

Housing Suffering Relapse Confronts Bernanke Credit Conundrum

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The recovering housing market may be heading for a relapse as President Barack Obama and Federal Reserve Chairman Ben S. Bernanke consider ending support for the source of the global financial crisis.

The Obama administration is studying whether to let a first-time home buyers' tax credit expire as scheduled at the end of November. Bernanke and his Fed colleagues may continue talking this week about how to wind down purchases of mortgage-backed securities, according to Peter Hooper, chief economist at Deutsche Bank Securities Inc. in New York. The two programs have helped stabilize real-estate demand, with new-house sales rising 9.6 percent in July from the prior month, the most since 2005.

Ending these efforts may stifle the housing rebound by depressing sales and pushing up both mortgage-backed bond yields and interest rates on home loans, even in the face of the record-low zero to 0.25 percent short-term rates the Fed has engineered, said economist Thomas Lawler. A weaker housing market would likely dampen the economic recovery and undercut shares of builders including Fort Worth, Texas-based D.R. Horton Inc. and Miami-based Lennar Corp., that have risen 40 percent this year, based on the Standard and Poor's Supercomposite Homebuilding Index of 12 companies.

"Things could get ugly," said Lawler, an independent consultant in Leesburg, Virginia, who spent 22 years at Fannie Mae, a Washington, D.C.-based government-controlled mortgage-finance company. "We could be facing a triple whammy at the end of the year: the expiration of the tax credit, the end of the Fed mortgage-buying program and rising foreclosures."

Major Test

This is the first major test of policy makers' ability to coordinate exit strategies as they seek to wean the economy off government support, said Brian Bethune, chief financial economist of IHS Global Insight, a forecasting company in Lexington, Massachusetts.

They have already acted separately, with the administration ending its \$3 billion "cash-for-clunkers" automobile trade-in program on Aug. 24 and the Fed starting to wind down its purchases of Treasury debt, which totaled \$285.2 billion between March 25, when the initiative began, and Sept. 16.

The 55-year-old Bernanke and his colleagues, who meet tomorrow and Wednesday to map monetary strategy, discussed "tapering" off the Fed's purchases of mortgage-backed securities and housing-agency debt at their last gathering in August, according to the minutes of that meeting. No decision was made by the central bank's policy-making Federal Open Market Committee.

Mortgage-Backed Securities

Under the current program, the Fed is scheduled to buy up to \$1.25 trillion of mortgage-backed securities and \$200 billion of agency debt by the end of the year. So far, it has purchased \$862 billion of the former and \$125 billion of the latter.

A trio of Fed presidents -- Jeffrey Lacker of Richmond, James Bullard of St. Louis and Dennis Lockhart of Atlanta -- has publicly raised the possibility the central bank might not spend all the money authorized for the mortgage-backed securities. Lacker questioned whether the economy needs the additional stimulus in an Aug. 27 speech.

New York Fed President William Dudley, who is vice chairman of the FOMC, has sounded more cautious.

“The market expects us to complete these programs,” he said Aug 31. “To contradict that market expectation is a pretty high hurdle.”

Abrupt Stop

An abrupt stop might push up mortgage rates by a half to one percentage point, said Hooper, a former Fed official. Tapering off -- by reducing weekly purchases and stretching them beyond the end of the year -- would have a more muted effect, pushing rates up by at least a quarter percentage point, he said, adding that the Fed may announce just such a strategy after its meeting this week.

Mortgage rates for 30-year fixed home loans averaged 5.04 percent in the week ended Sept. 17, down from 5.07 percent the previous week, according to McLean, Virginia-based Freddie Mac, a government-controlled mortgage-finance company.

Borrowing costs for home buyers are relatively high based on the historical relationship with the Fed’s target rate for overnight loans between banks, currently at zero to 0.25 percent.

