A Modest Slowdown Ahead

Mortgage lenders will see slower origination volume in 2006, with overall single-family originations slipping by 20 percent. Refinancings will fade dramatically and be off their 2005 pace by 40 percent. But home sales will continue to show strength as 30-year mortgage rates end the year at around 6.7 percent.

BY DOUG DUNCAN AND ORAWIN VELZ

The U.S. economy has shown remarkable resilience in the face of recent hurricanes and the associated energy-price spike. The economy had strong momentum pre-Hurricane Katrina, and it remains on track for solid growth in the fourth quarter, albeit slower than the 4.3 percent seen in the third quarter of 2005. // Growth should be strong in the first half of this year, boosted by rebuilding efforts, but should taper off later in the year. Although gasoline prices have receded significantly from their high immediately after the hurricanes, the elevated level of natural gas prices presents a risk for the economy going forward. // Consumers have been spending more than they earn, thanks to large gains in wealth—especially from unusually strong home-price appreciation—allowing homeowners to extract a significant amount of home equity, boosting consumption spending. As of this writing, the saving rate has been negative for five consecutive months starting in June. However, the saving rate is trending higher after hitting an all-time low in August.

Continued increases in interest rates as well as an expected moderation in home-price appreciation should decrease home-equity extraction, further dampening consumer spending growth. In addition, consumers will likely face extremely high heating bills this winter, reducing their disposable income.

Economic growth should slow to more sustainable levels in the second half of this year, when expenditures for rebuilding in the storm-damaged regions wane (see Figure 1) and consumption spending growth starts to slow. Economic growth will continue to be healthy, however, as growth in business investment should pick up to offset slowing consumption growth.

Strong employment growth in a tight labor market is still a concern for the Fed, as wage pressures could be building.

Labor markets will remain solid

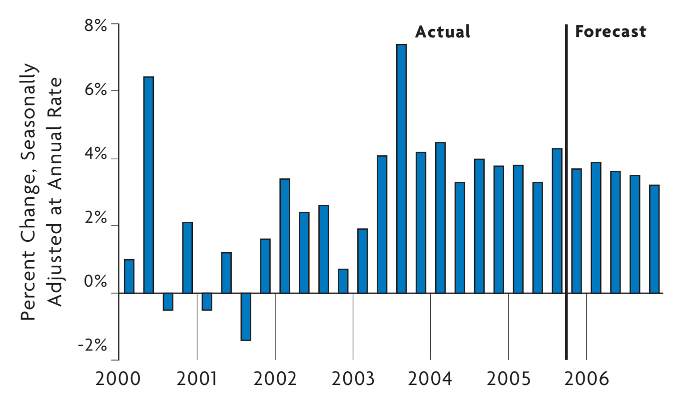
The weakness in the labor market during the hurricanes turned out to be temporary rather than the start of a deteriorating trend. Payroll employment showed solid gains of 215,000 jobs in November and, with an upward revision to the September data, it turned out that the labor market overall managed to add jobs despite thousands of job losses in the devastated Gulf Coast region.

Going forward, positive economic indicators—including expanding manufacturing activity, low inventories and receding energy prices—point to a continued strong labor market, with job gains averaging around 190,000 a month over this year.

The Fed will continue its modest tightening

Following the hurricanes, inflationary pressures have become more of a concern. Although core inflation continues to be contained, it is still hovering near the upper end of the Fed's comfort zone consistent with price stability. For example, the personal consumption expenditures (PCE) index, excluding food and energy items—the Fed's favorite measure of inflation—increased by 1.8 percent in October from a year earlier, near the 2 percent upper end of the Fed's zone.

Figure **1** **Real Gross Domestic Product (GDP) Growth**



SOURCES: U.S. Bureau of Economic Analysis, Mortgage Bankers Association (MBA) Forecast

Strong employment growth in a tight labor market is still a concern for the Fed, as wage pressures could be building. The November payroll report showed that average hourly earnings increased strongly from a year earlier. That is consistent with anecdotal reports by the 12 Federal Reserve banks on current economic activity (better known as the Beige Book) that signs of tightening in labor markets and difficultly in filling certain jobs were evident in many Federal Reserve Districts.

