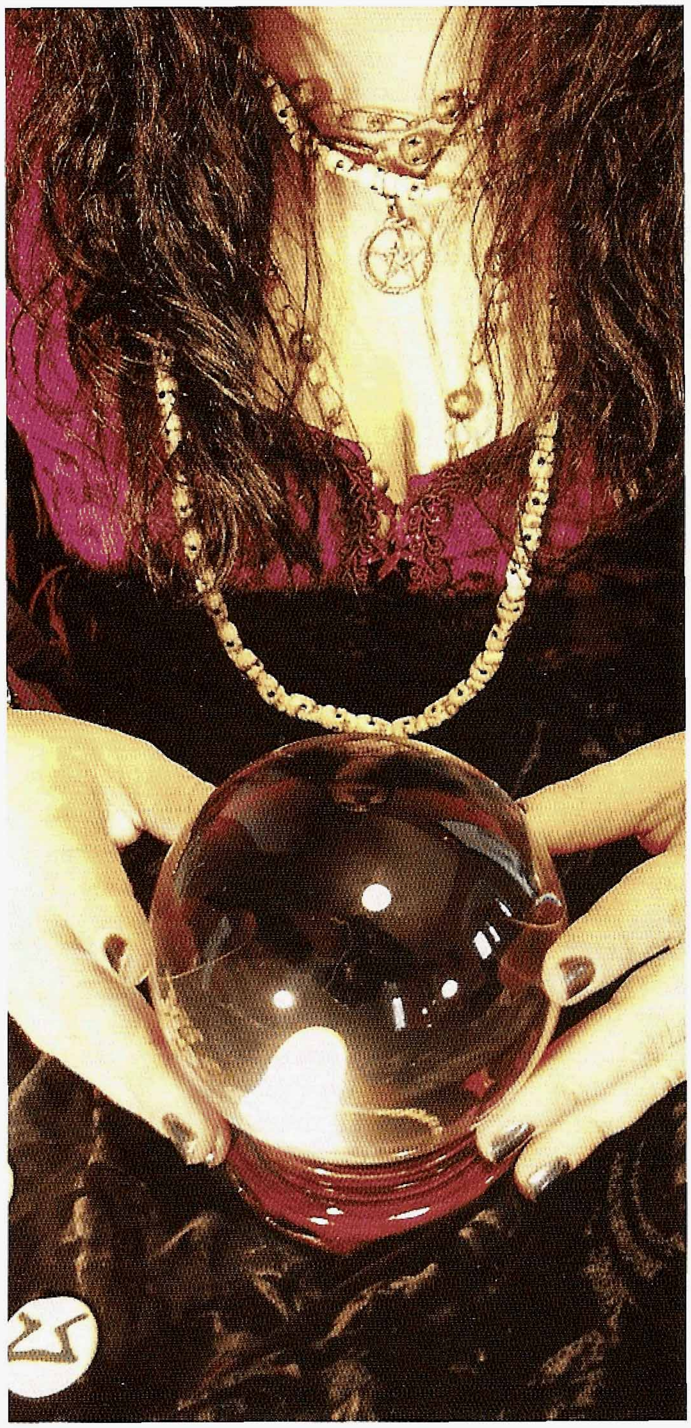
Lending

A Lender's Look into the Real Estate Crystal Ball

by Joanne S. Liu



Homeownership rates in the United States are the highest they've ever been, which means today's real estate market conditions directly affect more and more individuals—including the record high 73.4 million homeowners in this country. From 1996 to 2004, the national homeownership rate rose 3.6 percent, from 65.4 percent to 69.0 percent. The rate reached a record 69.1 percent in the second quarter of 2004.

What's in store for the real estate market? Everyone seems to want to know. In addition to homeowners, people directly involved in the mortgage loan industry have closely followed the real estate boom over the past several years. Continual warnings of a real estate bubble, however, have popped up. In June 2005, Alan Greenspan, then Federal Reserve Chairman, referred to the "froth" in the housing market which "may have spilled over into mortgage markets."

Barry Habib, CEO of the Mortgage Market Guide service, believes that all this talk of a real estate bubble created a real estate bubble *trap*. "The future of the real estate market is fine," he says. "But I feel really bad for those people who got caught up in the housing bubble trap." These people, spurred by concerns that any home they bought would be significantly overvalued, rented instead of purchasing a home and subsequently lost out on real estate appreciation.

Habib makes his point by appealing to logic: Examine the behavior of a homeowner. When he or she sells the house, the next logical step is to purchase another house. Sure, some people will go back to renting, but in most cases, homeowners turn around and purchase another house to replace the one they just sold.

Habib likens the real estate market to food put in a microwave. Food that's been heated in a microwave will have some hot spots and some cool spots. In the same way, the real estate market has areas of hot and cold depending on the specific region in the country.

