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Gazing Into the Future of the Housing Industry

How will QE3 affect the mortgage market — and the economy — in 2013?

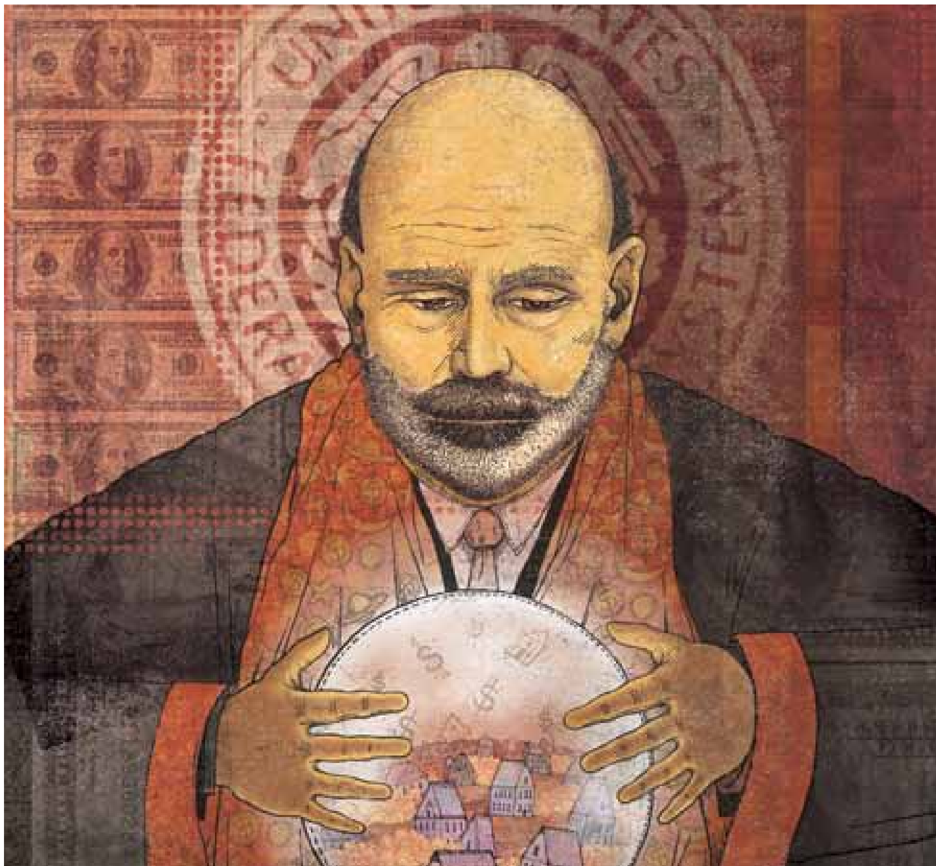

Illustration: Dennis Wunsch

This past September, following months of rumors and debate, Federal Reserve chairman Ben Bernanke announced plans to reignite the stalled economy with a third round of quantitative easing, known as QE3. This program is a game changer. The Federal Reserve has fired up the printing presses, opened the checkbook and is buying agency mortgage-backed securities (MBS) to the tune of $40 billion per month with no end in sight.

This forward guidance is expected to put downward pressure on long-term interest rates, but that's not the only effect QE3 will have. As 2012 draws to a close, what does the future have in store for the mortgage industry? What fortunes — or misfortunes — wait around the corner? ››

Although QE3 certainly will have an impact on the economic landscape of 2013, it's by no means the only piece of legislation that will affect the market. In addition, the Federal Open Market Committee (FOMC) surprised many by extending its so-called "operation twist" program until the end of this year, which allows them to sell shorter-term bonds for longer-term maturities in an effort to drive down interest rates. Additionally, the near zero interest-rate guidance has been extended into 2015.

That said, QE3 is drawing the bulk of the headlines. The FOMC has been clear regarding the intent of the program, stating its hope that QE3 will help improve the job market. Even if doesn't improve employment right away, the committee has said that it will continue to purchase agency MBS until improvement is achieved, an intent that reflects the committee's general commitment to ensure that inflation is at a rate that's consistent with its dual mandate to foster maximum employment and price stability.

Time and time again, history has shown us that even the best-laid intentions can lead to unintended consequences, so it's difficult to predict all of the effects that QE3 will have. Before considering some of the possible outcomes, however, let's take a look back at some of the recent developments in the industry and the economy as a whole.