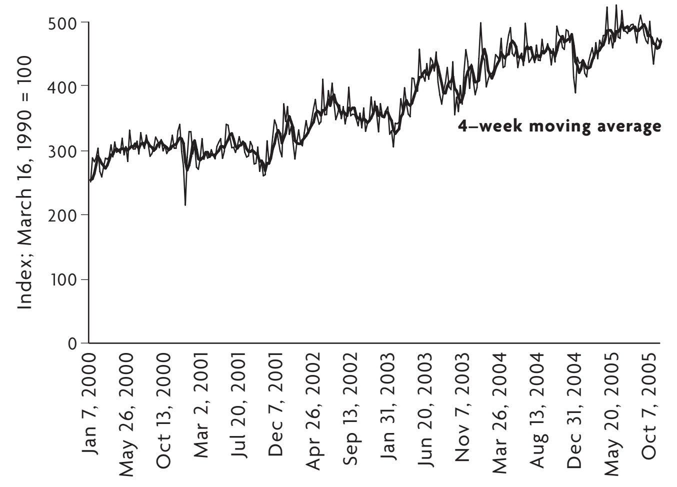
However, recent reports indicate that productivity gains are again very strong. The growth in productivity, growth in the amount of output per worker hour, can act to offset the increase in labor costs. We anticipate that productivity growth will remain strong over the next year.

The Fed will continue to be vigilant on inflation, and near-term monetary policy is unlikely to change in any meaningful way when Ben Bernanke replaces Alan Greenspan as chairman of the Federal Reserve. Bernanke's views on monetary policy are consistent with Greenspan's.

We expect the Federal Open Market Committee (FOMC) to continue to increase its federal funds rate target to 4.75 percent by March. Then it will stay on the sidelines and wait to assess the cumulative impact of the previous rate increases.

In the past couple of years, despite the fact that the Fed has repeatedly increased short-term rates, longer-term rates have remained within a narrow range. This is what Greenspan has referred to as a "conundrum." There are three potential explanations for this unusual behavior of long-term rates. First, investors could be expecting a slowdown in future economic growth, which would put downward pressure on rates. (We tend to discount this explanation.) Second, it could reflect the fact that the Fed and other central banks have been remarkably

Figure **2** **Purchase Application Index**



SOURCE: MBA Weekly Mortgage Applications Survey successful in their war on inflation: Long-term inflation expectations truly are contained. Third, there appears to be a global savings glut, as noted by incoming Fed Chairman Bernanke. Evidence for this third explanation includes the fact that almost every trading partner of the United States is running a trade surplus relative to the United States, and as a result foreign investors have an almost insatiable demand for U.S. financial assets.

These factors combine to create market risk premiums on longer-term U.S. financial assets that are significantly below historical norms. Despite the conundrum, we do expect longer-term rates to increase. But we expect these rates to increase only modestly, with the 10-year Treasury reaching 5.2 percent by the end of 2006 and 30-year mortgage rates hitting 6.7 percent—about half a percentage point above their current levels. If inflationary expectations increase, we would anticipate that market risk premiums could widen significantly, leading to greater increases in these longer-term rates.

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The housing market will cool modestly

With the very strong pace of home sales through October 2005 (the latest data at press time), both new and existing-home sales were certain to set a fifth consecutive record in 2005. However, the housing market appears to have peaked in the fall of 2005, according to several leading indicators of housing activity. In particular, mortgage applications for home purchases have trended down, and housing inventories have continued to increase.

The Mortgage Bankers Association (MBA) purchase application index declined by nearly 5 percent in October from September's level, to post the index's lowest reading since February. Although the purchase index increased again in November, reversing an extended downtrend, the index remained nearly 7 percent below its most recent high in early September. The four-week moving average in the index, which removes week-to-week volatility, fell in mid-November to its lowest level since June (see Figure 2).

The level of purchase applications is still strong, however, suggesting the decline in home sales in the coming months should be modest. With projected modest increases in mortgage rates to less than 7 percent by the end of 2006, home sales should decrease by about 3.5 percent in 2006.

