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PODCAST: US Housing Market: Are There Cracks in the Foundation?

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The US housing market is starting to cool off a bit, but the big question is whether there are cracks in its foundation. Paul Varunok, head of Securitized Assets with Franklin Templeton Fixed Income Group, shares his view on our latest Talking Markets podcast. He discusses the state of the US housing market today and why he doesn't see a repeat of the housing crisis that hit the US market a decade ago. He also shares some thoughts on where he's finding opportunities as an investor in the space.

Here are some highlights of Varunok's views presented in the podcast:

- Rising mortgage rates represent a headwind for some home buyers, particularly first-time home buyers that are struggling just to get a down payment. But, there's a large millennial cohort coming into the prime home-buying age. We think that demographic should continue to give tailwinds to the consumer and to the home buyer.
- Overall, there has been peripheral slowing in the housing market, especially on the coasts, but we still have some positive tailwinds for the consumer. US unemployment is at a 50-year low and growth in the economy is still respectable.
- Leading up to the financial crisis a decade ago, there was a lot of leverage in the housing sector. There were a lot of products being availed to people that probably should not have gotten mortgages. Banks, in general, have cut back on home-equity lending except to the very high credit quality. In contrast to a decade ago, by and large, they are requiring a 20% down payment on a home purchase.
- From an investment standpoint, we like mortgage credit, and we have found opportunities in the single-family rental markets, the credit risk transfer area and the agency mortgage-backed securities market.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to a new episode Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I'm your host, Richard Banks.

Ahead on this episode—concerns in the US housing market. Paul Varunok, Head of Securitized Assets, Franklin Templeton Fixed Income Group, breaks down what's causing the cooling, and how it's significantly different from the financial crisis.

Kristine Hurley: Thanks Richard. Paul, thank you for joining us today. Generally, a healthy housing market underpins a healthy economy. We are seeing some pretty negative news, it seems, around what's been going on with the US housing market. Is it as bad as some of the headlines might seem or is it misleading?

Paul Varunok: I think some of the headlines are misleading. What you have had since the financial crisis [of 2007-2009] after the big drawdown in the housing market, some particular areas have done a lot better than others in terms of home price appreciation, and what we are seeing now is a little cooling in those areas, particularly on the coasts. So if we look at housing overall, just recent numbers in November, some of the positives—building permits were up, existing home sales were up, Case-Shiller Home Price appreciation was about 5%—all very positive. On some of the negative sides, and what you are hearing about, is affordability and [mortgage] rates over 2018 went up about one full percentage point from about 4% to 5% and that's constrained affordability. And with home price appreciation increasing 4-5% a year over the last seven years, wages have not kept up with the pace of home price appreciation, so I think those are some of the negatives that you are hearing. It's a little more of a cooling than a drastic slowdown.

Kristine Hurley: With mortgage rates moving higher, you are hearing a lot about how, for some first-time home buyers, these are the highest rates that they have ever seen. Is that going to be a big constraint on the market going forward?

Paul Varunok: It's certainly a headwind. If you look the median home price is about $230,000 in the United States. People on the coasts feel that is a very foreign number because you are looking at averages closer to $400,000-$500,000. So, a move in one percentage in terms of the median home price, those mortgages that are $230,000 means a monthly payment extra of a $125. As you go up in dollar amounts, if you are going for a $400,000 mortgage, that means $250 per month extra, and those are after-tax dollars. So that can really, kind of constrain some of the first-time home buyers that are struggling enough just to get the down payment.

Kristine Hurley: So when you look at that median home price, that's on a national basis obviously, but skewed when you look at the center of the country and the coasts but, what is happening with home prices overall and what are driving those trends?

