US home prices should maintain strong momentum despite higher rates

By the Securitized Asset Team

october
2013

The decline in US house prices is widely considered one of the main causes of the 2007–2008 financial crisis and the weak economic recovery that followed. US home prices have rebounded strongly during the past year; however, mortgage rates have also increased, sparking concerns that rising rates will jeopardize the housing recovery. To forecast home prices, we closely follow existing indices and build our own models in order to help understand long- and short-term price drivers. Based on our analysis, several key factors suggest that price momentum should be sustainable despite rising rates.

RISING RATES & HOME PRICES: OUR VIEW

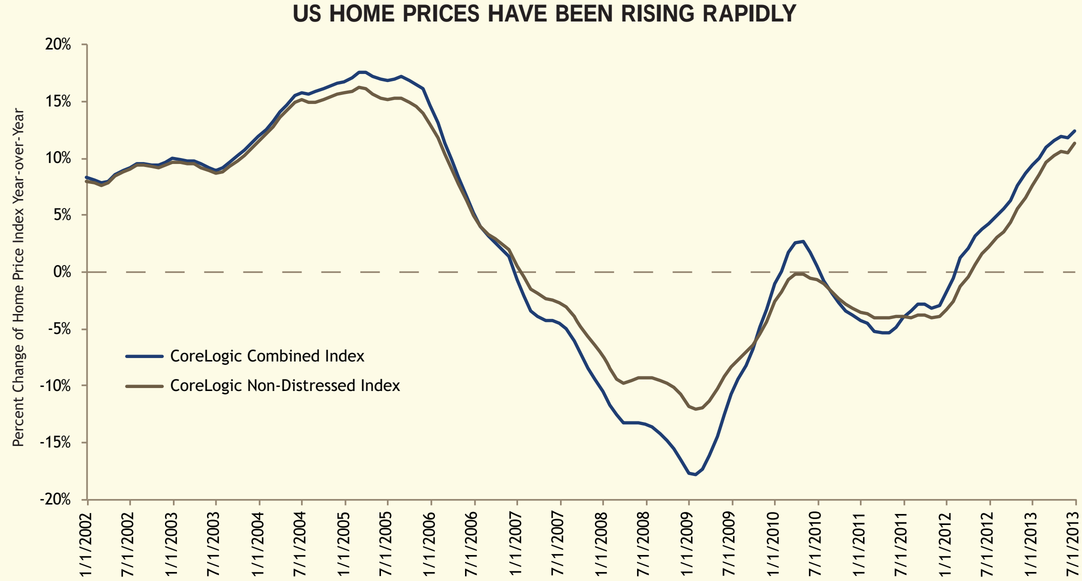
US home prices have been rising rapidly, but positive momentum should be sustainable despite higher rates. Why?

- Higher rates have reduced affordability, but affordability remains very good by historical standards.
- Other long-term drivers of house prices—household formation and income growth—are beginning to recover from very depressed levels as the economy improves.
- Short-term drivers of house prices are currently very supportive: low supply of homes for sale, stronger demand due to positive buyer expectations, and modestly improving credit availability.

SNAPSHOT OF THE CURRENT US HOME PRICE RECOVERY

US national home prices, as measured by *CoreLogic Combined Index*, are up 12.4% year-over-year through July and still accelerating. Because index composition and seasonality can bias the results, we also monitor the *CoreLogic Non-Distressed Index*, which excludes foreclosures and other distressed sales. This index is up 11.4% year-over-year, indicating that recent increases are broad-based, not just seasonal.[i] The current recovery began in early 2012, with price growth turning positive and then accelerating rapidly.

US HOME PRICES HAVE BEEN RISING RAPIDLY



Source: CoreLogic, monthly data from 1/1/2002 to 7/1/2013, data as of 9/10/2013.

Housing markets are inherently local, and state- and local-level data have been strengthening. Through July, home prices were up in 49 of 50 states year-over-year. Not surprisingly, states that experienced the largest housing bubbles and subsequent declines (California, Arizona, Nevada and Florida) are seeing the most significant increases. Prices are increasing more slowly in certain judicial states[ii] with exceptionally slow foreclosure processes and large remaining pipelines of distressed properties (New Jersey and Illinois are good examples). Even after the recent increases, US national home prices are still down 18% from their peak, and prices in some states are significantly lower (for example Nevada at -43%). There remains significant room to recover.