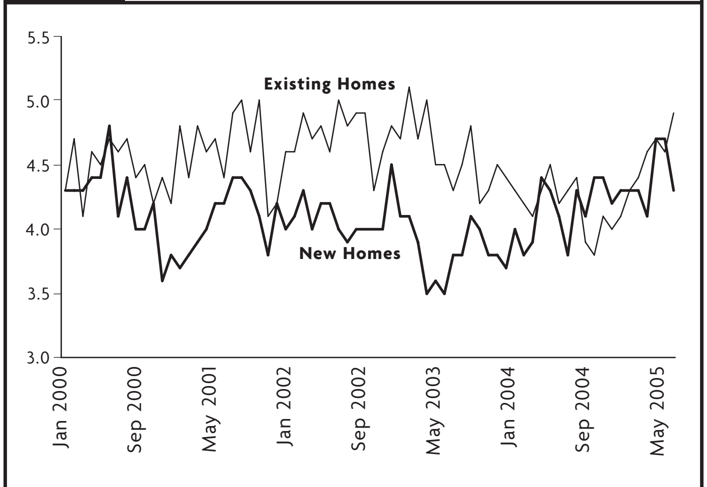
Leading indicators for home-building activity suggest that home building will likely trend down moderately in the coming months. After holding up better than expected in the previous two months following Hurricane Katrina, home builders' optimism dropped sharply in November to the lowest level since May 2003.

A sharp uptick in mortgage rates in October through mid-November and rising building material costs were likely responsible for the decline in optimism. We expect residential construction to decline modestly, about 5 percent in 2006, as reconstruction efforts should help support homebuilding activities in the Gulf Coast region.

Until recently, inventories of unsold homes have been low on a historical basis relative to monthly sales volumes (see Figure 3). However, the absolute number of unsold homes as well as the months supply (inventory/sales ratio) of unsold homes has been increasing over the past year. In particular, condo inventories have accumulated more rapidly than inventories of unsold single-family detached properties.

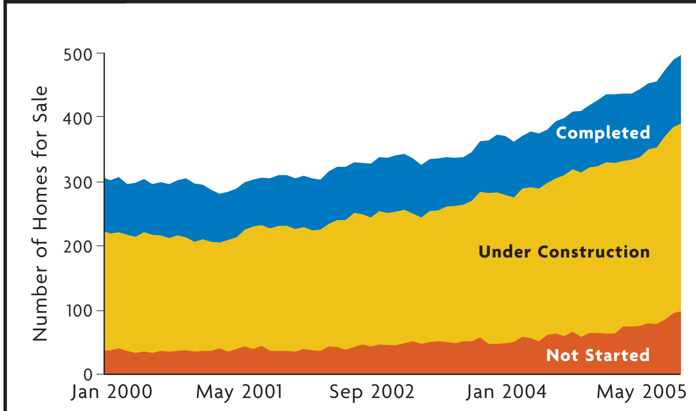
In June 2004, the months supply of unsold condos stood at 3.1. Since that time, it increased to 4.5 in October 2004 and 5.5 in October 2005. This prompted the appreciation rate for condos to slow to less than that for single-family detached properties beginning in July 2005. With the increase in properties on

Figure **3** **Months Supply (Inventory/Sales Ratio) of New and Existing Homes**



SOURCES: U.S. CENSUS BUREAU, NATIONAL ASSOCIATION OF REALTORS (NAR)

Figure **4** **New Homes Available for Sale**



SOURCE: CENSUS BUREAU

the market, buyers become less aggressive in their bids and sellers trim their asking prices, leading to a deceleration in home-price appreciation rates.

With respect to the current situation for new homes, the structure of the inventory is still healthy. More than 20 percent of new homes for sale in October are units that have permits but where construction has not yet begun—a near-record-high share (see Figure 4). This could be either because banks are more reluctant to finance spec construction or because builders have exercised caution. Regardless, this implies that builders could pull out a large portion of the increase in inventory if demand were to soften.

With the projected modest decline in home sales in 2006 and the observed increases in unsold inventories, home-price gains are projected to moderate in 2006 from the very rapid and likely unsustainable pace of the past several years. Home-price gains should remain healthy at about 5 percent to 6 percent this year—about half the pace experienced in 2005.

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The ARM boom is ending

Over the past several years, many analysts have been surprised at the persistently elevated adjustable-rate mortgage (ARM) share, given the historically low level of long-term, fixed mortgage rates (see Figure 5). Borrowers have traditionally gravitated to ARM products to extend their purchasing power in a rising-rate environment. As the Fed continues to raise short-term interest rates, the yield curve has flattened significantly.

ARM products are much more influenced by Federal Reserve policy than fixed-rate mortgage (FRM) products. Since the beginning of 2005, the spread between fixed- and adjustable-rate mortgage yields declined by more than 40 basis points to about 115 basis points by the end of November, according to Freddie Mac's Weekly Primary Mortgage Survey. The share of ARMs for conventional purchase loans has slowly trended down since June 2004, when the Fed started monetary tightening. Continued steady rate hikes expected over the coming months and subsequent increases in ARM rates would further deteriorate housing affordability conditions, cooling ARM lending.

