

# Slowly Climbing Out

BY MIKE FRATANTONI AND JOEL KAN

**Residential origination volume in 2012 looks to be the lowest on record since 1997. However, things could surprise to the upside. Just don't bet the house on it.**

**T**he economy is growing, but at a slower pace than necessary to significantly reduce the unemployment rate. While there may be decreases from month to month, the unemployment rate is likely to increase again in the first half of 2012. In such an environment, we expect mortgage rates will rise only gradually over the coming year, and the housing market will continue its slow, arduous climb to recovery. ▲ There are substantial uncertainties regarding this outlook. We anticipate that Europe is already in a mild recession and have taken that into account in our outlook. However, there is the potential for the downturn there to metastasize into a true financial crisis. In fact, as of early December, on a week-to-week basis, it is not clear whether the crisis is already upon us, or whether European Union (EU) policymakers will be able to contain it. ▲ Central banks around the world have acted in concert to ease strains in an effort to reduce any potential shocks to the financial system. If the crisis does get out of hand, however, the U.S. economy would get knocked off course, and we would likely fall back into a recession of our own. ▲ Such an outcome would push the unemployment rate up further and would keep mortgage rates lower for longer. Nonetheless, we do not expect a deep recession in the United States even in the event of a full-fledged banking crisis in Europe. It would make for a tougher trail to recovery, though. ▲ There is a chance the housing market could surprise to the upside. In fact, we have seen hints as of early December that this may indeed be happening. ▲ Should these green shoots grow into something stronger by the spring buying season, there would be a direct benefit to the economy from rising home sales, more construction and somewhat faster home-price growth. Such a development would further support consumer spending. ▲ At this point we don't want to oversell the likelihood of this path or even the extent of its impact, but we do think it's worth there is

a real chance of a housing-led growth recovery in 2012. Not another boom—but a genuine improvement over 2011 and definitely an easier ascent up the mountain.

Regardless of which path the economy and mortgage rates take, we are predicting another tough year for the industry, with total residential origination volume coming in at its lowest level since 1997.

Continued slow economic growth means unemployment will remain elevated through 2012. That will potentially slow the improvement in delinquency and foreclosure volumes, so in addition to lower production volumes for the industry, mortgage servicers will continue to be under pressure.

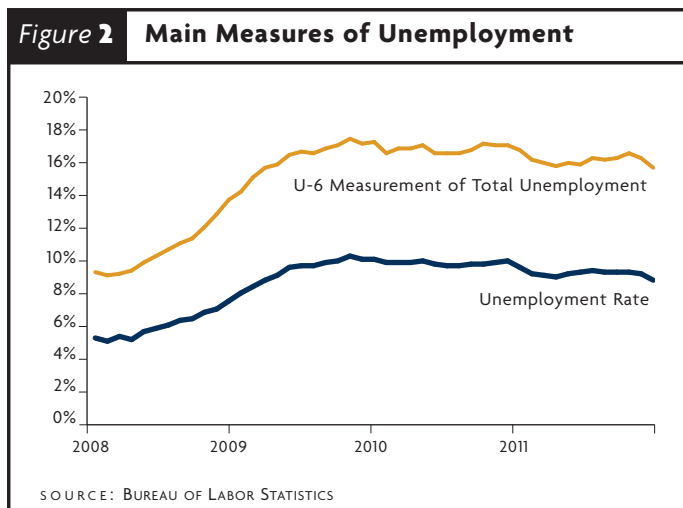
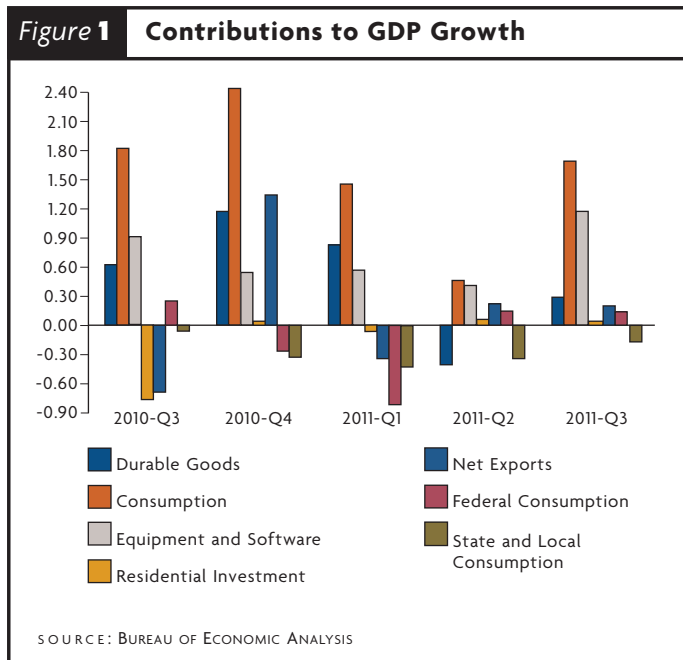
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Two components of the economy are leading the way. First, consumer spending, particularly on durable goods, was solid in the third quarter of 2011 and has been for much of the year (see Figure 1). Some of this is related to spending for autos, although the level of auto sales remains quite low by historical standards. (It is also interesting to note that the “durables” category includes goods such as iPads® and iPhones®, so those lines outside of the Apple store are having an impact on national income.)

