

Homebuilders

MBS call takeaways: Normalizing rate volatility could drive mortgage rates lower

Industry Overview

Takeaways from call with BofA MBS team

We hosted a conference call with Chris Flanagan, BofA Head of US Mortgage and Structured Finance Research, to discuss how recent events in the US banking sector could impact mortgage rates and the housing market. Our key takeaways include:

BofA MBS team expects mortgage rates to fall through 2023 despite recent spike in interest rate vol: BofA mortgage-backed securities (MBS) team expects mortgage rates to decline to ~5.25% by year-end 2023 (~6.5% today). Since the end of February, the 10-year treasury yield has declined to 3.4% from 4% but the 30-year mortgage rate is up 50bps. The mortgage spread to 10y UST has widened to 340bps compared to the long-term average of 160-170bps. Rate volatility (uncertainty) has gapped higher on Fed and bank MBS sales concerns. Our MBS team expects MBS spreads (and therefore mortgage rates) to decline as rate volatility normalizes from current elevated levels with clarity on Fed policy path and easing bank contagion risk.

Agency mortgage availability should not be impacted by tighter regional bank credit, but Jumbo origination could slow: Roughly 75% of mortgages are securitized. Out of the securitized mortgages, 97% are agency MBS that are guaranteed by US government agencies and do not carry credit risk (only prepayment risk). The privately securitized MBS market, which caused many of the issues in 2008, is just 3% of the market. Regional bank sales of MBS are a near-term risk if deposits continue to fall, but 85% of MBS is held by the Fed, banks and overseas investors. Our MBS team does not expect the Fed to sell MBS given it would be inconsistent with Fed financial stability and FDIC liquidation optimization objectives. One area that could see pressure would be in Jumbo origination where some of the regional banks were top 10-15 originators in 2022.

We expect large builders to take share in tighter credit environment: We expect homebuilders with access to the public equity and credit markets to gain share if regional banks tighten credit: 1) smaller, private builders rely on bank loans (often from regional banks) for financing, 2) M&A could accelerate, and 3) land developers could be forced to lower prices with fewer buyers in the market and higher carrying costs. The homebuilding industry tends to consolidate during periods of distress and public builders (around 40% share) gained significant market share following the 2008-09 housing crisis.

Low supply is good for new home demand: Housing demand has improved in early 2023 and we expect new home demand to continue to outpace the resale market for a few reasons: 1) existing home inventory remains historically low as current homeowners have locked in rates below current levels (80% of existing mortgages <40%). We estimate around 30-35% of the current available inventory is new home vs historical average of 15-20%, and 2) builders can offer mortgage rate buydowns (usually 100-150bps) that are not available in the resale market. We believe housing demand and affordability troughed in 4Q22. Despite historically low affordability, we think there is a lot of pent-up demand in the market: there are 3 million renters with household income >\$150k in the US (vs just 1.3mm annual home completions) and 5mm+ millennials aging into the peak home buying age over the next 5-10 years.

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