

The Affordable Mortgage Depression

Government policies were designed to increase homeownership. Affordable Mortgages, created to realize this goal, were responsible for the Housing Bubble and distorted the economy. The unwinding of these distortions will result in a Global Depression.

Mortgage Rates Do Not Matter

Yesterday the feds pumped \$600 billion more into bailing out the economy. This time they manipulated mortgage interest rates by pledging to buy mortgage backed securities. The following includes a headline and excerpt from a Bloomberg story which sums up the action.

“Mortgage Rates Tumble on Fed Debt Purchasing Plan”

“Nov. 26 (Bloomberg) -- U.S. mortgage rates plunged by the most in at least seven years yesterday as a Federal Reserve pledge to buy \$600 billion of debt succeeded where seven cuts in the central bank's benchmark rate had failed.

The average rate for a 30-year fixed mortgage fell to about 5.5 percent last night after starting the day at 6.38 percent, according to an estimate from Bankrate Inc. It was the biggest one-day drop in at least seven years.”

Everyone from the policy makers to mortgage brokers to homeowners seem to be thrilled by the action and its immediate result. Optimism springs eternal that lower mortgage rates will prop up home values and bring buyers back into the market. Unfortunately this is not the case.

1. Mortgage Rates Do Not Matter When Housing Prices Are Declining

The role of expectations in this crisis continues to be overlooked and underappreciated. In a vacuum, lower rates would mean more buyers and higher prices. We are not in a vacuum.

When asset prices are falling and potential buyers expect them to continue to fall, people stay out of the market regardless of the cost of borrowing. While the mortgage payment on a house today is lower than it would have been last week, why would a prospective buyer purchase a house that is declining in value? Waiting a year (or three) allows a buyer to purchase the asset more cheaply. Buying a house today only exposes the new owner to leveraged equity losses.

This is the nature of deflation. Potential buyers don't borrow money to purchase assets that are falling in price. Banks don't lend money to purchase assets that are falling in price except under restrictive terms. The restrictive terms further restrain demand and reinforce falling prices.

2. Marginal Interest Rates Today Are Much Higher Than During the Housing Boom

The Bubble was fueled partly by extraordinarily low interest rates. While 30 year mortgage rates were widely reported during the boom, they were also largely irrelevant. Buyers and investors at the margin relied on ARMs and Option ARMs which provided, on a temporary basis, the ability to service mortgages for as little as 1% per year. It was these insanely low effective interest rates that supported unsustainably overvalued housing. Now that the market has wisely eliminated these economic time bombs from the mortgage market, marginal interest rates have risen dramatically.

Despite the headlines, mortgage rates have not dropped to 5.5% they have increased from the 1% to 2% range. Current housing valuations remain unsupportable at the current interest rate level. Prices will continue to fall.

3. One-Time Government Initiatives Are Ineffective

The expectation of future government purchases of mortgage backed securities dramatically reduced interest rates. But what happens as we approach the end of the \$600 billion spending spree? The market will understand that the government arbitrarily manipulated demand for these securities and

mortgage interest rates. Unless investors are suddenly willing to jump back into the breach and accept below market compensation, interest rates will rise again.

One time shocks, be they stimulus checks or government shopping sprees, don't work. Savvy prospective home buyers will understand that this is a short term interest rate move. As rates rise again, demand will fall and price declines will continue. Lower monthly payments are great, but not if the value of your purchase is declining.

In fact, we might see rates start to climb in the near future. The market was charging interest rates above 6% based on perceived risk and the demand for mortgage securities. With interest rates now at 5.5% I would expect some of that capital to go away. If the market wasn't able to attract sufficient capital at 6.5% why would investors stick around for arbitrarily lowered returns.

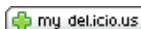
4. Non-Interest Rate Market Forces Will Continue to Determine Home Prices

Interest rates are a market force which impact housing values, but they are presently a minor one. Housing prices will continue to be determined by:

- The supply of unoccupied houses
- Housing inventories for sale
- Demand for home purchases
- Credit availability and terms
- Unemployment levels and trends
- Consumer confidence
- Perceived risk
- Expectations for the future
- Changing social and cultural values associated with homeownership
- Foreclosure volumes and trends

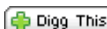
Every meaningful market force that influences price indicates that the housing market will continue to fall for the foreseeable future irrespective of mortgage rates.


Rate reductions make interesting headlines and are encouraging to optimists. They do assist individuals who have the ability to refinance their existing loans, but this beneficial economic impact is imperceptible given the laundry list of negative forces at work. Mortgage rates declines will have little meaningful impact on the housing market or the broader economy until prices approach a level where they are justifiable based on existing fundamentals and historical valuation norms.

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