A second important contributor to growth has been business spending on equipment and software. For many companies, the information technology (IT)

### Growth and risks to growth

The economy is growing—but where is that growth coming from?



cycle has required significant spending on systems, even though consumer demand for their products remains relatively light. It’s important to note that while these components are the relative leaders in terms of contributions to growth, neither is reflecting particularly robust growth.

On the other side of the equation, state and local government spending has been a net drag on growth, as municipalities cut back due to budget constraints. Construction spending has stabilized at a low level, meaning that residential investment is no longer a drag, but neither is it yet a contributor to growth.

Federal spending and net exports also are relatively neutral, with some risk in the near future to federal spending based upon the outcome of the budget negotiations. Net exports are at risk if the European situation worsens.

Growth in manufacturing seems to have stalled as well, despite a slight recovery in November’s data; the Institute for Supply Management (ISM) indexes have been forecasting decelerating growth for about half a year and in some months, even a contraction. Hiring in the manufacturing sector has weakened, as indicated by both ISM and Bureau of Labor Statistics (BLS) data.

In the third quarter of 2011, real gross domestic product (GDP) grew at a rate of 2 percent compared with 1.3 percent in the second quarter. Consumer spending drove much of the increase, with the highest quarterly growth rate of the year in that category, along with business fixed investment, which saw healthy increases in investment in structures and in equipment and software. State and local government spending continued to decline, but the third quarter’s decline was the smallest in a year.

Looking ahead, we expect GDP growth to average a little less than 2 percent in 2012. By 2013, the expansion should be on firmer footing, as we see growth accelerating to 2.5 percent or perhaps even faster.

Even though growth will be positive in 2012, a rule of thumb for the U.S. economy is that unless growth exceeds 2.5 percent, not enough jobs will be generated to keep up with population growth. That means the unemployment rate will remain little changed. The end result is it will continue to feel like the economy is only very slowly creeping out of a deep hole.

## Job market

To date, we have seen 14 straight months of non-farm payroll growth and 21 straight months of private-sector job growth. This growth has continued despite the headwinds from ongoing layoffs by state and local governments. Federal government employment has been little changed on net, other than temporary hires for the 2010 Census.

Our expectation is that private-sector job growth will continue, but likely in the neighborhood of 125,000 to 150,000 jobs per month—considerably lower than the 200,000 monthly average seen during periods of more robust growth. The latter is the level of job creation needed to bring down the unemployment rate.

With lackluster job growth through 2011, the headline unemployment rate has remained in a tight range of 9 percent to 9.5 percent for most of the year, falling to 8.6 percent in November due to a large drop in the size of the labor force. Unfortunately, given our expectation for sub-2 percent growth in 2012, we expect we will remain near that range this year as well.

Part of the analysis we did to reach that forecast was take a closer look at other unemployment measures. As shown in Figure 2, in addition to the headline unemployment rate, the BLS also reports a broader “U-6” measure.