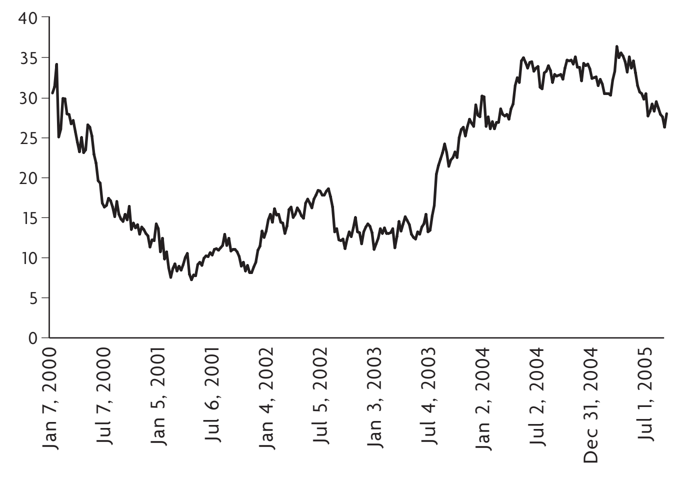
Refis will continue to decline, but purchase originations should stay strong

Mortgage rates have come off their lows, and refinancing activity is now fading. The MBA refi index continues to slump from its recent peak in early June. As mortgage rates are projected to continue to rise through the coming year, refinancing activity—as well as the subsequent lift to spending—is expected to dwindle by the second half of 2006.

The cash-out refi share should rise as mortgage rates continue to increase, as more homeowners choose to refinance to liquefy equity rather than to reduce monthly mortgage payments. Cash-out refis are more attractive than home-equity loans and lines of credit during an environment of rising short-term interest rates. Going forward, we expect a lower level of home-equity borrowing, as higher interest rates continue to dampen demand for mortgage refinancing and home-equity loans and lines of credit.

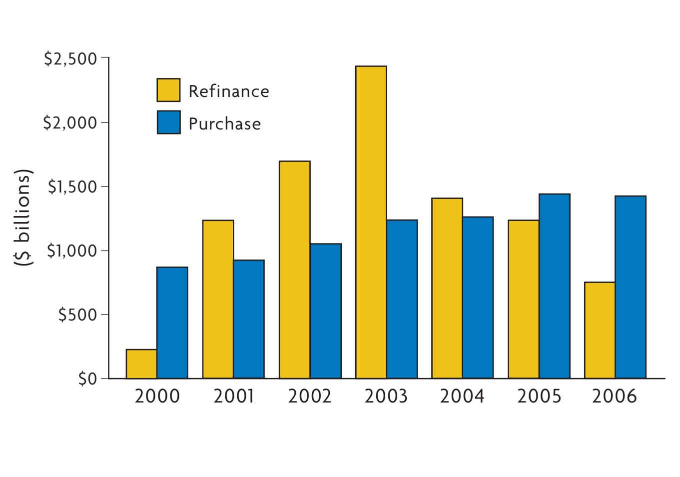
A record pace of home sales should combine with very strong home-price appreciation to propel purchase originations to $1.48 trillion in 2005—an increase of 135 percent from 2004's record level (see Figure 6). We project that refinance originations will decline by 11.9 percent in 2005 to $1.29 trillion. Overall, last year's mortgage originations should be roughly the same as 2004's $2.78 trillion.

Figure **5** **Adjustable-Rate Mortgage (ARM) Share**



SOURCE: MBA Weekly Mortgage Applications Survey

Figure **6** **Single-Family Mortgage Originations**



SOURCE: MBA

With only a modest projected decline in home sales in 2006 and still-healthy home-price appreciation, purchase originations should decline only modestly this year. With mortgage rates rising, however, refi originations will drop off significantly. We expect total originations to decline by about 20 percent, with refi originations declining by about 40 percent and purchase originations declining by 2.5 percent.

In 2006 we expect strong housing and mortgage markets, but they will be down from the peak levels experienced in the past few years.

U.S. mortgage finance assets and yield spreads

Global investor demand for mortgage-backed securities (MBS) has surged in recent years, as investors "reached for yield," seeking higher returns than those available on government bonds. Investors can purchase a variety of mortgage assets with differing structures of risk and return over a given period of time, from agency MBS to subprime mortgage securities.

