slight gain in October, suggesting business capital investment growth will weaken in the current quarter.

A near-term turnaround in manufacturing appears unlikely. The Institute for Supply Management (ISM) indicated that the manufacturing sector contracted in December for the second consecutive month. The last time this occurred was when the economy was emerging from the recession in 2009. The ISM survey for the service sector showed that activity continued to expand outside of manufacturing, albeit at a slower pace. The strong dollar and weak global growth reduced exports of goods and services in November by more than 7 percent compared with a year ago, the worst performance since 2009. Imports also fell over the past year but at a more moderate rate of about 5 percent. We expect net exports to remain a drag on growth in 2016, but that the impact will be smaller than in 2015.

## Housing Roundup

Home building activity picked up in November, as both single-family and multifamily starts surged. However, construction spending only posted a modest rise during the month, with single-family construction outlays edging up and multifamily construction spending declining. Meanwhile, existing home sales posted a double-digit drop in November, falling to the lowest level since April 2014. The new TILA-RESPA Integrated Disclosure (TRID) rule, which requires lenders to give buyers more time to review loan documents, may have delayed closings that otherwise would have occurred in November. If this is the case, we should see a sizable rebound in December.

New home sales increased in November but on the heels of substantial downward revisions, putting the three-month moving average well below the recent peak of earlier this year. The poor performance of November residential construction spending, combined with weak broker commissions implied by home sales, suggests much lower residential investment growth than we had expected in the prior forecast. Leading indicators of home sales were mixed: The pending home sales index fell in November for the third time over the last four months, while purchase mortgage applications rebounded in November and rose further in December.

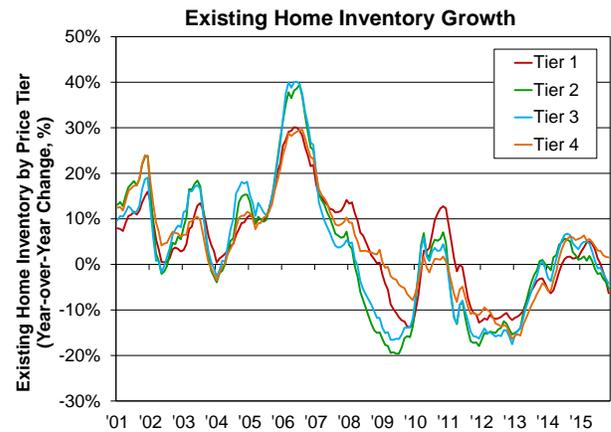
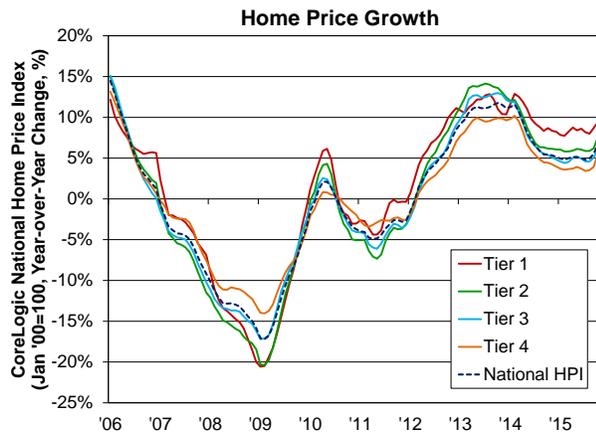
At its December meeting, the Federal Open Market Committee (FOMC) raised the fed funds target rate 25 basis points, the first rate hike since 2006. So far, this first move has had a minimal impact on mortgage rates. In our view, the FOMC's dovish statement and minutes confirmed our expectations of a gradual pace of monetary policy normalization. We expect three fed funds rate hikes in 2016, one more than the fed funds futures market implies, but one less than the number indicated by the median projection of the FOMC members. Given the strong December jobs report but muted inflationary pressures and a strong dollar, the next rate hike will likely occur in March 2016. Based on current Fed guidance, we expect the reinvestment of the Fed's securities portfolio to continue for at least another year.