The headline measure counts as “unemployed” only those without a job who actively sought work over the course of the month. The U-6 measure adds in those discouraged workers who stopped looking, as well as workers who may have taken part-time work, even though they wanted to work full-time. It also includes others who are only marginally attached to the labor force.

The U-6 measure, which has ranged from 15 percent to 17 percent during 2011, indicates there are many more individuals who may seek work if job openings pick up. With even the modest growth we are anticipating in 2012, coupled with the potential termination of certain unemployment benefits, we expect some of these workers will be drawn back into the job market. As a result, we may see increases in the headline unemployment rate—at least over the first half of the year.

For 2012, we anticipate the unemployment rate will average 9 percent, before falling to 8.5 percent by the end of 2013, given the stronger anticipated growth in that year.

If the United States were to fall back into recession as a result of a conflagration in Europe, the unemployment rate would likely once again top 10 percent. On the other hand, if we get a housing-led pickup in growth, we could see the unemployment rate fall closer to 8 percent by the end of 2012.

Regardless of the path, it will be a slow descent from these extraordinarily high unemployment rates, and a slow climb back to the level of jobs and paychecks the economy enjoyed prior to the recession.

## Rates and alternative paths

Weak growth, high unemployment rates and mild infla-

**Weak growth, high unemployment rates and mild inflation will prevent the Federal Reserve from increasing its short-term rate target until at least the end of 2013.**

tion will prevent the Federal Reserve from increasing its short-term rate target until at least the end of 2013. With short-term rates locked near zero, and with the Fed continuing to buy Treasury and mortgage assets as part of its quantitative easing programs, there will be downward pressure on long-term rates in the first part of 2012.

However, by the middle of 2012 and into 2013, longer-term rates should begin to trend upward in response to the accelerating recovery and in anticipation of rising short-term rates. Mortgage rates, too, will be slowly climbing from record lows.

Mortgage rates will follow the path for Treasury rates, likely averaging 4.7 percent through 2012, before topping 5 percent in early 2013 (see Figure 3). This compares with rates closer to 4.2 percent as of early December.

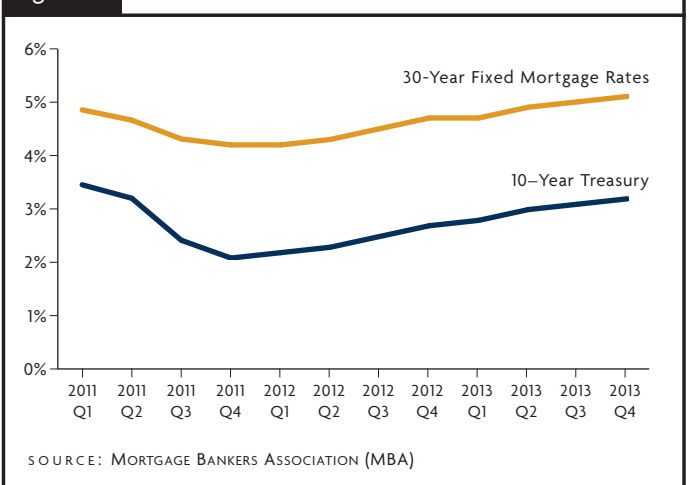
At any other time in the last 50 years, sub-5 percent mortgage rates would be considered incredibly low, but relative to the valley we have been in, a 30-year fixed rate of 4.5 percent will not impress many borrowers.

In addition to watching the economic and housing market data, we spend even more time these days tracking and evaluating proposed policy changes and communications to the public by Fed and other government officials.

The Federal Reserve’s outlook was slightly more downbeat in November and there was even a “dovish dissent” with Federal Reserve Bank of Chicago President and Chief Executive Officer Charles Evans in favor of more activist policies to promote economic growth. While the Federal Open Market Committee (FOMC) did not announce any new initiatives at the time, the committee noted it is ready to take action where necessary.