Mortgage assets must compete with other fixed-income assets, such as U.S. Treasuries, which are devoid of default risk. Mortgage assets carry a greater risk of default and early repayment, and thus mortgages must be priced higher to compensate for the risk. Typically during refi booms, the spread between mortgage and Treasury yields widens due to the increase in prepayment risk.

The mortgage-Treasury spread has averaged about 150 basis points in 2005, but has widened somewhat recently along with some widening in credit spreads on corporate debt (see Figures 7 and 8). Going forward, we expect mortgage credit spreads to narrow toward 2005's average; however, there is a risk that these spreads could increase if credit quality deteriorates.

Credit quality and an expected modest rise in delinquencies

Continued job gains and rising wages should be positive for household balance sheets. If interest rates rise gradually and housing activity declines modestly, as we expect, credit quality should remain solid. However, many factors appear to be conspiring to increase delinquency rates in the near term.

First, the large cohort of loans originated in the 2002–2003 refinance wave is reaching the peak delinquency period. Second, rising short-term rates are putting pressure on ARM borrowers. Third, the share of the market comprised of subprime loans has been growing significantly in the past several years. And finally, energy prices (especially natural gas and home heating oil) are expected to remain elevated going into the winter. Thus, it is reasonable to expect somewhat higher delinquency rates over the next several quarters.

Summing up

In 2006 we expect strong housing and mortgage markets, but they will be down from the peak levels experienced in the past few years. Expect strong economic growth in the first half of the year, moderating to a slower but still-healthy pace of growth later in the year. This slowdown will reduce further upward pressure on interest rates.

We expect mortgage rates to end the year at about 6.7 percent, roughly half a percentage point higher than where they are at this writing. We expect total single-family mortgage originations to decline by about 20 percent, with refi originations declining by about 40 percent and purchase originations declining by 2.5 percent. Mortgage performance trends will continue to be strong, but do expect some increase in delinquencies, starting from a very low base. **MB**

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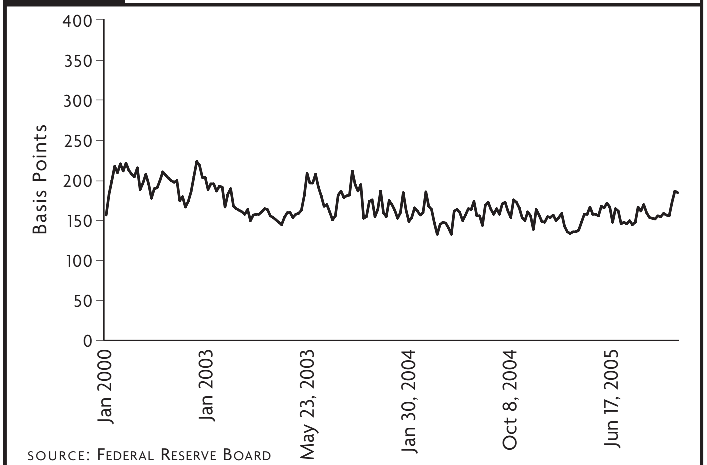
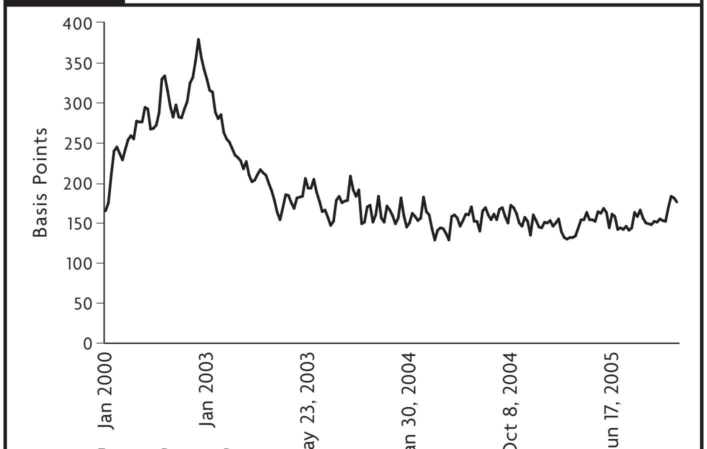
Figure **7** **Yield Spread: 30-Year Mortgages and 10-Year Treasuries**



SOURCE: FEDERAL RESERVE BOARD

Figure **8** **Yield Spread: Baa Corporate Debt and 10-Year Treasuries**



SOURCE: FEDERAL RESERVE BOARD