Because of the expected slow pace of U.S. monetary policy normalization and continued easing by major central banks around the globe, we project that the 30-year fixed mortgage rate will rise from 3.90 percent in the fourth quarter of 2015 to just 4.15 percent in the final quarter of 2016. While our base forecast points to a gradual rise in mortgage rates, a rate spike remains one of the downside risks for the housing market this year.

Home price appreciation remains strong. For example, the Case-Shiller national house price index rose 5.2 percent in October from a year ago, the biggest gain since July 2014. The CoreLogic national index advanced 6.3 percent in November from last year, also the biggest rise since July 2014. In addition to the overall indices, CoreLogic provides trends of four individual home-price tiers calculated relative to the median national home price. The low-price tier has appreciated most rapidly in recent months, increasing 8.2 percent year over year in November. Of the four segments, this low-price tier is the only one with prices surpassing their pre-bubble peak. Given that most potential first-time homebuyers will focus more on this segment of the market, where price gains continue to be robust and inventory is extremely lean,

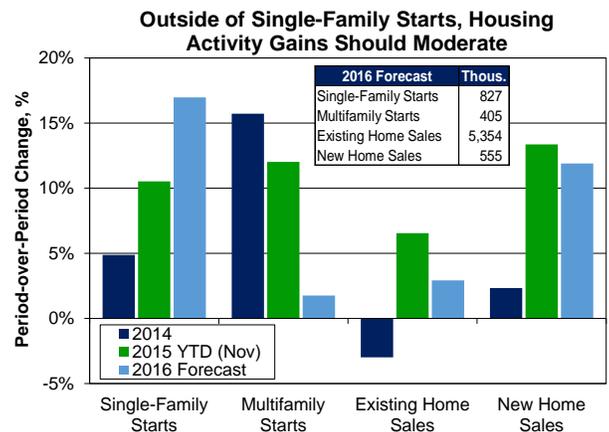
they will likely encounter more difficulty in finding a home they can afford even if mortgage rates edge up only gradually this year as we expect.

### Potential First-Time Homebuyers Are Facing Mounting Challenges From Robust Home Price Appreciation amid Tight Inventories for Starter Homes



**Note:** Tier 1: 0-75% of median, Tier 2: 75%-100% of median, Tier 3: 100%-125% of median, Tier 4: 125%+ of median

Although mortgage rates are expected to rise only slightly this year, we believe the home sales market will face a challenge of deteriorating housing affordability, driven by continued strong home price appreciation that outpaces household income growth, especially for potential first-time homebuyers. Furthermore, while lending standards have eased, they remain tight relative to the pre-bubble period. Thus, we expect growth in total home sales to moderate this year to about 4.0 percent, compared with an estimated gain of 6.0 percent in 2015. Multifamily housing starts have been very robust throughout the expansion, so we expect only a small gain this year from already elevated levels. (For more information on rental market conditions, read the [January 2016 Multifamily Market Commentary](#)). Single-family starts appear to have posted a sizable gain of approximately 9.0 percent in 2015, but the increase was from depressed levels. We expect single-family starts to rise about 17 percent this year, if our expectations of easing supply shortages (e.g., skilled labor, available lots) amid continued rising household formation come to fruition. Nonetheless, inventory should still remain historically lean, allowing another year of solid home price appreciation at the national level. However, price increases will vary significantly across regions, with moderating gains expected in some oil-producing states.



We revised lower our estimates of both purchase and refinance mortgage originations in the fourth quarter of 2015 to reflect lower home sales and refinance volume than anticipated. Following an estimated 29 percent rise in 2015, we expect total single-family mortgage originations to drop about 17 percent this year to \$1.4 trillion. As a result of the rising rate environment, the mortgage market is expected to tilt further toward purchase loans going forward. We expect the refinance share of originations to trend down from 46 percent in 2015 to 32 percent in 2016.

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Economic & Strategic Research (ESR) Group

For a snapshot of macroeconomic and housing data between the monthly forecasts, please read ESR's [Economic and Housing Weekly Notes](#).

**Sources for chart data:** Mortgage Bankers Association, Bureau of Economic Analysis, Bureau of Labor Statistics, Autodata, CoreLogic, Census Bureau, National Association of REALTORS®, Fannie Mae ESR Forecast

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