Special Report

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Is The US Housing Market About To Enter A Sweet Spot?

- **The key is whether mortgage industry capacity constraints will no longer be tested by bouts of refinancing that crowd out new purchase mortgages.**

Availability of credit has clearly been a sore point in the US housing market for a number of years now. In fact, it's one of the main remaining hurdles to achieving considerably faster and more diversified economic growth. New research from staff economists at the Federal Reserve combined with our own observations may suggest that this issue of access to new mortgage loans may be on the cusp of changing for the better should other fundamental drivers remain generally constructive notwithstanding some ongoing housing headwinds.

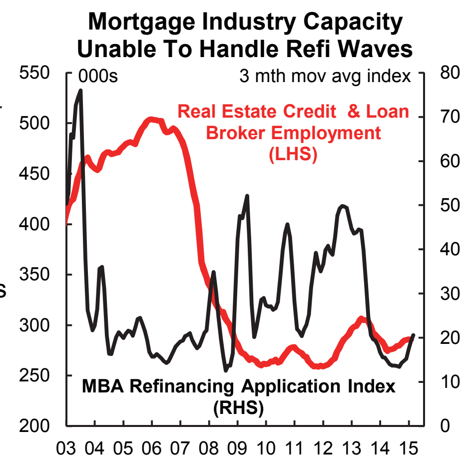
The thesis that follows posits that the mortgage industry has been capacity constrained for some time and therefore unable to deal with a volatile and unexpected series of large refinancing waves that crowded out the ability to process mortgage purchase applications. If this series of refinancings is approaching a mature point in the cycle, that may connote a greater ability to divert origination capacity toward newly originated mortgage loans which, in turn, would drive new purchase and homebuilding activity. The two core arguments are outlined below.

Mortgage Industry Capacity Constraints

The crux of our first argument aims at bringing to our clients a thesis based upon a research paper published this month by a pair of economists at the Federal Reserve Board — Steve Sharpe and Shane Sherlund — that is titled ***Crowding Out Effects of Refinancings on New Purchase Originations***.

The authors reason that after the mortgage industry thinned the ranks of staff in the wake of the crisis, meeting refinancing waves after controlling for other factors resulted in crowding out new purchase applications because of capacity constraints. Observe in chart 1 that the number of employees in the sector fell from about a half million pre-crisis to a quarter-million afterward. That 50% cut suitably took out industry spare capacity in the immediate aftermath of the crisis, but left the industry unable to later keep up with processing of refinancing applications that soared.

Chart 1



Source: Scotiabank Economics, Mortgage Bankers' Association, BLS.

The study's authors back up this thesis by pointing to evidence of how mortgage providers rationed access to newly originated purchase loans by temporarily widening spreads over funding costs during each successive refinancing upsurge. The authors found that low purchase loan approval rates during refi waves were particularly focused upon higher credit-risk borrowers with lower credit scores whose mortgages are generally harder and costlier to complete. This could be why only the most sparkling borrowers got approved and for reasons that go beyond credit quality differences absent refi waves.

Why not simply expand capacity to meet this new demand? This swell of refinancings was probably unanticipated at the time of the earlier industry cutbacks because few people — if anyone — anticipated Treasury yields and fixed mortgage borrowing rates pushing as low as they did over the ensuing years. The mortgage industry may have been reticent to expand capacity to meet these successive bouts of refinancing because of how volatile and fleeting they can be and the industry lacked confidence to expand capacity on a pure bet that purchase activity might pick up any slack between waves of refinancing.