More recently, however, in a joint announcement with a group of other central banks including the European Central Bank (ECB), Canada, England, Japan and Switzerland, the Federal Reserve announced a coordinated effort to facilitate liquidity in global financial markets. This

**Figure 3** MBA Rate Forecast for 2012 and 2013



was a preventative measure in the event the debt situation in Europe causes a sudden and severe deterioration in financial conditions.

Around Thanksgiving, the fiscal supercommittee tasked by congressional leadership and the administration with reducing the U.S. budget deficit announced it could not come to agreement on any planned deficit reductions. With this failure, there is a risk of sharp cuts in federal government spending in 2013—more severe than they would have been under supercommittee proposals. As of press time, Congress still had not determined whether to extend the payroll tax cuts and extend unemployment benefits into 2012, or whether to act to forestall some of the automatic cuts. Policy gridlock certainly adds to the uncertainty in the economic outlook.

We also saw the announcement of a second phase of the Home Affordable Refinance Program (HARP), commonly being referred to as HARP 2.0, which is aimed at helping higher loan-to-value (LTV) and underwater borrowers ease some of their payment burdens. The expanded program began on Dec. 1, 2011, and runs through Dec. 31, 2013, and is for loans that were purchased by Fannie Mae or Freddie Mac before May 31, 2009.

The new guidelines removed the LTV cap, eased the requirements for appraisals and provided additional relief from reps and warrants on the original loan. If the revised refinance program succeeds, it will not only provide additional cash flow to borrowers, but also reduce the chance of more mortgage defaults and other related consequences.

#### Housing market including shadow inventory

Even with historically low mortgage rates and housing affordability near all-time highs, housing demand and

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home sales have remained weak. As a result, even though the pace of new construction remains quite slow, there continues to be an overhang of housing inventory. In fact, the inventory of new homes is at its lowest point in the last 50 years, with only about 160,000 new homes for sale across the country.

As of October 2011, there were 3.3 million existing homes for sale, down from a peak of more than 4.5 million in 2007. Many current owners have been hesitant to list their homes for sale as prices continue to drop.

Going forward, these owners and their homes, a tremendous pent-up supply, are the most important variable for the market, as any upturn in prices could potentially lead to a flood of new listings, cutting off price gains before they are truly established.

We expect the pace of home sales in 2012 to be little changed from 2011, with close to 5 million existing-home sales and 350,000 new-home sales.

Home prices should reach a trough by midyear before beginning to slowly increase in the latter half of the year. Of course, all housing markets are local, so some areas will see gains throughout the year while others will have to wait until 2013 before reaching a bottom.

As shown in Figure 4, the share of home sales that were distressed sales (foreclosure sales, short sales) remained quite high through 2011—roughly 30 percent nationally, and much higher in certain markets. However, the shadow inventory—the set of distressed loans likely to end up in the market as distressed sales—is both falling and becoming more concentrated in just a few states.

#### Foreclosures and delinquencies

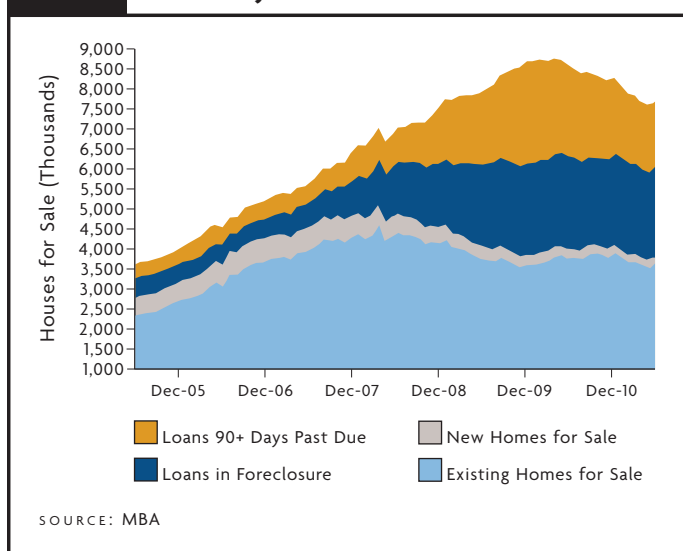
The overall delinquency picture is improving as short-term delinquencies declined in the third quarter's data. However, we are starting to see some quarterly increases in new foreclosures started, driven by the ending of loss-mitigation review periods and other state remediation programs and foreclosure moratoria.