The yield on the benchmark 10-year Treasury note is 3.22 percentage points more than the federal-funds rate, compared with an average of 1.45 percentage points during the past 20 years, according to data compiled by Bloomberg. Thirty-year mortgage rates average 1.69 percentage points more. While that is down from 3.19 percentage points in December, it is still above the average of 1.4 percentage points for this decade before the credit markets seized up in the second half of 2007.

Fed Purchases

The Fed’s purchases of mortgage-backed debt so far this year have dwarfed net issues of such securities by Fannie Mae, Freddie Mac and government-run mortgage-bond insurer Ginnie Mae, which totaled about \$440 billion through the end of August, said Walt Schmidt, a mortgage-bond strategist in Chicago at FTN Financial.

Once the Fed exits the market, the spread between yields on mortgage-backed debt and Treasury securities will have to rise, perhaps by a half percentage point, in order to attract other buyers, he said. The spread now is about 140 to 145 basis points, down from around 215 at the start of the year.

“One of the key linchpins to the restabilization of our economy is getting housing back,” said Laurence Fink, chairman and chief executive officer of New York-based BlackRock Inc., the largest publicly traded U.S. money manager. “There is a great need” for the Fed to “continue to invest in the mortgage market right now,” added Fink, 56.

Crucial Extension

A number of Washington-based organizations -- the National Association of Home Builders, the National Association of Realtors and the Mortgage Bankers Association -- say an extension of the buyer’s tax credit is also crucial.

Lawrence Yun, chief economist of the realtors' group, estimates that about 350,000 home sales through August were directly attributable to the tax credit of up to \$8,000 for first-time buyers.

Treasury Secretary Timothy Geithner, 48, called signs of stabilization in the U.S. housing market "very encouraging" and told reporters on Sept. 17 that the Obama administration will take a "careful look" at extending the credit.

Congress may not pass an extension; the chances "seem slim," said Mark Calabria, director of financial-regulation studies at the Cato Institute in Washington and a former staffer on the Senate Banking Committee. Public opposition to increasing the federal budget deficit is high, and there's little appetite on Capitol Hill for finding spending cuts to offset the cost of the tax credit, he said.

Fastest Pace

The deficit will total \$1.6 trillion this year as revenue falls and the government spends at the fastest pace in 57 years, according to the nonpartisan Congressional Budget Office.

In a sign of the public's concern about the deficit, 62 percent of people surveyed in a Sept. 10-14 Bloomberg News poll said they would be willing to risk a longer-lasting recession to avoid more government spending.

The impact of terminating the tax credit will show up first in the new-home market, said David Crowe, chief economist of the home-builders' association.

"It takes at least four months to build a house, and you need to buy it before Dec. 1 to qualify," he said. "If you haven't started building it by now, it's too late."

Housing Starts

Single-family housing starts fell 3 percent in August to a 479,000 annual rate -- the first decline since January -- according to seasonally adjusted figures in a Sept. 17 report from the Commerce Department.

Residential construction and home sales led the way out of the previous seven recessions going back to 1960, according to David Berson, chief economist of PMI Group, a mortgage insurer in Walnut Creek, California. Real-estate sales fuel consumer spending, which historically accounts for about 70 percent of gross domestic product, he said.

"Housing has been the sector of the economy with the largest multiplier effect," said Berson, former chief economist at Fannie Mae. "Whether buying new homes or existing homes, people tend to fill them up with things: new furniture, new appliances, and new window coverings."

To be sure, some economists are betting the housing recovery is here to stay. The market has "clearly bottomed," said Dean Maki, chief U.S. economist for Barclays Capital in New York. Even some of the optimists are hedging their bets given how dependent the market has been on government and central bank support.

"I'm right in there with the rest of the cheerleaders, but there are no historical anecdotes, no historical data points to use for this," said Lewis Ranieri, the 62-year-old mortgage- bond pioneer who is chairman of New York-based Hyperion Partners LP. The U.S. housing market is "still very fragile."