Mike Fratantoni, Senior Director of Single-Family Research and Economics at the Mortgage Bankers Association (MBA) in Washington, D.C., acknowledges the rapid growth in home prices. He says, "Last year at the national level, we had about 13 percent growth in home prices across the country—fast around the coasts, and a little bit slower in the interior part of the country." In fact, home prices have risen in the last four years at a rate of approximately 12 percent.

For 2006, Fratantoni predicts home price growth will come down substantially to somewhere between 5 and 6 percent. For 2007, Fratantoni forecasts a rate of home price growth that is closer to 4 percent. He also anticipates a 7 to 8 percent drop in the level of home sales and housing starts, or new construction, and concludes, "We are headed for a soft landing, and we anticipate the market's going to decelerate further."

Despite these cautionary words, Fratantoni believes the underlying fundamentals are strong. "We're not predicting any widespread decline in prices, but rather just a slowing in the rate of appreciation going forward," says Fratantoni, who adds, "That 4 to 6 percent rate is much more in line with the longer-term historical average we've seen in the U.S." Fratantoni says the average annual home price growth rate over the last 25 years is 5 to 5.5 percent. This year's growth, he predicts, will likely be typical while 2007 might fall slightly below the average.

An MBA research paper released last year points to a strong economy as one of the factors that reduces risk to the housing and mortgage markets. Habib says the economy's labor market is crucial. "Look at the job market. The 4.8 percent unemployment rate is (indicative of an) exceptionally strong economy. If there's a strong job market, you're going to see a good real estate market." A company looking to hire more employees in an economy with a low unemployment rate will probably need to cast a wide net over a larger geographical area. To entice new employees to relocate, the company must offer higher compensation, which, in turn, gives new employees more money to purchase homes.

Fratantoni's assessment of the economy is also upbeat. "The unemployment rate now is about 4.8 percent, and we think it'll stay right about there. And then (there's) strong job growth averaging 180,000 to 190,000 new jobs per month. So, the economy is operating right at its long-run potential."

Fratantoni also examines interest rates as they relate to the real estate market. He says, "We had a relatively weak fourth quarter of 2005 in terms of GDP growth at 1.7 percent. We expect a very strong first quarter (of 2006)—something like 5 percent." In fact, recent numbers indicate first quarter growth at 4.8 percent.

He adds, "Inflation right now is at the upper end of the Fed's comfort zone," which may persuade the Federal Reserve to increase its federal funds target. Indeed, on May 10, 2006, after fifteen straight increases, the Federal Reserve raised its target by 25 basis points to 5 percent. Fratantoni cautions that inflation may affect the Federal Reserve's behavior. "There is a risk that if inflation heats up, they (the Fed) might have to increase its target further." The Federal Reserve has admitted to the significance of inflation, stating that "some further policy firming may yet be needed to address inflation risks."

Borrowers are also turning back to fixed-rate mortgage loans. "We are seeing borrowers increasingly opt for fixed-rate mortgages as opposed to adjustable rates," he says. Fratantoni says the adjustable rate mortgage (ARM) share is down to 28.5 percent of mortgage loan applications at the end of March 2006, which is down from a peak of 36 percent in March 2005, just one year earlier. Overall mortgage loan applications are also down. According to the MBA's survey for the week ending April 21, 2006, the market composite index, which measures mortgage loan application volume, is 22.4 percent lower compared to the same week in 2005.

Mortgage interest rates are at their highest levels in recent years. For example, the 30-year fixed rate mortgage interest rate in early April 2006 was at almost 6.5 percent, its highest level since 2002. In addition, the one-year ARM mortgage interest rate in the same time period was almost 6 percent, its highest level since 2001.

Delinquency rates are on the rise as well. Do these increased rates indicate trouble in the real estate market and the mortgage loan industry? The best way to answer this question is to first understand mortgage loan trends. Fratantoni says, "The main factor driving delinquency on mortgages is what's going on in the labor market." In a recession, when unemployment is rampant, delinquency rates increase. The unemployment rate, as mentioned earlier, is low, so why then the rise in delinquency rates?

Fratantoni says, "There was this absolutely enormous refinance wave between 2002 through the beginning of 2004, with $4 trillion in origination in 2003." He says, "If you look at performance on a historical basis, the peak delinquency rate (for a loan) is somewhere between three and five years after origination." Before borrowers purchase a home, they save up for a period of time and establish their credit—they're typically in the best financial shape possible. After the purchase, borrowers often encounter difficulties in the first couple of years. They may run up costs that come with buying a new home and may not have the money to make mortgage payments. Only after the four- or five-year mark do borrowers stabilize their finances and start paying down the principal.

Fratantoni believes delinquency rates will continue to rise for some time for this very reason: The loans from the refinance wave are just hitting their peak delinquency rate period. "Because of this mechanistic moving of this pig through the python, you expect some increase in the delinquency rate," he says.

Rising delinquency rates, then, are not cause for immediate concern in the real estate market. Rather, economic factors, such as inflation, job growth, and the unemployment rate, emerge as better indicators of the real estate market's health. **CUB**