Paul Varunok: Home prices, in general, in 2018, should end approximately up 5%, and if you look at long-term averages, the long-term average over the last 20 years—you have had some very high home-price appreciation years and some very low with the drawdown after the financial crisis—but long-term average is about 4.2% since 2000. So that's a reasonable number, and if you go back to say 1980, it's only a little bit lower than that—between 3.5% and 4%. And 2019 estimates are all over the place, but we expect home prices to be up between 3% and 4%[1]. Now if rates were to go back up, we would think that we would be at the lower end of that 3% to 4% in 2019. So overall, my view on the housing market is, yeah, we have seen some peripheral slowing, especially on the coasts, but we still have some positive tailwinds for the consumer and the new home buyer or the home buyer in general. You have unemployment that's at a 50-year low, you have growth in the economy that is still respectable. We would expect about a 2% GDP growth for 2019—thereabouts. Wages growing around 3%, and a large millennial cohort coming into the prime home-buying age. That demographic should continue to give tailwinds to the consumer and to the home buyer.

Kristine Hurley: You do hear a lot about how that cohort wants to experience things more than own things. Has that played into any trends in renting versus owning?

Paul Varunok: Sure. Certainly after the financial crisis, we saw many more people renting and homeownership got down to a low. Since that time, over the last few years, we have seen homeownership rates go up and rentership go down. The millennials were right in the crosshairs of the financial crisis, so they were really taken aback by the decline in home prices when they have been taught their whole lives that home prices only go up. That turned out not to be the case on a national basis following the financial crisis. As time goes on and these millennials start forming families and household formation is positive we believe that they will have a higher take-up on homeownership, and we are starting to see that turn the corner now.

Kristine Hurley: So you talk about how it's a slowing market but we are still seeing home price appreciation just at a lower level. It still seems supportive. As the headlines do focus a little bit more on the negative, you do have questions resurging about the 2007-2008 experience. How is this different than the housing crisis?

Paul Varunok: It's hard to draw a parallel between the two timeframes. Leading up to the financial crisis, there was a lot of leverage in the housing sector. There were a lot of products being made available to people that probably should not have gotten mortgages, you know, in terms of low down payment mortgages, silent seconds, floating rate and all these other products. On top of that they were being packaged into securities and sold off to investors, so there was very little alignment of interests between the mortgage originator and what happened to that mortgage at the end whether it defaulted, the mortgage originators generally didn't care because they were selling it off to another product. So, without getting too far in the weeds, those products made available to mortgagees or borrowers are no longer available, and the securitization of those products are no longer really happening to any large extent. I would say those with low credit scores have been largely locked out of the market where before the financial crisis, they had pretty easy access to gaining mortgage financing. Now what we are starting to see is non-bank lenders come into the market, and this is where, you know, leverage can start increasing. Now they are not a major part of the market yet, but I'm always looking for where the leverage is in the market and whether that leverage is being correctly priced. So I look at some of these non-bank lenders and what's their skin in the game in terms of making these loans when a lot of these loans are being passed off to investors. So maybe not done in a securitized vehicle but still being passed off, and whether that leverage is being compensated for. So it's something that I watch. I don't think it's a major part of the market right now but it's something that we keep our eyes on in terms of looking at delinquencies and losses in those types of products.

Kristine Hurley: You are also starting to hear more about home equity loans. Is that something that should be a concern?

Paul Varunok: I don't think just yet. Again, the home-equity loans that many people think of are pre-crisis products that were really less home-equity loans, and more just outright loans made to subprime borrowers. And those typically came with very little down.

Again, the borrower had very little skin in the game, the originator had very little skin in the game, and it was sold off to some securitized vehicles, and that left the overall risk with the ending investor. Those products are really not as available as they were, as I was just saying. The home equity [loans] that we are seeing taking out are more along the lines of agency mortgage-backed securities. What we are seeing is—I don't think this is a bad thing, and you see this every time home price appreciation really goes up—is that those with good credit scores that will fit into the agency underwriting box—either Fannie Mae or Freddie Mac and to a lesser extent Ginnie Mae—will refinance your loan and take out a larger loan. That's a way of tapping the equity in the house, and it may be at a higher rate, which, all else equal, you would say, "well, why would you take out a mortgage at a higher rate?" Because they are tapping that equity, and we are seeing more of that, and we watch those trends, and we don't think they are alarming. Banks, in general, have cut back on home-equity lending except to the very high credit quality. Where we are seeing some of the home-equity lending is those non-bank originators that I mentioned before—a lot of the online originators and such—and it really depends what they do with those home-equity loans and whether they still have skin in the game after they originate them.