HOME PRICE CHANGES FOR SELECTED STATES THROUGH JULY 2013

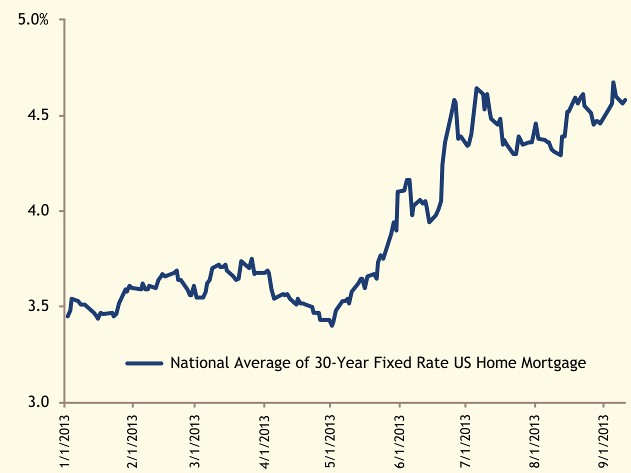
	CoreLogic Combined Index, Year-over-Year Change	CoreLogic Non-Distressed Index, Year-over-Year Change	Recovery since market bottom, CoreLogic Combined Index	Decline since market peak, CoreLogic Combined Index
Nevada	27.0%	24.2%	37.8%	(43.0%)
California	23.2	20.1	34.6	(22.9)
Arizona	17.0	14.9	37.0	(32.5)
National	12.4	11.4	22.8	(17.6)
Florida	12.6	13.4	24.9	(37.4)
New York	8.5	8.6	12.9	(5.3)
Texas	9.1	10.0	16.1	0.0
Minnesota	7.8	7.3	17.9	(15.9)
New Jersey	4.1	4.4	9.2	(23.1)
Illinois	6.0	8.2	16.5	(23.2)

Source: CoreLogic, data as of 9/10/2013.

RISING RATES & THE HOUSING RECOVERY

The 30-year fixed mortgage rate increased sharply since the end of April, moving from about 3.5%, where it had been for most of 2013, to 4.5%, as shown in the first chart below. The sudden move ignited concerns that rising rates might squelch the housing market recovery. We estimate this recent rate increase will raise the monthly mortgage payment for new borrowers by an approximate range of 10–15%. While this is a meaningful increase, our analysis suggests affordability will remain strong in historical terms. Other long-term drivers (better income growth and increasing household formation) and short-term drivers (limited supply of homes for sale, positive borrower expectations of house prices, and improving credit availability) should support continued house price appreciation.

30-YEAR FIXED RATE MORTGAGE

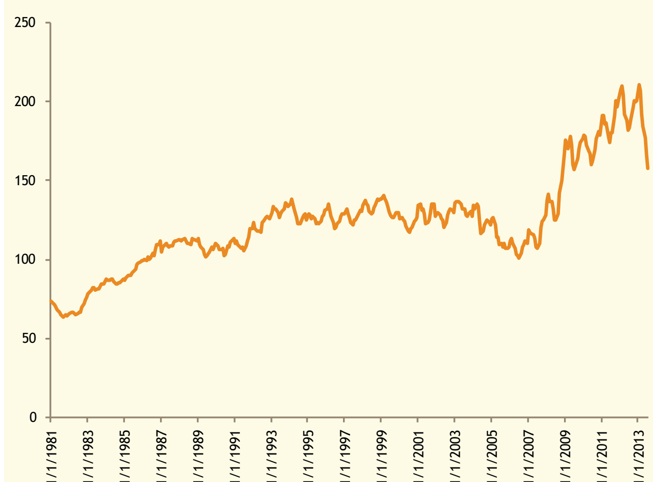


Source: BankRate.com, data from 1/2/2013 to 9/10/2013.

LONG-TERM PRICE DRIVERS

- **Housing Affordability**
  Higher rates directly reduce housing affordability, but we find that even after the recent rate increases, affordability in the US remains better than at any time from 1981–2010. If home prices increase another 10% and mortgage rates increase another 2% (a very large move in interest rates), we estimate affordability would still be approximately average when compared to the 1981–2010 period. It is important to note that, in our opinion, affordability is a long-term driver of house prices and it is not a good predictor of house prices one to three years out. For example, prices rose from 2003–2006, even as rates increased and affordability declined, and prices fell from 2008–2011, even as rates were cut and affordability improved.

HOUSING AFFORDABILITY INDEX



Source: Haver Analytics, monthly data from 1/1/1981 to 7/1/2013.

- **Income Growth & New Household Formation**
  We believe the long-term trend in house prices is set by income growth and the number of new households. Income growth during the recovery from 2008–2009 recession has been very weak by historical standards, and even slight improvement would be supportive of house prices. New households form as people move out to start families; however, during the last five years, many people in their 20s and 30s delayed moving out, creating a lag in demand for housing. A study from the Federal Reserve Bank of Cleveland estimated that from 2007–2011, household formation was 2.6 million below normal levels, especially among young people. We think stable or improving economic conditions will give more people the ability and confidence to start their own households, increasing longer-term demand for housing.

