Mortgage Market Cure Will Be Worse Than The Disease

While last Wednesday's magic carpet ride in Fannie Mae and Freddie Mac, two entities whose existence ceased to be justifiable long before the previous housing bubble began, no doubt turned a head or two, the simply fact of the matter is we are now starting to reap what the Federal Reserve planted (and yes, that is "planted," not "sowed," unless you are teaching Sunday school somewhere, in which case why are you reading this reprobate?) with its purchases of mortgage-backed securities in QE3.

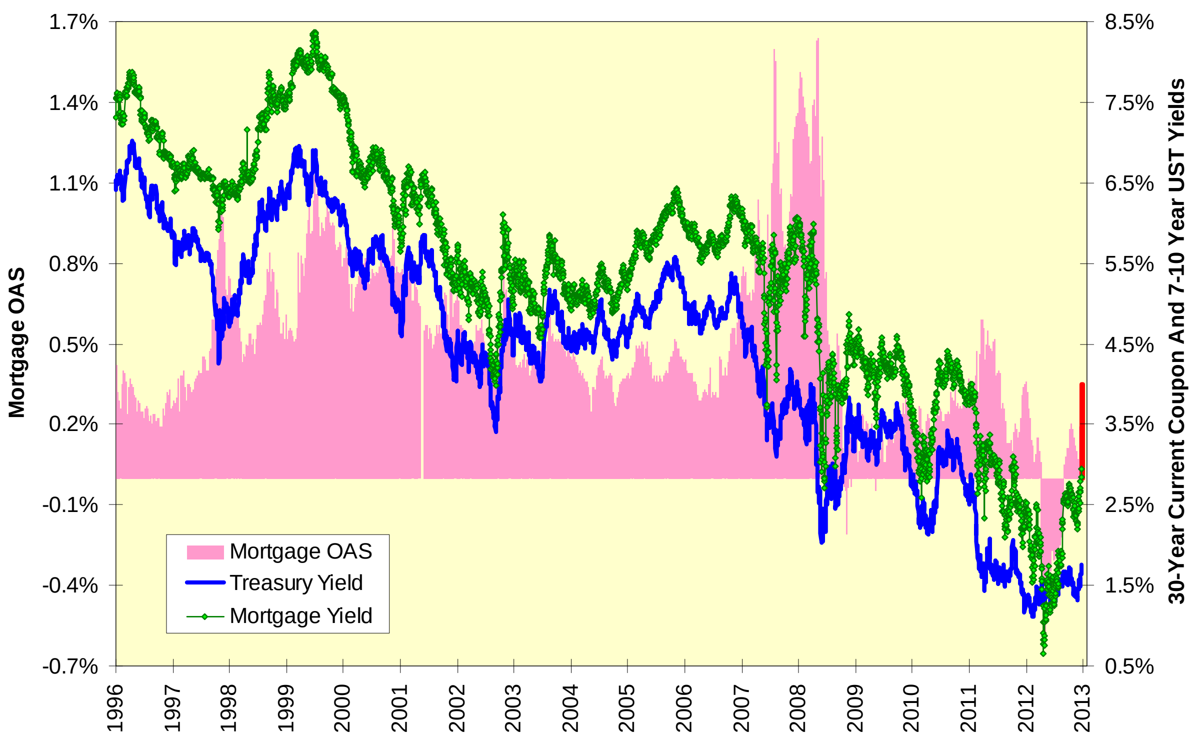
Even though the Case-Shiller data reported last week were strong, they were for March and therefore are a backward-looking response to the artificially low mortgage rates created by QE3 in September 2012 and exacerbated by QE4 in December. Forward-looking indicators such as the relative performance of homebuilders or the movement of lumber futures are pointing lower for the housing industry. September lumber futures have declined 29.4% since mid March; over the same period the S&P 1500 Homebuilders index, stomping-ground of Pulte Group, Lennar and D.R. Horton, has underperformed the Supercomposite itself, 1.51% to 5.83%.

In the eternal struggle between looking backward and looking forward, put me down in the forward-looking camp, please.

Mortgage Spreads

Every market bully learns quickly and the hard way they can push a market higher or lower for a short period of time, but they cannot keep it there even armed with a printing press; all you need to do is pull up a chart of ten-year Japanese government bond yields over the past month. The mortgage market has encountered much the same thing; yields on FNMA 30-year current coupon mortgages fell to preposterously low levels last September and have rebounded since then. Their option-adjusted spread is back to year-ago levels.

Mortgage OAS Rising Quickly



Affordability And Rewards

As home affordability has three components, buyers' cash flow available to housing, the financing costs and capital price of the home, both higher home prices and higher mortgage costs are negatives for prospective buyers. Oddly, higher home prices are treated as unalloyed good news whereas they are good news only for those on the sell-side of the equation. That is life, though; I never get a call from a reporter asking me why the stock market rose so much or why gasoline prices are declining. We do have our mental roster of who wears the white hats and who wears the black hats.

As no one wants to see home prices fall or mortgage rates rise, the political impulse will be to engage in further subsidization of the housing sector. As has been the case in the healthcare and education industries, both of which have seen oodles of preferential financing, the suppliers will reap the economic rent of those subsidies; there is a reason why healthcare and education expenses always seem to rise faster than anything else.

The more money that will be thrown at housing, the more existing homeowners will benefit relative to prospective buyers and the further the market will be distorted. If misallocation of resources had feathers, it could be our national bird.

The only way out of this emerging problem will be for disposable personal income to rise even faster than home prices. Yes, that would be nice. It is also unlikely as real disposable income has been struggling to grow over the past quarter-century and will continue to struggle until we hit the next productivity boom for as-yet unknown reasons.