There is a continued divergence in trends for states with judicial foreclosure systems and those with non-judicial systems. While there has always been a disparity in the level of loans in foreclosures under the two systems, we are seeing a divergence of late that is strongly linked to the foreclosure regimes and the speed at which loans enter and exit the process.

States with a judicial foreclosure system are seeing a greater backlog of loans in foreclosure because loans entering the process are not able to be resolved quickly enough. This is despite the fact we have seen a decline in new foreclosures for a few quarters.

Foreclosure starts increased by 12 basis points to a quarterly rate of 1.08 percent for the third quarter 2011 and the increase was the first in a year, after the starts rate had declined for three straight quarters. The percentage of loans in the foreclosure process was unchanged at

**Figure 4** Inventory of Homes for Sale Plus Shadow Inventory



4.43 percent but is still the lowest in a year.

This overall picture, however, masks some significant differences among states. Twelve states saw an unchanged level or a decrease in foreclosure starts for the quarter. Among those states, New Jersey, Arkansas and Washington were a few that had significant decreases across all loan types—an implication that there might have been state-specific factors causing what might be a temporary stop on the initiation of the foreclosure process. These states also saw significant increases in the percentage of loans that are 90-plus days delinquent, which is typically where loans waiting to enter the foreclosure process are parked.

Similar to the second quarter, the top five states in terms of the number of loans in foreclosure account for more than 52 percent of the national total in the third quarter of 2011.

By loan type, this top-five share is more than 50 percent for prime and subprime fixed-rate loans, is almost 69 percent for prime adjustable-rate mortgages (ARMs) and 56 percent for subprime ARMs. Four out of these five states are states with a judicial foreclosure system.

Only 10 of the 51 states have a foreclosure inventory rate that is higher than the national average, with nine of those being judicial foreclosure states. The distribution of the foreclosure starts rate by judicial and non-judicial states does not show much of a pattern.

The stock of loans in foreclosure weighs on home prices and home-price expectations, and in combination with a weak and fragile job market, is holding down a more robust recovery in the housing sector.

We are descending from the summit in terms of the shadow inventory of distressed loans as we gradually work through the problems created during the boom.

As of the third quarter of 2011, 86 percent of seriously delinquent loans were originated prior to 2008 (see Figure 5). This pool of problem loans will continue to be resolved, and we expect that delinquency and foreclosure rates will be lower by the end of 2012 than they are today, with the acknowledgement that there will be fits and starts of foreclosure activity through the year. Sometimes you have to hike sideways for a while to find the safest way down.

### Purchase-market trends

What do we expect in terms of the composition of the origination market? As rates slowly rise, we expect refinance volume to fall, slowly moving the industry toward a purchase market—although purchase and refinance activity are likely to be evenly split in 2012.

Following that, 2013 will likely be a true purchase market, with the refinance share of originations dropping to 30 percent.

In the purchase market, we anticipate that the product mix will continue to be plain-vanilla mortgages as it has been in 2011. In November, 85 percent of purchase mortgage applications were for 30-year fixed-rate mortgages (FRMs), with 7 percent for 15-year fixed loans, 5 percent for hybrid ARM loans and the remainder for other products.

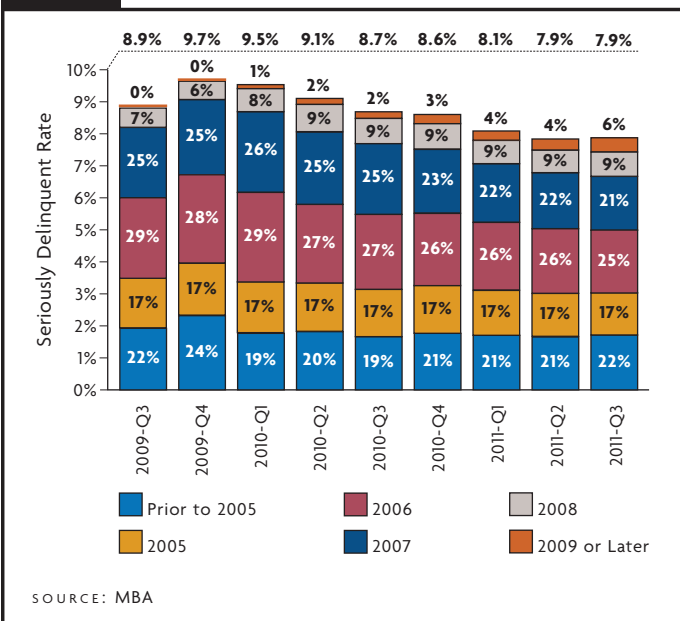
There is also a sizable portion of the market attributa-