Kristine Hurley: From an investor perspective, what does all of this mean for you? Where are you finding opportunities?

Paul Varunok: I think from an investor standpoint, there are a couple of ways of looking at it. Our view is still generally positive on the housing sector, and so we like mortgage credit, and we have found opportunities in the single-family rental markets, a very small market, so most listeners probably haven't heard of it, and the credit risk transfer area, which is a derivative off of some of the Fannie Mae and Freddie Mac collateral.

On the other side—on a much larger market that's more prevalent and probably more familiar to many of the listeners would be the agency mortgage-backed securities market. And with higher rates, we are seeing a slowdown in refinancing and refinancing in the agency mortgage-backed securities market is typically your number one risk because you get your money back sooner than you anticipated. As rates go down, people refinance their mortgages, and then, as an investor, you have to deploy that money at a lower rate, but what we are seeing is some of that risk come out of the market with the higher rates and only about 8% to 10% of the market is currently refinanceable. So from an investor standpoint, we still like mortgage credit and we like prepayment risk on agency mortgage-backed securities. You do have other considerations such as the Fed [Federal Reserve] and their involvement in terms of their balance sheet with mortgage-backed securities, but generally we still like mortgage and mortgage credit.

Kristine Hurley: When we go into another recession, whenever that may be, what does that mean for the housing market? Again, 2008 is the most recent experience and people have expectations.

Paul Varunok: Yes, again, I think 2008 is a tough parallel to make because most of the mortgages that are being produced now are those mortgages that have 20% down. So you have to put 20% of the home price down for the bank to give you a loan, and generally, that's how they are securitized into Fannie Mae and Freddie Mac. Mortgages, generally—they are all 20% down. They do have other programs. Again, Ginnie Mae is less so—they are more for first-time home buyers. But that and the increase in regulation, risk-retention rules for those that securitize these products and just very tight underwriting have us at a better place than we were back in 2006 and going into the financial crisis where home price appreciation had been averaging in the low teens in the early 2000s and up to the financial crisis, so there was a lot more leverage baked into the system than we have seen and the housing market right now is only 12% above pre-financial crisis levels and that's after 10 years. So the appreciation, if you were to do a straight line, has not been that big, but the drawdown was very large and so was the recovery. But over time, if you average that out, it's more like 1% per year where the average over longer periods has been about 3.5% to 4%.

Kristine Hurley: For someone who might be looking to buy a home for the first time or someone who might be looking to move to a larger home and move maybe out to their first-time home, what trends or expectations would you relay to them?

Paul Varunok: I would say just to watch mortgage rates very carefully and explore different lenders. Now I did mention some of the online lenders but that could be a good source of capital, if they are willing to give you a loan. You look at Ginnie Mae, especially for the first-time home buyers, they have programs where you can have as little as 3% down, so they are there for home affordability. If you do have that 20% down, which is a large amount for a lot of people, then you'll have an easier access to credit. People are willing to give you those loans, I'd say keep your credit tight, meaning don't take out a lot of credit cards because that will affect your credit scores. And, make all your payments on time.

Kristine Hurley: Paul Varunok, head of Securitized Assets, thank you for joining us.

Host/Richard Banks: So that's it for this episode of Talking Markets with Franklin Templeton. Thanks to Paul and to Kristine. If you've enjoyed their insights and would like to hear more, check out our archive of previous episodes and subscribe on iTunes, Google Play, or just about any other major podcast provider. So until next time when we uncover more insights from our on the ground investment professionals, goodbye!

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