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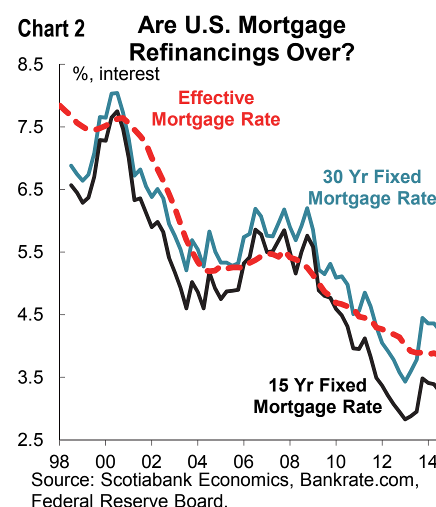
One might also surmise that non-price measures beyond the price effects considered by the study's authors may have also been utilized to ration credit. Consider, for instance, the stories we've been hearing for some time now about a medley of odd criteria used to determine credit worthiness in the US mortgage market. Examples have included requiring borrowers to provide explanations for individual checks and other debits clearing their accounts over a number of prior years. It is possible that these were examples of artificial non-price constraints on borrowing applications that reflected capacity constraints in US mortgage markets. Think of it as parallel to application bottlenecks at the most desirable universities that ration demand in ways that go beyond other institutions' focus upon more standard criteria like GPAs or SAT scores.

Is The Refi Wave At An End?

Now if unanticipated refi waves within the context of industry capacity constraints sparked rationing of demand for purchase applications, then the next question quickly becomes focused upon asking whether the refi boom may be over. If so, then a quarter million mortgage industry employees face one of two possibilities. Either they will be let go in a renewed bout of downsizing, or their efforts will be employed toward originating brand spanking new mortgages. We lean toward the latter argument for reasons we'll come back to in a moment.

As chart 2 demonstrates, the average effective mortgage interest rate (EMIR) being paid by American mortgage borrowers ended last year at 3.83% — the lowest on record. This reflects some newly originated loans at record-low mortgage financing rates and the cumulative effects of a series of refinancings on previously outstanding mortgages. This effective mortgage interest rate has tracked the blended average of the 15 and 30 year fixed rates lower. The EMIR now actually sits on top of the most popular rate — the 30 year fixed mortgage rate as reported by Bankrate.com. The smaller share of outstanding mortgages in adjustable rate products was re-priced well after the Fed went to zero.



Source: Scotiabank Economics, Bankrate.com, Federal Reserve Board.

Given that 30 year US mortgages are priced off10 year Treasuries and swapped, if Treasury yields are unlikely to move lower than they have over the past couple of years then it may well be that the refinancing boom has largely run its course or is close to having done so. That does not mean or require that Treasuries cannot rally from here. It means that if they do, then it is unlikely to spark another massive refi swell sustained over a lengthy period as most borrowers already refinanced at the rate lows of 2013-14 including the lower depths set before the 'taper tantrum' in the Spring of 2013. Refi waves will be shallower and shorter in length and can increasingly coincide with pick-ups in purchase application approvals.

Finally, we doubt that mortgage companies will simply cut staff by even more if the refi wave is over. Given that they held employment in the 250-300k range since 2010 despite unanticipated rounds of refinancing activity, it's not clear to us that they would further cut this possibly minimum collective staffing requirement as opposed to directing them to originate new purchase loans.

Conclusion

The broad takeaway is that US housing markets may be on the verge of entering a sweet spot if the argument advanced in this article operates against the continued backdrop of an otherwise constructive set of conditions. Those with prior debt have refinanced at the lowest borrowing costs in generations given the one-way refinancing option that is fairly unique to the US mortgage market. This may have been the first focus of Fed policy to enable debt refinancings as a way of facilitating the deleveraging process.

At the same time, those who may soon be seeking to buy could be faced with easier credit access than they have faced in at least 7-8 years and increasingly able to buy in the context of a hiring boom that helps offset other headwinds. That, in turn, could well enable the US to withstand the effects of somewhat higher borrowing costs; in essence, an extension of this thesis is that the worst thing that could happen to mortgage purchase approvals could be, say, a full percentage point drop in the 30 year fixed mortgage rate from here. Cheap mortgages are great, but not if you can't get approved or capacity constraints stay focused on refis; slightly less cheap borrowing rates accompanied by higher approval rates could net out to a positive outcome for US housing markets. Regardless, our argument is that unless mortgage rates drop by arguably more than they have in 2013-14, the refi wave may be coming to an end and industry capacity could be put toward raising approval of purchase applications.