Taking stock

Even before QE3, the housing market began showing signs of a winning streak after years of dismal data. Standard & Poor's

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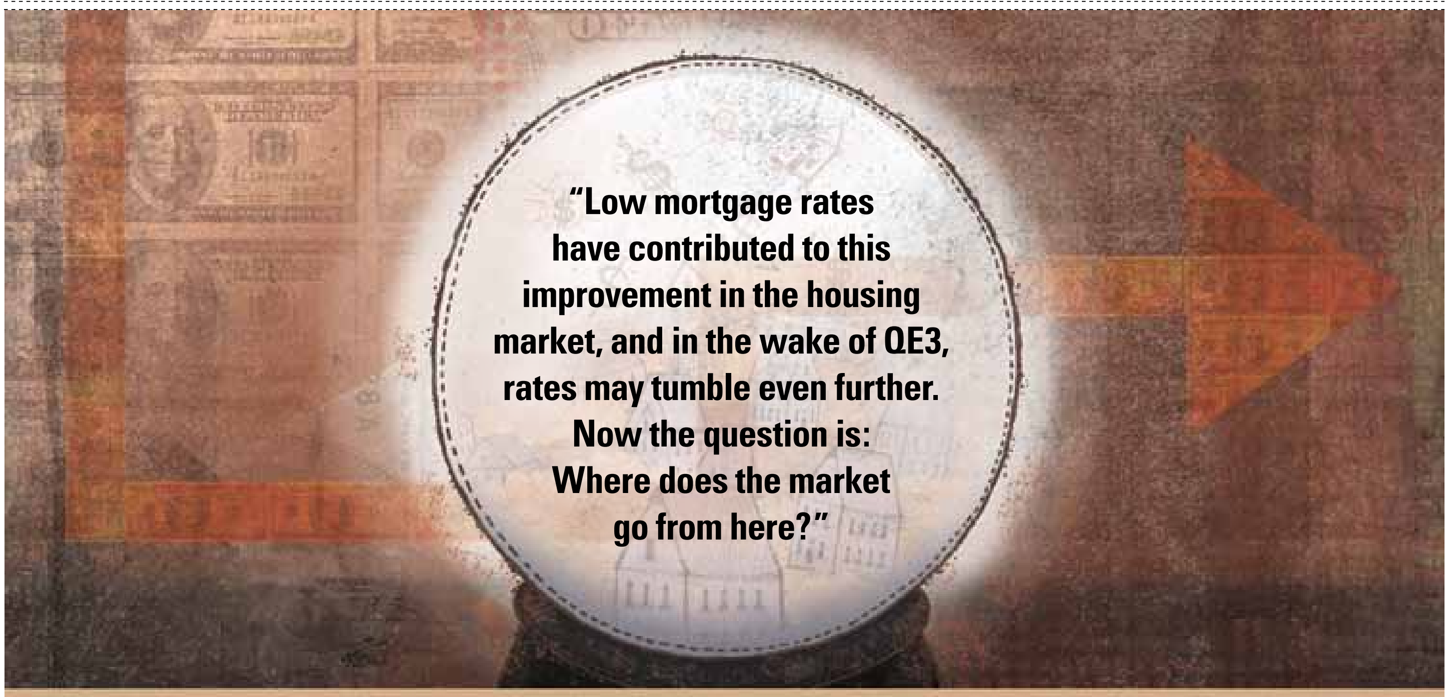

Case-Shiller home price indices continued to show improvements in the housing market at a national level. This past July, for instance, prices in 16 of the 20 cities in their 20-city composite index posted year-over-year increases.

Additionally, this past second quarter, the median price of existing single-family homes increased in 110 of 147 metropolitan statistical areas, according to the National Association of Realtors (NAR). Between second-quarter '11 and this past second quarter, the Federal Housing Finance Agency (FHFA) also reported a 2.4 percent improvement in their seasonally adjusted purchase-only housing price index. Meanwhile, NAR reported that distressed property sales were down 33 percent this past second quarter, which likely contributed to the increase in median prices across the nation. No matter which report you read, it seems as if they're all optimistic. Here are a few more highlights from NAR's recent reports:

- **Existing-home sales** showed signs of year-over-year growth this past second quarter by increasing 8.6 percent while existing inventory dropped by 24.4 percent.
- **New home sales** could reach 600,000 in 2013, which would be double the total of 2011.
- **Pending home sales** are at elevated levels compared to last year. The last time pending sales showed such strength was in spring 2010, when the tax-credit incentive encouraged homebuyers to act immediately to gain a tax break.
- **Housing starts** have been forecast to continue on an upward trend and reach 1.12 million in 2013.

These figures and findings have led many industry economists to feel optimistic about the country's recovery. In a recent release, Alex Villacorta, director of research and analytics at Clear Capital, said that the U.S. economy has finally gained some momentum this year.

