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Economics Group

Interest Rate Weekly

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 410-3275
Mark Vitner, Senior Economist
mark.vitner@wellsfargo.com • (704) 410-3277
Michael A. Brown, Economist
michael.a.brown@wellsfargo.com • (704) 410-3278

How Sensitive Is the Housing Market to Rising Interest Rates?

Even a modest rise in mortgage rates will restrain demand for new and existing homes. Home sales should still improve in 2015, however, benefitting from stronger job growth and increased household formation.

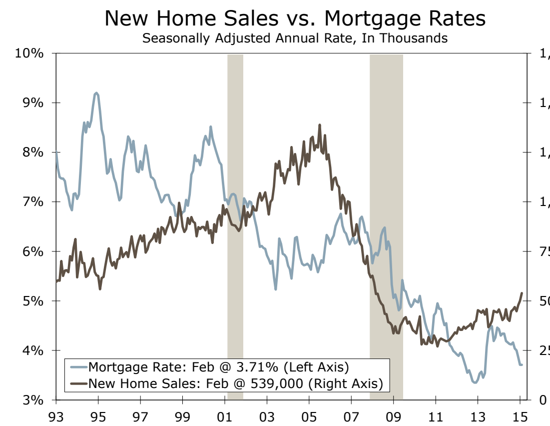
Even with Low Rates, Housing Remains Interest-Rate Sensitive

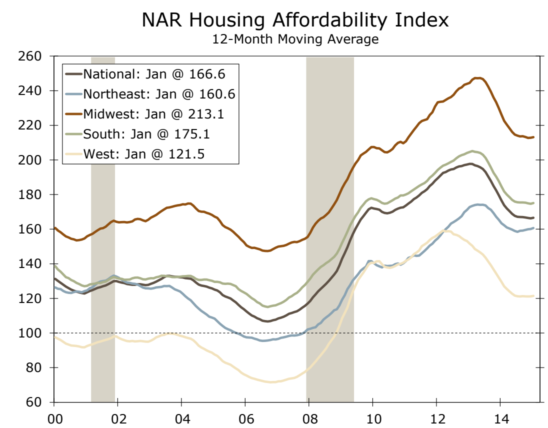
Fed Chair Janet Yellen and other Federal Reserve Bank presidents and board members have made it fairly clear that interest rates are likely to rise in 2015. The timing and magnitude of any increase in interest rates is still an open question. We expect the Fed to begin to nudge the federal funds rate higher in late summer or early fall. Mortgage rates will likely rise ahead of any change in policy rates, but again the timing and magnitude of any increase remains an open question. Mortgage rates typically track the yield on the 10-year Treasury note and that rate is greatly influenced by the expectations for short-term interest rates over the next few years. How well the Fed manages its message about the future course of short-term interest rates will be a key determinant of how quickly mortgage rates rise.

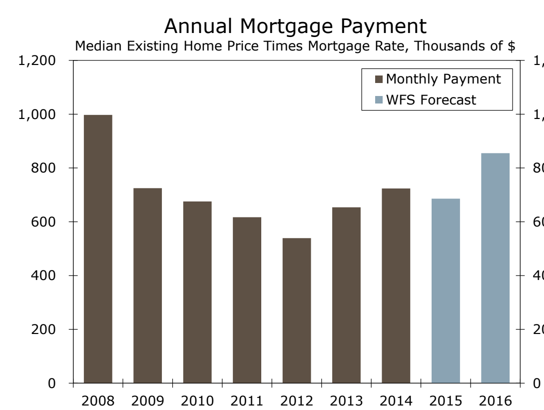
Questions about mortgage rates are timely because we are moving into the peak home-buying season, which is essentially the second quarter. Two years ago, the spring home-buying season was abruptly upended when the Fed revealed that it would likely begin to taper its security purchases sooner than the financial markets expected. Mortgage rates spiked 115 basis points in the span of just 10 weeks and home sales soon crumbled, as many sales contracts were canceled and potential buyers stepped back. Sales of new homes fell 25 percent almost immediately following the "Taper Tantrum" and existing home sales fell roughly 10 percent over the next several months. This is an outcome that policymakers are consciously working to avoid in 2015.

The fact that home sales remain sensitive to rising interest rates is not surprising, but the speed at which this correction took place in 2013 and the magnitude of the pullback in home sales was enlightening. Some had hoped that the housing market would better withstand rising mortgage rates because the increases would come off astonishingly low levels and mortgage rates would still be well below their historic norms even if they rose a percentage point or more. Moreover, low mortgage rates did not appear to be providing much additional support to home sales, so some even argued that the sector had become less interest rate sensitive. That argument does not seem to hold.

We see a couple of reasons why housing may prove to be even more interest rate sensitive than it has been in the past. For starters, median household incomes have barely budged, so housing affordability has fallen as housing prices have rebounded. Qualifying for a mortgage is also more difficult today and income requirements are more stringent. Even a modest rise in mortgage rates could price many potential buyers out of the market, particularly with many younger, first-time buyers carrying a great deal of student loan debt.







Source: U.S. Department of Commerce, FHLMC, NAR and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual 2014				Forecast 2015				Forecast 2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25
3 Month LIBOR	0.23	0.23	0.24	0.26	0.28	0.30	0.70	0.95	1.20	1.45	1.95	2.45
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.88	3.95	4.16	4.22	4.27	4.35	4.62	4.74
3 Month Bill	0.05	0.04	0.02	0.04	0.05	0.14	0.56	0.86	1.15	1.41	1.80	2.28
6 Month Bill	0.07	0.07	0.03	0.12	0.15	0.26	0.62	0.92	1.20	1.52	1.83	2.36
1 Year Bill	0.13	0.11	0.13	0.25	0.23	0.29	0.68	0.98	1.22	1.56	1.87	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.63	0.71	0.89	1.08	1.28	1.74	2.05	2.47
5 Year Note	1.73	1.62	1.78	1.65	1.52	1.69	1.79	1.90	1.99	2.22	2.33	2.62
10 Year Note	2.73	2.53	2.52	2.17	2.00	2.20	2.36	2.40	2.45	2.51	2.76	2.88
30 Year Bond	3.56	3.34	3.21	2.75	2.65	2.80	2.91	2.98	3.08	3.17	3.35	3.57

Forecast as of: March 27, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.6	3.0	N/A
FOMC	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1
PCE Inflation			
Wells Fargo	0.9	2.1	N/A
FOMC	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: March 27, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: March 18, 2015

Source: IHS Global Insight, Federal Reserve Board and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Michael T. Wolf	Economist	(704) 410-3286	michael.t.wolf@wellsfargo.com
Mackenzie Miller	Economic Analyst	(704) 410-3358	mackenzie.miller@wellsfargo.com
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Cyndi Burris	Senior Admin. Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

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