## Federal Reserve Takes Center Stage… Again

## Market Recap

The Federal Reserve has taken initiative on tapering. In other words, it's no longer talking about tapering, it's doing it. On Wednesday, the <u>Fed announced</u> it would reduce its monthly purchases of U.S. Treasury notes and bonds and mortgage-backed securities (MBS) by \$10 billion to \$65 billion each month. As it now stands, the Fed will buy \$35-billion worth of Treasury notes and bonds and \$30-billion worth of MBS. Up until December, it was buying these securities at the rate of \$85 billion each month.

By purchasing these securities, the Fed creates demand, which drives down their yield. Because mortgage rates — specifically the rate on the 30-year fixed-rate loan — are influenced by the yield on these securities, they've been held down over the past few years. The concern going forward is that as the Fed withdraws its demand, mortgage rates will rise.

So far that hasn't been the case. (Then again, the Fed just announced additional tapering this past Wednesday.) Rates remain sedated. In fact, they've been down for most of the past week. <u>Bankrate.com's</u> national survey shows the rate on the 30-year loan dropped six basis points to 4.50%. <u>Freddie</u> <u>Mac's</u> survey shows the rate dropped seven basis points to 4.32%.

So why didn't mortgage rates immediately rise?

There are a couple extenuating factors: For one, the Fed remains committed to keeping interest rates low. Specifically, it remains committed to keeping short-term rates near zero, which it can do by keeping the federal funds rate — the rate banks lend to each other — at zero. The fed funds rate impacts bank liquidity, so it impacts lending, even for longer-term loans. A zero fed funds rate increases liquidity. In addition, investors in emerging markets — such as Turkey, Brazil, India, etc. — have been selling their investments. Growth in a few of these countries has stalled, while the others are seeing more political and fiscal strife. How does this impact our credit rates? Money leaving these countries is finding a home in haven investments like U.S. Treasury securities and MBS.

Going forward, we think mortgages rates are unlikely to go lower. According to <u>recent data</u> from the Commerce Department, gross domestic product (GDP) growth is picking up pace. The preliminary numbers for the fourth-quarter of 2013 show GDP growing at a 3.2% annualized rate. The consensus estimate called for 3.0%. If the rate of economic growth actually is accelerating, interest rates are unlikely to fall.

We'll need to keep an eye on the employment numbers, which will be released this coming Friday. The job-growth numbers were disappointing for December, even though the unemployment rate fell. If the job numbers disappoint again, we'll have to question if GDP growth is sustainable. On the other hand, if the numbers improve, that's a good indicator the economy is indeed healthy.

Economic Indicator	Release Date and Time	Consensus Estimate	Analysis
Construction Spending (December)	<u>Mon., Feb. 3,</u> 10:00.am, ET	0.3%% (Increase)	Important. Residential spending remains strong, but commercial spending is gaining pace.
Mortgage Applications	Wed., Feb. 5, 7:00.am, ET	None	Important. Purchase activity has trended higher, which portends rising home sales.
Employment Situation (January)	<u>Fri., Feb. 7,</u> 8:30 am, ET	Unemployment Rate: 6.6% Payrolls: 170,000 (Increase)	Very Important. Strong payroll growth is needed to sustain economic growth.
Consumer Credit (December)	<u>Fri., Feb. 7,</u> 3:00 pm, ET	\$16 Billion (Increase)	Moderately Important. Increased revolving credit use reflects the trend in rising retail sales.

## Still Doesn't Feel Right

The overall economy might very well be growing, but it doesn't quite feel that way in housing. For most of the past year, new home sales have been the can't-miss segment of the housing market. That is until December, when <u>sales dived</u> to an annual rate of 414,000 units compared to 445,000 units in November. Some analysts blamed bad weather for the shortfall, but then bad weather is common in all Decembers. We have a more concrete explanation: Higher lending rates likely played a role in disappointing sales, as did soft job growth for the month.

Existing home sales also disappointed... yet again. Sales continue to lag, and that trend appears likely to continue. The <u>NAR reports</u> its pending home sales index declined 8.7% in December, which points to a further decline in sales for the next month or two. Lack of inventory continues to weigh on sales. And like with new-home sales, lack of new jobs in December surely didn't help. We have to admit that we are somewhat circumspect on the health of the economy. We say that because sales of new and existing homes really should be stronger than they've been. Perhaps we are being overly pessimistic. We'll feel a lot better about the economy if payroll growth exceeds the consensus estimate for 170,000 new jobs this coming Friday. Let's hope that's the case.