ble to government-insured loans, with 42 percent of the purchase market consisting of government lending, including FHA, Department of Veterans Affairs (VA) and U.S. Department of Agriculture (USDA) programs. As the loan limits on FHA are now higher than those for the government-sponsored enterprises (GSEs) in high-cost markets, and as FHA continues to be the primary source of financing for first-time homebuyers, we expect that this share of the purchase market will remain high in 2012.

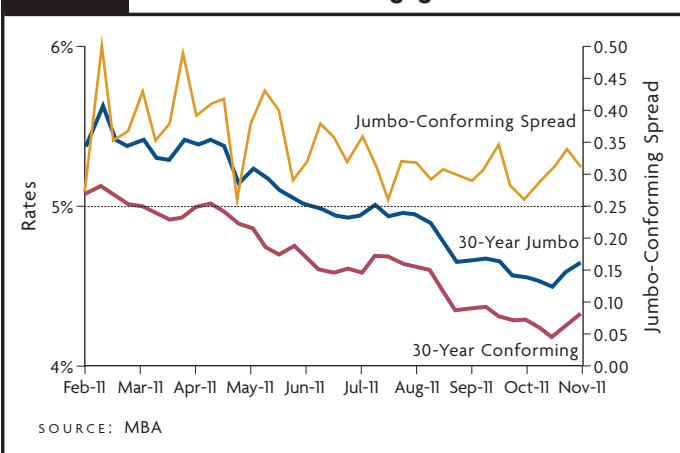
Investors and second-home buyers remain a steady but important source of housing demand, with 6.4 percent and 5.7 percent of November purchase applications, respectively. However, this share varies considerably across the country. In Florida, for example, the investor share was 5.6 percent in November, while the second-home share was 13.1 percent.

In terms of loan size, given the uncertainty and changes to the conforming loan limits, we have been closely watching the \$625,000 to \$729,000 bucket. In sum,

**Figure 5 Seriously Delinquent Loans by Origination Year (Non-Seasonally Adjusted)**



**Figure 6 Spread Between Conforming and Jumbo 30-Year Fixed Mortgage Rates**



loans are still being made in this category but production is not keeping up with the lower-balance portion of the market, and this bucket has seen an increase in ARM share as most of these loans are destined for portfolio lenders.

MBA's Weekly Application Survey now also includes mortgages for 30-year jumbo loans and 5/1 ARMs. The jumbo-conforming spread was stable in 2011 between 30 and 40 basis points, as shown in Figure 6. There seems to be increasing competition among portfolio lenders for prime jumbo business, even in the absence of a securitization channel for these loans, so we expect that the new larger jumbo sector will be served at perhaps only somewhat higher rates.

**The net result for our industry will be purchase originations that are little changed from 2011, and a falloff in refinance originations.**