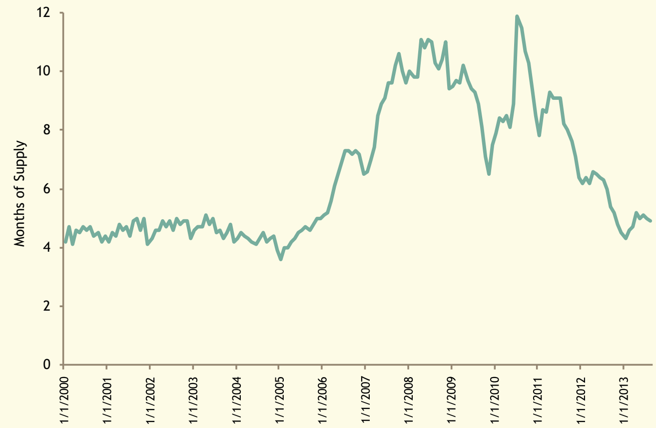
SHORT-TERM PRICE DRIVERS

In the short run, home prices can fluctuate around the long-term trend. As discussed below, we currently view key short-term drivers as positive for house prices.

- **Limited Supply**
  We think the current supply/demand picture is very bullish for US house prices. On the supply side, both new and existing home inventories are near record lows. New home construction is finally increasing from very low levels, but it will likely take several years for builders to acquire and develop land, hire workers, and build houses. Existing home inventories are also near record low levels. The large pipeline of homes in foreclosure still waiting to be liquidated has been a risk for home prices, but we have seen two positive developments in this area. First, the total number of properties in foreclosure has started to decline. Second, due to various government modification and foreclosure documentation initiatives, the speed at which foreclosed properties are being liquidated has slowed sharply. These trends are helping reduce overall existing inventory and support house price appreciation.

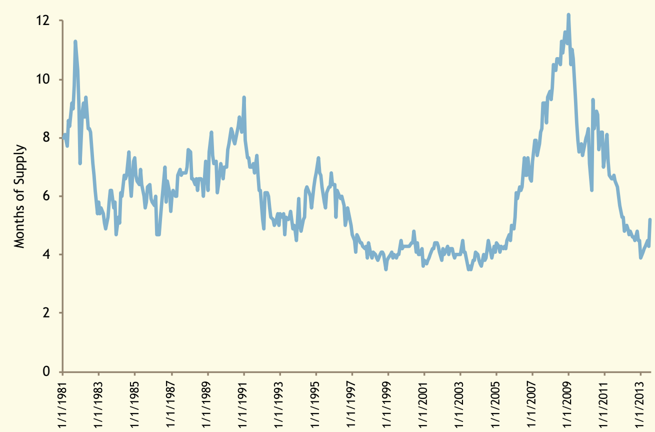
- **Positive Buyer Expectations**
  On the demand side, borrower expectations are very important in determining short-term house prices. When prices are going up, consumers expect them to appreciate further, and when prices are going down, consumers expect them to decline further, at least in the short term. If consumers expect home prices to increase 10% in the next 12 months, many are likely to accelerate their purchases, even if mortgage rates are high. The inverse can also be true; an expected 10% drop in home prices during the next 12 months would prompt many consumers to wait a year or more before buying, even at a very low mortgage rate. From 2009–2011, for example, buyers were scared by the housing bust and expected prices to drop further, so many delayed home purchases.

SUPPLY OF EXISTING SINGLE-FAMILY HOMES



Source: National Association of Realtors. Monthly data from 1/1/2000 to 8/31/2013, seasonally adjusted annual rate.

SUPPLY OF NEW SINGLE-FAMILY HOMES



Source: US Census Bureau. Monthly data from 1/1/1981 to 7/31/2013, seasonally adjusted.

Months of supply equals value of property on the market divided by monthly sales volume.

- **Improved Credit Availability**
  Mortgage credit in the US has been very tight since the financial crisis, in part because banks have been dealing with "legacy" losses from mortgages originated during the 2003–2008 period. However, credit performance of mortgages originated from 2010–2013 has been excellent, and this is encouraging banks to loosen underwriting standards. We expect mortgage underwriting standards to slowly become less restrictive, which would allow more consumers to obtain mortgages and contribute to home price growth.

OUR CURRENT OUTLOOK FOR HOUSING

When we consider these factors together, we forecast that home price growth should begin to slow over the next 12–24 months to the mid single-digits, still a very healthy rate. We forecast home price increases of approximately 10–12% in 2013 and 5–7% in 2014.

In our view, the biggest risk to house prices would be considerably stricter underwriting standards by government-sponsored enterprises (GSEs). Today, the GSEs (Fannie Mae, Freddie Mac) and the Federal Housing Administration (FHA) still provide four out of every five mortgages in the US. The FHA plays a particularly important role because it helps provide credit for first-time home buyers and those with smaller down payments. We believe policymakers understand that the transition of mortgage underwriting back to private markets needs to be done gradually, but we continue to monitor this area very closely.

The implications of house price increases are significant. Housing-sensitive sectors, such as homebuilders and non-agency residential mortgage-backed securities (RMBS), stand to benefit directly from stronger housing demand. More broadly, we expect higher house prices to help repair consumer and bank balance sheets, improvements that have positive implications for the US economy as a whole.

ENDNOTES

[i] *Change in distressed share of homes is the primary driver of seasonality. Analyzing year-over-year measures also helps address seasonality issues.*

[ii] *Judicial states process foreclosures through the courts.*

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