Surprised again

↳ By Alex J. Pollock

"Why We're Always Surprised" is the subtitle of my book, *Finance and Philosophy*. The reason we are so often surprised by financial developments, I argue in the book, is that "The financial future is marked by fundamental uncertainty. This means we not only do not know the financial future, but *cannot* know it, and that this limitation of knowledge is ineluctable for *everybody*." That certainly includes me!

At the end of last year (in December 2018), interest rates had been rising, and it seemed obvious that they would likely rise to a normal level, at last adjusting out of the abnormally low levels to which central banks had pushed them in reaction to the financial crisis. The crisis began in 2007 with the collapse of the subprime lending sector in the U.S. and of the Northern Rock bank in the U.K, and ran to 2012, which saw the trough of U.S. house prices and settlement of defaulted Greek sovereign debt at 25 cents on the dollar.

Six years had gone by since then, it seemed that it was high time for normalization. This view was shared during 2018 by the Chairman of the Federal Reserve Board and its Open Market Committee. It also seemed that the long period of imposing negative real interest rates on savers, thus transferring wealth from savers to leveraged speculators and other borrowers, needed to end.

What would "normal" be? I thought a normal rate for the 10-year U.S. Treasury note would be about 4% and correspondingly for a 30-year U.S. fixed-rate mortgage loan about 6%, assuming inflation ran at about 2%. I still think those would be normal rates. But obviously, it is not where we are going at this point.

For the final 2018 issue of *Housing Finance International*, I wrote, "The most important thing about U.S. housing finance is that long-term interest rates are rising." Surprise! Long-term interest rates have fallen dramatically. The U.S. does not have the negative interest rates, once considered impossible by many economists, which have become so prevalent in Europe, remarkably spreading in some cases to deposits and even mortgage loans. But the U.S. does have negative rates in inflation-adjusted terms. The 10-year U.S. Treasury note is as I write yielding about 1.5%. The year-over-year consumer price index is up 1.8%, and "core inflation" running at 2.2%, so the investor gets a negative real yield once again, savers are again having their assets effectively expropriated, and we can once again wonder how long this can continue.

What do the new, super-low interest rates mean for U.S. housing finance?

The higher U.S. mortgage loan rates, which reached almost 5% for the typical U.S. 30-year fixed-rate loan in late 2018, "would have serious downward implications for the elevated level of U.S. house prices, which already stress buyers' affordability," I wrote then. Had those levels been maintained, they definitely would have put downward pressure on prices. But as of now, seven years after the 2012 bottom in house prices, the U.S. long-term mortgage borrowing rate has dropped again to about 3.8%. This has set off another American mortgage refinancing cycle and is helping house prices to continue upwards.

In the U.S. system, getting a new fixed rate mortgage to refinance the old one is an expensive transaction for the borrower, with fees and costs which must be weighed against the future savings on interest payments. The fees depend on state laws and regulations; they range among the various states from about $1,900 on the low end to almost $6,900 on the high end, according to recent estimates. On the lender side, the post-crisis increases in regulatory burden had raised the lenders' cost to originate a mortgage loan to as much as $9,000 per loan – the increased volume from "refis" (as we say) may have reduced this average cost to the lender to about $7,500. It is expensive to move all the paper the American housing finance system requires in order for the borrower to obtain a lower interest rate.

Meanwhile, with the new low interest rates and high house prices, "cash out refis" are again becoming more popular. In these transactions, not only do borrowers increase their debt by borrowing more than they owe on the old mortgage loan, but they reset their amortization of the principal further out to a new 30-year schedule. In both ways, they reduce the build-up of equity in their house, making it more likely that they will still have mortgage debt to pay during their retirement.

In general, there are no mortgage prepayment fees in the U.S. The old, higher rate loans are simply settled at par. This continues to make prices of mortgage securities in the U.S. system very sensitive to changes in expected prepayment rates. If investors have bought mortgage loans at a premium to par, which they often do, upon prepayment they have lost and must write off any unamortized premiums they paid.

The most notable American investor in mortgage securities is the central bank, the Federal Reserve. As of August 21, 2019, it had on its books $115 billion (with a B) of unamortized premium, net of unamortized discounts. Not all of this may be for its $1.5 trillion mortgage portfolio; still, a refi boom might be expensive for the Fed.

Speaking of the Federal Reserve, its then-Chairman, Ben Bernanke, wrote in 2010 about his bond buying or "quantitative easing" programs: "Lower mortgage rates will make housing more affordable and allow more homeowners to refinance." The latter effect of promoting refis is always true, but not the former claim of improved affordability. It ceases to be true when low mortgage rates have induced great increases in house prices, as they have. The high prices obviously make houses less affordable, and obviously mean that more debt is required to buy the same house, often with higher leverage – notably higher debt service-to-income ratios.

U.S. house prices are now significantly above where they were at the peak of the housing bubble in 2006. They have risen since 2012 far more rapidly than average incomes. The Fed's strategy to induce asset price inflation has succeeded in reducing affordability.

According to the Federal Housing Finance Board's House Price Index, U.S. house prices increased another 5% year-over-year for the second quarter of 2019. "House prices rose in all 50 states…and all 100 of the largest metropolitan areas," it reports. Its house price index has now gone up for 32 consecutive quarters.

The S&P Case-Shiller National House Price Index has just reported a somewhat lower rate of increase, with house prices on average up 3.1% for the year ending in June. There is art as well as science in these indexes – the FHFA's index notably does not include the very high ("jumbo," in American terms) end of the market. According to Case-Shiller, in some particularly expensive cities, house price appreciation has distinctly moderated, with year-over-year increases of 1.1% for New York, 0.7% for San Francisco, and negative 1.3% for Seattle.

The AEI Housing Center of the American Enterprise Institute has house price indexes that very usefully divide the market into four price tiers. It finds that at the high end of the market, the rate of increase in prices is now falling, while the most rapid increases are in the lowest priced houses – just where affordability and high leverage are the biggest issues, and where the U.S. government's subprime lender, the Federal Housing Administration, is most active.

On a longer-term view, Case-Shiller reports that national U.S. house prices are 57% over their 2012 trough, and 14% over their bubble peak. When U.S. interest rates rise again, whether to normal levels or something else, these prices are vulnerable. How much might they fall? That may be another surprise.