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Downunder Daily

Re-fi Re-vive

Will falling long-end yields lead to a consumer-supportive mortgage refinancing boom in the US? There will be some response, but I think the boost will be much smaller than in the last cycle.

It's now attractive for a large number of mortgages to be refinanced, given the fall in long-end yields. Exhibit 1, courtesy of colleague Janaki Rao, shows the distribution of outstanding agency mortgages (prime, conforming mortgages). Over 40% of these mortgages can be refinanced at current rates.

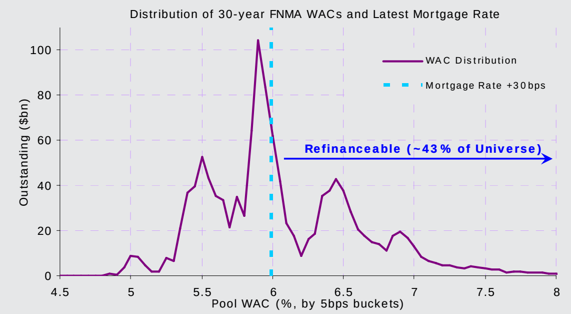
The ability to refinance a fixed-rate mortgage is one of the few free lunches in financial markets. Only a mug wouldn't. It is also one of the most powerful transmission mechanisms for monetary policy – although it obviously depends on falling long-end, not short-end, rates. Borrowers are now responding to the fall in mortgage rates: The index that measures applications to refinance mortgages has doubled over the past month, and is now at the highest level since the halcyon days of the 2003 refinancing boom.

This will provide some financial support to households. But that support is likely to be significantly less than seen in the previous cycle, for several reasons:

First, lending standards are being tightened, so while applications to refinance are rising, it's likely that some of those applications will be in vain. We have already seen this phenomenon with applications for a mortgage to purchase a home: Applications have been rising since late 2006, but sales keep falling (Exhibit 3).

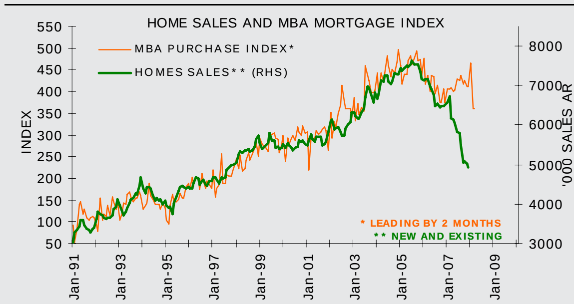
Second, refinancing in 2002-04 was associated with a surge in mortgage equity withdrawal (MEW). Borrowers increased their loan size when they refinanced, providing important stimulus. Now, however, there's much less scope to increase mortgages due to tighter lending standards and falling home values. There is simply less equity to extract.

Exhibit 1
In the Money!



Source: Janaki Rao; Morgan Stanley Research

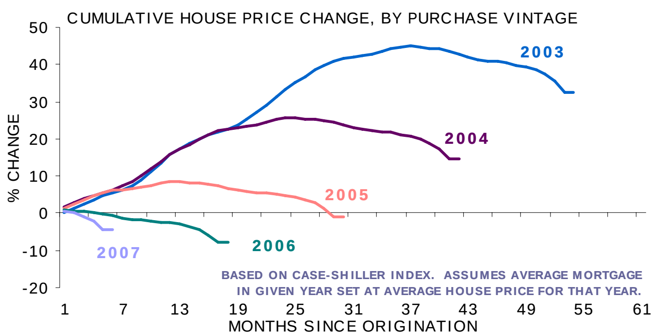
Exhibit 2
Don't Ask if a Refusal Offends



Source: NAR, MBA; Morgan Stanley Research

Exhibit 3 shows the change in house value by purchase year. The average house bought in 2005, 2006, and 2007 is now worth less than what the buyer paid. Houses bought in 2004 are, on average, up only 10%. This leaves little or no scope for equity withdrawal.

