

# 2016 Best Year in a Decade for Housing; 2017 is a Wild Card

By: Jann Swanson | Thu, Dec 22 2016, 12:52 PM

This year, with less than two weeks left to go, is shaping up to be the **best year for housing in a decade** according to Freddie Mac's Economic & Housing Research Group. Their year-end wrap up and forecast however, sees a more mixed picture for 2017.

This year saw home sales through November at the **highest level since 2007** and construction, as measured by housing starts, were at the fastest pace since 2008. Home prices finally erased all of the losses experienced during the downturn. Economic growth appears to be accelerating in the latter half of 2016 and the labor market remains at full employment, but rising interest rates threaten to slow and possibly turn back housing's momentum. The group restates its belief expressed in November that housing will stall a bit in 2017 as higher rates reduce home sales, curb the pace of growth in housing starts, and slow house price growth.

Still the **fundamentals favor improvement** in housing markets. Population and income growth should support housing demand going forward. Once housing absorbs the shock of higher interest rates, growth will resume. They see 2018 as being a strong year for housing markets despite the mortgage rate forecasts.

Looking back over the past year the economists see the **biggest surprise was the decline in interest rates** that almost coincided with the New Year. Despite the first hike in the federal funds rate in nine years in December 2015, concerns about overseas economic growth, particularly in Europe, started a decline in mortgage rates in January and they continued to drift down through early summer. Then the Brexit vote in late June sent the 10-year Treasury to its lowest-ever yield and pushed 30-year fixed mortgage rates below 3.5 percent.

Rates remained low throughout the rest of the summer and into early fall. At the beginning of September, rates drifted upward until they stood at 3.54 percent on the Tuesday before the U.S. election. After the election they increased by more than 0.5 percentage points in just a few weeks back to where they started the year. As of early December, they are the highest they've been since October of 2014.

The decline in interest rates early in the year **helped support housing**, but the economists say that was merely the icing on the cake. They had forecast, based on labor market strength and pent up demand for housing, that the market would perform well even with modestly higher rates. The surprising drop helped to spur housing activity to the highest levels in a decade.

Yet despite low mortgage rates and strong demand, new home construction did not pick up as fast as was forecasted last year. Housing starts for much of 2016 remained essentially unchanged from a year earlier and well below long-term averages with the lack of available skilled labor appearing to be a primary culprit. The rate of new home construction is contributing to supply-constrained markets and making it difficult for prospective buyers to find a home.

**Tight supply** and robust demand, buttressed by strengthening labor markets and low mortgage rates, have kept the pressure on home values. House prices are rising by about 6 percent on a year-over-year basis, with few signs of slowing and, according to many reports, house prices are back to their pre-recession peaks on a nationwide basis. But Freddie Mac points to two additional factors; after adjusting for inflation house prices are still about 20 percent below their real (inflation-adjusted) peak and, while national house prices have recovered there's wide variation across geography. Some states, like North Dakota declined very little during the bust and are substantially above their pre-recession peak. Other states, such as Nevada, have experienced rapid double digit house price growth, but are still more than 10 percent below their pre-recession peak.

Rising prices have improved the value of the housing stock **substantially** in the last five years while mortgage debt has declined. This has increased home equity by about \$7 trillion, to \$13 trillion since the low water mark in the first quarter of 2009. Freddie Mac says this improved equity position leaves American households primed to expand borrowing in coming years.

Increased equity along with near historic low interest rates led many homeowners to refinance this year. Over the 12 months ended in September Freddie Mac facilitated about 823,000 refinancings, saving homeowners an average of \$2,400 in interest payments the first year. Their current forecast is \$1 trillion in single-family mortgage refinance originations by year's end, the **highest total since 2012**. Borrowers also are starting to take advantage of their increased equity through cash-out refinances. An estimated \$42 billion was cashed out in the first three quarters of 2016, up \$10 billion over the same period in 2015.

Freddie Mac extended its year-end forecast to include 2018. Over the next two years, they anticipate that economy will keep growing at a modest pace, inflation will pick up and the labor market will stay at full employment. Interest rates will gradually rise as the Federal Reserve continues on its path of policy normalization. Housing markets will slow a bit in 2017, but they will recover after they absorb the initial shock of higher interest rates.

Mortgage origination activity **will slow significantly** in 2017 as refinance activity withers. In 2018, mortgage origination activity will increase slightly, but the composition will shift to a purchase-dominated market-unlike any mix seen since the 1990s.

The key themes for 2017 and beyond will be:

- **Homebuyer affordability pinch.** As mortgage rates rise and home price growth remains positive, homebuyer affordability will be a growing challenge in many markets. Though it is starting to show signs of picking up, the growth rate in personal income is still well below house price appreciation. While the forecast is for home price growth to slow from 5.9 percent this year to 4.7 and 3.8 percent over the next two years, income growth probably won't keep up with those gains. This means homebuyer affordability will challenge prospective homebuyers in many markets.
- **Construction picks up, but only gradually.** The estimate is that long-run fundamental demand for housing is about 1.7 million units annually. Construction this year will supply about 1.16 million units. Completions should increase to 1.26 and 1.36 million units in 2016 and 2017, still below long-run demand.
- **Mortgage market shifts to a purchase mix.** Refinance waves end swiftly when mortgage rates rise, and Freddie Mac expects to see that happen now. Mortgage refinance activity will drop to very low levels, and the refinance of mortgage originations will drop to 28 and 20 percent in 2017 and 2018, respectively. Increased purchases will partially offset this drop, but in 2017 Freddie Mac forecasts about a 25 percent reduction in mortgage originations. The market will stabilize in 2018, with purchase gains nearly offsetting refinance declines that year.

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