"June home price trends provided further evidence that housing has turned the corner, with the momentum of the recovery picking up speed," Villacorta said. "Barring a major economic meltdown, we expect to see this organic growth sustain and strengthen throughout the end of [2012]."

Lower rates

Low mortgage rates have contributed to this improvement in the housing market, and in the wake of QE3, rates may tumble even further. Now the question is: Where does the market go from here?

MBS purchases of this magnitude can add support to the market and deliver a dose of confidence among traders. The increase in buying activity in the bond market can push MBS prices even higher and mortgage interest rates even lower.

Although lower rates benefit the housing market, they also lead to more refinances, which is a major boon for current homeowners. This past year, multitudes of homeowners took advantage of low interest rates and refinanced their mortgages, and the onset of QE3 may bring even more refinances in the coming year.

Being able to refinance at lower rates surely benefits homeowners, but there's invariably a price to be paid in the financial markets. That's because refinancing, curtailments, full-debt retirement and defaults all produce prepayments. And, when these hit the market, investors remaining interested in the MBS pool are reduced by the prepayment amount.

Investors then have a choice: either continue to focus on the fixed assets of the bond market, or put their money to work in the riskier stock market. With the recent refinance activity surging to high levels, the flood of prepayments coming back into the bond market could hurt prices — and if so, rates may creep higher again. In addition to prepayments, many other factors can contribute to the seesaw action often seen in the mortgage bond market. The escalating economic crisis in Europe, developments in

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the domestic job market and the ongoing actions of the Fed will influence the direction of MBS. In particular, good news from Europe may hurt U.S. bonds, but bad news may prove beneficial to them, at least in certain respects.

Jobs and inflation

In 2013, the job market undoubtedly will continue to garner much attention, as well as continue to affect the bond market. QE3 will only intensify that attention, as all eyes will be watching its ability to stimulate job growth.

Why does the job market wield such an influence on the bond market? In short, when the job market is strong, people often feel better about their own economic situations and are more likely to spend money and buy homes. Further, a strong job market generally produces higher wages, which also results in increased confidence. This helps to fuel the industry and the economy as a whole.

If the job market isn't doing well, however, people tend to worry about their employment and worry about their ability to find comparable livelihoods should they lose their jobs. In addition, fewer jobs produce less spending in the economy — and less tax receipts — and weakness in the job market usually leads to wage stagnation. All of these factors create uncertainty, which drives investors to the safe haven of bonds. Confidence, however, encourages them to leap into the riskier assets of the stock market.

According to data from the U.S. Department of Labor, more than 1.8 million jobs have been added within the past year, although this still represents fairly anemic growth. According to a recent statement, Bernanke will be looking for "substantial improvement" in the labor markets before he considers taking the economy off of life support. Sustained economic recovery largely is dependent on a healthy housing market, but a healthy housing market requires jobs, making QE3 all the more vital.

As far as inflation is concerned, the Fed's target zone for inflation is 2 percent, and levels have been relatively tame as of late. That noted, however, if not closely watched and managed, inflation could come back with a vengeance and result in unintended consequences. A sign of this came shortly after the announcement of QE3 this past September, as inflation expectations rose to their highest level since May 2006.

Numerous industry economists have shared their concerns that QE3 could lead to higher inflation. The challenge with inflation is that it often can become uncontainable quickly. Although inflation isn't an immediate threat, if it becomes less stable it may cause investors to seek out the higher returns of the stock market, thereby weakening bond prices and driving mortgage rates higher. As signs of inflation begin to show up in consumer prices, mortgage rates may suffer even with the Fed's purchasing power at work.

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The Fed is committed to this latest round of quantitative easing for as long as it takes, saying that an accommodative monetary policy will remain necessary for a "considerable time" after economic recovery strengthens. This certainly is noteworthy, but what does it mean in the long term? What constitutes a substantial recovery, and what represents substantial improvement in jobs? Perhaps even more pressing, how long is a "considerable time" after recovery strengthens?

This new version of an old Fed program may have your head spinning — and rightly so. Ultimately, no one has a complete picture of the ramifications that QE3 will bring. Within the industry, there has been some concern that U.S. monetary policy has been too easy for too long, and a growing number of economists are warning that more quantitative easing will not have any effect on employment and may do more harm than good. What will happen when it stops? Will there be a self-sustaining recovery?

Thanks to the Fed's enormous commitment, mortgage rates likely will continue to remain low for an extended period of time, making homes more affordable, boosting sales and dropping inventory. Beyond this, however, QE3 may lead the market into uncharted territory, for better or worse. ●

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