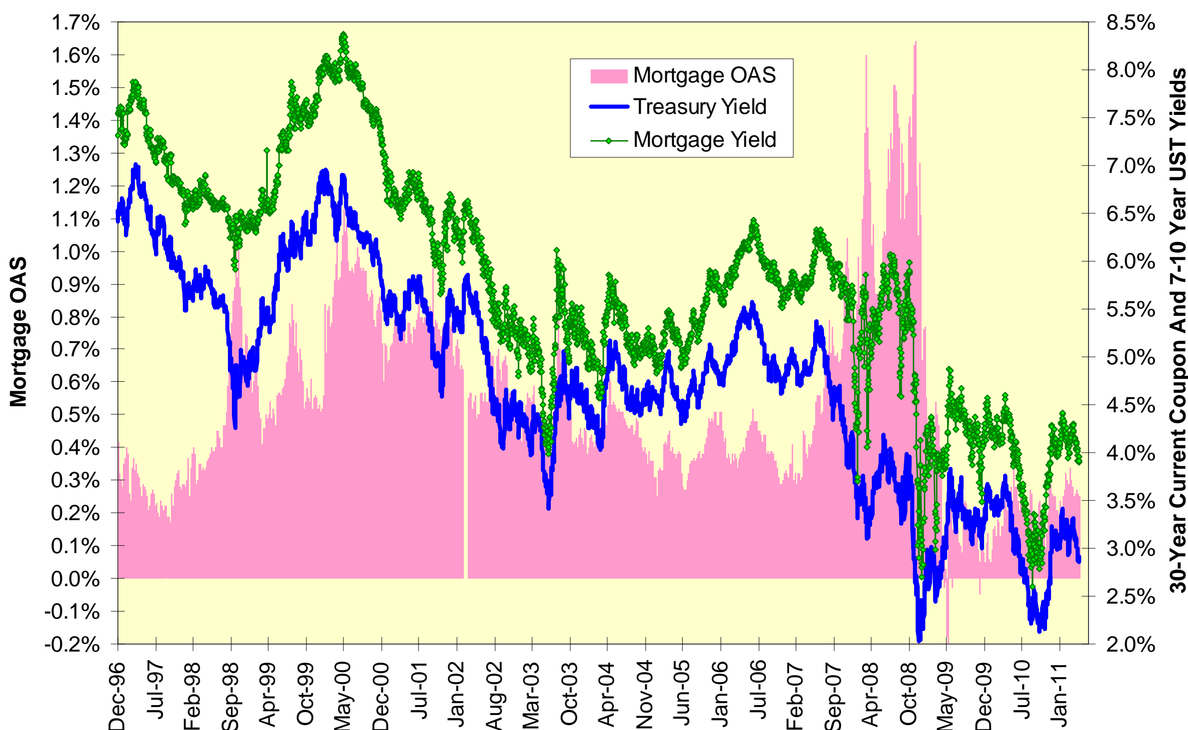
Mortgage Market In A Zombie State

As I am not an expert in voodoo, nor do I intend to attend any sort of evening classes at the local community college filled with frustrated career-changers who see putting others into stupefied trances as a way toward personal fulfillment, I will have to offer apologies in advance if I insult any actual voodoo practitioners by mentioning them in the same breath as mortgage-backed securities. I will even offer up my home state of Illinois as a zombie state in its own right, complete with cell-blocks full of former elected officials.

With all of that out of the way, allow me to point out just how dead the mortgage market has become by charting the path of the option-adjusted spread (OAS) on Fannie Mae-conforming 30-year current-coupon mortgages along with the interest rates on both those mortgages and 7-10 year U.S. Treasuries.



This measure used to put in some real mileage; in fact, economists if no one else regret the series begins at the end of 1996. The mortgage debacles of the mid-1980s, the prepayment rush in 1992-1993 and the extension risk mortgage fiasco of 1994 all would have produced some wild swings in OAS levels. We certainly see what the 2007-2008 mortgage-market flameout (I keep searching for good synonyms for “debacle;” mortgages can do that to you) did to OAS levels.

After 2008, more specifically after the 2009 purchases of $1.25 trillion in mortgage-backed securities by the Federal Reserve in QE1 and the open-ended federal backstopping of the mortgage menaces Fannie Mae and Freddie Mac, the market went into its present voodoo state. We do not have to worry about prepayment risk other than from people lucky enough to sell their houses and close their mortgages in the process, nor do we have to worry about a flood of new and increasingly creative mortgages being issued to new home buyers as those do not exist. We do not have to worry about small lenders selling mortgages up the chain for securitization as the mortgage derivative market has been judged unsafe at any speed. Finally, we certainly do not have to worry about Fannie and Freddie defaulting, not when they have access to your taxes and the Federal Reserve’s printing press.

It is all over, poof, gone with the wind. Before we started rounding federal budget numbers to the nearest $10 billion, mortgages were the largest debt market in the country and they often were the tail wagging the Treasury dog (yikes; that is some image). Their embedded optionality – mortgagees were short a call option on bonds – and the ease with which financial engineers could package them into all manner of exploding cigars made them a favorite of

the sort of people too dangerous to trust with nuclear weapons. Remember, all pretenses aside, the next person to model mortgage prepayment behavior will be the first one to do so.

We have seen already one result of this mortgage zombification, and that is an unusually quiescent Treasury market. We will see another continue to unfold and that is the reversal of years of ever-higher homeownership. The overall consequences of this will be far-reaching and will affect everyone from home-improvement retailers such as Home Depot or Lowe's to home-furnishing retailers such as Leggett & Platt and Ethan Allen Interiors. This is a trend that will last for decades and will affect the quality of American housing stock very negatively.