Inflation Holds Key to Fannie Mae's New Forecast

Fannie Mae's economists have revised a lot of their forecast from last month as new data has come in. The outlook for the 2021 GDP has been revised modestly to **7.1 percent** from 7.0 percent on a Q4-over-Q4 basis. The revision was due to data indicating stronger second quarter growth in personal consumption which they expect was driven heavily by inventory restocking and will decelerate significantly in the second half of the year. They also moved the 2022 growth forecast down one-tenth to 2.7 percent and revised upward their inflation forecast.

As did the Federal Reserve on Wednesday, Fannie Mae says much of the recent uptick in **inflation** was **transitory**, but price pressures are likely to last into 2022. Lagging effects stemming from recent rapid house price growth will generate upwrd pressure. They forecast the Consumer Price Index (CPI) will remain elevated at around 5 percent annually through the end of 2021 before decelerating next year, and that the core Personal Consumption Expenditure Deflator (core PCE), will end 2021 at 4.6 percent and remain elevated at 2.9 percent at the end of 2022.

Because of the view of inflation factors as temporary, the economists said they did **not** meaningfully change their growth forecast. However, if the problems behind those factors are not resolved, inflation will be the primary risk to the forecast followed by consumer behaviors related to reopening and COVID-19 developments.

If a stronger underlying inflation trend develops, there is risk of a **wage-price spiral** which could likely lead to a substantial jump in longer-term interest rates and an earlier and more aggressive pace of Fed tightening. This would be expected to drag on growth and negatively impact home sales, house prices, construction, and mortgage originations. Other risks to housing include to what extent recent migration to suburban areas and less expensive metros continue after full reopening, the effects on home sales and prices from the expiration of mortgage forbearance programs, and how soon construction supply chain problems are resolved.

Fannie Mae significantly **downgraded** the forecast for second and third quarter **home sales,** largely due to the ongoing lack of available listings and a softening pace of new construction because of those supply constraints. They now expect 2021 sales to increase 4.2 percent from 2020, compared to their previous 6.3 percent projection.

Ongoing **supply constraints** are dragging on homebuilders and there are reports of some refusing new orders or delaying construction. However, the lack of listings available continues to drive demand for new homes and there should be some rebound in starts activity in coming months. Still, ongoing labor scarcity and a lack of buildable lots is limiting production capacity and homebuilders may have difficulty ramping up further.

The economists expect housing starts this year will be **17.2 percent higher** than in 2020; downgraded from the prior forecast for a 19.3 percent gain. Even with the downgrade, it would be the fastest construction pace since 2013. The forecast for single-family housing starts is for a 20.2 percent increase over 2020.

The slowdown is not being driven by waning demand. House prices continue to rise rapidly on an annual basis, up 13 percent in April on the CoreLogic National House Price Index, the highest rate of growth since 2006. The most recent measures of average sale-to-asking price continued to move higher and the average time on the market remained at record lows. These all point to the continued lack of supply as the primary driver of the recent sales softening.

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The company says it believes there is **still** enough demand to drive a **much higher** rate of sales if the inventories were available and expect to see at least a modest increase in listings in coming months as COVID worries wane ad some homeowners reassess their living situations once the future of work-from-home arrangements becomes clearer, and mortgage forbearance programs expire. They do not expect a high rate of foreclosure activity after those expirations, partially because of large gains in homeowner equity. There will however be some portion of distressed homeowners putting their homes up for sale.

The 30-year fixed mortgage rate has stabilized in recent weeks, falling from a peak of 3.18 percent in the first week of April and trending just below 3 percent since the end of April. Mortgage spreads compressed in May, briefly falling below 130 basis points for the first time since 2011 and well below the prior decade's average of approximately 170 basis points. Fannie's outlook for the 10-year and the 30-year fixed rate are unchanged at 1.6 percent and 3.0 percent, respectively, in 2021 and at 1.9 percent and 3.3 percent in 2022.

The overall 2021 mortgage originations forecast was little changed at **$4.1 trillion;** a higher expected pace of refinancing activity offset downward revisions to purchase mortgage originations. Expectations for the years purchase mortgage origination volume has been reduced by $33 billion to $1.8 trillion and refinance volumes increased by $54 billion to $2.3 trillion.

The forecast for 2022 originations ticked up to $3.1 trillion from a prior $3.0 trillion with purchase volumes expected to grow by 4 percent to $1.9 trillion. Refinance volume will total 1.2 trillion, an increase from last month's outlook but a 49 percent decline from 2021. The refinance volume will pull back from the 2020 peak throughout the forecast horizon. At the current interest rate level an estimated 49 percent of all outstanding mortgages have at least a 50-basis point rate incentive to refinance, down slightly from 51 percent in last month's forecast.