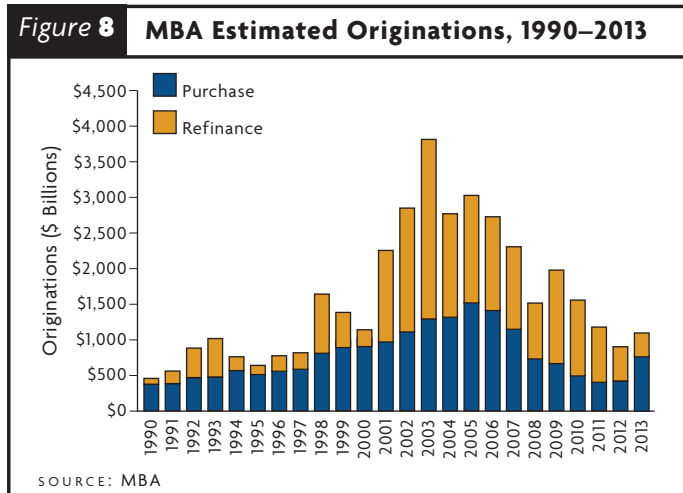
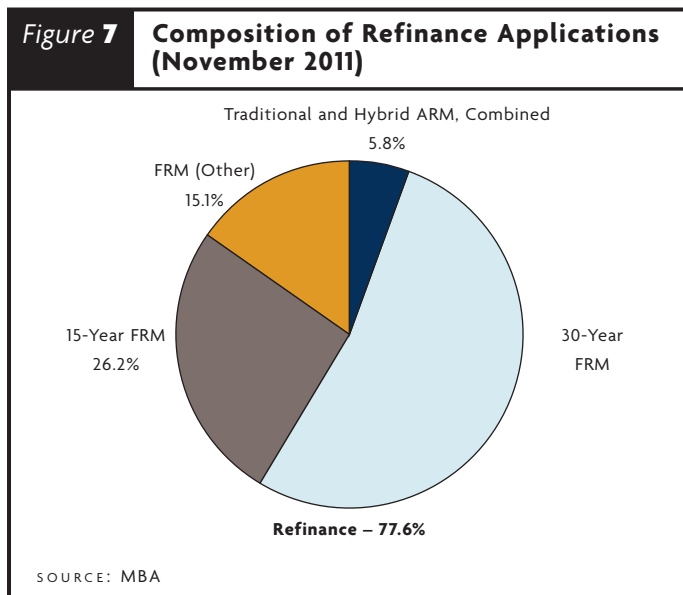
at the time would support.

In terms of the composition of the refinance business, the market is very much dominated by the 30-year fixed and 15-year fixed products, as shown in Figure 7. We expect the heightened share of 15-year and other shorter-term, fixed-rate loans will continue (and perhaps go even further, spurred by the HARP 2.0 program, which incents borrowers to move to shorter terms).

If the administration's objective of 900,000 loans to be impacted by HARP 2.0 is realized, it should add another \$25 billion to refinance volume per quarter, spread over the next two years. This is a measurable increase, but does not change our prediction

### Refinance market trends

In terms of refinance production, our expectation is that many applications taken in the fourth quarter of 2011 will not close until the first half of 2012—meaning that refinance origination volume in 2012 will be higher than rates



of a slow decline in refinance volume over this period.

### A slowly improving market

Summing it all up, 2012 will most likely bring a growing economy, but a still-weak job market; low mortgage rates, but rates that are trending upward; and a slowly improving housing market. The net result for our industry will be purchase originations that are little changed from 2011, and a falloff in refinance originations. In terms of total production, we are anticipating the slowest year since 1997, as shown in Figure 8.

What if the economy takes one of the alternative paths we outlined? If the United States falls back into recession and unemployment jumps again, we expect that purchase volume will fall short of our prediction.

Mortgage rates would be likely to stay lower for longer, but we are already approaching limits in terms of how low 30-year instruments can get in a world with 3.5 percent inflation and trillion-dollar budget deficits. Therefore, while refinance volume would come in higher than predicted, it would probably not be enough to offset the decline in purchase volume, given the level of burnout we have already experienced.

On the other hand, if we get faster growth due to a housing market that perks up faster than anticipated, purchase volume would come in somewhat higher, at marginally higher home prices. With faster growth would come a more rapid increase in mortgage rates, both from a shift in the potential timeline for Fed action and as inflationary pressures rise. This faster increase in rates would likely cut into refinance volume, somewhat offsetting the gain in purchase business.

Either way, total production is likely to remain quite low by historical standards. And even though the number of distressed loans continues to decline, servicers will continue to be hard-pressed to handle the volume. A tough year, indeed.

Happy New Year! **MB**

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