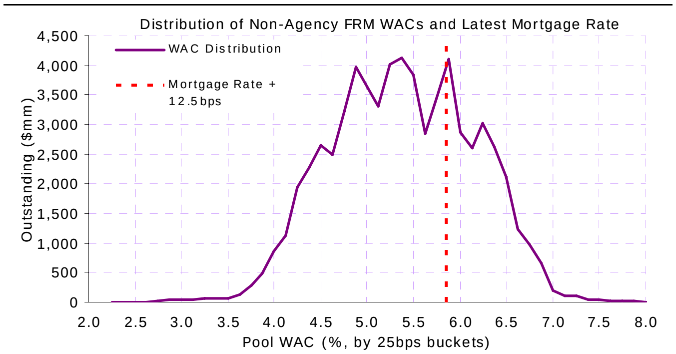
Exhibit 3
The Shrinking Scope for Equity Extraction



Source: Updated version of a chart that first appeared in Janaki Rao, *January 2007 Agency Prepayment Commentary*, 6 February 2007; Case-Shiller/S&P; Morgan Stanley Research

Third, while a large chunk of the conventional, conforming mortgage pool is eligible for refinancing, that's not true of the rest of the mortgage universe. Thirty-year jumbo mortgages, for example, were typically around 5½% in 2003-04, but are now being offered at over 6½%. Exhibit 4 shows the distribution of non-Agency fixed-rate mortgages.

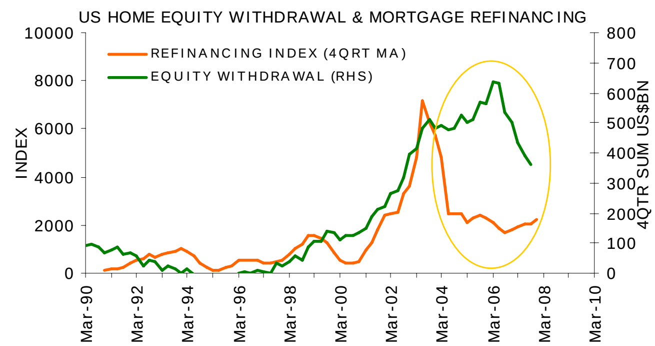
Exhibit 4
Not So Much Non-conventional Can Be Re-fied



Source: Janaki Rao Morgan Stanley Research

Finally, much of the monetary stimulus in the prior cycle came from mortgage equity withdrawal that was associated with turnover in the housing market, rather than refinancing. Initially, refinancing was important, but from 2004 onwards, there was a break between refinancing, which softened, and MEW, which stayed strong (Exhibit 5). What seemed to happen is that MEW was occurring as part of a property transaction: Typically, the borrower took on more debt than the seller paid down. As turnover boomed in the housing market, so did MEW.

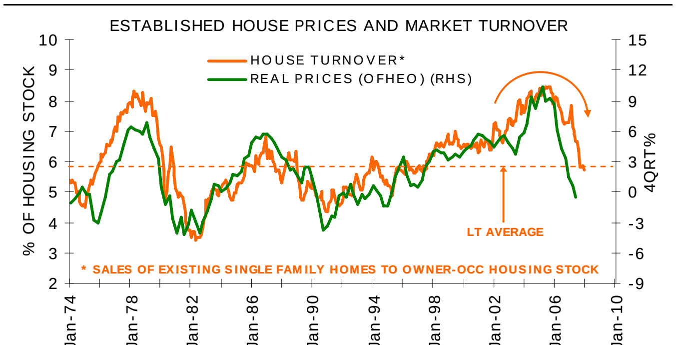
Exhibit 5
Mortgage Equity Withdrawal and Refinancing



Source: MBA, Federal Reserve; Morgan Stanley Research

However, as in any market, turnover tends to fall when prices weaken. Exhibit 6 shows the link between real house prices and market turnover. The weakness in prices will curb turnover, which, in turn, greatly reduces perhaps the single most important route for mortgage equity withdrawal.

Exhibit 6
Turnover Drove MEW



Source: OFHEO, BLS, NAR, Census; Morgan Stanley Research

This is all another way of repeating a point I made earlier in the week:: Monetary policy will be less effective in this cycle than it was in the last cycle. The Fed can cut, but the consumer won't respond in the usual fashion.

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